

Elliott Wave Stripped and Ready for Trading

By Tony Beckwith

It seems an almost immutable law in financial circles...at some point or other, novice and expert traders alike will feel the pressing need to check out Elliott Wave (EW) theory. It may be because the trader's reliance on traditional oscillators has let him down. It may be because a back-tested, optimised system has left a hole in his live trading account. Alternatively, it may be because of a seemingly-natural desire to see order in chaos, to believe in a guiding hand reassuringly organising market movements.

Ralph Nelson Elliott's 'The Wave Principle' has inevitably tended to come to the rescue, highlighting what he saw as a natural rhythm to market progression which could be generalized from his original work on the Dow Jones stock indices. Accepting that a market's trend direction breaks down into a pattern of five waves, with three (impulsive) waves in the trend and two (corrective) waves correcting that trend installs order where order is needed. Arguably, however, the principle has proven difficult to for traders to trade successfully.

Problems, problems... Numerous difficulties have always beset the use of EW in real, live trading plans. Not the least of these is the confusion typically caused by the different timeframes Elliott himself proposed. No less than nine orders of magnitude are involved – Grand Supercycle, Supercycle, Cycle, Primary, Intermediate, Minor, Minute, Minuette and Sub-Minuette. As practitioners Frost & Prechter said with understatement in 'Elliott Wave Principle', "the nomenclature of waves is occasionally one of the difficult aspects"!

Even armed with many of the current traditional EW software programs, a trader can face a daunting task trying to assess which wave timeframe he is in or, more importantly, should be in, let alone which to attempt to trade. Even if a trading decision can be made, the exit stop strategy may suffer interference from a smaller timeframe EW count unfolding as a trade progresses or from a larger timeframe imposing itself from on high. It may be useful or illuminating to be aware, but this is not ideal for a serious trader.

A further difficulty is the confusion caused by the need to link a current EW pattern with what has happened prior to it. This is why many EW analysts resort to 'connecting' or 'x' waves, to link unlikable patterns. It is far more useful for traders to understand immediately that an identified pattern may not actually connect in any sensible way to any price movement which has gone before. For trading purposes, recognising when there is no acceptable EW pattern on a market is more important than recognising when there is. There is no point trading off a pattern which is tenuously academic.

The trend is your friend... Following on closely from these obstacles are complications from the emergence of the dreaded 'extended impulse wave' and equally-fearsome 'complex correction'. For traders, the first development should not actually present a problem as no-one in their right mind should attempt to not only call the end of a trend but also to enter a trade off it. Accepting the premise that 'the trend is your friend', it is still perhaps remarkable how compelling is the glory many seek by calling the end of a strong trend. A very risky game.

As for the 'complex' or 'irregular correction', it can be a law unto itself and derail many a trader as a result. As Frost & Prechter said, again in 'Elliott Wave Principle', and with admirable understatement "corrective waves are quite a bit more varied than impulse waves". Irregular flat corrections, running corrections, reverse symmetrical triangles, double or triple threes (connected by those useful little 'x' waves) are

all actively discussed and highlighted with hindsight by EW practitioners. A trader navigating a position through one of these complex patterns has little chance.

As a result of these limitations of the standard and accepted EW approach, it is entirely possible for a trader to be monitoring a real position using much Elliott software and for the unthinkable to happen...the pattern labelling changes. The algorithms in the software detect an unexpected price progression and the assumed impulsive wave is re-labelled as one of the many variants of corrective wave. Decision time!

Simplicity always wins... There is another way. The approach often taken to problems in branches of physics and chemistry is to 'isolate' the problem. The Isolation Approach can be an extremely useful premise for a trader trying to use Elliott Wave principles. The difficulties caused by the need to fit an EW pattern on a certain timeframe inside a pattern sweeping over a longer timeframe or to fit smaller patterns within it can be removed by simply managing the trade according to its own timeframe. Even the conventional practice of seeking a confluence of EW patterns on different timeframes to add weight to an expected move may seem intellectually watertight, but can pose big problems for a trader. Which of the differing timeframe price targets should be used for the exit stop policy, and what if some of the timeframe patterns change en-route?

Isolating the timeframe enables the trader to calculate stable Reward levels to compare with the Initial (money) Risk of entering the trade and losing, consistently for each set-up.

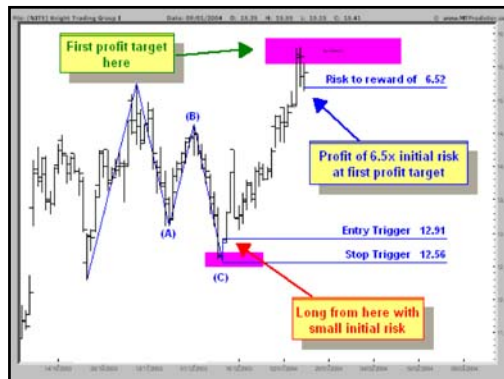
Confusion caused by needing to link an EW pattern with

prior history can be avoided by analysing the current pattern or trade set-up in isolation from prior market movement – a pattern in a vacuum. As for extended impulse waves, these relentlessly strong trends in a market will not impale a trader if a trade is only ever taken off the end of a correction. And not just any correction...a simple, three wave (zigzag) ABC correction obeying pre-determined rules forbidding complexity. For instance, Wave b must never breach the start of Wave a, Wave c must always exceed the end of Wave a and so on. Insisting on trading only clear-cut, balanced corrections to a clear-cut trend banishes the uncertainty of 'weak, non-horizontal double threes' (Frost & Prechter) and the like. If it's not simple, there's no trade set-up. Simple.

The nightmare of a software-generated EW count being automatically re-labelled midway through a trade can now be a distant memory.

The chart below shows an isolated ABC correction trade set-up on Knight Trading (NITE, Nasdaq), with a clear Risk/Reward outlook. It yielded a minimum 6.5x Initial (money) Risk: See Chart of Knight Trading Inc. NITE, Nasdaq.

Risk/Reward trading is finally possible! Following these precepts, the essential calculation of Risk and evaluation of Reward are now possible. The Initial (money) Risk is clear and calculable – the initial stop loss is, say, always 1 tick beyond the extreme price reached in the correction, the entry price is always 1 tick beyond the appropriate reversal bar extreme price. This money risk enables the trader to determine the size of position to trade, in terms of the no. of shares, futures lots etc. Furthermore, the Reward can be evaluated decisively – the first Reward level is the price zone representing the first target for the anticipated impulse wave on the same timeframe as the trade set-up in isolation, the second is the second and so on. This allows the trader to assess the Risk/Reward ratio of each trade set-up consistently, before a trade is ever entered. Without a clear and consistent Risk/Reward policy, a trader has a real uphill struggle. So, being able to demand that the first profit zone yields an R/R of at least 2-3x fosters the long-term profitability of any trading plan...



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Mr. Beckwith can be reached at www.mtpredictor.com