ElementalTrader

ElementalTrader Course Guide

Companion Reference Guide for Successful Harmonic Pattern Trading

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Introduction

Welcome to the Elemental Trader Course.

The purpose of this course is to introduce concepts specific to the method of harmonic trading.

The course is made up of six modules and these modules will start by introducing the foundations of harmonic trading concepts and will build from there until harmonic trading patterns are understood and can be applied and a personal trading plan developed.

It is important to start from the beginning of the course, as by skipping ahead, critical components of the system may be missed. A good analogy to this is building a wall, if bricks are missed out at the bottom of the wall, it will eventually fall down.

Therefore, the course should be followed progressively. Avoid jumping ahead and implementing a trading plan without first understanding the methodology behind the trading plan. If the time necessary to learn the methodology is not invested, the chance of trading success is reduced.

Module 1 — Introduction and Harmonic Trading Method Overview

Introduction to Module 1

This module introduces, and provides an overview, of a method of harmonic trading.

The objectives for this module are:

- to look at the components that are essential to developing a winning trading system; and
- to look at measures which can be taken, by developing a personal master trading plan, that will help ensure consistent trading results.

1.1 Introduction to Derek Frey

Derek Frey has been a full time trader since 1989. Derek started in the Futures and Options markets and as he gained experience be became a Futures and Options broker. In 2003, he started his own Futures and Options and Forex firm which he sold in 2008.

Derek has become renowned for his knowledge and, throughout his career; he has been sought after as a key market commentator. He is a weekly guest on Forex TV and has often

been quoted by many well known financial publications including the Wall Street Journal and The Economist. In addition, Derek was the Keynote Speaker at the International Traders Conference in Barcelona, Spain in 2008.

For the past few years Derek has put much of his focus in the currency market and Forex trading. Derek has also been a chief contributor and a vital resource to the development of the Elemental Trader course which is based on a Harmonic trading Method on which he focuses.

1.2 Developing a Winning System

Everyone who becomes involved in trading wants to be successful and one of the main elements of success is having a winning trading system.

Typically, any high probability trading system, that is a trading system with a high probability of winning, comprises ten essential components. These components are strategies which are particularly applicable to harmonic trading although they could be incorporated in the development of any trading method or strategy. However, before exploring these essential components, it is worth first considering why a trading system is important and what a trading system is.

1.21 Why Have A Trading System?

In considering why a system is required for successful trading, it is worth paying heed to a quote from the book “New Market Wizards” by Jack Schwager:

> *“Many traders unconsciously acknowledge their lack of progress by continually jumping from one system or methodology to another, never gaining true proficiency at any. As a result these people end up with one year of experience six times instead of six years of experience. In contrast, the superior traders gravitate to a single approach, the specific approach is not actually that important, and become extremely adept at it.”*

So why is it so important to develop a trading system? A trading system is the core of a trading business. Yes, trading is a business. A hobby is something that costs money and brings enjoyment or entertainment. Trading, on the other hand, is a business which should make money for the trader. Putting it simply, the trading system acts as the business plan which is followed for the trading business to make money.

1.22 What is a Trading System?

A trading system, or trading business plan, should include details of the tactics that will be employed in an aim to grow the trading business. A trading system should include:

- a set of instructions or a procedure to be followed;
- decision points;
- decision criteria; and
- actions.

Together, these form a plan which, when followed, helps locate high probability trades.

1.23 The Essence of a Trading System

The essential components of a trading system are:

Consistency

A good trading system is proven through consistency. Once a high probability system is developed it should be followed consistently. By continuously doing things differently, for example, trying new strategies or working outside the system, the importance or usefulness of the trading system will be diminished. Only through consistency can the methodology of the trading system be useful or proven effective.

Repeatability

A good trading system is repeatable, it should be possible to follow each of the steps in order and achieve a similar result a majority of the time.

Efficiency and Effectiveness

A repeatable trading system takes the guesswork out of trading and, in doing so, improves the efficiency of the trading business. Research, study and analysis will all always take time, but by following a trading system it reduces the time needed to get good results making the system efficient and effective too.

Measurability

By being repeatable, the trading plan can provide a measurable outcome, when implemented consistently. When a system is measurable, analysis and refinement of the system are then possible.

1.24 An example of a trading system implemented successfully

A good example of the successful implementation of a trading system can be found by looking at McDonalds. McDonalds have developed a system of preparation for cooking their french fries and they use that system in every restaurant around the world. They do it the same way, all the time, everywhere so that it does not matter where in the world you go and eat a McDonalds; you get the same consistent product. McDonalds have developed a winning system and stuck with it.

The same should apply to the implementation of any business model, it should be developed, applied, assessed and, if need be, refined until it is successful.

1.25 The Basic Form of a Successful Trading System

As was outline in section 1.22, a trading system should consist of details of tactics and these are underpinned by a set of rules or procedures to be followed and these will include:

- procedures to follow – which provide criteria for set up;
- decision points - which will create the methodology of the trade;
- decision criteria – which may include a per trade risk limit, risk to reward minimum and targets; and
- actions – determined by these previous criteria.

Following these procedures will lead to specific decision points where decisions must be made before a trade is entered. These decision points will arise in response to predetermined criteria and will lead to a specific action to be taken. In this case, the action will be to trade or not to trade, which means they are effectively go or no-go decision points.

Before a trade is entered, all the criteria for set up, that adhere to some sort of trading methodology or system, should have been met. The trading system should also have predetermined limits for risk and evaluate the risk to reward ratios for each individual trade scenario and again these should always be respected in making the decision to trade.

1.26 The 10 Essential Components of a High Probability Trading System

Now that the basic form of a trading system has been identified, the ten essential components for developing a trading system will be examined. These components are:

1. Locate and Identify a Set-Up

An important factor to understand is that the market does not move without reason. Instead, the actions of people cause the market to move. As price movement is a result of human response or human interaction, trade set ups only happen because of that human response.

In view of this, instead of using a "fire-ready-aim" reaction to price movement, it is better to let the price set-up aim, or point, to the action that should be taken. Only once the set up criteria have been met should this action be executed.

2. Evaluate the Set-Up

It is worth bearing in mind that not all trade set-ups are equal. Every set-up contains some degree of risk and only certain set-ups have a high probability of success. It may, therefore, be better to look at reasons for not taking a trade instead working up reasons to take a bad trade. This is the first decision point in the trading system:

- If the set up criteria are not met then, quite simply, the trade should not be made and instead should be aborted.

- If the set-up criteria are satisfactorily met then the next step should be considered.

3. Determine Potential Risk

Before entering a trade, the potential risk must be determined. Where the stop will be place should also be known before entering the trade. The effect of the placement of the stop on risk, based on the size of the trade from the point of entry or from the current price, should be calculated.

4. Check Potential Risk Against Personal Risk Guidelines

Personal risk guidelines should be determined based on what each individual trader considers an acceptable risk. Once the potential risk has been established, it should be evaluated against these personal risk guidelines. The risk used in determining whether a trade should be made should always be less that what the maximum personal risk guidelines indicates. This forms the second decision point in the trading system:

- If the trade exceeds personal risk guideline limits, the trade should not be taken and instead should be aborted.
- If the trade lies within personal risk guideline limits, the next step should be considered.

5. Select The Entry Point

If personal risk guideline criteria are met, then the entry point into the trade should be selected. In addition, at this time, the number of contracts and position size which will be used should be decided upon. The entry point, trade size and stops are all connected with the personal maximum risk limits.

6. Determine The Logical Exit

Once potential entry and risk have been assessed, the next step is to determine the logical exit point for exiting the trade as well as whether the entire trade will be closed all at once, or if some type of a scale out approach or strategy will be used.

Different trading systems can use different exit strategies. In addition to this, there are specific rules for exiting harmonic trades which will be covered in more detail in later modules.

7. Calculate Anticipated Profit

Using the chosen exit strategy, the anticipated profit from the trade can be calculated. The selected entry and exit prices can be used to determine target profit. It is important to remember to include costs and slippage in any profit calculations.

8. Calculate Reward to Risk Ratio

After risk potential and profit potential are evaluated, the risk to reward ratio can be determined. A personal minimum acceptable risk to reward ratio should be established by each trader, against which to compare the calculated risk to reward ratio.

Every trader knows that to be successful losses should be cut short and winners should be let run. However, most traders do not have any way to calculate the risk to reward of a trade. Therefore having a method with which to calculate in advance how much must be risked to realize a certain reward is an absolutely necessary part of any successful trading plan. Fortunately, with a harmonic trading pattern, using the steps above, this is a rather easy thing to do. This is then the third decision point in the trading system:

- If the reward does not outweigh the risk, the trade should not be taken and instead should be aborted.
- If the reward does outweigh the risk, the next step should be considered.

9. Completely Plan the Trade

All of the criteria determined by the previous components should be well though out before entering the market. In the same that an army wouldn't plan their retreat strategy after going to war, a trader shouldn't plan their exit strategy after entering a trade.

The predetermined stops are going to help evaluate any potential loss, the predetermined entry levels are going to help evaluate any potential risk and the predetermined exits are going to help evaluate potential profit.

10. Execute and Evaluate the Trade

It is only if all of the component criteria bounce in favor of the trade that executing the trade should be considered.

The focus of any trader should be on finding the right set up, following pre-determined guidelines and being consistent with trade execution. The money being traded should not be the focus; instead the execution of the trade should be the focus. The system should be used consistently, and maybe most important, the system should be kept simple.

1.27 Keep it Simple

A trading plan should consist of just a few sentences and it should be simple and repeatable. If a trading plan is too complex, it is more likely that short cuts will be taken. In addition, if a trading plan is too complex, it is not going to be easily repeatable.

Once a personal trading plan has been developed, it should be evaluated to check if it is practical and suits the lifestyle requirements of a trader. If it is not practical or does not suit lifestyle requirements, a new system may be needed. The reality is that most traders fail and this is at least partially due to them having unrealistic expectations from the outset.

Key aspects to be considered for a trading plan are: practicality and tradability, if it is overly complex, scrap it and start over.

1.28 Be Consistent and Realistic

The goal, for any trader, is high probability consistency and consistency is not something that can be given, it is something that is done

Let us first consider a trading myth. Most losing traders say something along the lines of “as long as the market is moving there is an opportunity to make money”, but those expectations are not in line with reality.

The truth of the matter is that market movement alone represents risk and does not represent opportunity. In other words, just because the market is moving is not a reason to be in it. The market is always moving. However, there are only certain periods of time when the probability of a successful trade is high.

In addition, it is very important to understand that no method can guarantee that the next trade

or the next ten trades are going to be winners.

Because of this, trading is not generally suited to someone who is easily discouraged. In fact, patience and persistence are two qualities which are in short supply in among 90% of traders who fail. When a new system is being used, it should be implemented for no less than one hundred trades before giving up or changing the system if needed.

1.3 Design a Master Trading Plan

A master trading plan is an essential part of any successful trader's life. Most traders who fail do not have a clear plan and their failure is at least partially due do to the lack of this preparation. Having a trading plan is the core of any trading business; it is the plan that will be used for the business to become successful.

1.31 Consistency

Part of the reason a master trading plan is so important, is that it encourages consistent action which, in turn, leads to consistent results. Achieving consistent results is what every trader aspires to.

Consistency, however, is a word that many traders do not really understand. First of all it is an action and not a result; consistency is not something which is gained. Instead, consistently is a way to act. Over time, by acting consistently, consistent results are achieved. That does not in any way imply that consistency will guarantee a winning trade every time. However, if consistent results are not achieved, it is ONLY because the approach to trading which is being taken is inconsistent.

Consistency only comes from actions and it is especially important to act consistently during times of losses. Most traders fail to stick to a plan and jump ship to another plan, especially after a string of loses, but this is when sticking to the plan and being consistent is most important.

Any good master trading plan is simple and repeatable thus facilitating consistency. It should

inherently show when where and why to enter a trade and, more importantly, when where and why stops should be run as well as where a trading target should be.

1.32 Probability

It is no secret that to make money in the market a trader must buy low and sell high.

The trick however is to know when something is low or high. Most traders struggle with this question, although many are not aware of it. The only way to reliable determine when something is low or when something is high is by using probability. Probability is used when a particular outcome can never be certain. A successful trader accepts the fact that they will never know what is going to happen next and this is at least partially due to the fact that trading is based on a non linear dynamical domain.

Non Linear Dynamical Domains

This may be an unfamiliar term, so to provide clarification, 'non linear dynamical domain' refers a set of data which is being presented, in infinite amounts, in a seemingly random fashion, there are an infinite number of things that can influence the data which is presented, and the rules that govern the data being presented are always changing.

A perfect example of a non linear dynamical domain is the weather. Everyone, in their day to day life, is very familiar with probability forecasts in the form of weather forecasts. When providing a weather forecast, a weather person will never say: "It is going to be 78.6°F at 11.51am with wind and rain blowing at 16mph from the south-southwest". The weather forecast is never that specific. Instead, they will say something like: "There is a 70% chance of rain and the temperature is going to range between 70 and 80°F with gusty winds out of the south west." The reason the forecast is presented like this, is because, as everyone knows, weather

> prediction is an imperfect science. And it is an imperfect science because of its non linear dynamical nature.

In the same way that the weather is a non linear dynamical domain, so are the markets. Therefore, trading probability can be considered in the same manner as a weather forecast.

In saying all of this, it is a big first step to accept it is it not possible to will win all the time. However, once this fact has been accepted, it will be clear that whilst nothing can be known with certainty, it can be known with a degree of probability.

1.33 Leverage

> "Give me a long enough lever and I can move the earth..."
>
> — *Archimedes*

The next concept that is critical to understand is leverage. Leverage is a very powerful trading tool. Unfortunately, a primary cause of traders failing is that most traders unknowingly abuse leverage.

Overleveraging a trade is not a short cut to success but rather an almost guarantee of failure. So it is very important to understand how leverage is calculated.

When a trader first opens a Forex account, the broker is going to ask what level of leverage the trader wants to use. It should be remembered that different brokers, in different countries, are governed by different regulations, so each trader must know what the requirements are for a broker they have selected for engaging in business. The leverage of ratio arranged with the broker does not mean that amount of leverage *should* be used to trade, it is simply setting a maximum that *can* be used.

In reality, it is the actual amount of leverage used in any given trade which is important, and that leverage can be calculated simply by dividing the lot size, or contract size, by the account value:

Contract or lot size ÷ account balance = leverage

To illustrate the concept of leverage more clearly, examples will be described below:

Leverage example 1:
If you have a 100 lot, or contract, size and you have $25,000 in your account, your leverage ratio will be:

100,000 lot size ÷ 25,000 = 4:1 leverage

Leverage example 2:
You have a mini contract which means you will be trading a 10,000 lot size and you have $5,000 in your account, your leverage will be:

10,000 lot size ÷ 5,000 = 2:1 leverage

It is worth remembering that the more lots which are traded using the same account balance, the higher the leveraging of the account. This is illustrated in the next example:

Leverage example 3:
You have a mini contract and are trading a 10,000 lot size, have $5,000 in your account and chose to make 3 trades, therefore your leverage will be:

3 trades at 10,000 lots size = 30,000 traded
30,000 lot size ÷ 5,000 = 6:1 leverage

Remember that less is more and rarely, if ever, should a leverage ratio of more than a 5:1 be used.

1.34 Risk Management

The next factor which leads most traders to ruin is the lack of clear risk controls.

Good risk management starts with a good understanding of the reality that the future can never be known with certainty. Therefore it is important to at least try to protect every trade with some kind of stop order. Stop orders, or stops, help protect traders from suffering massive losses.

Anther factor which must be taken into account is that, in the market, stops can be gapped, which is when the price moves through a stop order without trading at that price and so the stop order is instead filled at the next available price, which may be very far away from where to stop order was expected to be filled. This can result in larger than expected losses.

These factors mean that leverage should always be kept low, as sooner or later every trader is to experience at least one stop gap. The key is to make sure that hitting a stop gap does not altogether end the trader's ability to trade. The only way to try and prevent that happening is to ensure that leverage is kept low, even through a string of losses, so that so the trader lives to trade another day.

1.35 Setting limits

An important factor in a master trading plan is the setting of limits.

A good trading plan includes daily, weekly and monthly trading loss limits and it is important to have the discipline to stop trading when these limits are hit.

Every trader should have a set limit for maximum risk and exposure. The key here is less is more. Think of maximum risk in the same way as you think of the maximum speed in your car. You would never drive your car at maximum speed every time you get in it, if ever. A trading maximum is no different. Ideally, traders should risk 1% or less of their account at any one time.

Limit setting exercise - Find your loss limit

Use the following exercise to determine what your true maximum risk should be:

> Tonight, before you go to bed, go into the bathroom turn on the light and look at yourself in the mirror.
>
> Repeat out loud, while making eye contact with yourself, "I just lost X amount trading today". Place a number in there, an outrageous

number, whether it is $100,000, $10,000 or even $100, place that number in there.

Honestly feel any emotions that this evokes. You are likely to get uncomfortable, perhaps even a little angry, and this is what you want to expose.

If you do this exercise and feel anything more than complete calm and peace then you know that number that you filled in the blank above was too much.

If that is the case, repeat these step each night with a smaller number inserted until you reach a point where you can accept the loss and wake up the next morning without it still being on your mind.

You may find that the number is zero and that is okay but it means that trading may not be for you. Better to find out now in this exercise than to actually have lost money.

The real key to setting trading limits is honesty, and each trader has to find limit numbers that they can truly live with.

1.36 Reality

The reality is that losing and dealing with it is part of successful trading. Losing is part of successful trading. Once that has been accepted as fact, a trading method can be built around it. There is not and never will be a method that wins all the time so planning for the losing trades in advance is simply prudent.

Having a clear understanding of leverage and risk limits, to help manage the reality of losing trades, is the most important part of successful trading.

Summary of Module 1

To summarize this first module of the Elemental Trader course:

- Just as any successful business follows a business plan, a trader should develop and follow a trading plan;
- This trading plan should include criteria for set up, risk guidelines and a methodology for trade entry management and exit strategy; and
- A trading plan is not a guarantee of success but a lack of a trading plan is very commonly a guarantee of failure.

As stated at the beginning of this module, do not skip ahead and implement the plan without first understanding the method, the chances of trading successfully will only be diminished if time, which is necessary to learn the entire method, is not invested.

Module 2 — Fibonacci and the Gartley Pattern

Introduction to Module 2

This module discusses how patterns that are found everywhere around us can be translated into recognizable repeatable patterns which, when applied to the market, can be used to determine entries, stops and profit targets.

The objectives for this module are:

- to become familiar with the Fibonacci sequence; and
- to look at how Fibonacci rations, when applied to harmonic trading patterns, form the Gartley Pattern.

2.1 Humans as Creatures of Habit

People tend to settle with what they are comfortable with and if something takes them out of their comfort zone they generally hesitate to continue with it. As a result, humans are creatures of habits, and the habits of people can be recognized in patterns.

For example, say a person drinks coffee in the morning and that makes them comfortable and happy. This means that they will probably drink coffee every morning because it makes them comfortable and happy. As that action is repeated regularly it will establish a pattern, and any pattern can be studied and typically repeated to achieve a similar result.

Because people tend to repeat themselves in comfortable patterns, that can be reflected in market movement in charted patterns. Charted patterns are a reflection of human repetition in the market, so in essence, it is not the patterns that are repeating themselves, it is the repeating nature of people that are reflected as chart patterns. What is more, natural repetition can be studied in charted patterns.

However, these repeating patterns are not new and are not only found in human nature as Leonardo Fibonacci discovered.

2.2 Fibonacci

Figure 2.1

Leonardo Fibonacci was a 13th century mathematician who played a vital role in the introduction and the use of the Hindu Arabic numeral system. Prior to his time, the most widely used numeral system or number system was roman numerals.

Leonardo Fibonacci studied the natural repetition found in patterns nature. One of his most widely known studies revolves around a sequence of numbers that is commonly identified by his name, and that is the Fibonacci sequence. Fibonacci also studied how that same mathematical sequence could be applied to patterns that he observed everywhere around him in nature.

2.21 The Fibonacci Sequence

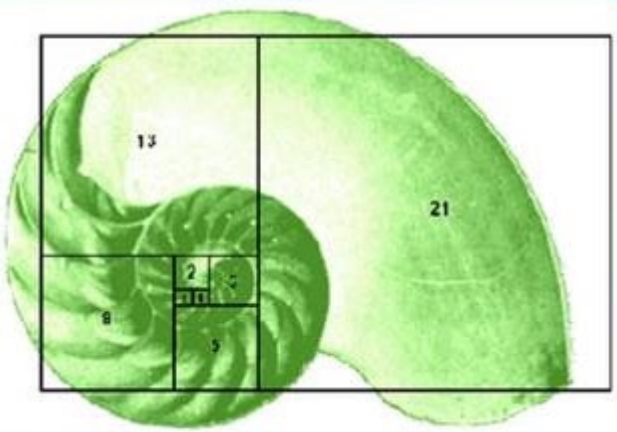

Figure 2.2

It is possible to observe how the Fibonacci sequence is viewed in nature by looking at simple structures like the illustration of the seashell that is seen here and the concentric spiral that develops as the sequence progresses.

Specific ratios, that are found in this naturally recurring sequence, can be used by traders as a

tool for market analysis.

It is easier to understand what makes the Fibonacci sequence so significant by looking first at the sequence itself:

0, 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, 233, 377, 610...and so on into infinity.

Within the sequence the each number is the sum of the previous two numbers:

0+1 =1, 1+1=2, 1+2+3, 2+3+5, 3+5=8, 5+8=13, 8+13+21, ...and again into infinity.

Therefore, by adding any two adjoining numbers in the sequence, the following number is generated.

2.22 The Golden Ratio

As the Fibonacci sequence continues another pattern begins to develop as dividing a number by the following number converges to a common ratio known as the Golden Ratio.

1÷1=1.000, 1÷2=0.500, 2÷3=0.667, 3÷5=0.600, 5÷8=0.625, 8÷13=0.615, 13÷21=0.619, 21÷34=0.618, 34÷55=0.618...

As can be seen, if 21 is divided by 34 and then result is rounded to the third decimal place, the ratio is 0.618. And again, if 337 is divided by 610 and that the result is rounded to the third decimal place, the ratio is 0.618. By continuing in the sequence, and rounding to the same decimal place, 0.618 emerges as a common number.

2.23 Another Key Ratio

Another ratio that is common within this pattern uses a little bit of different math. In this case, a number in the sequence is divided by a number two ahead in the sequence:

1÷2=0.500, 1÷3=0.333, 2÷5=0.400, 3÷8=0.375, 5÷13=0.385, 8÷21=0.381, 13÷34=-0.382, 21÷55=0.382, 34÷89=0.382

By doing this a common ratio of 0.382 emerges.

So for example, if 233 is divided by 610, the number two ahead in the sequence, and the answer is rounded to three decimal places, it results in the Fibonacci ratio of 0.382.

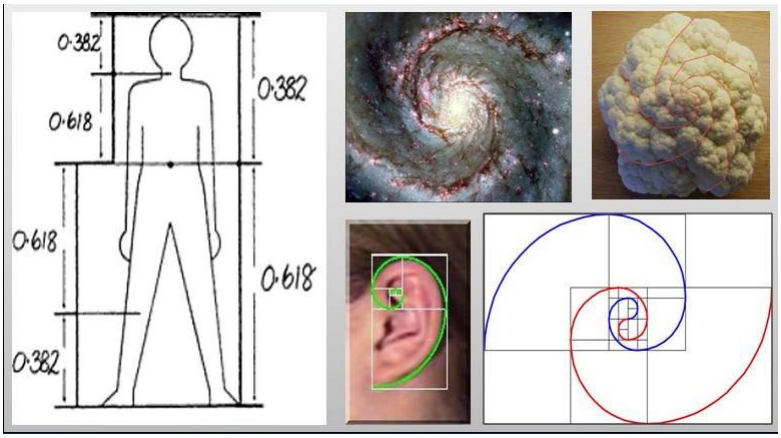

Figure 2.3

The Fibonacci sequence of numbers and the two ratios detailed above apply to patterns found throughout nature. In essence, the Fibonacci sequence and the ratios found within it are basically the numbering system of nature and the patterns appear everywhere in nature from the ratios in the human to the spirals of the galaxy and the growth patterns with certain vegetation body as can be seen in Figure 2.3 opposite.

2.24 Fibonacci sequences and ratios and the Market

As the Fibonacci sequence and ratio patterns are found throughout nature it should be easy to understand that similar patterns can found within the trading markets too since people are part of nature. Thus the Fibonacci sequence and ratios can be found in the movement of currency prices in the Forex market. Therefore market traders know of Fibonacci as an analysis tool based on ratios within the Fibonacci sequence.

As these ratios apply to trading, trading charting packages that are available typically do most the underlying maths work and all a trader needs to do is to apply it to their trade decisions. In this case, the harmonic trading software, the Elemental Trader software, will draw the correct ratios for the patterns which are going to be discussed later in this course.

2.25 A lot of math!

In this section, a lot of maths has been laid out and, if the truth be told, there is much much

more to know about Fibonacci and the Golden ratio than can be covered in this course. Indeed, a full study of Fibonacci could fill an entire course in itself.

However, the study of Fibonacci and how it applies throughout the natural world is fascinating and is a topic worth doing some personal research on and learning more about.

2.3 Fibonacci Ratios for Harmonic Trading

The two Fibonacci ratios that will be the basis of harmonic trading are:

- the Primary Fibonacci ratio of 1.618; and
- the Reciprocal (1÷1.618) Fibonacci ratio of 0.618.

From those two Fibonacci ratios additional useful ratios, needed to form the harmonic trading patterns, can be calculated. These additional ratios are:

√1.618 = 1.27
Found by taking the square root of 1.618 to obtain the 1.27 ratio;

√0.618 = 0.786
Found by taking the square root of the 0.618 ratio to obtains the .786 ratio; and

√0.786 = 0.886
Found by taking the square root of the 0.786 ratio to find the .886 ratio.

All of these ratios are important and fit within the patterns that harmonic trading can be based upon. In use, all of these ratios are critical in calculating harmonic trading patterns, and the base harmonic pattern that all other harmonic trading patterns are derived from is the Gartley pattern.

2.4 The Gartley Pattern

This pattern was discovered as a means of outlining the patterns in the stock market by H. M. Gartley in his book “Profits In The Stock Market” which was published in 1935. Although

this pattern is named the Gartley pattern, the book did not discuss specific Fibonacci ratio retracements. Instead, it was not until much later that specific Fibonacci retracements levels were assigned to the pattern.

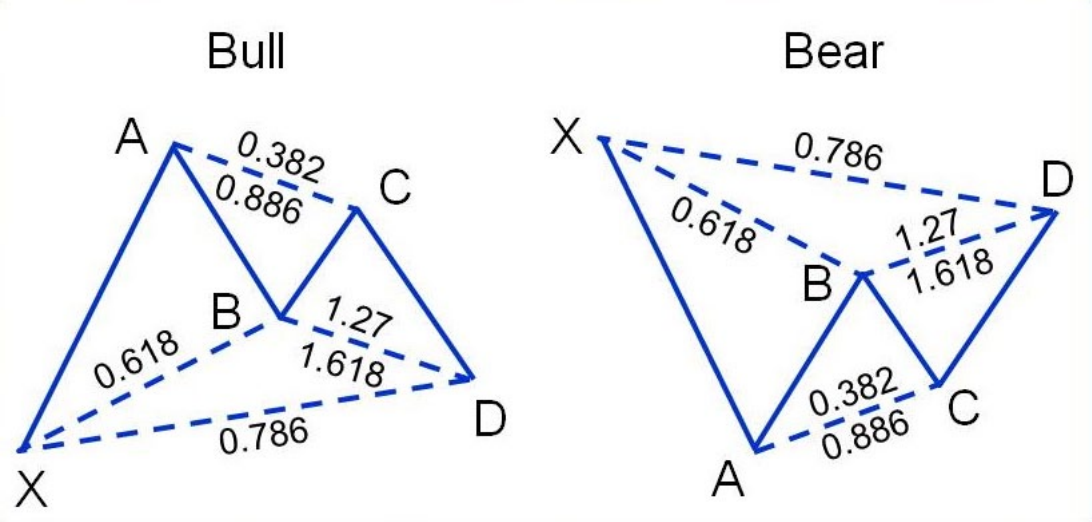

Figure 2.4

The diagrams in Figure 2.4 above illustrate two versions of the Gartley pattern, and as we can see, this pattern develops in both Bull and Bear structures as a means of identifying potential reversal levels.

2.41 The Bear Gartley Pattern

The Bear Gartley pattern is shown in the Figure 2.5 below:

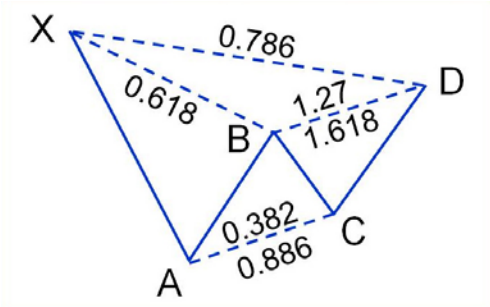

Figure 2.5

While at the beginning this pattern might look a little intimidating with all of the numbers and letters and lines and dashes, in fact the Fibonacci ratios are only going to be used to determine three points of entrance, the B point, the C point and the D point that we can see within the pattern.

Point B is the most import ant level to find because it is the heart of the pattern. Without point B it is not possible to move on to finding Point C or Point D.

Finding point B starts at point X which in the Bear Gartley pattern begins at a relative high. This may or may not be the highest point in the chart being viewed, however, the more extreme the high the better, for the instance, the top part of a trend.

As the price falls from point X, it will continue to create new lows. At each dip, a new low is formed until the price bottoms out at some point. It is not possible to determine when the price is going to bottom, but it will bottom out at some point and this forms point A. This is now when the real work begins, as up to this point, it has been a case of waiting for the market to move.

Now is when the Fibonacci ratios come into play. A measurement is taken from point A back to point X and it is predicted that the price will return, within the Gartley pattern, back up to the 0.618 of the XA leg. Of course, just predicting the temperature for the day can only ever give an approximation, the application of the 0.618 ratio is an approximation, but it should be pretty close. This forms, Point B and as this is where the rest of the pattern develops from, it is a critical point.

This can be seen in the chart example on the next page.

On chart 2.1, the Fibonacci levels have been inserted as horizontal lines highlighted in orange between the point X and point A. Rising from point A, the market has returned back to the 0.618 level, as can been see highlighted in red right here to form point B. As can be seen, this is an approximate level, and the market has, in this case, pushed just a few pips through the 0.618 level but is still pretty close.

From point B, as the market falls, it is possible to look for the formation of the next point which is point C.

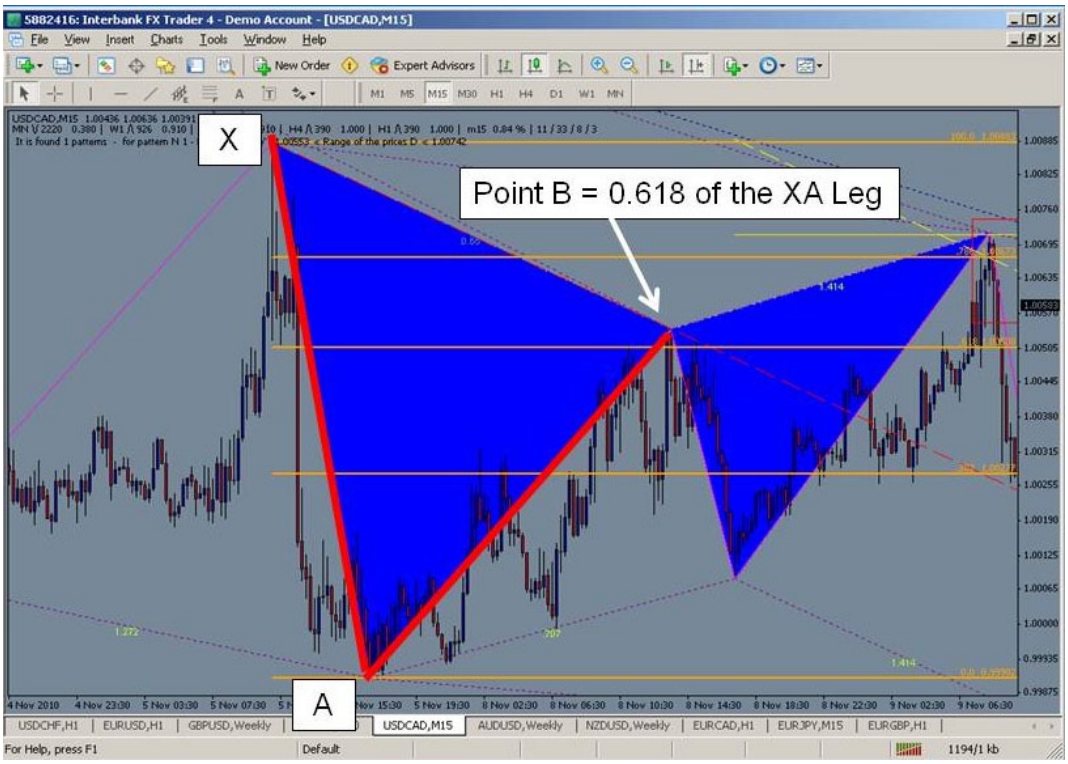

Chart 2.1

Now it is natural that the question will come up “Can I trade as the pattern develops?” And yes, of course it is possible to trade the B to C leg or the C to D leg as they develop, but it would be like moving into a house before it is built. It might be fine for a little while, and sometimes it will work, but it could come back crashing down around you. So as with the analogy, it is better to wait until the full development of the harmonic pattern is completed.

As the market falls from point B, it moves back towards point A and from there, point C can be measured and then defined. To find the point C retracement, the Fibonacci levels from A to B are inserted and point C will match up with the approximate 0.382 Fibonacci ratio of the AB leg. This can be seen on the following chart example.

On chart 2.2, the Fibonacci levels are highlighted in orange between the A and B points, the C point has now been formed and as can be seen it fell from the B level all the way back down to the approximate 0.382 level of the AB leg. In this case it pushed down through the 0.382 level just a little bit, but for the most part held at the 0.382 Fibonacci retracement of the AB leg and formed point C.

After bottoming out at point C the market begins to rally again and goes back up and eventually moves higher and eventually passes, Point B. Once the market moves past point B, the formation of point D is expected at the approximate 1.27 level of the AB leg. This can be seen in the next chart example:

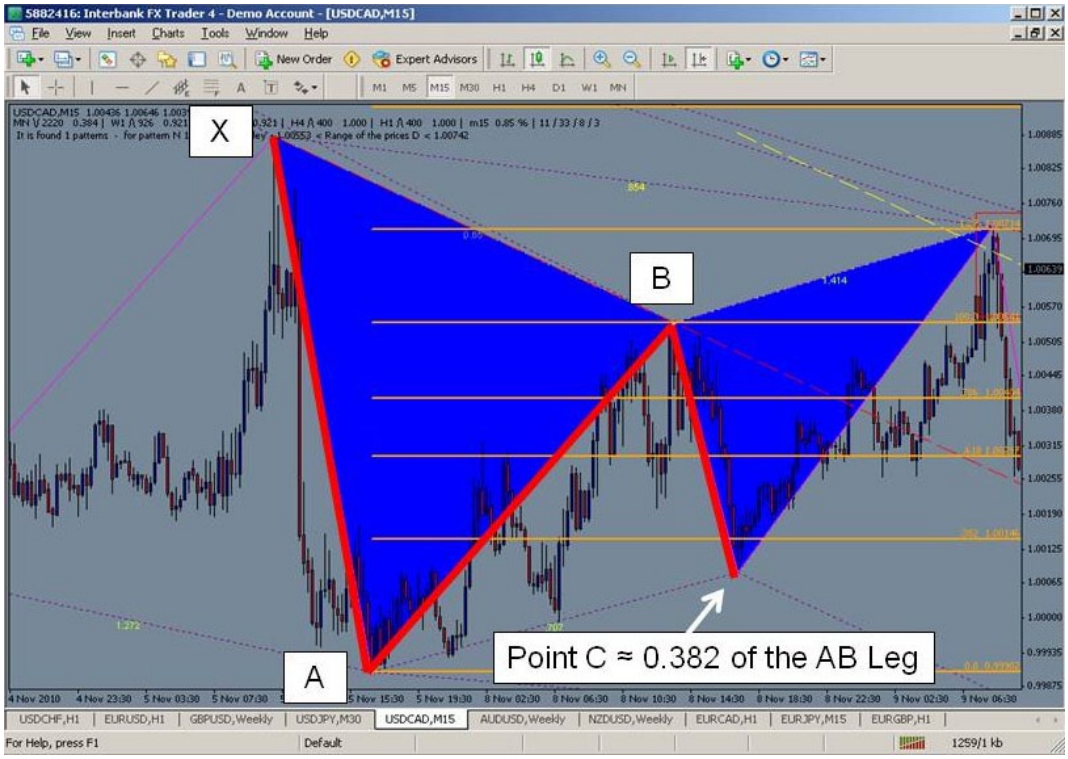

Chart 2.2

On chart 2.3, again, the Fibonacci levels are inserted and highlighted between point A and point B giving a reference for the formation of point D at the 1.27 Fibonacci level. As can be seen, point D forms approximately at the 1.27 level and this completes the Gartley pattern and forms what, in this course, is called the Potential Reversal Zone (PRZ).

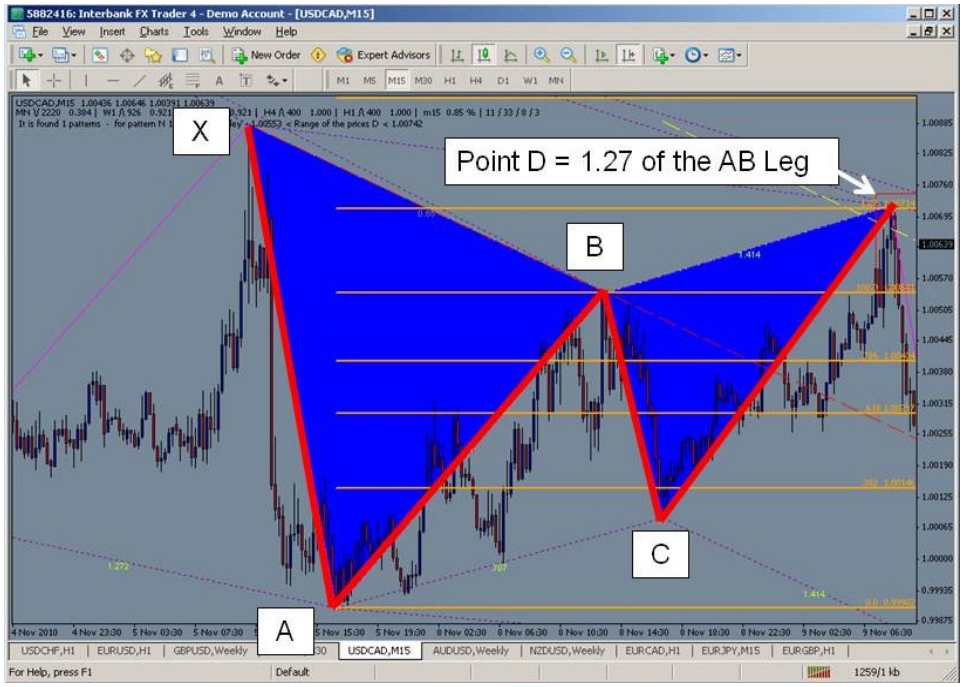

Chart 2.3

The PRZ is at point D and, as can be seen in Figure 2.5, point D not only matches up with the 1.27 level of the AB leg but also matches up with the 0.786 level of the XA leg which is a good illustration of the harmonics at play within the Gartley pattern. This can be seen in the following chart example:

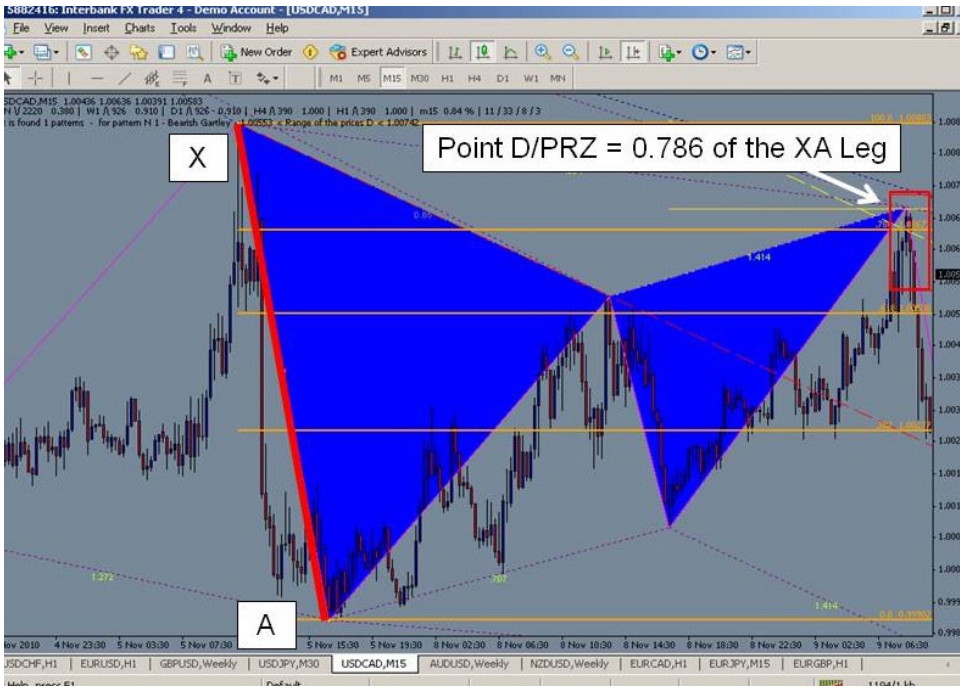

Chart 2.4

2.42 The Bull Gartley Pattern

The Bull Gartley pattern is shown in the diagram below.

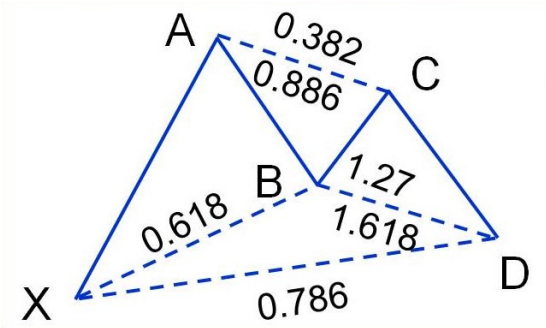

Figure 2.6

Much like the Bear Gartley pattern, point B is going to be the most important point to find as this is the heart of the pattern without which point C and point D cannot be determined. Finding point B again starts at point X.

Point X in the Bull Gartley pattern starts at a relative low. Again, this may or may not be the lowest point in the chart which is being viewing, but the lower the point chosen the better, the most extreme low possible will be the best to form the pattern.

As the price rallies off of point X the chart will continue to create new highs. Again, you do not know when these highs are going to stop, it may find a high, surpass that, find a new high, surpass that, find a new high, and keep going, but eventually the price tops out at some point and this forms point A.

Now is where the real work is going to begin again and the Fibonacci ratios can be applied. Taking a measurement from point A back up to point X, the price is expected to return back to the 0.618 level of the XA leg to form point B. This can be seen in the chart diagram below:

Chart 2.5

On chart 2.5, the Fibonacci levels have been inserted in orange between point X and point A and the market returns back down to the 0.618 level to form point B.

Once point B is formed, the market begins to rally again and starts to go back up. From point B, as the market rallies towards the point A level, it is possible to measure and look for the formation of point C by inserting the Fibonacci levels from point A back to point B. Point C is going to form when the market tops out somewhere between the 0.382 level and the 0.886 level of the AB leg. Once, the market forms a peak, it will have formed point C. After topping out at Point C, the market will eventually begin to fall again. The creation of point C can be seen in the following chart example:

Chart 2.6

As can be seen in Chart 2.6 the Fibonacci ratios between point A and point B have been have been inserted in orange whereby the bottom is 0 and the top is 1 (or 0% and 100% respectively. From point B, the market comes back up to the 0.886 level, or comes back up 86%, of this Fibonacci range.

As the market falls from point C it goes down and surpasses point B after which point D will be formed. Point D is between the 1.27 level and 1.618 level of the AB leg. These Fibonacci ratio levels have been inserted in the following chart example:

Chart 2.7

As point D is going to be formed between the 1.27 level and 1.618 level of the AB leg, this provides us with an estimate as to where point D will be formed. Once Point D has been formed, this completes the Gartley pattern. At this point, point D also becomes the PRZ.

Not only are the PRZ and Point D found between the 1.27 level and 1.618 level of the AB leg, but by harmonic alignment, the 1.27 level or 1.618 level of the AB leg should harmonize and come into alignment with the 0.786 level of the XA leg. This can be seen on the following chart example:

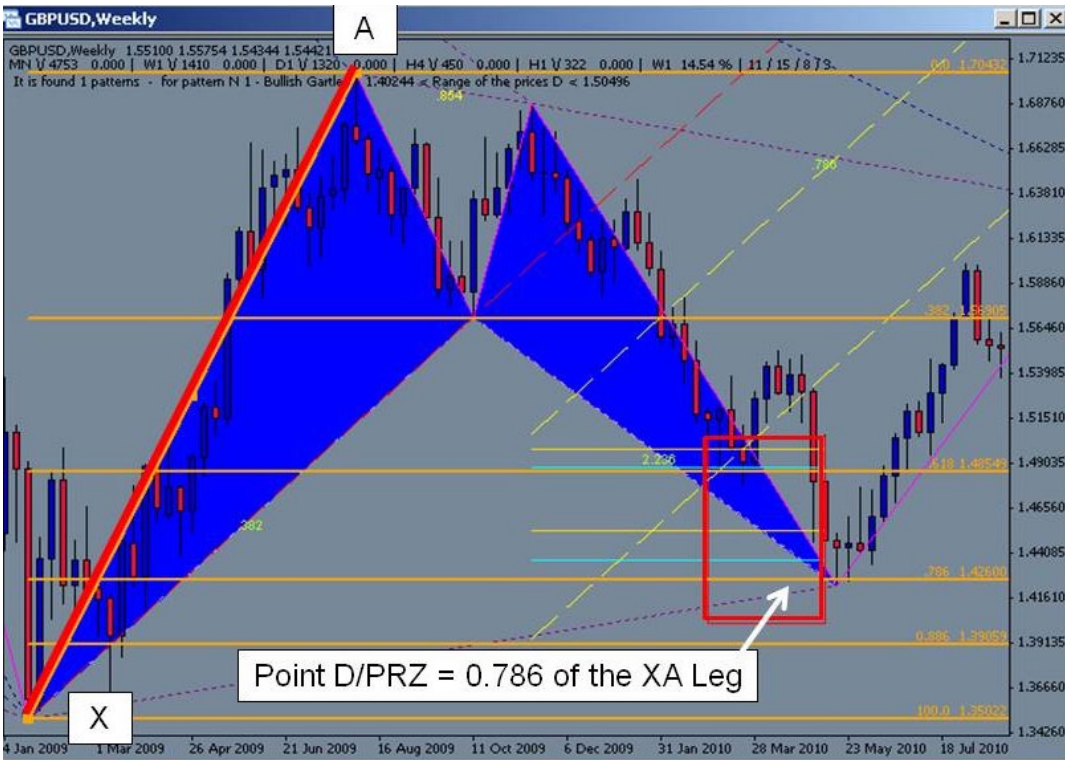

Chart 2.8

In chart 2.8, the Fibonacci ratios between point X and point A have been inserted and, as can be seen, all the way down at the bottom of the PRZ is the 0.786 Fibonacci ratio of the XA leg. Therefore, as can be seen, this point D, the 0.786 Fibonacci level of the XA leg and the 1.27 or 1.618 levels of the AB leg, all convergence to form the PRZ, or potential reversal zone, where, in a Bull Gartley pattern, the market is expected to turn around and start going back up.

Summary of Module 2

This module has explored that people, being creatures of habit, tend to gravitate to things that are familiar and comfortable and in doing so, are likely to repeat themselves iteratively. This natural repetition can be studied throughout nature and recognized in patterns.

Fibonacci represented these patterns through mathematical ratios and using these patterns and ratios as Gartley patterns, it is possible to determine with high probability the location of potential reversal zones in which a market is most likely to change direction. Understanding these patterns can provide traders with potential entry points, stop levels to manage risk and even profit targets.

Module 3 — Other Harmonic Patterns

Introduction to Module 3

In this module, three additional harmonic patterns will be investigated. These patterns are simply variations of the Fibonacci ratios and the Gartley pattern. These patterns are not, of course, the only harmonic patterns available but these are the most tested and proven over time.

3.1 Identify Variations of the Gartley Patterns

The Gartley pattern was discovered in 1935 and Fibonacci ratios were later applied to the Gartley patterns in the 1990's. Since then, other Fibonacci ratios have been applied to trading markets and other patterns have emerged.

These patterns, like the Gartley pattern, will all be visually identified using the Elemental Trading software.

An important aspect of each of these patterns is that all of them can be identified and traded on any time frame. This means that a Gartley formation on a five minute chart can be just as useful as a Gartley that forms on a four hour chart. However it is worth bearing in mind that, depending on the time frame on which you are trading, potential stops and profit may be smaller or larger.

In any case, no matter whether the trading is taking place on a small or large time frame, point D is going to represent the point when potential reversal may occur and this is known as the PRZ.

3.2 The Butterfly Pattern

The butterfly pattern was discovered by Scot Carney in 1999 as he applied additional Fibonacci ratios to patterns similar to the Gartley pattern.

The main difference between the Butterfly pattern and the original Gartley pattern is that point D, or the PRZ, is above point X in a Bear pattern and below point X in a Bull pattern. Often, with the butterfly pattern the PRZ smaller and more precise than other patterns and as a result, this can provide greater trading opportunities.

3.21 The Bull Butterfly Pattern

The diagram below, Figure 3.1, shows how Fibonacci ratios apply to the Bull Butterfly pattern:

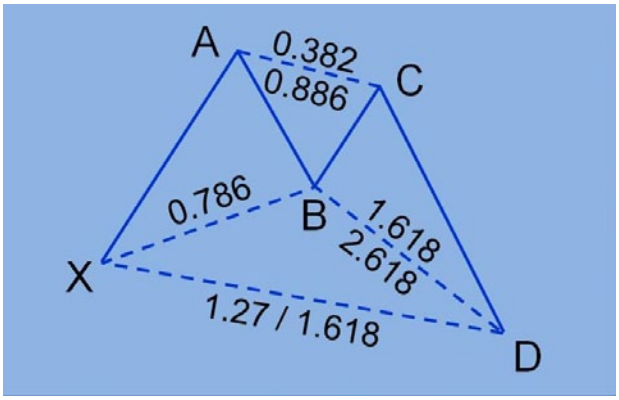

Figure 3.1

To the novice harmonic trader this may look like a breakout to the downside. However, as the harmonic Fibonacci ratios are applied to the pattern, it is possible to discern when reversal could happen and what initially appeared to be a breakout turns into a false break and a reversal.

Whilst, like the Gartley pattern, this may initially appear a little intimidating, in effect the Fibonacci ratios are simply being used to determine three points of interest, point B, C and D. Point B is again the most important level to find first as it is needed to find point C or point D.

Point B is found by starting with Point X. Point X in a Bull Butterfly pattern begins at any relative low, which may or may not be the lowest point on the chart being viewed but the lower point chosen, the better.

As the price rallies from point X it will continue to create new highs on each new rise, until the price eventually tops out at some point forming point A. The Fibonacci ratio can then be applied to the chart. Taking a measure from point A back to point X, the price is predicted to return back to the approximate 0.786 level of the XA leg and this is where point B will form, as can be seen on the following chart example:

Chart 3.1

To give some perspective of the time that these patterns take to develop on larger compressions, it is worth noting that Chart 3.1 is the GDP USD daily chart. This pattern began to develop back in October of 2010 and took almost 6 weeks, until the end of November, to develop.

On chart 3.1 the Fibonacci levels have been inserted in orange between point X and point A and as can be seen the market returns very close to the 0.786 level to form point B.

The market then begins to rally from point B and move towards the level of point A making it possible to measure for the formation of point C. To find the point C retracement, the Fibonacci levels from point A to point B are inserted into the chart as can be seen in the following example:

Chart 3.2

Point C is formed between the 0.382 or 0.886 Fibonacci ratios of the AB leg and on chart 3.2 the Fibonacci levels have been inserted in orange between the A and B points. In this case, the price has risen to and slightly surpassed, the approximate 0.382 level of the AB leg forming point C.

After topping out at point C the market then falls and eventually surpasses point B and will continue to fall to form point D as can be seen in the following chart example:

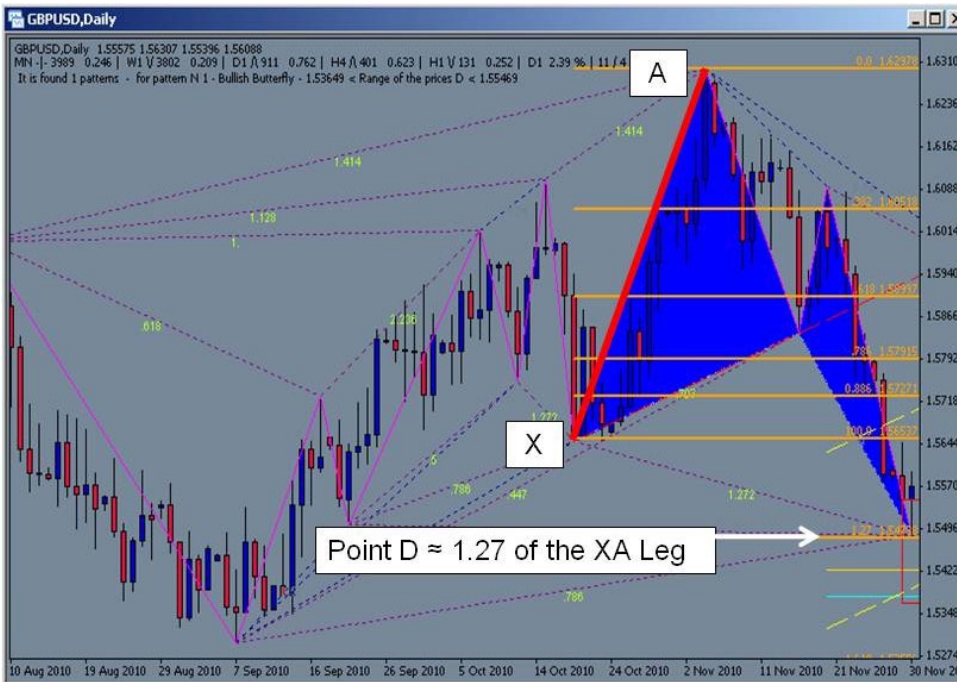

Chart 3.3

Once the market reaches approximate 1.27 level or 1.618 level of the XA leg of the pattern, point D is formed. This can be seen on the following chart example:

Chart 3.4

On chart 3.4 the Fibonacci levels have been inserted from point X to point A and this give us a reference point for the formation of point D at the 1.27 level of that XA leg. Once Point D is formed this completes the whole Bull Butterfly pattern and has forms the PRZ, the zone in which reversal may occur.

3.22 The Bear Butterfly Pattern

The following diagram shown in Figure 3.2 illustrates a Bear Butterfly Gartley pattern:

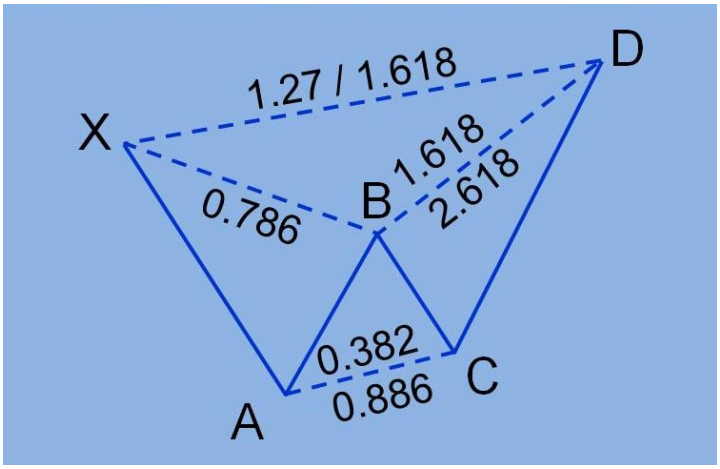

Figure 3.2

Much like the Bull Butterfly pattern, point B is most important level to find first, as this in needed to move on to point C and point D.

Finding point B once again starts at point X which on a Bear Butterfly pattern begins at a relative high. As the price falls from point X it will create new lows on each new fall until the price bottoms out at some point forming point A.

Using Fibonacci levels applied from point A back to point X, the price is expected to return back to the approximate 0.786 level of the XA leg to form point B. This can be seen on the following chart example:

Chart 3.5

It is important to note that Chart 3.5 is the Euro USD four hour chart, and this pattern began development on October 15th and it took about 3 weeks, until November 4th, to develop.

On chart 3.5 the Fibonacci levels have been inserted in orange between point X and point A and as can be seen, the market returns approximately to the 0.786 level to form point B.

From point B, as the market falls towards point A, it is possible to measure now for the formation of point C as can be seen in the following chart example:

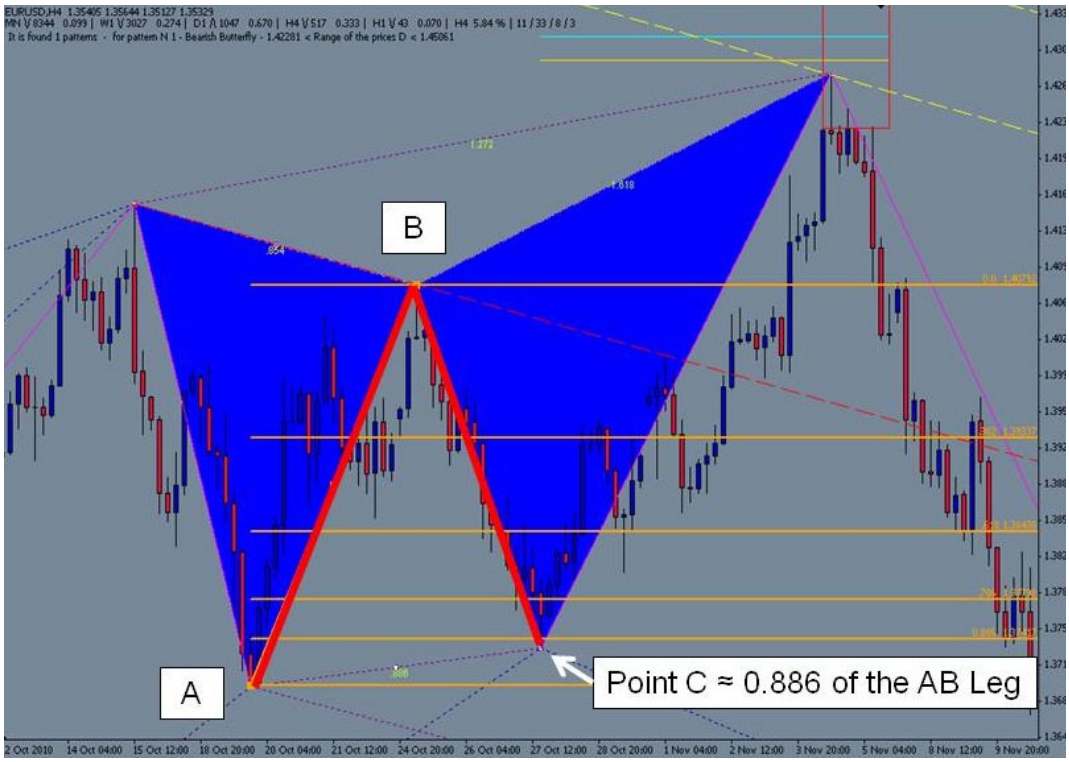

Chart 3.6

To find point C, the Fibonacci levels from point A to point B are inserted and point C will be formed at the approximate 0.382 or 0.886 Fibonacci ratio of the AB leg. In this case, the market has returned back down to the 0.886 of the AB leg to form point C. And after bottoming out at point C the market then rises and eventually surpasses point B.

Once it does, Point D is formed at the approximate 1.27 level or 1.618 level of the XA leg of the pattern as can be seen on the following chart example:

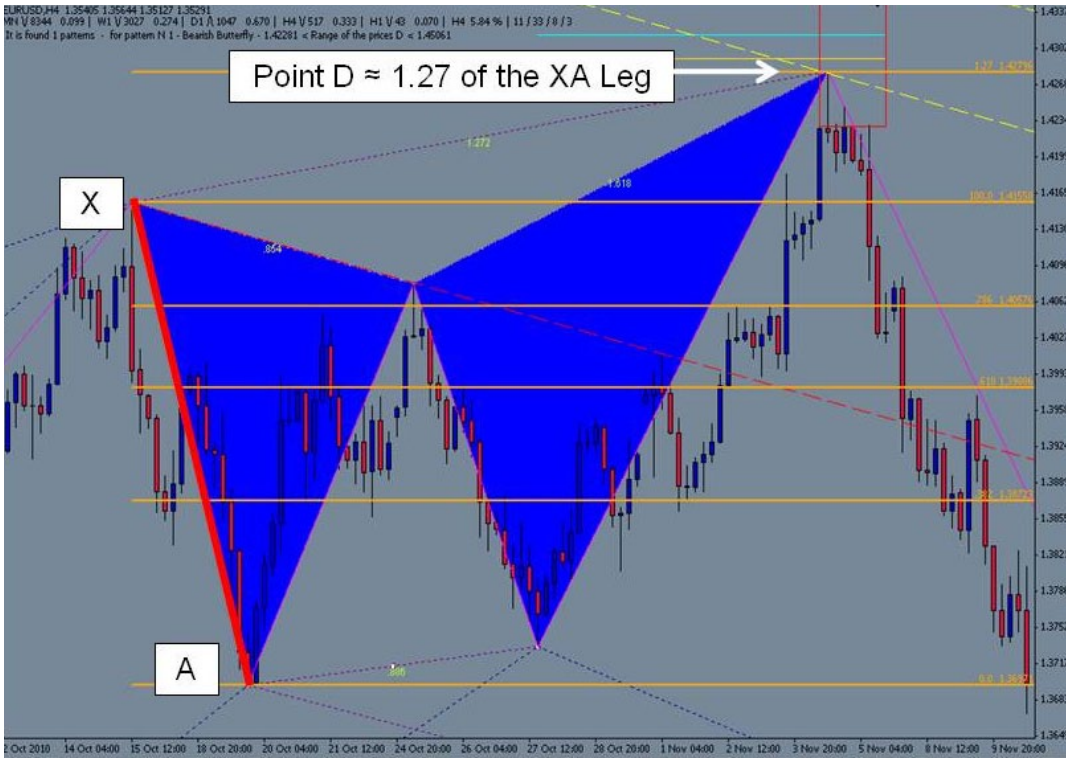

Chart 3.7

On chart 3.7, the Fibonacci levels are inserted from point X to point A giving us a reference point that forms point D at the 1.27 of the XA leg. Once Point D has been formed, the pattern is completed and the PRZ or potential reversal zone, the zone in which reversal may occur and this currency may begin to go back down, is formed.

3.3 The Crab Pattern

The crab pattern was discovered by Scott Carney in 2000 as he applied additional Fibonacci ratios to patterns similar to the Gartley pattern.

The main difference between the Crab pattern and the original Gartley pattern is that point D is above point X in a Bear pattern and below point X in the Bull pattern.

Often with the Crab pattern, the PRZ is the most exact when compared to other patterns and

thus can require smaller stop loss placement meaning the risk to reward ratio is often the best for the Crab pattern. Unfortunately, the crab is generally the most infrequent of the patterns and some patience may be required in waiting for this pattern to form and show up. However, the reward from this pattern is often well worth the wait. The Crab pattern is similar to the Butterfly pattern in that it may start off looking like a breakout.

3.31 The Bull Crab Pattern

This diagram shown in Figure 3.3 below illustrates the Fibonacci ratios applied to the Bull Crab pattern:

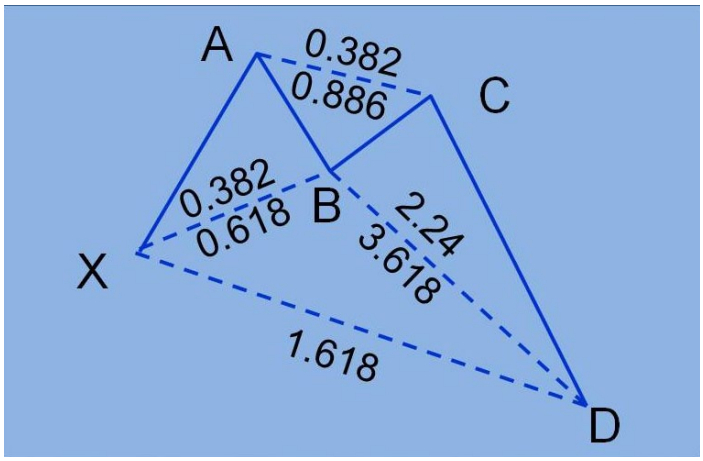

Figure 3.3

Much like other Gartley patterns, point B is the heart of the pattern as it is required to move on to the rest of the points. Finding point B starts at point X which in a Bull Crab pattern begins at a relative low, which may or may not bee the lowest point of the chart but the more extreme low chosen the better.

As the price rallies from point X, it will continue to create new highs on each new rise until the price tops out forming point A. Taking a measure from point A to point X, the price is expected to return back down to the approximate 0.382 level or 0.618 level of the XA leg to form point B. This can be seen on the following chart example:

Chart 3.8

Chart 3.8 is the Euro GDP fifteen minute chart which provides some perspective of the time it took to develop this pattern. This pattern began development late on December 8th and completed about midday the next day, December 9th.

The Fibonacci levels have been inserted between points X and A and the market returns to the approximate 0.382 level to form point B from where it begins to rally.

Once point B is established, it is possible to look for the formation of point C as the market moves back towards point A as can be seen on the following chart:

Chart 3.9

The Fibonacci levels have been inserted from point A to point B, Point C is formed when the market reaches between the approximate 0.382 or 0.886 level of the AB leg. On this chart point C is formed at approximately the 0.886 level of the AB leg.

Once Point C is formed the market then begins to fall and eventually surpasses point B after which Point D will be formed between the approximate 0.127 or 1.618 levels of the XA leg of the pattern as can be seen on the following chart example:

Chart 3.10

On chart 3.10 the Fibonacci levels have been inserted in orange from point X to point A giving a reference point and in this case, point D forms at the 1.618 of the XA leg.

The formation of point D completes the pattern and forms the as can be seen in the following chart:

Chart 3.11

3.32 The Bear Crab Pattern

The following diagram shown in Figure 3.4 illustrates a Bear Crab pattern:

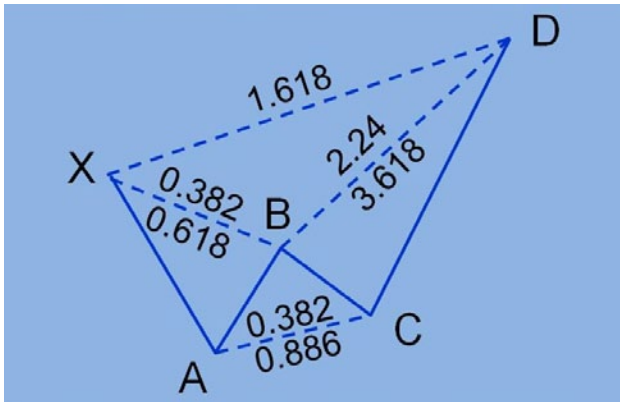

Figure 3.4

Like all other harmonic patterns which have been discussed, point B is the most important level to find first and finding point B starts at point X. Point X, in a Bear Crab pattern, begins at a relative high which may or may not be the highest point on the chart that is being viewed.

As the price falls from point X it continues to create new lows on each fall until the price bottoms out forming point A. Taking a measure from point A back to point X the price is expected to return back to the 0.382 or the 0.618 of the XA leg to form point B. This can be seen in the following chart example:

Chart 3.12

Chart 3.12 is the GDP USD 15 minute chart and this pattern began development on December 9th and completed on December 10th. On this chart, the Fibonacci levels have been inserted between point X and point A, and the market returns to the approximate 0.618 level to form point B before it begins to fall once again.

As the market falls from point B, it is possible to measure for Point C by inserting the Fibonacci levels from point A to point B as can be seen on the following chart example:

Chart 3.13

Point C is formed between the approximate 0.382 or 0.886 of the AB leg. On chart 3.13 the Fibonacci levels have been inserted between point A and point B and the price has now fallen to the approximate 0.382 area of the AB leg forming point C.

After bottoming out at point C, the market rises and surpasses point B. Point D is formed after the market passes point B and climbs to the approximate 2.24 or 3.681 levels of the AB leg of the pattern as can be seen on the following chart example:

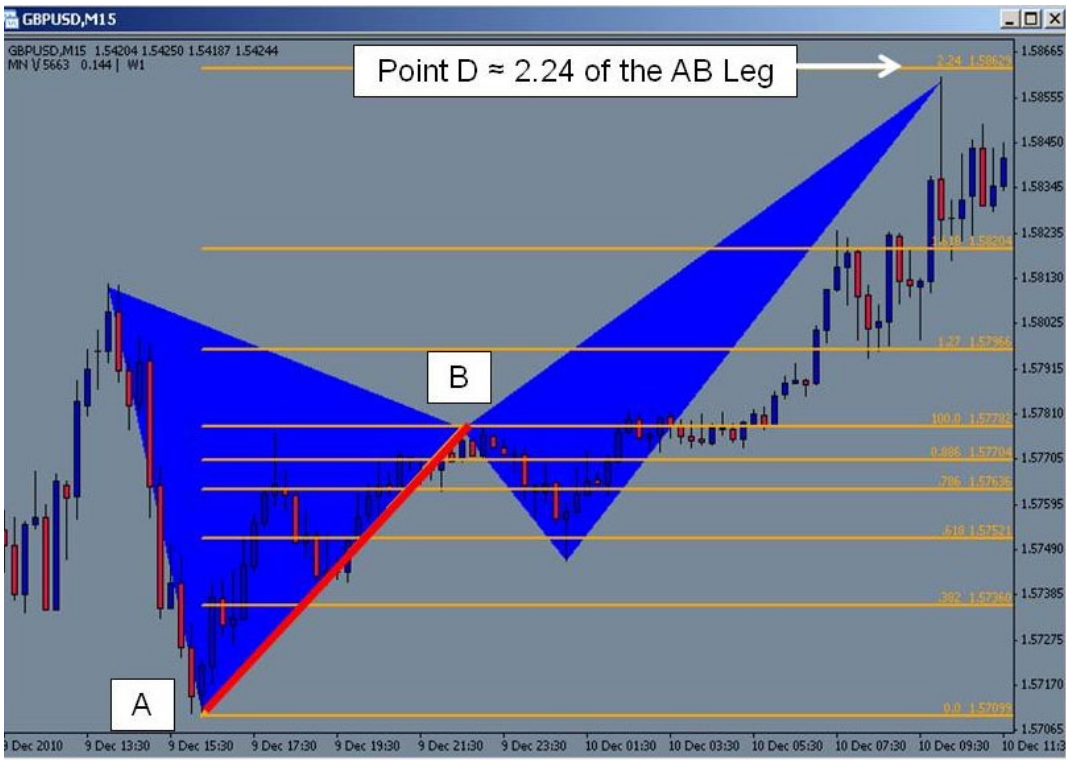

Chart 3.14

On chart 3.14, the Fibonacci levels have been inserted from point A to point B giving a reference point for the formation of point D at the approximate 2.24 level of the AB leg.

Point D completes this pattern and forms the PRZ or potential reversal zone as can be seen in the following chart example:

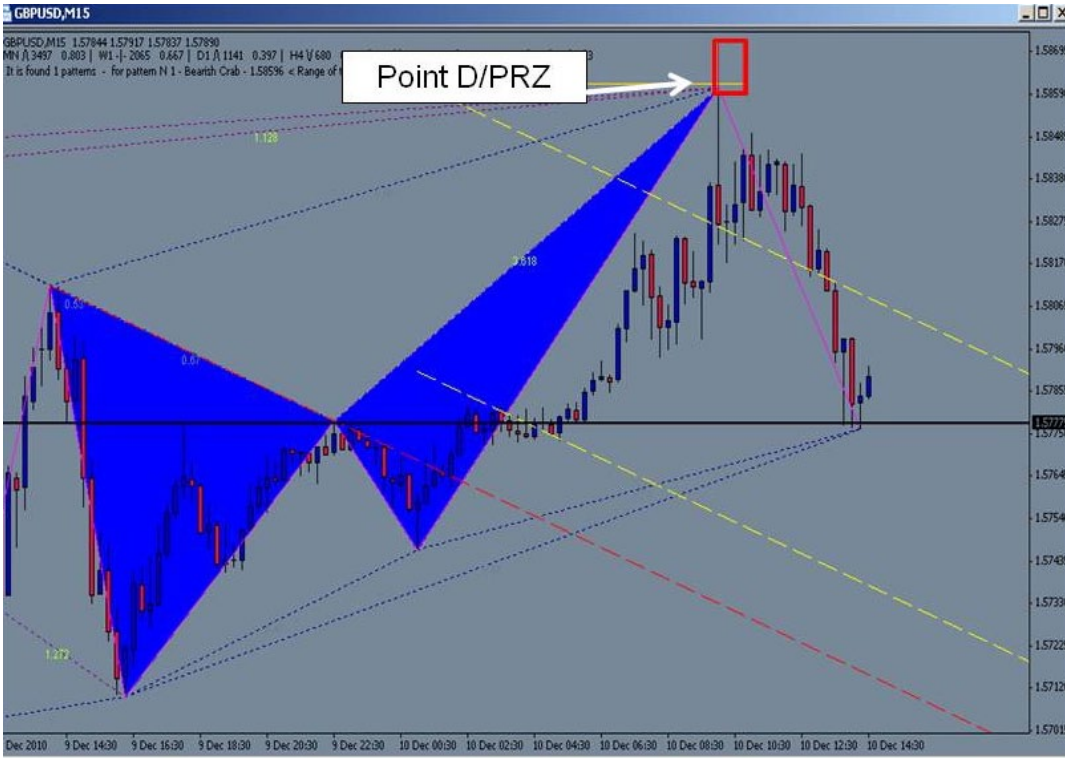

Chart 3.15

Point D, or the PRZ, represents the zone at which reversal, after the completion of the pattern, may occur.

3.4 The Bat Pattern

The Bat pattern was a harmonic pattern discovered by Scot Carney in 2001 as he applied additional Fibonacci ratios to chart patterns.

The main difference between the Bat pattern and the Butterfly and Crab harmonic patterns which have been discussed is that in the Bat pattern, point D does not pass point X. Instead, point D is usually found at the 0.886 level of the XA leg. The Bat harmonic pattern is the most closely related to the Gartley pattern as the D point does not pass the X point in either of these patterns.

3.41 The Bull Bat Pattern

The following diagram, illustrated in Figure 3.5, shows the Fibonacci ratios applied to the Bull Bat pattern:

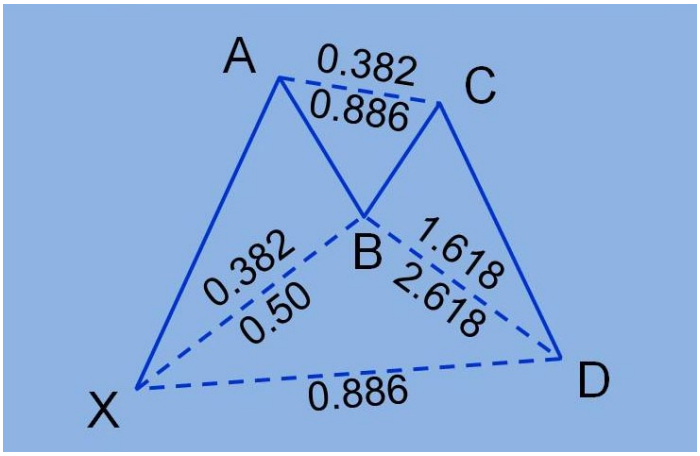

Figure 3.5

Once again, finding point B starts at point X. Point X in the Bull Bat pattern is at a relative low. As the price rallies from point X it will continue to create new highs at each rise until the price tops out at some point forming point A.

Taking a measure back from point A to point X, the price is expected to return back to the approximate 0.50 or 0.382 levels of the XA leg. This can be seen on the following chart example:

Chart 3.16

This is pattern is shown on chart 3.16 which is the CAD JPY daily chart and this provides a perspective of the time it took to develop this pattern. This pattern began development in late August and completed in about mid October.

On chart 3.16, the Fibonacci levels have been inserted between point X and point A, and the market has returned to the approximate 0.382 level to form point B before beginning to rally once again.

From point B it is possible to look for the formation of point C so as the market rallies and moves towards point. The point C retracement can be found by inserting the Fibonacci levels from point A to point B as is shown in the following chart example:

Chart 3.17

Point C occurs between the 0.382 or 0.886 Fibonacci ratios of the AB leg. As can be seen above, the price has risen to the approximate 0.382 level, forming point C.

After topping out at point C the market begins to fall once again and eventually surpasses point B after which point D is formed at the approximate 0.886 level of the XA leg of the pattern as can be seen on the following chart example:

Chart 3.18

On chart 3.18, the Fibonacci levels have been inserted from point A to point X giving the reference for the formation of point D at the 0.886 of the XA leg.

As can be seen on the following chart example, Point D completes this pattern and forms the potential reversal zone.

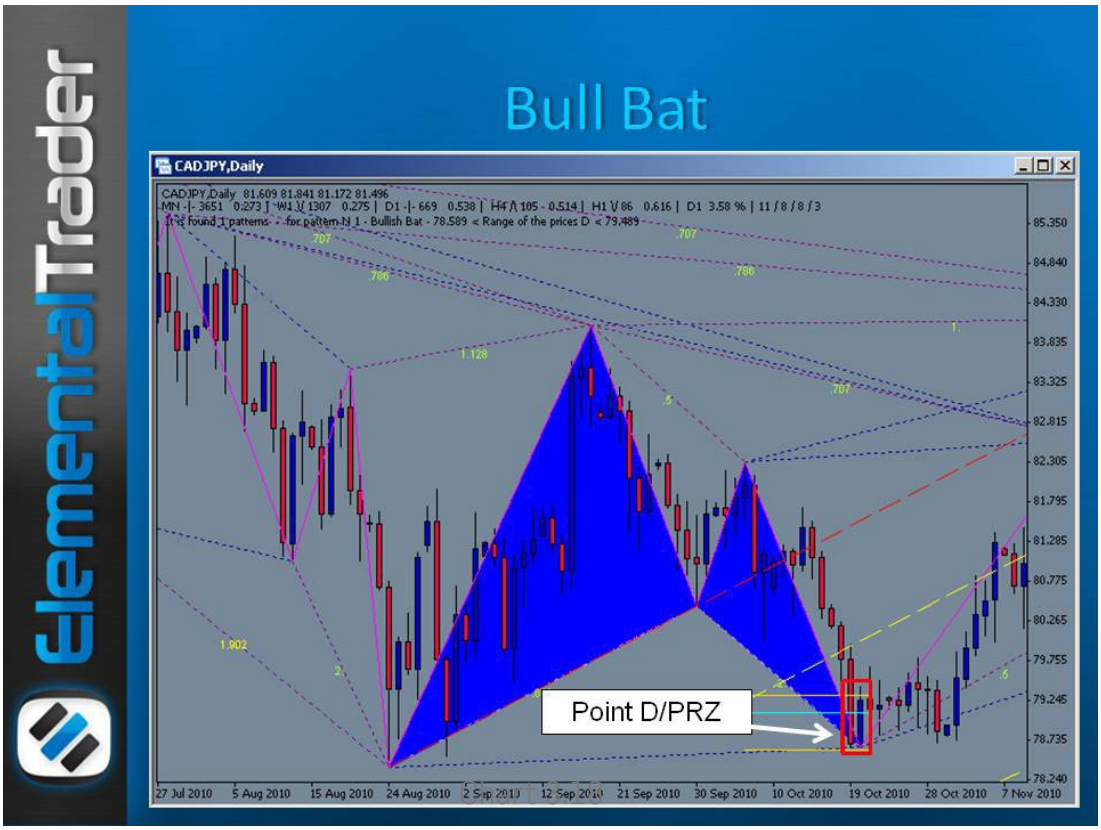

Chart 3.19

Point D, known as the PRZ, represents the point at which reversal may occur and the market may begin to rally.

3.42 The Bear Bat Pattern

The following diagram, shown in Figure 3.6, illustrates the Bear Bat pattern:

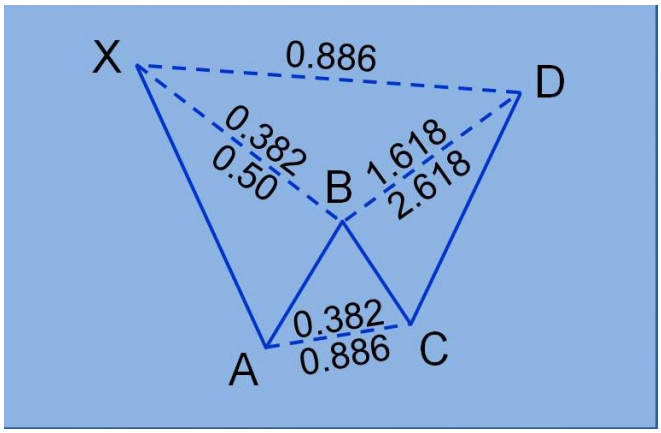

Figure 3.6

Finding point B starts at point X and, in the Bear Bat pattern, point X is at a relative high. As the price falls from point X it will continue to create new lows on each fall until the price bottoms out at some point forming point A. The price is then expected to return back to the approximate 0.382 or 0.50 of the XA leg to form point B. This can be seen in the following chart example:

Chart 3.20

Chart 3.20 shows the USD CHF weekly chart and this pattern began development in the February and did not complete until April. On chart 3.20 the Fibonacci levels have been inserted between point X and point A and the market has returned to the approximate 0.50 level to form point B. As the market falls from point B it is possible to look for the formation of point by inserting the Fibonacci levels between point A and point B. Point C is formed when the market is between the approximate 0.382 or 0.886 ratios of the AB leg.

Chart 3.21

On chart 3.21 the Fibonacci levels are shown between point A and point B and as can be seen, the price has now fallen to the approximate 0.382 level of the AB leg where point C is formed. After bottoming out at point C, the market rallies and rises surpassing point B. Point D will be formed as the market passes point B and reaches the approximate 0.886 level of the XA leg of the pattern as can be seen on the following chart example:

Chart 3.22

On chart 3.22 the Fibonacci levels are inserted from point A to point X giving the reference for the formation of point D at the 0.886 of the XA leg.

Chart 3.23

The formation of point D completes the pattern and forms the PRZ, the zone in which reversal may occur.

3.5 The Harmonic Patterns and the Elemental Trader Software

The above examples illustrate how Fibonacci ratios fit with some of the harmonic trading patterns which can be identified using the Elemental Software.

It isn't necessary to go through the process of drawing the Fibonacci levels onto the chart, as in practice, the software does that by identifying where those Fibonacci ratios are going to be, putting them onto the chart and identifying them with highlighted blue triangle areas. However, it is valuable to understand where those Fibonacci ratios lie and how they are formed as the pattern is being developed so that the patterns forming on the software can be better understood.

In addition to inputting the harmonic patterns onto the charts, the software also identifies

where the PRZ is and in a later module the use of the PRZ as an entry area will be explored. The PRZ will also be used to develop risk guidelines and potential stop placement.

Summary of Module 3

This module has explored the use of harmonic patterns and ratios to determine, with high probability, potential reversal zones in which the market is most likely to change direction.

Understanding these patterns can provide traders with potential entry points, stop levels to manage risk and profit targets.

Module 4 — Using the Elemental Trader Harmonic Trading Software

Introduction to Module 4

This module looks at the procedure to download, install and apply the Elemental Trader Software and, once the software is installed, the interpretation of the patterns and the PRZ will be investigated. Finally, strategies for entering, placing stops and managing trades using the software will be considered.

4.1 Downloading and Installing Elemental Trader Software

To download and install the Elemental Trader Software you must first visit www.elementaltrader.com.

On the Elemental Trader webpage, there is a link, arranged directly below the video. By clicking on this link, the software is accessed and it is possible to download the software and save this to the computer desktop.

Once the indicator shows the software has been downloaded and saved onto the desktop, by opening the program file folder, the broker being trading with can be found.

First go into “My Computer” then find the “C Drive”. Within the “C drive” find “Program Files” and within this, find the folder for the broker that is being trading with. Next, go into “Experts” and finally go into the “Indicators” folder.

The Elemental Trader icon can then be dragged and dropped from the desktop into the “Indicators” folder and this window can then be closed.

It is now possible to log into the brokerage platform being used and finish the installation of the Elemental Trader software.

Once the brokerage platform is open, pull up a new chart window by going to the “Market Watch” icon and clicking on the pair of currencies to be traded. Then chose the “Chart Window” option and a new chart is opened.

Now, go to “Custom Indicators” and double click on the “Elemental Trader” icon. Once at this screen, on the “Common” tab, there is no need to select to allow DLL imports, instead, “OK” can now be clicked.

To complete the installation, the brokerage platform must be closed and then reopened. The installation is now complete and by scrolling through different time compressions it is possible to see the different numbers, variables and patterns being displayed in real time.

Once the Elemental Trader software is successfully installed onto the trading charts, it is time to begin trading.

4.2 Recognizing Harmonic Patterns using the Elemental Trader Software

Using the Elemental Trader software, it is possible to look at the signals and how they are applied to the trading charts.

On this first example chart, chart 4.1 shown below, the harmonic pattern is highlighted with the blue triangles.

Chart 4.1

The candlesticks and background color of the screen may be different on your charts and these features which are customizable so can be set to suit personal taste. However, the Elemental Trader indicator colors of the triangles, pattern lines, Fibonacci ratios and PRZ designation are pre-set. Within the text at the top left of the chart 4.1, the identified signal is being indicated, in this case it is indicating a Bear Bat pattern.

The Elemental Software does the work of applying the proper Fibonacci ratios to each leg of the pattern. The PRZ is highlighted by the red box which can be seen here at the top right hand side of the chart.

Whilst it is not necessary to understand how the Fibonacci ratios apply to the chart to form the patterns in order to be able to trade them, it can be very helpful to understand how they fit within the construction of the patterns and interpret some of the lines that can be seen on the charts.

4.21 Applying Fibonacci Ratios to a Bear Crab Pattern

The next two chart examples will look at how the Fibonacci ratios apply to a Bear Crab pattern. Firstly, though is shown a diagram of the bear crab pattern into which the Fibonacci ratios are inserted.

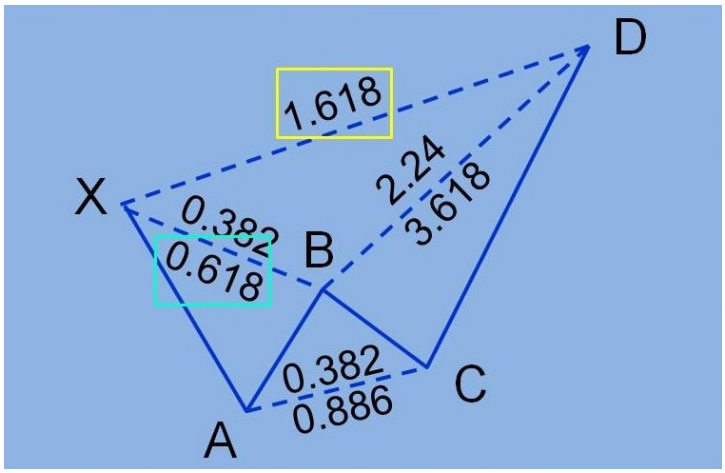

Figure 4.1

The two main points are point B, from which much of the pattern is based, and the ratio for which is shown highlighted in blue; and point D, or the PRZ in which reversal is most likely to occur, the ratio for which is highlighted in yellow.

In the Bear Crab pattern, point B is formed when the market retraces the XA leg, in this case, up to the 0.618 Fibonacci level. Looking at the chart 4.2 shown below it can be seen how the software enumerates this retracement with the Fibonacci ratio that is highlighted here in blue.

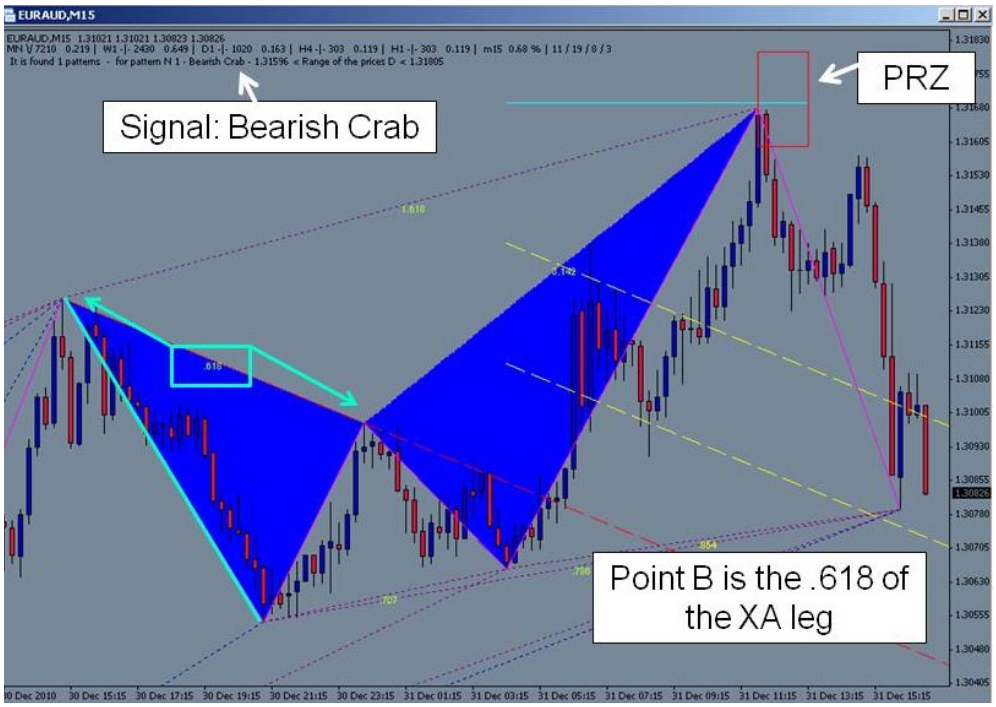

Chart 4.2

On chart 4.3 shown below, the discovery of point D is shown. Within the Bear Crab pattern, point D is formed when the market reaches the approximate 1.618 of the XA leg which in this case is highlighted by the yellow box.

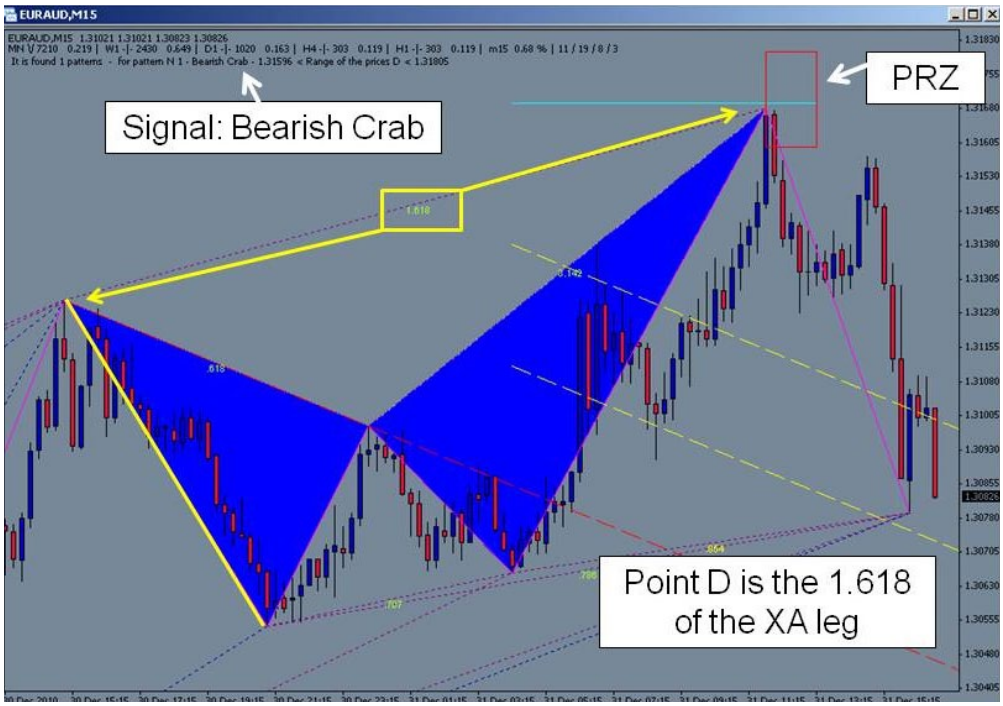

Chart 4.3

At this approximate ratio, point D, or potential reversal zone where reversal is most likely to occur, is formed and this is shown in the chart 4.4 below:

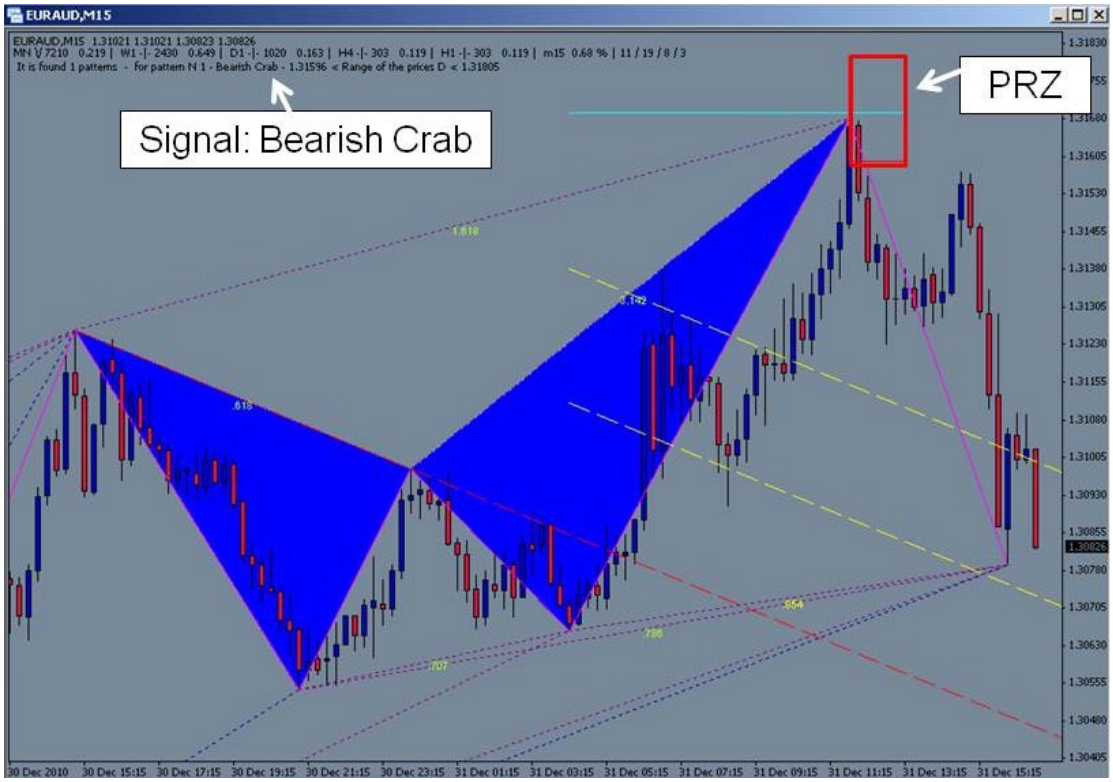

Chart 4.4

4.3 Implementing Strategy and Procedure

The next step is to look at how these patterns, once identified, will become market entry opportunities.

With any higher probability trading system there are rules that should be followed to ensure the best possible results are achieved and the Elemental Trader system is no exception. In particular, these rules to apply to risk to reward ratios, the scaling and trade entry procedures and trade management methods to follow once your entry has been made.

4.31 Risk and Reward

Risk to Reward may be the most important factor within the whole system. If more is always risked that there is to be gained it will be very difficult to make any trading account accumulations. With the Elemental Trader strategy, the risk and reward are, to a certain extent, already determined. The risk associated with any harmonic trade will be proportionate to the size of the PRZ. The shorter the PRZ, the less risk associated with the trade; the taller the PRZ, the more risk associated with the trade. Generally, stops will be placed just outside the PRZ, typically between 13 and 34 pips just outside the PRZ.

Looking at the following chart 4.5 it is possible to see the PRZ at the top right hand side of the chart.

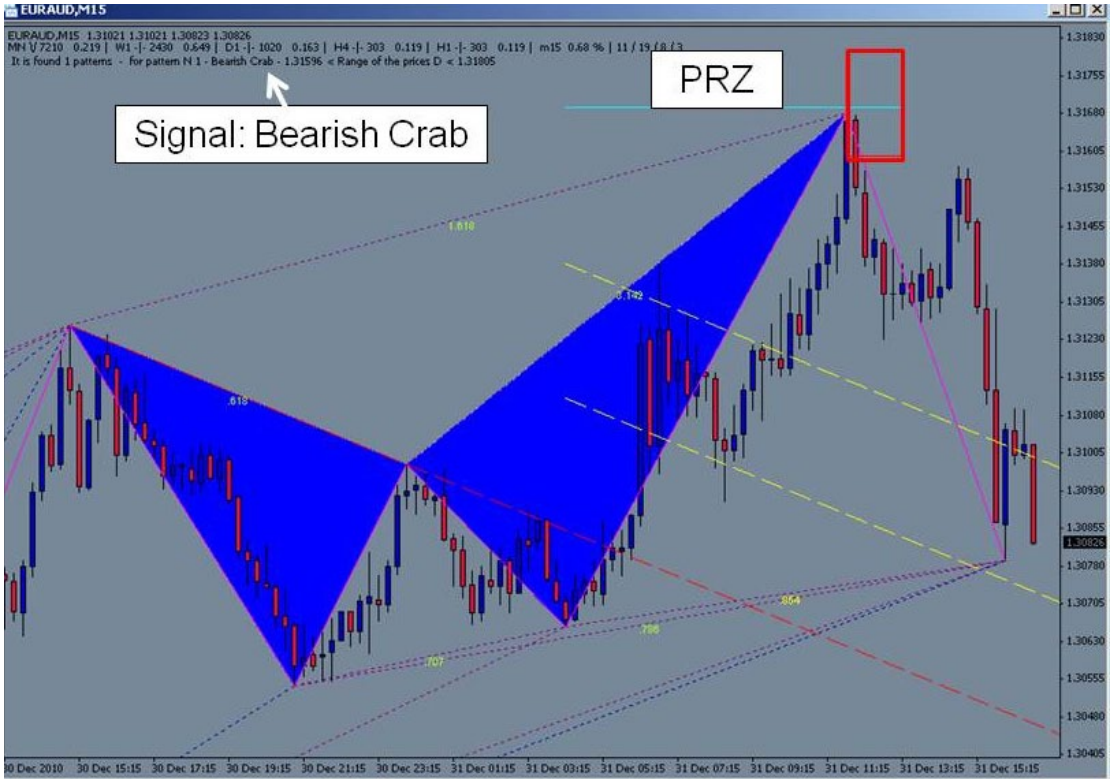

Chart 4.5

Chart 4.5 is the Euro AUD fifteen minute chart and it is showing a bearish crab signal or pattern. And in this case, the bottom of the PRZ rests at about 1.3160 and the top of the PRZ is around 1.3180 meaning that the PRZ is about 20 pips from the bottom to the top.

Risk

Applying the risk strategy from the master trading system indicates that the stop should be placed between 1.3193 and 1.3214.

To determine potential risk, use the average price of the PRZ as the entry price. The average price between the 1.3160 and 1.3180 limits of the PRZ is 1.3170, so this is used as the potential entry price.

Using a 20 pip stop above the PRZ, the stop should be placed at about 1.3200. To determine total risk, divide the PRZ in half, in this case 20 pips divided in half is 10, then add to this the stop of 20 pips above the PRZ which gives a total risk of 30 pips if this trade was to be entered.

However, risk is only half the equation and it is necessary to be sure that potential reward outweighs any potential risk, and to do this it is necessary to determine the potential profit.

Reward

As was mentioned above, the Elemental Trader software helps to determine the risk and reward associated with any given trade. As a rule of thumb, point B is used to determine potential reward as can be seen by looking again at the chart example:

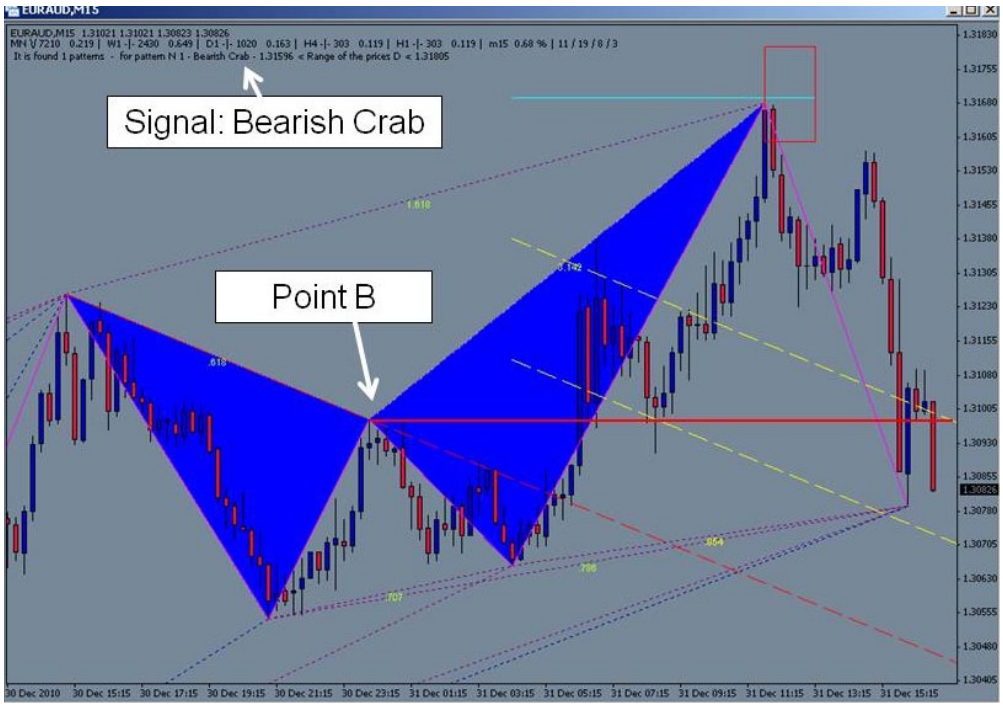

Chart 4.6

In chart 4.6, point B rests around 1.3098, so from the entry price at 1.3170 down to the point B level of 1.3098 gives a potential profit of 72 pips.

4.32 Calculate Risk to Reward ratios

Now that the total risk and potential reward have been calculated, it is possible to determine if the risk to reward ratio is balanced in favor of trading.

The risk to reward ratio can be calculated by dividing the potential reward by the known risk. In the above example, the potential gain is 72 pips and the total potential risk from the entry price is 30 pips, so 72 ÷ 30 gives a risk to reward ratio of 2.4. What that means is for $1 risk, there is the potential gain of $2.4.

It is very important to remember that this simple formula is not a guarantee of profit. There are far too many factors at play to ever guarantee anything when trading. However, by using this formula the probability increases that gain made will outweigh risks taken. At a minimum, the risk reward ratio should be 1.5 or greater. A trade with a risk reward ratio of less than 1.0 should never be taken as, this is risking more than could potentially be made and the trade will never balance favorably.

However, the most important factor of the risk reward ratio in trading is consistency, no matter which currency or compression is being traded from, the harmonic trading system should be applied in the same manner every time.

4.33 Determining Entry Procedure

Once it has been determined if the risk to reward ratio is favorable, the next step in the process is to determine the entry procedure.

Looking again at the chart 4.5, the PRZ was 20 pips from bottom to top. This 20 pip PRZ gives an indication of where the reversal of the market is most likely to occur, remember however, that it is only an indication of an approximate area and not an exact point. It should also be understood that whilst in this example the PRZ has a range of 20 pips, it could just as easily

have been 50, 80 or 100 pips or more, depending on the type of pattern that is being looking at or even depending upon the time frame on which the pattern is being looked at.

Another issue which is worth noting is that a harmonic pattern may be found on a certain brokers chart, but may or may not be seen on a different brokers chart. Why does this happen that? Well, it is simply due to the fact that the Forex is a non-centralized market and each broker's feed may be just that little bit different. However, just because the pattern can only be found on one chart does not mean that the pattern does not exist, the Elemental Trader software is designed to identify a pattern signal within certain variances and if they are not met they will not show on that particular chart. Going back to the analogy of predicting the weather, nothing is exact in a non linear dynamical domain.

A key factor, which needs to be taken into consideration when an entry procedure for a trade is being determined, is:

Scaling

As the PRZ is not an exact point, it is best not to put all your eggs in the one basket so to speak. For instance, at the bottom of a Bear PRZ when there is the potential for the market to continue to move higher within the PRZ by 20, 50 or 100 pips, it would be possible to ease into the trade by breaking the maximum lots available to be traded into several smaller lot trades.

Scaling is a mechanical process for entering the trade, using a series of predetermined entry points, within boundaries of the PRZ. Scaling can be mechanized to the point that the predetermined entry points can be preset and no further intervention is required for the trade to occur.

Having a mechanical process of easing into a trade, helps eliminate the influence of emotions in the trading process. If a trader had entered their maximum lots all at once, and the market then squeezed a little bit higher within the PRZ, there is a risk that negative emotions will take control causing fear and may lead to the trader close the trade too early for fear of a huge loss being sustained. There is no way of knowing the exact point in time or price that the market will turn and therefore it is worth bearing in mind that the market could in fact squeeze a little bit higher. Thus, every trader should always be prepared for what may come.

When implementing a scaling approach entry, ideally the orders should be scaled such that if all entries are executed, the average entry price is about 50% of the PRZ.

Taking another look at chart 4.5, a scaling approach to entry could be taken. In this case, the PRZ goes from 1.3160 to 1.3810. If the maximum lots tradable is equal to $100,000 or 10 lots then this should be broken down into smaller lot trades. In this case for example, the first scale entry could see three lots entered at 1.3160, which is the bottom of the PRZ. The second scale entry could be four lots entered at 1.3170, which is the middle of the PRZ. The third scale entry could be the remaining three lots entered at 1.3180 near the top of the PRZ. These entry levels can be predetermined and, using the Elemental Trader software, set as entry orders even at the beginning stages of the pattern set up.

Even when using such a mechanical entry process there are variables which can affect the trade. The preferred number of trade entries and the preferred trade size will be different for every trader and may even be different for every trade scenario. In addition, even though the entry points may be predetermined, it does not always mean that all of the orders will be filled. It should also be remembered that the PRZ is a *potential* reversal zone, and that reversal could occur at any point within that PRZ, even at the beginning of the PRZ.

However, taking factors like these into account, it is better, for example, to be in one small trade at the beginning wishing that more had been traded when the market reverses than it is wishing that less had been traded when maximum lots were traded at the beginning and the market doesn't reverse.

4.34 Trade Management

Once an entry into the market has been made, it is time to move into trade management mode.

The first goal in the management of any trade should be to reduce or eliminate risk.

Risk can be reduced by moving stops closer to the average price which means that risk is no longer a factor and so focus can be moved to managing profit.

There are two points at which the stop can be moved. The first of these is when the market moves 50% back to point B, which is the profit target from the entry price. The second of these is when risk has been overcome and this will typically be determined by the average entry price and whether one entry or four entries were made.

Looking again at chart 4.5, the average entry price was 1.3170. Point B, the profit target, was 1.3098 so a 50% move towards point B takes the market back to 1.3134. At this point, it is worth considering moving the stop from 20 pips above the PRZ, at 1.3200, towards break even or even scaling out of the trade with some profit.

However, if the trade had been scaled into with an average entry price of 1.3170, the market only needs to move back to 1.3140 to overcome any risk on the trade.

This can be seen illustrated in the following chart example:

Chart 4.7

In chart 4.7, the entry price at 1.3170 which is 50% of the PRZ. The potential profit target is point B at 1.3098 and when the market moves 50% back towards point B it is a good opportunity to lock in break even and thus eliminate risk. Once risk is no longer a factor, the focus can be moved to taking profit. So in the same way that scaling into a trade is useful to control emotions, scaling out is also useful to control emotions. In a way, scaling out satisfies the urge to take profit while leaving a little bit of the trade on for larger movements.

The caveat to all of this is that it is impossible to ever know where the market will go.

Therefore, it is worth considering which is worse:

- getting out with small profit and watching the market keep going, or
- going back to the break even stop and ending up with nothing.

Whatever of these options is worst means that it should be the other option which is implemented.

As detailed above, one approach to scaling out could be that when the market moves halfway back to point B then risk can be eliminated by moving the stop to break even thus, taking a portion of the profit at that time to ensure something is gained from the trade. This process of moving the stop can be followed until point B has been reached at which time it would be recommended that at least a majority of the position is closed or a majority of the profit is locked in if the decision is taken to let the trade ride longer.

Summary of Module 4

This module outlined the procedures for obtaining and installing the Elemental Trader software and then discussed how to identify the signals provided by the Elemental Trading software as they appear.

In addition, recommended guidelines for risk, reward, entry and trade management using harmonic trading patterns were explored and these guidelines will be useful in tempering the influence of emotions on personal trading.

Module 5 — Personal Trading Plan

Introduction to Module 5

This module will explore the development of a personal trading plan which is an important aspect of successful trading. The reasons why a personal trading plan is needed and the steps necessary to developing a trading plan that is personalized will be outlined before how the plan can be implemented is explored.

5.1 Appreciating the Need for a Personal Trading Plan

The need for a trading plan has already been discussed earlier in the course, but it is worth revisiting just what a trading plan is to appreciate why it is so important. A trading plan is a document that lists Forex trading goals and guidelines which a trader will follow prior to entering a trade, during an open trade and after the trade has closed.

Every trader should have a trading plan to follow and this should be personal to them. In looking to construct personal trading plan, it is important to write down personal trading goals and to develop a set of personal guidelines which can be followed to reach those goals. The guidelines should include steps to follow before entering a trade, when managing open trades and when evaluating a trade after it has closed.

5.11 Why Make A Trading Plan Personal?

It would be easy just to say "I want to be a successful trader". But without a personal plan to reach that goal it would be like driving across the country without a map: it may, or may not, be possible to end up at the desired destination, and there may or may not be obstacles encountered along the way. A trading plan increases the chances of some trading obstacles being avoided and trading goals being reached more quickly. By making this plan personal the route taken can be one which is completely acceptable to the person the plan is made for. Returning to the map analogy, perhaps motorways should be avoided, or a stop made for a coffee every 50 miles, so the route can be personalized to a specific persons needs. In effect, a personal trading plan acts as a map which can be followed to reach personal trading goals in a manner which is personally acceptable to the trader.

A personal trading plan should set personal goals, help develop a personal trading routine, follow personal guidelines and evaluate personal performance.

5.12 The Different Aspects of a Personal Trading Plan

With this understanding of why a personal trading plan is needed, it is worth digging a little deeper to understand how the plan helps a trader to reach personal goals by looking at each of these aspects of a trading plan in turn.

Set Goals

When setting personal trading goals, it is important to be specific, they don't need to be long drawn out paragraphs but short to the point statements about the goals including a starting point, milestones along the way and an ending point. Short term, mid term and long term goals should be included to ensure progress can be measured along the way.

Stating "I want to make a million dollars trading" doesn't map out a plan to achieve that goal; instead it just becomes more like a dream than a goal.

Goals should be realistic, measurable and time based.

Develop a Personal Routine

Having a plan also helps develop a personal routine. Routine almost sounds dull, but routine is important as routine breeds consistency.

An example of routine is setting the alarm clock for the same time, every day, for several months. After a while your body becomes adapted to that routine and you might find yourself waking up at that moment or just before your alarm clock even sounds.

By developing a personal trading routine the process becomes mechanical and, as has been discussed in the previous module, a mechanical approach to a trading process will reduce the chances that emotions take control of trading decision. By eliminating emotions from trading, the chances of sticking to a trading plan are better which in turn will lead to successful trade decisions.

A routine is consistent, familiar and mechanical and developing a routine makes following a set of guidelines easier.

Follow Guidelines

Guidelines are the map that will be followed during trading, and the map provides the steps to follow before entering a trade and specific guidelines about capitalization, risk and leverage management as well as about management of open trades and evaluation of those trades after they have closed. Guidelines help with trade management and account management and guidelines should always be followed.

Evaluate Performance

If personal goals are sufficiently specific, then there should be milestones along the way against which progress towards personal goals can be compared. These milestones help facilitate evaluation of trading performance. Performance can be evaluated in two difference ways, namely:

- trade performance can be evaluated; and
- trading performance can be evaluated.

Evaluating trade performance means evaluating performance of a single trade and this involves looking at the specific trade tactics of each individual trade: did it go as expected? What if any thing could be done differently on the next trade?

Evaluating trading performance means evaluating the progress towards personal trading goals: have the milestones which must be met in order to meet the goals set for the overall personal trading plan been achieved?

Therefore, to be a successful Forex trader, it is invaluable to have a personal trading plan as a personal trading plan means:

- trading is not based on emotion;
- trading decisions are made mechanical;
- trading progress can be measured; and
- trading goals can be achieved.

5.2 Developing a Personal Trading Plan

To develop a personal trading plan the steps required include establishing a personal vision and goals, developing an overall trading strategy that can be applied to all trades and which includes specifics of trade tactics for execution of each trade and considerations for evaluation of progress towards personal trading goals in essence, the primary components of a personal trading plan are:

- Personal visions and goals;
- A trading strategy;
- Trade tactics; and
- Evaluation systems which include:
    - a trade record
    - a trading journal

5.21 Personal Vision and Goals

Personal trading goals should be specific and should include goals relating to a starting point, milestones long the way and an ending point. The goals should be realistic, measurable and time based. The goals should also fit within an overall personal trading vision as to what is to be achieved from trading.

It is worth setting short term goals, in the range of 3 months; mid term goals, in the range of 6 months; and long term goals, that extend to a year, with all of these goals being specific, realistic, measureable and time based.

Setting shorter term and longer term goals facilitates ongoing evaluation of progress.

Personal Trading Goals example

Consider this goal: open a mini account with a balance of $6000 on July 1st and increase account balance by 50% in the first three months

Is it specific? Yes, it includes the account type and the opening balance of $6000 dollars.

Is it time based? E.g. does it have a starting point and an ending point? Yes, this goal starts on July 1st and continues for three months.

Is it measureable? Yes, the goal is a 50% increase from $6000 which is $3000 in three months. This equates to $1000 each month or $250 dollars each week, or five x 1 mini-lot trades of 50 pips each. This detail ensures that the goal is measurable along the way to achieving the overall trading goal.

Is it realistic? This is an altogether more tricky question and how to answer it will now be looked at in more details.

How can whether a goal is realistic be assessed? And is it possible to determine if a certain goal could even be achieved?

5.22 Using A Demo Trading Account

Using a demo trading account is probably the best way to answer these awkward questions. In turn, the use of a demo trading account is an important step towards developing personal trading goals. Ideally, the initial goal example will now become: Increase a $6000 dollar demo account by 50% during a three month period from July 1st through September 30th. This goal is now specific, time based and measurable and by trading on a demo account this also helps determine whether the increase is a realistic live trading goal.

This is why using a demo account, and creating a demo trading goal is needed. Setting a demo trading goal ensures that live goals for real money trading are realistic and attainable.

By developing a demo trading goal and then trading on a demo account first, analysis skills necessary for making informed trade entry decisions are developed. Using a 3 month demo account trading period is sufficient time to:

- develop analysis skills
- create a disciplined daily/weekly trading routine
- establish a baseline win-loss record
- gain experience with controlling emotions
- develop proficient dealing station skills
- establish realistic live account goals

In other words, using a demo account will help create a trading routine which will minimize the risk of emotions controlling trading decisions and by establishing a win loss record on a demo account it is possible to measure how successful trading goals are being reached. Demo trading is also where execution skills on the dealing station can be developed safely. By using a demo account, all of these aspects of trading can be established without risking real money in a live trading account.

Demo trading also helps realistic trading goals to be developed. For example if, after trading for three months on a demo account only a 5% return has been achieved, is it not particularly realistic to believe a 50% return could be achieved on the same basis on a live account.

Successful demo trading will increase the likelihood of overall trading goals being attained. The importance of a sustained period of demo trading in improving the likelihood of success in live Forex trading cannot be overstated.

5.23 Overall Personal Trading Strategy

The next step in developing a personal trading plan is to develop an overall personal trading strategy. The trading strategy will contains the guidelines that should be applied to every trade entry decision made and these guidelines should include:

- Primary ..... currency pairs
- Spend ..... hours per day studying and trading
- Risk no more than ..... % of account balance on a single trade
- Risk no more than ..... % of account balance on all open trades

Consider this first bullet point: Primary currency pairs.
Why pick only a few currency pairs out of so many? Well by concentrating on only a few pairs it is possible to gain an intimate understanding of those pairs, so any trade decision which then needs to be made on that currency pair is better informed. By trying to keep up with too many currency pairs development of a thorough knowledge may not be possible and critical confirmations or even trade opportunities may be missed.

It is worth committing to a certain amount of chart study time of the market each day. How much time is committed to this will be different for everyone. Internet traders may need to commit more time to chart study than traders who uses a long term chart development. Also, if the skill of trading is being learnt at the same time as a regular job is being undertaken, time may be more limited.

It is also important to include risk guidelines in the trading strategy. For example the personal acceptable maximum risk on a single trade opportunity may be 3% of account balance whilst for all open trade opportunities a maximum risk of 6% account balance may be the maximum acceptable risk.

5.24 Guidelines for Overall Account Management

The personal trading plan should also include limits on market exposure formed by developing guidelines for the overall account management which apply to every trade. These guidelines should include:

- Limit total exposure to ..... x account balance
- Set a stop loss level and limit level
- Evaluate risk vs. reward
- Move stop to break even after ..... pips of profit
- Do not push stop out just to remain in a trade

Consider the acceptable limits for total exposure, an example of maximum overall market exposure may be 5x account balance. The key is to set a guideline that will keep exposure manageable, which will limit risk and increase sustainability in the market.

Guidelines should be developed for setting stop loss levels that meet with the aim of moving towards overall trading goals. Setting a guideline for moving a stop after a certain number of pips, will help protect from significant losses. Once a stop is committed to, it should not be moved just to stay in a trade as this would be risking letting emotions take control rather than keeping it mechanical. A guideline should also be set for periodically checking progress towards trading goals at specific milestones.

5.25 Risk to Reward Evaluation

A guideline that evaluates risk to reward should also be set. Going back to what was discussed previously in relation to risk to reward in section 4.31, each new trade is unique. A stop of 50 pips on one trade may not be appropriate for the next trade; instead a larger or smaller stop may be appropriate. A stop may be determined by a PRZ or other technical analysis tools, trade size, consideration of market volatility around news announcements or a combination of all. The key is to determine whether the stop is in accordance with the personal risk guidelines which have been developed and if it minimizes potential loss. If the trade goes the opposite way from expected will it be possible to live to trade another day?

In addition, once the stop has been determined, it is important to establish potential gain, the reasons for the target limit and if there is there enough profit potential to justify the size of the stop.

Whilst a home runner shouldn't be aimed for on every trade, progress towards personal trading goals should.

5.26 Trade Tactics

Trade tactics are the specific rules for engagement each trade and are the rules that will be followed when looking to enter a new trade, manage an open trade, to determine how and when to exit a trade and then evaluate the performance of that trade. These rules provide the means necessary to evaluate each success and failure and disciplined use of the specific trade tactics will promote success.

Entering The Trade
This involves looking at the process that leads up to entering a trade and developing specific trade tactics that can apply to and be recorded for each individual trade entered. This is an important aspect of the personal trading plan.

Keeping track of the trade criteria for every trade can be achieved, by, for example recording the following details:

Currency pair: .....
Summary of analysis: .....
.....
.....
.....
.....

First, the currency that is being traded should be noted and then a note summarizing all that has been considered. Why is this trade being entered? What harmonic pattern is being signaled? Once potential entry point has been found, the next steps in the trading process should be examined and the following information noted:

Determine stop .....
Reason for stop level .....
Determine limit .....
Reason for limit level .....
Calculate proper trade size .....
(exposure and risk)
Evaluate risk to reward ratio .....
(go vs. no-go decision)

The noted information will be useful later for trade evaluation purposes. If, on applying the trade tactics a decision to make the trade is taken, it is worth also noting the spread or swap for the currency being traded and what is the entry price as well as ensuring that the decision to trade is not being based on emotions. After all this, it is time to enter the trade.

Managing the Trade

Once a trade has been entered, the next stage of the process is trade management. Trade tactics can be employed in one of two different ways to manage a trade.

On the one hand, stop loss and limit settings set up within the trading software can be left do their job. This means the trading process requires is less screen time, as it is not necessary to sit and stare at the charts. In addition, this tactic reduces the chance that emotions will take control of the trade scenario by keeping the process mechanical.

Alternatively, the performance of the trade can be tracked and the stop can then be managed. Managing the stop helps prevent loss. Moving to break even helps eliminate risk and by following the trade with the stop it may be possible to lock in profit and let the trade ride. Then, once the trade is complete you will look to close the trade.

Exiting The Trade

Several different tactics and be employed for closing a trade. In most cases, the trade may be closed when it has reached a limit level; the limit reached could be that daily or weekly profit goals have been met. The trade may alternatively be closed because it failed to meet the price movement expectations and therefore there is a desire to reduce the amount of risk or exposure

by just closing the trade.

Evaluating the Trade

A trade record can, once a trade has been closed, be used to evaluate the trade performance by recording the details of the trade, including the date, the time of the trade, the account number. All of these are going to be pertinent information to keep track of in order to evaluate progress towards goals.

After each trade it is also important to evaluate progress towards overall trading strategy.

By tracking the progress of trade tactics and by keeping a summary of each trade, it is possible to evaluate whether the trading system is performing as expected.

Whilst these might seem like time consuming details, evaluating trades and keeping track of performance involves an attachment to the trading process instead of just being a bystander on the guidelines.

A trading journal may also be kept. Just like any successful business evaluates performance and activities of each employee on a regular basis, a trading journal is a primary tool for evaluating the effectiveness of personal trading strategy and tactics.

5.27 Guidelines for Evaluation

It is important to be wary of comparing the number of winning trades to losing trades. The net profit or loss for a given period depends not only on the number of trades won or lost but on the lots per trade and the pips gained or lost per trade For instance by trading two lots for a gain of 50 pips on a mini account, $100 is gained. Then, on the next trade, you lose 75 pips but only used one mini lot. This will mean there is still a net profit of 25 dollars. It is important to remember that every trader has periods of ups and downs. However, be wary of adjusting trading plan guidelines too soon after some loses, instead, took for patterns of wins or losses before adjusting the trading strategy. This is a particularly important process when it is a demo trading account which is being managed.

5.3 Applying the Personal Trading Plan

Here is a simple trade plan template that you can use as you begin to customize your own plan:

Fill in your maximum risk amount .....
Choose the currency pairs you will trade .....
Choose the time frames you will trade .....
Choose the harmonic patterns you will trade .....
Choose your minimum and maximum risk/reward ratios .....

As we discussed, risk is an important factor in any plan and will help you to promote sustainability within your trading approach. Choosing the currency pair to trade will help to focus trading and reduce the amount of screen time necessary. The time frame traded may depend on the type of trading which is being undertaken. An internet trader may want to focus on smaller time frames whereas a position trader, or longer term trader, may focus on larger compressions. It is possible to choose to trade all harmonic patterns or to trade just one harmonic pattern. The minimum risk reward ratio is different for everyone as some traders have a risk tolerance greater than that of other traders.

The following is a sample personal trading plan put together by Derek Frey using the criteria outlined above:

Maximum loss limit:	1%		
Currency Pairs:	EUR/USD	GBP/USD	USD/CHF
	AUD/USD	USD/CAD	USD/JPY
Time Frames:	15 min and 1 hour		
	Gartley and other harmonics (bat, butterfly, crab)		
	Minimum 1:5:1 – 5:1 Risk/Reward ratio		

As you can see, this example personal trading plan uses a maximum loss limit of 1%, lists out particular currency pairs that will be focused on and the time frames that will be focused on, and the types of patterns that will be focused on, in this case the Gartley and other harmonic patterns. The acceptable risk to reward ratio is then determined. Also, in the “nifty fifty” plan, a

trading plan in which the guidelines set out that that trades should enter harmonic patterns at 50% of the PRZ, the stops are run 13 to 34 pips outside the PRZ, the first target is a move back to the price of the B point of the original pattern and that stops should be moved to break even once the trade moves 50% back towards the targeted zone and scaling out should then begin.

Of course having a plan like this is a great start but it is not really enough. The hardest part of any trading plan is sticking to it and this is the real challenge for any trader. Ideally, in order to succeed, a plan should be tried for no less than 100 trades before giving up on it. As commitment should be shown to a personal trading plan, it is important that when it is constructed, it reflects personal visions and goals to give direction to the trading process.

A personal trading plan is not a guarantee of success, but the lack of a personal trading plan is very commonly a guarantee of failure.

Summary of Module 5

This module has focused on importance of a personal trading plan and how vital it will be to trading success.

As a personal trading plan is developed, remember to be specific and include guidelines that are realistic, measurable and time based. A trading plan should provide the guidelines to follow prior to entering a trade, through trading strategy with rules that limit risk and exposure. A personal trading plan also should include rules to follow for entering a new trade, managing that trade and after the trade has closed evaluation that trade and the progress towards personal trading goals.

Putting a personal trading plan into practice on a demo account will help to ensure success upon progression to a live trading account with real money and it should improve the likelihood of attaining personal trading goals. Every trader should take time to develop a personal trading plan before risking money in the Forex.

Module 6 — Money Management

Introduction to Module 6

An important part of personal trading plan is adhering to sound money management practices. This module will explore money management whilst continuing with the development of a personal trading plan by approaching trading on the Forex as a business, by understanding the need of sufficient capitalization, developing appropriate leverage guidelines and also developing sound risk management guidelines.

A calculator may be help in working through some of the exercises later in this module.

6.1 Approaching Trading in the Forex as a Business

Before starting to trade in the Forex, it is important to look at trading in the Forex as a business with the understanding that the goal of any business is to make money. As with any business there are ups and downs and with trading there are winning trades and losing trades. The goal of the trader is to make more money on the winning trades than is lost on the losing trades.

6.11 Account Awareness

As trading in the Forex is to be approached as a business, an important business practice that should be employed is proper account awareness.

Proper account awareness does not only mean knowing where an account is held but also knowing how much is in the account, how much is currently being committed from the account for open trades, what the floating net profit or loss is and what amount of account capital is still available for opening new trades or holding current trades. It is important to keep track of all transactions at all times

6.12 Develop a Personal Trading Plan

It is rare for a successful business not to have a business plan. Therefore one way to ensure that a trading account is being used properly is by having a personal trading plan. Having a personal trading plan in place, and following the personal trading plan, ensures that trade decisions are mechanical and not based on any emotional response to the market.

6.13 Stay Flexible

Wherever possible, stay flexible with the trading plan in as much as it is important to stick to the plan by adhering to maximum risk and exposure limits, but where possible, be flexible enough to back off from those limits if the situation calls for it. There are few, if any trades, on which a maximum should be used.

6.14 Stick to the Plan

Once a personal trading plan has been developed, it is important to stick to the plan. Be cautious though about making changes too often and instead give the plan some time to work. A few losses here or there does not mean the plan has failed it could just be volatility in the market.

6.15 Evaluate Performance

By sticking to a plan, it is possible to regularly measure how the plan is working. Only after a predetermined period should progress be assessed and this should establish if headway towards the personal trading goals is being made. If headway is not being made, the changes need to be made to make certain that personal goals are going to be achieved need to be evaluated.

6.2 Account Capitalization

When opening a trading account, it is important to appreciate the significance of sufficient capitalization. In this case, capitalization means the amount of money with which a trading account is initially established.

Proper capitalization is one of the most important factors in trading success or failure and the ability as a trader to withstand periods of drawdown.

Table 6.1 shows some of the minimum recommendations for account capitalization for these different types of account. However, the leverage set up with your broker should also be taken into account as there may be different leverage requirements for US brokers or brokers outside the US.

Account Type	Minimum
Micro	$500
Mini	$5,000
Standard	$50,000

Table 6.1

The margin required to open a trade may be higher or lower and this could directly affect the amount of free margin available when holding an open trade.

Account capitalization is also an important consideration when using a demo trading account as it doesn't make sense to practice with a million dollar trading account if in reality you are only going to be trading with $5000 of real money.

And there are a few other considerations when it comes to account capitalization such as the type of trading being undertaken. Long term traders need to be able to ride the swings of natural ups and downs of a currency, so more capital and less leverage would be necessary. Short term traders may need less capital than a long tern trader because they are typically using smaller stops and not expecting to ride out swings but they do need enough to withstand periods of drawdown.

However, perhaps the most important aspect of capitalizing a trading account is that only risk capital should be used. This means that the only funds which should be used to capitalize a

trading account are those that the loss of can be afforded. Properly funding a trading account helps to ensure to withstand those periods when the market just doesn't return gains, even when a trading plan is being adhered to strictly.

6.21 Account Drawdown

A period of such sustained losses is called a period of drawdown. The drawdown is the amount an account loses during that period.

In this example shown in Table 6.2, the opening balance on June 1st is $5000.

After a week, there has only been one winning trade resulting in a pattern of overall loss. The overall percentage of loss outweighs the gain and the account ends up with a net 25% drawdown. But, important to this example, is the fact that even though there has been a 25% drawdown, this account still has $3750 dollars and the potential to recover from those losses. So once after adjusting to those losses, for example by reducing the amount of lots needed to trade on the next trade, it is possible to begin to look as to how to recover from those losses.

Date	Profit/Loss	Balance
6/1		$5,000
6/1	-$300	$4,700
6/2	$350	$5,050
6/3	-$400	$4,650
6/4	-$300	$4,350
6/5	-$250	$4,100
6/8	-$350	$3,750
Week of June 1	-$1,250	25% drawdown

Table 6.2

After a 25% drawdown on an account, it will take more than a 25% gain to gain that back. For example, a 25% loss on $5000 equates to a $1250 loss and $3750 remaining in the account. To get back that to that original $5000 from $3750 requires a gain of 33% on that remaining $3750.

$5,000 x 0.25 = $1,250 loss
$5,000-$1,250=$3,750
$5,000÷$3,750=1.33 or 33%

A sure fire route to failure after a period of losses is to let drawdown effect emotions. Therefore, after a period of drawdown it would be folly to immediately increase the lots to get the loss back quickly, instead, this is the time to adhere to

the trading plan, which in turn leads back to proper capitalization.

6.22 The importance of sufficient account funds

Having a sufficiently funded trading account increases the chances of recovery after a period of drawdown. With an insufficiently funded account it will become much more difficult to recover from losses.

Table 6.3 illustrates how the same drawdown of $1250 affects the overall account balance and then the subsequent percentage of recovery that will be needed to gain back those losses. What this shows is that if an account does not start with sufficient capital then the likelihood of recovery is severely hampered.

Mini Account Capitalization	Balance after a $1,250 Drawdown	Drawdown Recovery
$5,000	$3,750	33.3%
$4,000	$2,750	45.5%
$3,000	$1,750	71.4%
$2,000	$750	166.7%
$1,500	$250	500%

Table 6.3

6.23 Be prepared for losses

As it is unrealistic to believe that losses will never happen, a key factor in proper account management is to have a plan that prepares for these losses.

Every trader at some point experiences a period of drawdown. But the key is how you will prepare for those periods. A properly capitalized trading account increases the chance of weathering these periods successfully.

6.3 Develop Leverage and Risk Management Guidelines

In addition to proper capitalization, an important part of money management is the development of appropriate leverage and risk guidelines.

6.31 Leverage

Leverage allows a trader to fully control a large amount of currency in a trade without being required to fund the full amount of the trade. It is important to realise that regulations can change from time to time and may be different from what are shown in table 6.4 below.

Account Type	Amount controlled per lot	Margin req'd per lot at 50:1	Margin req'd per lot at 100:1	Margin req'd per lot at 200:1
Micro	$1,000	$20	$10	$5
Mini	$10,000	$200	$100	$50
Standard	$100,000	$2,000	$1,000	$500

Table 6.4

As can be seen in table 6.4, with a standard account, the amount controlled per lot is $100,000. If the leverage set up with the broker is 50:1 the margin required from the trader is $2000 to control that $100000. If the leverage set up is 100:1 then the margin required per lot from the trader is $1000 dollars to control that $100,000 standard lot. So as you can see the $ amount required from the trader, also known as the margin, depends on the leverage level set up with the broker.

Typical leverage levels are- 50:1, 100:1, 200:1 or 400:1. The higher the leverage level, the smaller the amount required from the trader. Leverage is a multiplier that increases the trader's ability to control a high amount of volume in the market.

The level of leverage is usually set up by the broker when a trading account is opened.

Account Type	Account Balance	Volume Controllable at 50:1	Volume Controllable at 100:1	Volume Controllable at 200:1
Micro	$500	$25,000	$50,000	$100,000
Mini	**$5,000**	$250,000	**$500,000**	$1,000,000
Standard	$50,000	$2,500,000	$5,000,000	$10,000,000

Table 6.5

As can be seen in table 6.5, if a mini-account was opened with $5000 dollars, leverage of 100:1 provides the ability to control $500,000 of volume in the market. This is because at 100:1 leverage the margin required is $100 per lot traded on a mini account. With $5000 dollars in that mini account $5000 divided by $100 per lot equals 50 lots. 50 lots at $10,000 control will leverage per lot equals $500,000 controlled.

Now just because it is possible to expose an account to such a level or risk does not mean that an account ***should*** ever be exposed to that much risk. Overloading an account to the maximum increases the chances of receiving a margin call. With a good trading plan the margin will never exposed to this amount of risk.

Indeed, it is recommended that total exposure in the market at any time is limited to a volume no greater than 5 times the account balance. By using this prudent approach, open trades can be better managed thus allowing greater flexibility. Using minimal leverage reduces the amount of risk that the account is exposed to and promotes sustainability. Establishing and adhering to risk guidelines in relation to leverage is an integral part of Forex trading success.

Here are some examples of how controlling volume controls the amount of exposure placed on an account balance.

Example 1

This scenario involves a mini account with $6000 balance. The trading plan guidelines limit the exposure to 5x the account balance which is $30,000, $30,000 divided by $10,000 control per mini lot limits trading to a maximum of 3 mini-lots committed to all open trades at any one time.

Whilst this example looks at a mini account, the same rules can supply to a standard trading account as can be seen when trying to establish the number of lots that should be committed to all open trades in the following example:

Example 2

A standard account has a balance of $40000 dollars and exposure guidelines are set at 5x account balance,

$40,000 x 5 = $200,000
Therefore $200,000 is maximum volume to expose the account to in the market.
$200,000 ÷ $100,000 controlled per lot = 2 standard lots
Therefore, 2 standard lots are all that we would want to commit to open trades at any one time in this scenario.

The margin requirements may vary depending how the account is set up with the broker. Some may offer 200:1 or even 400:1 but by increasing the leverage, exposure is also increased since lower amounts of leverage are required per lot.

It is recommended that if available, at leverage option of least 100:1 is used, and a guideline of using 5 x account balance is used to limit market exposure as this will mean you are better able to manage your open trades allowing for greater flexibility. This reduces the amount of risk that the account is exposed to and thus helps promote sustainability.

The goal in any good trading plan is to maximize profits and minimize risks. Even during periods of drawdown this helps you live to trade another day.

6.32 Risk Management

Appropriate risk management guidelines should be developed in the same manner in which leverage guidelines were. Risk generally means the amount of money that is acceptable to be lost if trading is unfavorable. Two different risk guidelines should be developed. The first should determine the maximum that will be ever be risked in a single trade. The second should determine the maximum total risk that will ever be taken when in multiple trades simultaneously.

In terms of what an acceptable amount of risk is, it really is something different for every trader based on personal risk appetite. However, ideally, no more that 3% should be risked on any single trade.

Establishing and adhering to risk guidelines is integral to Forex trading success.

Consider the following example of implementing a single trade risk guideline:

Lots Traded	Pips	Risk
1 mini	150	$150 ($1 per pip per mini lot)
3 mini	50	$150 ($1 per pip per mini lot)
5 mini	30	$150 ($1 per pip per mini lot)

Table 6.6

Example 3:

In this example, with a $5000 account, risking no more that 3%, the acceptable loss equals $150 dollars. As show in table 6.6, one mini-lot, $150 equates to 150 pips, at 3 mini-lots it equates to 50 pips.

If a possible trade entry is being considered and the acceptable stop for that trade would be 75 pips, it will be necessary to adjust the lot size to be within the parameters of the acceptable loss guidelines of $150. In that case, with this example, only two lots would be appropriate.

Ideally, when holding multiple trade entries, ideally, no more than 6% total of account balance should be risked at any time for all open trades.

Consider the following example of implementing a multi trade risk guideline:

Number of Trades	Lots Traded	Pips Per Trade	Risk
2 (1 mini lot each)	2 mini	150	$300
3 (1 mini lot each)	3 mini	100	$300
2 (3 mini lots each)	6 mini	50	$300

Table 6.7

Example 4:
In this example, risking 6% of $5000 for all open trades equates to a maximum of $300 risk.

However, whether the risk being taken is 3% in a single trade or 6% on multiple trades, it is important to remember that these would be considered **maximum** acceptable losses and this does not mean that on every trade, every time, maximum risk or exposure should be used whatever the trading context. To this end, each trade has unique characteristics and as a trader it is necessary to determine if the maximum risk is appropriate on any particular trade.

Consider the following examples of implementing trade risk guidelines:

Example 5:
The purpose of this example is to establish the maximum number of lots that are available to trade.

A mini-account has a balance of $10,000 and, following the guidelines of risking no more than 3% on any one trade, 3% of $10,000 gives a maximum single trade risk guideline of $300.

Based on the analysis of a pending trade, this trade will require a 50 pip stop. 50 pips is equal to $50 per mini-lot since 1 pip is equal to $1. The $300 maximum risk divided by $50 mini- lots gives 6 mini-lots.

Therefore, 6 mini-lots is the maximum number of lots that should be risked for this trade.

Example 6:
In this scenario the account balance is $8000 and of this, $400 dollar risk is associated with open trades.

A new opportunity has been found that requires a 40 pip stop.
Using the guidelines of a maximum of 6% total risk at any one time, what would be the maximum number of lots that could be traded on this new trade?

With an account balance is $8000 and risk guidelines limit of 6% total trading account over all trade, that gives $480 total risk available overall.

As $400 is already committed to open trades, that leaves $80 which can be risked. A 40 pip stop equals to $40 per mini-lot at $1 per pip in a mini-lot. So $80 divided by $40 per mini-lot gives 2 mini-lots that are still available to risk on a new trade opportunity.

6.33 Implementing Guidelines in Trading Scenarios

Now that the components of risk management and leverage guidelines have been developed, it is worth exploring some trade scenarios to explore how they are implemented.

A trade plan should include set guidelines for both appropriate leverage and sound risk management. Appropriate leverage guidelines will limit the total exposure of trading account to the market to five times the account balance. Sound risk management limits the risk that can be placed on trades to 3% for any one trade or 6% for a total of all trades. This is the total $ amount of account margin that may risk being lost if the trade does not go as expected.

By having these guidelines in place, the chance that emotions will take control of trading is reduced. It is important to apply these guidelines to each and every trade being considered.

The maximum risk should be used about as often as a car is driven at maximum speed which is almost never. Remember – less is more!

The following scenarios will use the account set up showing in the following table 6.8:

Account Type	Amount controlled per lot	Margin req'd per lot at 100:1*	Profit/Loss per pip per lot*
Micro	$1,000	$10	$0.10
Mini	$10,000	$100	$1.00
Standard	$100,000	$1,000	$10.00

Table 6.8

In table 6.8, the amount of volume controlled for each account type, the margin required or the dollar amount gained or loss per pip is shown. Remember that these are nominal values for margin required and pip gain or loss and they may be different depending on the broker and the currency pair being traded.

Example 7:
In this scenario the account being traded is a mini-account with $8100 with no trades currently open. Analysis of the GDP USD indicates a potential entry that after assessment requires a 50 pip stop. Using the stated parameters and the exposure and risk guidelines developed above; determine the trade feasibility and the number of lots that you would commit to this trade.

The account balance is $8100.

Maximum exposure guidelines would limit a new trade entry to 4 mini-lots.

Maximum risk guidelines would limit the lot trades to 5 mini-lots.

In any trade scenario the decision should be to use the guideline that is most restrictive. In this case the decision would be to enter the trade with a smaller 4 mini-lots as indicated by exposure guidelines.

However, it would also be possible to enter the trade with a lower amount of mini-

lots thus leaving some margin in reserve for any other trade opportunities that may arise.

Example 8:
Trading in this example is on a standard account with a balance of $41000 and no trades currently open. Analysis of the GDP USD chart indicates a potential trade entry that, after assessment, would require an 80 pip stop. Using the stated parameters and the exposure and risk guidelines developed above, which are the same for any account type, determine trade feasibility and the number of lots which you would commit to this trade.

The account balance is $41,000 and maximum exposure guidelines would limit a new trade to about 2 standard lots. Maximum risk guidelines would limit lots to be traded to about 1.5 standard lots. From these calculations, the risk guidelines give a limit of a maximum of 1.5 standard lots to be traded. If the broker dealing station allows for trades based on fractions of lots, the decision could be to enter the trade with 1.5 standard lots. If not, 1 standard lot would be the maximum that should be risked on this trade opportunity.

6.34 Important Reminders

It is important to remember that a trading plan should include guidelines for both leverage and risk management and that by following a sound trading plan exposure can be limited, enhancing trade manageability and promoting successful sustainability.

Trading guidelines should be applied to each and every trade limiting the chances of trading based on emotions.

Leverage and risk management guidelines are interconnected. The first priority should be to follow the more conservative of the two guidelines, the guideline that calculates the smallest number of lots per trade should be the one considered first.

Summary of Module 6

Forex trading is a business and the goal of any business is to make money.

To have a successful business trading business, it is important to have a business plan or a trading plan in place to ensure that trade decisions and risk management are mechanical and not based on emotional response to the market.

When shaping a personal trading plan, as with any successful business, the plan should be written out, followed and evaluated as trading goes along. The trading plan should be revisited from time to time to see trading goals are being met.

A trading account should be sufficiently capitalized, if this is not possible at this time, it is better to wait until it is before starting to trade

The trading plan should include sound risk management practices that take into account maximum risk on a single trade or all open trades and maximum leverage to limit account exposure.

Disciplined use of money management guidelines promotes success.

Adhering to a personal trading plan will increase the chances of success as a Forex trader.

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