Capture Profit with Technical Analysis

Hands-on Rules for Exploiting Candlestick, Indicator, & Money Management Techniques

Sylvain Vervoort

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Sylvain Vervoort
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The following is my weak attempt to glorify a book that I have fallen in love with.

This decade has been resounding proof that the philosophy of “Buy and Hold” doesn’t work and certainly doesn’t reduce risk. In the late 90’s, advisors were illustrating returns above 12 percent because that is what they experienced from the market in the 10 years prior. Now after two recessions in one decade where many lost half their portfolios two different times, I believe there is a new awareness about risk in the asset allocation methodology. We are told time and again from investment representatives that return is derived from asset allocation, NOT market timing. I wouldn’t want to be the one still selling that!

There is a vast difference between asset allocation and market timing. In between lies an area of opportunity that would shock the average investor who trusts their large firm investment advisor. In this world, investors buy near support levels and sell at resistance levels. They buy when the cycle is low and sell when it is peaking. Each time they buy, they know exactly where it is they would sell if things go wrong. They never lose unacceptable amounts on any single investment position. The result is outperformance of the market with less portfolio volatility. The bottom line is they never experience 50 percent draw downs in their portfolios like their buy and hold counterparts.
The LOCKIT system that Sylvain has outlined in his book is exactly such a system. You don’t need to have years of experience in the market to understand this approach. He leads you step-by-step through the decision process of which stocks to buy and when. More importantly he helps you determine an opportune time to sell.

The robustness of this system is what I like the most. It will work on any type of stock you want to follow. Some like the blue chip names while others look for more growth potential. Simply follow his methodical approach and you will come out ahead of the crowd.

I have been in the investment business since 1992 and have continually worked to improve my investment performance. I have spent countless hours developing quantitative mechanical investment systems and backtesting them. I have taken nearly every formula Sylvain includes in this book and rewrote it to test with my system. I couldn’t be more pleased with the results.

There is no doubt in my mind that good technical analysis will beat the market every time. The struggle is going through the maze of technical analysis tools and determining which ones make sense alongside each other. Sylvain has taken the tools that I have liked the most and turned them into a complete system.

John M. Norquay

*John M. Norquay has been offering investment advice since 1992. He is the owner of a registered investment advisory service in Madison, Wisconsin, where he utilizes both fundamental and technical analysis for his investment decisions. Mr. Norquay is also the founder of eWatch401k.com, a service which helps individuals keep their 401k accounts invested properly with a quantitative mechanical investment system he designed using technical analysis.*
Some 30 years ago, an enthusiastic stock trading colleague at work initiated what has become a lifelong pursuit for me. I can still remember the first technical analysis program running on my first homemade IBM PC. I manually entered the hexadecimal machine code in Read Only Memory for the startup of the machine. This was code that IBM was nice enough to publish in the first IBM PC technical manual.

A couple of years later after the European Options Exchange (EOE), Europe’s first option and futures exchange, was founded in Amsterdam, my friend convinced me that this was the place to make a lot of money with only a little starting capital. And so, with a group of colleagues we gathered some 400,000 Belgian Francs (some 10,000 dollars) to start an options investment club. I was going to make the trades based on technical analysis, and everybody would become rich in no time!

A few months later, the money was gone. Luckily, we continued our meetings at the nearby Chinese restaurant, so it wasn’t all sad.

Since hitting that bottom, I have been on what seems to be a never-ending quest to find the ideal way of trading the stock market using technical analysis.

After first completing an investment and credit advisor course, I have since conducted many courses and presentations about technical analysis and options. The best thing about presenting a course is that as a teacher you learn
even more than your students; so thank you very much to all who have attended my courses!

There are a lot of books about investing and technical analysis. Most of them concentrate on a very specific item, exploring that particular concept in great detail. A book with a real trading system, including all the required basic knowledge, is much more difficult to find.

This trading book is a complete reference on how to apply technical analysis for profits. It explains my own trading style—the whole complete story from start to finish. I learned from my mistakes and wrote down some rules to help you avoid making these same mistakes over and over again. You will actually find specific answers to the all-important “where to open” and “when to close” questions in this book. And, to spare your precious time and to speed-up the learning process, I am limiting the text to the bare essentials—what you really need to know. The best part—all of the techniques discussed will be illustrated with an application example.

If you are disappointed with buy-and-hold investing, then medium-term trading based on technical analysis is for you. These days technical analysis is quite extensive and a book with everything you should know about—from the basic bar chart to candlestick patterns and Elliott wave analysis—is not easy to find. Add trading rules, money management, and risk management and you have a book that is virtually impossible to find…. Until now! The goal of my book is to give you all of that information plus my own proprietary indicator SVAPO, a “Short Term Volume And Price Oscillator.”

All the basics and all the advanced ideas in technical analysis are not worth much if you don’t know how to combine and apply them. That is the goal of this book. With the LOCKIT methodology, you can apply the most effective trading techniques to capture consistent results in the markets. This book will teach you to look at the “Long” term trend, when to “Open” a trade, when to “Close” a trade, to look at the “K-factor” for risk and money management, and finally to make sure that you use an “Initial” and a “Trailing” stop—in short, “LOCKIT.” What you have in these pages is a step-by-step trading system using technical analysis, including tips on good money and risk management.

You already understand that some trade setups are better than others. That is why you will find trade setups that offer a better chance for success in LOCKIT.

Now and then, I notice advertisements about learning technical analysis in a couple of evenings or a weekend. Do you believe that this is possible? No, of course it’s not; you need to invest more time and you must practice as much
as possible. The best way to learn technical analysis is to use past price data, advancing day by day to make buy and sell decisions. Only if you are capable of making a profit, should you switch to real time; however, you should still be paper trading. If you are capable of making money at this stage, you can start with real money, but make absolutely sure that by then you have a good set of rules that you will follow without any hesitation. The LOCKIT rules will definitely help you to start off on the right foot.

While applying LOCKIT, you will make practical use of all aspects of technical analysis. For that reason, I wrote the part “Technical Analysis Basics,” which will give you a detailed description, including examples, of all the technical analysis techniques used by LOCKIT. For most of the techniques, we will show their application within LOCKIT.

LOCKIT introduces you to a number of special indicators and techniques for a more successful application of technical analysis like: zero-lagging moving averages, a Heikin-ashi Bollinger Bands %b indicator, SVAPO “Short term Volume and Price Oscillator,” trailing stop methods, and more. And let’s not forget, I’ve also included a very good money management method and a number of examples for good risk management.

I am fully convinced that trading based upon technical analysis (as proposed in this book) and following the LOCKIT rules will help you to make better and more profitable trading decisions.

To simplify the decision-making process, there is a set of LOCKIT trading rules for a number of different circumstances: long and short trading with a trend reversal or after a correction in an ongoing trend.

Please note that I will continue to contribute articles about technical analysis in Technical Analysis of Stocks & Commodities magazine. Here, my new ideas and findings (as well as other writers) will keep you up-to-date.

I am sure that this book with all the technical analysis techniques, money management, risk management, and high probability entries will be a turning point for your own technical trading.

I wish you lots of success and happy trading!

– Sylvain Vervoort
Capturing Profit with Technical Analysis
LOCKIT is a stock-trading method based on applying technical analysis and money and risk management techniques. Please note that special indicators used within LOCKIT are available in MetaStock® code. I have included a disc in the back of this book that has all of these codes ready for upload. If, however, you don’t use Metastock, the Appendix gives you a list of other programs that have all or most of the used code available for their application.

Also, please keep in mind that this chapter will give you an overview of the entire LOCKIT system in a step-by-step process. Now that you have a working knowledge of the basic technical analysis tools we use within LOCKIT, I think you will be impressed with how well the methodology works. If you need a refresher on the basics as you move through this next part, you have to no further to look than the previous chapters.

**LOCKIT is an acronym that stands for:**

**L** “Long term” What is the Long-term trend?

**O** “Open” The rules for Opening a position.

**C** “Close” The rules for Closing a position.

**K** “K-ratio” Keep risk under control and manage your money.

**I** “Initial stop” Set an Initial stop loss.

**T** “Trailing stop” Set a Trailing stop loss.
**STEP 1: LONG-TERM TREND**

First, we look at the long-term trend. We prefer to trade only in the direction of the long-term trend. Even with the use of technical analysis, you will have to leave enough price reaction potential for the intermediate-term in order to keep a stock in your portfolio for the longer-term.

**Figure 7.1: Bankrate Inc. with a 17% trailing stop**

Look at figure 7.1, Bankrate Inc. We have to keep a 17% trailing stop to keep us in the trade for the long term. Many times, this means we will have to use an initial stop in the same order; however, it is clear that we cannot permit many losing trades that cost us 15% or more. It is, therefore, important to understand what the long-term trend is doing.

**Estimating the Long-term Trend**

To estimate the long-term trend for the whole of the stock market, we use a stock index. During a long-term uptrend, we only trade on the long side.
On the other hand, we will only trade from the short side in a long-term falling market.

We use a monthly chart (Figure 7.2) to look at the long-term trend. Remember that it is easier to make money in a rising market than in a falling market, simply because a stock can go up from $1 to $100, or 10,000%, but it can only fall from $1 to $0, or 100%.

*Detailed information about technical analysis used within LOCKIT can be found in PART I chapters 1 to 4.*
We can say that a chart with higher price bottoms and higher price tops is in an uptrend. Lower price tops and lower bottoms means price is in a downtrend. The first indication of a possible trend reversal in an uptrend is a lower top compared to the last one. You get a confirmation when the next bottom is lower than the last bottom. In a downtrend, a first indication of a reversal is a higher bottom than the last one. You get a confirmation with a higher top than the last one.

The use of a moving average on monthly prices is the first tool that we will use in LOCKIT to look for the long-term trend; however, to avoid the lagging of the average used as much as possible, we will use a short 20-month exponential moving average with a zero-lagging compensation.

The long-term trend is considered up as long as this moving average is going up. When this average starts moving flat or slightly downward, you can use recent price support or resistance and trend lines to find confirmation for an eventual long-term trend change.

In MetaStock® you can create a zero-lagging exponential moving average as follows:

```
Period:= Input("Exponential Average period?",1,250,20);
EMA1:= Mov(CLOSE,Period,E);
EMA2:= Mov(EMA1,Period,E);
Difference:= EMA1 - EMA2;
ZeroLagEMA:= EMA1 + Difference;
ZeroLagEMA
```

Please utilize the disc in the back of the book for instant access to these codes. You may also download them from www.traderslibrary.com/tlecorner.

Additionally, it is best to use trend lines and trend channels for confirmation. Because we are looking at big price moves, we will use a logarithmic scale on the vertical axis. In most cases, trend lines tend to accelerate on the way to a longer-term target. A trend line broken by the closing price is basically a reversal signal.

Looking at figure 7.2, there was doubt in the S&P 500 long-term up-move during the second half of the year 1990, with the average moving down and breaking a shorter-term uptrend line (not shown). We had a more flat correction in 1994, but here the price remained above the uptrend line and above the
last support level. Finally, there was a bigger correction at the end of 1998. But even here, the price remained above the trend line and the last support line.

Of course, we can also use or combine the previous techniques with a trailing stop. If the closing price breaks the trailing stop, then we can assume a trend reversal.

As a reference, look at figure 7.3, which shows the period 2003 until 2007 on the S&P 500 Index. The closing price trailing stop used was 7%.

This is the first step in the LOCKIT system: Find out the long-term trend and take trades only in the direction of that trend.
**STEP 2: OPENING A POSITION**

After examining the long-term trend in LOCKIT step 1, let's investigate the medium-term using a weekly chart. Keep in mind that you are looking for the bigger medium-term trades. Are you, conversely, a short-term trader? If so, you would only look at the weekly chart to find out whether the price is or is not coming to a medium-term reversal point.

**CA Inc. Weekly Chart**

**The Day of 08/13/2004**

Let's look at figure 7.4, the weekly chart of CA Inc.

Because of the big price shift in this longer period, we use a semi-logarithmic scale for this weekly chart. First, we look for a probable Elliott wave count. If our count is correct, we may be near the end of a longer-term correction wave (4). Correction wave (2) was a sharp correction; most of the time, wave (4) would then follow with a flat correction, which seems the case here. Drawing a trend line through the tops (1) and (3) and a parallel line through the bottom of wave (2) show that we have reached a target price for wave (4) at the bottom of this channel. At the same time, we reach support at the 200-day simple moving average (dashed line), and we are finding support at a previous low point (wave (4) bottom) at a price level of $22.

We use three indicators: 1) SVAPO with the standard settings, 2) the standard 14 (weeks) SVE_RSI_StDev, and 3) the standard 18 (weeks) SVE_BB%b_HA. It is important to examine whether these indicators are making convergent or divergent moves.

These indicators are now moving in the lower part of their normal space, making a convergent move. Remember, there are usually no divergences in a wave 4 because the up move is still intact; therefore, we are not really looking at a price reversal. If there is a divergence, it will probably be a hidden one. We can now see that there is room for an up-move to create the next impulse wave (5), which must bring price above the top of wave (3), or above $29.60.

Looking at figure 7.5 (on page 208) and assuming that we reached a not-yet-confirmed bottom of wave (4), we could try to make a future price projection for wave (5). A Fibonacci projection with a first target at $22.50 already has given support three times for different wave (4) corrections.
Figure 7.4: Investigating the medium-term trend on the weekly chart of CA Inc.

Source - MetaStock® charts courtesy of Equis International.
A rising pitchfork, in line with the rising prices and the average, would cross the second Fibonacci target at $32. This is the closest target for the medium term to be reached in about 20 weeks.

But, be careful! This projection is only valid if we really have reached the turning point that starts impulse wave (5). Considering the solid support here, there is a good chance we are at the turning point. Do we have a confirmation on the daily chart?
Finally, let’s look at the daily candlestick chart for the last few months.

In figure 7.6, correction wave (4) consists of an ABC correction. The C correction itself has a lower order wave with another (A)(B)(C) correction, of which the (C) correction finally is an impulse wave.

We can see a number of signs indicating a possible end of this correction.

The price is reaching a second Fibonacci target at $22.40, drawn from the top of the B-wave and the first correction in the down-move. Also, the first Fibonacci target at $25 was touched exactly by intermediate wave (A).

A falling pitchfork between B and (A) and 2 gives a medium-term, down-moving channel. The price reaches the median line of this pitchfork again in the neighborhood of the second Fibonacci projection target.
The price now also touches the median line of a short-term, down-moving pitchfork drawn between the wave points 2, 3, and 4, and this happens exactly on the second Fibonacci target.

The price is moving far away from its 50- and 200-day simple moving averages. A move toward these averages is expected.

The last two candles make up a bullish harami pattern: a candlestick bottom reversal pattern.

Let’s also have a look at the indicators on the daily chart of figure 7.7.

**Figure 7.7: Interpreting the indicators on the daily chart of CA Inc.**

Source - MetaStock® charts courtesy of Equis International.
If this is going to be the turning point, we will see a divergence in the SVA-PO indicator next.

The RSI indicator is below the lower standard deviation line in the oversold territory.

And the BB%b indicator already has a divergence with the price and is moving up from below the 10-reference line.

Clearly, a turning point cannot be far away!

This is the second step in LOCKIT: Make use of the complete arsenal of LOCKIT technical analysis tools to decide if opening a position is the right thing to do.

**STEP 3: CLOSING A POSITION**

Step 3, closing a position, will be discussed after steps 4, 5, and 6.

**STEP 4: MONEY AND RISK MANAGEMENT**

**Money Management**

To comply with LOCKIT money management, we will invest in a fixed number of stocks. Each stock will get starting capital that is equal to the total capital divided by the fixed number of stocks. There is no profit or loss sharing between the stocks. My testing showed this to be the most effective system with the best results in the long run. We will go over this in more detail in chapter 10.

With a starting capital of $25,000 and a selection of 20 stocks, each stock will get $1,250 from the start. Losing 10% in one stock and one trade will be limited to $125, or just 1% of the total portfolio value. Furthermore, the total loss of one stock can never be more than $1,250, or 5% of the total portfolio value. This kind of money management makes the trading system crash resistant.

*In PART V, you will find all the details about money and risk management as applied by LOCKIT.*

**Risk Management**

Risk management means looking for an initial stop and a price target that gives you a good risk-to-reward ratio. The initial risk should be as low as possible, but it must have solid technical grounds.
Remember the reversal candlestick pattern in figure 7.6? We will take the low side of this pattern as the initial stop level. A closing price below this level is a selling signal. In this case, it means buying at $23 with a stop at $22.35, or a very low risk of only 3%.

In figure 7.8 you can see how, for the moment, we can only create a Fibonacci price target using a historical Fibonacci projection. If we calculate from the actual low point to the previous low point, the bottom of wave 3, it will give us three possible targets.

An important target is the first price resistance at the top of wave 4 at $25.35. At this level, we also expect resistance from the 50- and 200-day moving averages. Our initial stop and this target give us a good risk-to-reward ratio and justify opening a long position now.

To have an idea of when this target could be reached, we need this target crossing with some other line. There is, however, nothing we could use as
a reference for the moment. We could try to create a fictitious pitchfork. To find an acceptable inclination for this pitchfork, we could use the previous uptrend line between (A) and 1 as a reference.

Buying at $23 we comply with good money and risk management. On 08/13/2004, we buy $1,250/$23 = 54 shares of CA Inc. The possible loss is $0.65 per share, and the first price target is $2.35 higher. This gives us a minimum risk-to-reward ratio in our favor better than 3. This is exactly the type of trade we like to find in LOCKIT.

**STEP 5: INITIAL STOP**

We always set an initial stop right from the start.

The most important and most difficult decision is closing the position if the initial stop gets broken by the closing price. Here, it means the closing price should not fall below $22.35. Making the decision to sell on the break of the initial stop is not dependent on whether you are involved with long- or short-term investing. There must be no doubt, no discussion, no “yes but,” or any other excuses. If the closing price breaks your initial stop, you MUST sell!

**STEP 6: TRAILING STOP**

Equally important (in relation to holding on to as much profit as possible) is closing the position when the price falls through the trailing stop. Technical analysis has given you selling signals before; but, if you misinterpret them, you will need a trailing stop to take care of closing the position before you lose all of the profit. So, if price falls through the trailing stop, you MUST close the position. The trailing stop used is not only dependent on the investment period (short, medium, or long term), but is also related to the volatility of the stock.

To get an idea of the fixed stop percentage to apply for a certain stock in a certain period, you can use the following trailing stop MetaStock® formula:

```plaintext
{SVE_Stop_Trail%}
perc:=Input("Trailing Loss % ",0,100,14);
loss:=C*perc/100;
trail:=
If(C>PREV AND Ref(C,-1)>PREV,
Max(PREV,C-loss),
```

```plaintext
```
Capturing Profit with Technical Analysis

\[
\text{If}(C < \text{PREV} \text{ AND Ref}(C,-1) < \text{PREV}, \\
\text{Min}([\text{PREV}, C+\text{loss}], \\
\text{If}(C > \text{PREV}, C-\text{loss}, C+\text{loss}))); \\
\text{Trail}
\]

Please utilize the disc in the back of the book for instant access to these codes. You may also download them from www.traderslibrary.com/tlecorner.

Figure 7.9: More short-term reversals with a small 3% trailing stop on Intel Corp.

Short-term Trailing Stop

If you do not use extremely volatile stocks and you invest over the short term, then the trailing stop will be in the order of 3% to 5%, using daily charts. It is best to apply a trailing stop on a previous period to get a visual idea of what could be the best trailing stop for your particular stock. For that you can use the previous formula, SVE_Stop_Trail%.
With a 3% trailing stop, you have (in figure 7.9) four selling points for Intel Corp. looking at long positions.

During the same period, you can see in figure 7.10 only two selling points using a 5% trailing stop.

**Medium-term Trailing Stop**

A 7% to 11% trailing stop will be adequate for the medium term, using daily charts. The best thing is to apply a trailing stop on a previous period to get a visual idea for what could be the best trailing stop for this stock in this particular moment in time. For this, again, you can use the formula $SVE_{\text{Stop \ Trail\%}}$.

With an 8% trailing stop, you can see in figure 7.11 just one selling point for a long position in Intel Corp., looking at the same period as before.

**Long-term Trailing Stop**

A long-term trailing stop will have to be in the order of 11% to 15%. It is best to switch to a weekly chart when looking at the longer term.
Figure 7.11: An 8% medium-term trailing stop on Intel Corp.

Figure 7.12: A long-term 12% trailing stop on the weekly chart of Intel Corp.
In figure 7.12, note that with a 12% trailing stop in Intel Corp., there were two closing buys for short positions and one closing sell for a long position in the period 2003–2004.

**STEP 3: CLOSING THE TRADE**

**Long Position CA Inc. Short-term Follow-up**

Looking for short-term trading with CA Inc., you can see in figure 7.13 that a 5% trailing stop seems to follow the short-term price movement best.

We buy CA Inc. on 08/13/2004 for $23. The initial stop is set at $22.35. We keep a short-term trailing stop at 5%.

The important short-term price targets to keep in mind: $25.40, which was a previous top, and resistance from the 50- and 200-day simple moving averages. The next target is at $28.50, the third Fibonacci projection in the neighborhood of a total of four previous tops with previous wave tops (B) and 2.
On 10/06/2004, are we ready to sell now? After opening the position, the price moves straight up to the first Fibonacci target at $24.75.

In figure 7.14 we see a short-term correction at the end of August. If we do a Fibonacci projection from this new pivot point, we get exactly the same targets as before, proving that historical Fibonacci projections do work.

After this short-term correction, the price continued its move up to the second Fibonacci target. During this time, the 50- and 200-day moving averages were broken. The original uptrend line from the start of wave 1 and the bottom of wave 2 can, from now on, be drawn more sharply.

Next, there was a short correction back to the Fibonacci level, which is now support. At the sharper uptrend line, there was enough support to turn price back up again.
On 10/6/2004 – What Happens?

Price reaches a new high value at a level where a lot of resistance is found:

- We are exactly at the resistance of the line through (B) and 2;
- We are close to the third Fibonacci price target;
- We reach the upper side of a short-term, sharp up-moving pitchfork;
- We reach the resistance of an inverse trend line; and
- We essentially are completing an Elliott impulse wave count. Most likely, we are looking at the end of wave 5.

If there were good arguments to close our position on the way up, this seems to be the right moment. During the way up, there was no problem with the initial stop or the trailing stop.

We will always try to close the position based on good technical arguments and not wait for the trailing stop to be broken. If, however, the trailing stop is broken and we have not yet closed the position, the position MUST be closed!

Of course, before closing, we also have a look at our indicators in figure 7.15.

We can see a divergence with a second lower top in SVAPO, the RSI indicator is topping and is likely to diverge, and there is divergence with lower tops in SVE_BB%b_HA.

Conclusion: The indicators are in agreement that a top will be reached.

*We sell our 54 shares of CA Inc. at a closing price of $27.85, for a total amount of $1,503.9, minus the buying cost of $1,242, which yields a profit of $261.9 or 21%.*

The new available capital for buying this stock the next time is $1,250 + $261.9=$1,511.9. Remember; there is no profit or loss sharing with other stocks in portfolio.
10/18/2004: Opening a New Long Position?
Have a look at figure 7.16 to see if we should consider buying again. What are the arguments for opening a new long position?
The price has retraced back to the 61.8% Fibonacci retracement level, probably ending correction wave 2 of a medium-term uptrend impulse wave.

There is support from the previous turning point of wave 4.

A fraction lower, there is support of a previous doji candle top.

Price reaches the lower side of the up-moving pitchfork channel.

Price has fallen back between the 200- and 50-day moving averages, which are very close together.

Price has exactly fallen back to the upward trend line.

The last two candles in the chart are a bullish engulfing reversal pattern.
These are a lot of good technical reasons to buy this stock now!

OK, but what about the risk-to-reward ratio?

The short-term price target is the previous top at $28.20. With the long-term projection we did on 08/13/2004, we had a long-term target of $32. We can put an initial stop at the bullish engulfing pattern or just below at the trend
line support at $25.80, and buy now at a closing price of $26.58. The possible loss will be limited to $0.78, and the first price target is $2.40 away. This is a good risk-to-reward ratio to open the position.

Looking at the indicators in figure 7.17, we notice that SVAPO is very close to the lower standard deviation line, RSI is turning above the 50 level, and SVE_BB%b_HA is moving close to the lower side.

If we just had a temporary reaction in the uptrend, a reversal in the indicators is possible; it is normal that there are no divergences. If there were divergences, they would most likely be hidden, indicating a previous trend continuation.

This looks like a buy with a high chance for a profitable trade. You could profit from this and increase the buying power with 50% for this specific trade. The effect of increasing the buying power will be visible on the longer-term only. We will keep our normal buying power in our example.

Based on these positive arguments, we are buying 56 CA Inc. shares at a closing price of $26.58, for a total amount of $1,488.50. We keep an initial stop at $25.80 and continue to use a trailing stop at 5%.

12/07/2004: Time to Close the Position?

The price is moving up with almost no reactions within the up-moving pitchfork channel.

Look at figure 7.18 on the following page. On 12/07/2004, there seems to be a good chance for a price reaction.

- The price has reached a Fibonacci target level;
- The price has reached the estimated long-term target at $32;
- The price is moving up against the upper side of the pitchfork channel;
- The wave 3 up-move has been made with three consecutive sharper uptrend lines. The last sharpest trend line is now broken; and
- The last three candlesticks come close to what could be an evening doji star reversal pattern.

These provide more than enough reasons to believe that a reaction is coming and that it is best to take a profit now.
Looking once more at the indicators in figure 7.19, we see that SVAPO recently turned down from above the standard deviation level, but is moving up again. If, however, it turns down again, it will create a divergence. The RSI has turned already and is showing a divergence and SVE_BB%b_HA has a number of divergences too.

Chances are big that we have reached a top!

We sell the 56 shares of CA Inc. at a closing price of $30.75. The profit is $30.75-$26.58=$4.17, or a total of $4.17*56=$233.52—more than 15%.
The total available capital for the following trade in this stock is now $1,511.9 + $233.52 = $1,745, for a profit of $495 on the starting capital of $1,250 in less than four months.

Using the LOCKIT system for trading, based on a thorough knowledge of the basic technical analysis techniques, gives you a good chance for making more profit in the stock market.
LOCKIT RULES FOR OPENING AND CLOSING POSITIONS

I’ve compiled an overview of the LOCKIT rules for opening and closing long or short positions. Please read through these carefully and continue to use these examples as a reference.

LOCKIT Trend Reversal Rules for Opening a Long Position

A trend reversal will be more certain when more rules are giving a signal. We will use the following reference letters to indicate which rules are complied with where on the example charts.

General Rules – Opening a Long Position

F. Price reverses with a higher bottom in a downtrend.

G. Price reaches support. This support is given by the 100- or 200-day simple moving average, a support line, or the lower side of a trend channel or pitchfork.

H. Price breaks through the last steepest downtrend line.

I. There is a rising breakout or continuation window.

J. Price reaches a Fibonacci target level or retracement level.

K. Price moves in a trend and is far below the 50-day simple moving average.

L. A clear complete Elliott wave count is visible.

M. The zero-lagging TEMA average on closing prices (ZLTMAACL) crosses above the zero-lagging TEMA average on re-calculated OHLC heikin ashi prices (ZLTMHA).

N. The indicators (SVAPO, RSI, and SVE_BB%b) are in the oversold area, preferably having divergences with price. If you are keeping hourly, daily, and weekly charts, you can find the ideal entry time when buying signals are becoming apparent in all time frames.

O. A price-reversal pattern is visible in the price chart.

P. A candlestick pattern confirms the reversal. The next candle confirms the new uptrend direction with at least a closing price in that direction.
Q. AVOID trading while in a trend move and when the indicators keep moving close around their median value.

An Example

As an example, let’s look at figure 7.20, the medium-term chart of AMR Corp.

G. The price reaches a solid support level at the bottom of a sub-wave 4 (January 2006) of the previous uptrend; a window before that (December 2005) is still not closed.

J. The price reaches a 50% retracement level over the complete move up from September 2005 until May 2006. The level of 50% is a common retracement, providing good support.

K. The price is far below the simple moving averages. An upward move to the 50-day average is expected.

Figure 7.20: LOCKIT trend reversal rules for opening a long position

Source - MetaStock® charts courtesy of Equis International.
L. After the impulse move up from September 2005 until March 2006, we are likely to finish the correction wave with a double zigzag. If this is the turning point, we have now completed wave Y.

Next with figure 7.21, let’s look at the shorter term with a candle chart and our indicators.

G. The price turns at the lower side of the pitchfork. This pitchfork is nicely in line with the slope of the 50-day moving average.

H. The price breaks the third downtrend line with the sharpest inclination.

I. There is a window between the last and the previous candle; this could be a breakaway window.

Figure 7.21: More LOCKIT trend reversal rules on a short-term candlestick chart

Source: MetaStock® charts courtesy of Equis International.
N. All indicators are in the oversold territory; however, two out of the three indicators are not showing divergence with price, which could be an indication that this is still not the ideal moment to open a trade.

P. There is a bullish harami reversal pattern, followed by a candle with a window and a higher closing price. These are more than enough reasons to open a long position. This is especially true because we have a good risk-to-reward ratio if we buy at $20.04 and keep an initial stop at the low of the bullish harami pattern, at $18.78. This gives us an initial stop with a possible loss limited to 6%.

F: In figure 7.22, notice the possible start of an Elliott impulse wave 3 a couple of weeks later. We now have a higher bottom in price, which is an important trend reversal signal for the medium-term trend.
Next, the correction wave 2 in figure 7.23 makes a flat zigzag ABC correction, bringing the price still a fraction lower. We can now draw a pitchfork between the turning points of waves 1 and 2 and the start (Y) of wave 1, giving direction to the future price movement.

A Fibonacci projection over wave 1 gives us some future price targets. The crossings of these targets with the median and outer lines of the pitchfork give us some idea of when these targets could be reached.

**M:** The zero-lagging TEMA average based on the closing price (ZLT-MACL) crosses the zero-lagging TEMA average based on re-calculated OHLC heikin ashi prices (ZLTMHAHA). This is another confirmation that the uptrend has started.
LOCKIT Long Position Trend Reversal Closing Rules

The more rules that are followed, the more trustworthy the selling signal will be. We will continue to use the AMR Corp. example charts and the reference letters of the rules to indicate where each one falls on the chart.

General Rules – Closing a Long Position

F. After opening a position, the price keeps moving flat while indicators move in the expected direction. There is serious doubt about the expected price up-move, and it’s possible that the price will turn down after the flat move.

G. Price breaks the initial stop.

H. The price breaks through the last steeper uptrend line, or a support line, while the price is moving flat.

I. The price reaches a Fibonacci target level.

J. A clear complete Elliott wave count is visible.

K. A candlestick pattern confirms the top reversal. The next candle is preferably a candle confirming the new downtrend direction with at least a closing price in that direction.

L. The price reaches the upper side of a pitchfork or trend channel.

M. The indicators (SVAPO, RSI, and SVE_BB%) are in the overbought area, preferably having divergences with price. If you are keeping hourly, daily, and weekly charts, you can find the ideal selling time when selling signals become apparent in all time zones.

N. The price moves in a trend and is more than average above the 50-day simple moving average.

O. The zero-lagging TEMA average on closing prices (ZLTMACL) crosses below the zero-lagging TEMA average on re-calculated OHLC heikin ashi prices (ZLTMAHA).

P. The chart shows a price reversal pattern.

Q. The price breaks the trailing stop.

If you get a selling signal and it’s obvious that it is a temporary reaction coming to an end, you could close half of the open position. If it turns out to be a temporary reaction, you will still make a profit with the other half.
If, on the other hand, it’s really a turning point, then there is more room for closing the trade because losses are only half of what they would have been with the original quantity.

Note how in figure 7.24 the prices stay nicely within the up pitchfork: Half-way through November, price breaks above the pitchfork channel. A Fibonacci projection that started from intermediate wave 1 of extension wave 3 is reached.

I: The price reaches a Fibonacci target level.

J: There is a good chance that we have reached the top of wave 3; there is an intermediate impulse wave 1 to 5.
K: The doji in the candle chart is probably the first indication for a reversal. There is a chance that we will get an evening doji star as a reversal pattern.

M: All indicators are turning down from the overbought level; there is no divergence visible. This is an indication that the price will continue the move up after correction wave 4.

N: The price is moving far away from the 50-day simple moving average. At the start of wave 3 we saw a breakaway window. Then, we got an exhaustion window, which is a good indication that, at least, this moment in time, we are at a top level.

The most sensible action is to take profit. If the next wave is really a wave 4, we will try to enter a new position at the start of wave 5.

Next, we will list the LOCKIT rules for opening and closing a short position after a trend reversal.

**LOCKIT Trend Reversal Rules for Opening a Short Position**

F. The price reverses with a lower top in an uptrend.

G. The price reaches resistance. This resistance is given by the 100- or 200-day simple moving average, a resistance line, or the upper side of a trend channel or pitchfork.

H. The price falls through the last steeper uptrend line.

I. There is a falling breakout or continuation window.

J. The price reaches a Fibonacci target level or retracement level.

K. The price moves in a trend and is far away from the 50-day simple moving average.

L. A clear, complete Elliott wave count is visible.

M. The zero-lagging TEMA average on closing prices (ZLTMAACL) is downward crossing the zero-lagging TEMA average on re-calculated OHLC heikin ashi prices (ZLTMAHA).

N. The indicators (SVAPO, RSI, and SVE_BB%) are in the overbought area, preferably diverging with price. If you are keeping hourly, daily,
and weekly charts, you can find the ideal entry point when sell signals become apparent in all time zones.

O. There is a chart pattern reversal in the price chart.

P. A candlestick pattern confirms the reversal. The next candle is preferably a candle confirming the new downtrend direction with at least a closing price in that direction.

Q. **AVOID** trading when, while in a trend move, the indicators keep moving close around their median value.

**LOCKIT Short Position Trend Reversal Closing Rules**

F. After opening a position, the price keeps moving flat, while indicators move in the expected direction. There is serious doubt about the expected price down-move, and it’s possible that the price will turn the other way around after this flat move.

G. Price breaks the initial stop.

H. The price breaks through the last steeper falling trend line, or a resistance line, while the price is moving flat.

I. The price reaches a Fibonacci target level or retracement level.

J. A clear complete Elliott wave count is visible.

K. A candlestick pattern confirms the reversal. The next candle is preferably a candle confirming the new uptrend with at least a closing price in that direction.

L. The price is reaching the lower side of a pitchfork or trend channel.

M. The indicators (SVAPO, RSI, and SVE_BB%b) are in the oversold area, preferably diverging with price. If you are keeping hourly, daily, and weekly charts, you can find the ideal buy-back time when closing buy signals become apparent in all time zones.

N. The price moves in a trend and is far below the 50-day simple moving average.

O. The zero-lagging TEMA average on closing prices (ZLTMACL) crosses above the zero-lagging TEMA average on re-calculated OHLC heikin ashi prices (ZLTMACHA).
P. The chart shows a price reversal pattern.

Q. Price breaks the trailing stop.

**LOCKIT Trend Correction Rules for Opening a Long Position**

The buying signal will be more trustworthy if more rules are applied. We will continue to use the AMR Corp. charts for indicating the rules (with the use of reference letters) that are followed on the charts.

**General Rules**

F. The price reaches support. This support is the 50-, 100-, or 200-day simple moving average, a support line, or the lower side of a trend channel or pitchfork.

G. The price reaches the end of an Elliott impulse wave 2 or 4, or wave A of a correction wave.

H. The price breaks through the last steeper downtrend line.

I. There is a breakout with a rising (continuation) window.

J. The price reaches a Fibonacci retracement level.

K. There is a continuation chart pattern in the price chart.

L. The indicators (SVAPO, RSI, and SVE_BB%b) are close to the over-sold range, but are still around median levels. If you are keeping hourly, daily, and weekly charts, you can find the ideal entry time when buying signals become apparent in the smaller time zones.

M. Trade in the direction of the medium to longer-term trend.

N. A candlestick pattern confirms the reversal. The next candle is preferably a candle confirming the new uptrend direction with at least a closing price in that direction.

O. The zero-lagging TEMA average on closing prices (ZLTMACL) crosses above the zero-lagging TEMA average on re-calculated OHLC heikin ashi prices (ZLTMAHA).
As you can see in figure 7.25, the correction in AMR Corp. is an Elliott ABC zigzag pattern.

We now arrive at the point where everything seems to indicate a continuation of the previous uptrend.

F: The price finds support at the 50-day simple moving average, and the price turns up from the lower side of the pitchfork channel.

G: An ABC zigzag correction is complete; it is likely that we reached the end of wave 4.

H: The last descending trend line is broken to the upper side.
J: We closely reach a 61.8% Fibonacci retracement level, which is sufficient for a wave 4 move.

L: There is enough room for an up-move by the indicators.

N: In the candle chart, we have a bullish engulfing reversal pattern, followed by a hammer with a higher closing price.

With a stop at the low side of the bullish engulfing pattern, we have a good risk-to-reward ratio.

*There is no doubt that we must open a new long position here.*

**LOCKIT Long Position Trend Correction Closing Rules**

The selling signal is more reliable when more rules are applicable. As before, we are using the AMR Corp. charts to illustrate where the rules (reference letters) are followed.

**General Rules**

F. After opening a position, the price keeps moving flat, while indicators move in the expected direction. There is serious doubt about the expected price up-move, and it’s possible that the price will turn the other way around after the flat move.

G. Price breaks the initial stop.

H. The price breaks through the last steeper trend line or a support line while price starts moving flat.

I. The price reaches a Fibonacci target level.

J. A clear complete Elliott impulse wave count is visible.

K. A candlestick pattern confirms the top reversal. The next candle is preferably a candle confirming the new downtrend direction with at least a closing price in that direction.

L. The price reaches the upper side of the last pitchfork or trend channel.

M. The indicators (SVAPO, RSI, and SVE_BB%b) are in the overbought area, preferably diverging with price. If you are keeping hourly, daily, and weekly charts, you can find the ideal selling time when selling signals become apparent in all time zones.

N. The price moves in a trend and is far above the 50-day simple moving average.
O. The zero-lagging TEMA average on closing prices (ZLTMACL) crosses below the zero-lagging TEMA average on re-calculated OHLC heikin ashi prices (ZLTMAHA).

P. The chart shows a price reversal pattern.

Q. Price breaks the trailing stop.

**Closing the Position**

Look at figure 7.26 to see how the price moves up in a short period of time with high acceleration. Looking for selling signals? There are clearly a number of them. Is it time to close this position? Let’s investigate.

H: The last ascending trend line is broken to the lower side.
J: We reached a top for Elliott impulse wave 5.

K: We have two consecutive bearish harami patterns in the candlestick chart.

L: The price reaches the upper side of the last pitchfork. The price also reaches an inverse trend line drawn over the tops of waves 1 and 3, possibly the upper side of a longer-term up-channel.

M: Indicators are turning down in the overbought area. There are divergences visible with the RSI and SVE_BB%b indicators.

N: The price has moved far away from the 50-day simple moving average.

These are enough good reasons to take profit and to close the position now!

Looking at figure 7.27, you must agree it was a good decision!

Finally, we list the rules for opening and closing a short position after a trend correction.

Figure 7.27: Further price evolution confirms LOCKIT decision
LOCKIT Trend Correction Rules for Opening a Short Position

F. The price reaches resistance. This resistance is the 50-, 100-, or 200-day simple moving average, a resistance line, or the upper side of a trend channel or pitchfork.

G. The price breaks through the last steeper uptrend line.

H. The price reaches a Fibonacci target or retracement level.

I. There is a falling (continuation) window.

J. A clear complete Elliott wave count is visible.

K. The zero-lagging TEMA average on closing prices (ZLTMAACL) is downward crossing the zero-lagging TEMA average on re-calculated OHLC heikin ashi prices (ZLTMAHA).

L. The indicators (SVAPO, RSI, and SVE_BBB%b) are in the overbought area, preferably diverging with price. If you are keeping hourly, daily, and weekly charts, you can find the ideal entry point when sell signals become apparent in all time zones.

M. There is a chart reversal pattern in the price chart

N. A candlestick pattern confirms the reversal. The next candle is preferably a candle confirming the new downtrend direction with at least a closing price in that direction.

LOCKIT Short Position Trend Correction Closing Rules

F. After opening a position, the price keeps moving flat, while indicators move in the expected direction. There is serious doubt about the expected price down-move, and it’s possible that the price will turn the other way around after this flat move.

G. Breaking the initial stop.

H. The price breaks through the last steeper falling trend line, or a resistance line, if the price is moving flat.

I. The price reaches a Fibonacci target level or retracement level.

J. A clear, complete Elliott wave count is visible.
K. A candlestick pattern confirms the reversal. The next candle is preferably a candle confirming the new uptrend but at least a closing price in that direction.

L. The price reaches the lower side of the last pitchfork or trend channel.

M. The indicators (SVAPO, RSI, and SVE_BB%b) are in the oversold area, preferably diverging with price. If you are keeping hourly, daily, and weekly charts, you can find the ideal buy-back time when closing signals become apparent in all time zones.

N. The price moves in a trend and is far below the 50-day simple moving average.

O. The zero-lagging TEMA average on closing prices (ZLTMACL) crosses above the zero-lagging TEMA average on re-calculated OHLC heikin ashi prices (ZLTMAMA).

P. The chart shows a price-reversal pattern.

Q. The price breaks the trailing stop.

For a closer look at the charts in this chapter, go to www.traderslibrary.com/TLEcorner.
TEST YOUR CHAPTER 7 KNOWLEDGE

1. LOCKIT is a short name that stands for?

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C _____________________________________________________________
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2. Why are we looking at the long-term market trend?

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3. To open a trade we use?

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4. To close a trade we use?

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5. How do we apply good money management with LOCKIT?

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6. How do we limit risk with LOCKIT?

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7. The initial stop setting is based on?

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8. Why do we use a trailing stop with LOCKIT?

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For answers, please visit the Traders’ Library Education Corner at www.traderslibrary.com/tlecorner.