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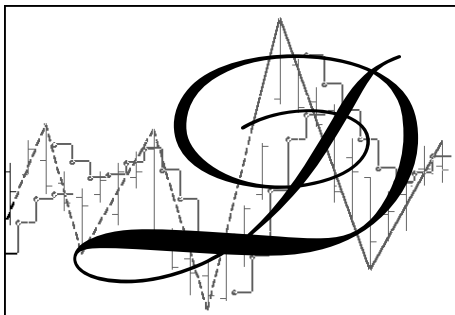
ROBERT
KRAUSZ'S

FIBONACCI TRADER®

JOURNAL

Volume 1, Issue 8

SETTING TARGETS & STOPS FOR YOUR TRADING PLAN



Dear Trader,
This issue, number 8, and the next issue, number

9, should be of real help to those traders using the Fibonacci Trader program to construct their own trading plans.

There is much more to developing a trading plan than just setting down some rules and parameters, clicking a computer key to check the results, and you are ready to go!

If it was as easy as that we would all be millionaires. The concepts shown in these two issues should help reality sink in, and you will learn how to adjust your trading plan accordingly. It will be more work, but you should see valuable results.

LETTERS

Some letters have come in asking about the

psychology of trading, and if I have anything available that may help with discipline, etc? The "Mental Harmonic Audio Tapes for Relaxed Trading" that Jack Schwager described in his book *New Market Wizards* are still available for \$99 plus \$5 S&H. There are two tapes, the first one teaches you how to relax, and the second tape tells your subconscious mind that you "deserve your winnings" and helps you focus on your trading plans.

If this is of interest you can call 512 443-5751. By the way, these tapes are not the "Holy Grail" nor will they replace a valid trading plan. But the tapes will certainly help to set a positive mental attitude towards your trading. We'll continue this discussion in the next issue.

I wish you excellent trading,

Robert Krausz, MH, BCHE

SETTING TARGETS & STOPS FOR YOUR TRADING PLAN

Every trading system is built using set rules that are based on some implicit expectation of the market's movement. For example, if you are using a trend following system, such as a simple moving average crossover, your system will capture profits from the markets if the markets trend. That is to say, if the price direction either rises or falls at a persistent rate then the system will realize a profit.

On the other hand, a sideways trending market will cross back and forth over the moving average and the system will produce a series of losing trades.

While the above comment may not seem particularly profound, the key point is that any mechanical system is a template because of the fixed rules, and if that template matches well with the rhythm of the market then profits are realized, but if the template of the system does not fit the rhythm of the market then the system will produce losses.

But does this have to be a totally black and white situation? No. Through detailed analysis of the individual trades of a system you will see that there is a mix of trades, some profitable and some losses. Looking closer, some trades are profitable immediately, while some trades will be at a loss, then recover, and the system exits at a profit.

Then unfortunately, some trades are profitable for a period of time only and turn into losses, and finally, some trades are a loss from entry.

What can we do with this information? The

best way that I have found to improve our trading method is to analyze the results using a measurement called Maximum Favorable Excursion (MFE) and Maximum Adverse Excursion (MAE).

John Sweeney, Technical Editor of Technical Analysis of Stocks & Commodities magazine, described this analysis in his book *Campaign Trading: Tactics and Strategies to Exploit the Markets*, published by John Wiley & Sons.

A number of topics are covered, but the foundation of the book is his MFE and MAE analysis. MFE is the maximum profit level attained while in a trade, whether the final outcome was a profit or a loss. MAE is the opposite measurement; what level of loss occurred for each trade, whether profitable or a loss?

To understand this concept let's look at some simple examples of this analysis using a

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simple trend following system we will build in The Fibonacci Trader.

We'll walk through an example of a buy signal on a 10-minute/50-minute/Daily plan of the June T-bond contract using a system that has only one rule: Buy on a "flip" of the Dynamic Trio Next;

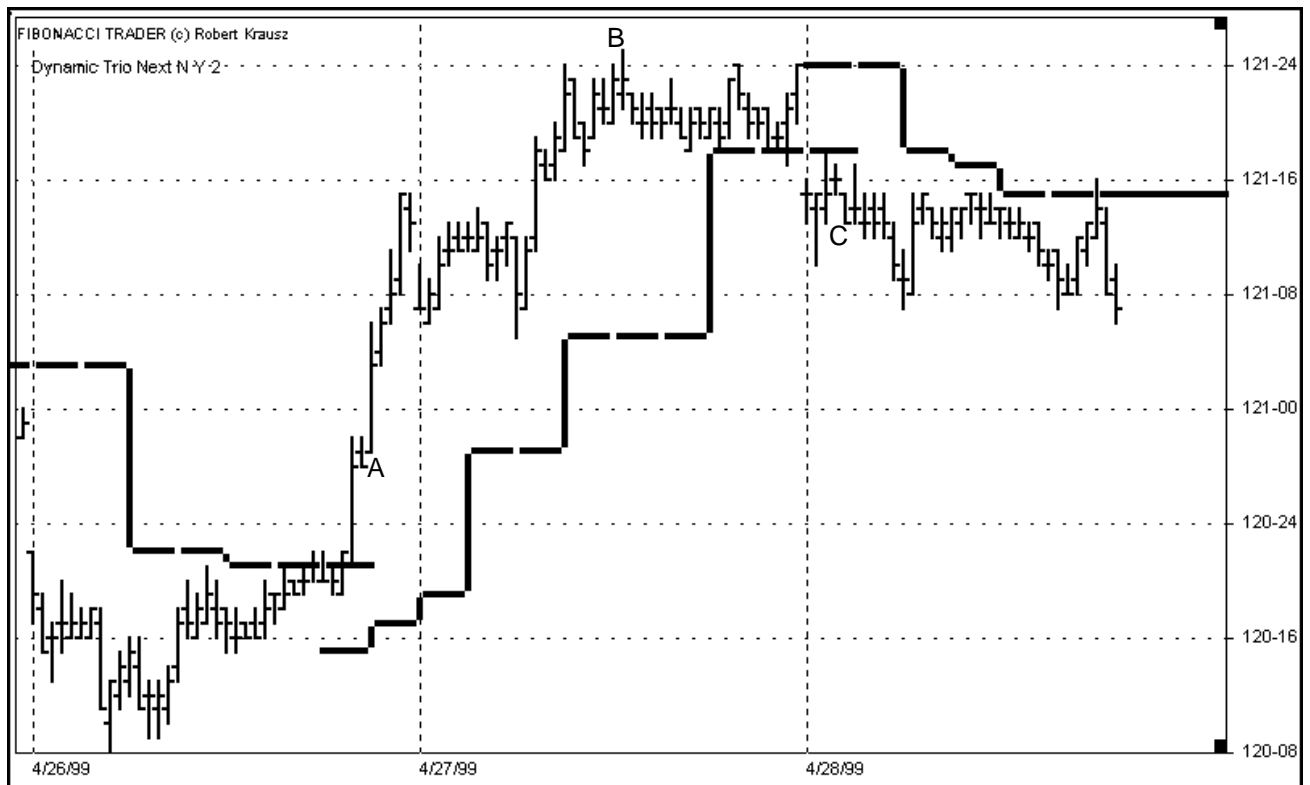


Figure 1: June 99 T-bonds 10/50/Daily Plan. Here the Dynamic Trio Next is used as our entry and exit indicator. The MFE was 29 ticks (A-B), the MAE was zero ticks and the profit was 14 ticks (A-C).

Sell on a “flip” of the Dynamic Trio Next.

Why use the Next time frame for signals? The shorter the time frame you use for observation the more noise in the price movement about the tradeable trends.

Most new traders gravitate to shorter time frames because there is the appearance that risk can be controlled in a tighter fashion, but more often than not more losing trades are generated with the shorter time frames making execution of a trading plan more psychologically difficult by trading very frequently the cost of slippage can mount up very fast. We’ll be talk more about trading psychology at the end of this Journal.

Looking at Figure 1 you can see that on Bar

A the market closed above the Dynamic Trio Next, which is the close of the 50-minute bar and therefore flips, signaling a long position at 120-28. The market rallied into the close with a nice kick off to this trade. The next day the market trended higher reaching 121-25 (Bar B) and then closing for the session just off the high at 121-24.

After the strong close the market opened lower the following day and at the close of the Next time frame (the 50-minute bar) the Dynamic Trio Next flips and the trade is exited at 121-10 (Bar C).

In this example the trade realized a profit of 14 ticks (excluding commission and slippage, something we will not ignore later), a Maximum Favorable Excursion (MFE) of 29 ticks (Bar

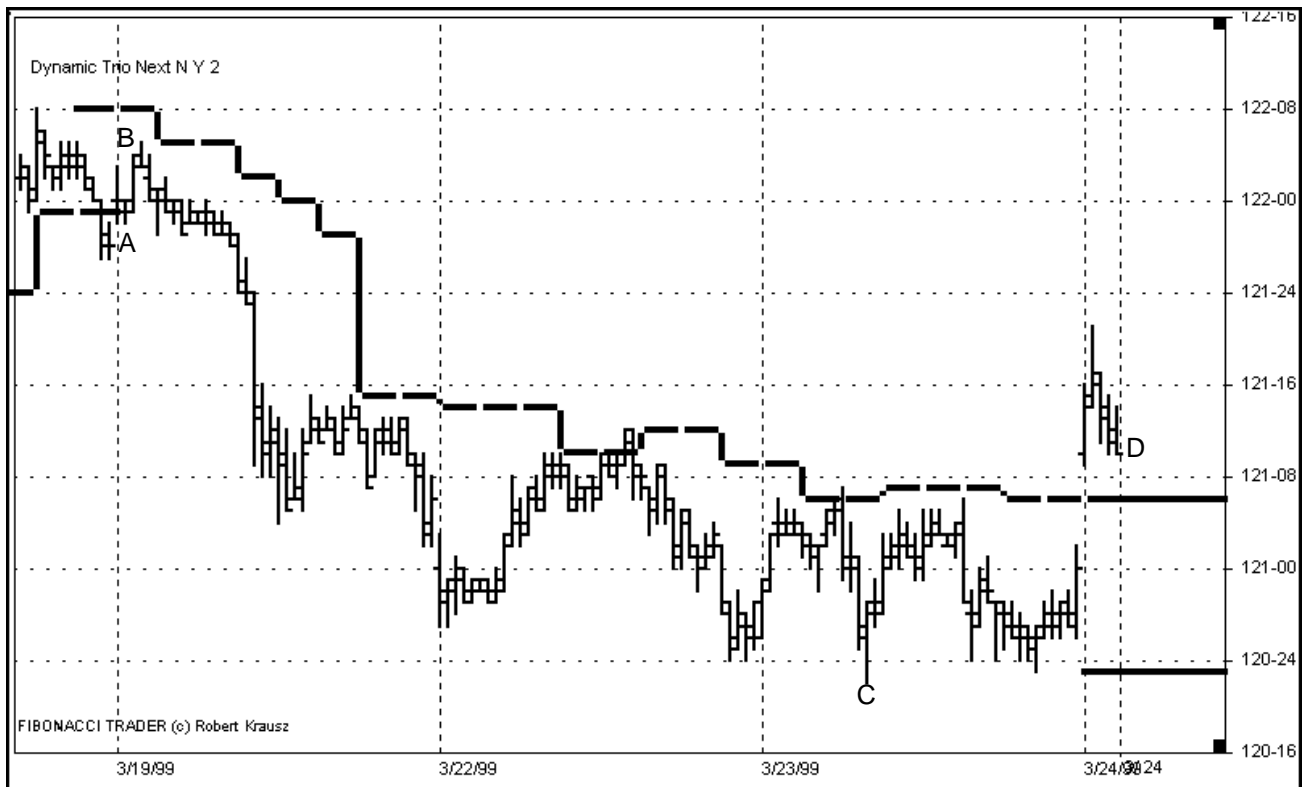


Figure 2: June 99 T-bonds 10/50/Daily Plan. Here the MFE was 38 ticks (A-C), the MAE was -9 ticks (A-B) and the profit was 18 ticks (A-D).

A to Bar B), and a Maximum Adverse Excursion (MAE) of zero ticks. This was a fairly nice trade because the trade was profitable did not experience any temporary drawdown.

Moving onto Figure 2, we see a sell signal on Bar A at 121-28, then the market edges higher to 122-05 (Bar B), but the market stalls and falls sharply to 120-22 (Bar C) and we are smiling. The market traces out a short term bottom with support at the 120-24 level then gaps up the following day, the Dynamic Trio Next flips, and the trade is exited at a price of 121-10 (Bar D).

This particular trade had a realized profit of 18 ticks, an MFE of 38 ticks, and an MAE of -9 ticks. Now that we understand how to measure MFE and

MAE let's take a look at this analysis over a month's worth of trades using a slightly more complicated mechanical system.

This next system highlights a key feature of the Fibonacci Trader that sets it apart from the other technical analysis software. It is the ability to do multiple time frame analysis. We'll take advantage of this feature with our next trading logic. We will still use the 10/50/Daily T-bond plan and the Dynamic Trio Next for our entry and exit signals as in our previous examples, but we will add an additional rule: The Dynamic BP Step High will be our *trend* indicator. That is to say, we will only take a buy signal to go long based on the Dynamic Trio Next if the Dynamic BP Step High is below the prices (the trend is up).

Sell short signals based on the Dynamic Trio Next will only be taken if the Dynamic BP Step High is above the prices (the trend is down). Any other signals will be an exit and go flat scenario. Figure 3 shows the rules in the Fibonacci Trader System module.

Notice that the Dynamic BP Step High is set to "use as trend indicator" and requires a two tick close.

Now here's a subtle but important point: Even though our entry and exit signals are based on the close of the 50-minute time frame, because we are using the Dynamic Trio Next, we can have a buy signal on a ten minute bar basis (Figure 4) because the Dynamic Trio Next may have flipped first to the long side, but the mar-

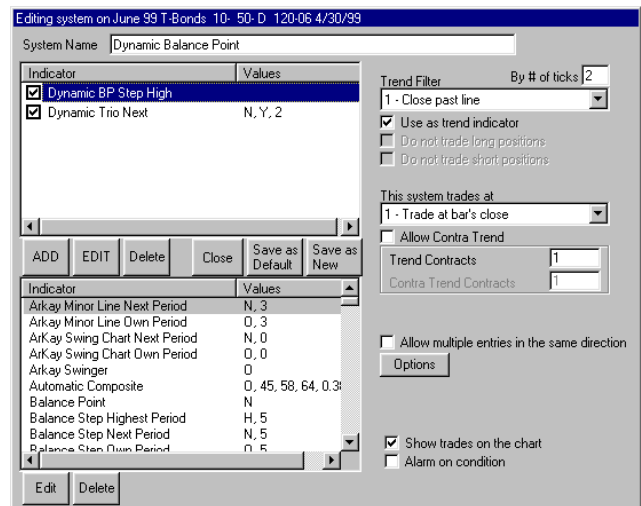


Figure 3: Trading System. Set the Dynamic BP Step High to "use as trend Indicator" and close by 2 ticks. The Dynamic Trio Next will signal the trades.

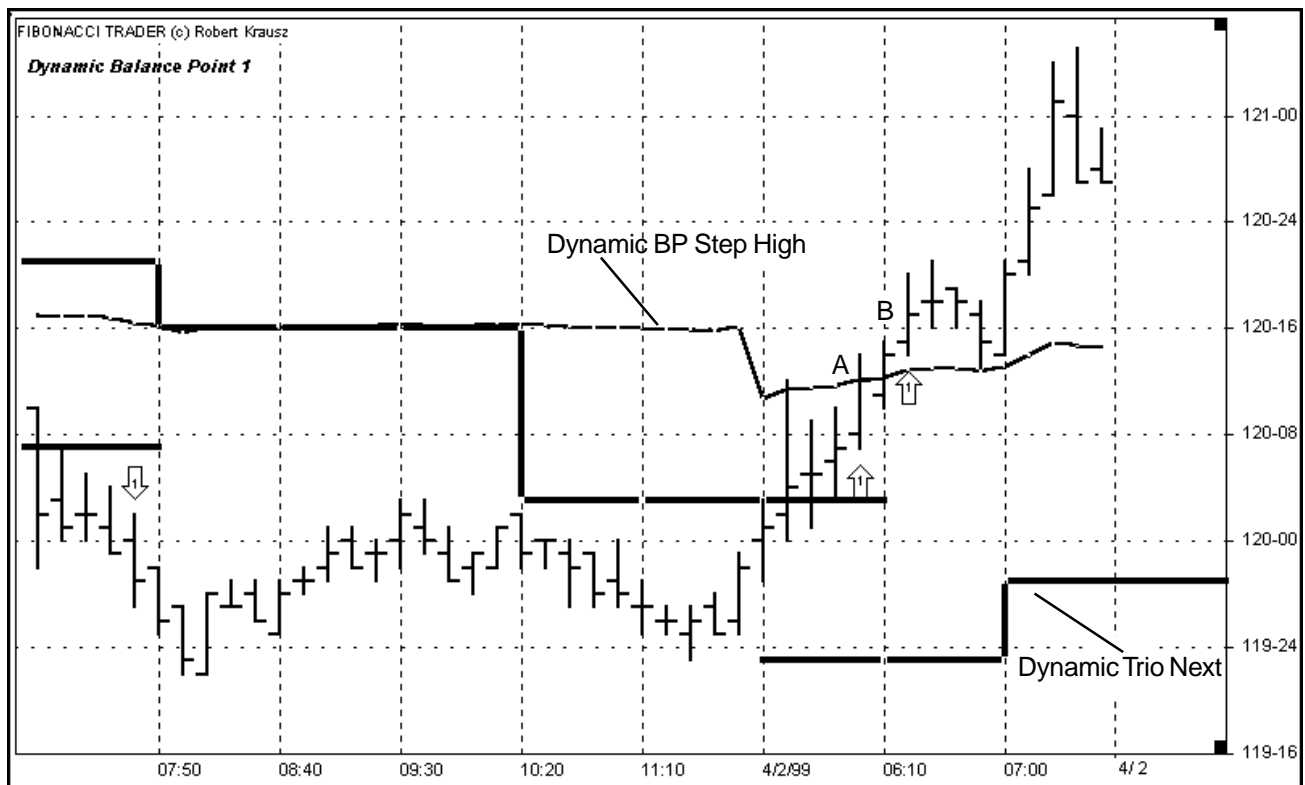


Figure 4: June 99 T-bonds 10/50/Daily Plan. Here, we can see the Dynamic BP Step High, and the Dynamic Trio Next. Notice at Bar A the Dynamic Trio Next flips, which is the close of the 50-minute time frame, and the system goes flat. But at Bar B the system goes long because the 10-minute Bar closed above the Dynamic BP Step High.

ket was below the Dynamic BP Step High, so we can only be flat. But, if the ten minute bar closes now above the Dynamic BP Step High we will go long via our rules. This is a special feature of the Fibonacci Trader many of our indicators are calculated on a Dynamic basis, giving us intraday signals based the higher time frame.

After running the system I copied the results for the month of April by selecting just the April results in the Results window, pressing the key combination “Ctrl C”, and then I pasted the information into an Excel spreadsheet. I then rearranged the columns to offset buys and sells, and then I visually checked each and every trade for the MFE, MAE, and profit.

You may, at first, think that this sort of detail work is something best done by a computer. I think not. This sort of visual detailed analysis brings you to a full focus understanding of the subtle nuances of the trading system. There is a very valuable psychological benefit to doing this sort of hand work because

you will have a better intuitive feel and acceptance of the trading system, an important psychological asset for becoming a successful trader. Figure 5 is the table of this analysis. Let's use this table version of the data and take a more visual look at the results.

April was quite a month for this system. Using a two tic slippage, the system netted out 108 ticks over 9 trades, including the assumption of an exit on the last day of the month. Figure 6 shows a histogram of the closed profits and losses of each individual trade. Five of the nine trades were profitable, with the best just over 60 ticks. The losses ranged from -1 tick to -27 ticks.

Let's take a look at the MFE and MAE for this month of trades. Figure 7 shows that every trade did start off with at the least a six tick profit for a minimum gain and the best trade reached an extreme of 98 ticks.

How might we use this information? One trading philosophy is to include a procedure to take a partial profit at some point in every

TRADE	DATE	TIME	B/S	ENTRY PRICE	DATE	TIME	EXIT PRICE	MFE	MAE	P/L	EQUITY
1	4/1/99	9:40	-1	119-29	4/2/99	8:00	120-12	7	-17	-15	-17
2	4/2/99	8:20	1	120-17	4/5/99	8:30	120-28	27	-4	11	-8
3	4/5/99	13:50	1	121-02	4/9/99	13:50	122-31	98	0	61	51
4	4/13/99	9:20	-1	122-23	4/19/99	12:10	121-22	52	-4	33	82
5	4/20/99	8:00	1	121-31	4/22/99	8:00	121-30	6	-5	-1	79
6	4/22/99	8:20	-1	121-23	4/26/99	13:00	120-28	47	-3	27	104
7	4/27/99	9:20	1	121-18	4/28/99	8:00	121-13	7	-8	-5	97
8	4/29/99	8:00	1	122-12	4/30/99	8:00	121-17	7	-30	-27	68
9	4/30/99	8:10	-1	121-16	Last Position Value		120-06	44	-6	42	108

Slippage = 2 Ticks

Figure 5: April Results. Here are the results for each trade including the entry date, time, price, exit date, time, price, MFE, MAE, Profit or Loss, and accumulated equity.

trade if the market reaches a preset objective. How might you determine a reasonable objective for a partial profit. It appears here by simply looking at the data one could set an initial target of 20 ticks for one contract, and then hold one more contract for an exit signal.

Profits are fun but what about the potential losses while in the trade? Figure 8 shows the MAE for each trade. Notice that in Figure 8 the MAE for most of the trades was -5 ticks or less, with two trades between -5 and -10, and two large negative movements, one for -17 (Trade 1) and one of -30 (Trade 8). Trade 3 never was at a loss.

If we compare this information with the realized profits and losses shown in Figure 6 we can see that Trade 1 had a closed out loss of 15 ticks and Trade 8's closed loss was 27 ticks.

Figure 9 (next page) is a composite display of this information for each trade, including an equity line for the month of April.

Based on this *limited* review of just one month's trading we could come up with two additional strategies that would reduce our risk while adding a target strategy for boosting our profitability. First, use a two contract position with a 10 tick loss from entry as an initial stop loss. Second, use a target provision of 20 ticks for the first contract, and hold the second contract until an exit signal occurs.

CONCLUSION

What we have discovered here are the template characteristics I described earlier in this

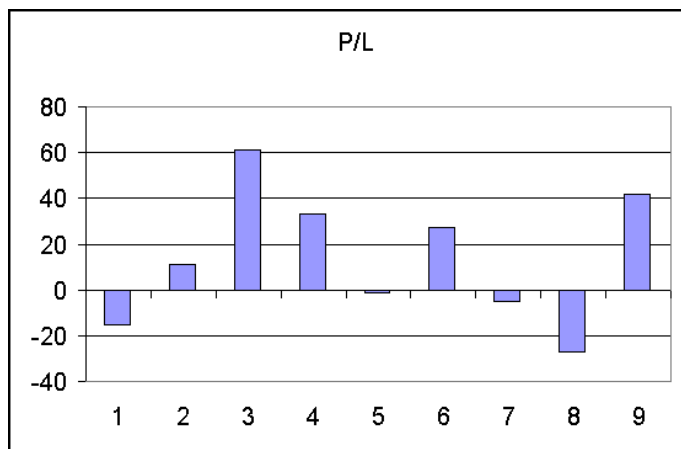


Figure 6: Profits and Losses. This histogram shows the individual outcome for each trade by ticks.

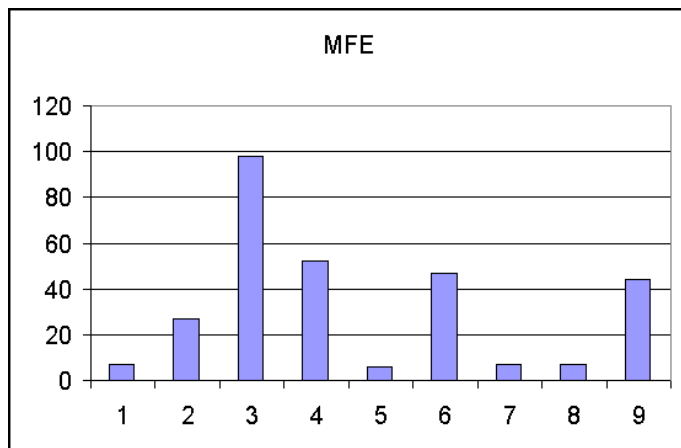


Figure 7: Maximum Favorable Excursion. Here, each trades maximum profit before exit is shown.

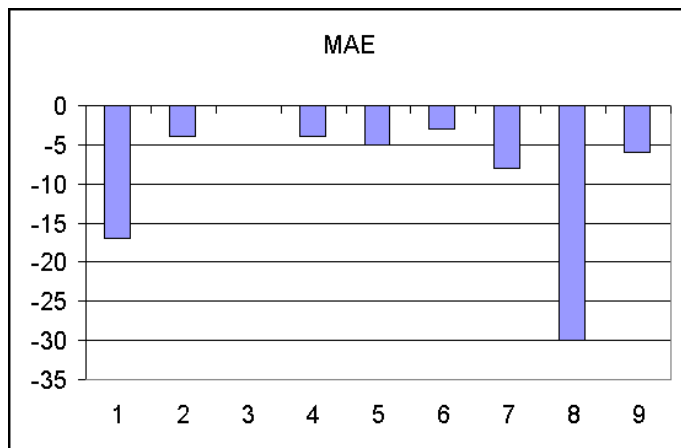


Figure 8: Maximum Adverse Excursion. Here is the negative number of ticks for each trade.

issue. We can now make some assumptions about this mechanical system. If the market goes into a tighter trading range (the rhythm of the market contracts) the twenty tick target will probably not be hit and only add more losses. But as long as the daily ranges are reasonable the mechanical system has a chance to make profits. But there is a problem in that one month's trading results are not enough of a back track.

Other months may be better or worse. Therefore, this set of procedures should be reviewed over a number of years worth of data before committing your capital. It may turn out that the twenty tick target is too high and the ten tick stop loss is too tight. You won't have a sense of confidence unless you check it out.

Something else we gain is the psychological edge of having a set of procedures that are designed to take advantage of two types of markets: Trend and trading ranges. Most importantly the mechanical system is on the line not the trader's ego. You have to learn to separate the two.

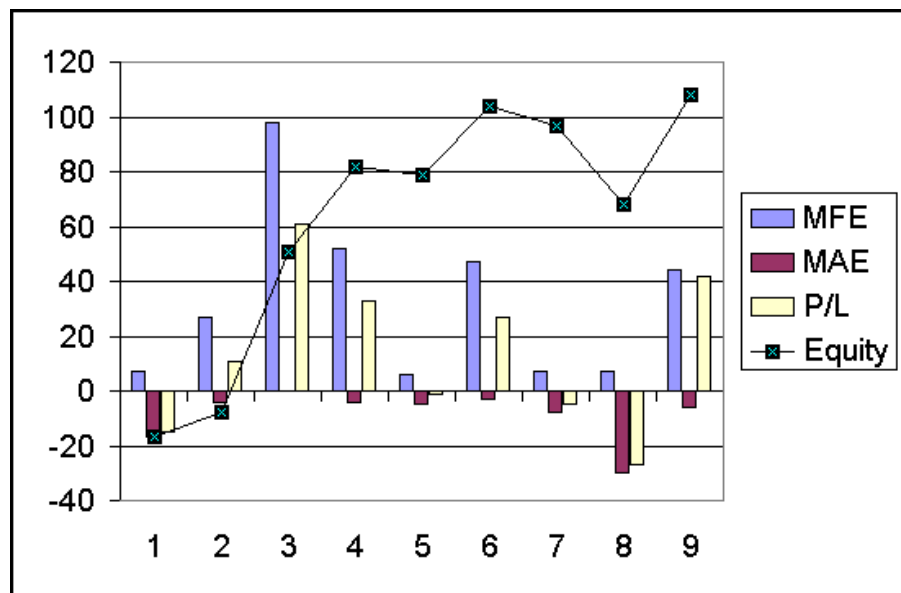


Figure 9: Composite Picture. Here is the MFE, MAE, Profit or Loss, and Equity Line (accumulated trades) for the month of April.

In the next issue of the Fibonacci Trader Journal we will look at both sets of rules for trading during the month of May and see if there is any improvement based on the additional rules.

We offer this particular topic in the Fibonacci Trader Journal as an example of the steps to follow when deciding how to determine *what* is a reasonable profit objective, and *what* is a reasonable amount of

money to risk on any one trade. We let the market tell us.

Take these concepts and apply them to your favorite market. If you discover that your procedures do not make profits on paper you will be very glad you learned it that way instead of the hard way.

I wish you excellent trading,
Robert Krausz, MH, BCHE

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