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Best-selling Author of *Options Made Easy* and *The Bible of Options Strategies*

Volatile Markets Made Easy

Trading Stocks and Options for Increased Profits

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Foreword

All through my career, I have been fascinated with the technical approach to trading. At first, I was convinced that technical patterns predicted the future.

I studied the masters—Gann, Elliott, and techniques like Fibonacci—and began to apply the principles to my trading. When I trade full time, I draw my own charts. What I found was that technical analysis could explain the past but not the future.

However, I found that the technical approach could and did help me find winning trades. And even better, it helped me to exit the trade without giving back my profits. Guy Cohen has articulated in eight chapters what I spent 30 years to learn.

Volatile Markets Made Easy is not just a book; it is a full course of instruction. The student will discover so many gems of knowledge that will help with their trading throughout his or her career that this book will never be far away.

Technicians can make their language confusing and difficult to understand. That is what I call job security. In *Volatile Markets Made Easy*, Guy Cohen simplifies the terms and gives the reader a road map that is easy to follow and less, well, technical.

Follow the principles clearly expressed in these pages and you will trade with greater confidence and, in my opinion, trade more profitably.

There is only one reason to trade and that is to win, make money, and enjoy a lifestyle like no other. Take command; follow the guide in the chapters before you. It will be a rewarding journey.

—Ned W. Bennett
CEO/Cofounder, optionsXpress, Inc.
March 16, 2009

Preface

In June 2008 the S&P 500 fell by 125 points, and the Dow Jones 30 Index fell by 1350 points. Several of my students more than doubled their money during that same time. They did it by using the techniques and strategies contained in this book.

This book is about making money. That's my job here, to help you make money by trading the financial markets.

This is a down-to-earth book aimed at helping anyone who doesn't have the advantage of trading within the bid-ask spread, who typically places trades via an online or full-service broker or in some countries via a spread betting firm. This book is for all private investors. There are wonderful texts for mathematicians—I've read a good number of them—but this book does not aspire to be one of them. My goal is to provide you with a sense of how to trade profitably from the principles I outline.

There's a big secret that I'm going to share with you. You *can* make money trading the markets, and you can do it by using these methods. But until you wholeheartedly embrace the concept of *wealth psychology*, you won't have cracked it to your fullest potential. What's more, until you have adopted the right mindset, not just for trading but for creating wealth as a whole, there exists the potential for a "retracement" for want of a better expression. How many times have you heard of people making fabulous fortunes only to blow it a few months or years later? Lots! And you may personally know a few like that too. I know I do.

As the title suggests, this book focuses on how to make money from strategies that take advantage of volatility in the markets. I should distill this further by saying that we're talking here about profiting primarily from *increasing* volatility. The strategies contained here will all put you in a "long" position whereby your risk will always be limited and definable. In other words, the strategies in this book will make you a net buyer of options. As such, your upside will typically be unlimited. I'm not going to be addressing short options strategies here.

There are several worthy short strategies that can work over and over again month after month. However, short strategies can put you in an unlimited loss position and typically have limited upsides. I'm aware of many people who made their living by selling short options during the late 1990's tech bubble and who indeed made fortunes from doing so. But when the market turned, so did their fortunes and in many cases their livelihoods, their homes, their children's education…you get the picture.

The point is, there's plenty of profit to be gleaned with long strategies with unlimited upside and limited downside, so we'll focus on those and make sure we do them right.

For now, here's a summary of what you're about to learn in this book.

Chapter 1 is an introduction to options. If you're already familiar with this topic, you should still go through it as a review before reading the other options chapters in the book.

In **Chapter 2** I explain my preferred technical chart patterns and why I like to trade them from a practical viewpoint. This chapter is focused on my favorite patterns and is not intended to be an almanac on all the chart patterns known to man. The aim is to be crystal clear as to what you should be looking for and why that's such a valuable approach to take.

We return back to options in **Chapter 3** where I summarize the Greeks. The Greeks are sensitivities to various factors affecting the pricing of options. These sensitivities have a direct effect on your trading.

Chapters 4 through 6 take you through my six favored options strategies. The aim is to trade safely, profitably, and with manageable risk at all times. Only when you witness the pitfalls of a strategy can you decide whether or not it's right for you. In Chapter 6 I explain how to maximize your income return by trading options—without having to risk too much. The only way to demonstrate this properly is to show you how some traders get it wrong by exposing themselves to inordinate amounts of risk, in many cases without even knowing they're doing it.

In **Chapter 7** we run through the steps of creating a trading plan. The steps are universal for all strategies.

Chapter 8 is the most technically challenging part of the book in which I go through some of the mathematical algorithms that define the whole subject of options trading. This chapter is mathematical in nature but has a practical element to it.

Finally, in **Chapter 9** I show you how to implement a trading plan for each of the six favored strategies so you can see how the processes work in practice and what you'll need to do as you start to implement your new trading program.

What distinguishes this book from others out there is that it is completely practical throughout. This isn't a book about theory. It's real world stuff, real *trading* world stuff, that is. I focus on six strategies that will bear fruit for you if you follow the rules and adhere to the certain principles outlined throughout this book. The most successful traders stick to just a few strategies that they understand intimately. This is what you should aspire to do as well.

I sincerely hope you enjoy reading this book and profit from it. I'm committed to communicating in a practical and down-to-earth way the same qualities I bring to my workshops and software products. Trading is a serious business, but it can be enjoyable too, especially when you're organized, disciplined, and committed to following sound principles. Those principles are laid out in this book with a sense of enthusiasm, fun, and humor that hopefully you can take with you.

Good luck!

chapter 2

Trends and Flags

This chapter is focused on a couple of chart patterns that work consistently, whether in the context of trading volatility or otherwise simply as devices for improving your timing in the markets.

Before we get into the chart patterns themselves, we must understand something even more deep-rooted. The key to consistent trading is good psychology.

- One of the keys to good psychology is having a trading plan. Trading without a plan is tantamount to amateur gambling.
- The key to a good trading plan is a clear set of rules.
- The key to a clear set of rules is an easily definable chart pattern that identifies clear areas of support and resistance for entry, exit, stop placement, and profit management.
- If you're clear about all that and can stick to the rules, then you'll win—pure and simple. I've trained people with no experience whatsoever, and they're now "boringly" consistent traders who understand the virtue of being patient and take only the prime opportunities on offer.

So let's review our requirements for finding a tradable chart pattern. It must provide us with easily identifiable areas of

- Support
- Resistance

For:

- Entry
- Stop placement
- Profit management

These are all critical elements. If you only trade when you have these elements in place, your trading results will soar in the right direction, whether you're trading options, stocks, or futures.

A Common Mistake

Have you ever traded a stock where you were in a winning position? Have you seen your paper profits start to increase as the stock rose in your favor? What did you do? Did you have a plan for taking profits, or did you stay in too long? *Did you stay in too long?* Did you stay in as the stock started to fall? Did you stay in until your profits were all wiped out and you then had a loss-making situation? Did your winner end up being a loser?

Most people who have invested in the markets have been through this type of situation…on multiple occasions.

Why is it that traders stay in a position too long? Why is it that traders don't take their profits when the signs are that the stock is about to reverse?

Well, I can only go by the countless interviews I've conducted with traders and investors, plus my own early experiences. The fact is that most people don't have a consistent method of identifying suitable candidate stocks regularly in the first place! So when they suddenly find themselves in a winning situation, they tend to hang on too long, as if it's the only opportunity they're ever going to find. Does that ring a bell? Because if you did know how to find good opportunities on a regular basis, then you wouldn't need to hang around in an existing position if all the signs said "sell."

There's another key, one that I've already alluded to. That is to have a clearly defined *trading plan*. Most traders have no idea what a trading plan is. They go to seminars and read books, but they are never taught how to enter or exit their trades. A trading plan outlines your entry and exit points so you know exactly what to do in any circumstance ahead of time. In other words, every trade has a business plan attached to it.

So we need to address two disciplines in this chapter:

1. How to find stocks
2. How to create a trading plan

Benefits of this Method

To clarify why the methodology you're about to learn is so important, here are some compelling reasons to make this a serious part of your trading routine:

- Not letting a winning position turn into a losing one.
- Gaining confidence to seek out and find new opportunities.
- Exercising discipline in your trading plan methodology.
- Specializing your trading based on proven chart patterns.
- Avoiding confusion with this simplified method.
- Only entering into trades when the trend is proven and confirmed by the pattern.

When people have attended my workshops, they leave knowing how to create a trading plan, which is exactly what we're going to accomplish here in the next few pages.

The typical problems faced by traders include

- Overwhelming amounts of information
- Complexity of trading methods
- Lack of confidence in finding new opportunities
- Lack of discipline owing to complexity and lack of confidence
- Poor timing of trades
- Time constraints to learn about and then implement trades

Every trader needs to create a proper trading plan and specialize in a proven chart pattern within the overall context of a trend. By following the method, you'll discover that time no longer is a constraint. You won't be overwhelmed because the trading plan is simple to execute, thereby helping your timing. Your confidence will increase as you start finding opportunities with ease.

The first step is to identify what types of stocks we're looking to trade.

We've all heard the expression "the trend is your friend." Well, although it's a little hackneyed now, the basic premise is true. Trading in the direction of the trend is the most consistently profitable method I've seen. The trick is how to identify that a trend is actually in place. Trends can vary in time from minutes on a tick chart to years on a monthly chart.

What Is a Trend?

A trend can be defined as follows:

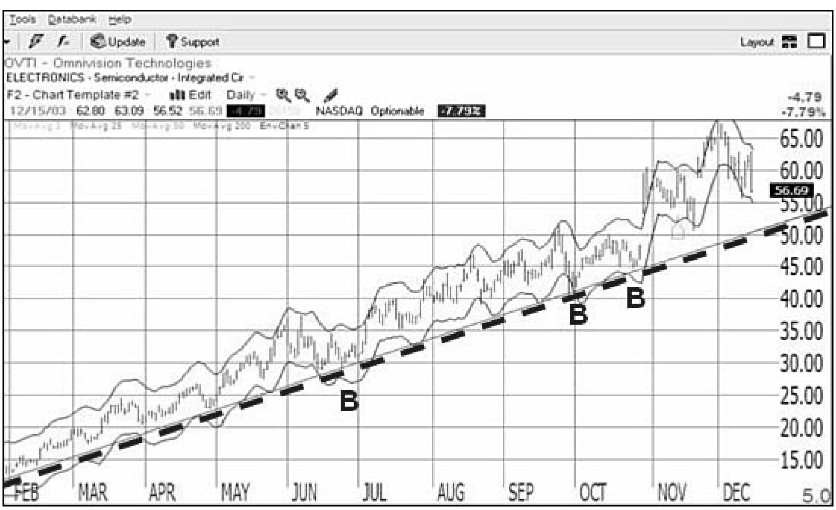
- **Uptrend**
  An uptrend can be described as a sequence of higher lows in conjunction with higher highs.
- **Downtrend**
  A downtrend can be described as a sequence of lower highs in conjunction with lower lows.

Some people define an uptrend as the point when the closing price is above the moving average (of a specific period), and a downtrend is when the closing price is below the specific moving average. I don't use moving averages of price movement to define trend, nor to source trending stocks. There are inherent challenges with only using moving averages, which I discuss next.

In my workshops I ask my students how they unearth trending stocks, and the two most common answers I hear relate to moving averages and fundamental filters. From those two answers I already know that the person concerned doesn't find trending stocks purely because moving averages and fundamental filters generally don't lead to trending stocks!

So first things first, let's look at some trending stocks and clarify why they're trending (Figure 2.1).

Figure 2.1 An uptrending stock



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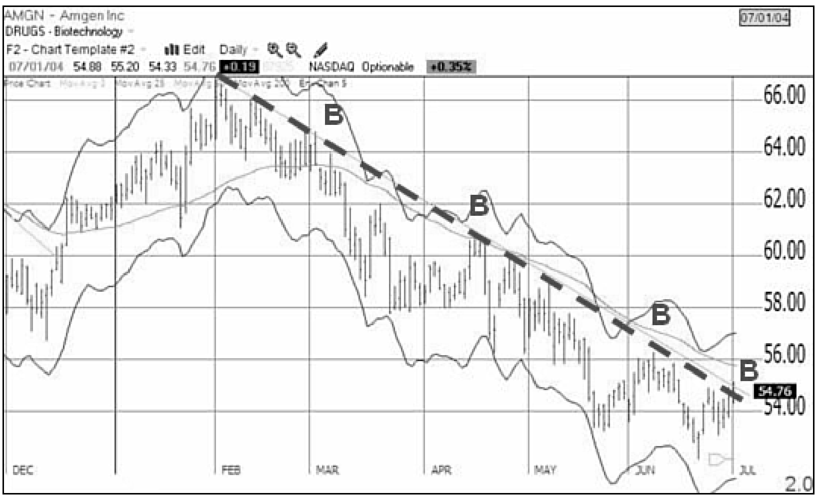
As you can see, the stock is rising and appears to keep bouncing off the imaginary trendline at the points B. This trendline is providing *support* for the stock. Typically we expect volume to rise as the price hits the trendline and bounces off it, confirming the supporting action. Notice that with an uptrend, we draw the trendline to join up the *lows*.

Sooner or later the uptrend has to be broken, and the stock will retrace downward. The beauty of using a trendline is that when the price breaks through it, we can define the trend as being over for the time being.

So far so good. Let's now look at a downtrending stock (Figure 2.2).

Figure 2.2 A downtrending stock



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Here is the opposite scenario. The stock is falling and appears to keep bouncing off the imaginary trendline at the points B. This trendline is providing *resistance* for the stock. Typically we expect volume to rise as the price hits the trendline and bounces off it, confirming the resistance action. Notice that with a downtrend, we draw the trendline to join up the *highs*.

Sooner or later the downtrend has to be broken, and the stock will retrace upward. By using a trendline we know that when the price breaks through it, we can define the trend as being over.

If this sounds easy, the reason is because it *is*! If you're looking for something more complex, then I'll show you moving averages and why they're more difficult for defining trends. You want your interpretations of trend to be made easily because it helps your decision-making process when it comes to actual trading. If your interpretation of a chart isn't clear, your trading will be equally as unclear, which will only lead to inconsistent, bad, and unsuccessful trading.

The Challenge with Moving Averages

Moving averages are the most widely known and used technical indicators. A moving average is simply the average closing price of a period of bars on a price chart. On a daily chart, a 20-period moving average is the average of the last 20 days' prices. Moving averages are useful for the way in which they smooth price action, and they are perceived by many to be good indicators of trend. The challenge, however, is in getting the settings correct, and those may change from stock to stock as different stocks will trend with different smoothness and different timescales.

The most popular way of using moving averages is to have one short term and one longer term. When the short moving average rises up through the longer term moving average, this is a bullish signal. When the short term moving averages fall down through the longer term moving average, this is seen as a bearish sign.

The problem is that this moving average crossover method is only relevant with trending stocks. And if we can't readily find or identify trending stocks, then there's no merit in it whatsoever. The other problem with it is that by the time the short Moving Average (MA crosses the longer MA, the stock price may well have plummeted or rocketed ahead of time. In other words, a moving average is a *lagging indicator*, and if the lag is too long, then the stock moves ahead without you. If the lag is too short, then there are no smoothing benefits to using the moving averages at all.

So what if the stock is rangebound or zig-zagging all over the place? Well, then moving averages aren't going to be any use to you.

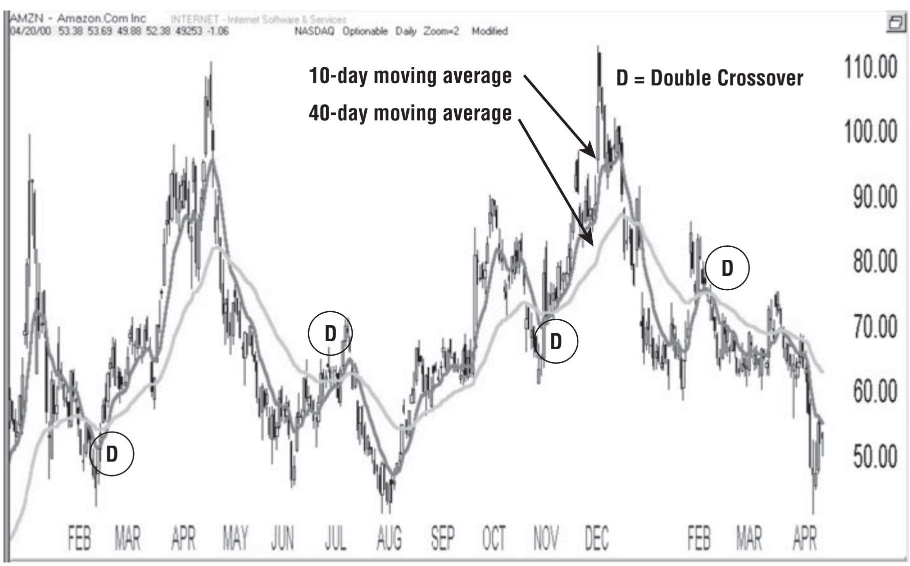
The chart in Figure 2.3 uses moving average crossovers, and the sell signal occurs a full $40.00 below the high of the stock. That's not exactly very efficient, and in the meantime the stock has been up and down in vicious swings that would send us diving for the Pepto-Bismol. Admittedly the 10-week and 40-week moving average settings here are too slow and therefore inappropriate. However, it's just as easy to get the moving average settings too fast, which then makes them equally as inappropriate.

Figure 2.3 Moving averages example

TC2000®.com. Courtesy of Worden Brothers Inc.

So moving averages are best used in the context of trending stocks. In the next example (Figure 2.4) we see how confusing the signals become when the stock is rangebound.

Figure 2.4 Moving averages double crossovers



TC2000®.com. Courtesy of Worden Brothers Inc.

Each "D" stands for "Double Crossover," whereby the moving average crossovers send a long and short signal (or short then long signal) in quick succession, resulting in losses to your account. If this happens continually, then your accounts can be eroded pretty fast! Do you now see how moving average crossovers could be something of a challenge if not calibrated correctly in each case?

Notice in Figure 2.5 that we're back into a trending situation. This time the trend is down, there are fewer double crossovers, and the position is a little clearer. But even here, (a) you still have those confusing double crossovers, and (b) you still need to understand how to *find* trending stocks.

Figure 2.5 Moving averages of a trending stock

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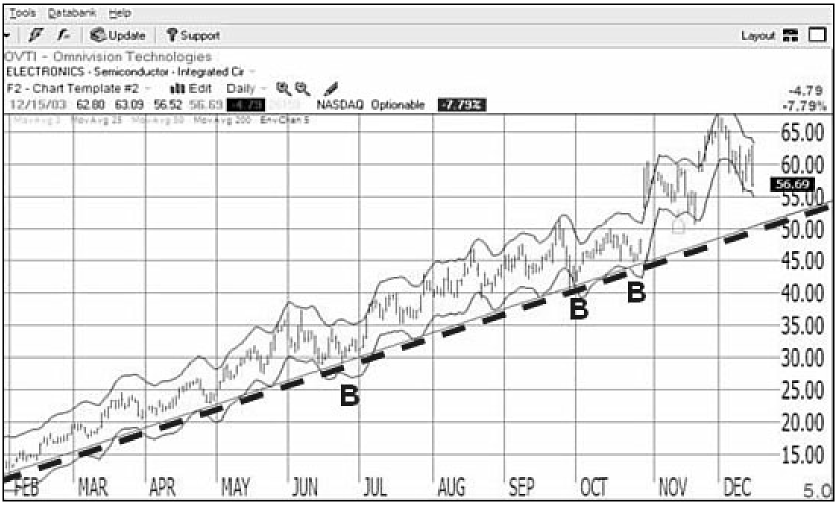
Trendlines

The easiest way to *identify* a trend is by creating a trendline for the price action. Trendlines are far more reliable and simpler to use than moving averages.

- With an uptrend, the easiest way to trade is to wait for the trendline to be hit and the price bar to bounce upward off it, continuing the uptrend.
- With a downtrend, the easiest way to trade is to wait for the trendline to be hit and the price bar to bounce downward off it, continuing the downtrend.

A break of the trendline, particularly with rising volume, may signify the end of that trend.

Figure 2.6 Trendlines



TC2000®.com. Courtesy of Worden Brothers Inc.

If the trendline is broken, particularly with an increase in trading volume, then you know the trend is over, and you can go and find another stock that meets your trending criteria. The advantage is that you exit almost immediately and the rule is very straightforward. If you were using a moving average, you might have to wait several more days until the lines cross over, and by that time you could be sitting on significant losses.

Trending stocks tend to move in steps. These steps involve thrusting moves followed by consolidation. These moves can be referred to as steps or in some cases, *flags*. A flag is distinguished by the significant thrusting move prior to the flag forming.

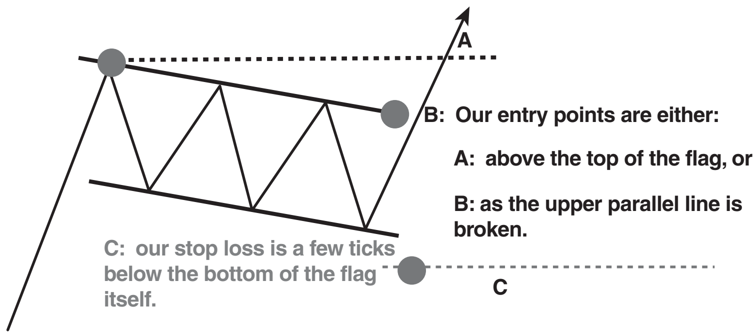
My favorite chart pattern is the flag. This occurs after a thrusting surge (the flagpole) then consolidates to form the actual flag. The thrust can occur in either an upward (bullish) or downward (bearish) direction. A flag occurs during a persistent and dominant trend and temporarily interrupts that trend before it resumes.

The flag itself consists of the price pattern rebounding off two parallel interim trendlines before breaking out in the direction of the dominant trend.

Bull Flag

With bull flags, our entry is a *buy* order, and our stop loss is a *sell* order. We anticipate a rising stock price.

Figure 2.7 Bull flag



So here we can see that we have the makings of a trading plan, and you enter your buy order at either point A or B.

Point A is at the level of the top of the flag. This is the most conservative entry point because it is where the price is making new highs. You must make sure that volume is increasing as the new high is made. Increasing volume means there is conviction behind the move, which makes it more likely to be sustainable.

Point B is where the price breaks out of the flag itself. This is more aggressive than Point A and again requires increasing trading volume to demonstrate conviction in the move.

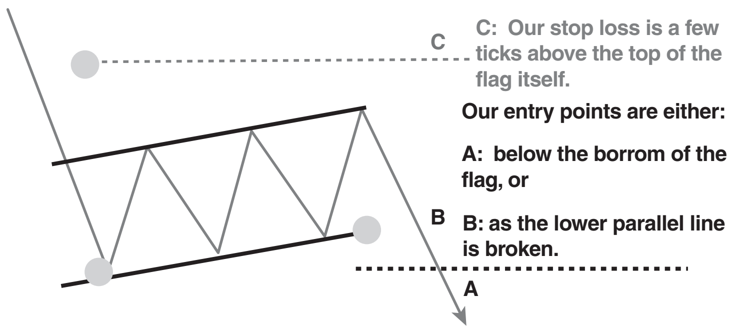
If the entry is activated, then you need a stop loss. Point C is the level where, if you were already in the trade, you'd exit with a small loss.

This is your basic trading plan for a bull flag within the context of an upward trend.

Bear Flag

With bear flags, our entry is a sell (short) order, and our stop loss is a buy order to close the position. We anticipate a falling stock price.

Figure 2.8 Bear flag



We enter our sell (short) order at either point A or B.

Point A is at the level of the bottom of the flag. As such it is the most conservative entry point because it is where the price is making new lows. You must make sure that volume is increasing as the new low is made. Increasing volume means there is conviction behind the move, which makes it more likely to be sustainable.

Point B is where the price breaks out of the flag itself. This is more aggressive than Point A and again requires increasing trading volume to demonstrate conviction in the move.

If the entry is activated, then you need a stop loss. Point C is the level where, if you were already in the trade, you'd exit with a small loss.

This is your basic trading plan for a bear flag within the context of a downward trend. You can see examples of both a bull and bear flag in Figures 2.9 and 2.10.

Figure 2.9 Bull flag chart

TC2000®.com. Courtesy of Worden Brothers Inc.

The chart in Figure 2.9 is actually a *cup and handle* pattern. These manifest themselves as flags at the end of a bowl pattern or right around a double top. If they break to the upside, two areas of resistance are broken, the flag itself and the previous high.

Figure 2.10 Bear flag chart

TC2000®.com. Courtesy of Worden Brothers Inc.

Flags Within the Context of a Trend

Now, what if I said to you, how about finding flags within the context of a trend? That means you can play the flag, knowing that the trend is backing you up. Now we're beginning to add some backbone to our trading plan.

All we have to do is draw a trendline to see if the flag is forming within the context of a trend.

In the previous two examples you could see that this is the case. The bull flag is within the context of a two-month uptrend, and the bear flag is within the context of a one-month downtrend.

Figure 2.11 Bull flag resolved to the upside

TC2000®.com. Courtesy of Worden Brothers Inc.

Figure 2.12 Bear flag resolved to the downside

TC2000®.com. Courtesy of Worden Brothers Inc.

I haven't drawn the trendlines in at the precise angles in these charts, but if they are broken by the stock price action, then you would exit the long (bull flag) or short (bear flag) positions. Similarly, to enter into the long stock position, the price would need to rise above the top of the bull flag or break up through the upper flag trendline.

To enter the short stock position, the price would need to fall below the bottom of the bear flag or break down through the lower flag trendline.

Can you see how you can make simple rules regarding the trend and flag patterns in order to create a cohesive trading plan?

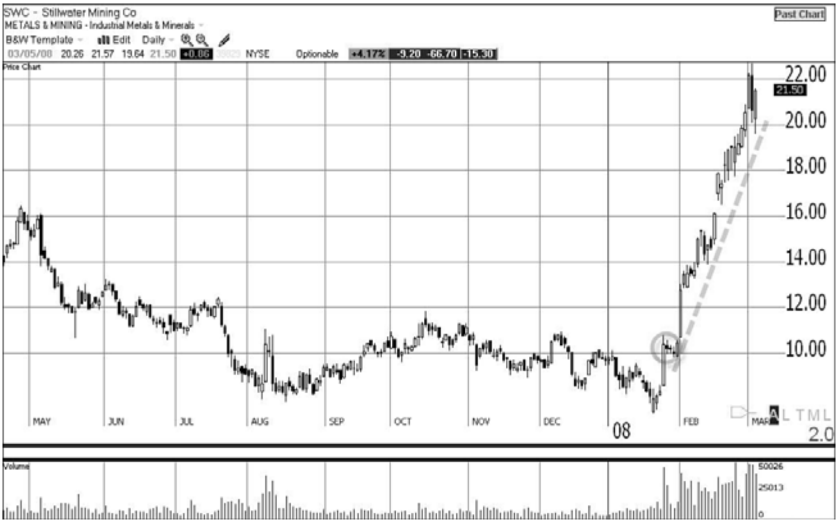
When a stock is trending, it typically does so in steps…or flags. So by identifying trending stocks, we're going to find flags too. Not all flags are in long-established trends. For example, take a look at this fantastic bull flag in Figure 2.13 that I found as the stock was emerging from a downtrend.

Figure 2.13 Bull flag in context of downtrend

TC2000®.com. Courtesy of Worden Brothers Inc.

As you can see in Figure 2.14, the stock doubled in one month after breaking out from the bull flag pattern. Furthermore, by simply drawing a trendline as the stock rises, you could manage your trade and exit with a huge profit once that trendline was broken.

Figure 2.14 Bull flag breakout from downtrend



TC2000®.com. Courtesy of Worden Brothers Inc.

Managing Your Profits

Stop losses are easy to understand and in the context of flag patterns, easy to identify and enter. However, one of the major difficulties traders have is how to manage profits. There are two areas of importance:

1. Taking partial profits or scaling out
2. Letting the rest run

You've probably heard things like "cut your losses and let your profits run." That's all well and good, but you must have a mechanism to do it. Flag patterns give you such a mechanism.

The One to One (1:1) Theory

If you intra-day trade the indices such as the S&P e-minis, then you may be aware of a pattern occurring that is known as an "equal drive" or 1:1. Supposedly the pattern originates from Elliott Wave and Gann theory, but having studied them in depth for several years, I'd stay away from them both in order to save yourself from going round in circles and getting very frustrated!

Let me save you some time right here and now. Counter to the Gann and Elliott theory, there is no pre-ordained destiny for the markets whatsoever. There are three factors that affect a stock price:

- Technical analysis (of which chart patterns, Gann, Elliott, Fibonacci, and a myriad of other techniques may be *part*)
- Fundamental analysis (the study of corporate and economic financial information)
- News (international, national, industrial, corporate, political, economic, and financial)

When news is at the fore, all the other techniques pretty much go out the window until the market returns to normal and stops over-reacting either out of panic or greed. This is why black-box trading systems never work brilliantly all the time. To be consistently successful, you need to factor in the human element for which the catalyst is a news event such as an earnings report, an economic data release, an election, or a surprise of any kind.

Back to 1:1s. The concept involved here is that a stock makes an "impulse" move in the direction of the dominant trend and then retraces before making another move in the direction of the trend.

The *theory* is that the second impulse move will keep going until it reaches the magnitude of the previous impulse move. Does this always happen? No, of course not, but we're using the theory *not* to help us enter our trades, but to help us *manage our profits*.

Figure 2.15 1:1 bullish

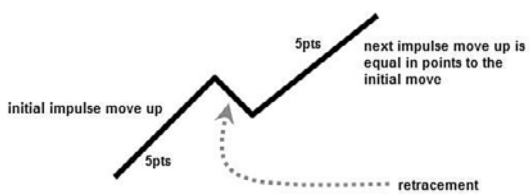
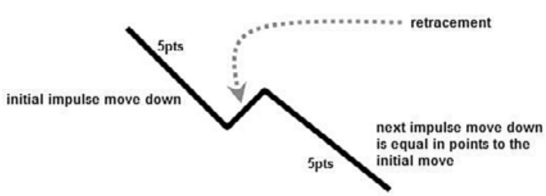


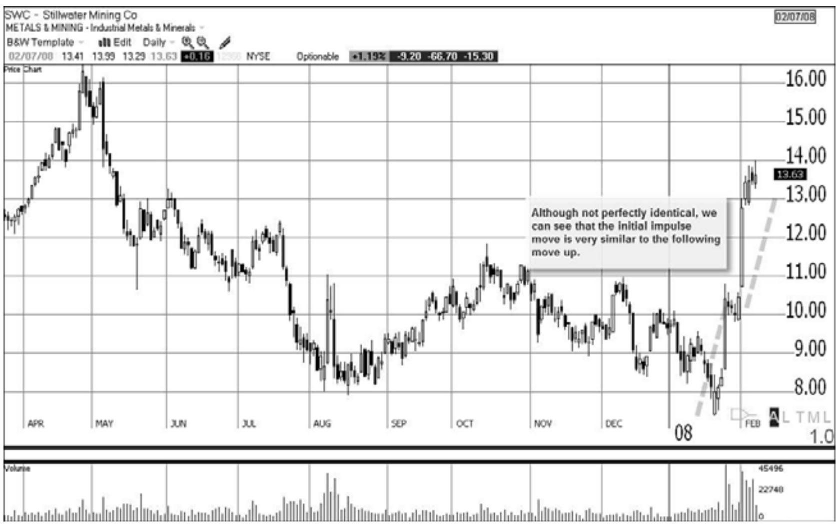
Figure 2.16 1:1 bearish



It's also feasible that the retracements themselves can make 1:1 moves, but you don't need to look at those for the purposes of managing your profits. So the question is how does the 1:1 theory help you manage your profits? Well, if we assume that the first impulse move occurs before the flag pattern, then we can project a target for afterwards if the stock price breaks out of that flag pattern in the direction of the trend.

For example, take that chart of SWC again from Figure 2.14. We can see that the second impulse move is very similar to the first move before consolidating again into the second flag pattern.

Figure 2.17 SWC 1:1 move



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Of course, who's to say how long this would continue? For our purposes we can use the theory to identify a target at which to take partial profits. The question is—at what point on the chart would you take partial profits? In my experience about 50% of the initial impulse move is a sound place to take some money off the table while letting the rest run with the trendline serving as a trailing stop.

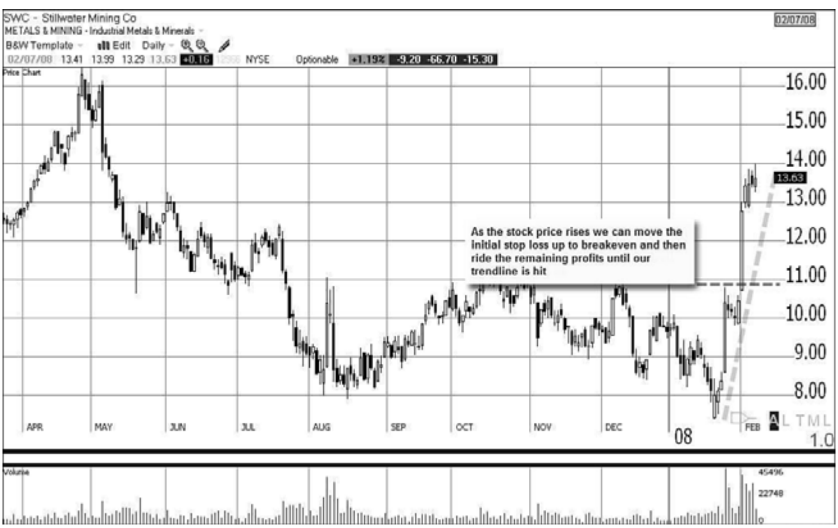
Figure 2.18 Setting profit target using 1:1

TC2000®.com. Courtesy of Worden Brothers Inc.

The trade is entered above the high of the first bull flag. The initial stop placement is just below the flag bottom.

As the stock price rises and we take partial profits, we can move our initial stop up to where we entered the trade and manage the remaining profits using a trendline.

Figure 2.19 Managing your profits by adjusting the initial sell stop loss



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It's important to note that you do have discretion over the trendline and how steep you want to make it. In the case of SWC, it's clear that the stock is making another bull flag pattern, so you may want to give it a bit more room to form the pattern and move further to the upside by adjusting the trendline and making it a bit shallower. With SWC it's quite feasible that you could have ridden this stock all the way to $20, almost doubling your money in just over one month.

Figure 2.20 Managing your bull flag profits by using a trendline

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The same works exactly in reverse for bear flags.

Figure 2.21 1:1 with downtrends

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As with the bull flags, we don't know how long the next impulse move will be, but our objective is not to try to predict the future. It's to employ a method to take partial profits and let the rest run in an organized and controlled way. Please don't fall into the trap of trying to predict the future. You'd be doomed to fail, sentencing yourself to a life's work that sends you round and round in circles. I've been there, so be warned!

You're going to look to take partial profits when the new impulse move reaches 50% of the previous one. You let the rest run with the downward trendline serving as your trailing stop.

Figure 2.22 Managing your bear flag profits

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In this example we're assuming that we see the trade on February 13. We place a sell stop limit to open at just under $15.00 (the low of the flag). Our initial stop loss is just over $16.00 (the top of the flag area), and we set our first target for partial profits at around $13.50, which represents a downward move of around $1.50, which is around 50% of the previous impulse moves downward.

Figure 2.23 Managing your profits by adjusting the initial buy stop loss

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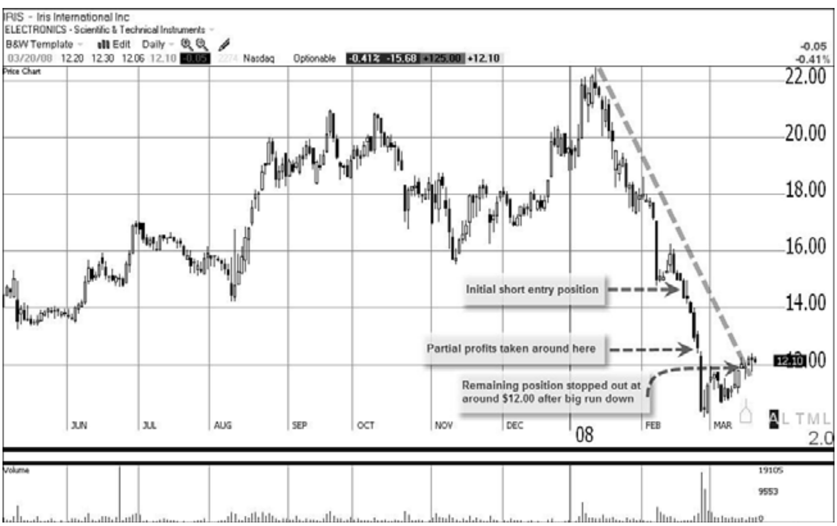
As the stock price falls in your favor, you can move the initial stop down to where your entry order was so that you put yourself in a no-lose position; in other words, "moving your stop to breakeven."

Figure 2.24 Using a trendline to exit a profitable trade



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We can see here how we took partial profits at the 50% mark (around $1.50 down from our entry point, making our first target around $13.50 as our initial trade entry was just below $15.00). The remainder of our position is stopped out at a profit as the stock bounces up and hits our trendline at around $12.00.

Rounded Tops and Flag Failures

What happens when a flag pattern doesn't do what it's supposed to do? There are two things that can happen:

a. The flag forms, breaks out, triggers your trade, and then immediately comes back and stops you out for a small loss.

b. The flag forms but doesn't break out, and your trade isn't triggered.

Case (a) is pretty straightforward. You know that you're not guaranteed a profit from the outset, but you can contain your risk to just a small amount.

Case (b) is interesting in that you can't make a loss in such a scenario. Remember you're entering a stop order to enter the trade. Therefore, if it isn't triggered, you cannot make a loss.

Let's take two examples of the same stock, BWLD. On October 2, the stock is forming a perfect bull flag, as shown in Figure 2.25.

Figure 2.25 BWLD bull flag (i)

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So far so good. It resolves itself to the upside, and you're in profit, having been triggered into the trade at around $38.90. On October 10, another bull flag starts to form. So if you missed the first one on October 2, you have another chance here on October 10, provided the high of the flag is exceeded, preferably with rising volume.

Figure 2.26 BWLD bull flag (ii)

TC2000®.com. Courtesy of Worden Brothers Inc.

The top of the flag is $42.12, so if the stock reaches, say $42.25 with rising volume, then we’d like to be in the trade. However, take a look at Figure 2.27 to what happens next.

Figure 2.27 BWLD rounded top

TC2000®.com. Courtesy of Worden Brothers Inc.

It never gets going and forms a rounded top pattern. Your order is never executed, and so you neither make nor lose money. This is one of the key benefits about flag patterns. Often when they don't work or are not going to work, you don't lose anything at all.

Let's now look at an example of a bear flag that doesn't get going. Using BWLD again, the bear flag is perfectly formed on March 14, but you should also notice that it's a double bottom, so that would give you a warning sign. If the stock breaks the previous low in January, then that's a stronger signal than merely breaking the low of the current flag.

Figure 2.28 BWLD bear flag

TC2000®.com. Courtesy of Worden Brothers Inc.

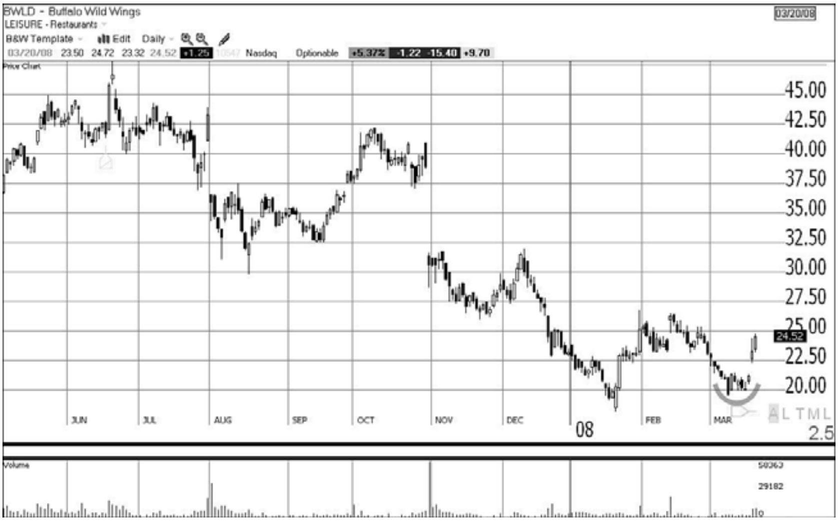
In order to be triggered into the short trade, your choice is that either the stock breaks below the current flag low, say around \$19.50 (as the actual flag low is \$19.63), or it has to break below the January low of \$18.25.

Figure 2.29 shows what happens next.

The stock gaps up, the trade isn't triggered, and yet you don't lose anything. That's a great result when what you anticipated doesn't materialize. Although this isn't perfectly formed in this particular example, just as we can get rounded tops from bull flags, we can also get rounded bottoms from failed bear flags.

Isn't it great that you can be wrong and still not lose anything?

Figure 2.29 BWLD rounded bottom



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Cup and Handle—Two Patterns in One

The cup and handle pattern is one of the most prized chart patterns out there. A few years ago I figured out why this is so: It's because it comprises two bullish chart patterns in one. The first is a "bowl" or cup. The second part of a cup and handle is a…you guessed it…a flag. Both individual patterns are bullish. Both together are very bullish.

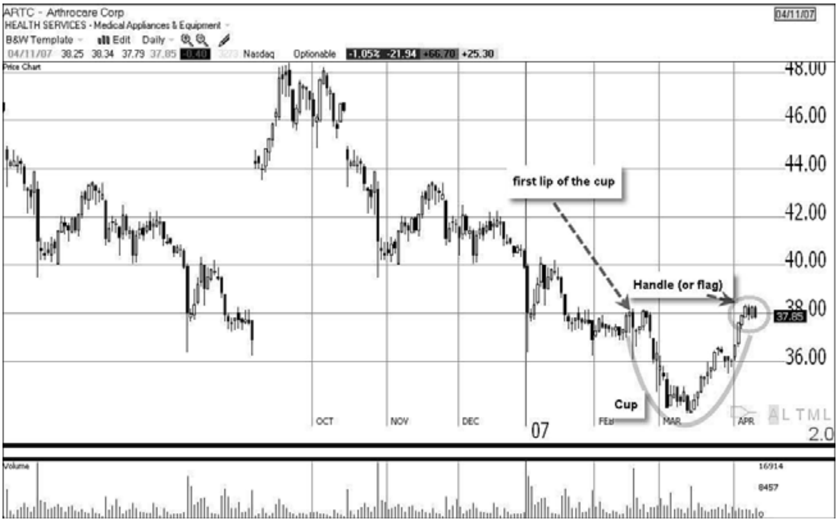
Take a look at Figures 2.30-2.33, and you'll see exactly what I mean. It's important to appreciate that cup and handle patterns come in all sorts of shapes, sizes, and timeframes.

- If the flag forms above the first lip of the cup, you trade it in the same way that you trade a bull flag by entering your buy stop order just above the flag area.
- If the flag forms below the first lip of the cup, you either trade it as a flag, or you enter your stop order above the first lip of the cup. In other words, you only get filled when both resistances have been cleared by the stock, preferably with rising volume.

All of the following charts resolved to the upside.

With ARTC in Figure 2.30, the handle (flag) formed its tops just above the first lip of the cup. This is a bonus as you can simply trade it as a flag pattern but with the added bonus that it is in fact a cup and handle and therefore a more powerful pattern.

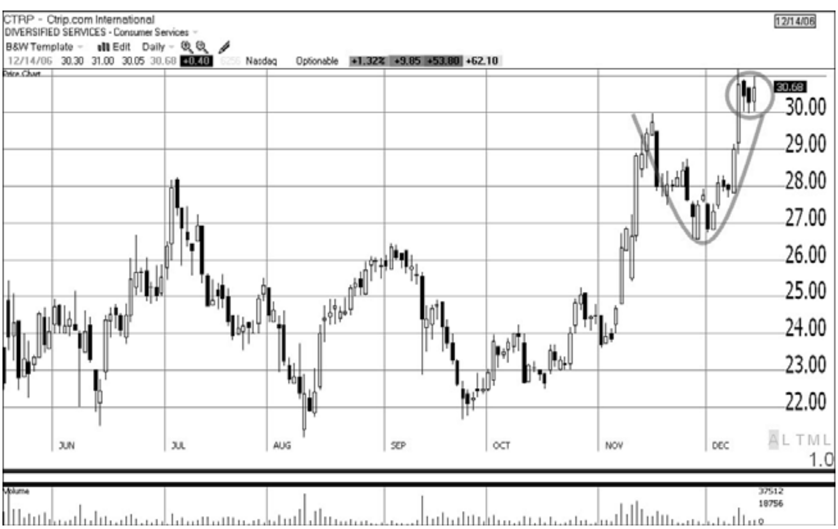
Figure 2.30 ARTC cup and handle



TC2000®.com. Courtesy of Worden Brothers Inc.

With CTRP, again the handle forms above the first lip of the cup. Notice how this pattern is literally only a month in duration, starting in mid-November and becoming ready to trade in mid-December.

Figure 2.31 CTRP cup and handle



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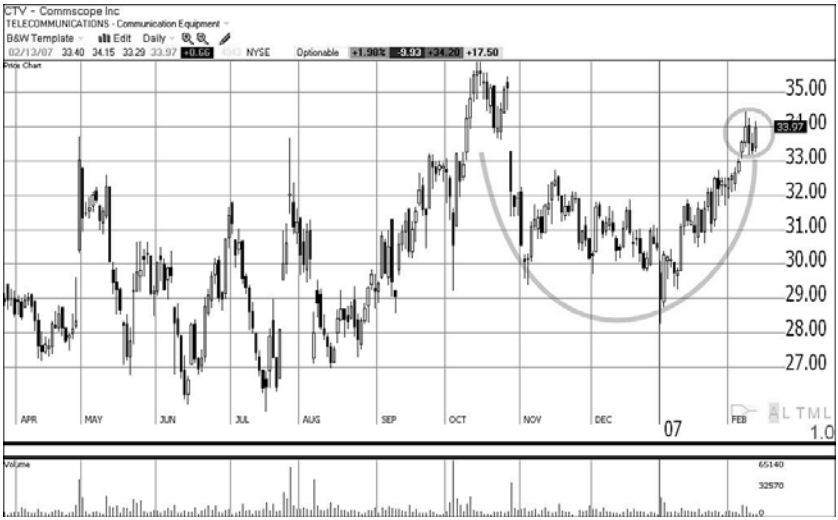
CTV is slightly messier, and the handle forms below the first lip of the cup. This is not nearly as easy to trade as the previous two charts.

Figure 2.32 CTV cup and handle



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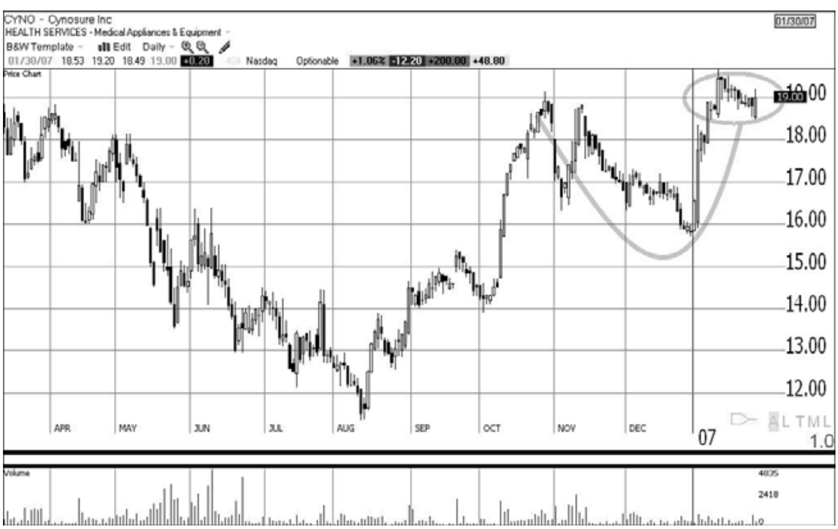
This last example, CYNO, has a very lopsided cup, which lasts for two months before forming an elongated handle—but it is still highly tradable.

Figure 2.33 CYNO cup and handle



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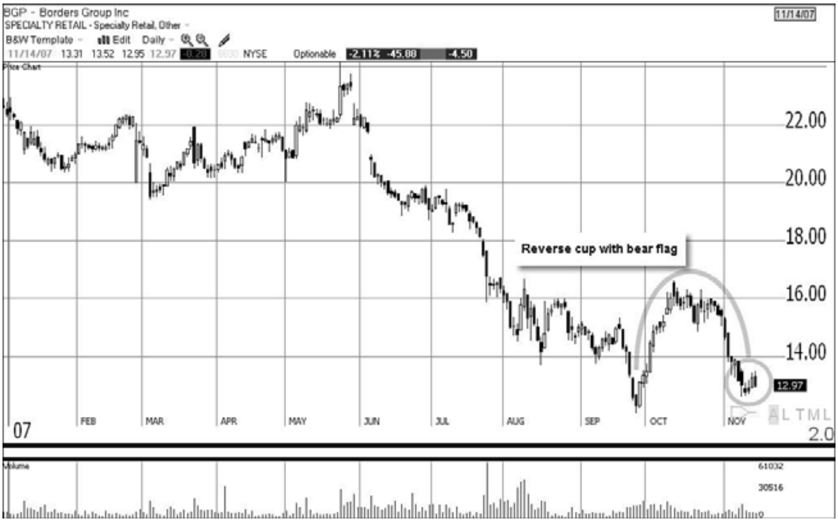
The opposite of a cup and handle has no official name but is identical in reverse.

Figure 2.34 BGP reverse cup and handle



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You treat the reverse cup and handle exactly the same as the cup and handle, except it's in reverse.

- If the bear flag forms below the first low of the upside-down cup, you trade it in the same way that you trade a bear flag by entering your sell stop order just below the flag area.
- If the bear flag forms above the first low of the cup, you either trade it as a bear flag or you enter your sell short stop order below the first low of the upside-down cup. In other words, you only get filled when both support areas have been breached by the stock, preferably with rising volume.

In Figure 2.34, the bear flag formed just above the first low of the pattern. If you wanted to trade this, you'd be safer to wait until the first low of the upside-down cup was breached. Just a few days later the chart formed another bear flag just below the first low of the upside-down cup, providing an opportunity to trade it as a straightforward bear flag.

Figure 2.35 BGP bear flag after cup and handle

TC2000®.com. Courtesy of Worden Brothers Inc.

Finding Flag Patterns

One of the keys to consistent trading is being able to find what you're looking for. Over the years I've developed sophisticated algorithms to find fantastic flag patterns with ease. Along the way, I've also found some simpler formulae that can do a reasonable job of finding decent consolidating patterns. You can find the basic formula by logging into www.volatilemarketsmadeeasy.com/formula.

Now you know why I hunt trending stocks that form flag patterns. If you want to be consistent with your trading, then most of the time you'll do better by trading in the direction of the trend. The key is how to find trending stocks and flag patterns at will. The problem many people have with trading a winning position is that they're scared they won't find one ever again. So they stay in too long and eventually end up forfeiting their profits. Does that sound at all familiar?

When the markets are generally trending down, there are likely to be fewer uptrending stocks and vice versa. Typically, whatever the general trend of the market, you will want to trade in the same direction until the trendline is broken. By trading in this way, you're being responsive to a potential change in direction, but you're not trading so tight that you'd be whipsawed out of a profitable position.

You've also learned in this chapter how easy it is to enter and manage trades with these patterns. That's the whole reason why I use them. My trading psychology is always crystal clear, and there's no room to maneuver and kid myself. For that reason alone, trading in this way is invaluable to me—and can be for you too. The bonus with these patterns is that they often experience explosive moves in the direction of the trend. Your trade is only triggered when the flag pattern is breached in the direction of the prevailing dominant trend. So if there is a reversal, you're not triggered into the trade, and if you're not in the trade to begin with, you can't lose money. This is another great reason to trade these patterns.

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