

The **TRADER'S** Journal

www.traders-journal.com

VOLUME 2 ISSUE 4

Interview with J. Welles Wilder

**FX - Filtering Out
the Noise**
Persistency
Paramouncy
Principle



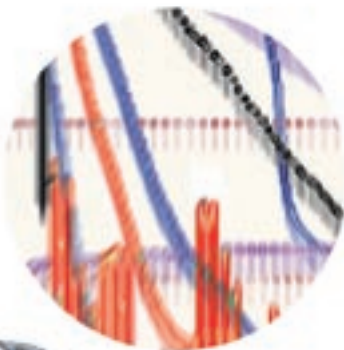
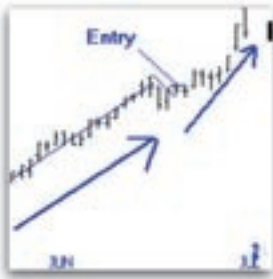
Trading Tools:
Candlesticks and Crossovers
CBOT's New \$25 'BIG' Dow Product
Selling Options
Action and Reaction Lines

ISSN 1793-2149



MICA (P) 352/05/2005

SG\$8.80 / A\$13.80 / HK\$68 / RM\$19.80



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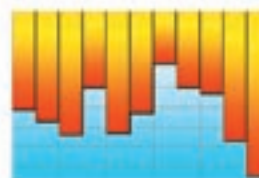
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DOUG SCHAFF

Filtering Out the Noise

Doug Schaff, who has traded the FX markets for close to 30 years, explains how to filter out the noise and how many confirmations are needed to enter a trade

Introduction

At FX-Strategy (FXS) we build technical forex trading systems to help us and traders like you make profitable trading decisions. But as good as a trading system is, it is still only a tool. Even the best trading systems have their limitations. I am going to show you how to filter out market noise to improve the odds that the trade signals you choose to act on are profitable ones.

We are going to take a look at a trending market and a sideways market. In the first market we will try to catch a trend in progress and in the second we will see if we can find a market retracement that is about to occur. In both of these markets I am going to show you how I confirm that a trade is worth taking.

Confirming Trend Signals

When I am day trading I like to start at 7:30 AM EST. Europe is well into its session and East Coast bank traders have not yet settled into the office. On Thursday April 20, I opened up my charts at 7:45 AM, saw the GBP/USD falling and that the FXS FAMA 15 System had produced the first of what would turn out to be several sell signals that day, as shown in Figure 1.

1. FAMA 15 went short GBP/USD at 1.7889 at 1:30 AM
2. System exited short position at 1.7876 at 2:15 for a 13 pip profit.



Figure 1 – GBPUSD 15-minute chart with FAMA 15 System, 19-20 Apr 2006

I like to use FAMA 15 because it trades with the trend; at least it is designed to do so. And those are the safer, more reliable trades. Here is more information on the system.

Introducing FXS FAMA 15 System

In an uptrend FAMA 15 buys at the FAMA midline, targeting the Hi Band to take profits. In a downtrend the system sells at the midline and sets the Lo Band as a profit target.

Though the system is designed for 15-minute currency charts, traders have reported that it can be useful in other timeframes as well.

Characteristic:	Short-Term, Trading with the Trend
System Indicators:	FXS Filters (blackbox) – Identify Trend Direction
	FXS – Adaptive Moving Average – Identifies Timing
	FAMA Hi Band – Profit Target for Long Positions
	FAMA Lo Band – Profit Target for Short Positions
Indicator Parameters:	FXS – Adaptive Moving Average: 5,2,0
Timeframe:	15-Minute

2005 backtested results for FAMA 15 show the system produces an average of 19 pips a trade about 70% of the time. (More information on FAMA 15 is available at www.fx-strategy.com)

FAMA 15 sells into a downtrend on a pullback to the FAMA midline. A FAMA 15 trading signal gives me market timing as to when to get into a moving trend. But on the morning of April 20th, the Pound was already at 1.7809. It had been steadily falling since the day before. Given that the average daily trading range for the GBP/USD had been running around 125, and the market had already fallen that much, I wanted to be cautious about selling. Even if a FAMA 15 sell signal popped up on the screen I was not going to take it unless I had independent confirmation that the strong downtrend was still active.

To cross-check the trading signal

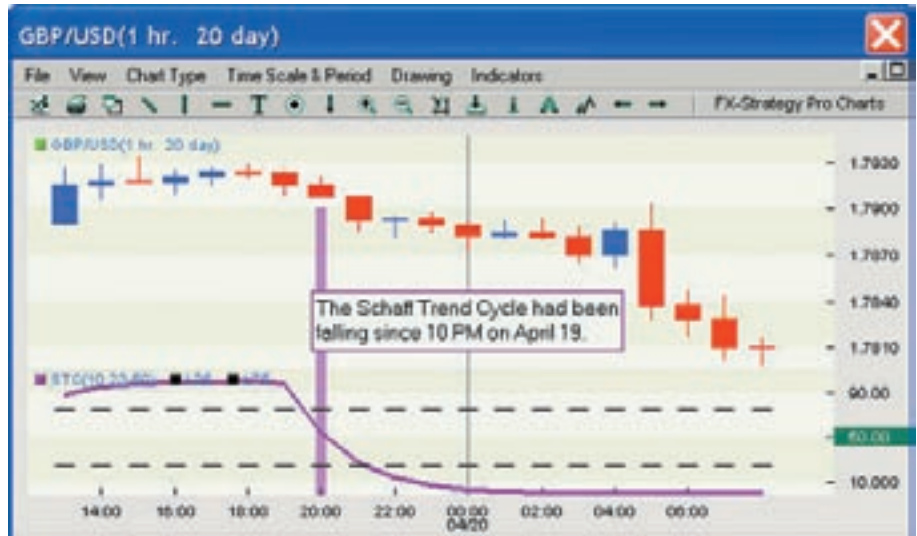


Figure 2 – The Schaff Trend Cycle showed the downtrend was still active.

I pulled up a 1-hour GBP/USD chart and applied the Schaff Trend Cycle (“STC”), as shown in Figure 2. The STC shows trend momentum, the strength of the trend.

The 1-hour STC showed bearish trend momentum. The STC had fallen to zero and stayed there. This confirmed the bearish trend. As long as this is the case I will take sell signals that FAMA 15 generates. Note: IF the STC began rising above 25 then I would NOT take a FAMA 15 sell signal.

The Next Sell Signal: At 8:15, FAMA 15 produced a sell signal at 1.7824. The STC was still “on the floor” near zero on the 1-hour price chart, confirming the signal. I went short the Pound.



Figure 3 – The next FAMA 15 sell signal occurs at 8:15.

Trade Entry Recap

A two-step process was used to enter the trade.

- Identify Prospective Trade – with FAMA 15 trade signal
- Confirm Trade Signal - using STC on the 1-hour chart

During the 9:30 pricebar, FAMA 15 exited at 1.27800 for a profit of 24 pips. The 1-hour Schaff Trend Cycle remained bearish throughout the day and FAMA 15 caught two more profitable sell trades.

Confirming Range-Trading Signals

We saw how the FAMA 15 System trades with the trend, and how to use the Schaff Trend Cycle (STC) to confirm its trade signals. Now we are going to take a look at a range trading market. A trading system that I like to use in range-trading markets is the Channel Trend 30 (“CT 30”). We are going to look at it on a 30-minute EUR/USD chart.

Introducing Channel Trend 30

CT 30 uses an 8-bar Price Channel indicator as shown in Figure 4. A blackbox momentum indicator is hidden. The system sells short or exits long positions at the upper price channel +3 pips. It goes long or exits short positions at the lower channel – 3 pips.

2005 backtested results for Channel Trend 30 show that the system produced an average of 21 pips a trade approximately 70% of the time. (More information on Channel Trend 30 is available at www.fx-strategy.com)

Characteristic	Short-Term Momentum, Range Trading
System Indicators:	FXS Filters (blackbox) – Identifies Momentum
	Price Channels – Trade Entry and Exit Points
Indicator Parameters:	Price Channels (8)
Timeframe:	30-Minute



Figure 4 – When momentum conditions agree, CT 30 sells at the Upper Price Channel + 3 pips and buys at the Lower Price Channel – 3 pips.



Figure 5 - Pro Commentary provides high-quality daily Support / Resistance numbers

How Channel Trend 30 Works

On April 19th Channel Trend 30 generates two trading signals as shown in Figure 4.

One was a winner and one was a loser.

- Sell Signal at 3:30 at 1.2359 exited at 8:00 at 1.2332 : + 27 pips
- Buy Signal at 20:30 at 1.2364 exited at 7:00 April 20 at 1.2324 : - 40 pips

Is there a simple, reliable indicator that we can use to cross-check these range-trading signals? Yes there is. Support/resistance levels can be used to confirm or reject trade signals produced by range-trading systems such as Channel Trend 30.

Using Support/Resistance as Confirmation

I get my support/resistance numbers from Pro Commentary, a daily currency market forecast that covers seven major currency pairs. Figure 5 shows the top portion of the April 19, 2006 Pro Commentary Report that provided the support/resistance numbers I used for the EUR/USD that day.

Placing the support/resistance lines on the 30-minute Euro chart gives us a basis to cross-check trading signals as they occur. The bias that day emphasized a resistance band between 1.2370 and 1.2400, which is also shown on the chart below.

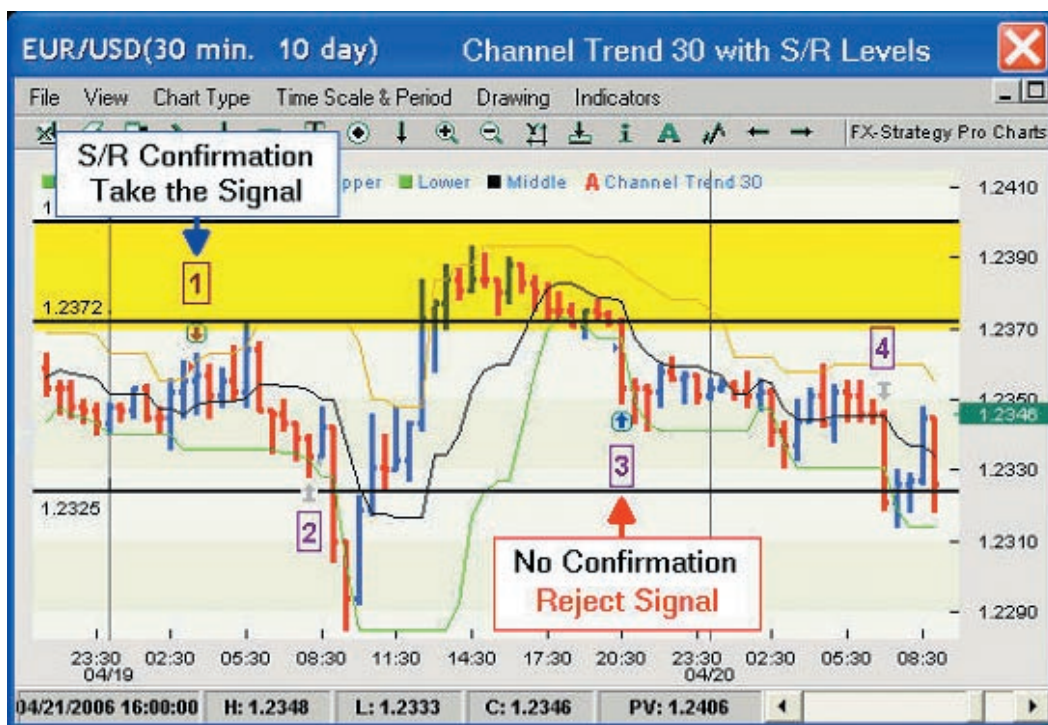


Figure 6 – Channel Trend 30 signals with Support/Resistance Levels

First Trade Signal Confirmed

Figure 6 shows that the 3:30 sell signal at 1.2359 occurred close to 1.2372 resistance. The 1.2370-1.2400 resistance band is expected to hold. This confirms the Channel Trend 30 sell signal. Traders can take the trade.

Second Trade Signal Rejected

The buy signal at 1.2364 that appeared later that day occurred below strong Resistance which had been tested during the day and held. Buying just before strong Resistance greatly lowers the chances of a successful trade. Thus, there was no confirmation of the buy signal. The buy trade signal was rejected.

Trade Entry Recap

As with FAMA 15, the trade entry process for CT 30 has two steps:

- Identify Prospective Trade – with Channel Trend 30 trade signal
- Confirm Trade Signal - using Support/Resistance Levels

Conclusion

You can significantly improve your trading odds by using a confirmation process such as the one described above. Practice making trading decisions in a demo trading account using automated trading systems. Remember that one of the best qualities trading systems – that they generate automated signals – can also work against them.

Taking a moment, that second step, to confirm a trade signal's validity can significantly boost the probabilities of a winner. You will occasionally reject trades that turn out to be winners. But you will avoid low-probability trades and come out better for it.

FAMA 15, Channel Trend 30 and four other built-in systems are available on FX-Strategy Pro Charts on a trial basis (www.fx-strategy.com). You can pull up descriptions on the FXS trading systems on FX-Strategy's website or on Pro Charts.

For more information about Pro Commentary, market commentary authored by forex veteran Ian Copey, please visit the FX-Strategy website at www.fx-strategy.com. Support/Resistance numbers in this article are courtesy of Pro Commentary and used here with permission by the author.

All Trader's Journal readers are welcome to test out Pro Commentary and Pro Charts, themselves, for free.

Doug Schaff has traded the FX markets for close to 30 years. His company FX-Strategy was created to assist currency traders and investment advisors with trading decisions. Training courses are available. Please visit his website at <http://www.fx-strategy.com> for more information.