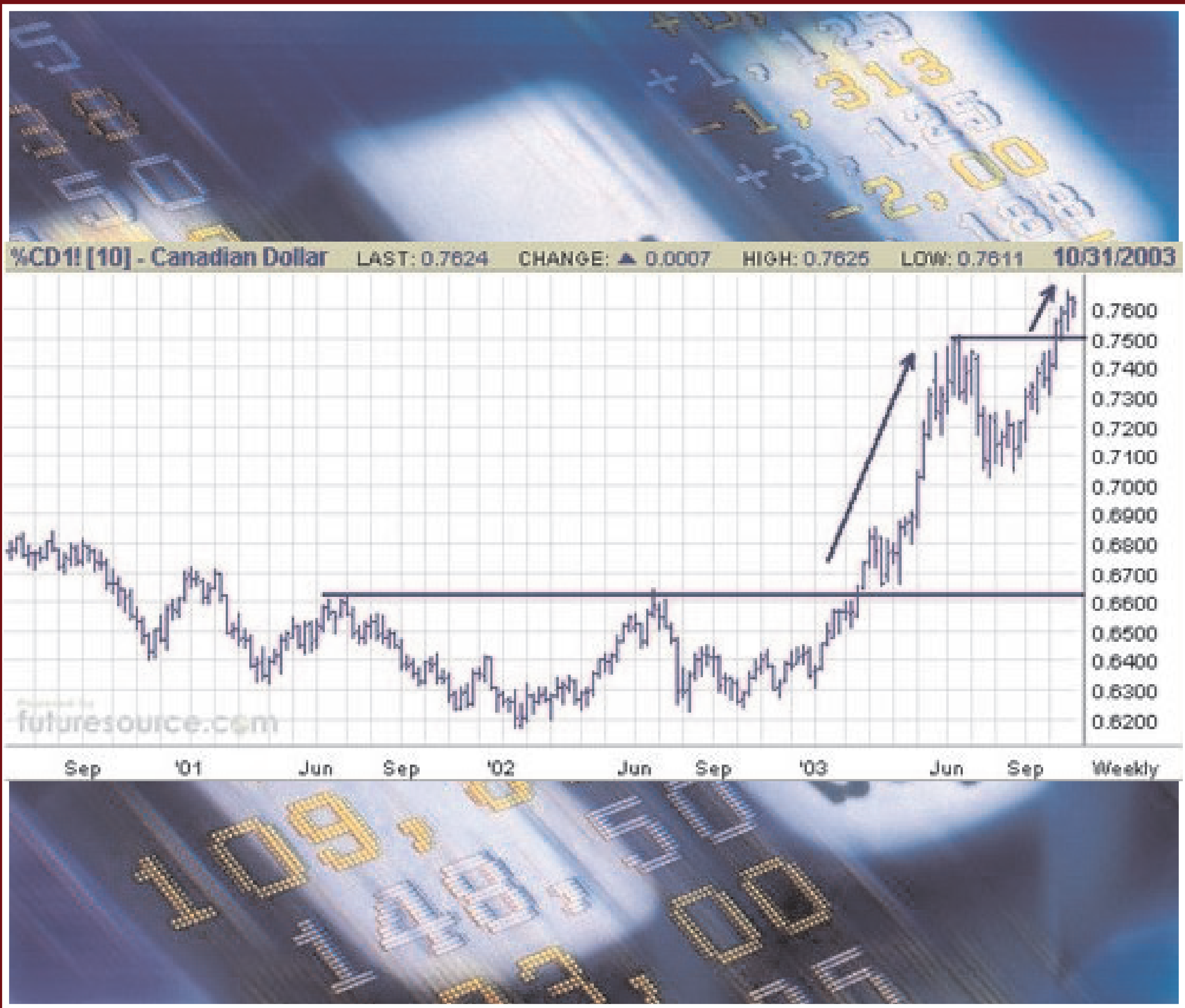
Trade Breakouts For Bigger Profit Potential



Windsor Advisory Services

An Introduction To Breakouts

Example

In today's trading world of complex technical indicators, breakout methods seems comparatively simple. Its simplicity is deceptive, in that it remains one of the most effective ways of trading, and if used correctly, you will be in on all the major moves regardless of the market traded. In fact, its simplicity makes it a tool that can be used by all traders from novices to seasoned market veterans. The logic behind breakouts is simple to understand and easy for any trader to implement. An additional benefit of breakouts is because the logic is so simple; traders find it easy to trade with discipline. This is not so with many technical indicators, or complex methods where the logic is not so easily understood. If you are going to trade any methodology with discipline, you must first have confidence in its ability to work. This is where the simplicity of the breakout method of trading is its strength. Traders understand it, and can trade with discipline, even when faced with a series of losing trades because they know the logic is soundly based and will make profits over the longer term.

Definition Of Breakouts

Trading breakouts is not a new concept; traders have been using breakouts for centuries. Today many of the world's top traders trade breakouts for big profits. So what actually is a breakout?

A breakout is the point at which the market price breaks away, or moves out of a trading range. The trading range can be for any length of time but once prices exceeds the high or low of the range, a breakout has occurred.

On the above chart when the yen breaks out, it is the start of a great up trend. It is these type of trends that all traders are looking for, as they yield the biggest profits.

Here is a potential breakout forming. Notice how resistance has been tested X 7 at the 1.18000 level making it very significant. A clear break above this level would see the odds of a continuation of the up trend being high.

Why Breakouts Work

The accepted market wisdom is "buy low sell high" and this has been taught to us in high school and is the accepted philosophy of many of the world's investment community, from economists to brokerage houses. The theory sounds fine, but it is very difficult to make money trading this way. The logic of breakouts is contradictory to this accepted market wisdom and works on the premise: That in order to make money you should "buy high and sell higher" in a bull market, and "sell low buy back lower" in a bear market. So why is the traditional investment wisdom of "buy low sell high" so difficult to make money in the real world of trading? For this we need to take a closer look at price action and the attitude of the majority of investors.

Alexander Elder in his excellent book "Trading For A Living", sums up perfectly why following breakouts can give traders the opportunity to catch the big moves:

"When you identify an uptrend and decide to buy, you have to decide whether to buy immediately or wait for the dip. If you buy fast, you get in gear with the trend but your stops are likely to be farther away and you risk more. If you wait for the dip, you will risk less but will have five groups of competitors: longs who want to add to their positions, shorts who want to add to their positions, shorts who want to get out at even, traders who never bought, and traders who sold early but are eager to buy. The waiting area for a pullback is very crowded! Markets are not known for their charity, and a deep pullback may well signal the beginning of a reversal. This reasoning also applies to downtrends. Waiting for pullbacks when a trend is gathering steam is an amateurs game."

If you want to have the opportunity to make the really big money from the big moves, you need to get in at the start and follow the move. Alexander Elder implies that you risk more than on waiting for a pullback. This is true in theory, but here you have to understand that theories are of no use until they are applied in practice. In practice, history shows us that by taking what seems a bigger risk by following a market breakout is less risky than waiting for the pullback. Why? Because the probability of the trend in motion continuing once the breakout has occurred, is higher than the trend continuing after a pullback has occurred.

Why Breakouts Increase Profitability & Decrease Your Risk

Perhaps the most famous traders in the history of trading were the "Turtles". The turtles emerged from a meeting between Richard Dennis and Bill Eckhardt about whether great traders were born or made. Bill felt that he could teach people to become successful traders. Richard felt that successful trading was down to genetics. In order to settle the debate, it was decided to advertise for trading apprentices and then try and teach them to become successful traders. The students were called the "Turtles" when Dennis explained the concept by saying they were "going to grow traders like they do turtles in Singapore" They were the most successful trading experiment in history, earning an average compound rate of return of over 80%. It was proved that with a simple set of rules complete novices, with no experience, could become successful traders. The rules used were simple and included the use of breakouts in the methodology taught. While only one component of the overall plan, the breakout methodology was very important part of how the traders actually got into and held the big trends for maximum profit.

In the book "Market Wizards", there is a very good interview with Bill Eckhardt and his analysis on what made the Turtles so successful. He illustrates the point further that traders, in their desire to "buy low sell high", create risk for themselves. By doing what is conventional and comfortable for them actually means they end up missing the biggest trends, and creating a greater risk for themselves, by lowering their probability of entering at the right time and making an overall profit.

" I don't like to buy retracements. If the market is going up and I think I should be going long, I'd rather buy when the market is strong than wait for a retracement. Buying on a retracement is psychologically seductive, because you feel you are getting a bargain versus the price you saw a while ago. However, I feel that approach contains more than a drop of poison. If the market has retraced enough to make a significant difference to your purchase price, then the trade is not nearly as good as it once was. Although this trade may still work, there's an enhanced chance that the trend is turning. Perhaps even more critical, a strategy of trying to buy on retracements will often result in your missing the trade entirely, or being forced to buy at an even higher price. Buying on retracements is one of those psychological ploys that gives psychological satisfaction rather than providing any benefits in terms of increased profits. As a general rule, avoid those things that give you comfort; its usually a false comfort."

Breakouts Make Your Money Work Harder

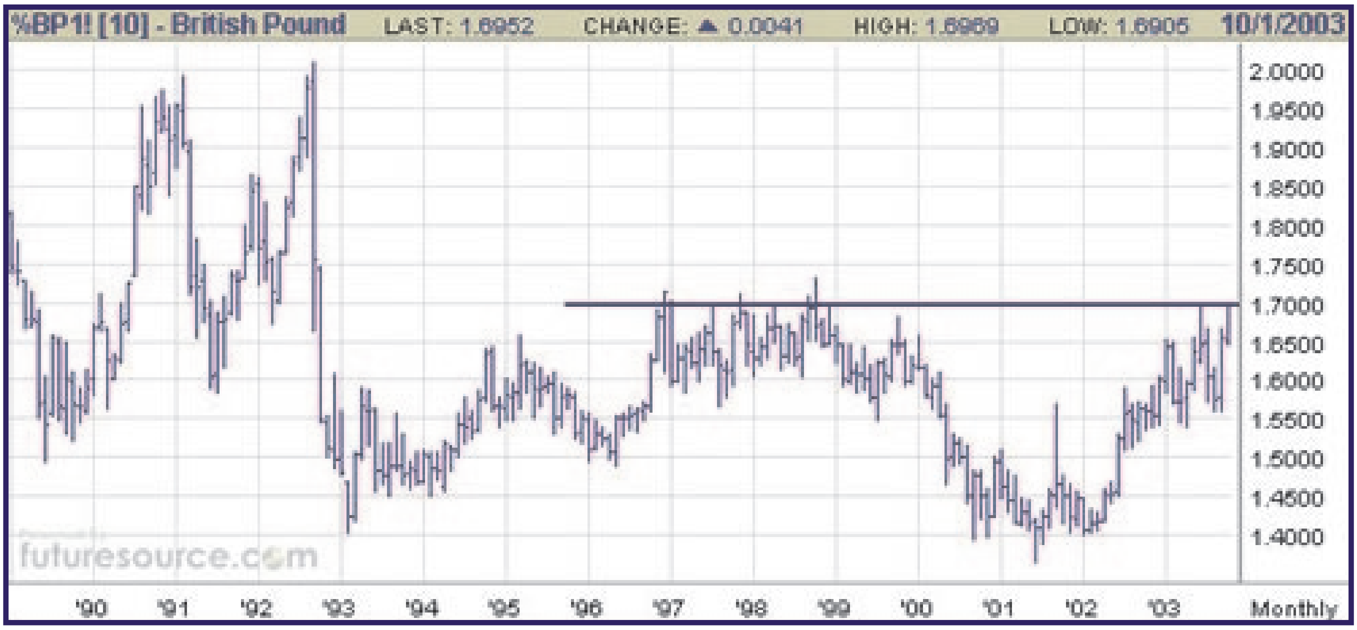
Another important reason for using breakouts, rather than buying low or retracements, is that trading capital is utilised better. It is the aim of all traders to lock into and hold trends. The fact is, however, that markets spend most of their time in trading ranges going nowhere. Many markets don't trend for months or even years. A trader who takes a trade in the anticipation that it will move, may have to wait a long time to see the trade move his way, if it does at all. This can tie up capital for long periods that could be utilised more productively elsewhere. The big advantage of breakout trading is you are only entering a trend in motion. As we all know, a trend in motion is more likely to continue than reverse. This is a basic premise that technical analysis is based upon, and breakouts get you in, as the trend emerges, and has a high probability of continuing. You therefore know you are only entering markets that have a high probability of trending strongly and making you big profits.

Validity Of A Breakout Be Selective

While many trades can be considered for trading breakouts, there are some trades that are more valid than others (which we have seen on previous examples) i.e., the probability of the breakout turning into a strong trend are greater. We need to look at some basic criteria for grading breakouts in terms of their probability of success.

1. As a general rule, the more times a line of resistance or support has been tested the more important the violation will be if it occurs. We generally never trade less than three tests.

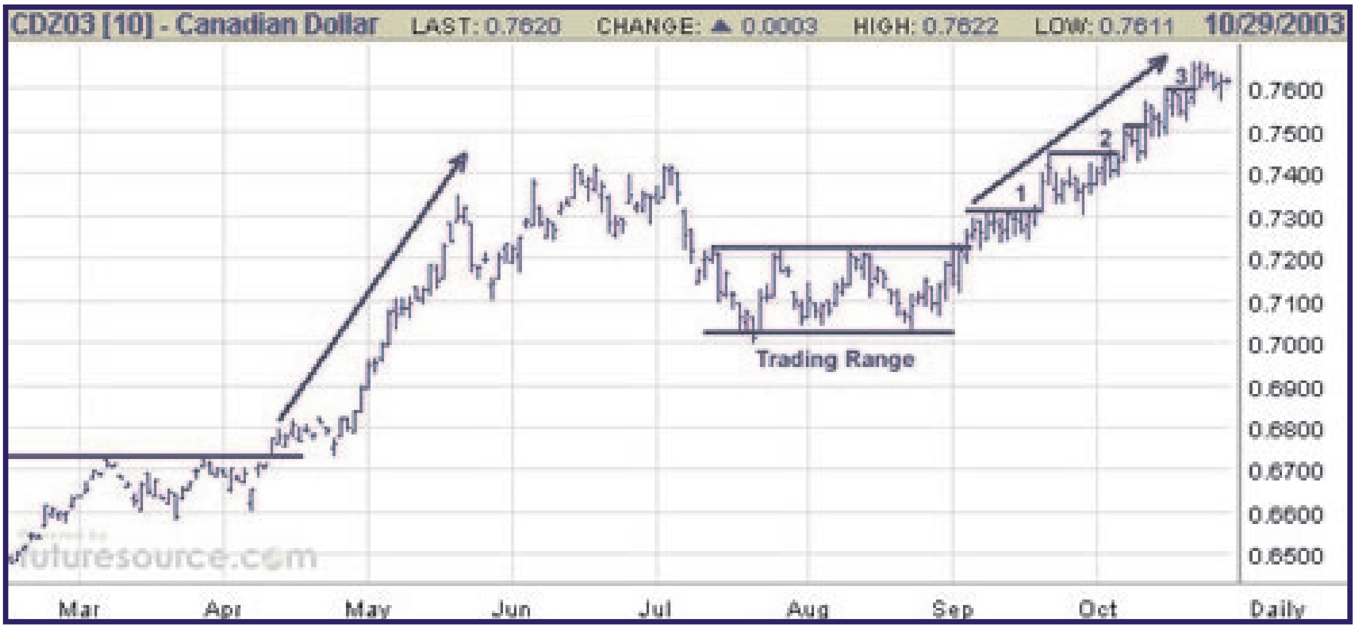
2. The time frame between the tests of resistance and support is also important and generally the longer the support or resistance has been in place, the more valid the break will be when it comes. A period of months is obviously a far more valid period than a few weeks.



Notice how the pound has had resistance at the 1.70 level since 1993. A break above this level is very valid as resistance has lasted so long, and has been tested so many times.

We saw at the start of this essay how the Yen overcame resistance on the daily chart and entered an accelerated up trend. The importance of the 8650 level can be seen even more clearly on the weekly chart where the resistance had been in place since September 2001.

When looking for breakouts, the longer term monthly and weekly charts should be looked at first and the daily chart used for timing.



On the Canadian dollar chart, you can see several uses of breakouts in a shorter time frame.

A - The initial break above resistance sees an accelerated up trend.

B - After the break and a fall the market settles into a trading range. Breaks from trading ranges tend to be highly significant, as they can indicate the end of a period of low volatility and the potential for a trending market.

C - once the trend is under way, breakouts occur in smaller time frames. 3 are indicated with a 3 - 5 tests of resistance. Once a trend is in motion, traders can use these to get into the market. They should not be used until a market starts to trend strongly.

Trading Breakouts & Placing Stops

Once a clear break has occurred, the odds are the trend will continue in the direction of the break. If the trend reverses quickly, and goes back to the breakout point rather than continuing, the break is likely to be false. Stops should therefore be at or near the breakout point.

A Simple Plan For Building Long Term Wealth

Breakouts have worked and will continue to work as they take advantage of human psychology, and the fact that the vast majority of traders are not prepared to act decisively as a potential new trend develops. The fact that breakout trading is so simple does not diminish its potential to make large profits over time. In fact its simplicity, as we have seen, is its strength, despite subtle changes in the markets. Over the years, breakouts continues to work because the underlying premise on which it is based (human nature) remains constant. There is no correlation in the market between the complexity of an indicator or method and its success. In fact, the opposite is true; most of worlds top traders who have made consistent profits have used systems that are essentially simple. Simple systems are the best because their logic is easy to understand and implement. If the system is easy to understand it is easier for a trader to execute it with discipline. There is no point in having a system unless you have confidence in it to trade it with discipline, even when faced by a losing run of trades.

Trading breakouts is a great method for catching the really big moves that can pile up big profits - that is the aim of all traders. Every trader could use a breakout system if they wanted to, the fact is they don’t, for reasons stated earlier. The fact that the bulk of traders don’t want to is the fundamental reason why they work and will continue to do so.