

Part VI

A Typical Elliott Wave Trading Plan

*There's a price for too much arrogance,
a price for too much greed;
And in complacent ignorance,
we've sown the whirlwind seed.*

Don Simpson, from the song "Serpent's Reach"

Errors in trading occur due to a variety of reasons, but the most common causes of trading disasters can be traced to three *cardinal sins*, namely *arrogance, greed, and ignorance*.

The sin of arrogance is less frequently seen nowadays; increased volatility in the forex markets has taken its toll. Traders who presumed to possess the *inside track* on market movements, and speculators who tried to will the market to go their way before it is ready, did not survive this far. There are not enough of the cocky traders left to make a mark on the casualty chart.

On the other hand, the incidence of the sin of greed waxes and wanes **like** an epidemic with the rise and fall of prices in the currency markets.

There is no way to smooth the swings except by changing the way people think. And *that* is an even more difficult proposition than eliminating greed in the marketplace.

The sin of ignorance is the most pervasive of the lot. With the amount of money being shifted around at the slightest perception of impending market change, its not unreasonable to presume that players involved in this *zero-sum* game actually understand the mechanics of price change. But the moans of victims who were zero-summed in their trading accounts at some point in the game is actually on the rise. So one is tempted to say that ignorance of market mechanics is endemic in the market place.

This last *sin* is one that nobody needs to suffer from. Even if the causes of price change are not yet fully understood (nobody knows exactly why people decide to buy or sell en masse at a point in time), it is enough to know what *does not* cause prices to fluctuate. For instance, the laws of cause and effect in the science of physics do not apply in the largely psychological phenomenon of price change. In another, price movements are not wholly random in all degrees of possible intervals between price changes; the October 1987 stock market crash drove this painful lesson home.

If a tool is workable, it is not of over riding importance to know exactly the *why's* and *wherefore's* as long as the basic truth behind it is understood. This is especially true of the Elliott Wave Principle. It suffices to know that the Principle is based on the proposition that the market is comprised of people, and that people will never change. They will react to similar situation in the same manner over and over again.

The Elliott Wave Principle, to my knowledge, was the first to explicitly recognize that market mechanics do not cause changes in market direction; only changes in psychology do. What R.N. Elliott has done is to establish normative behavior patterns from which specific rules can be declared; and from these rules broad guidelines and description of tendencies can be inferred. Specific market action can then be derived from these inferences.

Given the highly serialized structure of the model, a study of Elliott Wave Principle will train one to assess the probability and frequency of a future event. Situations which are deemed *impossible* under the various rules and guidelines are eliminated from consideration, thereby limiting the possible eventualities the trader has to cope with. Robert R. Prechter once likened the knowledge of the Elliott Wave Principle to the possession of a road map. With it, one can make a few deductions that will identify the most likely path that a bus will take (even if one has not made the trip before), thus eliminating 99 percent of other possible routes across unpaved lands.

It should immediately become obvious that the use of Elliott Wave Principle is not a mechanical approach to the market place. It is an approach in which *probability* rapidly becomes the catchword; it is a method in which the terms *prediction* and *forecasting* become irrelevant, even unwelcomed. One soon learns to replace these terms with the word *anticipate*.

Any analysis derived by application of its principles will always imply a forecast or prediction. Don't let the *implied* turn into *explicit*. While the Wave Principle is probably the most effective forecasting tool available, do not use it to forecast or to predict. Use it only to establish targets with high probability of achievement, or to establish alternative courses if subsequent market action nullifies the original objectives.

This may disappoint those who are looking for rigid, absolute answers to the forex markets' questions. But it is a fact of life that most predictions and forecasts are destined to fail; it is simply impossible to pinpoint the confluence of specific time and price elements at any part of a market movement. The best way to use the wave principle is to accept this fact. Provide for the occurrence of errors of judgement, then subsequently deal with the alternatives to produce winning strategies. There are no *guarantees* in the forex market, there are only *maybes*.

If one is to derive maximum benefit from this method, one has to learn to accept it for what it is, a tool to provide the input necessary to quantify the degree of risk or degree of reward in the current market structure. It is not a magical philosopher's stone; it does not turn base ideas into gold.

To a certain degree, this quantification process – let's call it “money management” – is more important than the analysis part of the tandem. To use an old analogy, analysis is the door to fabulous riches, while money management is the key that opens that door.

The first requirement of money management is a trading plan – a written, well-analyzed, step-by-step process, not a set of vague intentions kept in your head. This plan must not only provide for entering trades; it must also provide contingency for taking losses and accepting profits.

Put it this way. A trading plan without a system of cutting losses short and maximizing profit potential is like boarding a car without brakes and gearshift. You will certainly be able to depart, but it is doubtful if you will arrive at your destination. The worst, of course, is not having a trading plan at all. It's like boarding a car without a steering wheel. It is doubtful if

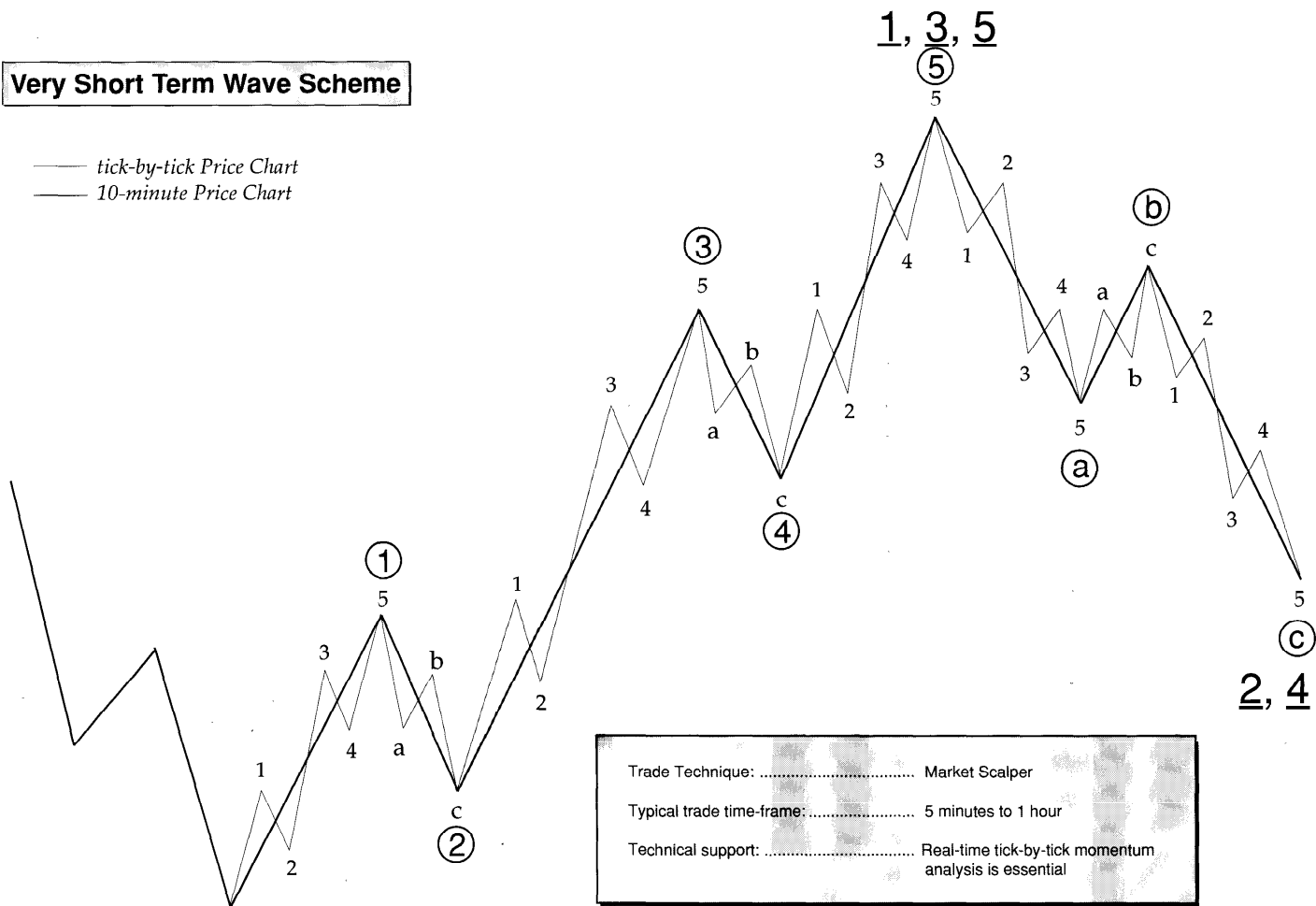
you can even depart; it is certain that you will never arrive.

In drawing up a trading plan, its spirit should be what Robert Beckman once said: "We are not trying to beat the market. We are trying to join it." There are subtle implications in Beckman's plea. The objective should be less in being "right" but more in being "successful". In other words, do not aim at getting a correct "forecast" for ego-boosting reasons. Rather, aim at making money on the trade, even when the forecast was wrong.

There is no contradiction involved here, from the standpoint of Elliott analysis. Most of the time, the probability of likely occurrence are so evenly distributed that favoring one scenario over others becomes a matter of preference. It is only at certain times in the market development that reliable, precise projections can be made. At most times, it is only possible to assess that being long is preferable to being short, or vice versa. With meticulous planning, that information is usually enough to succeed in the market place.

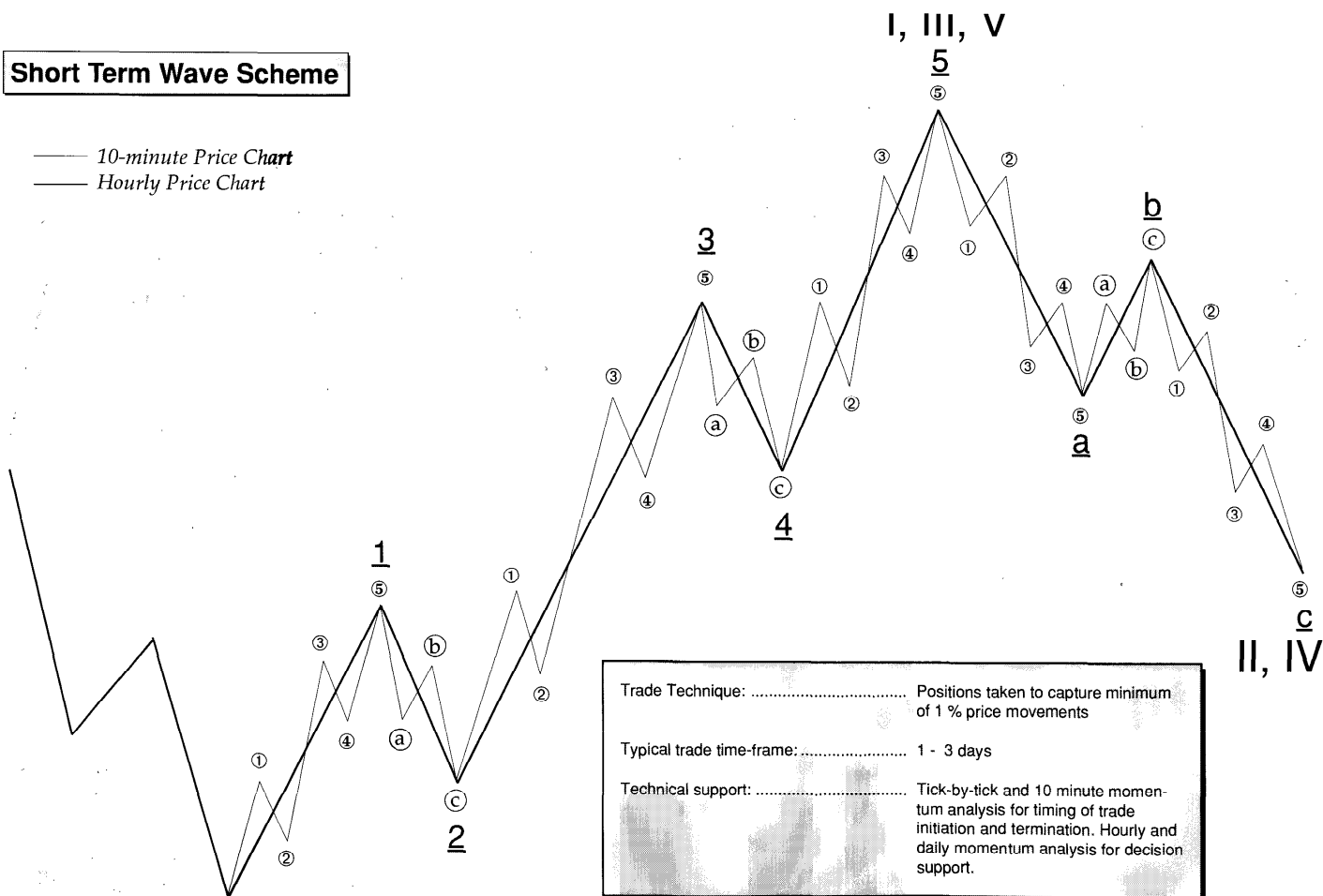
Very Short Term Wave Scheme

— tick-by-tick Price Chart
 — 10-minute Price Chart



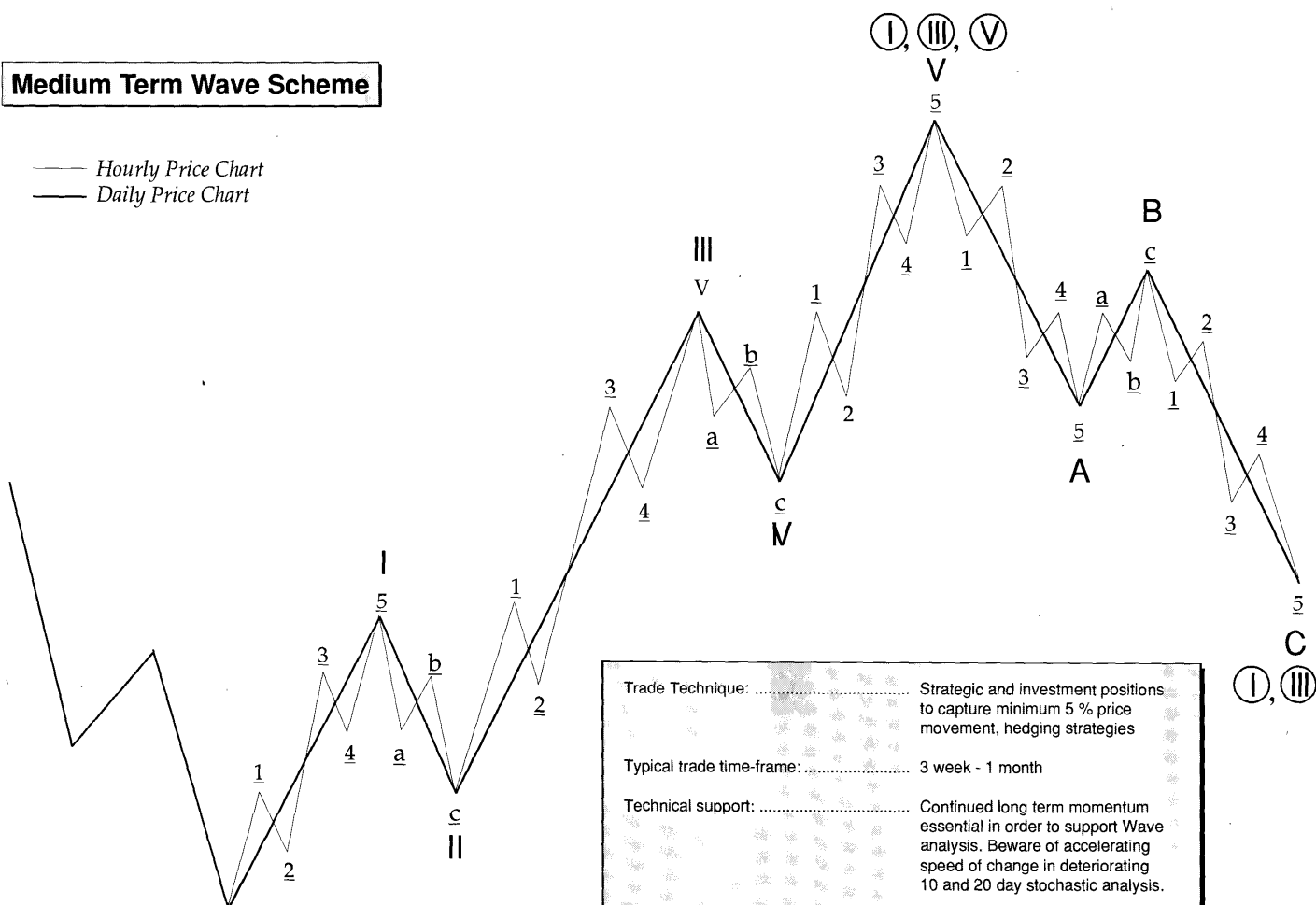
Short Term Wave Scheme

— 10-minute Price Chart
 — Hourly Price Chart



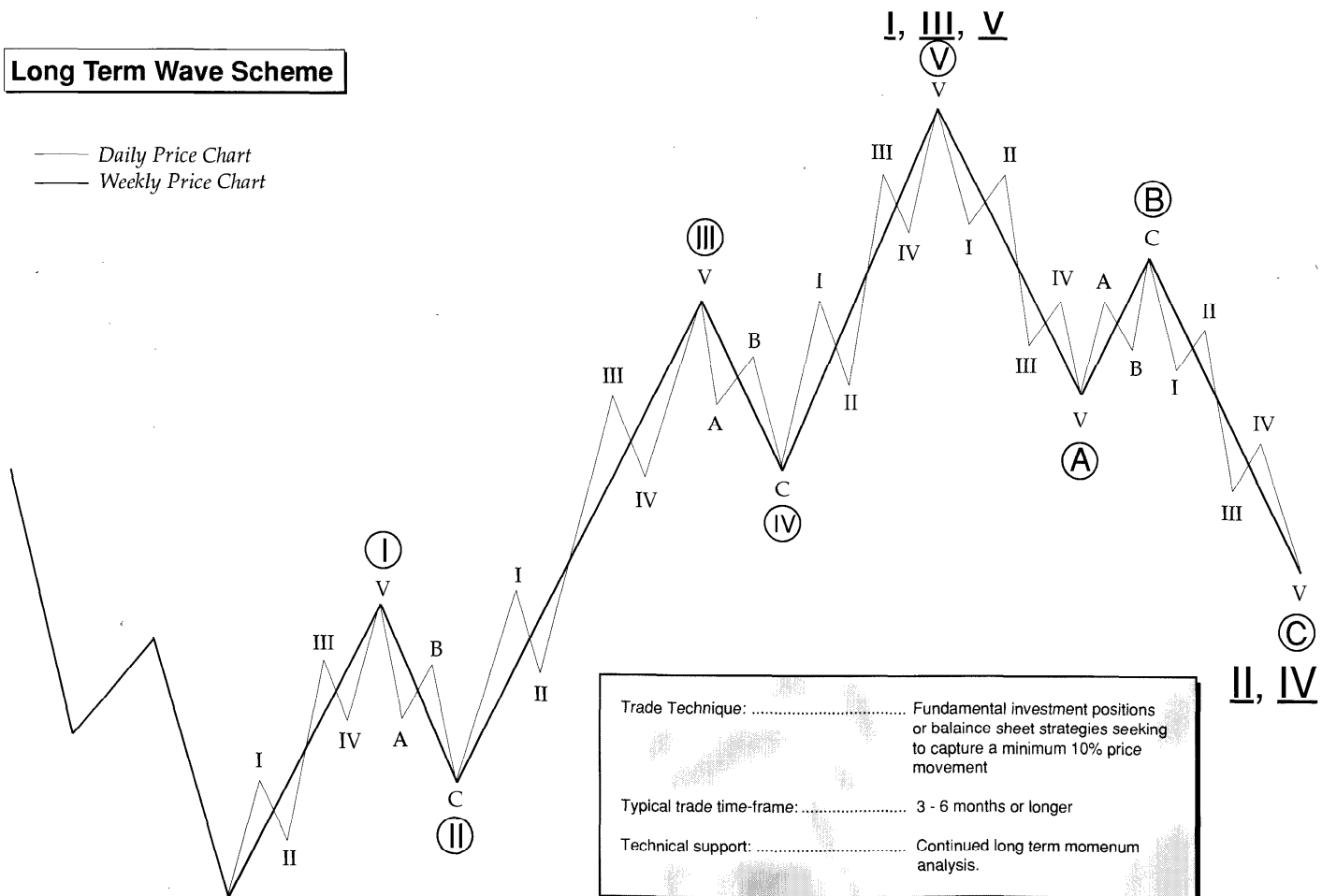
Medium Term Wave Scheme

— Hourly Price Chart
 — Daily Price Chart



Long Term Wave Scheme

— Daily Price Chart
 — Weekly Price Chart



Preparations for the Typical Elliott Trading Plan

Ascertain from the preceeding wave count that a five-wave sequence is highly probable from Point 0 (see *Trade No. 1*). Preferably, the expected five-wave move should be part of a larger pattern that could be comprised of five waves itself. In this ideal situation, the move from Point 0 to Point T (termination of the five-wave sequence) should compose the 1st Wave of the larger pattern (see Short-Term Trading Plan). However, if a large zigzag or any other deep correction is expected from the wave count, the Trading Plan may be activated. Just make it a point to remember that the potential movements are limited in this case.

Divide your trading capital into 10 equal units, if you are trading on *cash* basis. If you are trading on margin basis, divide your risk capital into 10 equal units, just the same. The intention here is to prevent the trader from risking his entire stake in any one trade. This also ensures that the trader will survive errors in judgement early in the trading exercise, and will have the wherewithall to continue the trading plan.

The nominal value represented by the leveraged capital is irrelevant to the over-all scheme of this money management system. If you are taking market positions on the basis of *trading limits* (as in the case of a bank forex trader), the maximum net exposure recommended in the trading plan should correspond to about two-thirds of your limit.

Finally, this typical Elliott Trading Plan may be used with any of the four wave schemes mentioned, the very-short term, the short-term, the medium-term, and the long-term wave schemes. The tactics won't vary significantly; only the time horizons of the recommended trades will differ. For example, the time of travel from Point 0 to Point T in the Very Short Term

Wave Scheme might be as short as 18 hours. On the other hand, it might take all of 7 or 8 months for the market to travel from Point 0 to Point T on the Long Term Wave Scheme.

The size of the price swings will of course vary from one wave scheme to the next. It can range from 75 to 125 *points* in the tick-by-tick chart to 200 pfennigs in the Long Term USD/DEM chart. Any choice of trading horizon, if a choice is available, will depend largely on the capacity of the trader to take losses. The shorter the wave scheme being followed, the smaller the risk in terms of face value. In percentage terms however, the risk in trading in accordance with the Very Short Term Wave Scheme should equal the risk inherent in the Long Term Scheme.

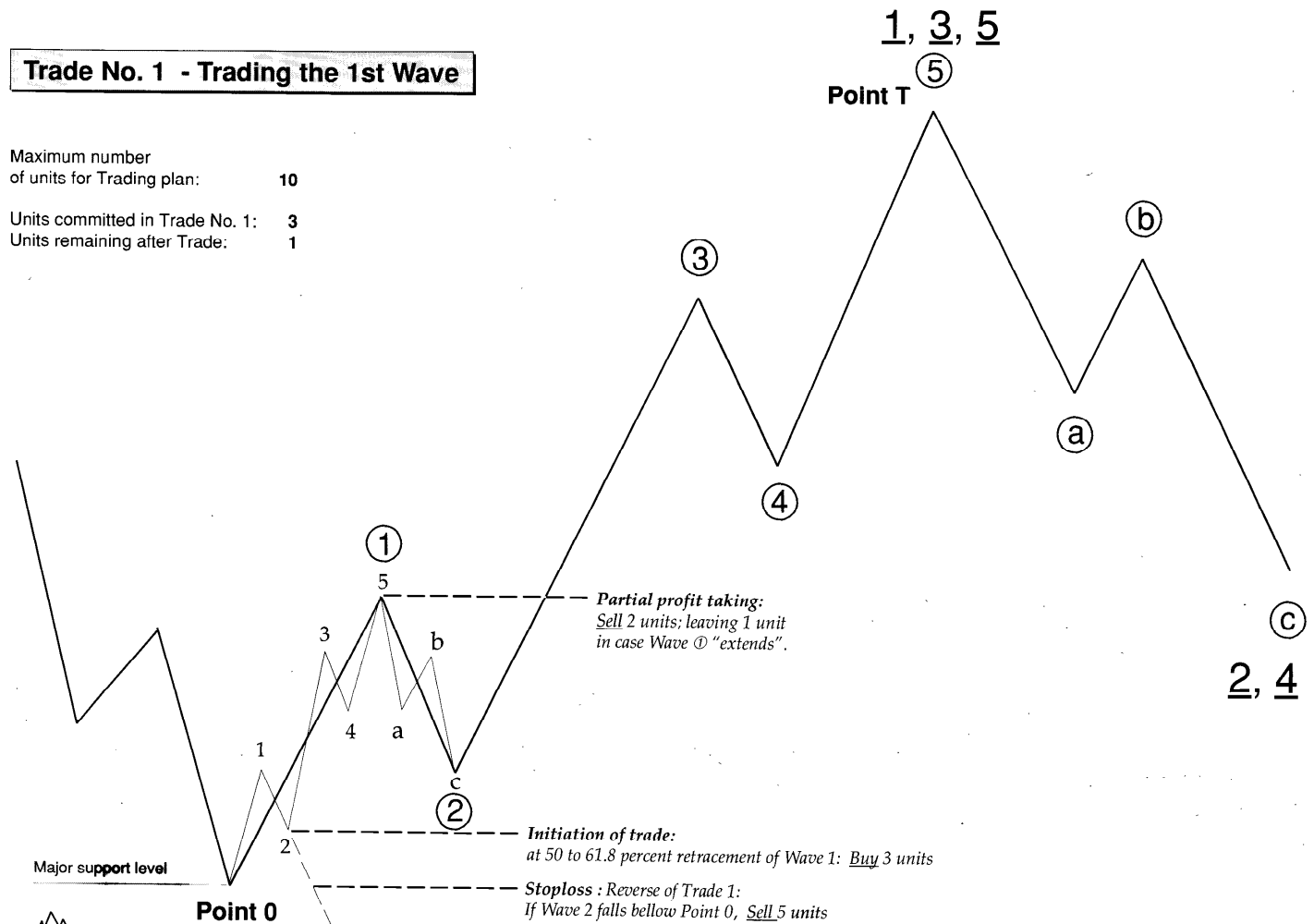
All of the trades described in the Typical Elliott Trading Plan follow a certain pattern, namely: 1) initiation of trade, 2) setting-up of stop loss levels, 3) case-by-case addition to existing position, 4) provision for partial profit-taking, 5) case-by-case reinstatement of position, and 6) termination of trade.

Trade No. 1 - Trading the 1st Wave

Maximum number
of units for Trading plan: **10**

Units committed in Trade No. 1: **3**

Units remaining after Trade: **1**

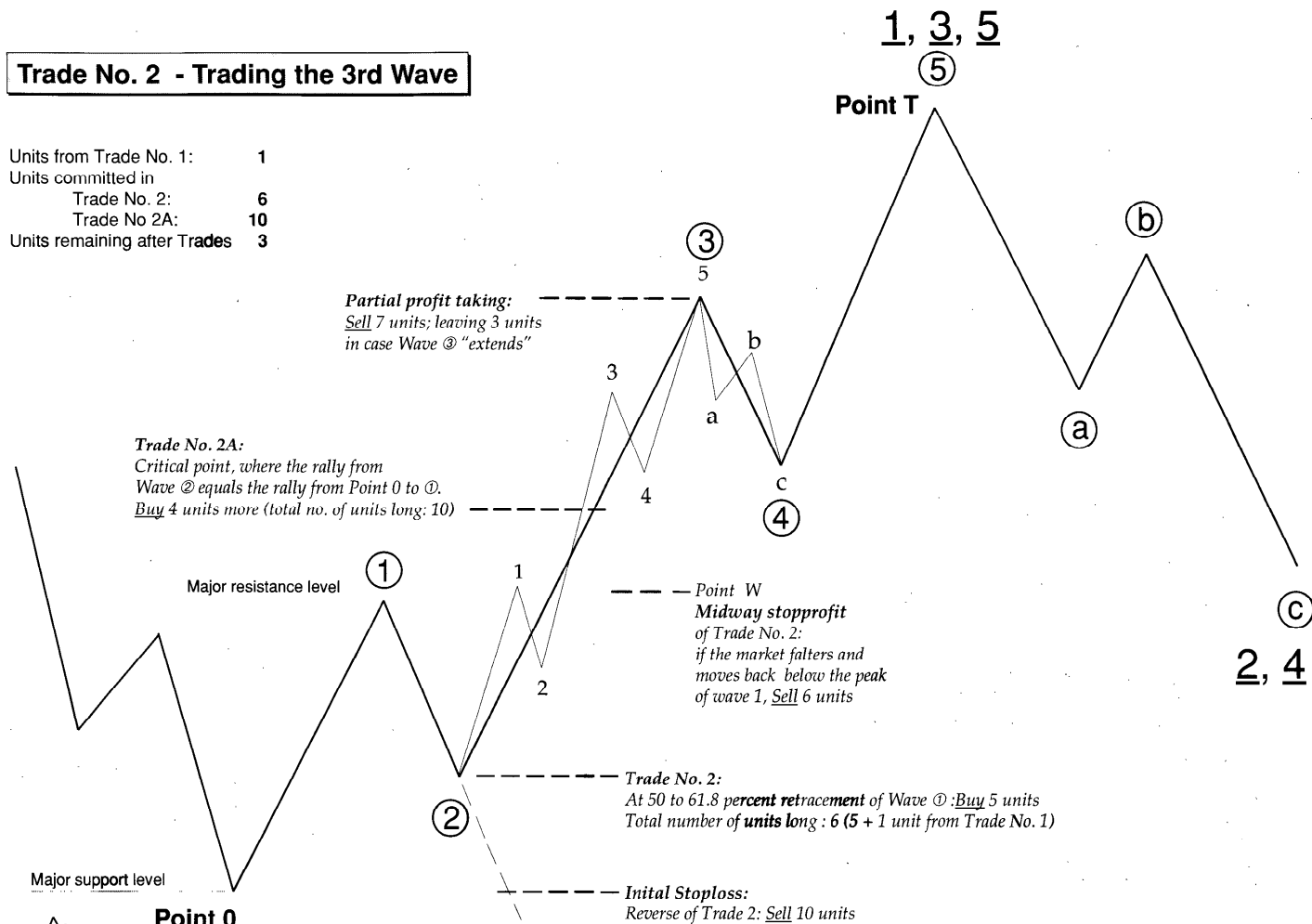


Trade No. 1

- 1) A sharp rally usually takes off from a pivotal juncture like Point 0. **Upon retracement of 50 to 61.8 percent of that rally, buy 3 units. Place a stoploss-reverse order just a few points below the level of Point 0.**
- 2) The reverse order calls for sale of 5 units but not more. The purpose of the net short position is to try to recover all or enough of the losses from the long trade so as to prevent the capital from being impaired. A bigger stake on the downside is unjustified at this point.
- 3) Remember: your analysis indicated that Point 0 is probably a pivotal point. If the analysis was wrong, it probably erred in identifying Point 0 as the end of Wave 5 in the previous sequence. If a mistake was indeed made, the odds are that Point 0 is an ending point for minor Wave 3 and therefore the rally from Point 0 is part of minor Wave 4. The downside profit potential, namely minor Wave 5, is therefore limited and should be traded as such. In this situation, being net short of 2 units fulfills the expressed objective of the reverse order, which is to recoup losses from Trade No. 1. Turning in a profit from the reverse trade is welcome, but not of overriding importance.
- 4) **When the upmove from Point 0 has completed a five-wave sequence, thereby terminating Wave ① as well, sell 2 units.** Leave one unit long in case a low-probability *extension* occurs at this phase. The probability for a peak of Wave 5 may be calculated by taking the price difference between the peak of Wave 3 and Point 0, then multiplying it by the ratio 0.618 and adding the product to the termination of Wave 4. Let's call this process the *Fifth Measurement Method*. Refer to Part IV for other methods on how to predict ending points for 5th waves.

Trade No. 2 - Trading the 3rd Wave

Units from Trade No. 1: 1
 Units committed in
 Trade No. 2: 6
 Trade No 2A: 10
 Units remaining after Trades 3



Trade No. 2

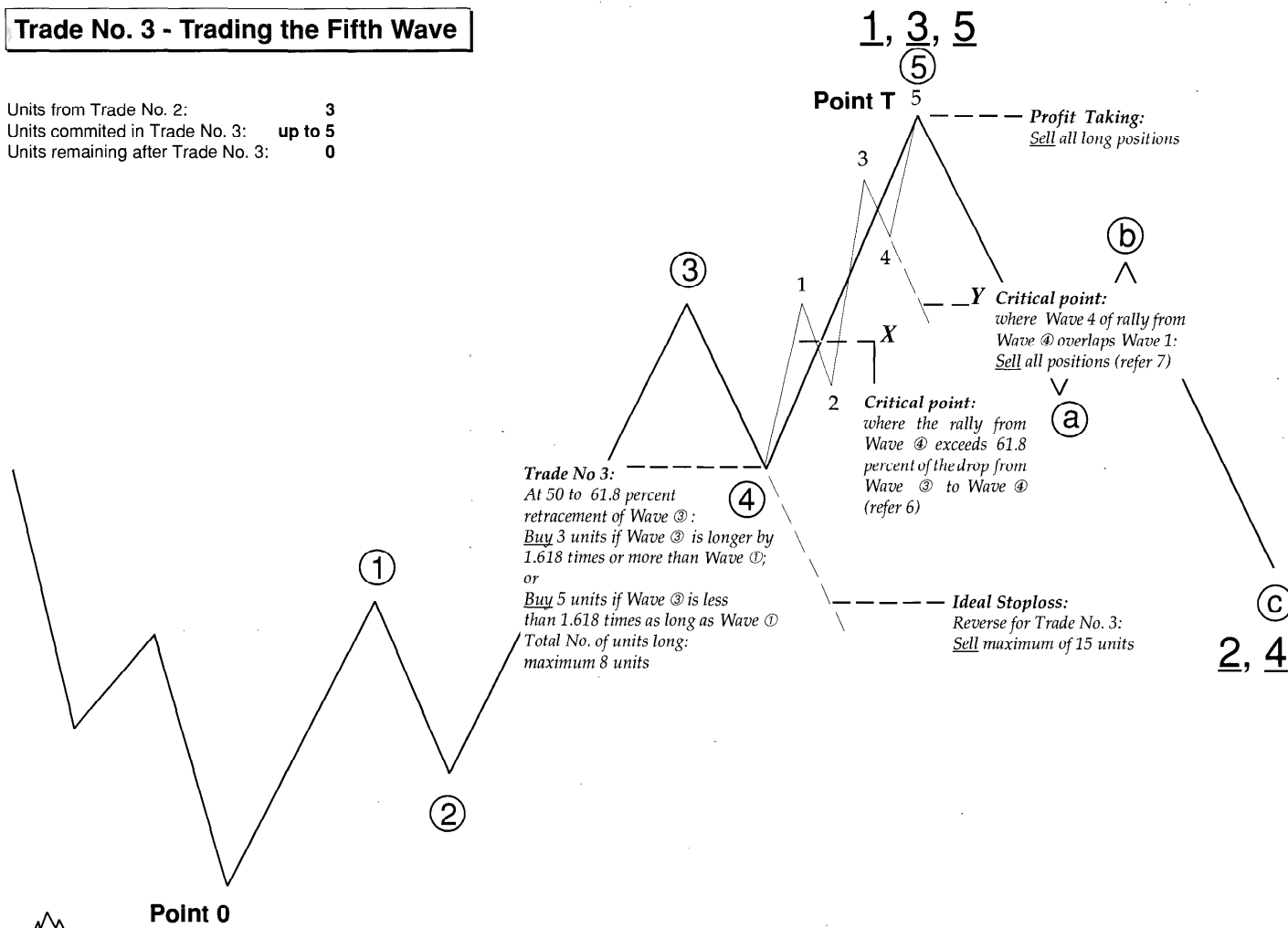
- 1) **When Wave ② has retraced to 61.8 percent of Wave ①, buy 5 units.** The open position is now a total of 6 units long. Since 3rd waves are generally the most powerful phase in any five wave sequence, one can choose to be more aggressive at this point. Another reason for confidence at this time comes from the following observation: a minor five-wave sequence has terminated in the previous upwards pattern. So even if a major expectational error was made in projecting the continuation of the move to Point T, the implication is that there should be at least one more five-wave sequence to the upside emanating from the end of Wave ②. Commit up to 60 percent of your capital in this particular trade.
- 2) **Put in place a stoploss-reverse order at just below the level of Point 0.** If the order is *elected*, sell 10 units. The net short position will be 4 units; even a relatively small movement falling below Point 0 should suffice to recover any loss incurred on Trade No. 2.
- 3) The order to reverse can now have more aggressive intentions relative to the first stoploss order, even if they are situated at the same level. The reasoning goes like this: There was a five-wave sequence from Point 0 to the peak of Wave ①. If it was followed by a drop below Point 0, then it is almost certain that the original analysis was flawed. The upmove from Point 0 to the Wave ① top should be correctly labeled as a C wave of an irregular correction. Therefore what has been labeled as Wave ① peak could actually be the terminus of a larger degree Wave 2, or Wave 4.
- 4) If the statement in 3) is true, the ensuing drop below the level of Point 0 has a long way to go. The termination of Wave 2 or Wave 4 mentioned above **should be followed by a downmove as damaging as the five-wave rally projected from Point 0 to Point T.** That is why the reverse order for Trade No 2 not only seeks to recoup any losses from the upside trade, but also serve as gambit in a new trading plan oriented downwards.
- 5) If the market moves higher according to expectations, contingency plans to preserve some of the profits have to be in place. **The most critical point at this stage is located at (W), the level where the distance traveled by the rally from Wave ② equals the distance traveled by the upmove from Point 0.** If the market falters near to that level then drops far enough to overlap the peak of Wave 1 (in Wave ③), sell 6 units to square off all positions. Then stand aside. There is nothing more that could be done rationally until the market unfolds further.
- 6) **When the price has exceeded Point (W) by the equivalent of 10 percent of the distance between Point 0 and end of Wave ①, buy 4 more units.** This brings the total number of units long to 10. **Call this Trade No. 2A.** There is now sufficient grounds to expect that Wave ③ will be at least 1.618 times as long as Wave ①. If Wave ③ extends, as is the case 60 percent of the time, it will likely be 2.618 times as long as Wave ①, or even longer. Clearly, it is desirable to be very aggressive at this point. Commit the entire stake of 10 units.

If you placed the stop profit level at the peak of Wave 1 (as suggested above), **the most that can happen is that you will break even** on Trade No. 2 and No 2A if the market drops unexpectedly. The whole trading effort has been geared towards this big moment. All the trades before and after this juncture are mere trading exercises. These two trades are what it is all about.

- 7) When a sequence of five waves take shape from Wave ②, project the probable terminal of Wave ③ by using internal and external wave relationships. Use the *Fifth Measurement Method* to calculate the probable end-point of Wave 5 in Wave ③. Measure also the distance traveled by Wave ①, multiply it by 1.618, then add it to the bottom of Wave ②. The price objective provided by this method should not vary much with the target obtained from the *Fifth Measurement Method*.
- 8) **Sell 7 units at the expected peak of Wave 3** *Fifth measurement method*, leaving 3 units long to take advantage of a high-probability 3rd wave extension that may materialize.

Trade No. 3 - Trading the Fifth Wave

Units from Trade No. 2: 3
 Units committed in Trade No. 3: **up to 5**
 Units remaining after Trade No. 3: 0



Trade No. 3

- 1) After Wave ④ has retraced 38.2 to 50 percent of Wave ③, one of the following steps is recommended:
 - i) Buy 3 units if Wave ③ is 1.618 times as long as, or longer than Wave ① ; or
 - ii) Buy 5 units if Wave ⑤ is less than 1.618 times the length of Wave ①.
- 2) The reasoning for the above steps goes along this line: If Wave ③ was longer than Wave ①, by a ratio of 1.618 or higher, Wave ⑤ is not likely to extend; its development is likely to be normal. Moreover, if Wave ③ had been extraordinarily strong, and had gained ground very quickly, Wave ⑤ has higher chances of turning into a *failure*, which would be the inability to exceed the peak of precursor Wave ③. Therefore, being overly optimistic of the upside potential at this point is not justified.
- 3) If Wave ③ was less than 1.618 times the length of Wave ①, Wave ⑤ has a very high likelihood of being extended. In this case, what is being labeled as Wave ⑤ is actually the middle phase of an extending Wave ③. Being aggressively long at this phase is therefore reasonable, even desirable.
- 4) The ideal stoploss-reverse order for Trade No. 3 should be placed just below the level of Wave ① peak. If the decline which is being labeled as Wave ④ drops below the peak of Wave ①, the premise of a five-wave sequence to Point T is wrong. The upmove to Wave ③ should therefore be more appropriately classified as a *zigzag correction*.

Any drop from the peak of this zigzag is therefore part of a large-degree decline which should travel way, way down the chart. The stoploss-reverse strategy can therefore be very aggressive, as the odds for an extensive downward move is very high in this situation. If the stoploss-reverse level is hit, sell up to 15 units, depending on the net long position in Trade No. 3.

- 5) If Wave ③ was extended (i.e., it is at least 1.618 times as long as Wave ①), and Wave ④ has given indications of following a 50 percent retracement or less relative to Wave ③, then a stoploss order may be placed at the level just below the corresponding 61.8 percent retracement of Wave ③.

There is no hard rule being invoked here. This contrived stoploss level will only be effective if the pattern of Wave ④ follows one of the sideways correction patterns (i.e., a flat, an irregular, a triangle, or a double-three). The basis for a limit below the 61.8 percent retracement is the observation that if a correction pattern starts with a sideways pattern, the likely limit of the retracement is 61.8 percent. Also bear in mind the Principle of Alternation with Wave ②.

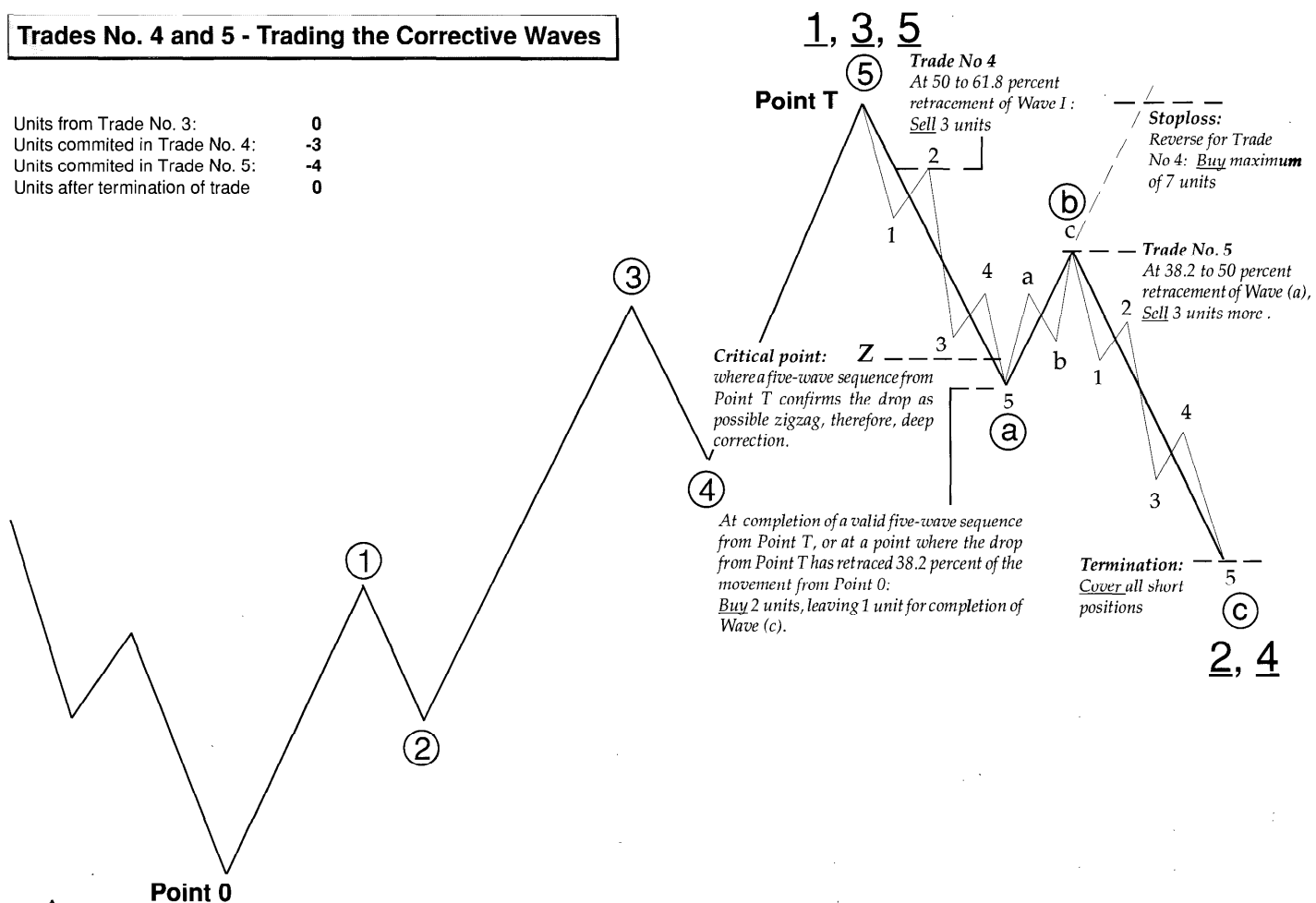
- 6) If the drop from the peak of Wave ③ can be established definitely as a *three* (composed of 3 waves) rather than a *five*, point X becomes a critical juncture for any rally to new peaks. Beyond this point, the probability of further declines diminishes to a negligible degree. With a 3-wave count from the peak of Wave ③, the only remaining argument for an extensive, large degree decline described in item 4) is for a small irregular correction to be ending at point X (this argument is technically in error when the larger

degree wave schemes are being traded). However, if the market rallies above point X, that is to say, higher than 61.8 percent of the drop from Wave ③ peak, then the irregular correction scenario is negated.

- 7) As in the earlier trades, a plan to preserve some profits should be in place once the market has sufficiently moved upwards. **If the market has gone as high as the peak of Wave 3 of Wave ⑤, but subsequently declined to the level of Point Y, then sell all positions and stand aside.** In this hypothetical example, it is very likely that Wave ④ is not over yet and that the corrective pattern (probably an *irregular*) will probably bring the market below the origin of the adjacent upmove. It is desirable to side step the short duration but generally destructive effect of the correction's resumption.
- 8) As before, once a five-wave sequence has nominally formed, project the probable ending point of Wave ⑤ by internal and external wave relationships. The peak of Wave 5 in Wave ⑤ may be calculated by using the *Fifth Measurement Method*, the peaks of Wave 3 and Wave 4 all in Wave ⑤. The peak of the larger structure Wave ⑤ may be similarly derived by applying the method on the peaks of Wave ③ and Wave ④. The peak of Wave 5 coincides with peak of the larger degree Wave ⑤.
- 9) At this stage, the trader has probably exploited most, if not all, of the potential of the five-wave movement from Point 0. It may be the case that Wave ⑤ will eventually extend. Or what has been described as Wave ⑤ peak may actually be just the mid-way point of a grossly extended Wave ③. But we have no way of knowing this at the peak of Wave ⑤. There is no longer any excuse for keeping the long positions open. The name of the game is *taking profits*; at a certain point *paper profits* have to be turned into hard cash. And this is as a good place as any.
- 10) So, at any of the levels where either Wave 5 or Wave ⑤ are expected to peak, sell all long positions without delay. Stand aside and wait for appropriate conditions to trade the correction of the movement from Point 0 to Point T.

Trades No. 4 and 5 - Trading the Corrective Waves

Units from Trade No. 3: 0
 Units committed in Trade No. 4: -3
 Units committed in Trade No. 5: -4
 Units after termination of trade: 0



Trades No. 4 and 5

- 1) **When Wave 2 of @ has retraced 50 to 61.8 percent of Wave 1, sell 3 units.** Since the expected decline is a mere correction, although a large one, the profit potential is limited. Tactics are therefore adjusted accordingly.
- 2) Put a stoploss-reverse order just above the level of Point T. If the stop is *elected*, buy a maximum of units. The size of the stake depends on how the length of the previous Wave 3. If Wave 3 was not extended, reverse the position by buying up to a maximum of units.
- 3) **Point Z confirms a five-wave sequence from Point T.** The retracement pattern of ⑤ is likely to be a *deep correction*, probably a zigzag.
- 4) The bottom of Wave 5, and therefore that of Wave @ as well, may be calculated by using the *Fifth Measurement Method*. **At the projected peak, buy 2 units, leaving 1 unit to take advantage of the hypothetical Wave ⑥ decline.** Alternatively, take some profits at the level where the drop from Point T has retraced 38.2 percent of the upmove from Point O to Point T. The rationale is this: If the *count* of the minor waves can not precisely produce a five-wave count (as it often happens in short-term wave schemes), then then probability of a sideways correction (for example, a flat) is too high for comfort. Taking some profits at 38.2 percent retracement level is a very logical action.
- 5) **When Wave ⑥ has retraced 38.2 to 50 percent of Wave @, sell 3 more units.**
- 6) Move the stoploss (no reverse this time!) to above the 61.8 percent retracement level of Wave @. If the stoploss is elected cover all short positions and stand aside.
- 7) Finally, when a five-wave sequence from the peak of Wave ⑥ has taken shape, compute for the likely trough of Wave 5 in Wave ⑥ using the *Fifth Measurement Method*. Project also the target for Wave ⑥ by assuming equality between the length of Wave @ and Wave ⑥. **Cover all short positions at the objective closest to the current market price.**
- 8) Wait for a new sign of a rally to activate the Elliott Wave Trading Program through another cycle.

Notes on trading corrections

There is a maxim popular with wave analysts, which should set the tone for this section: "You make money trading the impulse phases; you lose it trading the corrections."

There is a lot of truth in this somewhat facetious observation. But are reasons for having your skill in trading corrective waves. The market spends about 70 percent of the time in consolidations, while impulse waves take up the rest. Side-stepping corrections of course mean that the trader will be idle for more than half of the time. There are situations where corrective waves can be extremely profitable, as in second waves, for example. It is normal for second waves to retrace 50 percent or more; full retracement of 100 percent is not unusual.

Trading fourth waves can be very dangerous, however. There is no reliable way to predict where third waves will end. Many a pause suspected of being the onset of a 4th wave correction eventually turn out to be just that -a minor retracement in a roaring 3rd wave extension.

Trade corrective waves if you require, but proceed with extreme caution.

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