Chapter 30

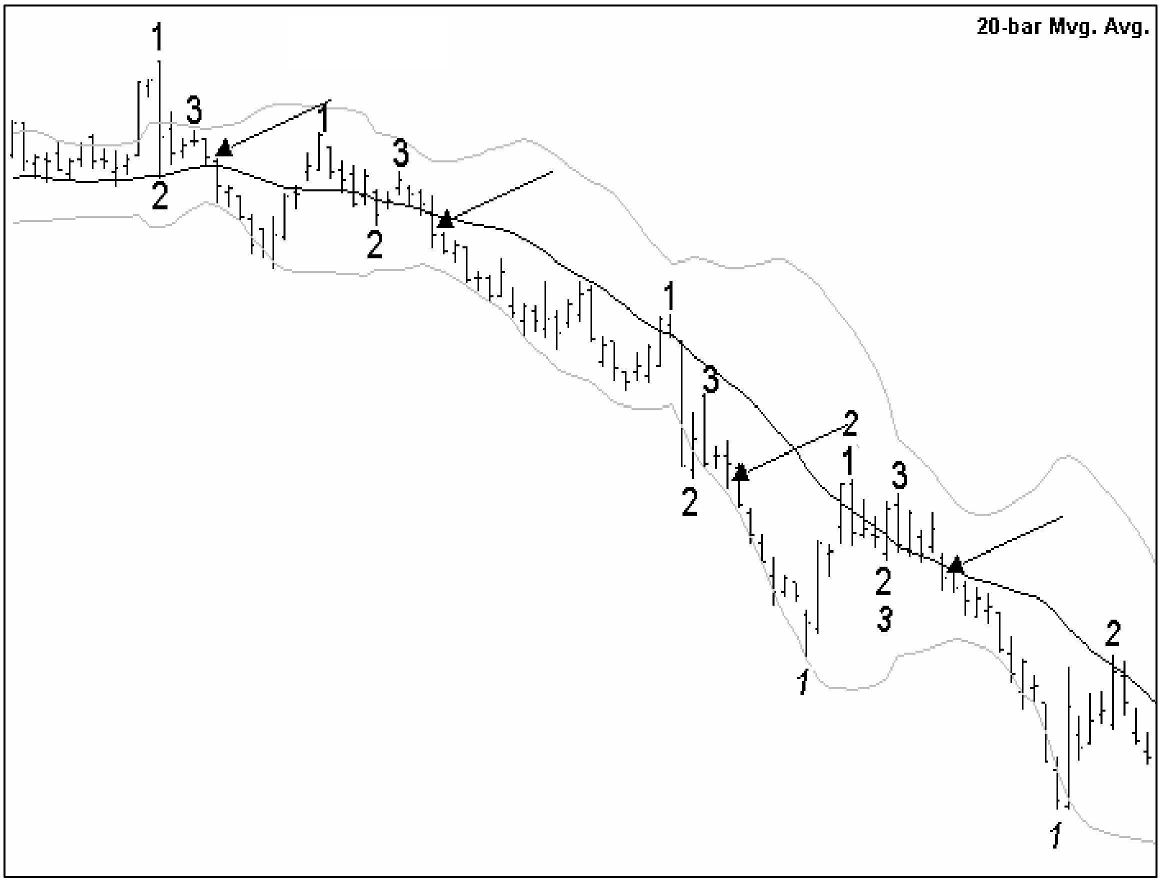
1-2-3'S AND BOLLINGER BANDS

We've mentioned previously that Bollinger Bands perform a very important function relative to ones ability to read price charts. Bollinger Bands offer a visual presentation of the location of two standard deviations by the price action. Statistically speaking, two standard deviations will encompass 96.5% of all price action based on a simple or exponential moving average of prices. If those prices are the close, for example, then we can expect that 96.5% of all closes will fall within the limits of the Bollinger Bands. Of all the methods for finding market turning points, the Bollinger Bands have proved to be the most successful, in that they are statistically reliable in showing a trader where so-called overbought and oversold are located. In fact, any software that will do separate Bollinger Bands, one based upon a moving average of the lows and the other based upon a moving average of the highs, will indeed provide an excellent indicator of relative overbought and oversold. In the examples that follow, we will be using the conventional Bollinger Bands set at 2 standard deviations based on a 20 bar simple moving average of the closes.

However, indicators are seldom enough in and of themselves for really good trading. Something else is needed to convict a trader of the fact that a market turn has taken place and that prices are now set to move in another direction, or at the very least cease moving in the direction in which they have been unfolding.

That something else is the 1-2-3 formation. 1-2-3 highs that originate at the upper Bollinger Band or the moving average line, and 1-2-3 lows that originate at the lower Bollinger Band or the moving average line, provide some very excellent change-of-direction signals to the alert trader.

Let's look at some examples of this type of trading. It works well for any time interval and in any market that is sufficiently dynamic to swing from side to side while trending, or swing with sufficient volatility within a Trading Range to cause there to be profitable trading opportunities. In fact, if prices are not moving much within a chosen time frame, then it is probably not worthwhile trading it at all. In general, this occurs when the Bollinger Bands become relatively flat.



Notice on the chart above:

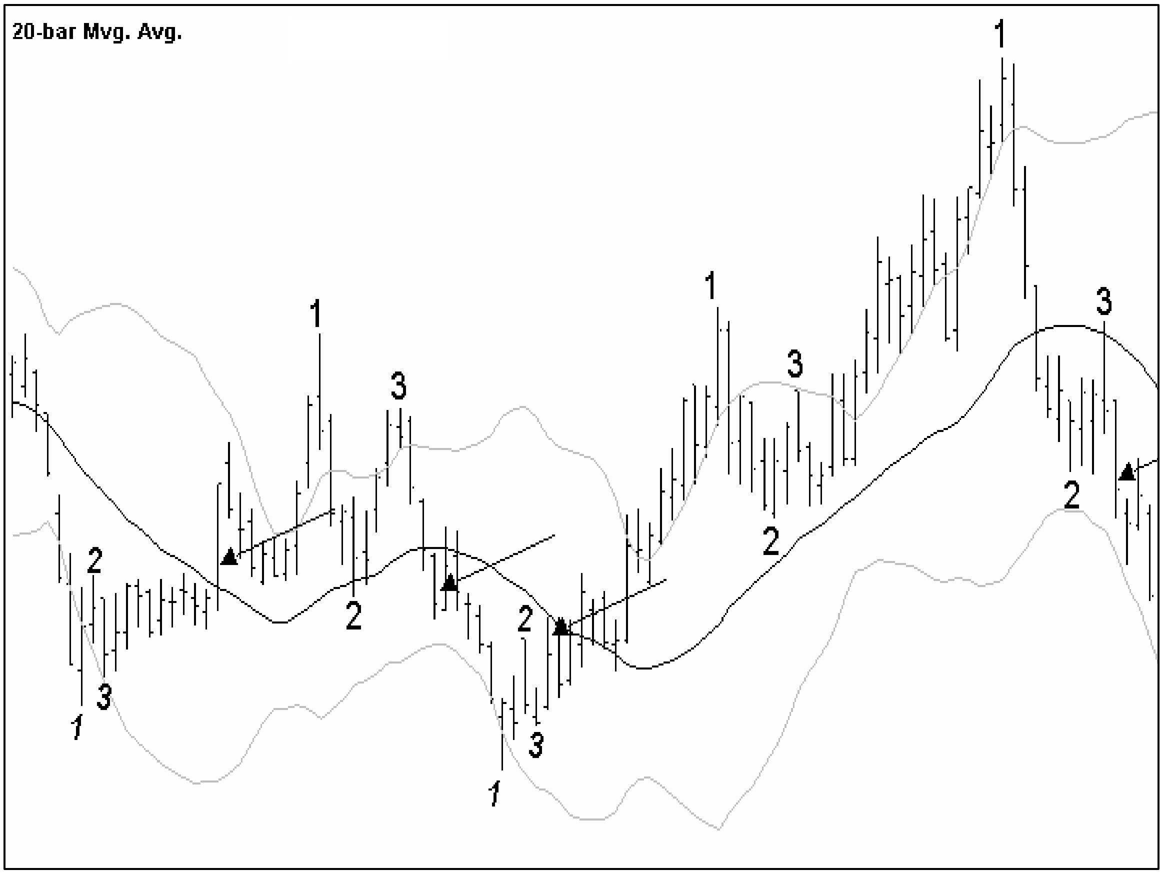
- 1-2-3 = Sell short formations.
- *1-2-3* = Go long formations.
- Arrows = Entry points

Rules: In a down trending market, prices must touch or exceed the upper Bollinger Band, or prices must touch or exceed the moving average line before a 1-2-3 formation becomes a legitimate formation from which to trade. In an up trending market, prices must touch or exceed the lower Bollinger Band, or prices must touch or exceed the moving average line before a

1-2-3 formation becomes a legitimate formation from which to trade.

1-2-3 Formations are further explained in Appendix A of this manual.

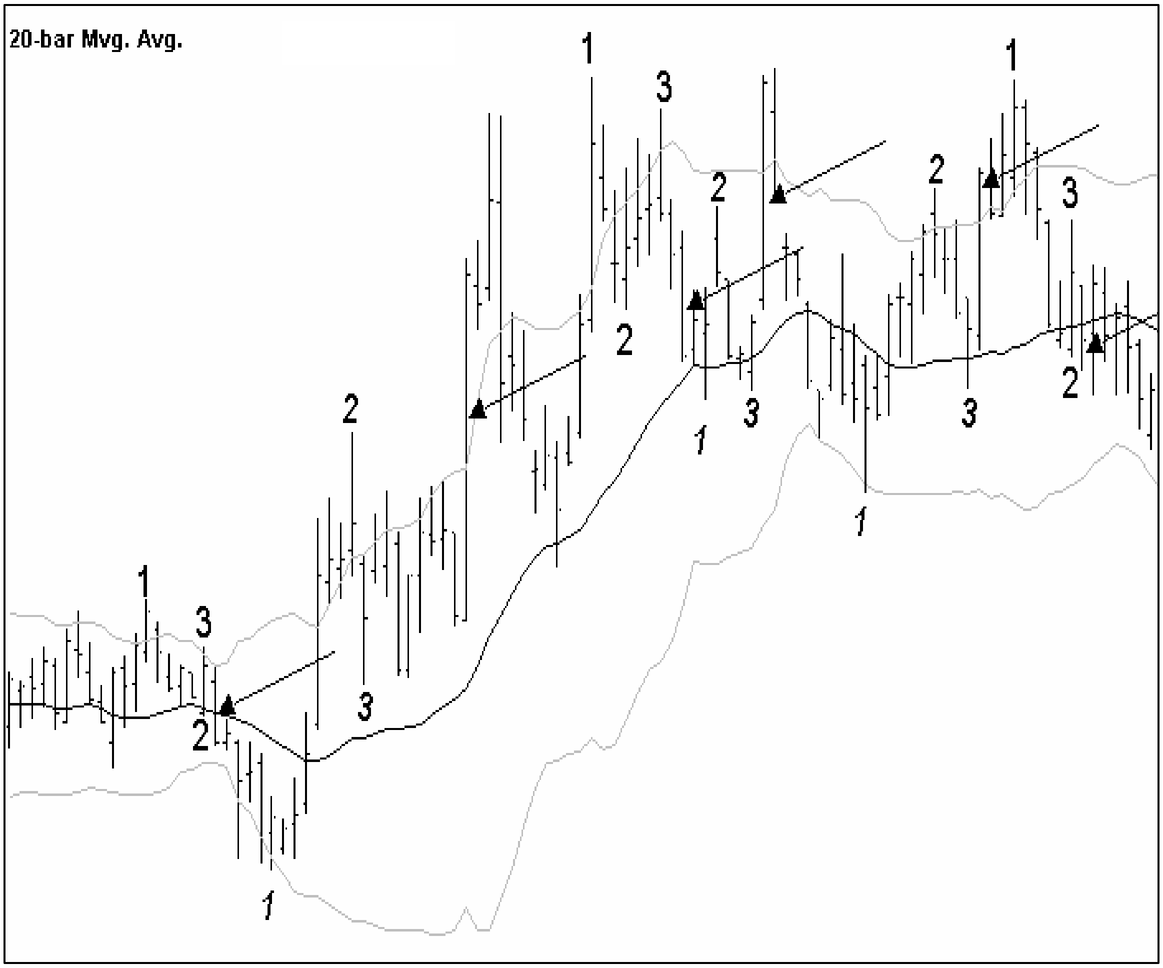
Let's look at a few more charts



Where do we place our exits? Exit points are placed one tick below the number 3 point in an up move, and one tick above the number 3 point in a down move. If you cannot afford to plan an exit according to that method, then you should avoid trading in your chosen time frame and perhaps drop down to a lesser time frame. There is always the option to not trade at all when you can't afford the appropriate exit point.

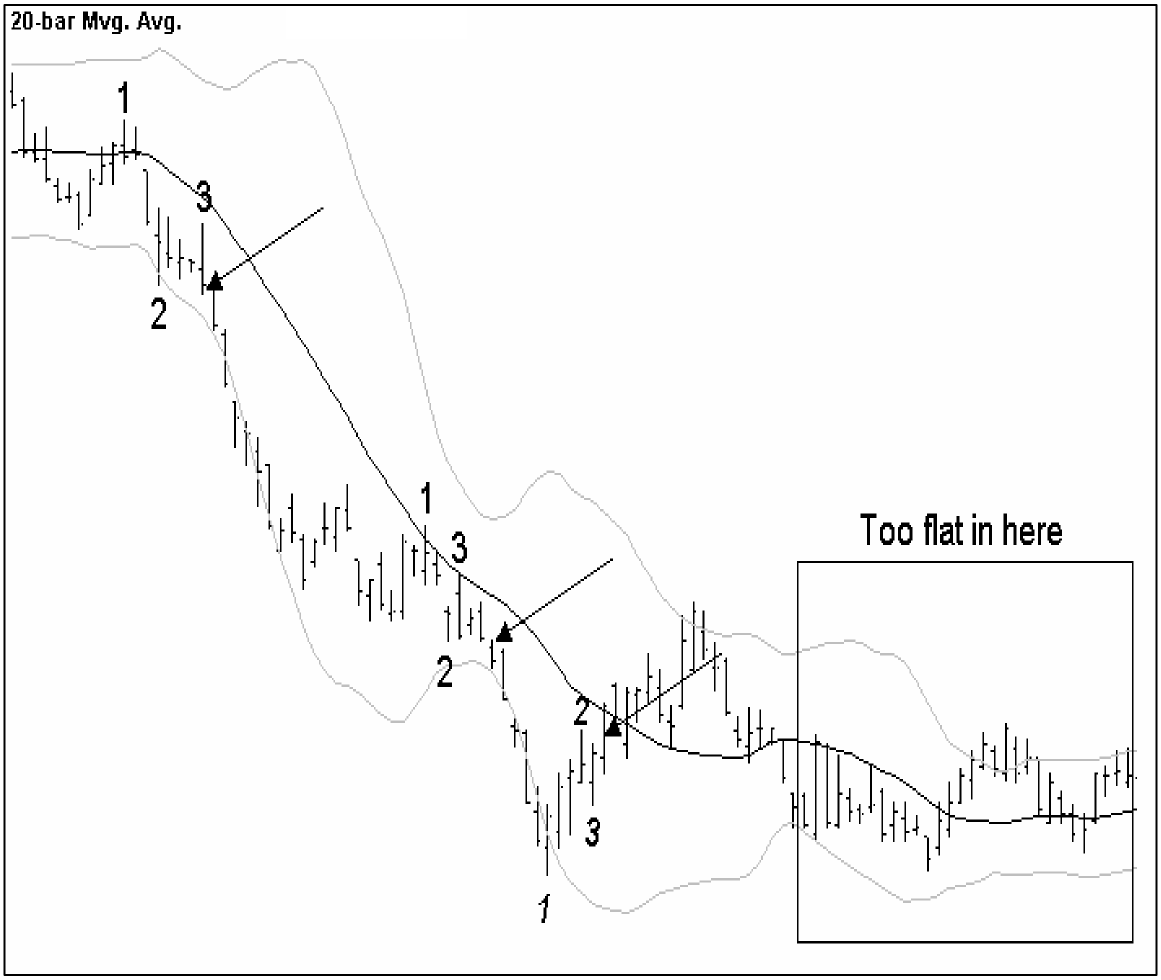
We also trail a stop or mental exit alert at natural support in an up move or natural resistance in a down move. We do that only after we have taken some profits out of the trade and are in position to do no less than breakeven.

Here’s another chart showing wildly swinging prices.



How’s this one for fun time? Sometimes we can pick some really volatile markets to trade. This one looks like Mr. Toad’s wild ride. If you find a market that displays a chart like this one, you might want to pass on it.

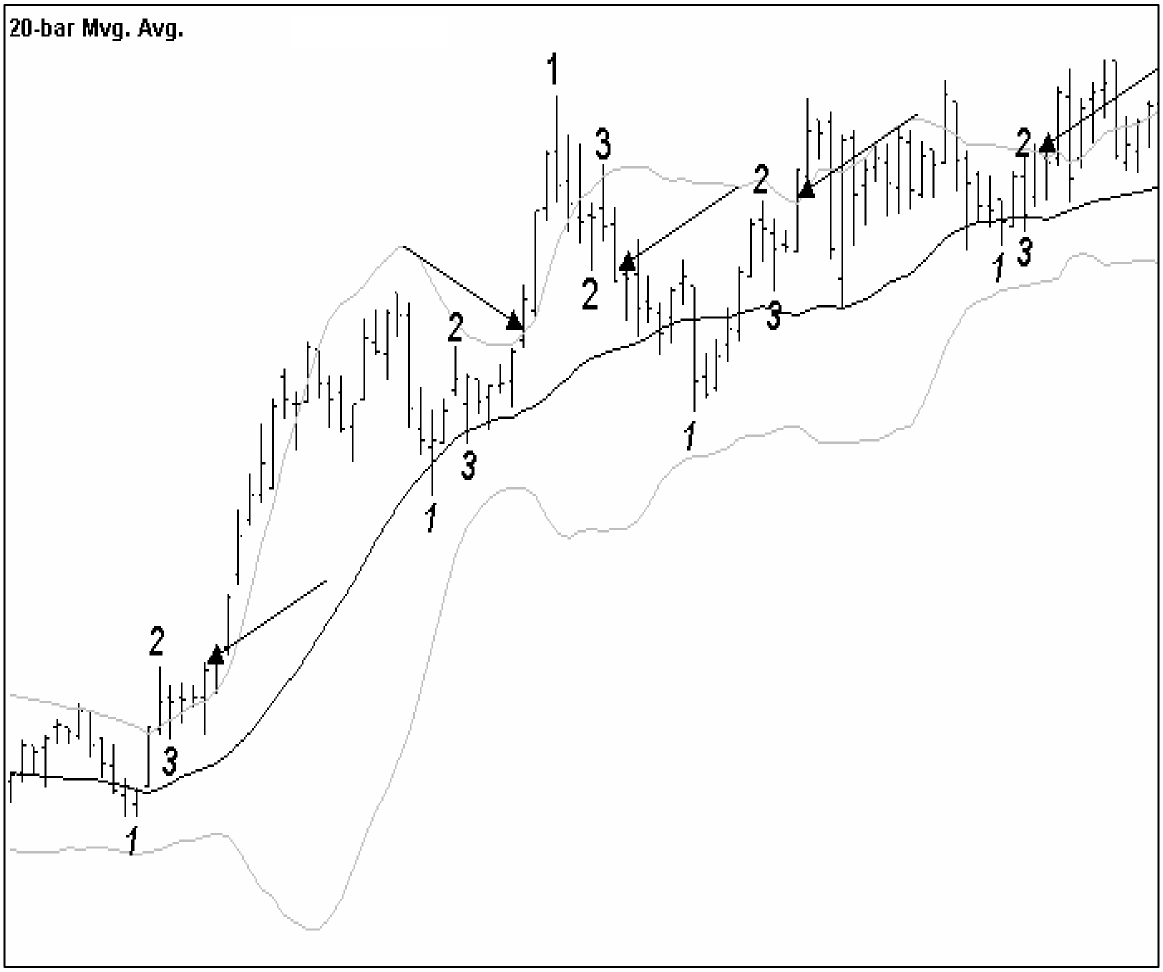
It’s better to find something like the chart on the next page.



This is the kind of price action that we like to see on a chart. Notice that the 1-2-3 formations are clear cut and crisp. In all cases, exits behind the number 3 points were easily maintained.

Subsequent to the last *1-2-3,* prices began to flatten out. There was almost a 1-2-3 high formation, but the #3 point failed to materialize. Beyond that, prices became quite flat. In other words, they quit swinging and the volatility went out of the market. At that time, look at what happened to the Bollinger Bands. They became relatively narrow.

With so many markets to choose from, we are almost always able to find liquid markets that are trending nicely either up or down, or making reasonably volatile swings which enable us to reap a profit.



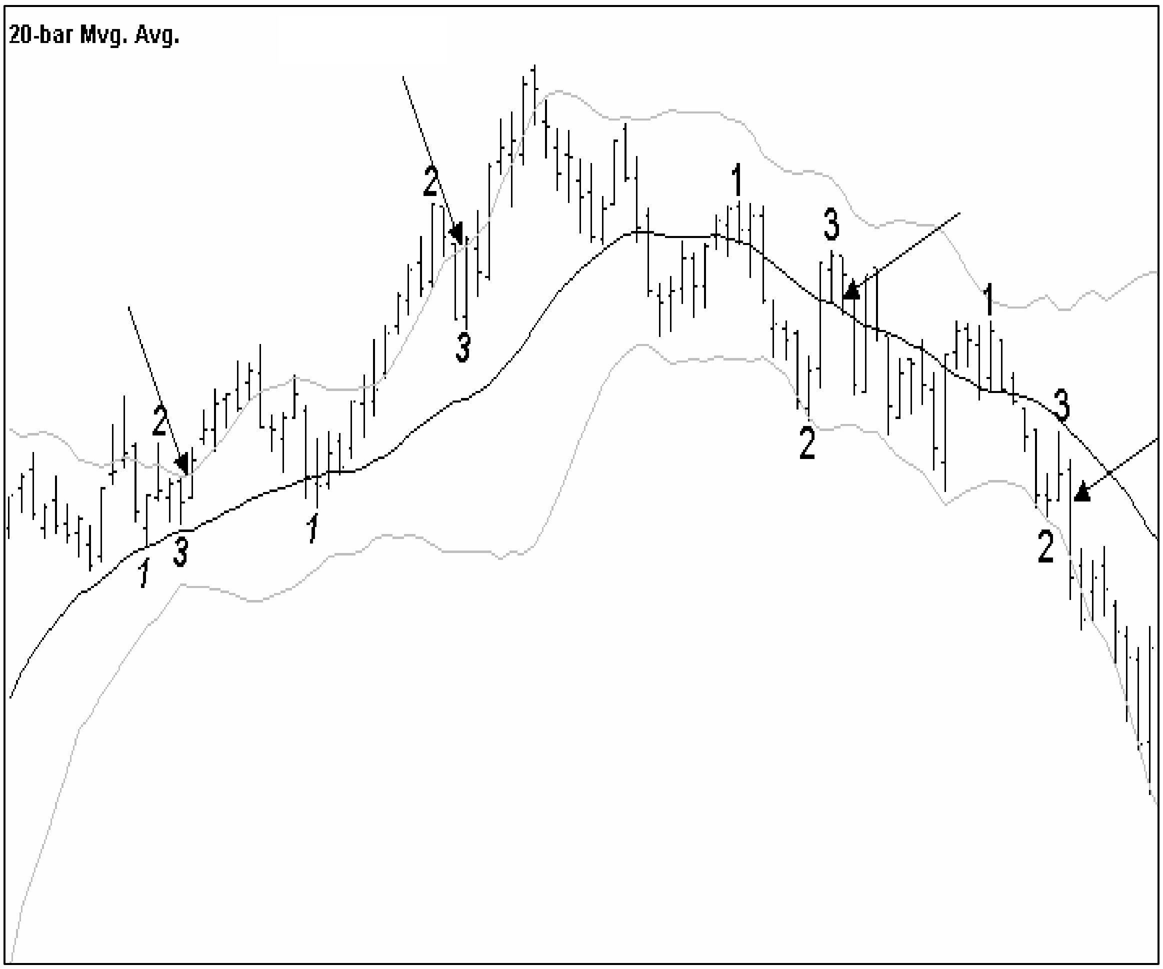
The chart above has some excellent entries. Once again, the #3 points are never really challenged.

Notice that the last *1-2-3* Low takes place in an area that is very flat. There were probably better entries available. Once the Bollinger Bands begin to severely narrow, it is often better to look elsewhere for a trade.

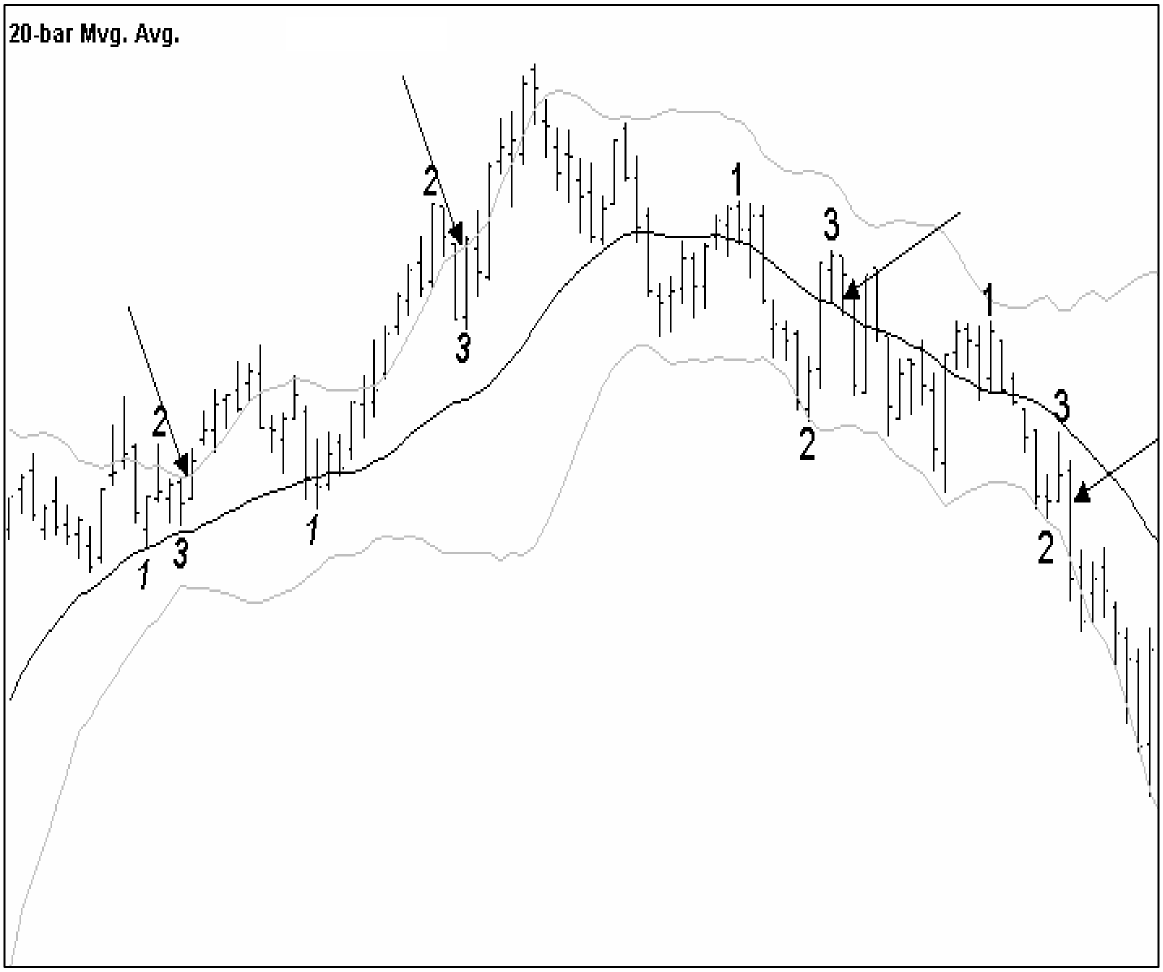
Also notice the next to the last *1-2-3* formation. Prices dipped well below the moving average line. But as long as the price bar making the #1 point does not lose contact with the moving average line, it remains acceptable to take the breakout of the #2 point as an entry signal.

We have been trying to show you these trades in the least favorable light so that you can appreciate how good they really are. We could have used the Trader's Trick as our entry, and considerably improved the results on those trades which had 1-2-3 highs and lows which originated at the moving average line.

Let's look at one more price chart. This time, we will use our arrows to point out those entries in which we could have used the Trader's Trick rather than a breakout of a #2 point. The Trader's Trick is explained in detail in Appendix B.



On the chart above, we've marked only those trades which had 1-2-3 formations originating at the moving average line. Obviously, there were also trades which had 1-2-3 formations originating at the Bollinger Band lines, but those trades use only a breakout of the #2 point as their entry. What we wanted to show you here is how much improved the entries are using the Trader's Trick on those formations in which the 1-2-3's originate at the moving average.



Also, notice that quite often 1-2-3's originating at the moving average are followed by a very pronounced trend.

We think that by now you should have this concept well in hand. What we suggest is that you go back over these charts, and review them while looking for the following:

- How many times does a strong trend follow a 1-2-3 formation which forms at the moving average line?
- How often does taking the Trader's Trick entry improve the results of entering a trade that is the result of a 1-2-3 formation which began at the moving average line?
- Is it really better to wait for the breakout of the #2 point when a 1-2-3 formation originates at one of the band lines?

- How many times does <u>not</u> taking the Trader's Trick keep you from entering a bad trade when a 1-2-3 formation forms at one of the band lines?

PERTINENT POINTS

The Trader's Trick may be used at either the bands or the moving average 1-2-3 formations. However, our experience has shown that at the bands, the #2 point needs to be taken out before entry. The Trader's Trick shows better results when used with the 1-2-3's which form from the moving average.

When prices reach one of the bands, we tighten stops or move our mental exit closer to the price action based upon the statistical probability that the move may be nearly over.

If a move has begun based upon a 1-2-3 which formed at one of the bands, we attempt to take some profits when prices reach the moving average. If our entry began based on a 1-2-3 which formed at the moving average, we attempt to take some profits when prices reach one of the bands. However, quite often 1-2-3 formations which form at the moving average ultimately result in a strongly trending market, and when that happens, we want to ride the trend as far as is possible before exiting our entire position.

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