You have probably heard about the 'Camarilla Equation' by now, and how Day Trading is made easier by it. Discovered in 1989 by a semi-legendary bond trader called Nick Stott, it is allegedly a secret day trading formula that will help your day trading reach new heights of accomplishment, with the bare minimum of risk. Or so the story goes. But what about the reality? We have investigated the Camarilla Equation thoroughly, and can now report on the truth behind this amazing phenomenon.

Origins of the Camarilla Equation

camarilla. cam·a·ril·la. A group of confidential, often scheming advisers; a cabal.[Spanish, diminutive of cámara, room, from Late Latin camera. See chamber.]

Discovered while day trading in 1989 by Nick Stott, a successful bond trader in the financial markets, the 'Camarilla' equation uses a truism of nature to define market action - namely that most time series have a tendency to **revert to the mean**. In other words, when markets have a wide spread between the high and low the day before, they tend to reverse and retreat back towards the previous day's close. The Camarilla Equation uses some complicated mathematics to pluck 8 levels out of thin air, using nothing more than yesterday's open, high, low and close. These levels are, frankly, astounding in their accuracy as regards day trading, even to seasoned traders, who know all about support and resistance, pivot points and so on. Despite popular fiction, the principles of the mathematics required to produce these levels are known to a number of people and organisations around the world, most notably SureFireThing.com , who supply an online Camarilla Equation calculator for day trading at probably the lowest cost available anywhere. There are a number of other sites purporting to supply the equation, but we cannot vouch for any of them, as none would give us a free trial!.

Camarilla Equation Levels

The Camarilla Equation produces 8 levels from yesterday's open, high, low and close. These levels are split into two groups, numbered 1 to 4. The pattern formed by the 8 levels is broadly symmetrical, and the most important levels are the 'L3' and 'L4' levels. Traditionally, while day trading, traders look for the market to reverse if it hits an 'L3' level. They would then open a position AGAINST the trend, using (according to the 'classical' rules) the associated 'L4' level as a stop loss. More modern theory suggests setting stoplosses that appear to you the trader to be prudent, and to not even open the trade until it has penetrated the level in the 'right' direction, i.e. demonstrated that it has found resistance (or support). In the case of the higher L3 level, this would mean that price had already reversed and pushed back down thru the level, heading south.

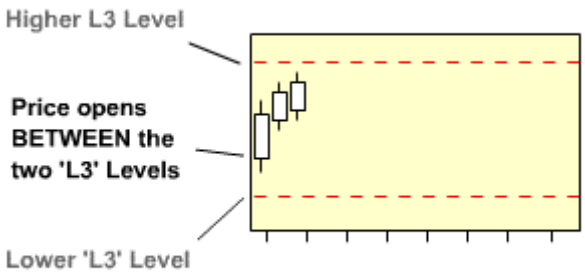
The second way to try day trading with the Camarilla Equation is to regard the 'L4' levels as 'breakout' levels - in other words to go WITH the trend if prices push thru either L4 level. This essentially covers all the bases - Day Trading within the L3 levels enables you to capture all the wrinkles that intraday market movement throws up, and the L4 breakout plays allow the less experienced trader to capitalise on relatively low risk sharp powerful movements. Here's what it looks like in action:-

Trading with the Camarilla Equation

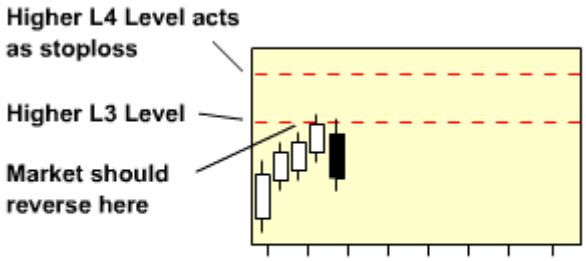
Trading with the Camarilla Equation is discretionary - although the main 'philosophy' of the system seems mechanical, a reasonable amount of experience and knowledge is needed to trade the equation well. Basically, you give the Equation yesterday's open, high, low and close. The Camarilla Equation will then give you 8 levels of intraday support and resistance. There are 4 of these 'L' levels above yesterday's close, and 4 below. They are numbered L1, L2, L3 and L4. The important levels to note are the 'L3' levels, where you take action, and the 'L4' levels that act as your stoploss points. How you specifically enter a trade depends to a great extent on the way the market opens.

Market Open INSIDE 'L3'

If the market opens INSIDE the L3 levels (i.e. BETWEEN the higher L3 and the Lower L3), you must wait for price to approach either of these two L3 levels. Whichever L3 it hits first determines your trade.



If the HIGHER L3 is hit, the idea is that you go SHORT (against the trend) in the expectation that the market is about to reverse, with the higher 'L4' level acting as your stoploss point.



SureFireThing, however, would recommend that you wait for price to bounce back down into the L3 level again before entering the trade, as you will therefore be technically trading WITH the short term trend. A fair amount of experience is needed for this style of trading. The opposite, of course applies if the LOWER L3 level is hit first - wait for it to come back, then go LONG.

Market Open OUTSIDE 'L3'

In this case, you wait for the market to retreat back thru the L3 level - you will then be trading WITH the trend, and once again, the L4 level acts as your stop loss. Taking profits is a matter of personal judgement - just be aware that you WILL want to take profits at some time during the day, because the market is unlikely to 'behave' and stay right-sided for your trade. These reversals from L3 appear to happen as often as 4 times out of 5 during intraday trading.

Trading Breakouts with the Camarilla Equation

The L4 levels, although used initially as 'stoploss' levels for reversal trades off the L3 levels, are actually phenomenally good 'breakout' levels themselves. If price pushes up thru the higher L4 level, the chances are it is going to keep on running that way. Our own research indicates that in such a breakout on the S&P, a move of up to 7 points can be expected, which is, as you will understand, a VERY significant proportion of a typical day's volatility.

Running with the breakout

As the equation specified no levels outside L4, knowing when to exit the trade becomes highly subjective. This is where SureFireThing's '{b}' version of the Equation becomes useful, as the 'profit target' of the {b} version seems, in our experience, to be quite a good level to watch for the move to falter. Taking profits here might often be a prudent course of action, as once your money is off the table, the worst that can happen is that you earn some interest on it! Stoplosses, of course are also subjective - we find on the S&P that 2 points or less is usually sufficient. Once again, SureFireThing's '{b}' version supplies a suggested stoploss, which seems to actually be quite a good suggestion in our experience.

In this example from the FTSE (The UK equivalent of the S&P) on 1st July 2003, the breakout is clearly signposted downwards, as is the suggested profit target. This particular breakout uses the levels from the {b} version of the equation, which usually correspond quite well to L4.

They say a picture is worth a 1000 words - below is a chart from 21st May 2003, showing what levels the Equation predicted (thanks to SureFireThing.com for permission to reprint this image) and what actually happened on that day.

A Classic 'L3' Day.

As you can see, the market respected the L3 levels very well, and gave an opportunity to make a double digit profit on the day. Our research leads us to believe that such opportunities are not, in fact, rare, but rather the usual state of affairs. Once again, thanks to SureFireThing for permission to reprint this image.

THIS IS NOT THE WORK OF SPREADTRADE2WIN, I HAVE COMPILED THIS AS A REFERENCE ON HOW TO USE THIS EQUATION.