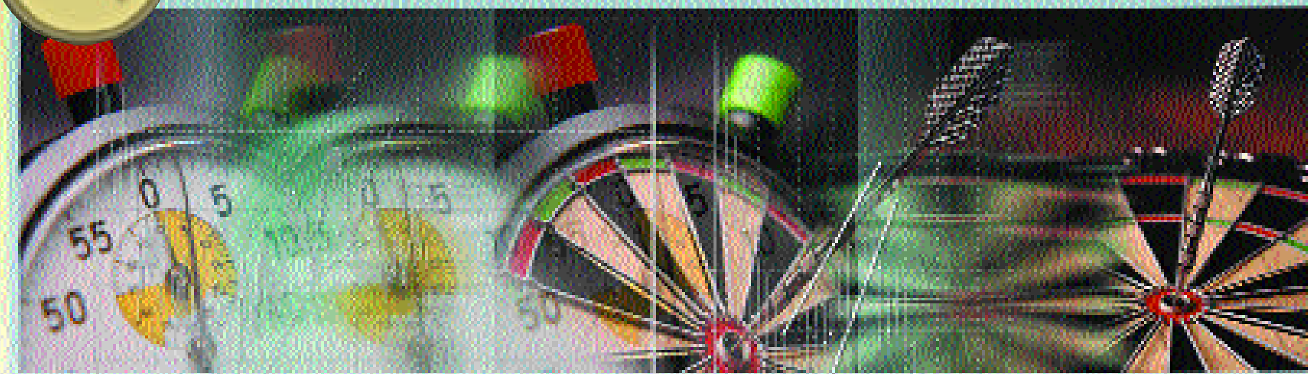


BY CHRISTOPHER TERRY

Multiple patterns, MULTIPLE TIME FRAMES

Converging patterns on different time frames can help pinpoint trade opportunities. This approach shows you how to set up these trades and take profits when opportunity arises.

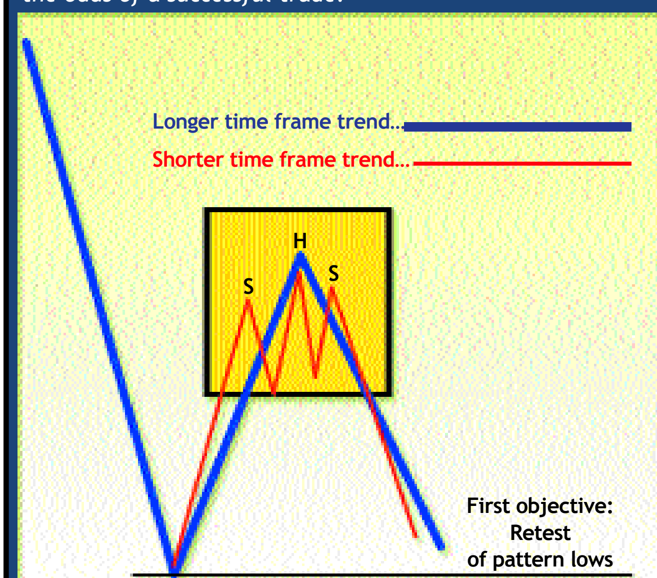
A number of classic chart patterns provide the two components necessary for profitable trading: an entry point and an exit point (either a stop-loss point or, hopefully, a profit target). You can raise the reliability of your trading using patterns by applying a multiple time-frame approach.

Such an approach uses two time frames, e.g., one-minute and five-minute, 15-minute and 60-minute, or daily and weekly. The longer time frame defines the direction of the trend. The shorter time frame establishes the pattern and trigger for the trade. The key is to look for a continuation or countertrend pattern on the longer time frame and then drop to the shorter time frame to find a reversal chart pattern for trade management.

Consequently, this approach trades in the direction of the longer time frame trend but against the shorter time frame trend, as shown in Figure 1 (above). The longer time frame (blue line) first trends down, retraces the first decline, and then retests the low. During the retracement a reversal pattern — a head-and-shoulders top — develops on the shorter time frame. This is the pattern we use for entry and risk management.

FIGURE 1 MULTIPLE TIME FRAMES

Finding a shorter-term reversal pattern within a longer-term pullback or continuation pattern can improve the odds of a successful trade.



There are a number of patterns you could look for on the longer time frame; the best for this scenario is a flag or a countertrend channel. Dropping to a shorter time frame (red line), a reversal pattern, such as a head-and-shoulders top, often appears at the end of the retracement.

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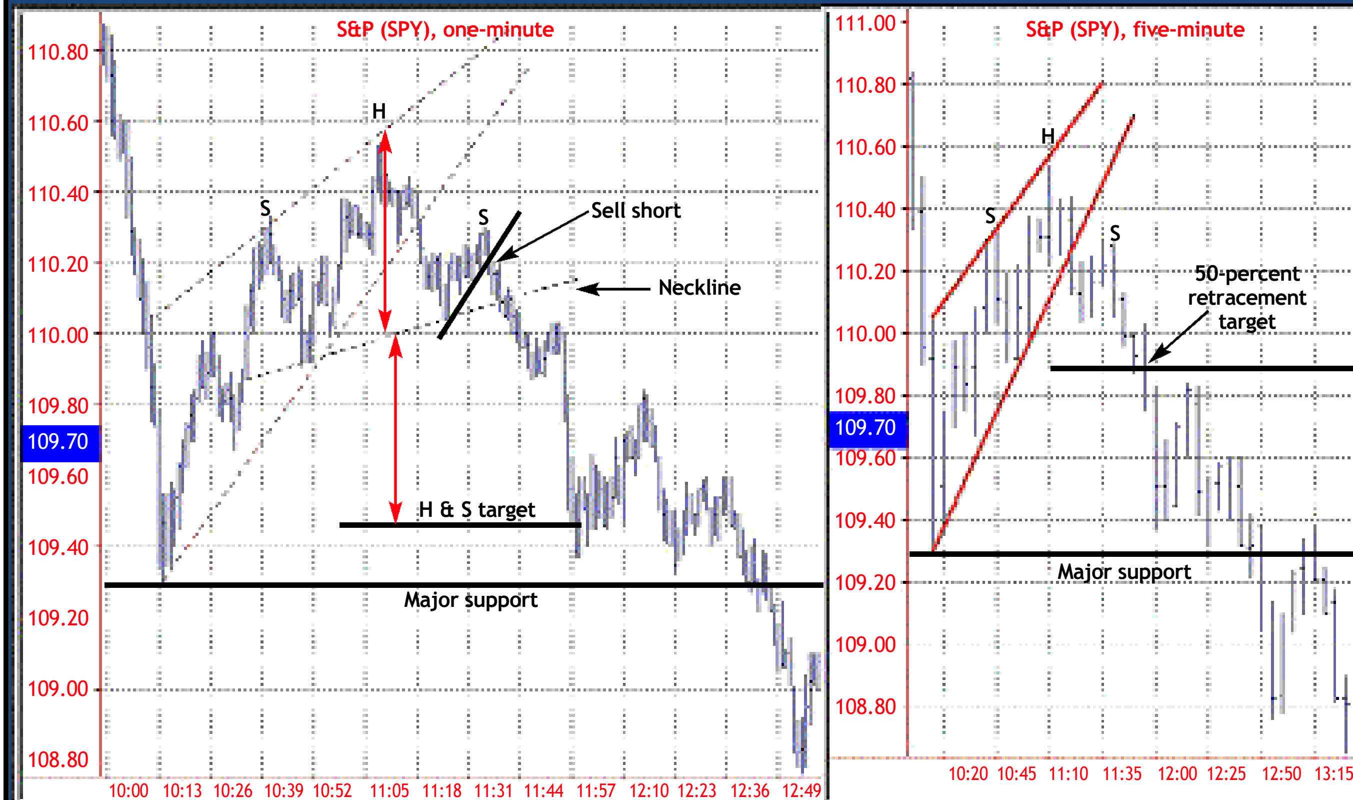
FIGURE 2 ADDITIONAL CONFIRMATION

Entering on a breakdown through the shorter-term trendline of the right shoulder of the H&S pattern provided a second confirming indication of downward momentum.



Source: TradeStation by TradeStation Group Inc.

The game plan

Figure 2 (above) shows an example using one-minute and five-minute charts of the Standard & Poor's tracking stock (SPY). The five-minute chart on the right has formed a rising channel pattern, and the one-minute bars on the left traced out a head-and-shoulders top pattern (a reversal formation). Together, they offer a strong combination for entering a trade.

If you were just following the five-minute chart, you would have most likely gone short as prices fell through the lower trendline of the upward channel at 11:20 a.m., which was not a bad entry. However, the H&S pattern provides confirmation the market is most likely done rising and the downtrend will reassert itself, which reinforces the trade's reliability. You can enter the trade after the development of the right shoulder at 11:36 a.m. In this case, you look to go short as price breaks the up trendline drawn along the lows of the right shoulder. A break of the *neckline* (the trendline connecting the lows of the patterns shoulders) is confirmation the pattern is complete and a harbinger of lower prices.

Look for continuation or countertrend patterns on the longer time frame and then drop to the shorter time frame to find a reversal pattern to manage the trade.

If you pay attention to support and resistance levels, you can see how you would look for the right shoulder to develop. First, before the right shoulder forms, it's possible to identify the resistance level for the left shoulder (110.30) and the head (just below 110.60). Once the market breaks the up trendline of the channel on the five-minute

FIGURE 3 TAKING PROFITS

Here, a downside penetration of the shorter-term H&S necklines signals a short entry. The H&S pattern also can be used to set basic profit targets.

Source: TradeStation by TradeStation Group Inc.

chart, watch for a support level for the right shoulder to form (which occurs just above 110.00 here). We would expect the right shoulder to peak in the vicinity of the resistance level of the left shoulder (110.30), which is exactly what happens in this case. By drawing an up trendline along the lows of the right shoulder, you go short when price breaks below this line; set your stop-loss just above the top of the right shoulder. (We will cover where to take profits shortly.)

Figure 3 (above) consists of daily and weekly charts of Veritas Software Corp. (VRTS). We follow the same criteria. The daily time frame (left) has an H&S pattern (reversal pattern) and the weekly time frame (right) has a rising channel pattern. Here, the daily chart shows the right shoulder is higher than the left shoulder and the neckline is rising as well. We can go short on a penetration of the neckline with a stop-loss just above the top of the right shoulder.

Taking profits

Three basic profit-taking targets can be used with this approach, giving you different levels to work with as a trade progresses. These profit targets are for short sales. The same approach, in reverse, can be used for long trades.

The first target for the pattern is a 50-percent retracement of the distance between the major low and the top of the H&S pattern. Because a 50-percent retracement would be a typical decline of the previous price move, we take partial profits at this level.

The H&S pattern also has a profit objective we can use as a target: the difference between the head and the neckline, subtracted from the neckline. The final profit target is the major low.

Use a trailing stop placed at the declining resistance levels once the trade moves in your favor.

Dual confirmation

As popular as technical indicators have become, a solid understanding of classic chart patterns analyzed on multiple time frames can provide the entry, exit and risk control structure of a solid trading strategy. Here, we have shown that the combined confirmation of two chart patterns over two time frames can signal trading opportunities near the completion of a countertrend price move. This approach offers a low risk-to-reward ratio and keeps you trading with the longer-term trend.