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Can anyone actually trade Elliott Wave?

Steve Griffiths, the Managing Director of MTPredictor Ltd, explains how Elliott Wave can be used in a highly consistent trading plan built on assessment of trade risk and reward

**ELLIOTT
WAVE**

Elliott Wave (EW) is a dirty phrase in some quarters. Despite the seductive rigours of its construction (markets tend to move in a five-wave sequence followed by a three-wave correction), the forecasts and claims of practitioners and gurus have often led many traders astray.

It is now over 70 years since R. N. Elliott first unveiled his approach - however, as Frost and Prechter state in the seminal Elliott Wave Principle, "for all his meticulous study and profound discovery, he displayed a typical investor's weakness in (at least once) allowing a prior opinion adversely to affect his objectivity in analysing a market"! EW has often come in for heavy criticism down the years. In part, this is down to the inevitable over-complication by analysts and waywardness of some of their forecasting.

Many traders have come to find it impossible to trade with decisiveness and control as they struggle to find a decent-looking pattern – maybe one that fits into larger patterns and yet breaks down into smaller patterns (there are 9 conventional timeframes); one that doesn't need mysterious 'X' waves to link it to previous patterns; one which obeys all Elliott tenets. Once over these hurdles, they will then often suffer a change of EW count on their trade chart – perhaps a long becomes re-labeled as a short or vice-versa!

So, what's the answer? Elliott can still have a lot to offer as a framework for trading, as opposed to forecasting so...simply avoid these clear pitfalls! Some of its basic premises can be stripped out legitimately and used in a highly consistent trading plan built on assessment of trade risk and reward.

The Isolation Approach™

How can Elliott be used to find low risk/high reward trades – the goal of any trading method or software program?

Accepting the easily-understood guideline that 'the trend is your friend', the ideal place to enter a trade is at the end of a correction to a trend. In EW terms, this means one of only three places: the end of a corrective Wave B into an impulsive (trend) Wave C; the end of a corrective Wave 2 into an impulsive Wave 3; the end of a corrective Wave 4 into an impulsive and final Wave 5.

If you can just concentrate on finding this type of correction, you have started well. Then, if you can somehow find and focus on only those where the apparent correction breaks down into 3 simple waves - you have found Elliott's simple ABC correction. This is exactly what the MTPredictor™ software identifies. You now have the basis for a low risk/high return trade.

Assessing Risk

In what sense 'low risk'?

Trade risk must adhere to the three Cs: clear, calculable and constant. This applies to two separate components of risk.

Firstly, the 'Initial Money Risk' in a trade entry at the end of a corrective wave meets the three criteria perfectly. Once decided in the trader's risk control plan, entry can always be at, say, 1 tick beyond the latest bar and the initial protective stop loss at 1 tick beyond the extreme price reached in the potential correction. Money risk is then known and the size of position to trade (no. of shares, futures lots etc.) can always be determined as a result – clear money management).

Secondly, 'Probability Risk' in a trade at the end of a corrective wave can meet the three criteria as closely as any mathematical uncertainty ever can. Confusion caused by complex corrections-to-trend is avoided by requiring the correction to sub-divide cleanly into the three basic waves a, b and c. There is room only for the simple abc correction. Confusion over where the correction should stop is avoided by demanding that it reaches a price level anticipated in Fibonacci/Elliott numerology e.g.

Wave c of the simple correction is a certain ratio of the length of Wave a (0.618x, 1.000x, 1.618x) and Wave b (1.272x, 1.618x, 2.618x).

This allows the establishment of Minimum, Typical and Maximum price zones for the correction to stop, and is crucial. Confusion over when the correction may be reversing is avoided by demanding that the market itself shows signs of price reversal e.g. a type of strong price reversal action, an oscillator turn, an indecisive Inside Day, a Japanese candlestick.

Judging Reward

In professional trading, the reward size must also be clear, calculable and constant. There can be no interference in reward assessment from the need to either fit in different timeframes or link with previous EW patterns etc. Although the nine recognised timeframes in EW (from Grand Supercycle all the way down to Sub-Minnette) may keep analysts continually occupied, they can be hugely complicated in real trading.

Not having to fit, say, an Intermediate level ABC correction-to-trend into a Major (larger) level pattern or to link it with any standard EW pattern immediately before removes the confusion typical of most EW approaches. This Isolation Approach enables the trader to carry out the established Fibonacci/Elliott calculations to highlight the price targets for a trade into the appropriate impulsive (Reward) wave. These zones are clear, calculable and constant.

Ideal Risk/Reward Trading - Time After Time

Having determined both the Initial money Risk calculated and the appropriate EW price (Reward) targets, the trader can ensure that only trades with a minimum Risk/Reward ratio of, say, 2x are ever actually considered. This Isolation Approach to EW means the trader can run a consistent exit plan on every trade e.g. partial profits taken at the first price (Reward) target, itself beyond the critical 2x threshold, and the rest of the position closed if the second profit zone is reached.

Note we use 'if' here - such an operation is not based on the delusion of hope or forecasting, the downfall of many desperate to be 'right' in EW. The whole exit stop strategy can (and should) be determined before any trade is ever placed.

Steve Griffiths is the Managing Director of MTPredictor Ltd. and developer of the MTPredictor™ trading software range - designed to automatically identify and risk-assess ABC corrections as well as other specific, tradable Elliott wave patterns. MTPredictor software uses the unique Isolation Approach™ to Elliott wave. For more information, please visit the MTPredictor Ltd website at www.MTPredictor.com