CREATE A NEW INCOME STREAM:

THE ONLY TRADING TECHNIQUE YOU'LL EVER NEED

NIGEL BAHADUR

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Introduction

If you could do anything what would you do? If you knew that you couldn't fail what new profession would you try? What did you always want to be when you were young?

For most of us the answer will centre around one of three things - fame, money or freedom. Perhaps you want to be a rock guitarist or world class singer - touring the world and living a life of excess. Maybe you're not interested in the fame but you would like the money that often goes with it. First class travel, five star hotels, beautiful homes and a designer wardrobe would suit you just fine. Or maybe you just want to do your own thing so you can enjoy more freedom instead of working long hours, missing your kids growing up and struggling in the rat race.

I can't help you to be the next Adele or orchestrate stellar fame but I can show you how to create money and freedom.

I started my career as a software developer and ended up running the company's Research and Development division managing people in six different countries. During my time with the business we grew from a small company to a relatively large operation but I paid a pretty heavy price.

After ten years I was completely burnt out. Thankfully, I'd built up some savings over the years and decided to take some time off to regroup and work out my next career move before I ended up in hospital. Unfortunately, I quit just around the time of the dot.com crash in 2000 and I began to see my hard earned savings quickly disappear. Like many people at the time I'd invested in the stock market. Remember, this was the time that *everyone* was investing in the stock market. You couldn't get into a cab in any city in the US without receiving stock tips from the driver! The problem was my broker

was losing money - my money. I wasn't working so I figured, 'hey, this can't be that hard - perhaps I could do better.'

One thing I've learned over the years is that no one - and I mean NO ONE - cares about your money as much as you do. I 'followed the money' and learned as much as I could about trading over the next couple of years. I even got to the point that I worked alongside some of the best traders in the world including Linda Raschke. During that time, I learned a huge amount, often very painfully, about how to make (and lose) money on the stock market. I've been through multiple bull and bear markets, several crashes, including the 'big one' - the GFC and have a profitable track record as a professional trader that now goes back about ten years.

But hey you've probably heard all this before - right? One thing about the stock market is that it's full of snake oil salesmen and bullshit artists. Around every corner is another 'trainer', 'speaker' or trading wizard keen to impart his wisdom, telling you what you want to hear and promising you the earth - an easy fast track route to untold riches, fast cars and luxury living - all for just three convenient instalments. They may even look the part, arriving at the training venue in a Bentley, a bespoke tailored suit and Italian shoes but it's all just part of the illusion. If these guys are actually making money (which is debatable) they are almost always making their money selling their 'make a million by lunch time without any effort' approach to trading rather than actually investing their own money in the stock market successfully.

Often this is the rub isn't it? "If you're so great at trading the stock market why don't you just stay in your boxers all day and make all the money you want?"

I could. But we live in an incredibly fast paced, dynamic and changing world - the days of being good at one thing for the rest of our lives and expecting that skill to stay relevant or engaging are almost gone. It's the era of the 'portfolio career' - having more than one 'string to your bow'. Today, it just makes sense to spread the risk and for all of us to create multiple streams of income. That way, if one is not producing as much

as it used to, we have a Plan B and Plan C to even out the inevitable peaks and troughs in every industry. I'm simply following my own advice. I love trading and it's given me the money, lifestyle and freedom I now enjoy but if I only traded the market I would only have one stream of income. That's always a dangerous position. So I want to create another avenue while also 'paying it forward'.

Over the years I've had the privilege of learning from some of the best traders in the world. These icons have taught me so much and often this information is not contained in books or online - it only lives inside their head. Like anything when someone is *really* good at something they are usually 'unconsciously competent' in that area. In other words, they no longer know what makes them special or appreciate the depth and breadth of their own knowledge. Their genius is second nature- often they've forgotten more about their industry than many will ever know in the first place. I've been privy to a lot of this 'tacit knowledge' and industry insight and if I can pass it on to a new generation of trader then those secrets stay alive. And hopefully you will pass it on to others too - imagine how cool it would be to teach your kids how to successfully trade the stock market. What an incredible gift that would be.

And although it may sound clichéd I also want to be part of cleaning up the industry. There are far too many charlatans praying on people's hopes and dreams and it's polluting the industry, strengthening the suspicion and mistrust people feel toward trading and the stock market in general. That's a travesty.

Learning how to invest in the stock market is one of the smartest things you can do for your own financial health and peace of mind. I'm not going to lie to you, it's an incredibly complex industry and most people who work inside it every day don't understand all of it. Why do you think so many traders consistently lose their client's money? But, you don't need to understand all of it; you need to understand enough so that you can appreciate what's going on and spot some consistently accurate 'buy' or 'sell' signals. You don't need a hundred different investment strategies - actually you

could do very nicely with two or three. I'll share one of the best one with you in this e-book.

Investing in the stock market doesn't mean that you have to spend the rest of your life staring at a screen terrified to make a cup of coffee uncase your stock takes a tumble while you're not looking! It doesn't mean you have to quit your job and stay in your pyjamas all day. And it doesn't mean you're going to make a million by lunch time without any effort.

Learning how to trade successfully and how to create profit consistently takes time and it does require some effort and a little courage - especially in the early days when you place your first few trades. But every expert was a beginner once. Plus, even if you choose to become a part-time trader that will still give you the opportunity to create another stream of income. It can easily be done around your current work or commitments and as long as you have a laptop or Smartphone with a strong and stable internet connection you can trade for anywhere.

Whether you are a complete novice or a seasoned trader sick of mixed results, this e-book explains one of the most successful strategies I've learned and one I still use regularly today.

The Only Trading Technique You'll Ever Need

There are literally thousands of trading techniques that you *could* learn as you seek to master the financial markets. But who has the time for that? Knowing that there is one rule for this situation and a different rule for a slightly different situation is overwhelming and confusing. But what if I told you that you could start your trading career successfully knowing just one technique? That would be much less daunting - right? The purpose of this e-book is to get you up to speed on that one strategy. And the best news – if you have the discipline to stick to one strategy then this could be the one and only trading technique you ever need.

Granted, you won't be able to make a trade using this technique every day. You may not find a suitable stock that is behaving this way every week but again who has time for that anyway? Most of us are interested in understanding the financial markets so we can enjoy more freedom, where we can make some extra money without necessarily swapping our time and working harder or longer to make it. Why then would you want to swap full time work for another full time job just watching pretty charts and color coded price movements on a screen to try and identify a potential trade from a smorgasbord of techniques and rules? That's too complicated and too time consuming. Besides, over the last 100 plus years, there has only been one discretionary trading technique that has worked consistently and it's called the breakout strategy.

Surely, it makes sense to focus your time, effort and attention on learning that one trading strategy and this e-book will explain all you need to know to do just that. We'll explore this technique in more detail, including its strengths and its flaws. Plus, I'll illustrate how to apply the technique to modern markets.

In order to ensure the e-book is relevant to as many people are possible from complete beginner to seasoned professionals I've included 'breakout boxes' to explain some of the key terms. Obviously if you already know what these key terms are then just skip past and focus on the details of the technique.

The Breakout Strategy

Identifying and predicting 'breakouts' in the financial markets is essentially the basis for just about every successful trading system ever invented. Even if you examined trend-following systems, the majority of their performance is acquired from trends that were started by a breakout. If you want to get into a trend early, you need to know how to spot and trade breakouts properly. You need to know how to identify them, how to initiate your trade and, most importantly, how to set your stops and protect your capital.

What is a Breakout?

As well as being used to describe teenage skin problems, a breakout is a 'break' 'outside' the consistent price range of a particular stock (or other financial instrument). It is an impulsive move away from a "value area" or sideways line on a price chart. Value areas or sideways lines on charts are also called "consolidation" areas.

According to *Investopedia* a breakout is, "A price movement through an identified level of support or resistance, which is usually followed by heavy volume and increased volatility. Traders will buy the underlying asset when the price breaks above a level of resistance and sell when it breaks below support."

This chart shows a financial instrument (in this case a FUTURES contract) that has historically encountered a lot of resistance near $928 and a lot of support around $850. This means that the price movement tends to track between these two figures - gaining support at $850 so it doesn't fall below and meeting resistance at $928 so it doesn't 'breakout' above $928. But notice how it heads sharply higher following the breakout. A breakout such as this indicates something significant has happened to the stock leading to a jump in price. Being able to predict a breakout and profit from the upward price movement is what this technique is all about.

The term breakout is most often used to describe the upward movement of the price of a financial instrument (stocks, futures, bonds etc.) that breaks through the resistance level and increases in value. Buying at the point of breakout will help secure profit as the price soars. Once a resistance level has been broken it is then regarded as the new support level and the process begins again.

However, price can also break below the support line and continue to fall lower. Often termed a 'breakdown' this is also useful to identify, especially if you already own the shares. You can sell before the breakdown and protect your capital or you can even profit from the breakdown by selling short using other investment tools such as options

(If unclear or you need a refresher on the difference between long and short trades see the explanation under Rule #3).

What is a Stop (A.K.A. Stop-Loss or Stop-Order)?

Never enter a trade without knowing how and when you are going to exit the trade in the event that prices turn against you. Setting a stop order at the same time as you place the trade ensures that you are automatically taken out of the trade if the price penetrates the level of your stop order.

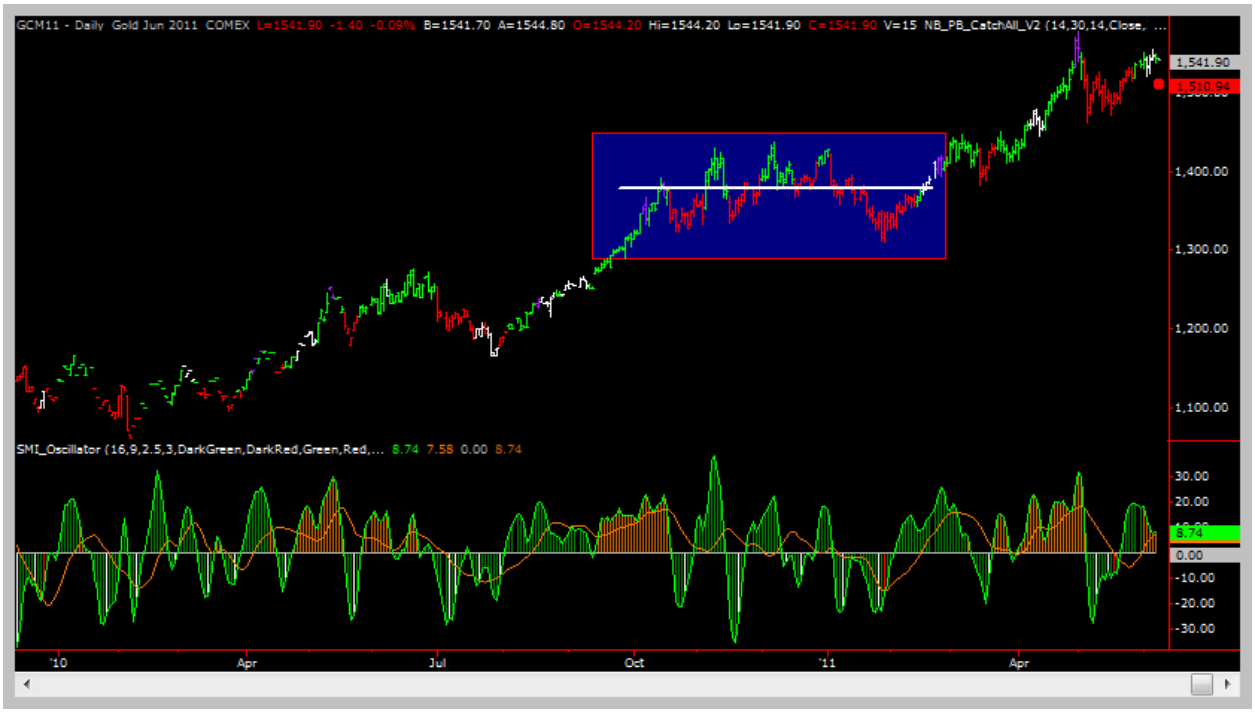
There are different types of stop orders. Stop-Limit and Stop-Market orders are the most common. Read more about these orders in lesson #3 of our free online training series. Visit our website at http://ustradingcoach.com/master-daytrading-in-just-30-days-lesson-3/

Breakouts Explained in Charts

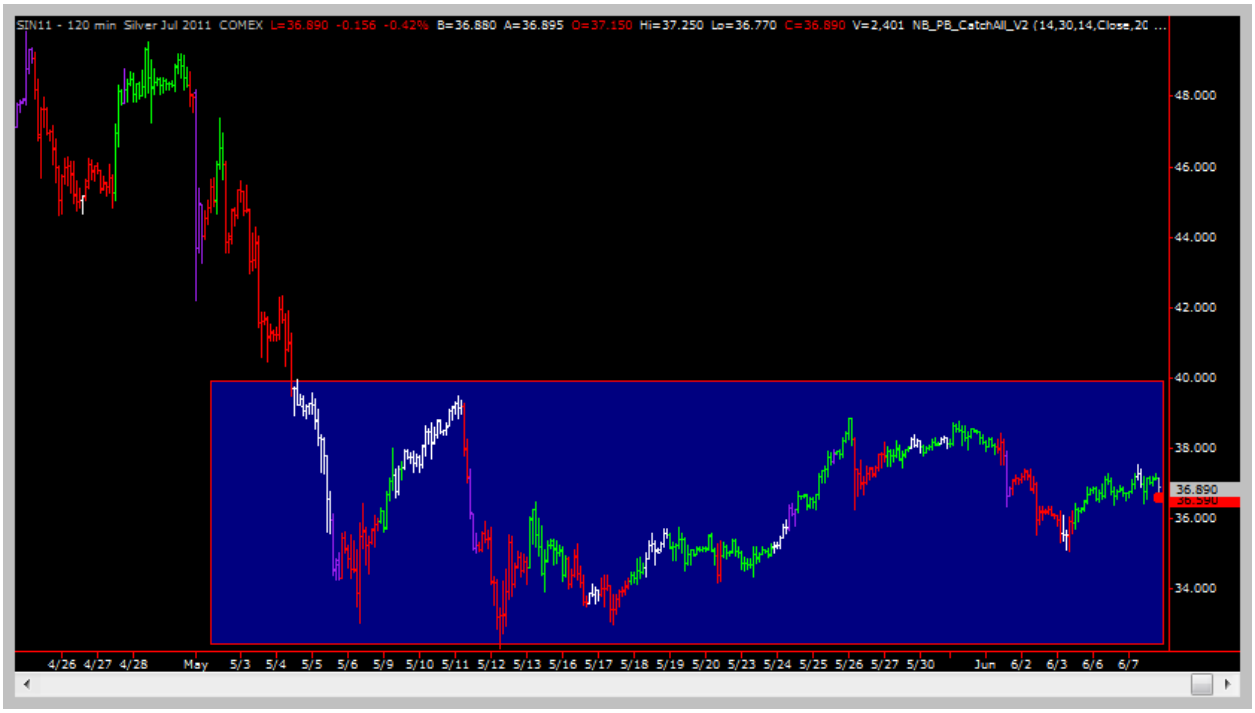
If a breakout is an impulsive move away from a "value area" or sideways line on a price chart - what does that actually look like on a chart? Obviously, if you are to use this technique successfully then you need to know what you are looking for.

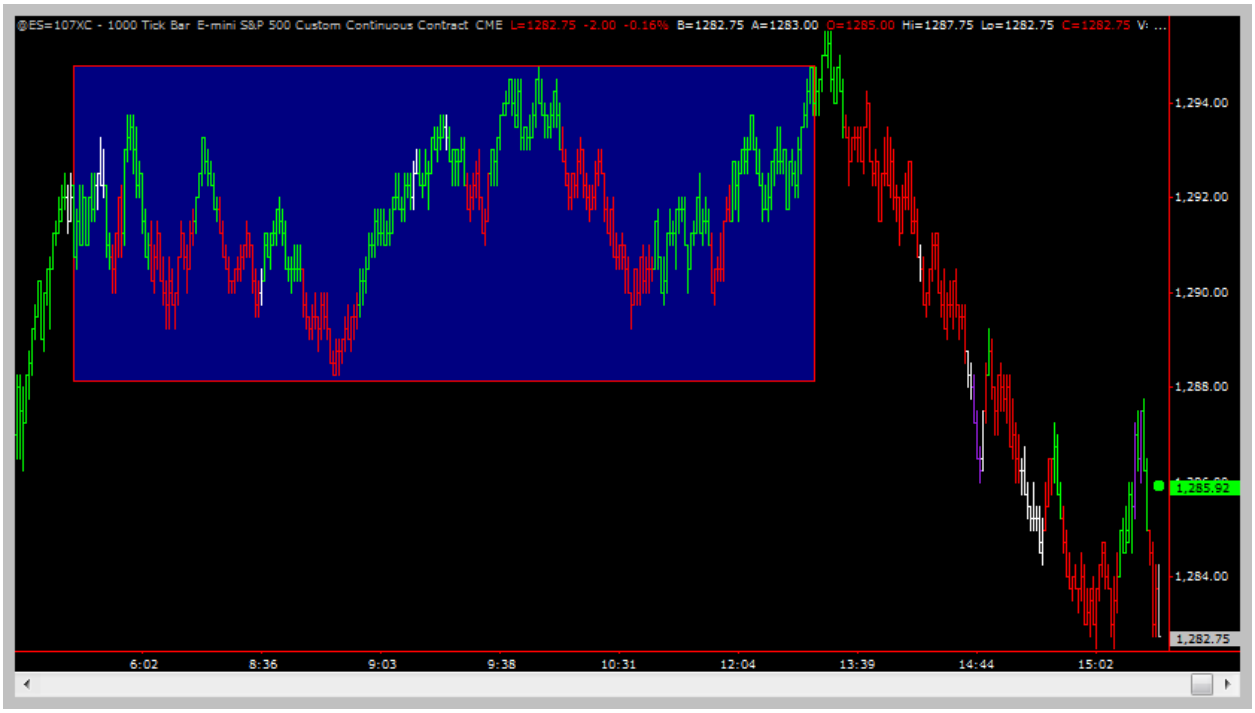
The following are a few of charts showing consolidation areas and the subsequent breakouts – I am sure that you can appreciate the size of the move and potential profit that result from some of these breakouts. As active traders, these are the types of moves that we all wish to catch AND stay with.


$CIY - Daily Continuous Commodity Index NYBOT L=652.82 1.81 0.28% B=0.00 A=0.00 O=651.66 Hi=653.64 Lo=649.94 C=652.82 V=0 NB_PB_CatchAll_V2 (14,30,14,Close,20,2 ...
620.00
600.00
580.00
560.00
540.00
520.00
500.00
480.00
460.00
440.00
420.00
Oct
'10
Apr
Jul
Oct
'11


GCM11 - Daily Gold Jun 2011 COMEX L=1541.90 -1.40 -0.09% B=1541.70 A=1544.80 O=1544.20 Hi=1544.20 Lo=1541.90 C=1541.90 V=15 NB_PB_CatchAll_V2 (14,30,14,Close, ...
1,541.90
1,510.94
1,400.00
1,300.00
1,200.00
1,100.00
SMI_Oscillator (16,9,2.5,3,DarkGreen,DarkRed,Green,Red,... 8.74 7.58 0.00 8.74
30.00
20.00
8.74
0.00
-10.00
-20.00
-30.00
'10
Apr
Jul
Oct
'11
Apr


@ES.D=108XC - Daily E-mini S&P 500 Custom Continuous Contract CME L=1284.75 0.00 0.00% B=1284.50 A=1285.25 O=1291.50 Hi=1295.50 Lo=1282.50 C=1284.75 V=2,060,1 ...
1,320.08
1,300.00
1,284.75
1,250.00
1,200.00
1,150.00
1,100.00
1,050.00
1,000.00
SMI_Oscillator (16,9,2.5,3,DarkGreen,DarkRed,Green,Red,... -23.43 -7.19 0.00 -23.43
30.00
20.00
10.00
0.00
-7.19
-20.00
-23.43
-30.00
-40.00
Oct
'10
Apr
Jul
Oct
'11


SIN11 - 120 min Silver Jul 2011 COMEX L=36.890 -0.156 -0.42% B=36.880 A=36.895 O=37.150 Hi=37.250 Lo=36.770 C=36.890 V=2,401 NB_PB_CatchAll_V2 (14,30,14,Close,20 ...
48.000
46.000
44.000
42.000
40.000
38.000
36.890
36.000
34.000
4/26 4/27 4/28 May 5/3 5/4 5/5 5/6 5/9 5/10 5/11 5/12 5/13 5/16 5/17 5/18 5/19 5/20 5/23 5/24 5/25 5/26 5/27 5/30 Jun 6/2 6/3 6/6 6/7



The charts above look really good, right? Wouldn't it be great if all our breakout trades looked and behaved like this? We really would be wealthy by lunch time after all!

Selecting Your Trading Instruments

Of course, you need to know where to look for these sorts of trades in the first place. For stocks, most traders have a 'watch list' that they go through every night (or weekend). Most novice traders will populate this list with the stocks in the S&P 500 and/or the Nasdaq 100. Eventually, traders graduate to using specialized tools to filter the entire market using volume and other indicators as criteria to create their candidate list of tradeable stocks. Over time you will get to the point where you can flip through hundreds of stocks in about 30 minutes because most of them either don't have the conditions necessary for a breakout trade or the price is still too volatile to be able to identify where a breakout may occur.

Selecting the RIGHT stocks to trade is an art form and something that is beyond the scope of this e-book. But, most traders tend to ignore this vital skill, focusing instead on sexy things like entry points. But what good is a great entry price into a trade if the trading instrument sucks?

In the stock market, only about 1 percent of stocks are set up at any one point for great trades.

We believe so strongly in the importance of stock selection that we've partnered with someone we think has done the best course work on this skill – Dave Landry. Check out the special offer he has put together for you if you're interested in developing this vital skill.

Now back to breakouts…

Futures are a little easier to trade because there's a lot fewer of them. For futures, there are maybe about 100 tradeable futures markets around the world. In the US there are only 25 futures markets worth trading.

For FOREX traders there are maybe 20 cross-rates worth trading and most traders will concentrate on maybe the 5 big ones: EURUSD, GBPUSD, USDJPY, USDCAD and AUDUSD. So whilst, you may initially be overwhelmed by the breadth of opportunity that presents itself to you with the breakout strategy, depending on what market you want to trade, it is fairly easy to fine tune your watch list or areas of interest so you only monitor a small section of the market for potential breakouts. Remember, you don't need to catch them all to be successful!

The other point that needs to be made is that although the charts above look exciting, to use this strategy successfully you need to know that breakout trades don't always go to plan – far from it…

The Ugly Truth about Breakouts

It's only fair to warn you up-front - trading breakouts often fails. Most breakout trades don't look and behave like the sample charts above. Breakout formations (the trading channel created between the upper and lower trend-lines) are notorious for whipsaws, false breakouts and morphing into larger consolidation areas. In other words, the price does not shoot up as expected but either drops as fast as it rose or simply creates a new normal price with little movement, which will over time create a new breakout formation.

As a result, expect to make profitable trades using the breakout strategy about 40 percent of the time. Often the win rate can fall below 30 percent. That's brutal, I know. But, the best, most successful traders in the world also have a 'batting average' of much less than 50 percent. In fact, some of the best traders have admitted to very successful years where they were only right 30 percent of the time. You're probably thinking right now, "What, you mean I'm going to get my breakout trades wrong more than I get them right? Yes - you are. That's the truth.

Just remember that you're playing a numbers and probabilities game. If you make 3-5 times as much on your winners as you lose on your failed breakout trades, then you can afford to have a 35 percent win rate and still make money.

And, before you get too despondent and give up before you've even began this is logical when you stop and think about it for a moment. Breakouts are unusual price behavior either above the resistance level or below the support level. They are often sudden. Logic would tell us that those sudden movements don't always go to plan. A stock may look like it's about to breakout but it may be a false alarm with the share price moving back to within the value area. The breakout may go in the opposite direction to the one you predicted but there are ways to minimise the risk and protect your capital which we'll explore in more detail in this e-book.

To be honest I think these sorts of statistics are part of the reason that people get scared off trading. We are so conditioned to believe that we must win every time, always come first and to push for consistent success that a 50/50 chance of success seems really poor odds.

But it still doesn't alter the fact that smart traders are using and have been using the breakout technique successfully for over 100 years. You need to go into the market with your eyes wide open. If you start trading and assume or believe that you are going to make money on all your trades, then you are in for a nasty wakeup call that could very easily push you back out of the market. And frankly, anyone who promises you otherwise is just parting you with your money by telling you what you want to hear instead of what you *need* to hear. But if you know the facts before you start, know how to exit quickly when the breakout moves against you and how to protect your money this technique is still a winner. **Remember - just because a breakout doesn't go the way you hoped doesn't mean you always lose money.**

The key to withstanding this ugly truth and 'staying in the game' is robust money management – maintain the discipline to ensure you never invest too much on any single trade and always follow the rules. No exceptions. When you do that then learning to trade breakouts properly is the ONLY tool you will ever need in your trading arsenal.

The 7 Golden Rules

If you want to be a successful trader and consistently make money in the market, you need to know the rules and follow them. Even seasoned professions know the rules. Over time, they may bend or break a few as their experience grows and develops but the people who make money year in year out do so by following the rules. For the breakout technique there are 7 golden rules and they are:

1. Only trade breakout formations that have converging trend-lines or parallel trend-lines.

2. The trend-lines MUST have at least five 'touchpoints'.
3. Only enter the trade once the stock has closed outside the trend-line.
4. Always place your protective stop on entry into the trade.
5. Identify your profit target (the target is the breakout point plus the adjusted height of the formation (for longs). Vice versa for shorts.
6. Once you've identified a breakout formation, make up to three attempts to capture the breakout. After that, ignore it and move on.
7. There should be a minimum of 40 bars between the upper and lower trend-lines. [This rule is optional].

That's it – seven rules that will guide your trading and help to future proof your results. Each of these rules is explained in detail below but essentially that's it! There are a few things to watch out for – primarily relating to the definition of a 'touchpoint'.

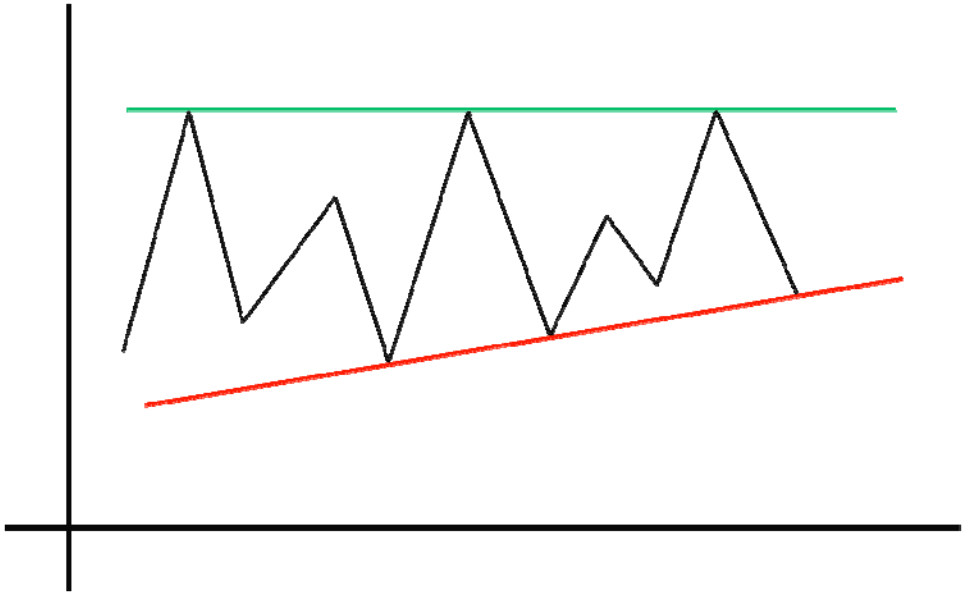
Rule #1: *Only trade breakout formations that have converging trend-lines or parallel trend-lines*

As the name would suggest converging trend-lines are when the trend-line of the upper limit resistance price of a stock converges or gets closer to the trend-line of the lower limit support price of the stock. There are three possible shapes to converging trend-lines that you need to look out for and one parallel trend-line:

1. A converging trend-line with a bias to increase
2. A converging trend-line with a bias to decrease and
3. An unbiased trend-line.
4. A parallel trend-line.

A converging trend-line with a bias to increase

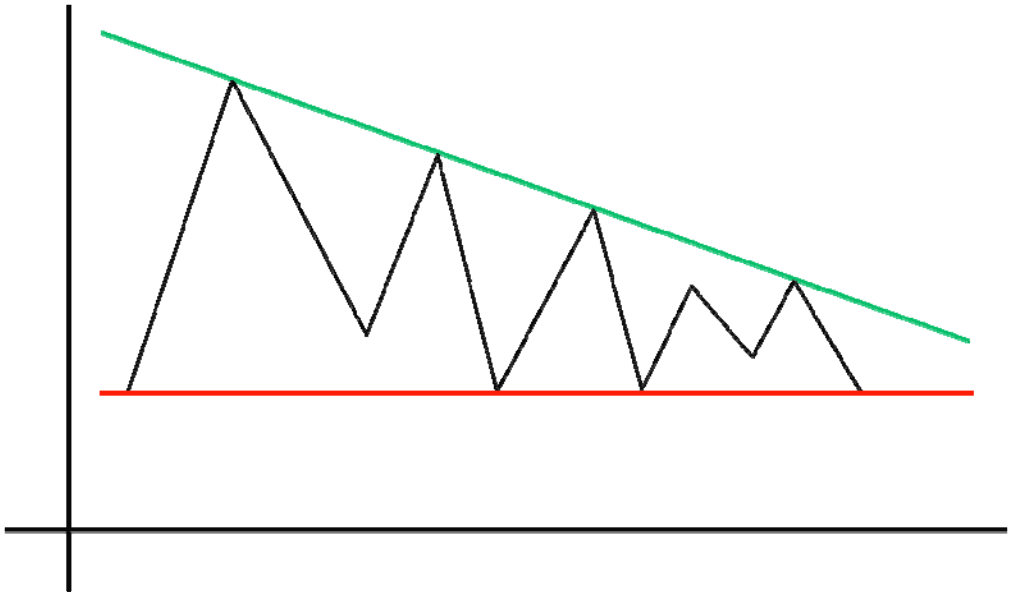
This is seen when the upper resistance level is relatively stable and therefore flat while the lower support level is increasing, thus creating a trading channel that looks like this…



This converging trend-line pattern suggests that while the resistance level of the stock is strong, there is an upward bias as the support price is increasing. This indicates that volatility in the stock will slow as the two trend-lines converge i.e. the support price and the resistance price will get closer and closer together leading to less volatility in the stock. It also tells us to pay close attention to that resistance line because if it breaks the price of the stock is likely to breakout and accelerate very quickly – you want to be on that trade when it does.

A converging trend-line with a bias to decrease

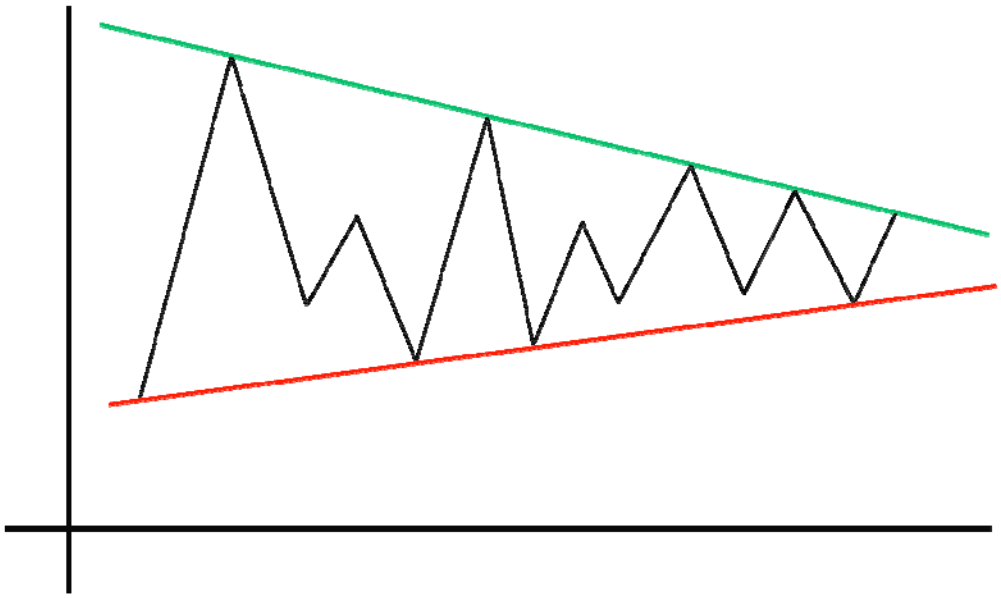
This is seen when the lower support level is relatively stable and therefore flat while the upper resistance level is decreasing, thus creating a trading channel that looks like this…



This converging trend-line pattern suggests that while the support level of the stock is strong, there is a downward bias as the resistance price is decreasing. Again this indicated that the volatility in the stock is decreasing as the two trend-lines converge. This pattern is less interesting to you as a breakout trader because it is the support line that is under pressure. If the support lines break the price of the stock is likely to tumble rapidly. If you own this stock, a converging trend-line with a bias to decrease may be your sign to sell and protect your capital.

An unbiased converging trend-line

This is seen when the upper resistance trend-line and the lower support trend-line converge at the same trajectory, thus creating a trading channel that looks like this…



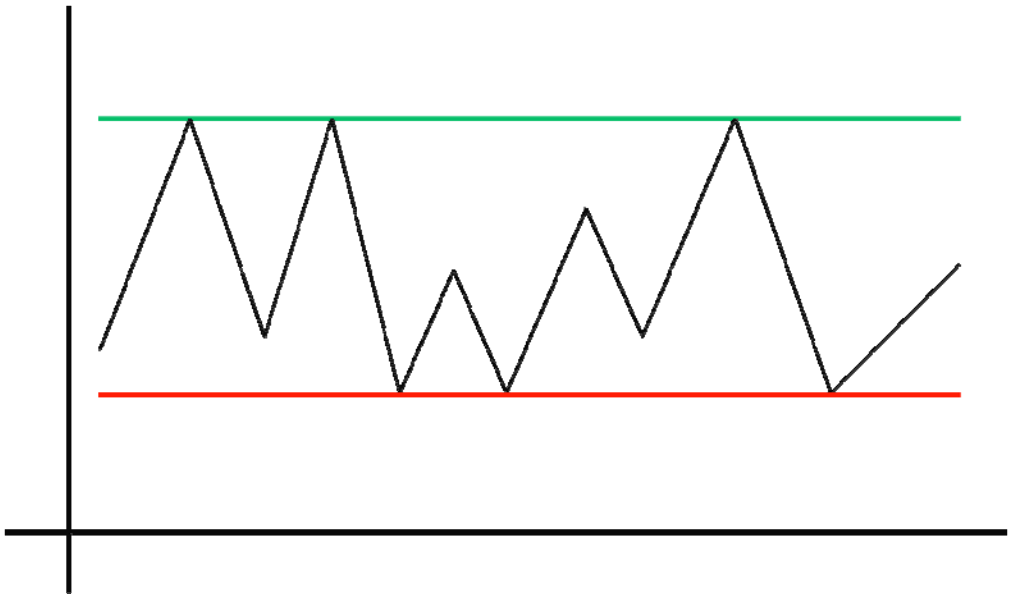
In this instance, neither of the trend-lines are flat - the upper resistance trend-line is decreasing and the lower support trend-line is increasing at much the same rate. Again this indicates a decrease in volatility because the upper resistance price and lower support price are getting closer together. Both trend-lines are relatively strong so you need to be ready for a break in either direction. If the resistance line breaks accelerated moves higher are likely and you want to be on that trade. If the support line breaks accelerated moves lower are likely and you should leave this trade for someone else.

Essentially, converging trend-lines are a sign of **decreasing** volatility in that stock. Volatility is enormously important for helping to identify potential breakouts. Thankfully,

volatility is also highly cyclical so any decrease in volatility is usually followed by an increase. The longer the period of decreasing volatility, the more powerful and longer lasting the ultimate breakout is likely to be.

A parallel trend-line

This is seen when the upper resistance trend-line and the lower support trend-line are tracking consistently in parallel to each other, thus creating a trading channel that looks like this…



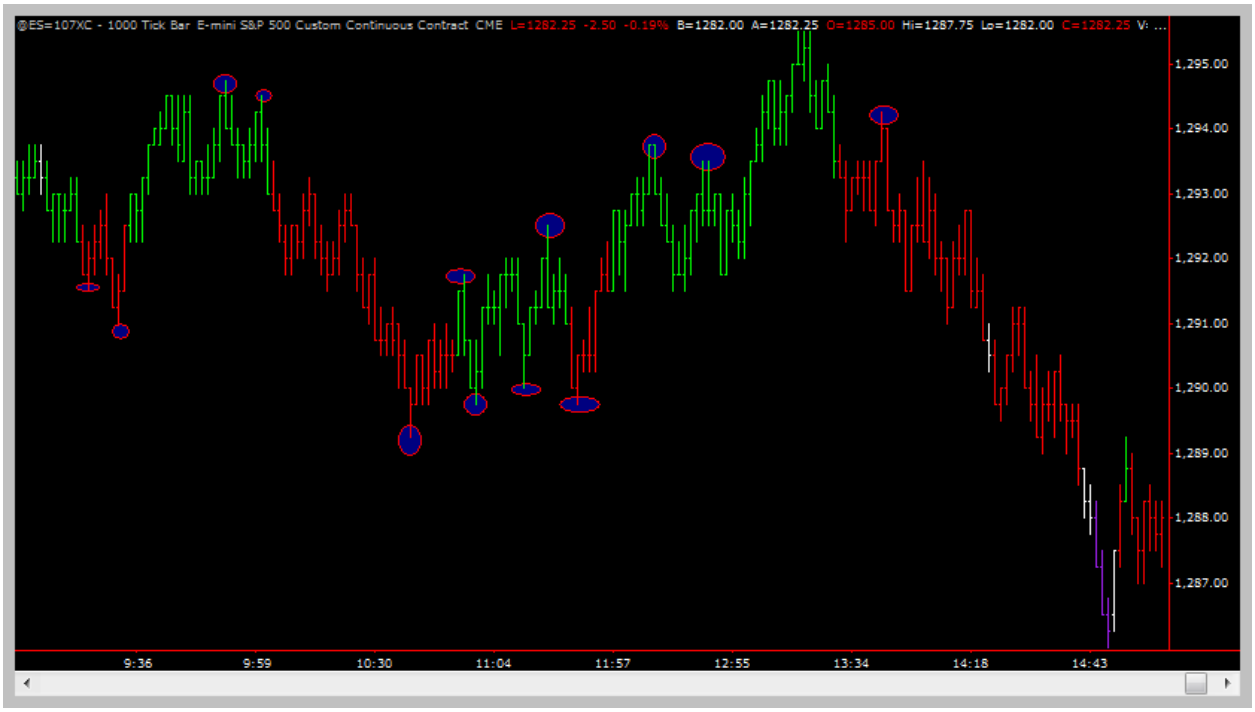
Although this pattern doesn't necessarily suggest decreased volatility it could still lead to a breakout if some of the other rules are met.

Understanding and plotting trend-lines

Trend-lines are drawn using SWING HIGHS and SWING LOWs. A swing high is simply a price bar that peaks out *above* two bars on either side. The two bars on each side of the swing high were lower than the swing high – even at their highest point during the period. (We discuss bars in more depth in lesson #7 of our free online training series.

Visit our website at http://ustradingcoach.com/master-daytrading-in-just-30-days-lesson-7/

Say for example each bar represents a day's trading activity and you want to plot a trend. You need to identify the swing highs which means you need to find price points where the closing price on that day was higher than the closing high the day before and the day after. You can see the seven swing highs circled at the top of the chart below…



A swing low is basically the opposite, so a price bar that is lower than the low of the bars on either side. Again, say each bar represents a day's trading activity and you want to plot a trend. You also need to identify the swing lows which means you need to find price points were the closing price on that day was lower than the closing low for two days before and after. You can see the six swing lows circled on the bottom of the chart above.

Once identified, you simply draw a trend-line connecting as many of the swing highs as possible and another trend-line connecting as many of the swing lows as possible. Each of the identified swing highs and swing lows that determine the trajectory of the trend

are known as 'touch-points'. Choosing a course through as many touch-points as possible ensures that the majority of the price action of the potential breakout formation is enclosed between those lines. This has been done in the chart below. Notice that you can count at least five touch points – three on the top line and two on the bottom. (This is very important and we'll come back to this in rule #2)

Although trading software packages will plot some trend-lines for you, they may not plot according to these rules so it's important to know how to do it. Software can however help you to identify potential candidates that fit the first rule of trading breakouts.

The other thing to notice in the example above is that there was a FALSE BREAKOUT. False breakouts are discussed later but we wanted to remind you that our examples are 'real-world' and not hypothetical.

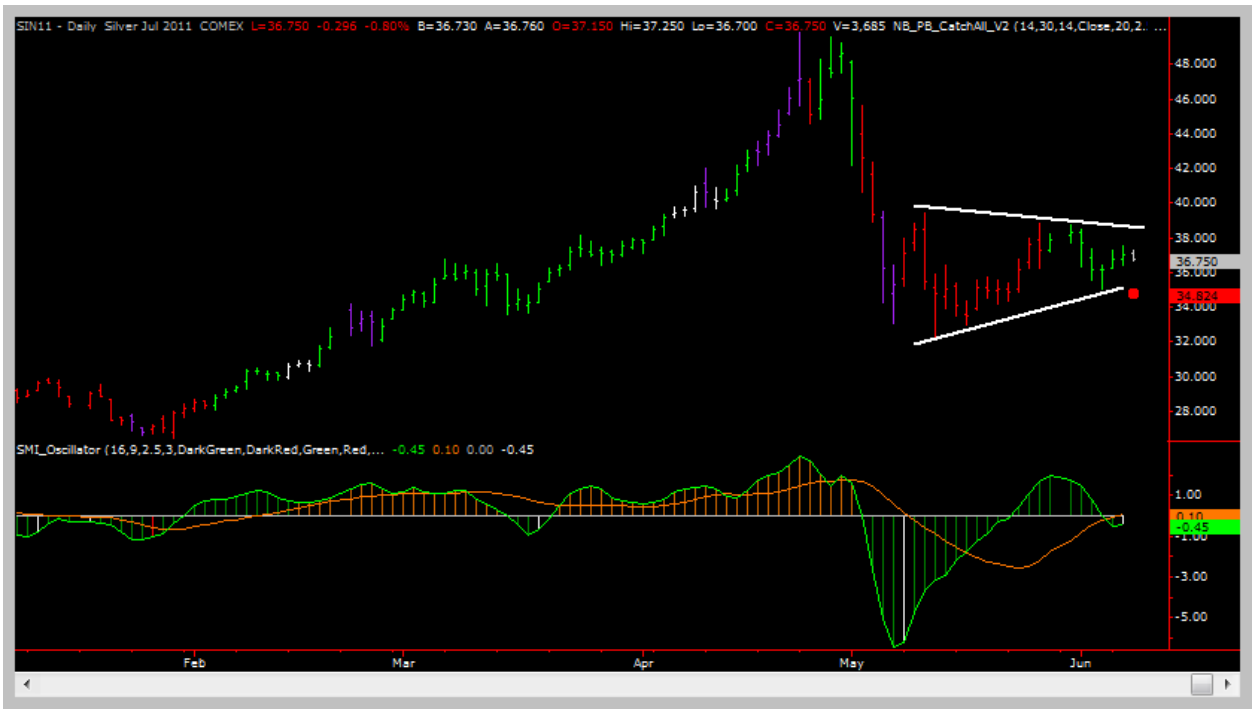
OK, so let's look at some more examples. The next chart shows that it is OK to draw the trend-line through some bars as long as the time spent outside the trend-line is short. In this case, only two bars were spent below the low of the formation. In the 'old days', out-of-line movements were rare and chart patterns tended to be a lot tighter. This change has been facilitated by high frequency trading or trading 'bots' that execute trades automatically. These automatic trading mechanisms don't respect support and resistance levels the way human beings tended to do. If a price breaks it will automatically trigger an immediate sell instead of 'working the order' around the support level. Working the order at support and resistance was the normal, expected thing to do back in the 'old days' because people used a lot of discretion and could tell

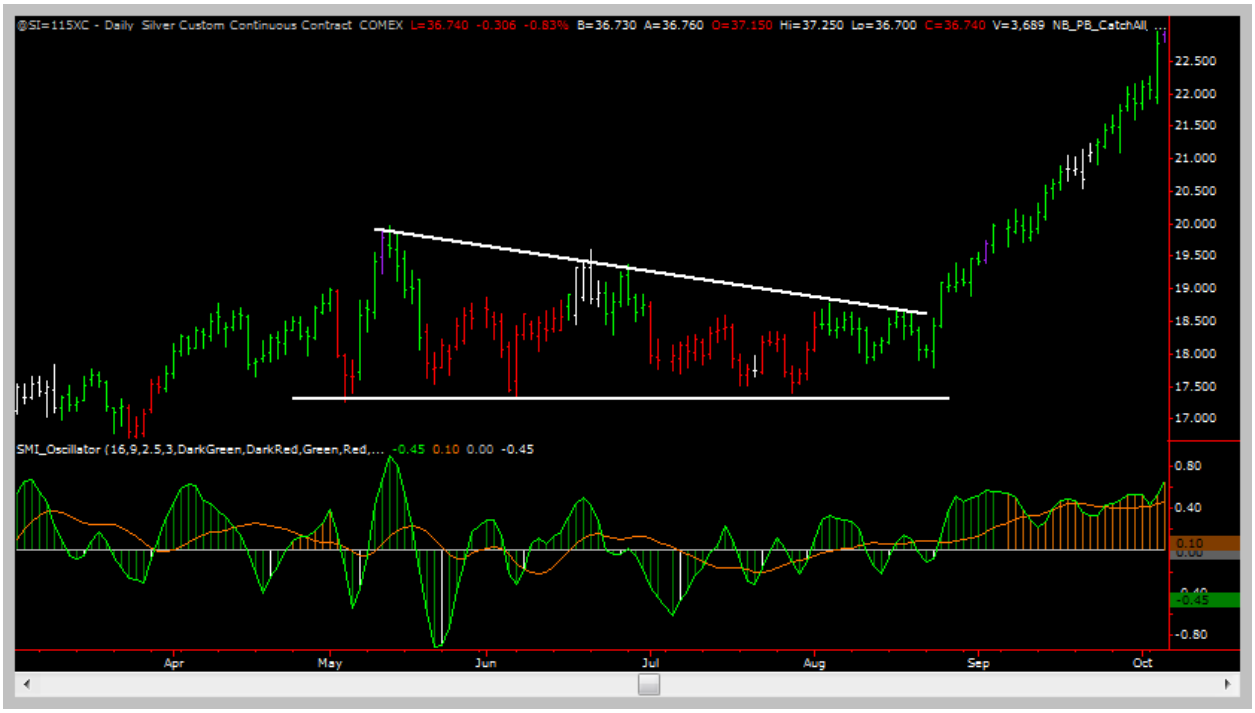
if a movement was 'real' or not. Machines don't possess that discretion. As a result, modern price movements can be 'whippy' or much more volatile. Allowing a brief out-of-line movement recognizes this new reality and still treats the trend-line as valid.

The chart below, which is the same as the one above shows what happened after the false breakout.

The chart above shows how the trend-lines would be redrawn. And, you can see that the subsequent breakout from that extended consolidation was real.

Below are some more examples so you can get a feel for drawing these lines.



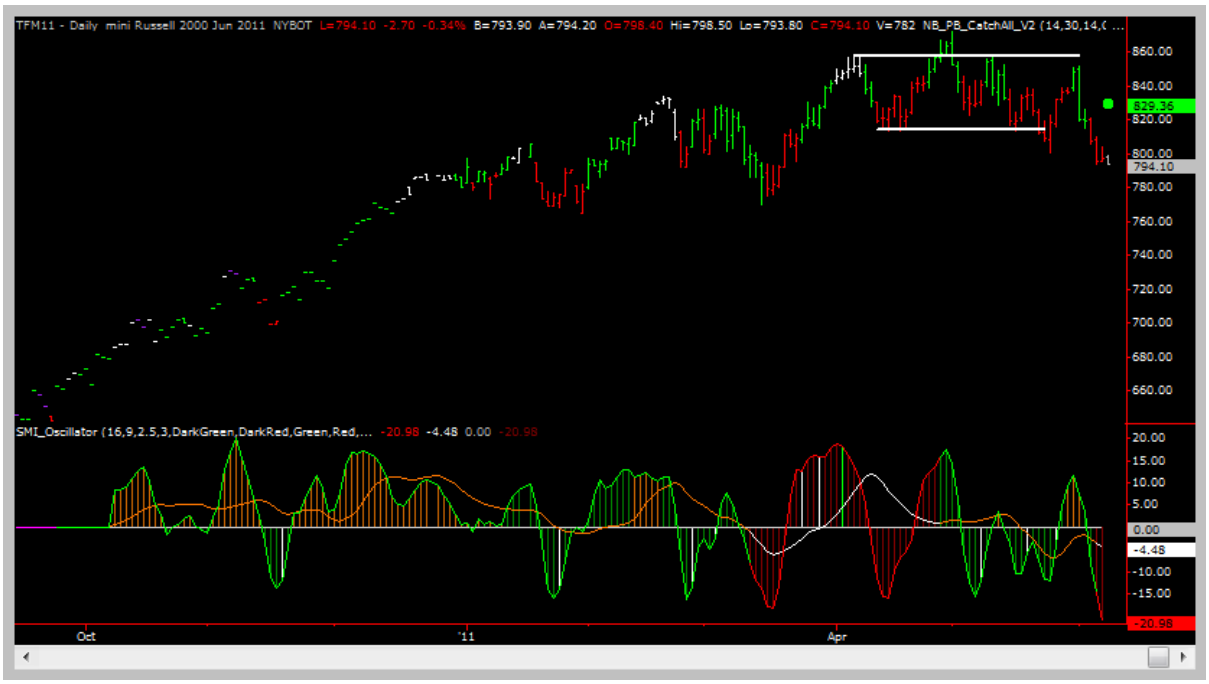


It is important to recognize that in all of the above chart examples, the trend-lines were converging or pointing towards each other. You would never use this strategy on a

stock where the trend-lines were pointing away from each other because this indicated increased volatility. We are looking for decreased volatility that is usually a precursor for increased volatility – remember prices are usually pretty cyclical so if a stock is losing volatility it's likely it's about to get more volatile again which offers you an opportunity to profit.

When seeking to identify potential breakout trades you can also use parallel trend-lines because they are also not pointing away from each other and although they indicate stable volatility, that stability could indicate an upward breakout is imminent if other rules apply. Stocks that display converging trend-lines or parallel trend-lines such as the one shown below are potential trades that you need to assess for the other rules before making your final choice.

There is a major benefit if you have parallel trend-lines – your risk control point (which we will cover later) tends to be smaller which means you can usually initiate a bigger trade giving you the opportunity to make a much larger profit.



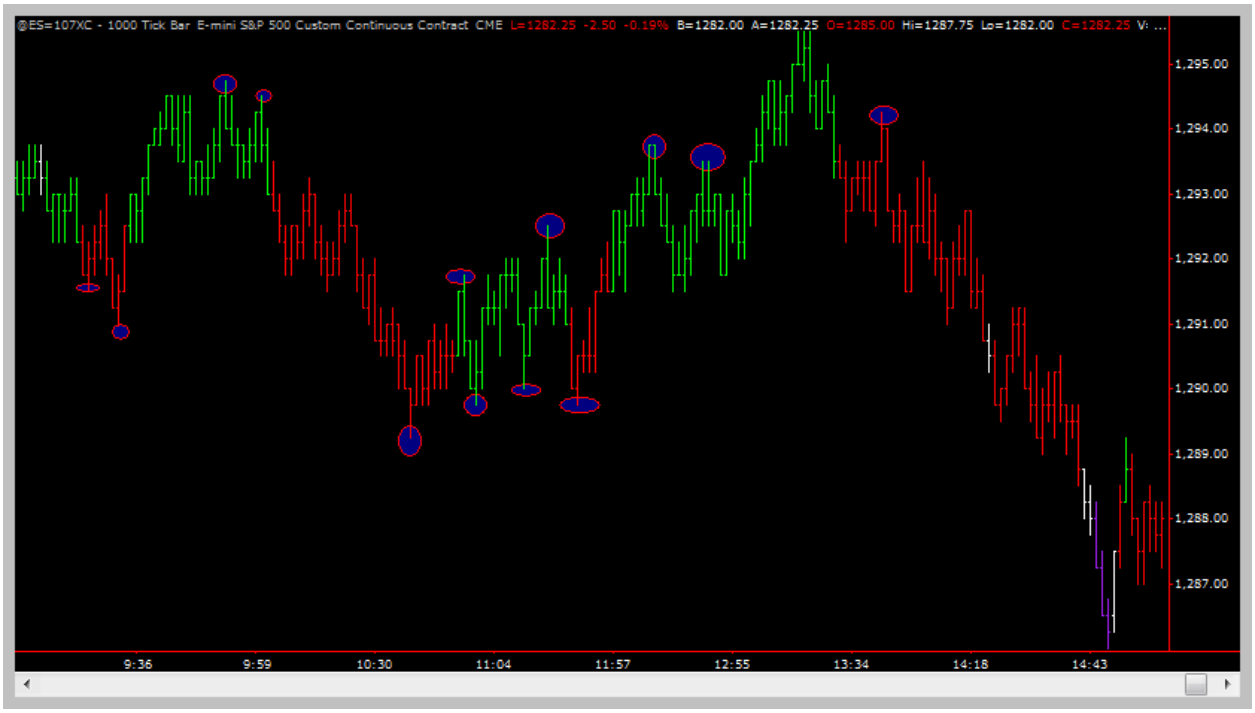
Rule #2: *The trend-lines MUST have at least five 'touch-points'*

In classical technical analysis, consolidation areas are drawn using trend-lines that only have four touch points. Given the volatility in today's markets, it is important to make sure that any potential breakout trades have at least five touch points determining the two trend-lines.

This additional 'must have' touch point should greatly reduce your chance of identifying false breakouts and 'backing the wrong horse'. The downside of this rule is that you will miss some breakouts but the added security, especially at the start of your trading career is worth the trade-off.

Remember from rule #1, the trend-lines are plot by identifying the swing highs and swing lows.

Reminder of Definition: *A **Swing High** is a bar that is between two bars whose highs are lower than the swing high bar. A **Swing Low** is a bar that is between two bars whose lows are higher than the swing low bar. Ideally neither of the two bars on either side of a swing high/low will be inside bars (bars whose low is higher than the prior bar and whose high is lower than the prior bar).*



Once identified the trend-lines need to pass through at least five touch points as shown again in the chart below…

If you take a moment to revisit all the chart examples in rule #1, you can see that all the converging or parallel trend-line formations had at least five touch points. And, just to be clear, a touch point is simply a swing high or swing low. Usually one trend-line will have three touch points and the other will have two.

Rule #3: ***Only enter the trade once the stock has closed outside the trend-line***

The first price bar that breaks through your trend-line and CLOSES outside of the trend-line is your entry signal into the trade (so long as all the other rules are in play). Take note of the emphasis on closes; if the bar breaks through the upper trend-line but closes inside the trend formation then this is NOT a signal to enter the trade. It has to close above the upper trend-line (for long trades) or below the lower trend (for short trades).

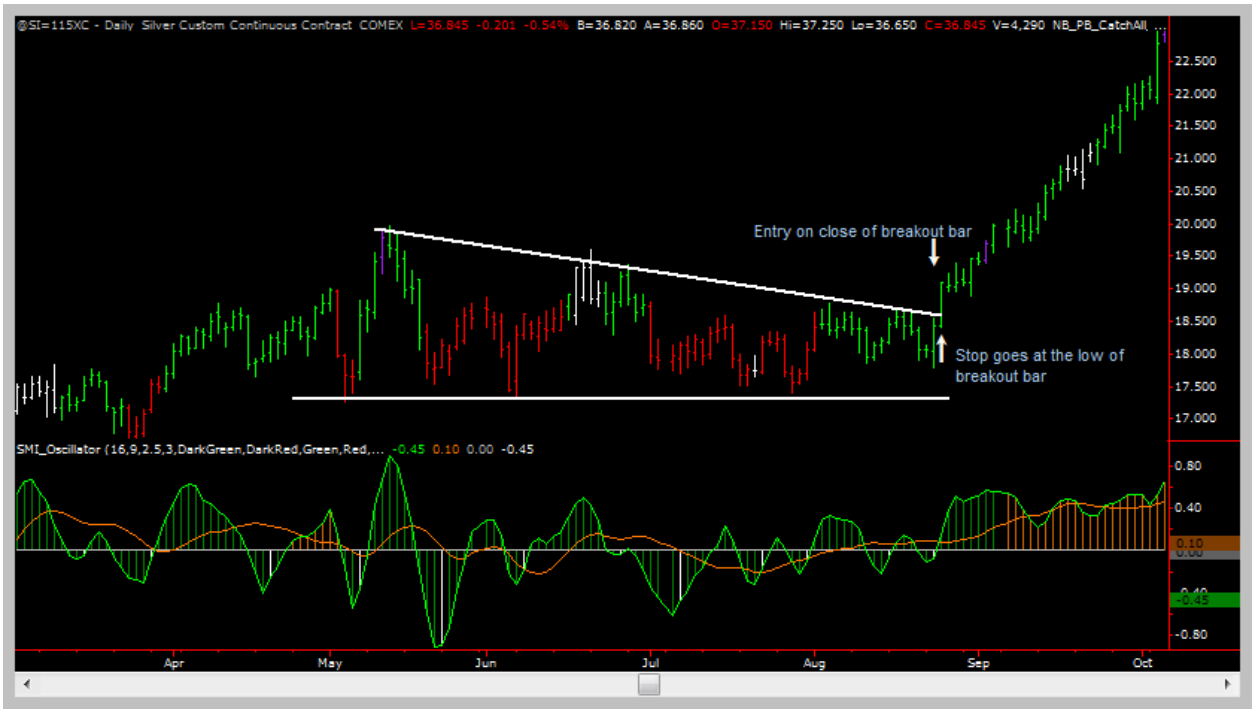
If the stock price breaks through that upper trend-line and closes above it, then you are initiating a long trade on the close of the bar. In practical terms that means you place the trade on market open the next trading day, which, in our 24 hour markets can mean as early as 5:00 PM Central Standard Time if trading US Futures markets.

Long Vs short trades

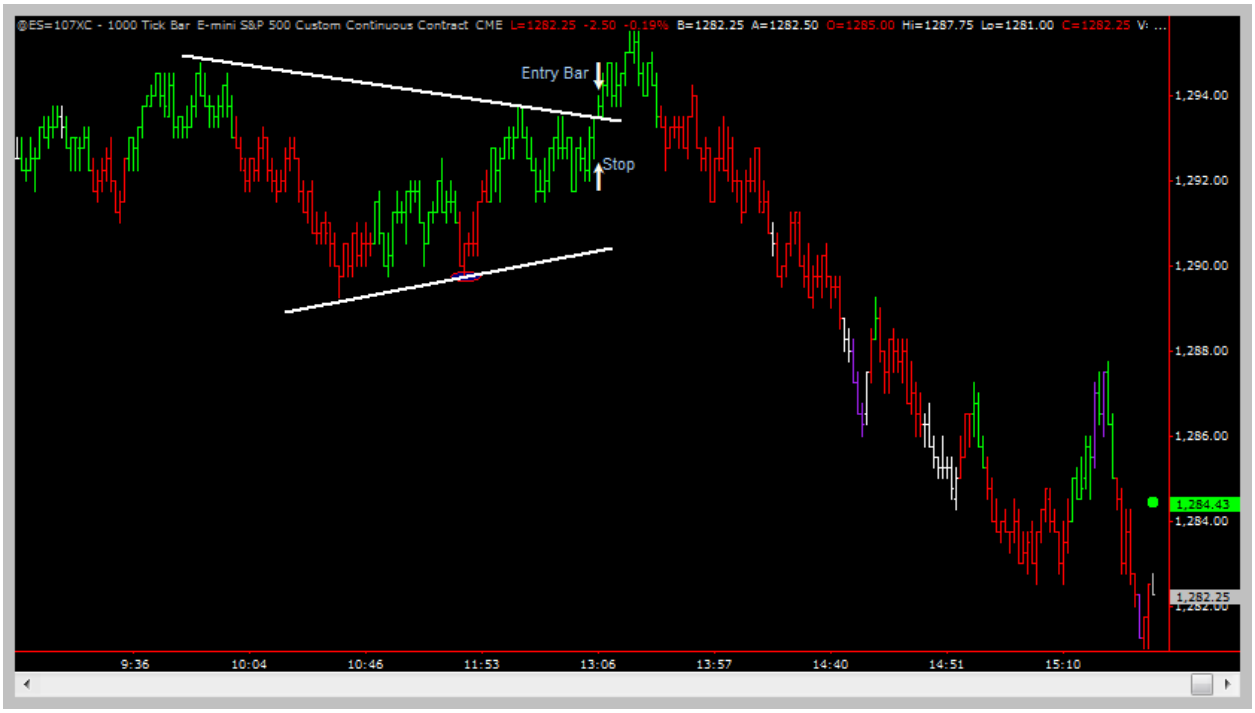
Online resource Investopedia has this explanation for the difference between long and short trades, "Essentially, when speaking of stocks, long positions are those that are ***owned*** *and short positions are those that are* ***owed****. An investor who owns 100 shares of XYZ stock is said to be 'long 100 shares'. This investor has paid in full the cost of owning the shares. An investor who has sold 100 shares of XYZ stock without currently owning those shares is said to be 'short 100 shares'. The short investor owes 100 shares at settlement and must fulfil the obligation by purchasing the shares in the market to deliver. Oftentimes, the short investor borrows the shares from a brokerage firm in a margin account to make the delivery. Then, with hopes the stock price will fall, the investor buys the shares at a lower price to pay back the dealer who loaned them.*

When an investor uses option contracts in an account, long and short positions have slightly different meanings. Buying or holding a call or put option is a long position because the investor owns the right to buy or sell the security to the writing investor at a specified price. Selling or writing a call or put option is just the opposite and is a short position because the investor owes the holder the right to buy the shares from or sell the shares to him at the holder's discretion."

Below is one of our charts from earlier. You can see this stock experienced a nice impulsive move outside of the upper resistance level trend-line. Entry would therefore be on the close of that bar or the open of the next bar ($19.00 in the chart below). The sell stop-order to protect your capital would be placed on entry to the trade at below the low of the entry bar ($18.50 in the chart below)



This next chart shows a false breakout to the upside (this is also a chart from our earlier chart examples). The entry bar and the stop levels are marked. You will notice that in this case the stop-order level is NOT the low of the entry bar. This is because the low of the entry bar is above the trend-line – your protective stop needs to be inside the trend formation to minimise risk. Instead, we took the prior bar which had a low inside the trend-lines.

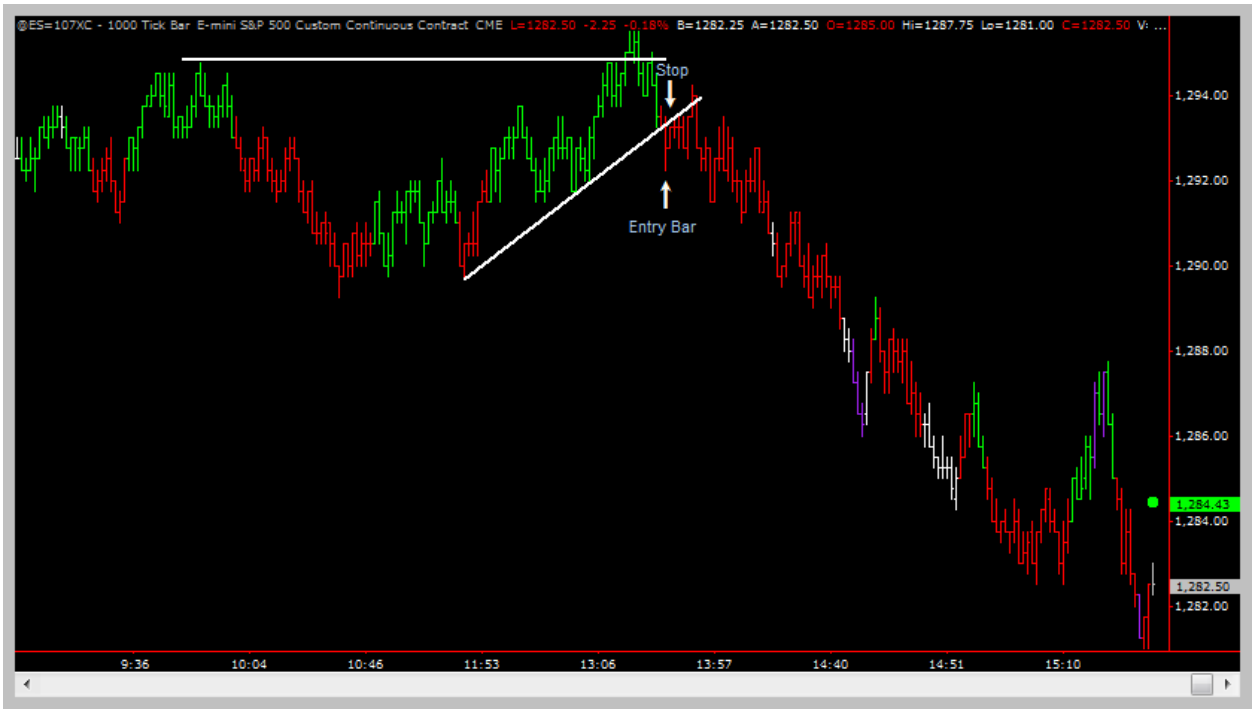


In this instance, the breakout was a false breakout so the trade was stopped out when the price started to fall again. The new trader to this technique might be tempted to take this trade because price penetrated the trend-line. In this case there was one bar that did that. But the bar did NOT close outside the trend-line so it was not OK to enter the trade at that point. Someone new to trading breakouts might not realize that right away – the human tendency is to just look for bars that move outside the trend-line without regard for where the price closed.

If possible, once you're stopped out the trade, seek to re-draw the trend-lines. The chart below shows one possible way to redraw the trend-lines.

In this instance above, it looks like we used the WRONG breakout bar for our example. But, the initial bar that penetrated the lower trend-line did not CLOSE outside the trend-lines. Thus, the bar we identified as the entry-bar for the short trade is the correct bar.

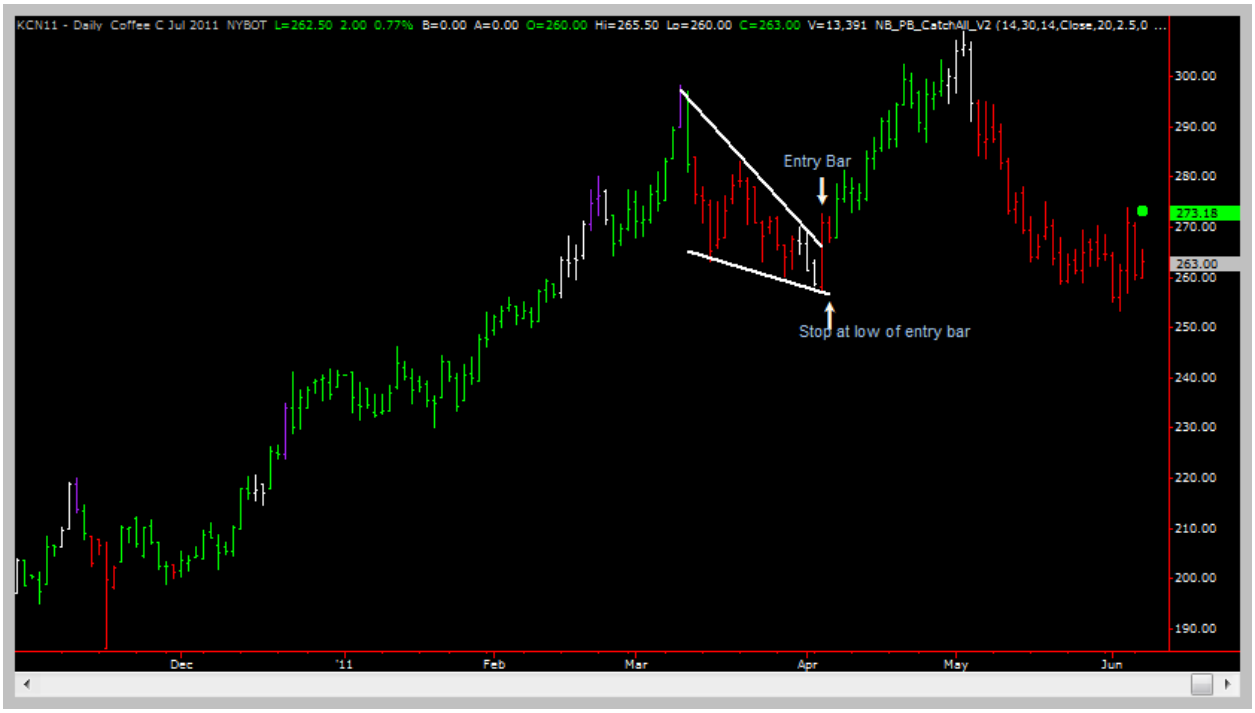
Here is another way we could have re-drawn the trend-lines on the same chart.



In this chart, the breakout trade would have been stopped out. And the trend-lines would have been redrawn as shown in the prior chart.

In this chart, the close is outside the trend-line so the entry into the trade would be at 1,510.90. The stop-loss order would be placed at entry as the low of that same bar – in this case 1,480.00. The trade looks positive in this chart.

In the chart above the entry signal for a downward breakout is the closing low outside the lower support line at around 178.00. Again the stop-loss order is the high of the same bar, in this case 190.00. Again this breakout trade was profitable, even when it rallied at aroun 140.00 it was a long way from the stop.



The above chart is another example of converging trend-line. It is a classical chart formation called a descending wedge. The breakout was to the upside.

Rule #4: *Always place your protective stop on entry into the trade.*

Protecting your capital is crucial for trading success. I've already explained that even the best traders in the world have a success rate of between 30 – 50 percent. Most traders, even the successful ones will have more losing trades than winning trades but they still make money. You might be wondering how that's possible but the reason is simple – they protect their downside and minimise the risk to their capital through the consistent use of protective stops.

Successful traders never enter a trade without knowing when they will exit. The protective stop ensures that exit so although the trader may not win every time they don't necessarily lose and if they do lose money it's never a lot.

So where do you place your protective stops?

If you are entering a long trade i.e. you are buying stocks that you believe are going to go up in price, then you place the protective stop at the low of the bar of entry so long as that low is below the upper trend-line. Otherwise, use the low of the first bar whose low is below the upper trend-line.

If you are entering a short trade i.e. you are selling stocks (before buying them) on the assumption that you can buy them back cheaper and realise a profit when the price falls, then you place your protective stop at the high of the bar of entry so long as the high is above the lower support trend-line. Otherwise, use the high of the first bar whose high is above the lower trend-line.

I tend to give the stop a few ticks of 'wiggle room' and not use the exact high and low. (As a reminder, a 'tick' is the minimum price movement allowed by an exchange. So for stocks, the minimum price movement is 1 penny. For S&P e-mini futures the minimum is 0.25. Before the advent of electronic trading the minimum price movement of a stock was 1/8th.) So place your stop-loss orders a couple of 'ticks' from the exact high or low to give yourself some lee-way.

Rule #5: *Identify your profit target (the target is the breakout point plus the adjusted height of the formation (for longs); Vice versa for shorts.*

Now that you know where to enter a trade and how to protect your capital from losses, you need to know your criteria for positively exiting a successful trade. You probably already know that entering a trade without a plan for how and when you will get out the trade if it turns against you is a recipe for disaster. But, it's also not that smart if you don't know your profit target and are not clear when you will exit a successful trade. Many traders 'let it ride' only to end up kicking themselves when they let their greed take over, fail to get out in time and turn a profit into a large loss.

You need to know your profit target and stick to it. First, you need to calculate a minimum target. You get this by taking the share prices at the last two touch-points in the upper and lower trend-lines in the formation and subtracting them.

Looking again at a chart we've already seen, you would take the last touch point of the upper resistance trend-line (1,293.50 – labelled "1" in the image) minus the last touch point of the lower support trend-line (1289.50 – labelled "2" in the image) = 4 (your minimum target).

That gives you the amount of points you're shooting for – in this case, four. For long trades, simply add that to the breakout level (the point at which the breakout bar crosses the upper resistance trend-line). Again looking at the diagram above that would be 4 + 1293.00 = 1297.00. Your target profit would be 1297 – as soon as the stock reaches that value you would exit the trade and bank your profit.

If you were making a short trade you would simple subtract your minimum target number from the breakout level or the point at which the breakout bar crosses the lower support trend-line.

Note: the breakout level is the point at which the breakout bar crosses the trend-line. This is different from your trade entry-price!

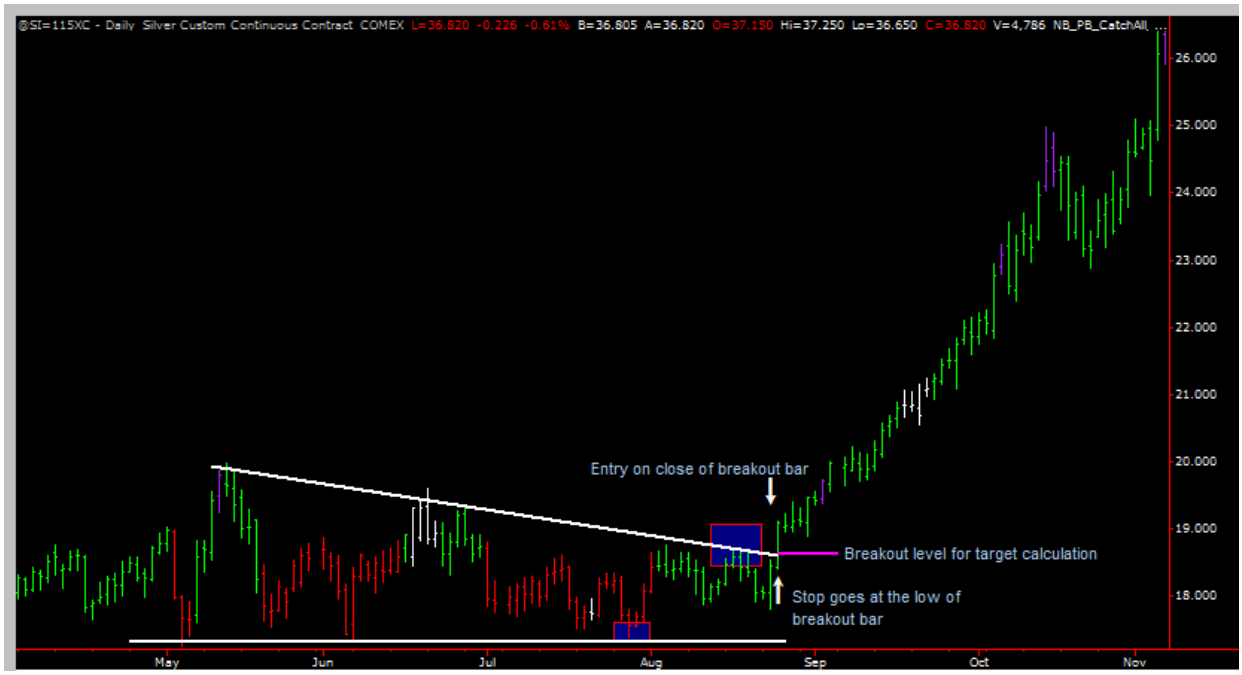
Now, let's look at another example.

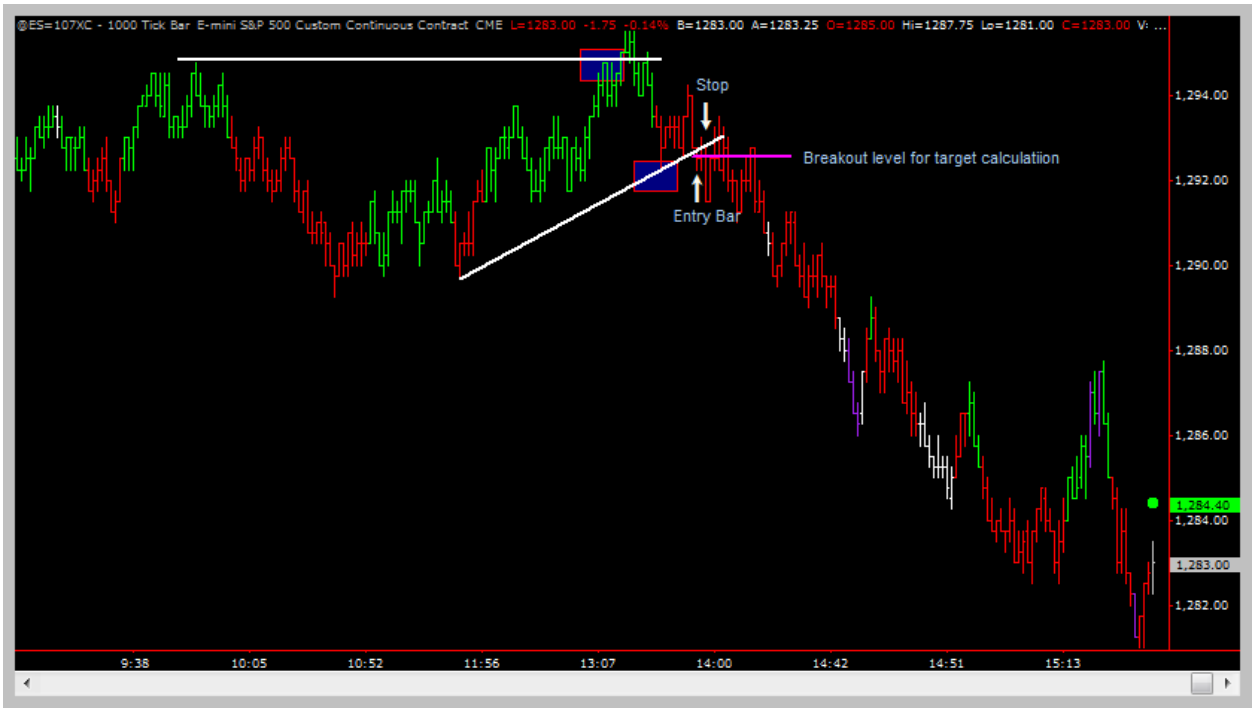
Again, you've already seen the chart below. This time, though, we are showing two blue squares and a pink line. The two blue squares are the last two touch-points inside the consolidation. The last upper trend-line touch point is 18.64 and the last lower trend-line touch point is 17.39. (18.86 – 17.39 = 1.25). This gives us a projected move of 1.25 full points from the breakout level.

The breakout level is identified by the pink line on the chart (18.75). This is a long trade so we add 18.75 to 1.25 to give us our target profit price of 20.00. Once the price of the stock reached 20 we would have cashed out for our target profit. Of course, as you can see from this graph we would have been weeping into our breakfast cereal on this one because the price greatly exceeded the target.)

Note for advanced traders

Advanced traders might take a portion of their profits at the target and let the rest run, using a trailing stop-loss order to protect their existing profits. The disadvantage of this technique is that the trader will have an even lower win ratio. The advantage is that the trader stands a much better chance of hitting a couple of home-runs per year which can greatly increase their profits.





The chart above is the third example. The two blue squares again show the two most recent touch-points. The difference in the price levels is 1294.50-1292.25 = 2.25 ES points. As this is a short trade we subtract 2.25 from the level shown at the pink line on

the chart (1292.50) to get the target of 1290.25. Again, in this example, the breakout greatly exceeded the projected target.

Of course, if you'd been following my rules you'd be hopping mad and busy emailing me to complain bitterly how rule #5 just lost you thousands of dollars. The thing is these types of breakouts are pretty rare. Becoming a genuinely successful trader requires consistency and the only way to do that is to consistently take profits and protect against losses.

But, once you get more familiar with the technique there is no reason why you can't adjust your profit targets to shoot for bigger wins. Once you've made some money – consistently, and probably once you've missed a trade like the two above you may want to play around with this rule. If you reach that point then there is only one strategy I recommend – take half your position off the trade at the minimum target, move your stop too breakeven and then let the rest ride – taking portions of profit out every time you hit a multiple of your initial target.

So going back to the short trade example above you would take half your investment out at 1290.25, move your stop to 1292.50 (the entry price of the trade) and let the other half ride until you decide to cash out if the price shifts direction.

Rule #6: *Once you've identified a breakout formation, make up to three attempts to capture the breakout. After that, ignore it and move on.*

As mentioned earlier, identifying genuine breakouts from chart formations can be tricky because they have a nasty habit of generating a lot of whipsaws or price corrections. Whenever possible, after every whipsaw, you should redraw the trend-line.

However, after three attempts to capture the breakout, you should give up. The market is obviously not friendly and you should not waste any more capital. In this situation, your normal instinct may be to stick with it so you can 'make your losses back' on the

same trading instrument. But a consolidation that has taken you money three times is telling you that it's not really ready to truly breakout. What's the point of losing more money? Of course, the trade may be successful on the 4th try but that's not the point. The point is you need to draw a line under that trade after three attempts and move on otherwise you will throw good money after bad and you will almost certainly lose in the long run. Move on to something better – there is always another trade around the corner.

Rule #7: *There should be a minimum of 40 bars between the upper and lower trend-lines. [This rule is optional].*

The reason for this rule is simple – we estimate that 40 bars is enough to create a large enough pattern where a breakout has enough power to really run. The psychology behind the consolidation of price is that there are buyers and sellers who are effectively in balance – enough buyers come in the lower trend-lines to push prices up and enough sellers come in at the upper trend-lines to push prices back down. However, eventually either buyers run out of patience or capital and therefore sellers come to dominate the price action leading to a break down or sellers run out of inventory (or short sellers run out of capital) leading to a breakout to the upside.

This suggested 40 bar rule provides enough time for sellers or buyers to reach their limit. However, certain markets such as Grain Futures can have very small patterns leading to large breakouts – these markets tend to be reactive to exogenous events such as weather. But for most stocks or other financial instruments, you need a large enough and long enough consolidation to really build up the explosive power required for a breakout to lead to large gains.

Money Management

If you follow these six or seven rules for trading breakouts you will improve your success rate. You still won't win them all but you will be able to consistently use this

strategy to make money in the market. At least you will if you also practice sensible money management. Knowing what trades to place is one things, knowing how much to place on that trade is quite another.

Deciding your trade-size is however, pretty simple. You know your entry level and you know your stop position so all you need to so is calculate the dollar value of that risk and put on enough contracts so that you lose, at most, 1 percent of your capital if you were stopped out of the trade.

Let's take a look at a couple of examples

Example #1: Long Trade

When you initiate a trade using this technique, you know four things:

1. You know your entry price. Let's assume this was 1292.50.
2. You know your stop price level. Let's assume this was 1280.00
3. You know the value of your trading account. Let's assume that this is $100,000.
4. You know your target price. This is irrelevant for this calculation (but check out the breakout box below for why this might be important in your decision as to whether you should take the trade)

With the numbers in this example you are risking 1292.50-1280 = 12.50 per trade. If this were a stock, then for each share you buy you would be risking $12.50 per trade. If this were an S&P e-mini futures contract you would be risking $12.50*50=$625.00 per contract.

Now, assuming that you are going to risk one percent of your total capital on this trade. One percent of your total capital is $1000.00.

If you are trading stocks, then you can purchase 1000/12.50 = 80 shares.

If you are trading something like the S&P e-mini futures contract, then you can purchase 1000/625 = 1.6 contracts. Since you can't trade a fraction of a contract you would be trading either 1 contract or, rounding up, 2 contracts (thereby risking slightly more than 1 percent of your capital)

Example #2: Short Trade

The three most important numbers to keep in mind are:

1. Your entry price (the price at which you short sold the stock or other financial instrument). Let's assume that price is 1800.
2. Your stop-loss price level. Let's assume that is 1810.
3. Your account value. Again, let's assume that is 100,000.

The difference between your entry price and the price at which the trade would be exited for a loss is 1810 – 1800 = 10.00. If this were a stock, you would be willing to lose $10.00 per share. If this was a CME GOLD contract, you would be willing to lose 10*100=$1000 per share.

Again, assume that you are willing to risk 1 percent of your capital on this trade - $1000.00 on your 100,000 account. If you are trading stocks, then you should trade 1000/10 = 100 shares of stock. If you are trading a futures gold contract, then you would trade 1000/1000 = exactly 1 contract.

An Additional Risk Consideration

There is an additional consideration when deciding how many shares or contracts to trade and that is the amount of your capital you need to purchase those shares.

In our first example we needed to trade 80 shares. What if the price of each share is, say, $1300.00? Then you would need $104,000 to put the trade on which is more than your entire account of $100,000. You might not want to risk your ENTIRE account on

one trade – what happens if a CEO gets arrested or the firm gets caught in an accounting scandal? These are the types of events that can cut 50 percent off a stock price immediately. With your entire account used up for one stock, you can lose 50 percent of it overnight in a 'freak' event.

So, you might think about trading a smaller number of shares.

In the case of a futures contract, you are less exposed because:

a) You are using only a fraction of your capital for margin to initiate the trade. This means you can put on more trades which can help hedge your exposure to any one market.
b) Most futures trade almost 24x7 so a freak event stands a greater chance of being caught by your stop-loss order thus limiting your losses. Stocks do not trade 24x7 so you stand the risk of a GAP opening that blows through your stop-loss level. In other words, your stop could open on the next day of trading lower than your stop-loss and therefore not get triggered!

Why the target price matters

We mentioned in the first example above that the target price could be a factor in your decision making process on whether to enter a trade. The reason is this: You might be risking more on a trade than you might make.

Using example #1 above, let's assume your target price is 1296. So you will be making 3.5 points on the trade if you are right and the trade is successful but you will be losing 12.50 points if you are wrong. This is probably not a wise decision. Generally speaking, you would want to have a target price that is a multiple of your risk so that you are making, say 2 or 3 times the amount you would lose if you are wrong. This serves as an additional filter on what trades you should initiate.

Remember, you can easily make 10 bad trades in a row but if you are only ever risking 1 percent of your capital, you will be able to manage the losses until the wins emerge. In this case you would only have lost 10 percent of your capital (assuming you don't run into a bad-gap opening). Obviously losing 10 percent is never enjoyable but it's manageable and allows you to stay in the game. Longevity in trading is extremely important and you will never achieve longevity if you don't manage your money and consistently limit your downside risk.

Many professional traders who have been trading breakouts for decades usually risk only 0.5 percent of their account size on most of their trades. Contrary to what you read in the news, really great traders are not the hot shots, flying by the seat of their pants winning big and losing bigger – they are the consistent players who manage their money smartly.

How your Psychology Matters

While breakouts have the potential for large profits with manageable risk, it can be a mentally challenging strategy to use consistently. I alluded to that at the beginning of this e-book when I explained the importance of consistency. If you are going to try this strategy every now and again then changes are you won't be successful; the key is to use it relentlessly – then and only then, will you stay in the game long enough to profit from the successes. Knowing the reality of this strategy is crucial, knowing and accepting that you will not make a profit most of the time is also critically important – especially for your psychological peace of mind. In life, we are told repeated that winning is everything, success is all that matters. What is constantly downplayed is the fact that success is only possible alongside failure – no one wins all the time. The biggest mistake traders make is they jump into the market with optimism and enthusiasm without any real appreciation for how it will feel when they lose or they make a poor trade. It's tough - especially at the start. Often, it's enough to push that trader out the market all together. And that would be the biggest mistake of all.

Instead, get educated and be realistic about what you are doing. Even the best traders in the world only profit from the breakout technique 30 – 50 percent of the time. The trick is not to lose too much money when you are wrong. And that's why the 7 rules are so important. They will help you to identify potential trades while minimising your downside risk so you can stay in the game. Remember, the key is consistency – using this technique time and time again. Even if you make 10 losing trades in a row, it is important to take the next trade and the next trade after that. That next trade could be the one that recoups all your little losses and boosts your profits.

By keeping your trade size small to minimise your risk, you are better able to handle the inevitable string of losing trades. Remember, you cannot expect your win rate to exceed 40 percent and most years, it will likely hover between 25 and 30 percent! But, done properly, breakout trading has the longest consistent history of positive results across the trading universe regardless of instrument type.

Follow the rules and you will massively increase your chances of success, take out partial profits when you can and let part of the trade ride so that you can really capitalise on the big moves when they occur. Catching these really big trade can make the difference between a winning year and a losing year. The Pareto Principle tells us that 80 percent of our results come from just 20 percent of our effort. With the breakout strategy it's even higher… more than 90 percent of your profit will probably come from just 10 percent of your trades!

You need to appreciate that fact going into the game, so that your inevitable losses don't force you out and away from those profits. Just stay in the game and follow the rules.

Wrap Up

This e-book has covered everything you need to know about breakout trades, how to find them and the rules to implement to keep your capital safe and your profits healthy.

Breakouts in one form or another have been responsible for most of the longest running trends and the success of some of the most famous traders including the "Turtles".

Do you remember the 1980s movie Trading Places? Two wealthy investors (Mortimer and Randolph Duke) had differing views about whether anyone could be trained to be a successful trader. They make a bet and Eddie Murphy and Dan Ackroyd's characters swap lives with hilarious consequences. Well the 'Turtles' is the real live equivalent of that experiment conducted by legendary commodity traders Richard Dennis and William Eckhardt.

In the 1980s Dennis had turned an initial stake of less than $5,000 into more than $100 million! His partner Eckhardt believed that Dennis possessed a special gift of some sort that made trading successfully easier for him than the 'average joe'. Dennis disagreed. He believed that anyone could be taught how to be successful if they learned the right rules and had the financial and psychological discipline to stick to them.

To settle the argument Dennis placed a newspaper advert inviting people to apply to join a training program taught by him. Thousands applied but only 14 were accepted. He called his students 'Turtles' after recalling turtle farms he had visited in Singapore and deciding that he could grow traders as quickly and efficiently as farm-grown turtles.

So did it work? Absolutely - according to former 'Turtle' Russell Sands the group personally trained by Dennis earned more than $175 million in only five years. Richard Dennis had proved beyond a doubt that beginners can learn to trade successfully. And the rules he followed were for breakout trading – the strategy you've learned in this e-book.

Even today (early 2016 – the last time this document was edited), many famous fund managers and discretionary traders are getting killed by trying to catch a bottom in markets like the energy market. However, those who were following the breakout rules

and simply stuck with the trend are winning year in year out. These are the SYSTEMATIC higher timeframe traders who are making a profit tracking weekly or monthly charts instead of just hourly or daily charts. These traders almost always use breakout techniques to make the bulk of their profits. Even "Macro" traders time many of their trades using charts and, almost always, the chart construct that triggers their trades are based on breakout patterns.

If you would like more information on this technique along with updated charts and the structure of the current market action, please check out www.ustradingcoach.com.

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Nigel Bahadur is an independent trader with a "go anywhere a market is moving" philosophy. The President of Structured Markets Inc., he trades Futures, Stocks and Options with the primary focus being on the US Futures markets.

Prior to 2011, he provided trading related consulting services to hedge funds (primarily LBRGroup/Granat Fund) and other entities under the SMI corporate umbrella.

In a prior lifetime (i.e.: more than 10 years ago), he ran the software development arm of EXE technologies and Neptune Software. He is well-versed in the requirements and challenges of creating enterprise software, having created multiple commercial enterprise class products over the years.