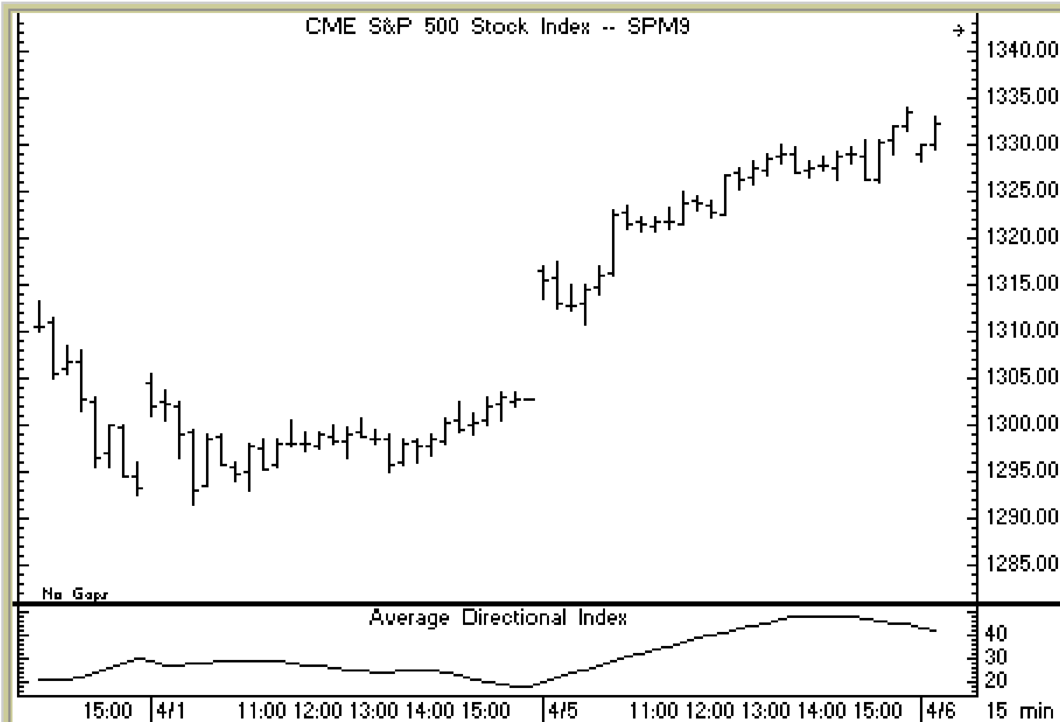
Capturing Trend Days

A **trend day** occurs when there is an expansion in the daily trading range and the open and close are near opposite extremes. The first half-hour of trading often comprises less than 10% of the day's total range; there is usually very little intraday price retracement. Typically, price action picks up momentum going into the last hour -- and the trend accelerates.

A trend day can occur in either the same or the opposite direction to the prevailing trend on daily charts. The critical point is that the increased spread between the high and low of the daily range offers a trading opportunity from which large profits can be made in a short time.

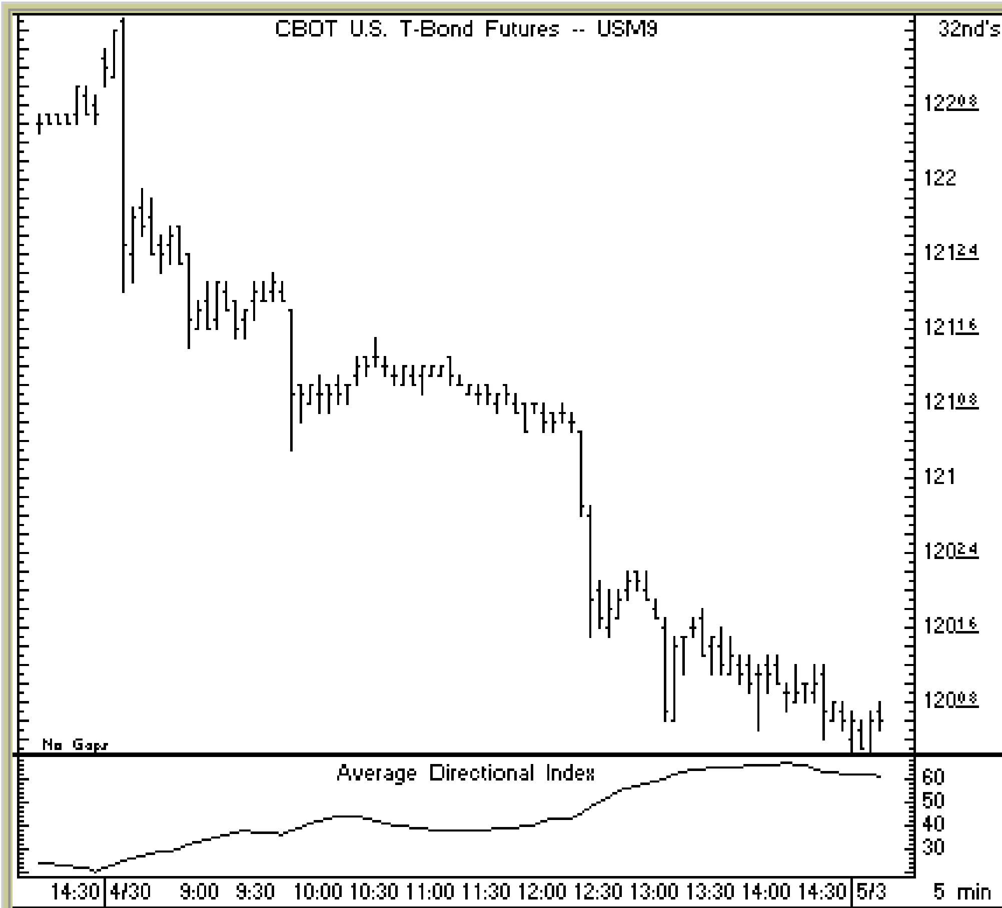


Classic Trend Day - A large opening gap created a vacuum on the buy side. The market opened at one extreme and closed on the other. Note how it made higher highs and higher lows all day. Also, volatility increased in the latter part of the day--another characteristic of trend days.

Traders must understand the characteristics of a trend day, even if interested only in intraday scalping. A trader anticipating a trend day should change strategies, from trading off support/resistance and looking at overbought/oversold indicators to using a breakout methodology and being flexible enough to buy strength or sell weakness. A trader caught off guard will often experience his largest losses on a trend day as he tries to sell strength or buy weakness prematurely. Because there are few intraday retracements, small losses can easily get out of hand. The worst catastrophes come from trying to average losing trades on trend days.

Fortunately, it is possible to identify specific conditions that tend to precede a trend day. Because this can easily be done at night when the markets are closed, a trader can adjust his game plan for the next day and be prepared to place resting buy or sell stops at appropriate levels.

The Principle of Range Contraction/Expansion



Trend Day Down

Several types of conditions lead to trend days, but most involve some type of contraction in volatility or daily range. In general, price expansion tends to follow periods of price contraction, the phenomenon being cyclical. The market alternates between periods of rest or consolidation and periods of movement, or markup/markdown. Volatility is actually more cyclical than is price.

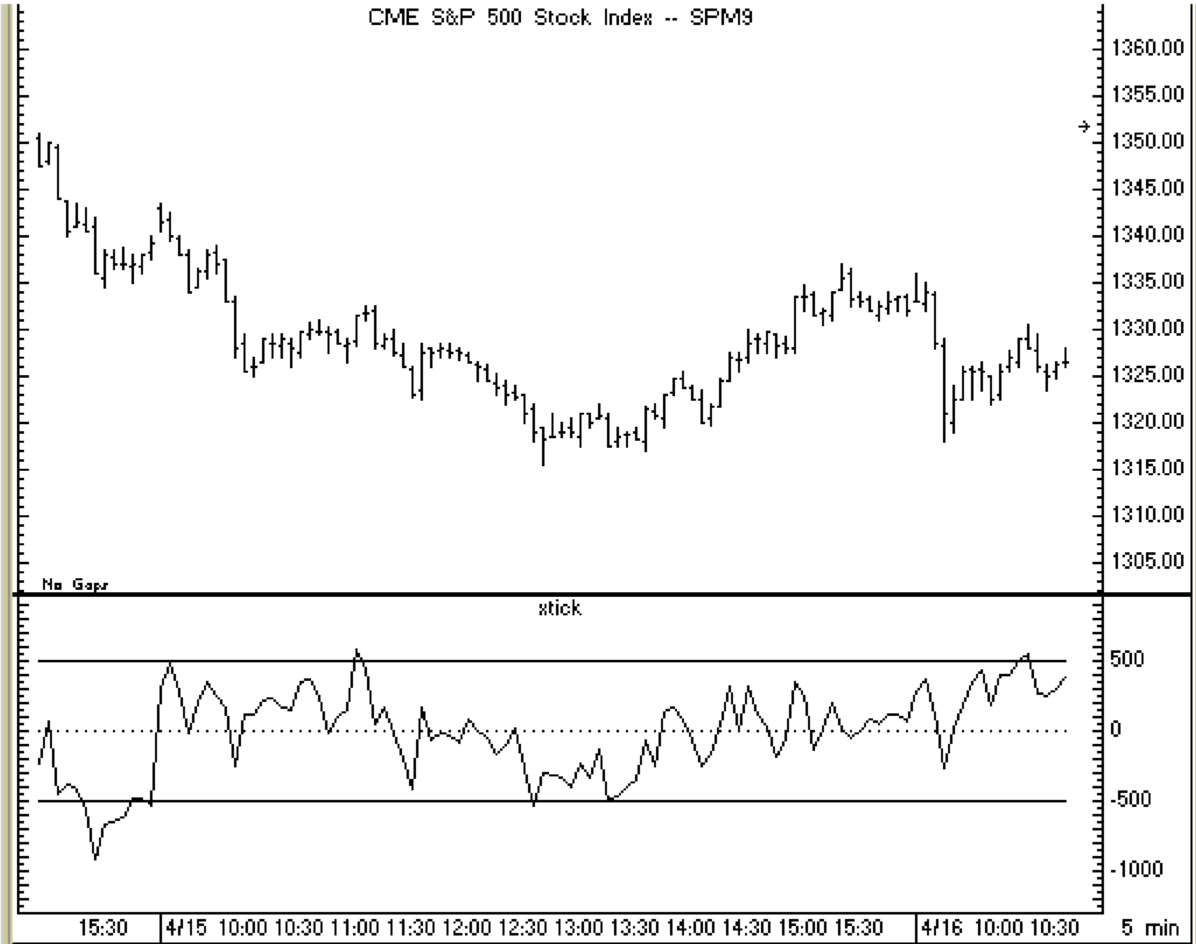
When a market consolidates, buyers and sellers reach an equilibrium price level -- and the trading range tends to narrow. When new information enters the marketplace, the market moves away from this equilibrium point and tries to find a new price, or "value" area. Either longs or shorts will be "trapped" on the wrong side and eventually forced to cover, aggravating the existing supply/demand imbalance.

In turn, the increase in price momentum attracts new market participants, and pretty soon a vicious cycle is created. Local pit traders, recognizing the one-way order flow, scramble to cover contracts. Instead of price reacting back as in normally trading markets, "positive feedback" is created -- a condition in which and no one can predict how far the price will go. The market tends to gain momentum rather than to check back and forth.

We can tell when the market is approaching the end of contraction or congestion because the average daily range narrows. We know a potential breakout is at hand. However, it is difficult to predict the *direction* of the breakout because buyers and sellers appear to be in perfect balance. All we *can* do is prepare for increased volatility or range expansion!

Most breakout trading strategies let the market tip its hand as to which way it wants to go before entering. This technique sacrifices initial trade location in exchange for greater confidence that the market will continue to move in the direction of trade entry.

The good news is that breakout strategies have a high win/loss ratio. The bad news is that whipsaws can be brutal!



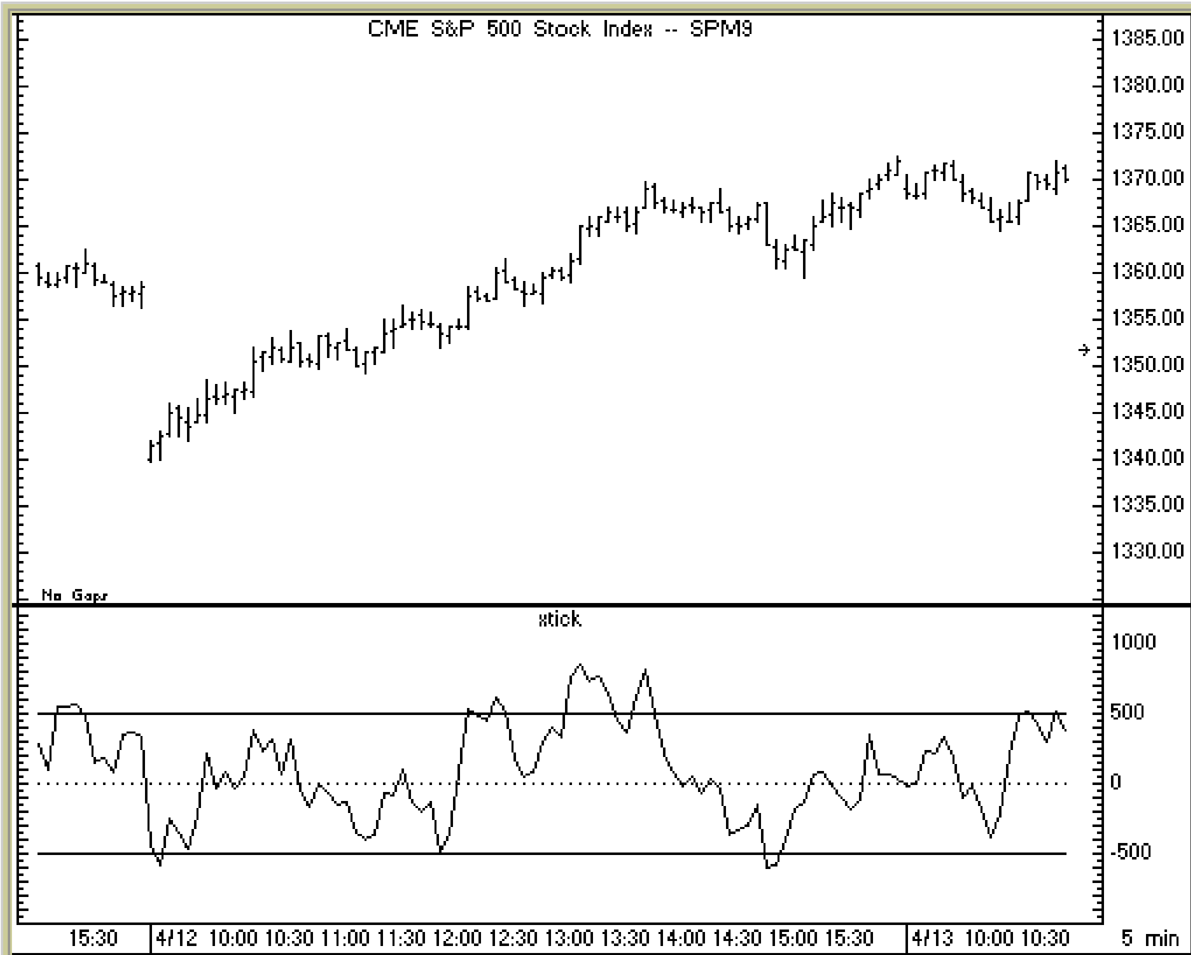
Tick Readings for Short-term day trading - Volatility conditions are important to quantify even if you are a short term day trader. In a normal consolidation market, overbought/oversold type indicators, such as intraday tick readings, can work well for S&P scalps.

Conditions Preceding a Trend Day

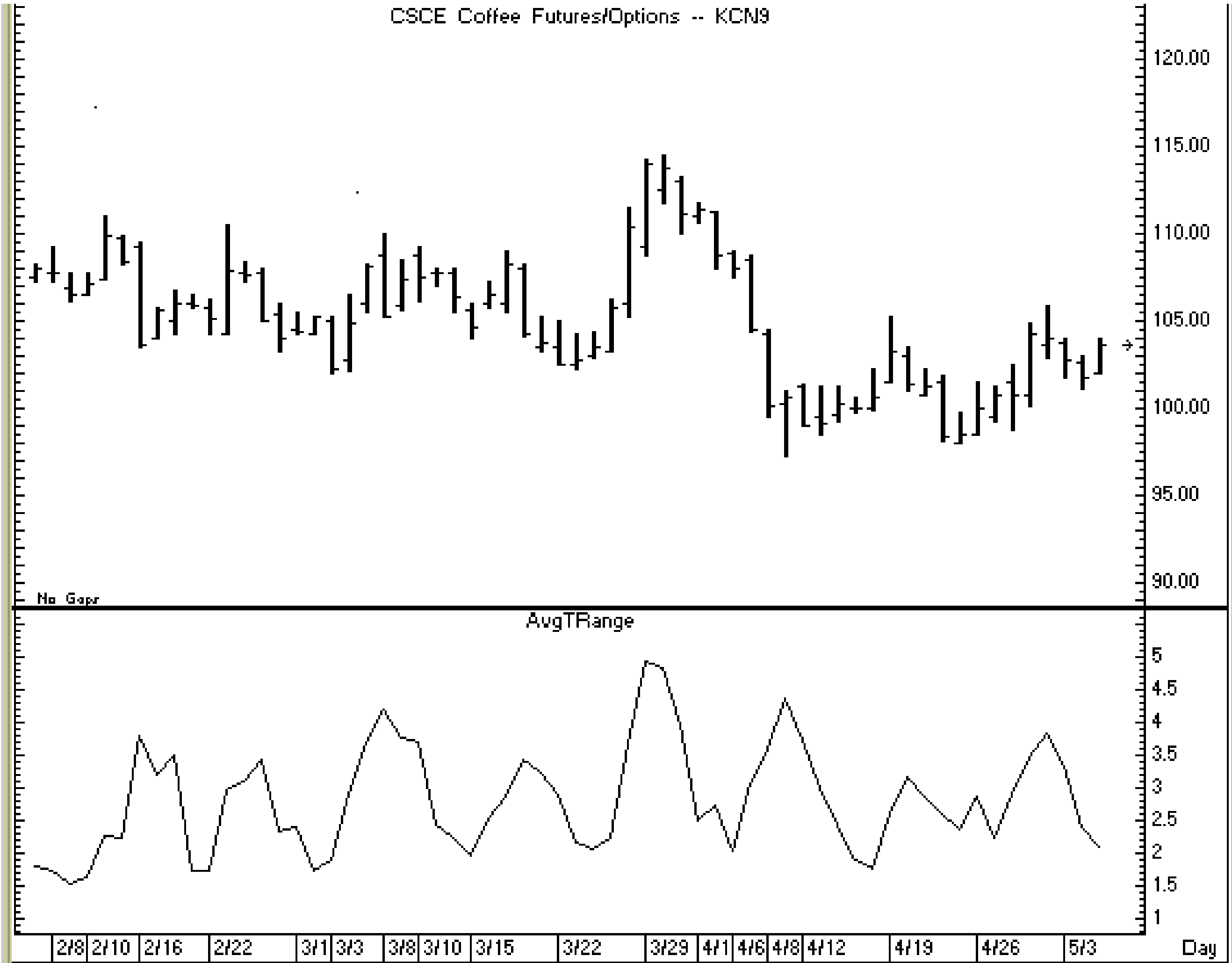
Several key price patterns can serve as alerts to the potential for significant range expansion:

- ***NR7*** -- the narrowest range of the last 7 days (Toby Crabel introduced this term in his classic book, ***Day Trading With Short-term Price Patterns and Opening-range Breakout);***
- a cluster of 2 or 3 *small daily ranges*;
- the point of a *wedge*-type pattern (which usually exhibits contracting daily ranges);
- a ***Hook Day*** (wherein the open is above/below the previous day's high/low -- and then the price reverses direction; the range must also be narrower than the previous day's range; leads traders to believe that a trend reversal has occurred, whereas the market has instead only formed a small consolidation or intraday continuation pattern);
- ***low volatility*** readings, based on such statistical measures as standard deviations or historical volatility ratios or indexes;

- ***large opening gaps*** (caused by a large imbalance between buyers and sellers);
- ***runaway momentum*** (markets with no resistance above in an uptrend or no support below in a downtrend. This condition differs from the above setups in that volatility has already expanded. In a momentum market, however, the huge imbalance between buyers and sellers *continues* to expand the trading range!)



Fading extreme tick readings can be dangerous - On a trend day, a countertrend strategy of fading extreme tick readings could result in substantial losses.



Ave. True Range highlights range contraction/expansion - The 3-Day Average True Range Indicator highlights how cyclical the phenomenon of range contraction/range expansion is. Volatility tends to be more cyclical than price.

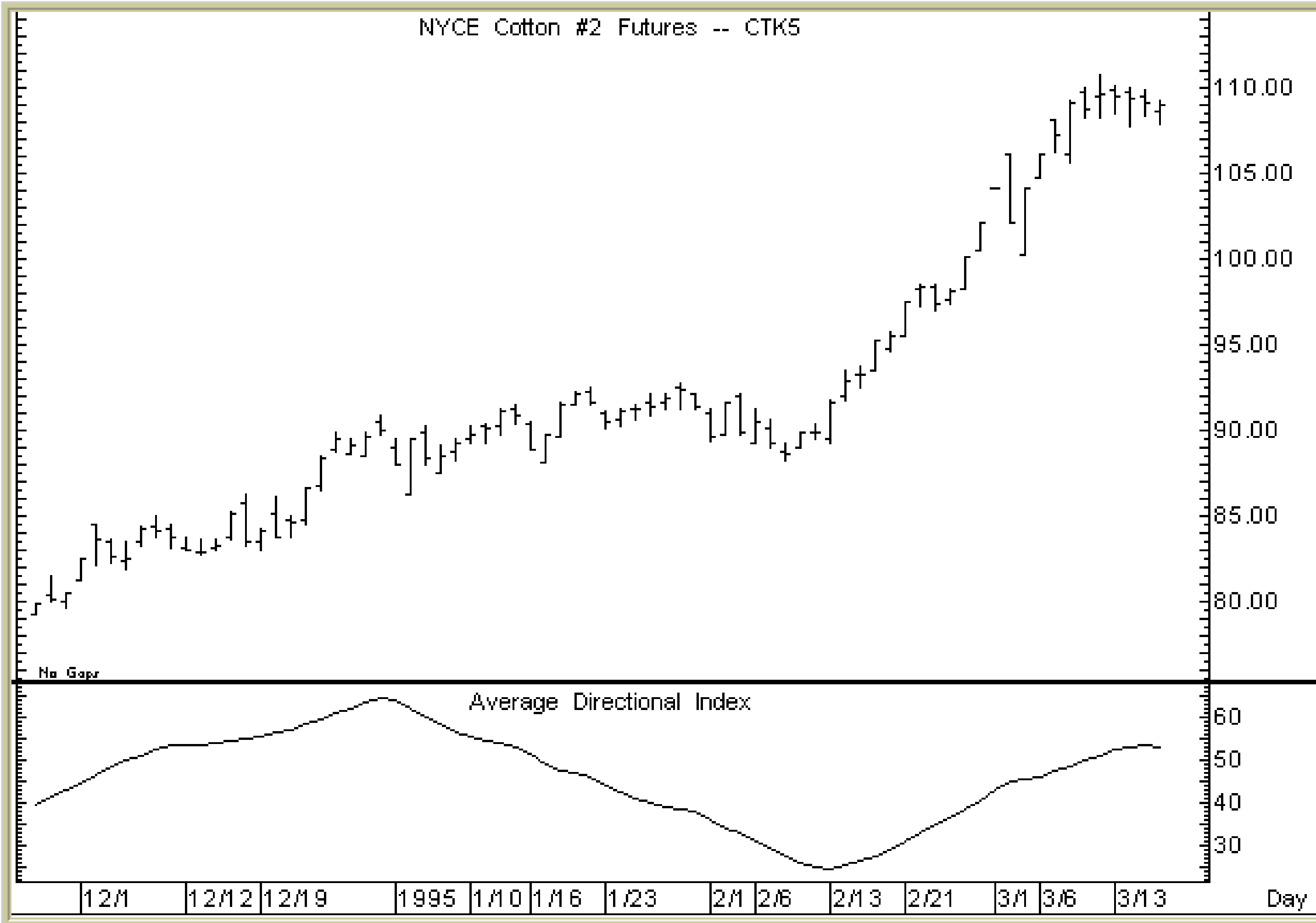
Trading Strategies

A breakout strategy, or intraday trend-following method, can best capture a trend day. Wait for the market to tip its hand first as to which direction it is going to trend for the day. Rarely can this be determined by the opening price alone. Thus, most breakout strategies enter only after the market has already begun to move in one direction or the other, usually by a predetermined amount.

Add the following techniques to your repertoire. All of them will ensure you participate in a trend day.

- ***Breakout of the Early-morning Trading Range***. The morning range is defined by the high and low made in the first 45-120 minutes. Different time parameters can be used, but the most popular one is the first hour's range. Wait for this initial range to be established and then place a (1) buy stop above the morning's high ***and*** a (2) sell stop below the morning's low. A protective stop-and-reverse should always be left in place at the opposite end of he range once entry has been established.

- ***Early Entry***. Toby Crabel defined this as a large price movement in one direction within the first 15 minutes of the opening. The probability of continuation is extremely high. Once one or two extremely large 5-minute bars appear within the first 15 minutes, a trader must be nimble enough to enter on the next "pause" that usually follows. With many of these strategies, the initial risk can appear to be high. However, a trader must recognize that as the trading volatility increases so too does the potential for good reward.
- ***Range Expansion off the Opening Price***. A predetermined amount is added or subtracted from the *opening* price. Though Toby Crabel also described this concept in his book, it was really popularized by Larry Williams. The amount can be fixed, or it can be a percentage of the previous 1-3 days' average true range. With resting buy and sell stops in place, the trader will be pulled into the market whichever way price starts to move. Entry, often made in the first hour, can be made earlier than the breakout from the first hour's range. In general, the further price moves away from a given point, the greater are the odds it will continue in that same direction. The ideal is continuation in the direction of the initial trend once the trade is entered.



Volatility tend to increase as a trend matures - Trend days also frequently occur in runaway momentum markets. There is little range contraction evident in the latter part of this trend move. Rather, emotions run high as the imbalance between supply and demand reaches an extreme.

- ***Price Breakout from the Previous Day's Close***. This strategy is similar to the above, with buy and sell stops based on a percentage of the previous 1-3 days' range added to the previous *close*. The advantage to using the closing price is that resting orders can be calculated and placed in the market ***before*** the opening. The disadvantage is the potential for whipsaw if the market moves to fill a large opening price gap.
(Another version of a volatility breakout off the open or closing price is the use of a standard-deviation or price-percentage function instead of a percentage of the average true range. All the above methods can be easily incorporated into a mechanical system.)
- ***Channel Breakout***. One of the more popular types of trend-following strategies in the nineties, Donchian originally popularized the concept by employing a breakout of the 4-week high or low. Later, Richard Dennis modified this into the "Turtle System," which used the 20-day high/low. Most traders don't realize that simply entering on the breakout of the previous day's high or low can also be considered a form of channel breakout. (Another popular parameter is the 2-day high or low.)

Exit Strategies

One of the easiest and more popular ways to exit a breakout trade is simply to exit "Market-On-Close. " The ideal trend day closes near the opposite extreme of the day's range from the opening. This strategy keeps the trader in the market throughout the day, yet requires no overnight risk. Most breakout strategies actually test out better for trades held overnight because the next opening will so often gap in a favorable direction. Thus, another simple strategy is to exit on the next morning's opening.

Instead of a strategy based on time, such as the close or the next day's open, one can also use a price objective. One popular method is to take profits near the previous day's high or low. One can also determine a target based on the average true range.

For the classic market technician, point-and-figure charts can provide a "count" which establishes a price target. This method is valid only if price breaks out of congestion or a well-defined chart formation.

Trade Management

In general when testing volatility breakout systems, the wider the initial money-management stop, the higher the win/loss ratio. With breakout strategies, the initial trade must be given room to breathe.

However, a discretionary day-trader will learn that the best trades move in his favor immediately. In this case, move the stop to breakeven once the trade shows enough profit. The stop can be trailed as the market continues to trend, but ***not*** too tightly. Because a great majority of the gains can occur in the last hour as the trend accelerates, try not to exit prematurely.

When trading multiple contracts, scale out of some to ensure a small profit in the event of a reversal. However, do not add to a position: The later the trade is established, the more difficult it is to find a suitable risk point.

A Few Words on Volatility Breakout Systems

Trading a mechanical breakout system can provide invaluable experience. The average net profit for the majority of these systems is quite low, so they may not guarantee a road to riches; but they serve as a terrific vehicle to gain a wealth of experience in a very structured format.

If you are going to trade a mechanical system, you must be willing to enter ***all*** trades! It is impossible to know which trades will be winners and which ones losers. Most traders who "pick-and-choose" have a knack for picking the losing trades and missing the really big winners. The hardest trades to take tend to work out the best! With most systems, a majority of the profits come from less than 5% of the trades.

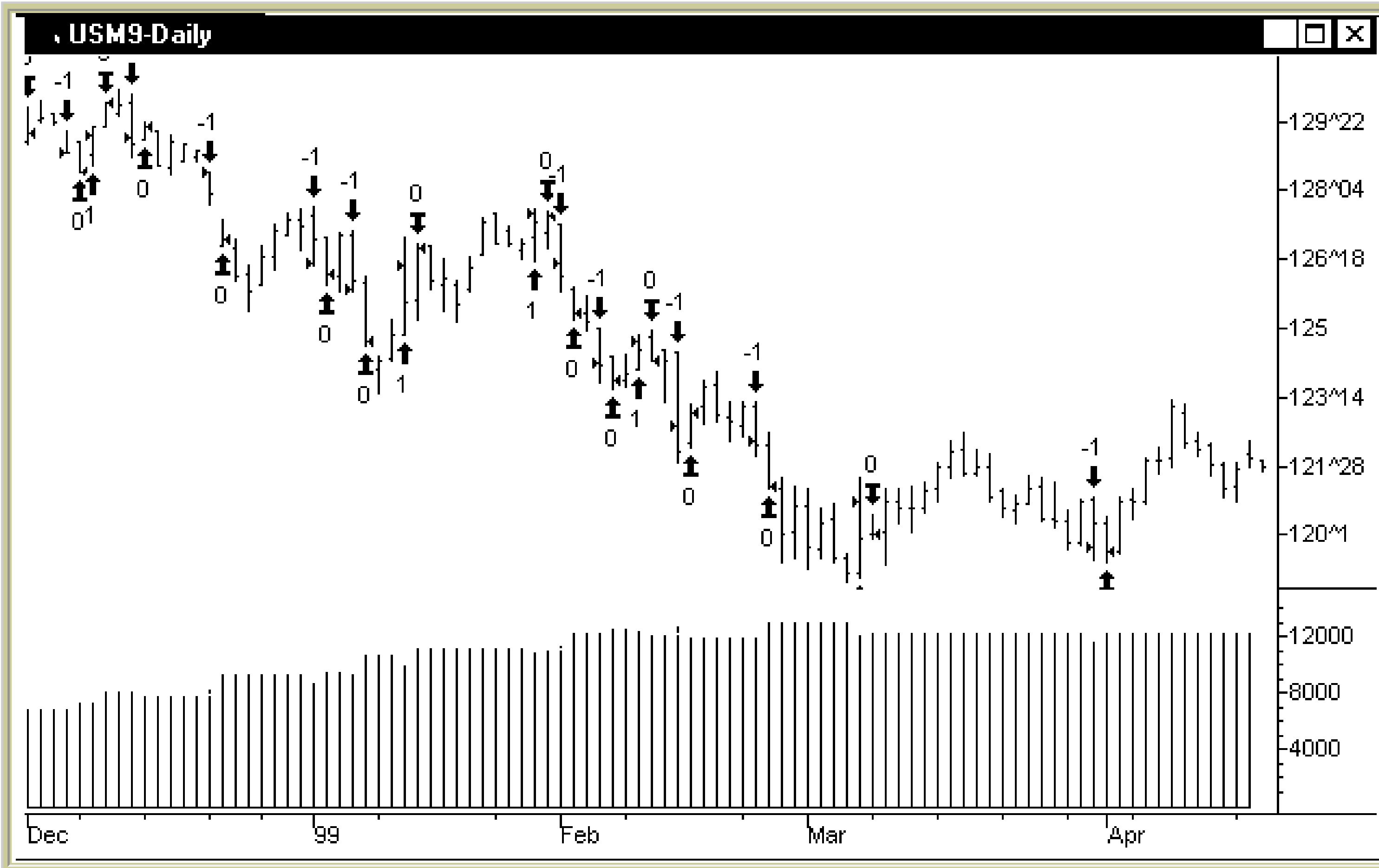
Though most breakout methods have a high initial risk point, their high win/loss ratio makes them easier to trade psychologically. You might get your teeth kicked in on the losers, but, fortunately, big losses do not happen very often. Also, if trading a basket of markets, as one should with a volatility breakout system, diversification should help smooth out the larger losses.

To summarize the main benefits of trading a breakout system:

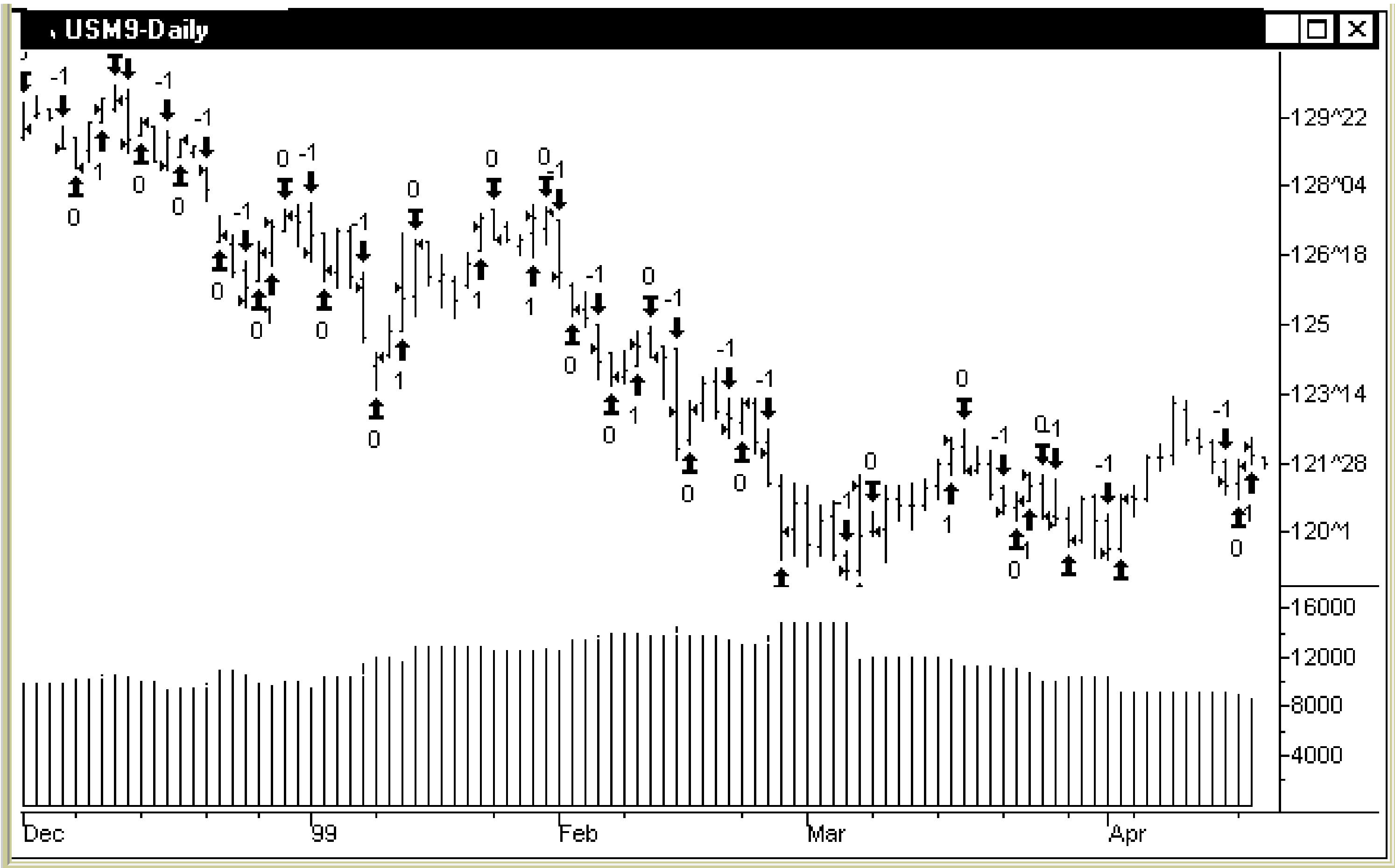
- it teaches proper habits, in that there is always a well-defined stop;
- you get lots of practice executing trades;
- it teaches the importance of taking every trade;
- it teaches respect for the trend.

Additional Considerations when using Breakout Strategies

- overall average daily trading range (must be high enough to ensure wide "spread");
- volume and liquidity;
- seasonal tendencies (e.g., grains are better markets in spring and summer);
- relative strength;
- commercial composition.



Volatility Breakout System - An equity curve for a simple volatility breakout system that enters on range expansion off the previous day's CLOSE and exits the next day. Once again, the market opened on one extreme of its range and closed on the other. It made a steady pattern of lower highs and lower lows all day.



Volatility Breakout System - This volatility system is based on range expansion off the OPENING price and then exiting on the next day's close. Over the long run, entering on range expansion off the opening price or off the previous day's close does equally well. In this case, entering on a breakout off the opening price resulted in a higher equity peak at one point but a larger drawdown later.

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