



The Trend Is Your Friend – and Pauses in Trends Will usually Resolve in Continuations

Capitalising on Continuation Patterns

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Trending stocks tend to breakout and then pause, or consolidate, ahead of continued price appreciation. Setting entry points just above resistance can enable traders to capitalise on breakouts while avoid entry should the stock linger sideways or break down. Identifying those continuations and setting proper entry levels is the subject of this article.



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Trends

Technical analysts seek to identify and capitalise on patterns, or tendencies, in stock charts, and of particular interest is the tendency of stocks to continue trends, either up or down. Stocks that have broken out (or down in the case of shorts) go through periods of consolidation ahead of the next move, and identifying these consolidations and key entry points can optimise the chance of winning trades.

This strategy is built on the assumption that, as the adage goes, the trend is your friend and that pauses in trends will usually resolve in continuations of those trends. This, of course, requires that these pauses, for the most part, are sideways, in the form of triangles, flags, etc, and that the stock price remains range-bound, building pressure ahead of the next release.

An example of this is an ascending triangle pattern, as seen in the MGM Resorts International (MGM) chart from mid-December 2010 (Figure 1). MGM had been consolidating out of a big upmove that had taken it from nine in late August 2010 to nearly 13 3/4 in mid-October, a more than 50% move. It tested its key 13.80 resistance level a couple of times since October, but could not break through, with the stock each time retracing to a new higher low. This created the ascending

triangle pattern whose upper horizontal trend line – the key 13.80 resistance level – appeared ready to be broken as the lower line angled toward it.

Buy Stops

While the ascension of the triangle suggested the stock was poised to break out, there was, of course, no guarantee. So, rather than anticipate and risk the stock backing off or continuing sideways, forcing us to hold longer than we would like, we set a “buy stop” price at 13.85, just above the resistance line, in order to be positioned should the stock break out. MGM, in fact, did hit 13.85, and accelerated to our target of 14.80 the very next day.

In another example of a bullish consolidation, Developers Diversified Realty (DDR) narrowed nicely for three months in a symmetrical triangle, converging towards the apex (Figure 2). As the stock edged up towards the top of the narrowing channel, we put in an 11.55 buy stop order, just above the top of the upper trendline. The stock proceeded to explode from there in early October into our 12.71 target area.

The use of buy stops is a critical component of a strategy such as ours that capitalises on continuation patterns. A buy stop is an order to enter a trade at a price above where the stock is at currently. It enables traders to wait

F1) Ascending Triangle



Figure 1 shows an ascending triangle pattern in the chart of MGM Resorts International (MGM), with a series of higher lows, an example of a price pattern poised to continue its trend, which MGM proceeded to do.

Source: www.tradesignalonline.com

F2) Symmetrical Triangle



Figure 2 shows another example of a bullish consolidation, using the chart of Developers Diversified Realty (DDR). The pattern narrowed towards the apex of the triangle, a point at which it was set to resolve in one direction or another.

Source: www.tradesignalonline.com

for the stock to come “up” to the buy price as evidence of continued momentum.

In our strategy, we use the hours after market close to study the day’s patterns and prepare what is called Buy Stop Limit Orders before the next trading session. This involves setting a buy stop just above the previous day’s high, as well as setting a limit, or maximum entry, price. The use of a limit price avoids chasing a stock should it gap up too high. Conversely, short trades use Sell Stop Limit Orders, setting entry points below previous day lows.

Our Buy Stop Limit Orders are day orders, and thus if the stock opens below the buy stop price and fails to reach it during the session, the trade is cancelled. Sometimes the trade set-up is reinitiated for the following or subsequent sessions, but often a new, more promising chart set-up is selected for the next day, as a failure to meet the expected breakout often results in a dissolution of the upward pressure.

Stop Losses

We also cancel trades if the stock opens above the limit price, as a retracement from there back to the buy stop price is a move in the opposite direction (and our strategy looks to capitalise on momentum, not bottom-fish). Likewise, if the stock moves below the stop loss price before hitting the buy stop,

we cancel the trade because of the break in momentum and because any snapback from there up to the buy stop would be considered too quick a move and subject to additional consolidation.

A recent chart on McGraw-Hill (MHP) shows how an ascending triangle just like MGM can sometimes fail to follow through as expected, and how our strategy works to avoid entering a bad trade (Figure 3). MHP had been making higher lows since late November 2010, narrowing towards its upper trendline resistance just below 39.15. Setting our buy stop at 39.15 in a pre-open order in early March, we were positioned in case of a breakout, but also protected when the stock failed its third test of that level. The stock dropped below our stop loss price, cancelling out our trade. No harm, no foul, and the capital that would have been tied up or lost in the trade was free to use the next day in another bullish continuation pattern.

We set the stop losses in our trade orders mostly in the range of 3-5% below entry. If the position is filled and moves lower, we are protected. If the position advances, we raise the stop. When a stock rises 1% above its entry prices, stops are moved to 0.2% above entry to lock in a profit. Targets are 4-12% above entry, and usually follow the direction of the ascending trendline, such as the 14.80 level in the MGM example.

Using this strategy, for every ten trades, 2-3 stocks tend to continue their trend, yielding a 10%-12% gain, while other picks are exited at a small 0.2% gain to 2-3% loss.

Position Size

One additional risk management strategy we use is determining the number of shares. We determine the number of shares for a trade through a formula that ensures that no more than 1% of the account level is risked in a trade. The formula is 1% of the account level divided by the difference between entry price and stop loss price. For example, with a \$30,000 account and a trade with a \$0.50 difference between entry and stop loss, the number of shares would be 300 (1% of 30,000) divided by 0.50 – which comes to 600 shares. If stopped out for a \$0.50 loss, the loss is no more than 1% (\$300) of account value.

Conclusion

Our strategy plays the trend, but through the use of buy stops we maximise our chance of entering a trade on a breakout with the trend resolving in our favour. There are many times these trends do not move our way, but most often the trade is cancelled by then and we are safe to trade another day.



F3) Failure to Resolve Higher



Figure 3 shows the importance of buy stops. As McGraw-Hill (MHP)'s pattern fails to resolve in a continuation of the uptrend, no entry is made, as price does not reach the buy stop and instead falls below the stop and the trade is cancelled.

Source: www.tradesignalonline.com

Strategy Snapshot

Strategy name:	Trading Continuation Patterns
Strategy type:	Trend Following
Time horizon:	Daily Chart
Setup:	Stock price must trade above previous day's high, but not above limit price, for trade to fill.
Entry:	Buy-stop limit order (sell-stop limit order on shorts)
Stop-Loss:	3-5% below entry
Take Profit:	Raise stop to 0.2% above entry when stock reaches 1% above entry
Trailing-Stop:	Not used
Exit:	Target (4-12% above entry price) or stop
Risk and Money Management:	1% of account risked per trade
Average number of signals:	1 per day
Average return per month:	Total return averages 10% per month