

TRADING QUALIFIED TRENDS

L.A Little (Author, Professional Trader)
Founder of Technical Analysis Today
www.tatoday.com

What is Trading?

- Many loose definitions floating around ...
- My definition is that trading is **speculating**. It's **speculating on a future outcome** typically based on some bias
- Most trading systems are:
 - Based on a Bias (fundamental, technical, sentiment, behavioral, etc.)
 - **Probability based** (because the future is necessarily probabilistic – no certainties)
 - Typically **trend based**

Trend – The Most Basic TA Concept

- Why is the definition of trend so important?
- Trend is at the center of most trading systems
 - Moving Averages,
 - MACD,
 - Oscillators,
 - Bollinger Bands, etc.
- It's pervasive in the literature and referred to repeatedly
- The problem is that **trend hasn't been precisely defined**

So ... what is Trend?

- Again ... many loose definitions ...
- Some say trend is the directional movement of price
- The classical definition of trend was proposed by Charles Dow and William Hamilton over 100 years ago as:
 - Uptrend is a series of higher highs & higher lows
 - Downtrend is a series of lower highs & lower lows

Classical Uptrend in Google



Classical Downtrend in Google



Given the downtrend, do you sell Google?



If you did you are still kicking yourself

GOOG Google Inc.(NQ NM) 492.28 7.43 1.53%

D: 12/17/2009 O:596.44 H:597.64 L:593.76 C:593.94

R:3.88 Y:



How Can You Avoid Buying or Selling at Exactly the Wrong Time?

- **Compute and Consider Trend Holistically**
- **Key Characteristics are:**
 - Systematic and programmatic
 - Provides a qualitative measure
 - Applicable to all time frames
 - Utilizes the basic TA fundamental data points
 - Price
 - Volume
 - Time

... and that's what I have done



TREND QUALIFICATION & TRADING

Techniques *to* Identify
the Best Trends *to* Trade

L. A. LITTLE



Defining Trend Systematically/Programmatically


- The basic algorithm is:
- All bars are potential SPL/SPH
- For SPL, if next six bars have a higher low, then it's SPL
- For SPH, if next six bars have a lower high, then SPH



Defining Trend more Precisely

- This trend identification process is referred to as the Neoclassical Methodology. It allows for:
 - Algorithmic definition of swing points
 - Systematic detection of swing point tests and ability to measure the intensity of the buyers/sellers at those price points
 - Algorithmic detection and measurement of swing point breaks and thus the qualification of trend as ...
 - Strong or weak
 - Confirmed or suspect

Checking Our Trend Definition Checklist

- Systematic and programmatic 
- Provides a qualitative measure
- Applicable to all time frames
- Utilizes the basic TA fundamental data points
 - Price
 - Volume
 - Time

Trend Definition and Qualification

- Trends come into existence and are qualified when a swing point is tested and breaks
- When a break of a swing point has comparatively **more** volume it is denoted as **Confirmed**
- When a break of a swing point has comparatively **less** volume it is denoted as **Suspect**
- “Comparatively” implies measuring volume that existed at the prior swing point to the break out bar

Confirmed Bullish Trend – an example



Trends and Friends

- They say that the “Trend is your Friend” and that’s generally true but ***some friends are better than others***
- A **Confirmed** trend is generally a ***better friend*** and typically the one you want pursue
 - It has greater persistence – from 2% to 7% greater depending on the time frame and the direction
- A **Suspect** trend is a more ***questionable friend*** ... not one you can blindly trust
 - It has less persistence and is more likely to die an early death
- In trading, you get to choose your friends
- You should choose them carefully

Checking Our Trend Definition Checklist Again

- Systematic and programmatic ✓
- Provides a qualitative measure ✓
- Applicable to all time frames
- Utilizes the basic TA fundamental data points
 - Price
 - Volume
 - Time

How are Time Frames Defined?

- Each time frame needs to be reasonably consistent in terms of the number of bars so that they can be treated identically
- Roughly 60 bars to a time frame – not too much or too little data to analyze
- Width of the bar can be varied to create differing time frames
- Treating time as bars on a chart is a valuable abstraction

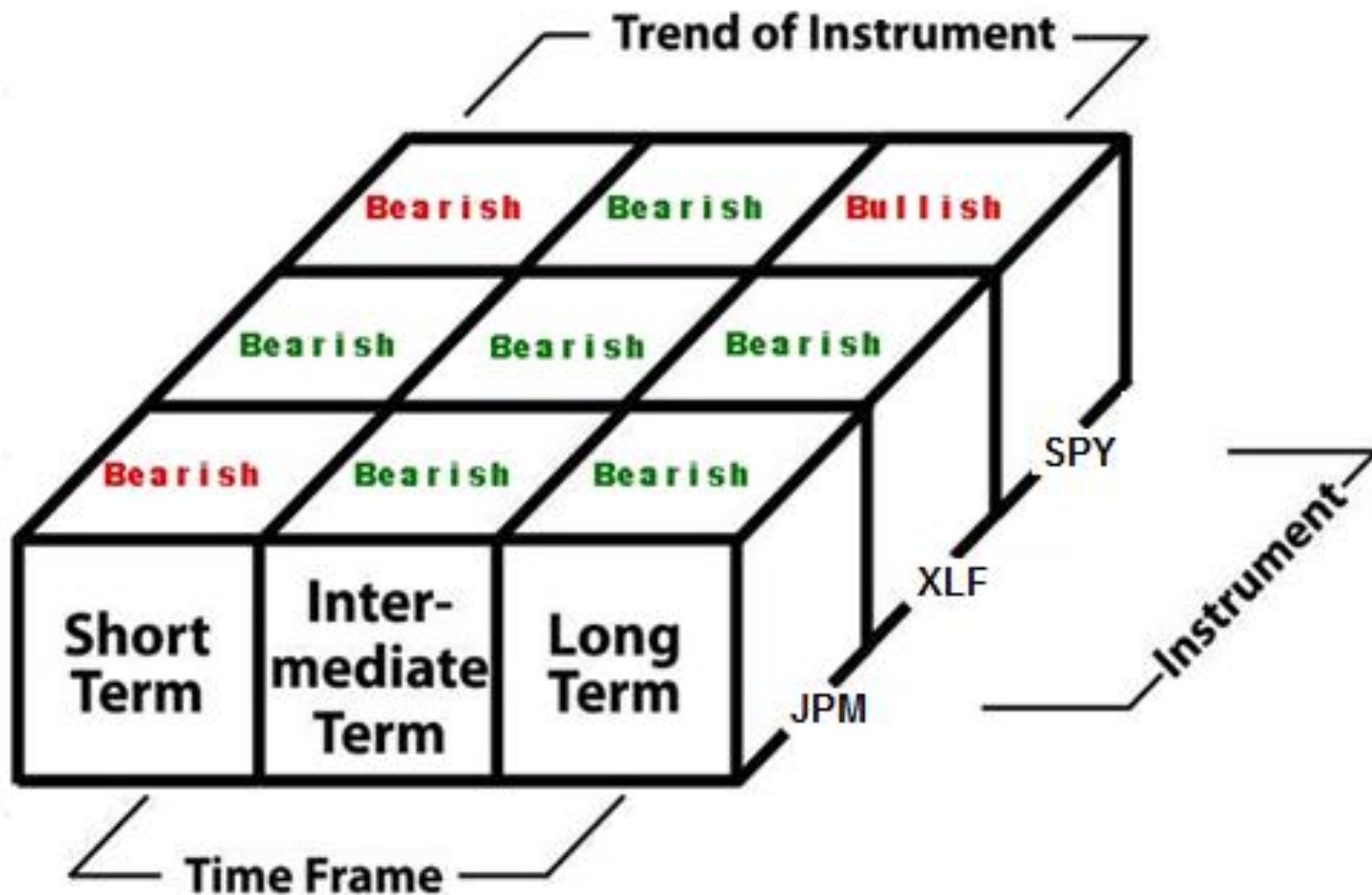
Defining time frames as bars gives abstraction

- **Generally accepted that there are 3 time frames so to get roughly 60 bars per time frame here are examples for a **swing trader** versus a **day trader****
- **Swing Trader Time Frames**
 - Short Term Time Frame – 3 months of daily bars
 - Intermediate Term Time Frame – 1 year of weekly bars
 - Long Term Time Frame – 5 years of monthly bars
- **Day Trader Time Frames**
 - Short Term Time Frame – 2 days of 10 minute bars
 - Intermediate Term Time Frame – 10 days of 60 minute bars
 - Long Term Time Frame – 20 days of 2 hour bars

Trends & Time Frames

- Unlike classical TA, when you qualify trends you end up with **6**
 - not **3** trend types
 - **Confirmed** or **Suspect** Bullish
 - **Confirmed** or **Suspect** Bearish
 - **Confirmed** or **Suspect** Sideways
- ... and there are 3 time frames
 - Short, Intermediate, and Long Term
- ... and there are outside influences on a stock's trend – namely the sector and general market influences
- That's a lot of data to try and visualize so I create a visualization tool called **The Trading Cube**

The Trading Cube



The Trading Cube is a snapshot view of trend

- It is like an accountant's balance sheet
- It tells you what is the qualified trend at a specific moment in time for
 - The stock
 - The stock's sector
 - The general market

Swing Trader's Time Frames per Trading Cube



XLF – Long Term Time Frame



XLF – Intermediate Term Time Frame



XLF - Short Term Time Frame

XLF Financial Select Sector SPDR Fund 12.82 -0.52 -3.90%

D: 08/30/2011 O:13.16 H:13.27 L:12.97 C:13.16

R:0.3



Volume 86,961,924



Why are all Time Frames Important?

- Circling back to Google – how do you know not to exit?
- The break was **suspect**
- Trend had not broken on the intermediate term



Important to consider all Time Frames



Checking Our Trend Definition Checklist Again

- Systematic and programmatic ✓
- Provides a qualitative measure ✓
- Applicable to all time frames ✓
- Utilizes the basic TA fundamental data points
 - Price
 - Volume
 - Time

Price and Volume ...



Checking Our Trend Definition Checklist

- Systematic and programmatic ✓
- Provides a qualitative measure ✓
- Applicable to all time frames ✓
- Utilizes the basic TA fundamental data points
 - Price ✓
 - Volume ✓
 - Time

But what about time ... how can it be incorporated?

What if ...

- What if trend was thought about as having a life cycle
 - A trend comes into existence
 - A trend persists for some period of time
 - A trend eventually ends
- If viewed this way, a trend could be thought of as a household appliance ... like a microwave for example



A microwave has an expected life cycle

- The failure rate can be computed
- It can be presented as a probability table/curve
- For a microwave, the mean failure rate is roughly 10 years
- So what about trends ... can probability failure rates be computed?

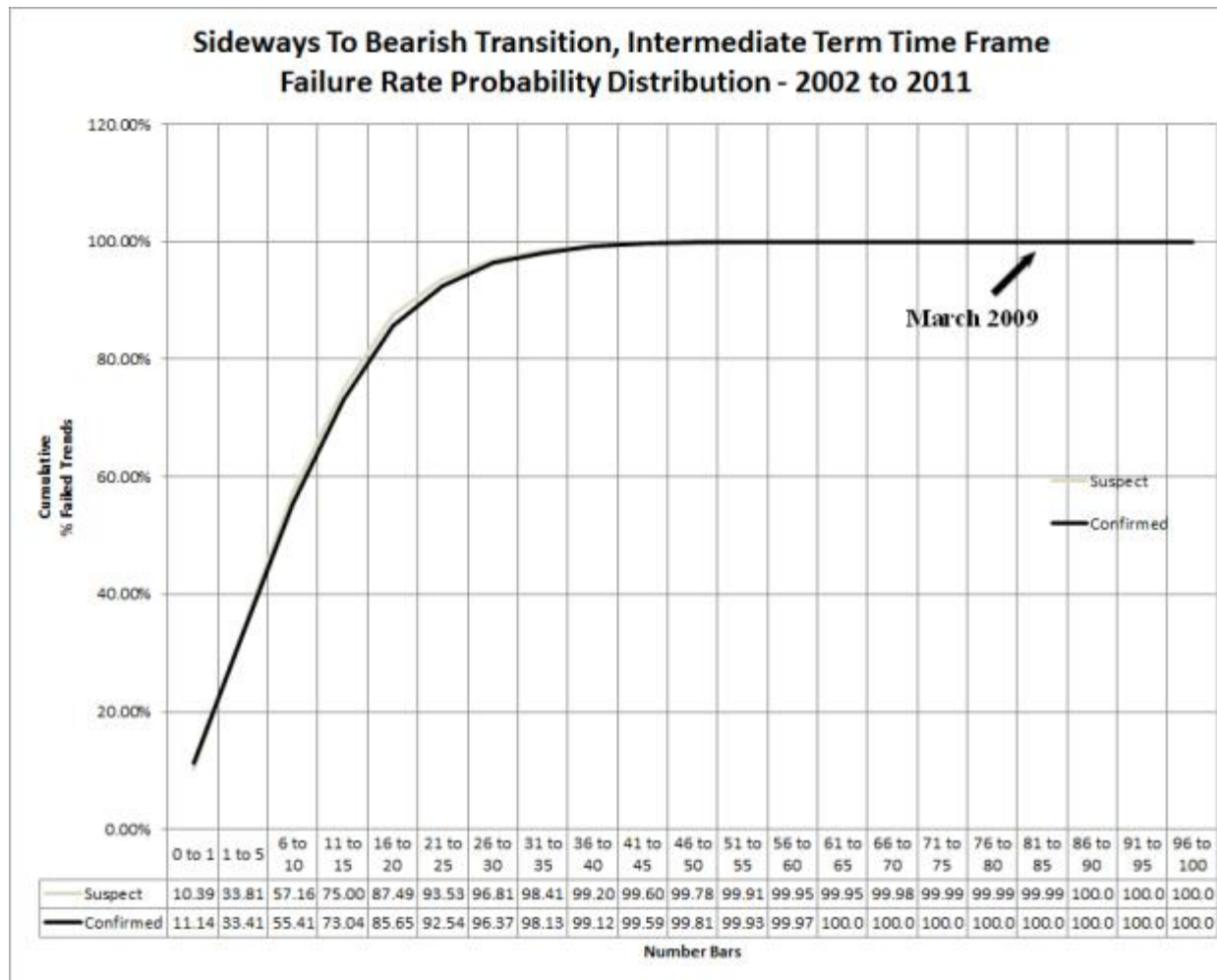
A trend has an expected life cycle also

- Because trends can be determined algorithmically
- ... the creation of a trend is kind of like the microwave hitting the store shelf and being bought
- ... and because trend transitions can also be determined automatically this is like the microwave finally breaking
- Thus, trends have failure rates too and they can be computed and displayed as tables/graphs

What was the failure probability rate at 2009 low?

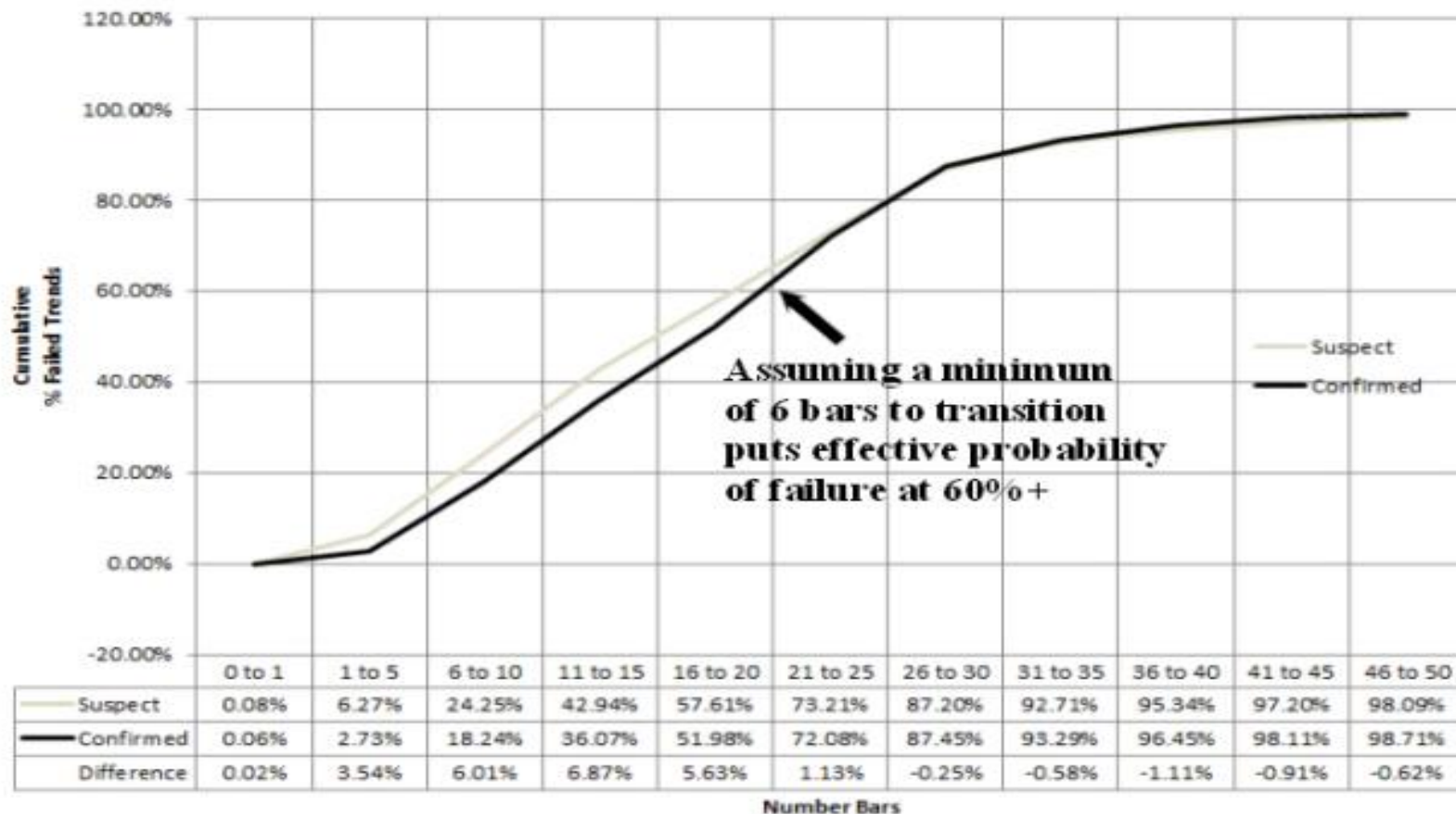


Failure Probability Curve For 2009 Bearish Intermediate Term Trend



Failure Probability Curve For 2009 Bearish Long Term Trend

**Bearish to Sideways Transition, Long Term Time Frame
Cumulative Failure Rates - 2002 to 2011**



So, is there is a Better Way to Determine and Trade Trend?

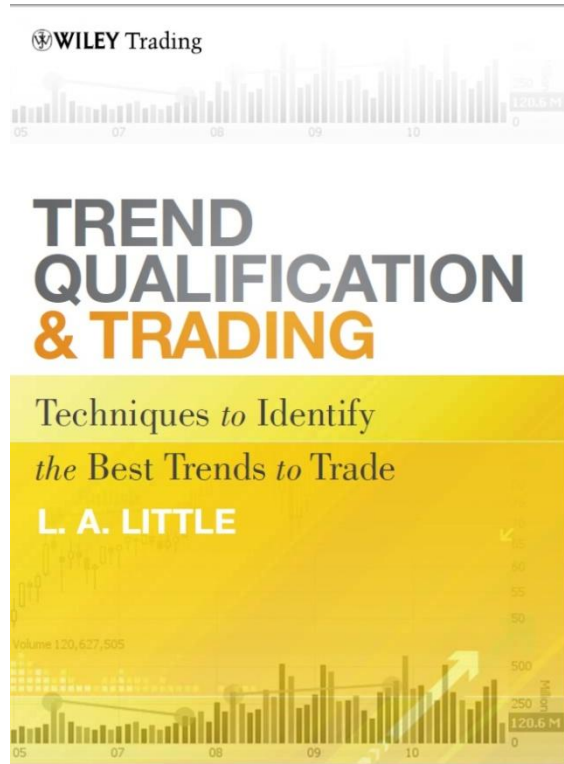
- **ABSOLUTELY!!!**

- Systematically and programmatically
- By qualifying trend as **Suspect** or **Confirmed**
- By being able to apply the methodology to all time frames
- By utilizing **all three** of the basic TA fundamental data points
 - Price
 - Volume
 - Time

With Qualified Trends you can avoid buying and selling stocks at exactly the wrong time.

If you want to learn more ...

Buy the book ...



Get the tools free for a month ...

- Trading Cube
- Trading Cube Scanner
- Anchored Support & Resistance
- Trading Signals
- Swing Trading Portfolio
- Etc. all on www.tatoday.com