

Determining Your Exit Strategy

Elliott Wave Risk And Reward

Establish your exit stop strategy before placing your next trade.

by **Tony Beckwith**

Traders have no business trading if risk/reward analysis is not at the top of their concerns. If a trader has no idea of the potential profit return on any given trade relative to the initial risk of taking the trade at all, his long-term profitability is in question.

Elliott wave (EW) analysis has come in for its fair share of criticism over the years, due at least in part to the inevitable overcomplication by analysts and the fallibility of some of their forecasting. However, by steering clear of these two pitfalls, some of the basic premises of EW analysis can be stripped out and used in a highly consistent risk/reward trade plan.

JUST REWARDS

To evaluate the reward part of the equation, Elliott wave analysis can help by pointing to where the reward is likely to be strong. Accepting the premise of market movement in EW means accepting the five-wave sequence that has become trading legend.

Elliott wave theory states that a market tends to unfold with three impulsive (trend) waves and two correction waves linking them. It works this way: wave 1 up, wave 2 correcting down, wave 3 back up to new highs, wave 4 correcting down, then wave 5 back up to new highs to complete the sequence (and vice versa).

In combining this with the more easily understood axiom that “the trend is your friend,” the ideal place to enter a trade is, by implication, at the end of a correction to a trend. In Elliott wave terms, this means one of only three places: the end of a corrective wave B into an impulsive (trend) wave C; the end of a corrective wave 2 into an impulsive wave 3; and the end of a corrective wave 4 into



Accepting the premise of market movement in Elliott wave analysis means accepting the five-wave sequence that has become trading legend.



FIGURE 1: A TYPICAL ELLIOTT FIVE-WAVE SEQUENCE. The wave analysis nailed the October 2002 low.

an impulsive and final wave 5.

Figure 1 shows a typical Elliott five-wave sequence on the S&P Depository Receipts† tracking the Standard & Poor's 500 index (SPY), which nailed the bear market low. The reward size must be clear, calculable, and unmovable. One difficulty for traders using conventional EW analysis is the potential confusion from having to assess different time frames and previous EW patterns that may or may not link with the present. The nine recognized time frames of Elliott analysis — from grand supercycle all the way down to subminuette — may keep you occupied and be an enormous source of complication in actual trading.

The alternative is not having to fit, say, an intermediate-level ABC correction-to-trend into a major level pattern or to link it with any standard EW pattern immediately before. This eliminates the confusion typical of most EW approaches. In addition, it enables you to carry out the Elliott calculations to pinpoint the price targets for a trade into the appropriate impulsive (reward) wave. These zones are known and unmovable.



CLEAR RISKS... TWO, ACTUALLY

As far as risk is concerned, it too must be clear, calculable, and unmovable. This applies to the two different elements of risk.

First, if you enter a trade at the end of a corrective wave, the three criteria are met perfectly; for example, if your entry is at one tick beyond the latest bar and the initial stop-loss is one tick beyond the extreme price reached in the potential correction (where price movement has invalidated the trade). The money risk is known and the size of position to trade (number of shares, futures lots, and so on) can always be determined as a result.

Second, the probability risk in a trade at the end of a corrective wave can meet the three criteria as closely as any mathematical uncertainty ever can. Confusion caused by complex corrections to trend can be avoided by demanding that the correction subdivide cleanly into the basic EW waves a, b, and c. There is room only for the simple abc correction.

Confusion over where the correction should stop can be avoided by requiring that it reaches a price level anticipated in Fibonacci/Elliott numerology. For example, wave c of the simple correction is a certain ratio of the length of wave a (0.618x, 1.000x, 1.618x) and wave b (1.272x, 1.618x, 2.618x). This is crucial, as it allows you to establish minimum, typical, and maximum price zones for the correction to stop.

You can avoid confusion over when the correction may be reversing by requiring that the market itself show signs of price reversal — for example, a type of strong price reversal action, an oscillator turn, an indecisive inside day, a Japanese candlestick pattern, and so on.

Figure 2 shows a typical ABC correction trade setup on Comerica (CMA) with clear reward and risk levels, yielding a minimum 7x risk/reward.

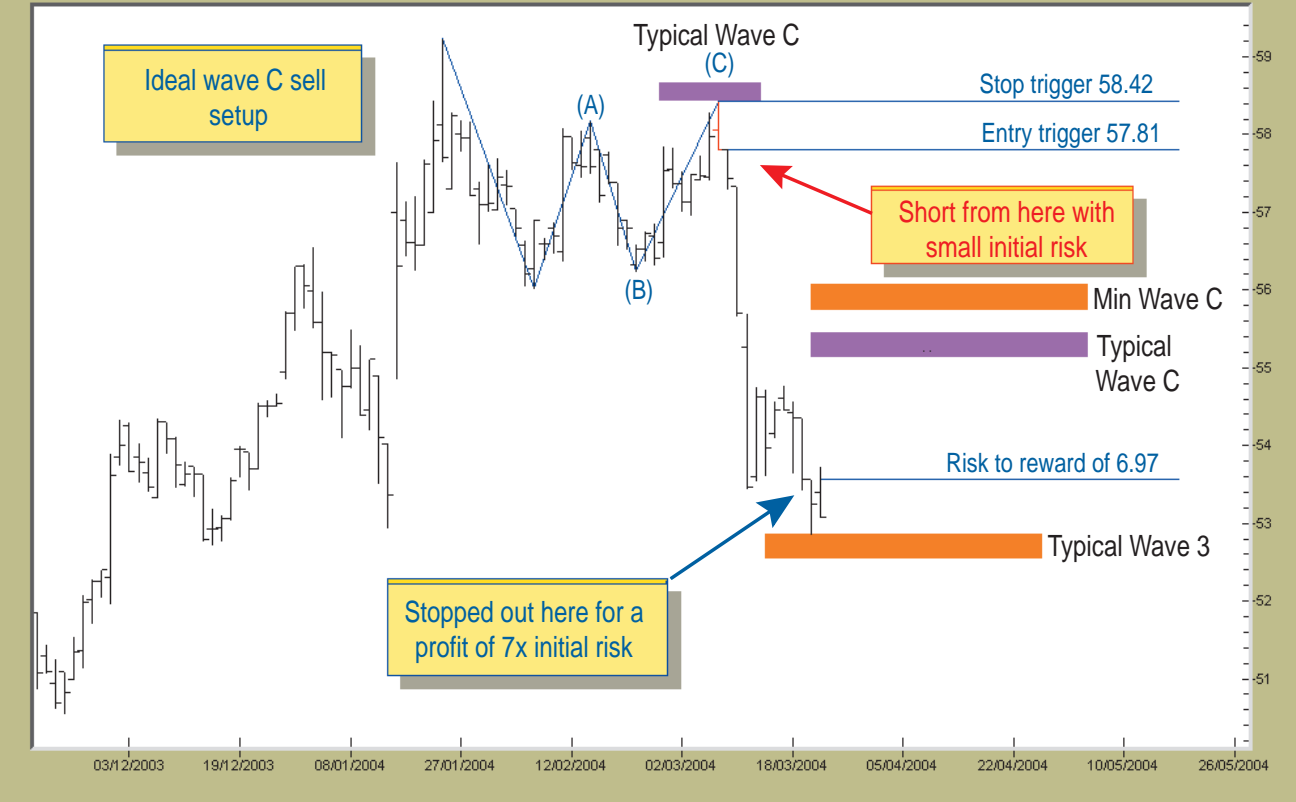


FIGURE 2: ABC CORRECTION. Here, you can clearly see the risk/reward levels.

IDEAL RISK/REWARD TRADING

With both the initial *risk* calculated and the appropriate Elliott wave price (*reward*) targets determined and fixed, you can ensure that only trades with a minimum risk/reward ratio of, say, 2x are ever actually entered. This approach to EW ensures that you can operate a consistent exit stop strategy on each trade, with, for example, partial profits taken at the first price (reward) target, and the remaining position taken off the table if the second profit zone is reached.

Note the *if*. This risk/reward trading operation is not based on the delusion of hope or forecasting, the downfall of many an EW practitioner. In this multiple-position example, if the price

manages to close beyond the first profit target, the exit stop could be moved into that first zone to protect the solid profits on the remaining position. The entire exit stop strategy can (and should) be determined before any trade is ever placed.

So you see, asset-stripping Elliott waves can be highly profitable!

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