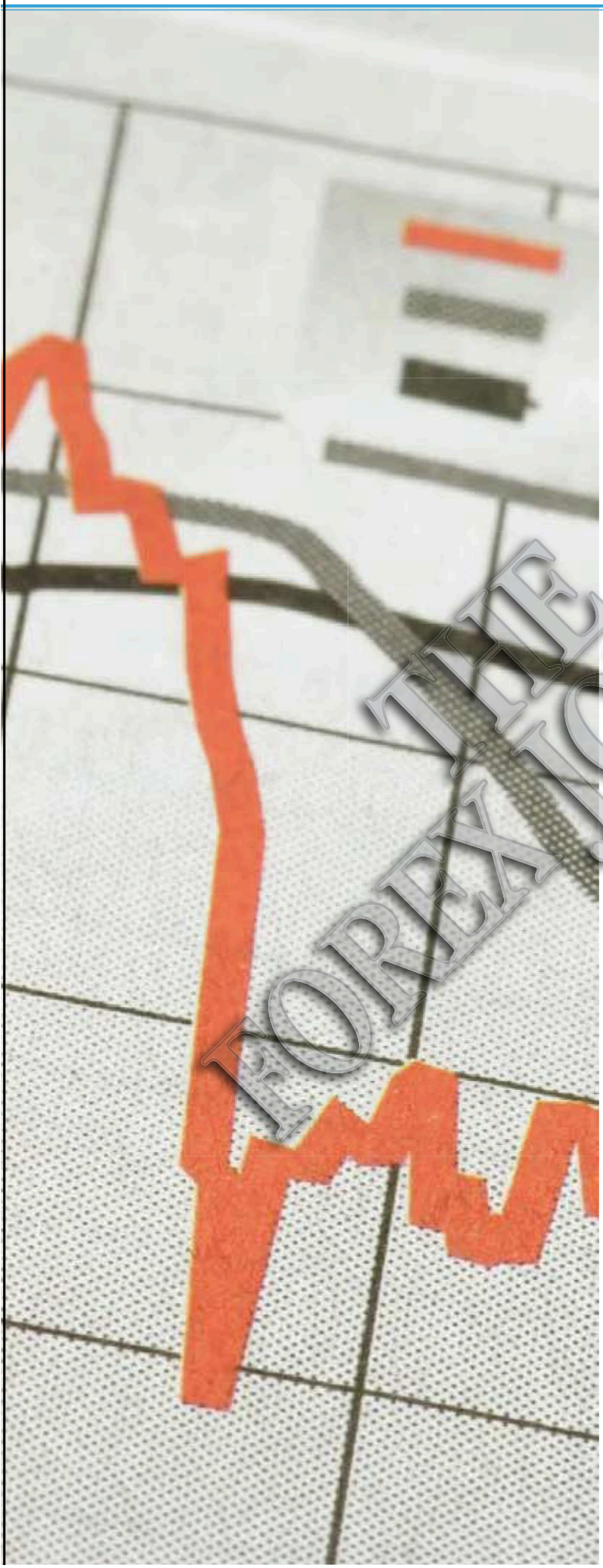
BREAKOUT SYSTEMS



Breakout systems can be considered another form of swing trading. Ron Schelling leads a discussion on things to look for in developing a breakout system.

In this article, I will share a number of simple breakout strategies used by many professional traders in today's trading arena. There are many different strategies ranging from simple to complicated that can be successfully combined with proper money management.

Breakout systems can actually be considered another form of swing trading, which is a style of short-term trading designed to capture the next immediate move. In other words, the trader is not concerned with any long-term forecast or analysis, only the immediate price action.

A crowd usually has the psychology that if the previous day's high is crossed to the upside, the general price move is up as well and they are more likely to buy than sell. The opposite is true when the previous day's low is crossed down.

Further, many traders use the previous day's high and lows as their stops. If prices cross below the low, traders will

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be stopped out, while the opposite is true for the previous day's high.

Volatility breakout systems are based on the premise that if the market moves a certain percentage from a previous price level, odds favor some continuation of the move. This continuation might only last one day or go just a bit beyond the original entry price, but this is still enough profit to play for. In any case, a trader must be satisfied with whatever the market is willing to give.

Some traders look to weekly breakouts. So, if today's close is higher than the previous week's high or today's close is lower than the previous week's low, it is called a trend change.

With a breakout system, a trade is always taken in the direction that the market is moving at the time and is usually entered via a buy stop or sell stop. The bit of continuation that the trader is looking for is based on the principle that momentum tends to precede price.

There is also another principle of price behavior that is at work to create trading opportunities. That is, the market tends to alternate between equilibrium (balance between the supply and demand forces) and a state of disequilibrium. This imbalance between supply and demand causes "range expansion" with the market seeking a new level and this is what causes us to enter a trade.

There are several ways to create short-term (volatility) breakout systems. Therefore, whichever method you choose should be a matter of personal preference.

In designing a system, one can choose to place an entry stop off the opening price or the previous day's closing price. This entry stop can be a function of the previous day's range or a percentage of the previous 2 to10-day ranges etc. Mechanical exits can range from using a fixed objective level to using a time function such as the next day's open or close. Most of these systems function best with the use of a very wide stop.

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Another way to trade in breakout mode is by using "channel breakouts," which is simply buying the highest high of the last n-days. An example would be a 7-period channel breakout. In the case of an inside day breakout pattern where one buys the high or sells the low of the previous bar, a 1-period channel breakout is actually being used for the trigger. The most famous long-term breakout system adapted by Richard Dennis for training the "Turtles" was the 4-week channel breakout originally designed by Richard Donchian.

Trader benefits derived from trading a Volatility Breakout System:

Trading a short-term breakout system can be an excellent exercise to improve your trading.

1.) It teaches you to do things that are hard to do – buying high or selling low in a fast moving market! For most people, this feels quite unnatural!

2.) It always provides a defined money management stop once a trade is entered. Not adhering to a defined money management stop is the most common cause of failure among traders.

3.) It teaches a trader the importance of follow-through once a trade is entered, as most breakout systems perform best when the trade is held overnight.

4.) It provides a great means for traders to improve their execution skills. Most volatility breakout systems are fairly active compared to a long-term trend-following system. A trader can gain skill in placing orders in a diverse number of markets. Having a mechanically defined entry point is sometimes just the thing needed to overcome a trader's fear of pulling the trigger. The order is placed ahead of time and the market automatically pulls the trader into a trade if the stop level is hit.

Even if a person prefers to ultimately enter orders using discretion, trading a mechanical volatility breakout system

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can be an invaluable exercise. It should at least increase a trader's awareness of certain types of price behavior in the marketplace, especially if one is conditioned to entering on counter-trend retracement patterns. It cannot help but impress upon one the power of a true trend day.

Pros and Cons of Trading a Breakout System:

Like most systems, volatility breakout systems will clean up in volatile or runaway markets but tend to thrash when conditions get choppy or volume dries up. I believe they are still among the most profitable systems to trade, and I also feel they will continue to be profitable in the long run. However, so you do not get the impression that there is a Holy Grail of systems, the following considerations should be kept in mind:

Entries can be nerve-racking, especially when the market is in a runaway mode. The best breakouts will not give retracements to enter on. You are either on board or you are not! If you conceptualize that the best breakouts turn into trend days, and are most likely to close on the high or low for the day, then it is not so difficult to enter. Usually, it is best to have a buy/sell stop already resting in the market.

Sometimes, a market opens with a gap outside the initial entry level. Often, these turn into the best trades. They can also turn into the most aggravating whipsaws. Big gaps test out that one should still take the trade, but they will definitely add more volatility to your bottom line. If your trade gets stopped out and a new signal is given in the opposite direction, this reversing trade usually more than makes up for the first loss.

Whipsaws are a drag but they are inevitable when trading a breakout system. Many times I have bought the highs and sold the lows. It takes a great deal of "confidence in the numbers" to trade this type of system. System testing should always be done for a minimum of 3 years and preferably for 10 years. Be sure to examine out-of-sample data to see how the system performed.

On balance, a volatility breakout system can be traded on most markets. However, a market might be very profitable one year followed by mediocre performance the next. A portfolio of 10 to 12 markets seems to work well. The problem with trying to trade too many markets at once is

that it can become quite difficult to keep up with the activity level if your parameters are fairly sensitive. Many times in systems development, people overlook what one person can realistically handle in terms of trade management.

Enhancing a Basic Volatility Breakout System:

Adding filters can sometimes create further system enhancements. Examples of filters include indicators to determine whether or not a market is in a trending condition, seasonality, days of the week, or degree of volatility contraction already present in the market. Periods of low volatility in the market can be defined by a contraction in true range, a low ADX or a statistical indicator such as a low historical volatility ratio or a low standard deviation.

A system might look something like this:

1. Initial volatility condition = true
2. Buy or sell on a stop based on the current bar's open, plus or minus a percentage

   of the previous day's range.
3. Initial risk management stops once a trade is entered.
4. Exit strategy.

Types of variables that can be used in a simple range expansion breakout system:

1. Period – the breakout is based on a function of the previous day or the previous 10-day period, for example.
2. Range – does it use the average range for that period or the largest, smallest, or total range?
3. Percentage – what percentage of the range is used? For example, it is possible to use 120% of the previous 3-days' total range.
4. Base – is the range function added to the previous day's close or the current day's open? This function may also be added to the high or low of the previous bar or a previous period such as the last 10 days.

As a general rule of thumb, the greater the percentage factor used, the greater the percentage of winning trades will be. However, the overall system may be less profitable because fewer trades are taken.

Once again, an example of an initial condition might be – enter a trade only on a day following the narrowest range of the last 7 days. Or, take a trade only if the market has made a new 20-day high or low within the last five trading days. Whenever you add a filter to a system, be sure to compare the results to a baseline and examine the difference in activity level.

EXIT STRATEGIES:

1. Time based (2nd day's close, 1st day's opening)
2. First profitable opening (Larry Williams)
3. Target or objective level (1 average true range, previous day's high/low)
4. Trailing stop (displaced moving average, parabolic, 2-day high/low)

RISK:

Controllable Risk – the amount of risk that can be predetermined and defined by a money management stop.

Types of money management stops:

1. Fixed dollar amount
2. Function of average true range
3. Price level (i.e., bar high/low)

Uncontrollable Risk:

1. Overnight exposure (close to open risk) – you cannot exit a position when the market is not trading. Thus, you are subject to adverse gaps, which can be exaggerated by news or events.
2. Slippage risk – fast market conditions or thin, volatile markets often cause a trader to get filled at prices much worse than expected.

In general, the numbers behind most systems are very dependent upon capturing a few good trades. You cannot afford to miss the one good trade that can make your

month.

Here are some tips for trading a breakout or any other system:

1. Gain confidence by first trading a system on paper.

2. Make sure you can successfully trade a system mechanically before attempting to add any discretion.

3. Track your actual performance against the mechanical system at the end of each day, rating your success by whether you can match the system's performance.

4. Monitor performance over an adequate sample, perhaps 100 trades or a set number of weeks. Do not let a down week or trade cause you to stop following the system.

5. Manage the exits rather than filter the entries. It is impossible to tell in advance which trades will be the good ones. The one entry skipped might be the BIG ONE, and it is important not to miss it.

   Managing the exit means two things – the first, learn when it is okay to let that occasional great trade run an extra hour or two before getting out; the second (which really depends on one's skill level), learn to recognize a bit sooner when a trade is not working and exit just before the stop is hit.

   All systems display subtle nuances and insights into the market's behavior over time.

6. Keep a notebook of your observations and patterns you notice. In this way, you truly "make the system your own."

7. Never be concerned about how many other people are trading systems. If slippage seems excessive, it often suggests a significant breakout from a triangle or period of congestion. Remember – something had to drive the market far enough to penetrate the breakout point in the first place!

If you are interested in reading more look at:

www.trading-strategies.info

http://infiniteyieldforex.blogspot.com/

www.FxForaLiving.com

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