How the Wave Principle Can Improve Your Trading

Every trader, every analyst and every technician has favorite techniques to use when trading. But where traditional technical studies fall short, the Wave Principle kicks in to show high probability price targets. Just as important, it can distinguish high probability trade setups from the ones that traders should ignore.

Where Technical Studies Fall Short

There are three categories of technical studies: trend-following indicators, oscillators and sentiment indicators. Trend-following indicators include moving averages, Moving Average Convergence-Divergence (MACD) and Directional Movement Index (ADX). A few of the more popular oscillators many traders use today are Stochastics, Rate-of-Change and the Commodity Channel Index (CCI). Sentiment indicators include Put-Call ratios and Commitment of Traders report data.

Technical studies like these do a good job of illuminating the way for traders, yet they each fall short for one major reason: they limit the scope of a trader's understanding of current price action and how it relates to the overall picture of a market. For example, let's say the MACD reading in XYZ stock is positive, indicating the trend is up. That's useful information, but wouldn't it be more useful if it could also help to answer these questions: Is this a new trend or an old trend? If the trend is up, how far will it go? Most technical studies simply don't reveal pertinent information such as the maturity of a trend and a definable price target – but the Wave Principle does.

How Does the Wave Principle Improve Trading?

Here are five ways the Wave Principle improves trading:

1. Identifies Trend

The Wave Principle identifies the direction of the dominant trend. A five-wave advance identifies the overall trend as up. Conversely, a five-wave decline determines that the larger trend is down. Why is this information important? Because it is easier to trade in the direction of the dominant trend, since it is the path of least resistance and undoubtedly explains the saying, "the trend is your friend." Simply put, the probability of a successful commodity trade is much greater if a trader is long Soybeans when the other grains are rallying.

2. Identifies Countertrend

The Wave Principle also identifies countertrend moves. The three-wave pattern is a corrective response to the preceding impulse wave. Knowing that a recent move in price is merely a correction within a larger trending market is especially important for traders, because corrections are opportunities for traders to position themselves in the direction of the larger trend of a market.

3. Determines Maturity of a Trend

As Elliott observed, wave patterns form larger and smaller versions of themselves. This repetition in form means that price activity is fractal, as illustrated in Figure 2-1. Wave (1) subdivides into five small waves, yet is part of a larger five-wave pattern. How is this information useful? It helps traders recognize the maturity of a trend. If prices are advancing in wave 5 of a five-wave advance for example, and wave 5 has already completed three or four smaller waves, a trader knows this is not the time to add long positions. Instead, it may be time to take profits or at least to raise protective stops.

Since the Wave Principle identifies trend, countertrend, and the maturity of a trend, it's no surprise that the Wave Principle also signals the return of the dominant trend. Once a countertrend move unfolds in three waves (A-B-C), this structure can signal the point where the dominant trend has resumed, namely, once price action exceeds the extreme of wave B. Knowing precisely when a trend has resumed brings an added benefit: It increases the probability of a successful trade, which is further enhanced when accompanied by traditional technical studies.

4. Provides Price Targets

What traditional technical studies simply don't offer — high probability price targets — the Wave Principle again provides. When R.N. Elliott wrote about the Wave Principle in *Nature's Law*, he stated that the Fibonacci sequence was the mathematical basis for the Wave Principle. Elliott waves, both impulsive and corrective, adhere to specific Fibonacci proportions, as illustrated in Figure 2-2. For example, common objectives for wave 3 are 1.618 and 2.618 multiples of wave 1. In corrections, wave 2 typically ends near the .618 retracement of wave 1, and wave 4 often tests the .382 retracement of wave 3. These high probability price targets allow traders to set profit-taking objectives or identify regions where the next turn in prices will occur.

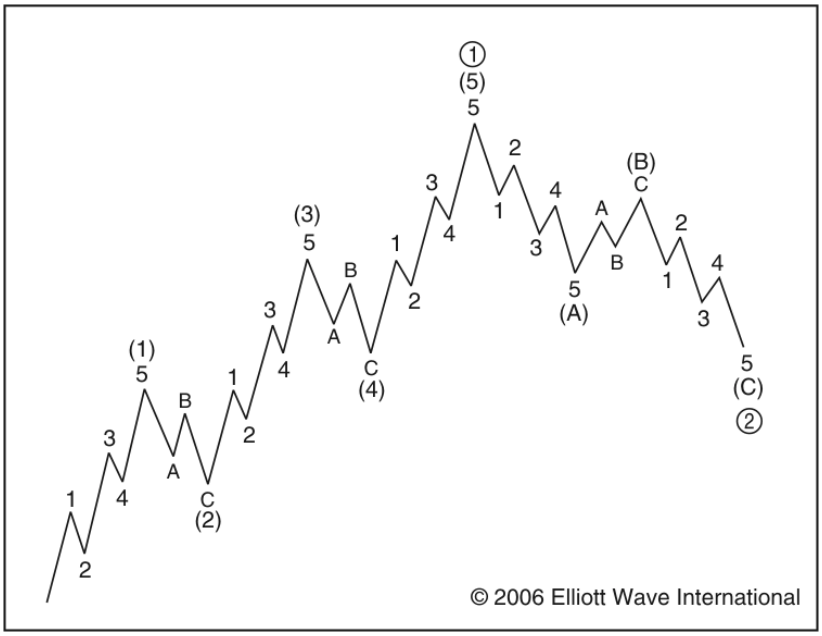

Figure 2-1

5. Provides Specific Points of Ruin

At what point does a trade fail? Many traders use money management rules to determine the answer to this question, because technical studies simply don't offer one. Yet the Wave Principle does — in the form of Elliott wave rules.

Rule 1: Wave 2 can never retrace more than 100% of wave 1.
Rule 2: Wave 4 may never end in the price territory of wave 1.
Rule 3: Out of the three impulse waves — 1, 3 and 5 — wave 3 can never be the shortest.

A violation of one or more of these rules implies that the operative wave count is incorrect. How can traders use this information? If a technical study warns of an upturn in prices, and the wave pattern is a second-wave pullback, the trader knows specifically at what point the trade will fail – a move beyond the origin of wave 1. That kind of guidance is difficult to come by without a framework like the Wave Principle.

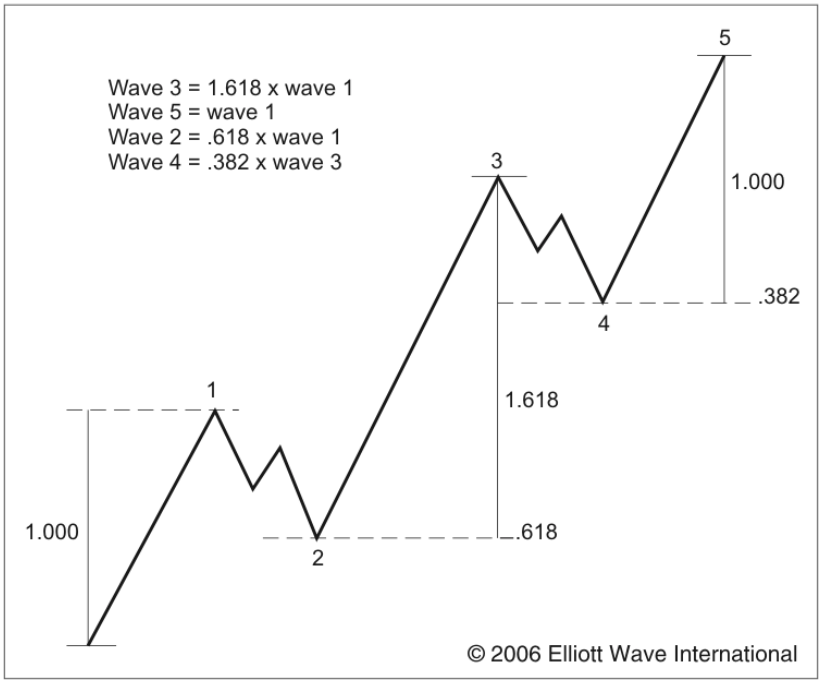

Figure 2-2

What Trading Opportunities Does the Wave Principle Identify?

Here's where the rubber meets the road. The Wave Principle can also identify high probability trades over trade setups that traders should ignore, specifically by exploiting waves (3), (5), (A) and (C).

Why? Since five-wave moves determine the direction of the larger trend, three-wave moves offer traders an opportunity to join the trend. So in Figure 2-3, waves (2), (4), (5) and (B) are actually setups for high probability trades in waves (3), (5), (A) and (C).

For example, a wave (2) pullback provides traders an opportunity to position themselves in the direction of wave (3), just as wave (5) offers them a shorting opportunity in wave (A). By combining the Wave Principle with traditional technical analysis, traders can improve their trading by increasing the probabilities of a successful trade.

Technical studies can pick out many trading opportunities, but the Wave Principle helps traders discern which ones have the highest probability of being successful. This is because the Wave Principle is the framework that provides history, current information and a peek at the future. When traders place their technical studies within this strong framework, they have a better basis for understanding current price action.

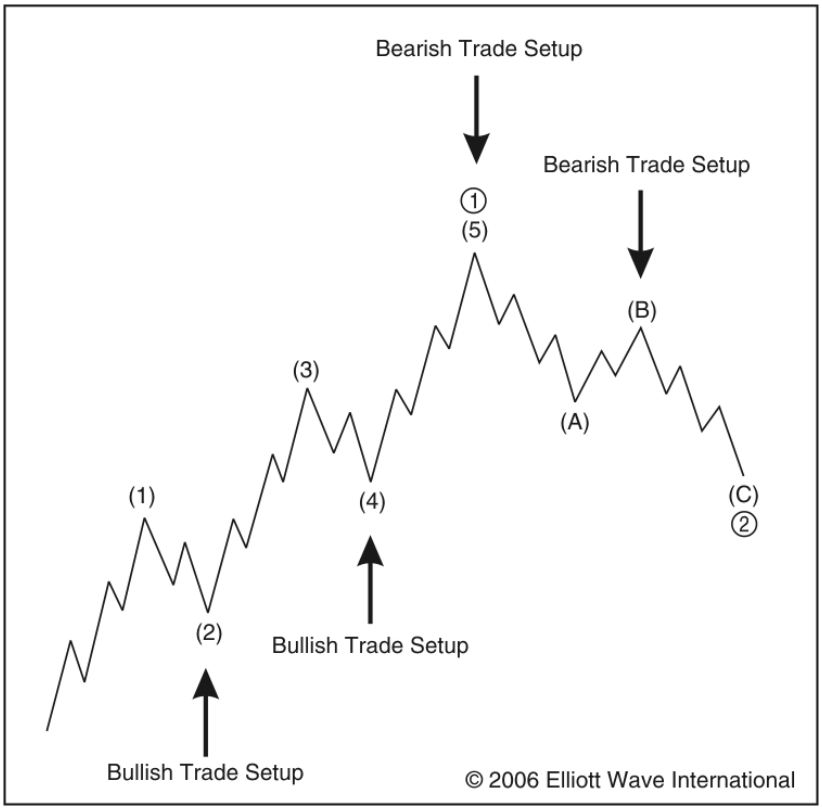

Figure 2-3

[JULY 2005]

How To Use the Wave Principle To Set Protective Stops

I've noticed that although the Wave Principle is highly regarded as an analytical tool, many traders abandon it when they trade in real-time – mainly because they don't think it provides the defined rules and guidelines of a typical trading system.

But not so fast – *although the Wave Principle isn't a trading "system," its built-in rules do show you where to place protective stops in real-time trading.* And that's what I'm going to show you in this lesson.

Over the years that I've worked with Elliott wave analysis, I've learned that you can glean much of the information that you require as a trader – such as where to place protective or trailing stops – from the three cardinal rules of the Wave Principle:

1. Wave two can never retrace more than 100% of wave one.
2. Wave four may never end in the price territory of wave one.
3. Wave three may never be the shortest impulse wave of waves one, three and five.

Let's begin with rule No. 1: Wave two will never retrace more than 100% of wave one. In Figure 4-1, we have a five-wave advance followed by a three-wave decline, which we will call waves (1) and (2). An important thing to remember about second waves is that they usually retrace more than half of wave one, most often a making a .618 Fibonacci retracement of wave one. So in anticipation of a third-wave rally – which is where prices normally travel the farthest in the shortest amount of time – you should look to buy at or near the .618 retracement of wave one.

Where to place the stop: Once a long position is initiated, a protective stop can be placed one tick below the origin of wave (1). If wave two retraces more than 100% of wave one, the move can no longer be labeled wave two.

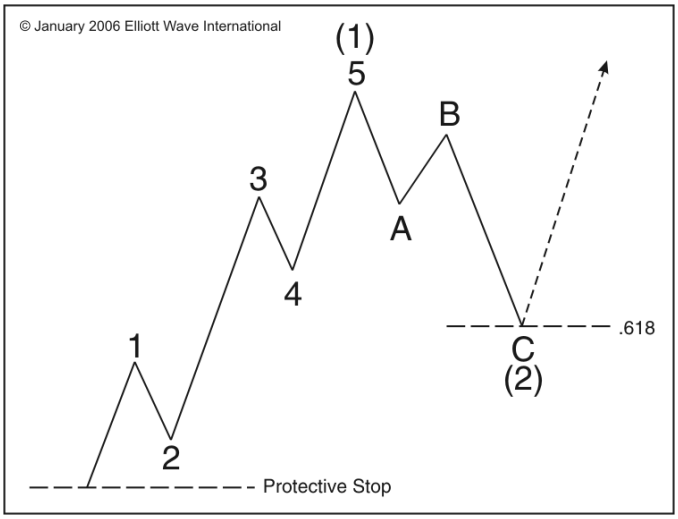

Figure 4-1

Now let's examine rule No. 2: Wave four will never end in the price territory of wave one. This rule is useful because it can help you set protective stops in anticipation of catching a fifth-wave move to new highs. The most common Fibonacci retracement for fourth waves is .382 of wave three. So after a sizable advance in price in wave three, you should look to enter long positions following a three-wave decline that ends at or near the .382 retracement of wave three.

Where to place the stop: As shown in Figure 4-2, the protective stop should go one tick below the extreme of wave (1). Something is wrong with the wave count if what you have labeled as wave four heads into the price territory of wave one.

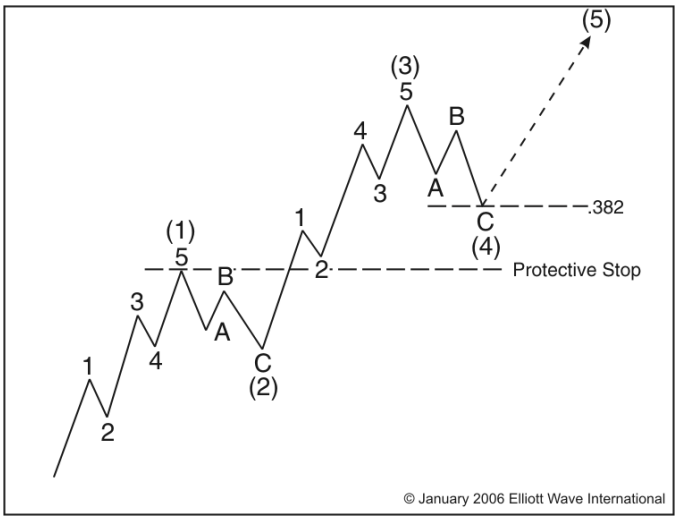

Figure 4-2

And, finally, rule No. 3: Wave three will never be the shortest impulse wave of waves one, three and five. Typically, wave three is the wave that travels the farthest in an impulse wave or five-wave move, but not always. In certain situations (such as within a Diagonal Triangle), wave one travels farther than wave three.

> *Where to place the stop:* When this happens, you can consider a short position with a protective stop one tick above the point where wave (5) becomes longer than wave (3) (see Figure 4-3). Why? If you have labeled price action correctly, wave five will not surpass wave three in length; when wave three is already shorter than wave one, it cannot also be shorter than wave five. So if wave five does cover more distance in terms of price than wave three — thus breaking Elliott's third cardinal rule — then it's time to re-think your wave count.

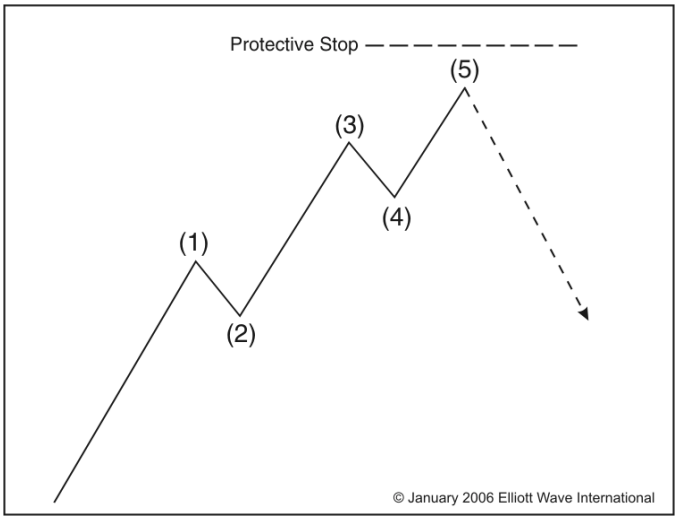

Figure 4-3

[January 2006]

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Also be sure to check out Jeffrey's online trading tutorial, How to Spot Trading Opportunities Using the Wave Principle (http://www.elliottwave.com/education/online_tutorial/default.aspx?code=club).