Although more complex strategies work for some, a proficiency in reading price action itself is sufficient to succeed in trading for most retail traders. Here, we define this concept and quantify some ways to profit from it.

Price action fundamentals

BY AL BROOKS

The term price action is vague and means different things to different people. The broadest definition refers to any representation on a chart of any aspect of price movement during the course of trading. This includes any financial instrument, on any type of chart, in any time frame. Most day-traders are technicians and many use indicators to help them determine when to enter or exit a trade. However, if you become proficient in reading price action itself, it alone can provide you with all the cues you need to enter and exit trades.

Price action analysis, demonstrated here in the E-mini S&P 500, is an elegant approach to trading the markets. The approach is largely discretionary and is open to the standard criticisms that systematic traders lob at such techniques, but it has a lot going for it, as well. Price-action analysis requires little up-front investment in expensive analysis software, and can allow you to focus on mastering the process of trading without being overly consumed with mastering a rigorous and complex collection of techniques. It may appear elementary, but that makes it a good place to start for a beginning trader and an excellent way to re-invent a trading program that has fallen on hard times.

"Taking Action in the E-mini," August 2007, already examined some slightly more advanced, specific techniques of price-action analysis, and future articles will take the concept further. This article, however, backs up a bit to offer a more solid grounding on this philosophy, as well as provides examples of simple price-action strategies that work.

MOVING ON UP

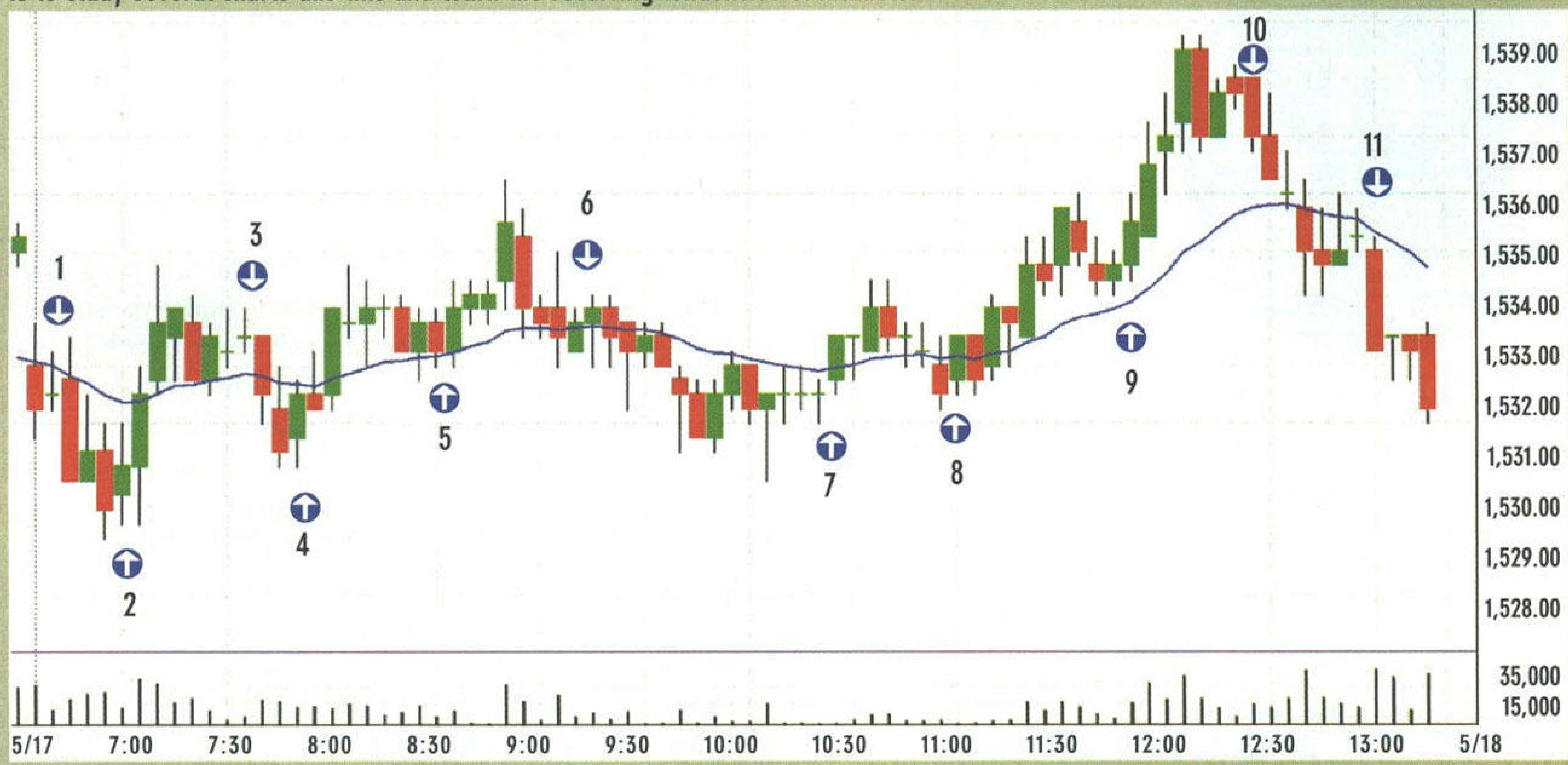
One way to apply price action analysis is with chart patterns, but most traders quickly learn that the common ones have a lot of exceptions and nuances that can result in losses if ignored. These exceptions and nuances highlight an important lesson of trading: For most of us, it is necessary to focus on one technique, market and even time frame and then spend hundreds, if not thousands, of hours studying that combination. It's a hard fact of trading, but only a few can be successful actively trading multiple markets, across many times using a diverse collection of indicators. For most traders, a minimalist approach is best.

Another reason focusing on one approach is so important is logistics and risk tolerance. Trading is about transferring money from other peoples' accounts to your own. You do not have to take 20 trades in a day for this to occur. Although it is not advisable to commit an entire account balance to one trade, with $5,000 of available account equity, you can trade 10 contracts of the 10-year T-note futures with the goal of making one trade a day that nets four ticks of profit. After commissions, this is about $575. For many, this market and time frame might be boring or logistically unworkable; for others, it might be perfectly reasonable. You need to decide this early and go from there.

If a strategy is valid, it fits into your schedule, your equity can handle it and your risk parameters are intact, you should be able to develop a reasonably high winning percentage if you take your time to hone your technique. Then, real success is a matter of increasing position size, rather than changing the frequency of your trading, which inherently affects your strategy.

11 WAYS TO PAYDAY

Here are 11 possible trades on the five-minute S&P 500 chart, contained in one trading day. The first step to identifying patterns that work is to study several charts like this and learn the recurring tendencies of markets.



Source: Tradestation

For example, if you find a single pattern on a five-minute E-mini chart that consistently generates one-point profit (four ticks) while risking only one point for your stop, it's only necessary to place one or two entries a day. This will net about $45 per trade per contract after commissions. It's small, but on a 25-contract position, it equates to about $250,000 a year. Such size is reasonable, as well. The E-mini S&P futures can easily absorb a 25-lot position with no movement in price.

FINDING THE PATTERNS

Finding patterns that have high winning percentages requires studying many charts during a long period. The amount of study required is why it's critical for most of us to pick one market and one time frame. This choice is your own, but you certainly can do worse than examining the E-minis on a five-minute chart.

There are two prime advantages to the E-mini S&P 500 futures: movement and liquidity. There is always opportunity (volatility), and retail traders can almost always get their price in this electronically traded market. As for the five-minute chart, even on a bad day, there are usually 10 possible trades that present themselves. While one- and three-minute charts offer more trades, keep in mind that a great trade on these time frames also will become a great trade on a five-minute time frame. Also, the shorter-term intraday charts frequently produce countertrend setups that often are losers, and when you have too many losers, it affects your focus.

Each market and time frame combination has a profit target and a stop size that are more effective than others. For the five-minute E-mini chart, a six-tick profit target combined with a six-tick stop works well through time (except on unusual days when the day's range or the range of the five-minute bars is unusually large, then you should double the profit target to eight ticks and the stop to 12 ticks). When starting out with this market/time frame combination, it helps to concentrate on scalping these six ticks, rigidly adhering to the six-tick stop loss. As you become proficient and gain confidence, you can start scalping out part of your position and letting the rest swing with a breakeven stop in place. This is especially useful when you might be catching the high or low of the day, or at the end of a strong pullback in a powerful trend.

As a logistical rule of thumb, entering on a stop order results in a higher winning percentage at the expense of potential profit (all else equal). For example, if you want to go long, place a buy stop at one tick above the high of the prior bar (your signal bar). The bar where you enter is the entry bar. Next, place an OCO order (one-cancels-the-other) to exit either on a limit at four ticks above your entry (your profit target) or a stop at six ticks below your entry (your stop loss). A market will almost always trade at least one tick above your limit order for you to get filled, so a successful six-tick scalp will require the market to rise at least six ticks above the high of the signal bar.

SIMPLE METHODS THAT WORK

One technique for finding reliable patterns, although study intensive, is to examine numerous charts and find several that have 10 or more successful trades if you had used the four-ticks profit, six-ticks risk approach. Then you physically mark them for study, as shown in the chart in

"11 ways to payday" (page 47).

Next, look for recurring patterns among these trades. It will take some time, but you will eventually discover many patterns that work. Then, learn to understand when these patterns fail and try to understand why. Then, begin trading just one contract, placing two or three trades a day. At this point, overtrading and stress, which can derail the learning process — not to mention result in big losses — are your biggest enemies. Do not put yourself in a position where emotions interfere with your analysis and execution.

One method demonstrated in "11 ways to payday" might seem too obvious to ever be effective, but it works. On the majority of days, the market will not be trending (defined as opening on one extreme and closing on the other). Instead, it will have four to six swings up and down. Once the market makes a new high or low, sell the high or buy the low. Just after "Entry 9" in the chart, the market made a new high for the day. At the completion of each subsequent bar, you would place a sell stop at one tick below the low of the just completed bar. You would have been filled at "Entry 10."

Another important observation is that the market often makes a second attempt to do something if the first attempt fails. The second attempt is usually a good entry in the opposite direction when that second attempt also fails. For example, "Entry 3" is a short after there were two attempts at a bull move. (There were two instances in this pullback where a bar extended above the high of the prior bar.)

This also occurred with the "Entry 11" short, which developed after two attempts at going higher (the first attempt was just before the "Entry 10" short). "Entry 6" is also a short after two failed long attempts. "Entry 2" demonstrates the opposite effect: It was the second attempt at a move higher, and it worked.

Do not limit yourself to examining only the highs and lows of bars. On the five-minute E-mini chart, every part of the bar tells you something important. Look at where the close is relative to the high and low, as well as relative to the close of one or several bars earlier. Note the sizes of the tails and at how many ticks the current bar extends beyond the prior bar or series of bars.

For example, if down momentum is strong, you would not look to buy, expecting any buy signal to fail. Look at the bar that formed two bars before "Entry 11." The tail extended only one tick above the prior bar's high, immediately trapping new longs into a losing trade. Entering on traps is one of the highest percentage trades that you can make. You know the longs are trapped, so think about where they will be stopped out. Place a sell stop order to go short at that price. The chart has a 20-bar exponential moving average (EMA). You'll want to get a feel for how price acts around the EMA. "Entry 4" was after the market had a bear trend bar break below the EMA, immediately followed by a bull trend bar that closed just below the indicator. Other simple tools are trendlines and trend channel lines. These can help you to better analyze potential breakouts, tests of past extremes and false breakouts.

There is no quick or easy way to become a good price-action trader. However, if you spend the hours needed to get a feel for the right market and time frame for your situation, find reliable patterns and ease slowly into applying them on a large scale, you can make money. For many of us, long-term success in trading is rooted in simplicity. Price-action trading may not exploit the latest technologies, require thousands of dollars in seminars and software, and be difficult to quantify in a rigorous sense, but for the right trader, it simply works. **FM**

Al Brooks stopped practicing medicine 20 years ago to day-trade for his personal account full time, and has been doing so ever since.