

The Grand Finale

Trading Wave 3

Trading wave 3 could prove to be the most profitable of all waves. Here's an example using DAX futures.

by *Mircea Dologa, MD*



my previous two articles, I discussed various techniques you could apply to trading while a wave 3 was in process. In this, the third and final part of the series, I will walk you through a trade so you can see how to utilize everything I discussed in the first two parts.

GETTING READY

1. Be alert to the possibility of an extended W3 trade

- Identify the profitable low entry.
- Price should be near the close of the previous day.
- Price should gap down, opening below the close, then return above the close and fill the gap from the low of the day/morning, or vice versa. This is known as the *oops* phenomenon.
- Price gaps down, consolidates for several bars, then fills the gap from the low of the morning/day. Again, you have the *oops* phenomenon.

- Follow the price movement from downtrends to uptrend.
- Once a low is formed, wait for an upswing in wave 1A and its retracement or wave 2B (38.2 – 50%). After the retracement, you can set up for the wave 3C ride.
- Be aware that a low may not necessarily be the starting point for wave 1, but rather the end of wave B of an ABC correction. Wave C will follow, taking the form of a terminal-ascending triangle. A similar situation might take place when an impulse pattern has a wave 5 failure. This will be a classic double-bottom formation.
- Be aware of the formation of w1 of a future W3. It can coincide with the entry (as is the case in the example). The length of the move will give the tone:
 - o Five bars for a swing
 - o 13 for bars with an average trend, *and*
 - o 21–34 bars for an extended wave.

Often, the number of bars in a trend is in sync with the Fibonacci sequence — zero, 1, 1, 2, 3, 5, 8, 13, 21, 34, and 55.

The number of pullbacks varies from two to six, with each containing one to five bars.

2. Typical entry (see Figure 1)

- After the close of the breaking bar, apply these ratios: 1.5 (entry) and -0.5 (typical initial stop-loss). For long trades, add one tick to the entry and subtract one tick from the stop-loss. Do the converse for short trades.
- There shouldn't be any neutral bars prior to entry.

3. Initial stop-loss (see Figure 1)

- Place a buy-stop entry as soon as you detect a trading opportunity.
- Enter a typical initial stop-loss after your entry is executed.
- Analyze the situation to make the best-balanced risk/reward ratio choice through the use of typical or aggressive stop-losses.
- A long entry was executed at 4109.5 – 11:22 hours.
- A typical stop-loss of 11 points was placed at -0.5 ratio of the breaking bar (4098.5).
- An aggressive stop-loss was placed at 4103.5. This is the low of the third blue bar (second after the

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breaking bar), minus one tick; it gives a six-point initial stop-loss only.

- An aggressive stop-loss was placed at 4104.5. This is the daily pivot minus one tick. This is a five-point risk with the same stop potential and smaller risk. (See sidebar, "Stop-loss methodology.")

4. Breakeven and trailing stops

If price reaches your entry level then proceeds to move to the $1.618 * W1$ level, it is likely that a W3 is in progress. After the W2 retracement is completed, you could apply the typical ratios: 1.618 (4113), 2.618 (4124), and 4.236 (4142). These are going to be your money management parameters, your target and your trailing. The exact location of your trailing stop should be one tick below the typical ratio values.

The breakeven shouldn't be a problem when the slope of the trend is 45 degrees or more. The price will rapidly reach a comfortable distance from the entry and automatically protect your gain. When the slope of the trend is less than 45

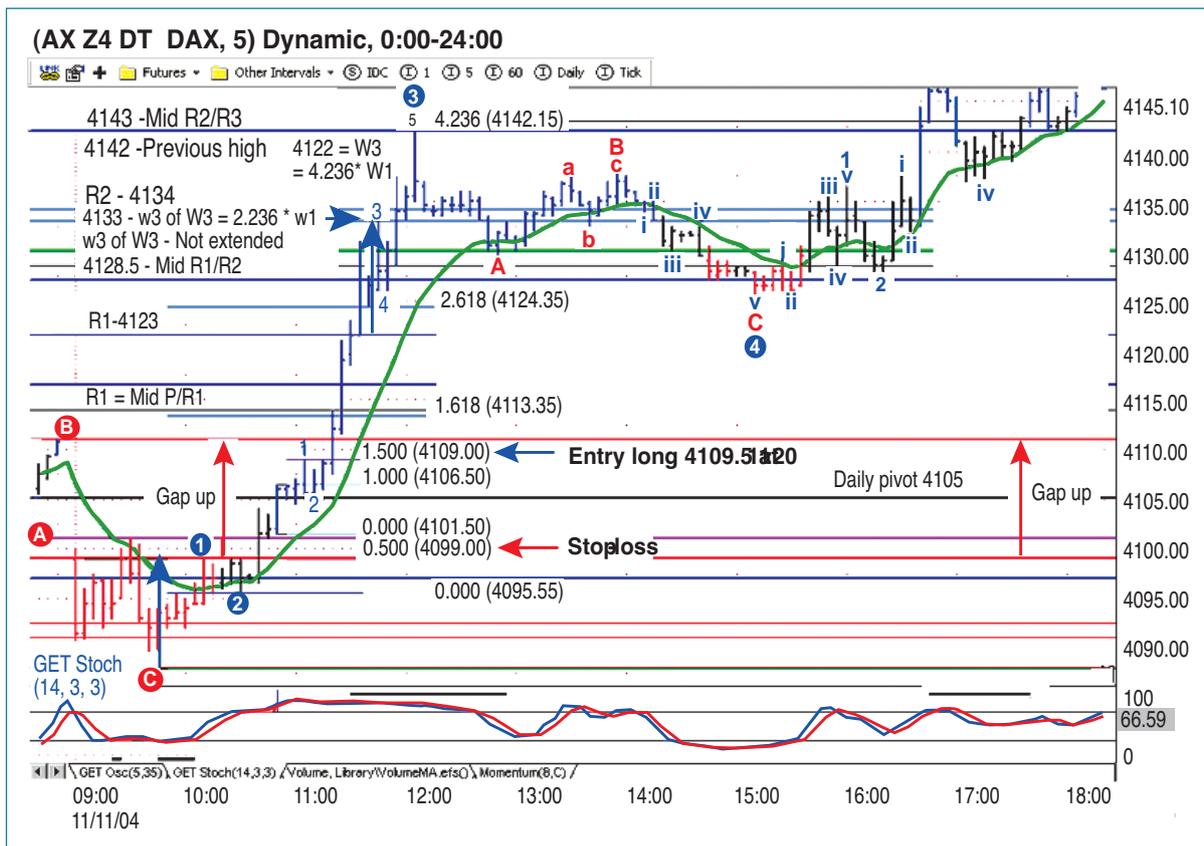


FIGURE 1: TRADING WAVE 3. Here's an example using the five-minute chart of the DAX futures on 11/11/04.

STOP-LOSS METHODOLOGY

- **Breaking bar:** As soon as you execute your entry, enter at 1.5 ratio of the breaking bar plus a tick (4109.5). The initial stop-loss is at -0.5 ratio of the breaking bar, minus a tick (4098.5). Observe the market closely to identify an optimal stop-loss rather than the typical stop-loss (-0.5 ratio).
- **Break-even stop (first stop):** When price reaches a running distance, place your first trailing stop at the 1.618 ratio. It should fall within the average of your ATR. You could exit here, but if you are willing to take more risk, this is when you add more units to your trade with the same stop-loss or even a tighter one.
- **Second trailing stop:** When the price is at a running distance of five points from this trail, place the second trailing stop one tick below the 1.618 ratio. If the price is moving along with big volatile bars, it is likely that W3 will be extended and the trend will end well behind 21 bars (typical length of an extended wave 3).
- **Third trailing stop:** Place this stop one tick below the 2.618 ratio when the price is at a running distance of 4.5 points from this trailing stop. If price continues up with volatile bars, you can be sure that the W3 is extended, and you just entered the third of the third wave territory (w3 of W3). Once again, the trend will end between 21 and 34 bars (Fibonacci numbers). When the swing is extended over the 2.618 ratio, it is likely it will reach 4.236, or even 6.85 ratios. So you make the 4.236 ratio your target. Now, it becomes tougher to catch the top. I highly recommend you not try this unless you have a strict trading plan with tight stops.

- **Subsequent trailing stops:** Once prices move above 2.618, you no longer apply the running distance concept. You would use a tight trailing-stop technique based on one or more of the following factors:

Regression trend channel (RTC) — Exit below the close of the first breakout bar under the lower channel line.

o *Reversal bar(s)* on lower time frame; exit below the low of reversal bar minus a tick.

Two-bar rule — When a market is trending higher, look for the top, which will be followed by two bars where the close will be lower than the open. This is a strong reversal signal. Use their synergy with other confirming factors such as reversal bars, divergences, and multi-time pivot clusters. You should wait for the open of the third bar to be under the close of the two prior bars. This rule does not work well with small range bars.

- **Dormant stop-losses:** The buy-stop (short trade exit) and sell-stop (long trade exit) technique is mainly used for extended wave trades. Instead of trailing the market price, it forecasts the price well in advance by searching for ratio-related profit nests. These stops are based on Fibonacci ratios: 4.236 or 6.85, and designed only for a complete exit. You could also use 1.618 or 2.618 ratios, but only for partial exits. If you are only trading one unit, the 1.618 ratio becomes the standard value. — *M.D.*

degrees, you should be wary not to be stopped out by a whipsaw and keep a safe distance from the price.

In addition, you could use the 21-bar average true range (ATR). I prefer to use a 3- to 5-point ratio on a five-minute chart. Some traders may recommend using 1.50 – 2.00 ratios of ATR for trailing stops.

- If a whipsaw stops you out, don't hesitate to reenter as soon as is feasible. This would be one tick above the high of the bar that initiated the pullback.
- If the established "running distance" is less than three points, it will be better to stay with the existing stop-loss value and establish the values of breakeven and trailing stop-loss later when the running distance reaches the acceptable capital preservation limits. Patience is gold!

KNOWLEDGE AND CONFIDENCE

To trade the markets, you need both knowledge and confidence: Knowledge explains how the market works, and confidence is your ability to use it. The more you see how the market reacts to your proposed strategy, the more you will believe in it. Ultimately, this will make you a self-confident

trader. And once you achieve this, you'll see why trading wave 3 can be extremely profitable.

Mircea Dologa began his investment and trading career in 1987. As a Commodity Trading Advisor, he subsequently founded a new teaching concept based on the practical aspects of trading. He may be contacted at mircdologa@yahoo.com or via his website at www.pitchforktrader.com.



SUGGESTED READING

Dologa, Mircea [2006]. "The Third Wave," *Technical Analysis of STOCKS & COMMODITIES*, Volume 24: May.

____ [2006]. "Trading The Trend In Wave 3," *Technical Analysis of STOCKS & COMMODITIES*, Volume 24: June.

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