

Taking Quick Profits Versus Boxing in Profits: "Bread and Butter" or "Bread Crumbs?"

I am fortunate enough to mentor a diverse group of traders, some of them professionals, some of them just starting out. It's a fascinating experience as a teacher to teach each of these traders one on one, because the goal is not to make them clones of me, but to develop them into successful traders with their own style of trading. Each of them has different strengths and weaknesses, and different ways of looking at the market. They all progress at their own rate. Some of them manage other people's money (I currently mentor two different CTAs, a hedge fund manager, and the manager of the midwest branch of a stock brokerage firm, along with a handful of individual traders), and some of them are just starting out, so they are trading very small accounts. Some of them make five to ten trades in a day, and some of them make two or three trades a week.

I recently wrote a multi-part article for MoneyShow.com called "Getting Paid to Trade by the Market," which highlighted a profit-taking technique four of my students use, although each has their own variation on it. We call it "Bread and Butter" because it's much like "making donuts" or "slicing sausage." The first is a phrase I use to call my intraday "cookie cutter" trades because they are basically doing the same thing over and over (repetitious, not exciting and profitable equals "making the donuts"). The second is a phrase a friend of mine uses when he speaks of how he approaches the markets. He says he "slices sausage" each day, and at the end of the month, all the slices add up to a mountain of sausage.

The four students use variations on the same theme, which I highlighted in the MoneyShow.com article. For example, in the currency futures, one student uses a maximum stop loss of ten ticks. As soon as price has gone seven ticks in his favor, he moves his initial stop loss to break even. If price goes 14 ticks in his favor, he takes off one third of his position and moves his break-even stop up to a seven-tick stop profit order. If price goes on to reach 21 ticks in his favor, he takes another third of his position off and moves his seven-tick stop profit up to a 14-tick stop profit. Then he tries to manage the last third using market structure, meaning if he is long, he will hide his stop profit orders at higher and higher levels as price leaves higher swing lows, because there will be limit buy entry orders at each of the swing lows left by traders that missed getting long, or traders looking to add to their positions. His goal is to get to break even fast and get to his first two profit targets the majority of the time—and catch a much larger move on the final third of his position about 20% of the time.

Another student takes half of his position off just below the first overhead market structure if he is long, then moves his initial stop loss order up to break even. He then treats the remaining half as a "runner," trying to maximize the profit on the remaining half by hiding his stop profit orders below market structure as it unfolds.

Another takes a third of his position off at ten ticks and then moves to break even, then takes a third off at 20 ticks and leaves his stop profit at break even. He takes the final third of his position off at 40 ticks, a level he has seen as a statistical "node," or regularly reachable profit target in the currency futures he generally trades.

The final trader of the four bases his targets on the percentage of the average range of the past 20 trading days. He takes his first profit at 10% of the recent range and moves his initial stop loss order to a break-even stop. Then his second profit order is at 25% of the recent range, and his final target is at 60% of the recent range. Once he has moved his stop loss order up to break even, he leaves it there, trying to let the trade mature.

Let me show you a chart from the MoneyShow.com article, "Getting Paid to Trade by the Market," because a

chart often makes things much clearer:

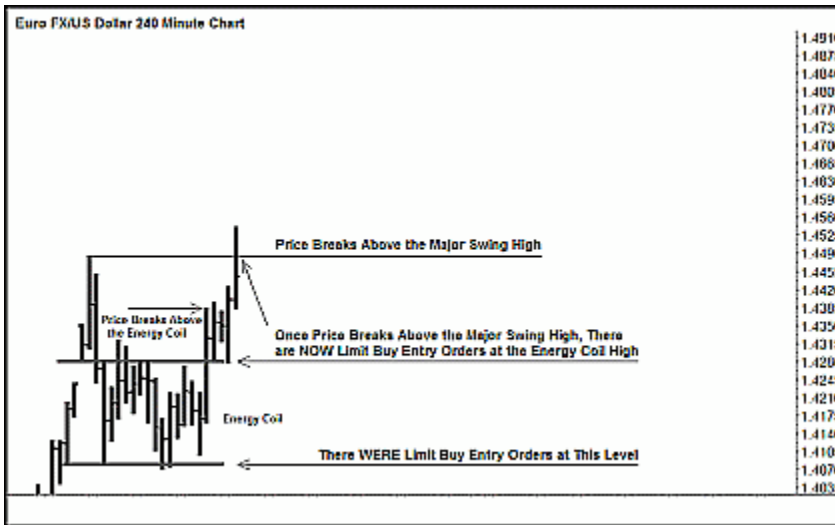


You can see that this particular chart shows that one of the traders I mentor takes half his position off just before the first overhead market structure when he is long, and then moves his initial stop loss order to break even. On the chart above, you can see that he moved to break even after price reached his first profit target, getting him out of half of his position for a nice 75-tick profit, but it then came back down and stopped him out at break even on the second half of his long position.

Do these four traders make money? They do indeed. One of them is a very active CTA, one is an experienced trader that likes to book profits to reinforce the methodology he is using when he trades, and the other two are fairly new traders with smaller accounts. These two traders like “Bread and Butter” trading as a style because they are trying to build the size of their accounts as they master this methodology, so moving to break even quickly and taking frequent smaller profits is more comfortable to them.

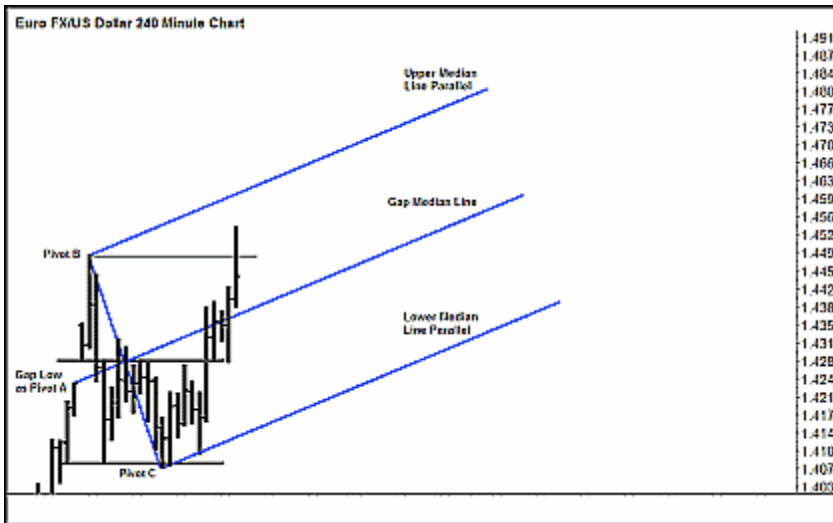
Now, you should know that I did not teach any of these students this exit method—they each developed their own exit strategy on their own. Four of them developed a similar twist without my input that I eventually named “Bread and Butter.” But I mentor other traders as well, and one of them read the “Bread and Butter” article on MoneyShow.com, and at his next mentoring session, told me that in his opinion, I wasn’t really helping these traders by encouraging them to take frequent quick profits. We discussed the reasons each of these traders had for choosing the “Bread and Butter” method of relatively quick exits, and though this trader acknowledged that each trader should embrace a style they are comfortable with, he wanted to continue the discussion. He wanted to know if I had made a trade that day, and if so, what did *my* trade look like? In his mind, after studying my articles and the posts I made on Web pages and free forums over the past six or seven years, and having been in my mentoring program for more than five months, he felt my trade would look vastly different than the “Bread and Butter” trades. In fact, he said that if I had a position on, in his opinion, it would show that the “Bread and Butter” traders were really only taking the “bread crumbs.” I chuckled at his analogy and then admitted I had indeed taken a trade that day, after the “Bread and Butter” traders had been stopped out at break even on the remaining portion of their trades. Let’s take a look through my eyes at what was happening in the market at that point, what caused the market to move the way it moved, and how I entered and managed my trade.

Now, it's important to note that the "Bread and Butter" chart used by the trader in the original article was a 60-minute chart of the Euro FX/US Dollar cash FX pair. I generally trade on 240-minute charts, so some of the price action appearing on the first chart (a 60 minute chart) disappears on a 240-minute chart, because each 240-minute bar contains the price action of four 60-minute bars.



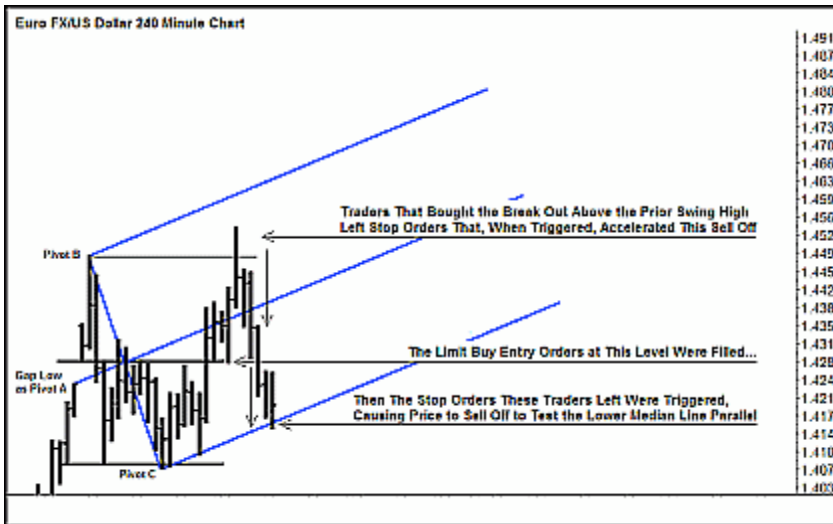
Price gapped open higher on Sunday night, leaving what became a major swing high before trading lower. Price then formed an energy coil, an area of congestion where price restores its energy. The low of the energy coil was just above 1.4070 US dollars per euro, and the high of the energy coil was at roughly 1.4280. Price was unable to close above or below the energy coil for 14 bars, but it finally showed a change in behavior by breaking and closing above the energy coil. It then consolidated its gains, leaving a pair of bars that had lows that tested the highs of the energy coil. But after four closes above the energy coil, price shot higher and broke above the major swing high made early Sunday night.

There had originally been limit buy entry orders at the low of the energy coil, left by traders that were willing to get long at the multiple bottoms just above 1.4070. But once price broke above the major swing high, the majority of the limit buy entry orders moved higher, to the multiple tops of the energy coil near 1.4280 that had been resistance but was now most likely support. These limit buy entry orders were left by traders that had failed to get long when price was bottoming at 1.4100, and now were watching new highs being made above 1.4500 when they were not long—the train had left the station without them, as they say.



When price broke above the major swing high at 1.4483, I added a blue up sloping Median Line. Note that, like the “Bread and Butter” traders, I used the low of the Sunday night gap as Pivot A when drawing my Median Line set. This particular type of Median Line is called a gap Median Line because one of the extremes of an open gap is used as a pivot.

At this point, I had a pretty good feeling for where the limit buy entry orders were sitting, and though price had taken out the major swing high, I was not ready to enter a trade—I did not see any sign of what I consider to be a high probability trade entry set up. Nor did I see any trade set up that had an initial stop loss that was within my own acceptable range. I was mildly bullish, but I saw nothing interesting enough to get me to enter the market at this point.

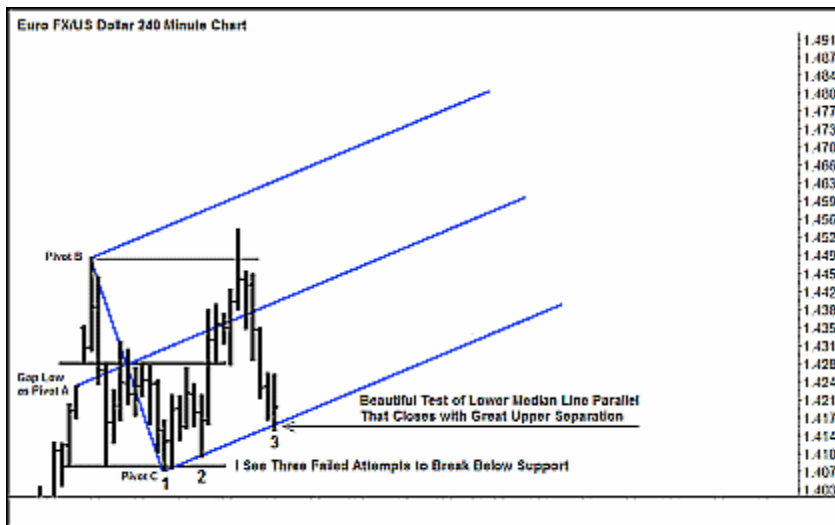


Then an interesting thing happened—one of those market moves that occur when you least expect them. When price broke above the prior swing high at 1.4483, a good deal of traders went long on the break out to new highs. Though price made it up to 1.4542, note that the break out bar closed well below the prior swing high, and in the lower half of the break out bar. That meant that all those traders that went long on the move to new highs had losses in their positions at the close of the same 240-minute bar they had entered on. And looking at the next five bars, you can see that the news did not get better for these traders. There *were* limit buy entry orders at the high of the prior energy coil, at about 1.4280, but by that point, the break out buyers were liquidating their long positions, and price ran right through these resting buy orders.

And the traders that had patiently left limit buy entry orders at the 1.4280 area quickly found that once their buy orders were filled, they too were holding losing positions, and so the sell off continued as the second set of stop loss orders began to be triggered.

The outcome of this break to a new high followed by a sell off through multiple areas of support left price testing the up-sloping lower Median Line parallel, and in fact, the test bar pushed through the lower Median Line bar. To this point, few traders likely got out of their long positions with a profit unless they were using “Bread and Butter” style orders to take profits on the way up, and moving their stop loss orders to break even.

As this last bar closed, here is what I saw:



As the last bar closed, I took a very close and careful look at this formation and at its interaction with the up-sloping blue Median Line set. I immediately saw that the last bar had tried to break and close below the blue up-sloping lower Median Line parallel. But price closed well above the lower Median Line parallel, with great upside separation. This is a sign of strength—a sign that there are buyers below the market.

As I looked to the left of this formation, I noted that price had already tested this blue up-sloping line and failed to break and close below it. Finally, looking just a little further to the left, I noted that the low I used as my Pivot C tested the multiple lows just above 1.4070, but was unable to break below them, and in fact, closed with great up side separation above these multiple lows. Now I looked at the entire formation and saw three failed attempts to break below areas of support. And note that each failed attempt to break support was at a higher and higher level. This formation is not talked about much these days, with the advent of all the pretty computer generated indicators, but when I was first learning to trade, it was called “Three Drives to the Bottom.” And generally, if the three drives to the bottom had higher and higher lows, price tended to move higher after the third drive lower.

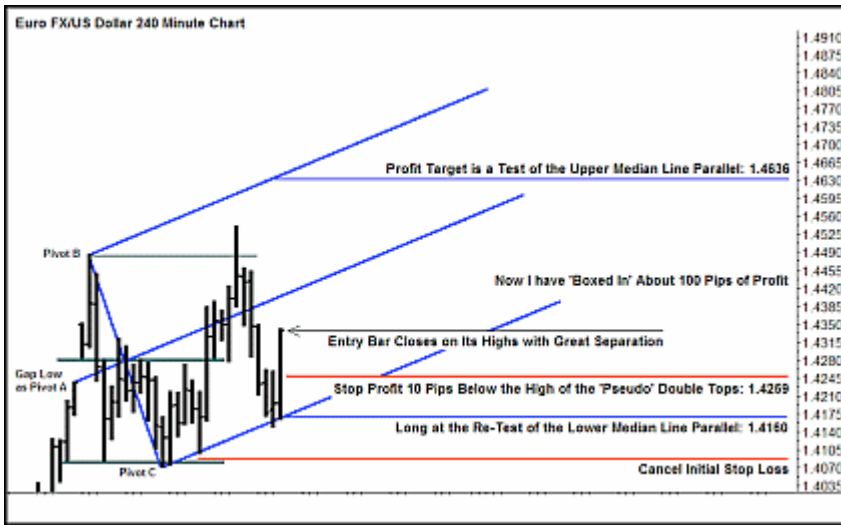
Take a look at what I now had in mind:



I was unwilling to get long when price broke out to new highs because there was no high-probability trade set up that I recognized, and there was no acceptable stop loss. But this formation was quite familiar to me, and I had this in mind:

1. I wanted to buy a retest of the blue up-sloping lower Median Line at 1.4160
2. My initial stop loss would be five pips below the prior swing low that had tested the lower Median Line parallel, at 1.4092.
3. My profit target was a test of the upper Median Line parallel, at 1.4636

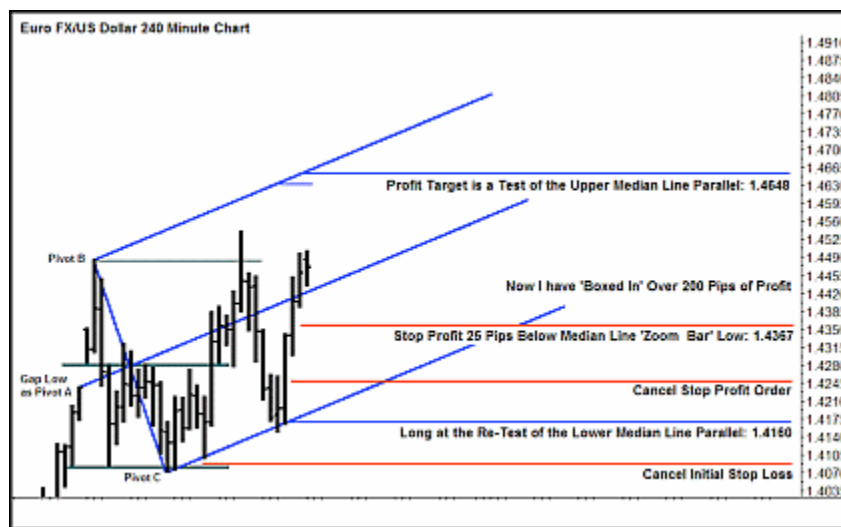
What made me think price would make it past the Median Line if it turned higher from here and make it up to the upper Median Line parallel? If the market retested the lower Median Line and allowed me to get long, there were two possibilities: 1) I'd either get stopped out very quickly, because I would be wrong about the three higher lows and the great upside separation at each test being a sign that there were good buyers below the market; or 2) The market would go significantly higher, because the long positions had all been liquidated at this point. Only the market knows where it is going, and the market is always right. Let's see what the market did next:



Price did indeed come down and retest the blue up-sloping lower Median Line, getting me long at 1.4160 in the process. And look where the retest bar closed: On its highs, and with great upside separation—another sign of strength. So far, so good!

As my entry bar closed, I noted it was a wide range bar that closed on its highs, and at this point, from where I entered my long position to the close of the entry bar at 1.4341, I had a potential profit of 181 pips! I certainly couldn't let this much profit turn into a loss. I could move my initial stop loss order to break even, but I didn't want to leave 181 potential points of profit on the table unprotected either. When I am long, I generally place my stop profit orders underneath market structure, because there are generally limit buy entry orders sitting at these structures that will act as some protection for my stop profit orders. But there was no conventional market structure for me to hide my stop profits below this time—the recent sharp sell off had destroyed all semblances of structure, other than the bottoming formation that was still intact.

After a bit of thinking, I decided to put a stop profit order ten pips below the tops of the pair of bars with nearly the same highs the current bar had just run above. I cancelled my initial stop loss order at 1.4092 and entered a stop profit at 1.4259, locking in roughly 100 pips should price turn on a dime and sell right back off.



The next three bars were also higher and each had a higher close. There was still no obvious market structure for me to hide any stop profit orders beneath, but with price closing at 1.4472, I now had a healthy potential 312 pips of profit in the position. I had no choice but to be creative—I placed my stop profit order 25 pips below the low of the bar that had zoomed above the Median Line, at 1.4367.

In reality, these are nothing more than “cash profit stops” because they are not using any widely used market structure as protection. I never use cash stop loss orders, but I now had so much profit in this position that I had to keep “boxing in” profits, using what amounted to a cash profit stop. To me, using cash profit stop orders is quite different from using cash stop loss orders, though I seldom ever use cash stop profit orders. It's very unusual for me to find myself with a position and no structure to hide my stop orders above or below, but the market is always right! I was here with a great deal of profit in my open position and I had to protect it.

Note that I ran my cursor along the upper Median Line parallel and found that because of the upward slope of the line, my profit order should now move higher, to 1.4648. I am trading with the trend because I am long

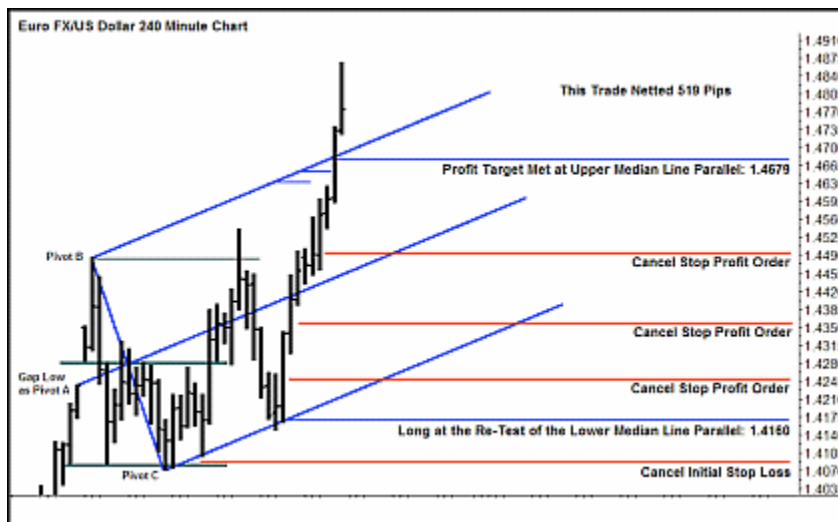
against up sloping lines, so I get paid more the longer I hold this position as long as I move my orders higher.



Three more bars unfold, and again, all three closes have higher highs and close higher. There is still no discernable market structure (this is what I refer to as a “chimney formation”), though it’s not yet clear if it is just the opposite side of the downward chimney formation from the prior highs. I am on the right side of the market, and at the close of the last bar on this chart at 1.4600, I have a potential profit of 440 pips.

I cancel my prior stop profit order and move it higher, to 50 pips below the low of the just-closed bar at 1.4492. If price turns around at this point, I will be stopped out for a very nice profit of 332 pips. Once I move up my stop profit order, I check where price would intersect with the upper Median Line parallel when the next bar forms. That price is 1.4679, and so I move my limit sell order and profit target accordingly.

This part of trading is the hard part—doing the little things without making mistakes. But it’s the attention to detail and the logical movement of stop orders and profit orders that can maximize your profitability. It is fun to look at the newest multi-color, computer-generated lagging indicator in the magazines, but it is truly the work once you get in a trade—managing the trade correctly—that can make all the difference in the world—but it isn’t fun to look at, and most traders don’t really want to talk about it or read about it. New indicators are fun toys! Money management is...well, boring. But a good understanding of money management really drives your profits, in my opinion.



The next bar ran higher, taking me out of my long euro FX position at 1.4679, for a total net profit of 519 pips. Price did go higher, but that didn't bother me in the least. I had a plan, I traded my plan, and now I was flat with a nice profit. The market would go where it wanted to go, but my planned ride was over. And it ended quite nicely, thank you.

As a mentor, how do I compare my style of trading this market with the style used by other traders, namely those using "Bread and Butter" style trading to approach these markets? Certainly, I made much more on my trade than any of them did. But my capital was exposed for a great deal longer than their capital was exposed. And I was willing and able to be very patient when looking for an entry. If I go three or four days without a trade, it doesn't bother me in the least. My focus is on producing a smooth capital appreciation in my account, not building my account from \$10,000 to \$15,000 in XX months. Nor do I have clients looking over my shoulder asking me to trade frequently. I have the luxury of only "swinging the bat at the pitches I recognize," as Ted Williams used to say. If I don't see a trade set up I like, I'll wait patiently—one will eventually come along in one of the markets I watch.

And if you look closely at my stop profit movements, there was a little "Bread and Butter" order placement going on as well. In the end, I feel that traders must master their tools, master themselves, and find a trading style that suits their strengths and weaknesses. In mentoring, I do my best to help each of my students become the best trader they can be by developing a style that suits their own strengths and weaknesses. Only then can they become the best trader they can be.

I wish you all good trading!

Best,

Timothy Morge

timmorge@gmail.com
www.medianline.com
www.marketgeometry.com

Timothy Morge
President
MarketGeometrics, and Blackthorne Capital, Inc.
Web sites: www.marketgeometry.com or www.medianline.com