Tips for Traders | 4/13/2009 10:38:00 AM

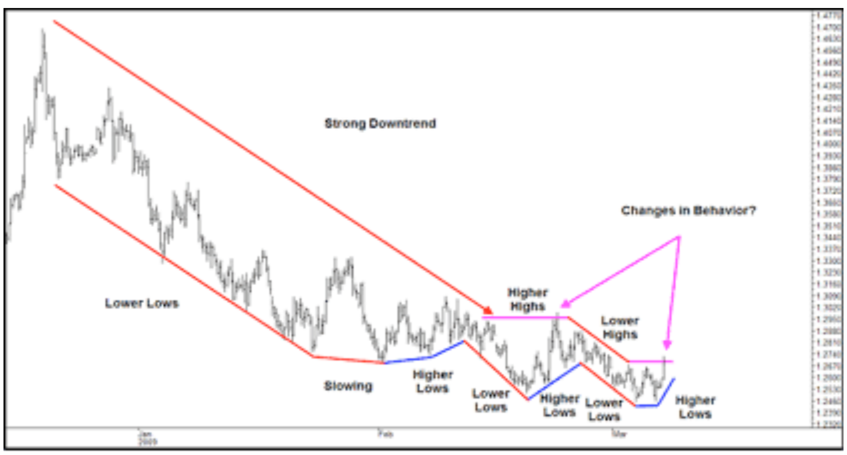
The Right Way to Use Lines in Trading

I have been working with lines as my main trading tool for more than 38 years now. Lines are simple, lines capture the probable path of price well, and lines work over and over and over. My favorite lines are the three parallel lines that make up Median Lines, but I work with all sorts of lines in my trading.

A trader e-mailed this past week asking why I never traded using trend lines or channels. I responded that I use both in my trading, but rarely show these tools because they are not my "bread and butter" tools, the ones I use most often. And that spawned the idea of looking at the same major move in a market with a handful of different line tools. So here we go!

First, let's look at the market structure we're going to use to evaluate the effectiveness of these tools. We'll also see if we can spot any changes in behavior, so we can watch how quickly each of the different tools responds to changes in behavior by the market.

I found a gorgeous swing on a 240-minute bar chart of the euro FX against the US dollar FX chart. Let's take a look at it:



Price is in a gorgeous downtrend, making lower highs and lower lows from mid-December 2008 through late-January 2008, when the downtrend began to slow its pace. Price continued to make lower highs until early February and then it began to consolidate, making higher lows for a two-week period in early February with three slightly higher highs. The price action here is too flat to call it an uptrend.

Then price plunged once, making new lows for the entire move, and when it climbed higher from this new low, it made a series of higher lows and higher highs, and the final higher high broke above the prior swing high of the prior downtrend. This is often a sign that a change in behavior has begun, but you can see on this chart that price did not follow through! Instead, price headed lower to make a lower low for the move.

Note that the size of the swings contracted during this last run lower.

And when price failed to make a new low for the move, it spiked higher and traded above the prior two swing highs—again, a sign that a change in behavior in this market is probably at hand.

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Now let's look at the first line tool: The simple trend line.

Simple trend lines can be very powerful trading tools; if you apply quality money management and some simple trade entry techniques. When I sell against a trend line, I always ask myself: “Can I afford to hide my stop loss buy order above the limit entry sell orders at a prior swing high?” These limit sell orders act as a buffer to slow the rise in price and should act as protection for my stop loss order.

If I am buying against a trend line, I always ask myself: “Can I afford to hide my stop loss sell order below the limit entry buy orders at a prior swing low?” These limit buy orders act as a buffer to slow the fall in price and should act as protection for my stop loss order. If I can't hide my stops behind prior swing highs or lows, I generally do not take the trade.

You can see I found some very nice trades in this downtrend, and all of the short trades except the final trade hit their profit targets. The final trade was profitable, but was exited at a profit stop hiding above a swing high.

I use the same entry and exit techniques, the same money management style, and the same risk/reward ratios when trading using simple trend lines as I do when trading using Median Lines. You can make a lot of money trading using simple trend lines if you know how to use them.

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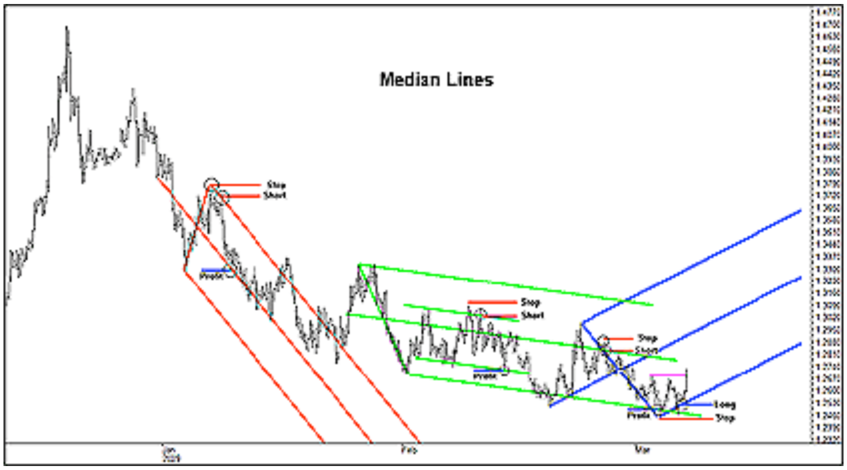
Now let's look at my “lines of choice,” Median Lines, on the same market move:



I find that when I trade currency pairs, I often use Schiff Median Lines and sliding parallels. Schiff Median Lines take the normal pivot A of the Median Line’s alternating A-B-C pivot set and shifts it down 50% and to the right 50% towards the B pivot. Sliding parallels are lines inside or outside the Median Line set that have the same slope as the Median Line, but are drawn from a regional high or low. Because these lines have the same slope as the Median Line, they carry the same frequency and often act as good support or resistance once they are tested.

I found a nice short trade using a red, down-sloping Schiff Median Line and caught the move from the upper Median Line parallel down to the Median Line. Then I found a nice short entry on the third test of a green inside sliding parallel that gave me a run down to an inside sliding parallel drawn in an equal distance above the lower Median Line parallel. Had I let the trade run with a trailing stop above prior swing highs, I could have caught the run down to the lower Median Line parallel, but it would have been a wilder ride.

I found another nice short at the re-test of the green, down-sloping Schiff Median Line from below, and this trade easily made it down to the lower Median Line parallel.

If you look closely, I added a blue, up-sloping traditional Median Line. When price tried to make new lows for the move and failed, I took a new long position on the re-test of the blue, up-sloping lower Median Line parallel which was still open when the current chart ended. We'll revisit this same Median Line at the end of this article series.

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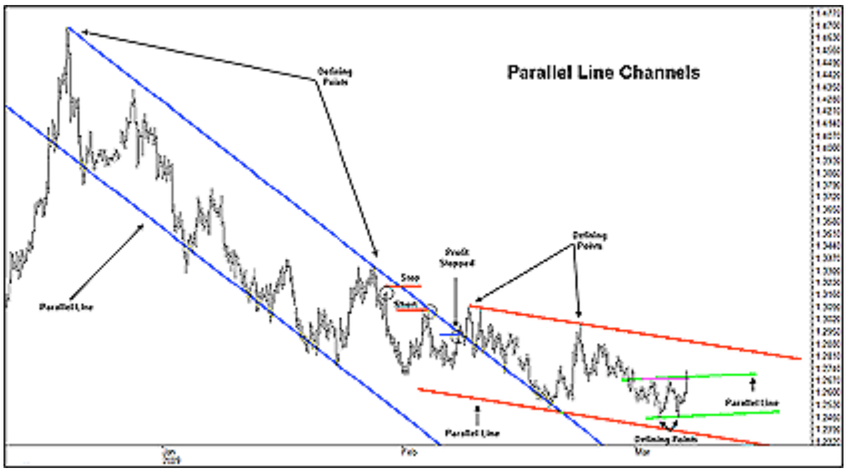
Next we'll look at a simplified cousin of the Median Line: Parallel line channels.

When you look at someone's charts of price that have parallel channel lines on them, you always have to know where the pivots used to form the channels reside, or else you may be looking at trades that weren't possible! Remember, parallel channels take three pivots, two to form a trend line and one that is then used to form the parallel line. I have clearly marked the three defining points on each of the parallel line channels on this chart, and trades can only be made after the defining pivots.



I was able to find a profitable trade using parallel channel lines on this market swing, but the great breadth and depth of the first half of the swing made it difficult to “catch a ride” lower. And once price got into its congestion phase, the channels just didn't come into play, unless I narrowed them so much that any position taken would soon be stopped out in a “wash and rinse” type move.

Don't let my inability to find many quality trades in this major swing turn you off to parallel channel lines, however. If you learn how to use them, apply quality entry and exit setups, always use solid money management and a good risk reward ratio, you can make money trading with parallel channel lines.

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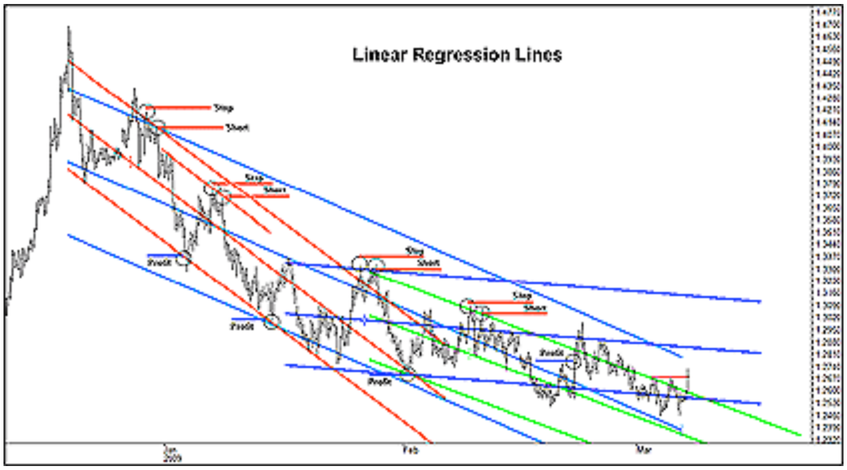
Now let's look at what some consider to be the computer-enhanced version of Median Lines: Linear regression lines.



Roger Babson began working with moving averages in the very early 1900's, putting parallel channels above and below them when trying to determine the length and depth of an upcoming expansion or decline in the economic cycle. You can see these same techniques used today in Stoller (STARC) bands, Bollinger bands, Keltner bands, and many other variations, but call them what you will, they are all built on one principle: Revision to the mean. In older times, it was often said “As above, so below,” and that is basically the idea behind the various types of bands and channels.

When computers came upon the trading scene, raw computing power was unleashed on all the trading ideas and techniques of the past. Many of them were simply tweaked and others were “improved” by the power of the computer. Linear regression channels supposedly fall in this second category. In many ways, they function like self-adjusting Median Lines or parallel line channels. Their “self adjustment” is their strength, but also their weakness.

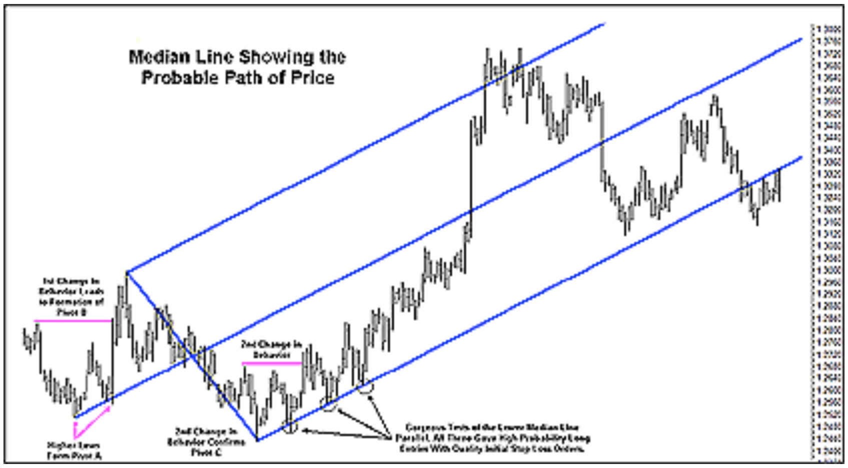
I was able to find quite a few profitable trades using linear regression channels. I applied the entry and exit methods on the linear regression channels that I use in my normal trading. I always use solid money management and a high risk-reward ratio when I trade. If you look carefully, you'll see I even used an inside sliding parallel for my second trade entry, and this is one of my favorite Median Line trade entry set ups.

You must know the “learning period” of the linear regression lines before you can judge their effectiveness, so for each set, the learning period begins at the start of the lines and ends at a small vertical line placed on each of the center or middle linear regression lines. The linear regression lines are then projected forward and you can look for potential trade entry set ups after each “learning period.”

Looking at the success I had in finding nice trades using linear regression lines, you might wonder if they have a weakness! I mentioned it earlier: Linear regression lines “self correct,” so they are very curve-fit. They are not a true leading indicator. Instead, they project forward the current mean, and you base your trades on the idea that price will return to the mean (in this case, the mean or its upper or lower parallel line).

Linear regression lines are powerful tools and can give you some wonderful trading opportunities if you combine them with quality trade entry set ups, solid money management, and keep your risk-reward ratio high enough. Please remember that they are constantly curve fitting themselves to price action, so unless you are careful, they will generate too many signals and you will constantly be “washed and rinsed” out of your positions.

Now let me show you why I favor Median Lines as my “lines of choice” when trading:



This is the same market, during the next five weeks of price action. From three alternating pivots, chosen by changes in behavior by price, I drew a simple Median Line and its parallels. Once drawn, you can see the lower Median Line parallel gave you three tremendous opportunities to get long, with low-risk stop loss orders. Price never came down to test your stop loss orders, it simply moved forward in relatively calm trading until price got near the Median Line and then exploded higher! These lines even gave me the near-perfect profit target at the upper Median Line parallel. In my trading experience, there is no better leading indicator than a good set of Median Lines.

The various line tools are all quite good if you learn how to use them and couple them with solid trading practices. Don't feel you have to limit yourself to one or the other, because they each have their strengths and weaknesses, so try one or try them all and find the ones you like. Then if you add good entry and exit set ups, quality money management practices, and watch your risk-reward ratio, you'll soon be on your way to consistent profits.

I wish you all good trading.

Best,

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