



## Trading A-B-C Patterns

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Many trend trading techniques rely on a breakout of price, that is, price continuing to move in the direction of the trend with uninterrupted momentum. However, price tends to ebb and flow back and forth within the larger trend which can in turn offer up other low risk entry points that are not as recognizable as a pattern or resistance breakout. Then benefits can be twofold; reduced slippage, especially when a line of resistance is extremely obvious to all market participants, and secondly reducing the risk of buying at an overextended point of the price swing. Indeed more often than not we can often get in very early to a potent part of the trend and execute a perfect swing trade.

The downside to the pattern is its a little more complex to pick up, especially using computer scans, so eyeballing the charts tends to be more beneficial if not slightly more time consuming. However, if you already eyeball charts each and every day these patterns will start to jump out at you. Next we'll add some basic rules in order to place as much objectivity on the setup itself as well as the ongoing trade management; in fact on going trade management is extremely easy.

So what is an A-B-C pattern? It's a 3-wave counter trend move normally associated with Elliott Wave analysis, but essentially it's a healthy pause. For our purposes we're going to be looking at these patterns in isolation, that is, we simply don't care for the larger Elliott Wave count of the intricacies of that type of

analysis. We only want to find the A-B-C patterns and trade them on their own merits. In an ideal world we also wish to trade them in the direction of the primary trend, although some of the best opportunities arise when that primary trend is on the turn.

The **Primary Trend** is **UP** when the 50-day moving average is greater than the 50-day moving average yesterday. The **Primary Trend** is **DOWN** when the 50-day moving average is less than the 50-day moving average yesterday.

Nothing complex in this and usually a quick glance at the chart will suffice in determining the trend.

The next part of the setup is the pattern itself, the A-B-C. There are a myriad of guidelines for defining these but the rule of thumb is 'keep it simple' If it looks like a 3-wave counter trend move with some decent symmetry, then it probably is. If you need to ponder and guess whether it's a 3-wave counter trend move, then it probably isn't. Remember, the profits aren't made by the pattern. The pattern is simple a comfortable way to enter the trend. Nothing more.

**Basic A-B-C Guidelines:**

1. 3-waves against the prior advance
2. Waves –A and –C tend to be the same length
3. The depth of the counter trend should fall between 35% and 70% of the prior thrust.
4. Symmetry of time should also be balanced

Don't get too hung up on all these being in place to perfection. We're traders, not perfectionists, but the key rule is, "when in doubt, stay out". There are plenty of these patterns around so you can afford to stand aside if you're unsure.



### Chart 1:

The application of the trend indicator clearly shows that Alliance Resources (AGS) is in an uptrend. We don't have to look too hard to see this.

Can you see the A-B-C?



### Chart 2:

In my book Adaptive Analysis I discussed the use of Swing Percentages that measure the distance from highs to lows based on a percentage of the underlying price. It enables us to group market noise into families. This chart shows all swings above 15% and removes the noise of any swing below 15%.

It also shows a clear A-B-C pattern!

At this juncture we do not know whether the market will continue to trade higher or whether it will meander about or even fall. We're not in this game to make

forecasts; we're in it to assess probabilities and create a positive expectancy. Our pattern here allows us to find a comfortable entry point yet more importantly define specifically at what point we're wrong so we can cut our losses.



### Chart 3:

David Jones (DJS) shows a clearly defined trend as well as an A-B-C pattern. In this example the pattern is seen easily using a 5% swing. The percentage swing will differ from stock to stock depending on volatility but will also change over time as the personality of the stock changes. The correct swing level is found when you remove much of the small noise and are left with the cleaner swings.

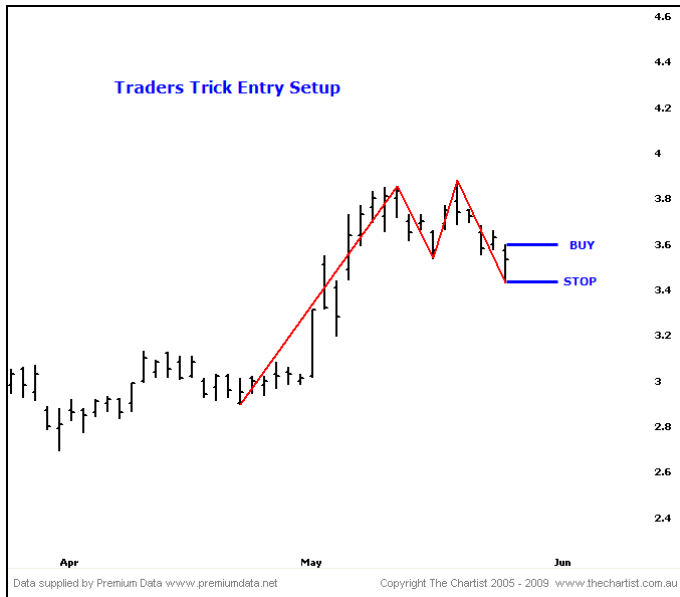
Next is the entry which is an area that I have studied for some time and taken the time to watch how others do it, after all, trading an A-B-C pattern is not something new. There are basically two schools of thought when entering; aggressively trying to pick the absolute low point using the Traders Trick Entry (TTE) or taking a slightly more conservative approach to allow a little more wiggle room.

The Traders Trick Entry (TTE) enables the lowest risk on the trade and will therefore allow the highest risk adjusted reward. However, it will also create a lower win rate because it is apt to being stopped out prematurely on market noise. Only the cleanest patterns will offer the best trades.

I'm not going to recommend the TTE but we'll discuss it anyway as it may suit you better. The TTE attempts to pinpoint the low of the A-B-C pattern, specifically

the exact bar that makes that low. I stress again that we can't know ahead of time that this bar will be the low, but we will amend the entry each day until the pattern is triggered or it's invalidated.

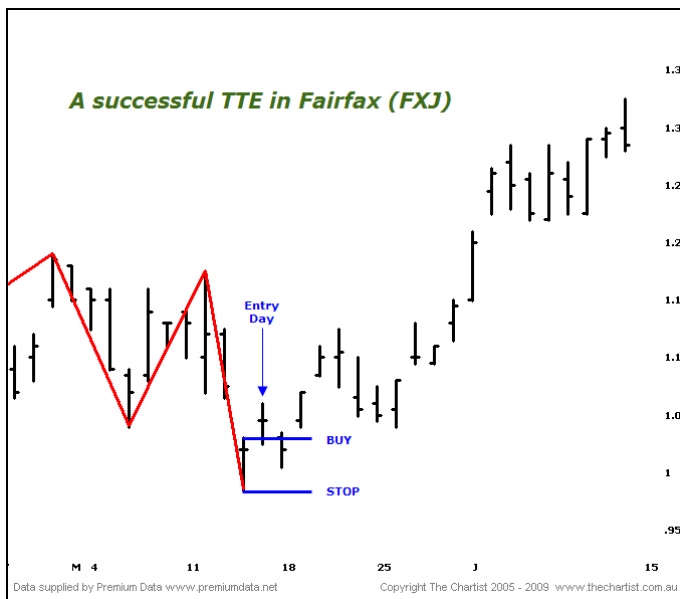
Consider again our chart of David Jones (DJS):



#### Chart 4:

When wave-C nears its expected end point we will place a buy order 1c above the high of the most recent bar. If price swings up through that high tomorrow we will enter long. If price makes another lower high tomorrow, we will amend the entry down again until price swings higher.

Place the protective stop 1c below the lowest low.

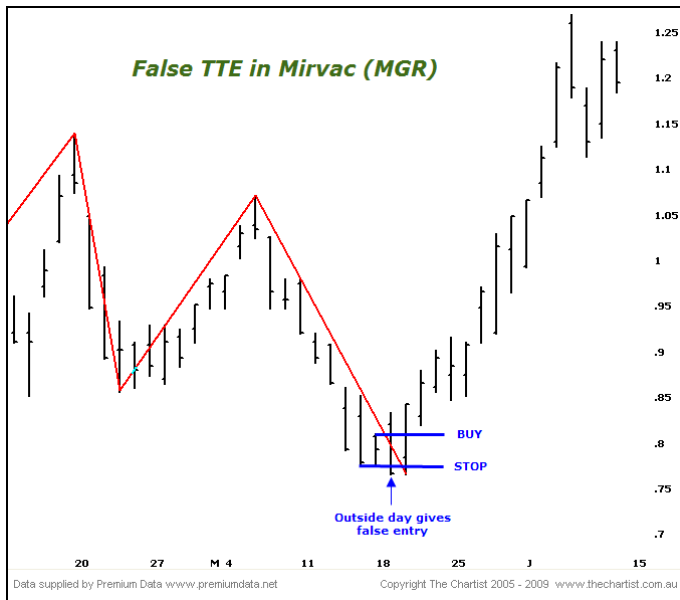


#### Chart 5:

Here is a great example of why the TTE can offer large risk adjusted returns. The reward for this FXJ trade is just shy of 6x the initial risk in a short space of time, and it may be even more in due course.

But they're not always this clean...

They're great when they work and in hindsight you can always pick up the better examples and somehow neglect the ones that don't quite work out. When using these low risk setups we must be ready for a lower win rate but also be prepared to stay with the setup in case it remains valid for the next trading session. Too often one can get annoyed with the initial stopped trade and forego the next signal, even when it's just as valid as the one prior.



### Chart 6:

May 18 showed a perfect low risk TTE setup in MGR with a tight inside bar and a close off the lows. The next day price jumped out through the May 18 highs triggering the TTE, but then reversed to make a new low and stopping us out.

On May 20 price again jumped with a perfect TTE and the trend remains nicely in place with a nice 6x risk/reward.

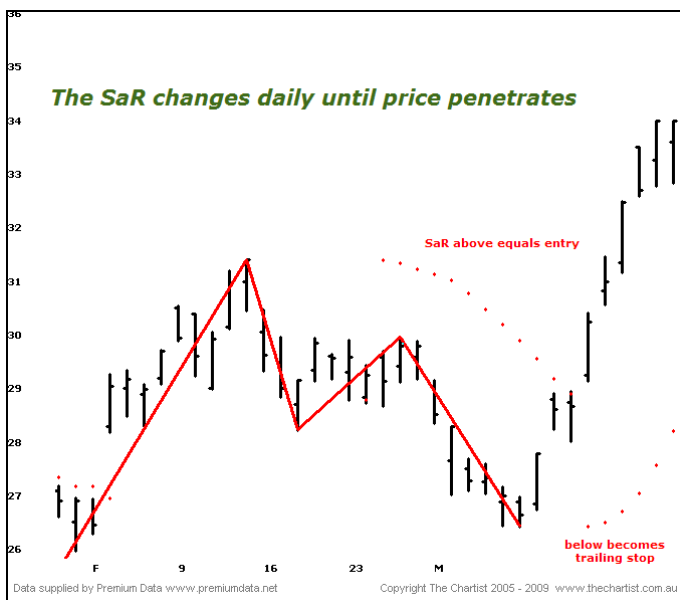
Whilst the TTE is certainly a valid entry mechanism and will provide very large risk adjusted rewards, it may not be for everyone as the win rate will drop below 30%. To increase the winning rate we need to allow a little more wiggle room which leads us to another simple, yet effective and objective entry trigger, the Parabolic SaR.

The **Parabolic SaR**, was created by Welles Wilder and is based on the relationship between a market's price and time. It is primarily used in trending markets and is based on always having a position in the market, however, the indicator may also be used to determine stop points and estimating when you would reverse a position and take a trade the opposite direction. The indicator derives its name from the fact that when charted, the pattern resembles a parabola or French curve.

The Parabolic SaR is usually found on all decent Technical Analysis packages and incorporated with most Broker platforms. The only input is known as the Acceleration Factor (AF) which is almost always set to a default of 0.02 and rarely changed. We're not going into detail about it here, sufficed to say that there are plenty of references from a Google search should you wish to look into more.

**The SaR will serve as our entry trigger level as well as our trailing stop.**

When applied to the chart the SaR will appear as a small series of dots above and below price. When we see the A-B-C correction the SaR above will become the entry level. Once triggered, the SaR will switch below and then become our trailing stop.

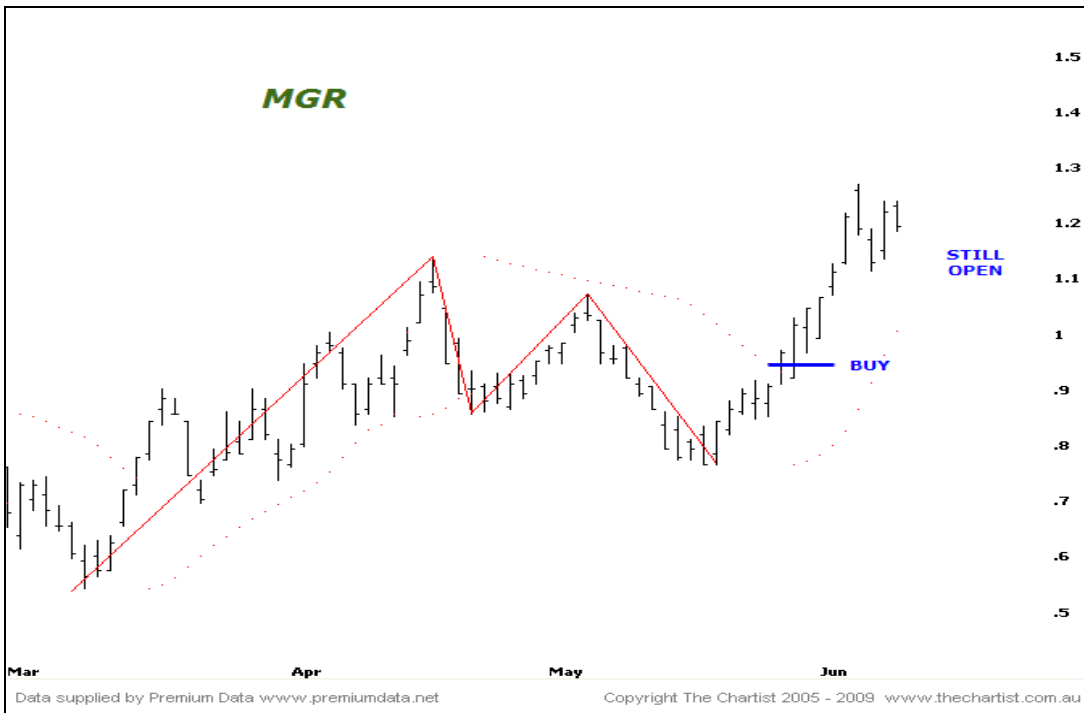
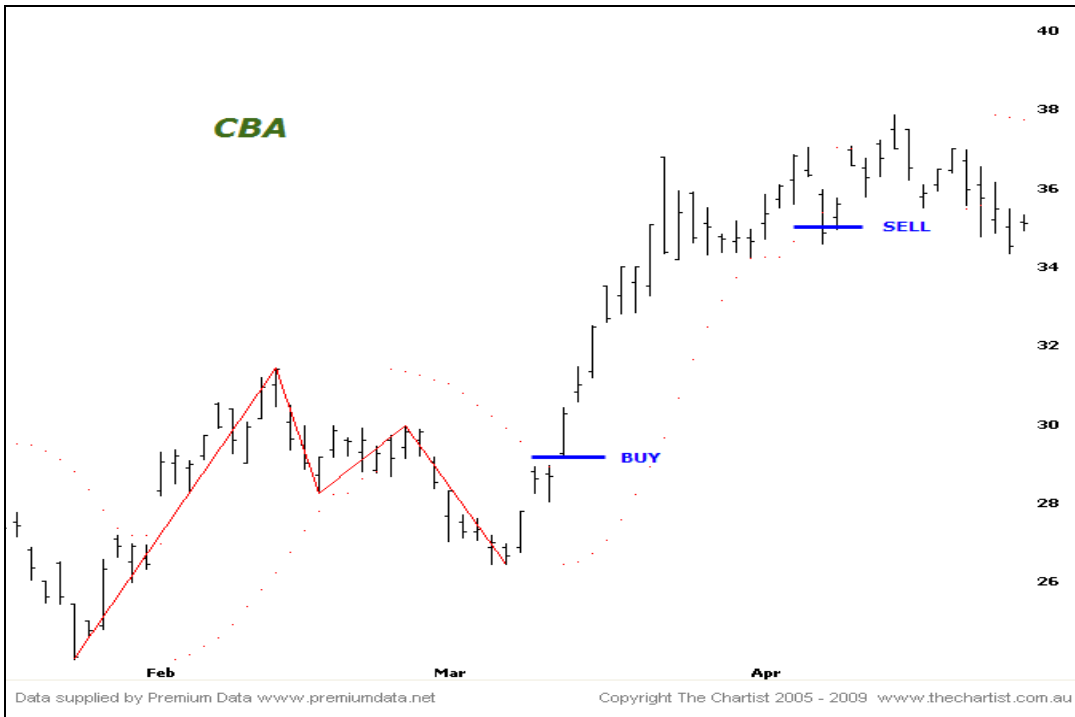


#### **Chart 7:**

CBA shows a classic A-B-C pattern followed by an upside penetration of the SaR. As the entry level changes daily we must amend our order appropriately.

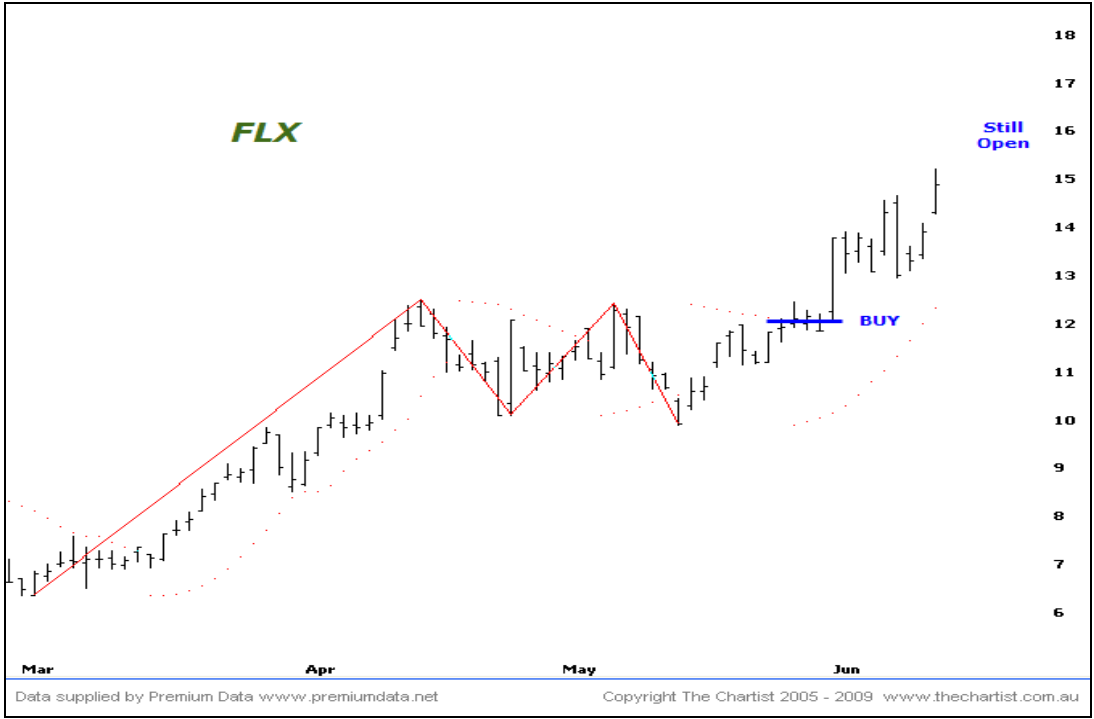
Once triggered the SaR 'flips' below price and now becomes our trailing stop for the ride higher.

The benefits of using the SaR entry allow better confirmation that the next swing higher has started as well as offering some buffer from market noise. Whilst we will get a higher winning percentage we will usually not get large risk adjusted rewards like the TTE.









One of the most difficult aspects is finding these specific patterns so I use MT Predictor, the only software package designed to scan for A-B-C corrections quickly and efficiently.

Now that you understand how to trade these patterns with some objectivity you will find more opportunities from our normal nightly analysis and well as bring them to you in the Power Setups area.