Anatomy of a Winning Trade

By Sam Perdue

Introduction

Some people begin trading their own accounts because they may have had bad experiences with their previous broker. Others may trade the markets out of curiosity. Regardless of the driving intention, new traders may find themselves a bit overwhelmed at the plethora of different techniques, indicators and security types that are available to trade. In this article, I would like to introduce a possibility for making sense of the market movements and how a professional trader may create a high probability trade with limited risk. In explaining these concepts, I am assuming that you are familiar with charting securities and options spreads.

Elliott Wave

One of the techniques that traders use to determine market direction is the Elliott Wave. The Elliott Wave was created by R. N. Elliott. He noticed that the market did not move in a linear fashion. Markets would rise and fall while maintaining an overall trend. According to Elliott, these trends would unfold in patterns consisting of five and three waves. A five wave sequence that is followed by a three waves sequence completes a market cycle.

The five wave sequence.

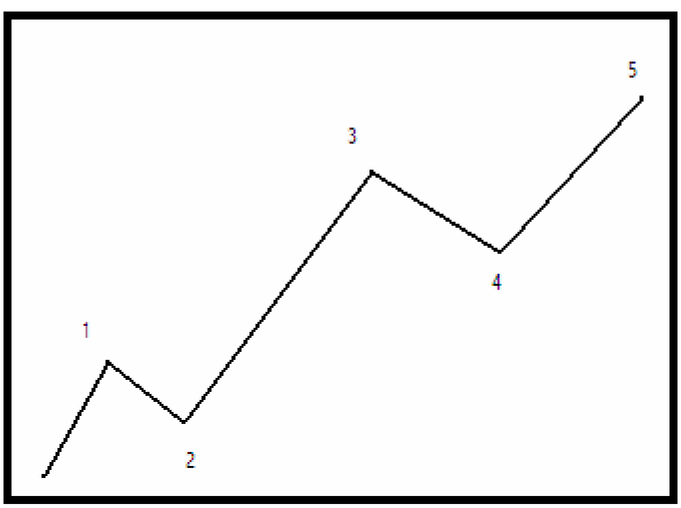

Figure 1

In Figure 1, we can see the basic five wave sequence of the Elliott Wave. Notice how the direction, in this example, is trending upward. Even though the market is moving upward, there are swings upward followed by corrections downward. One of the interesting things about this type of movement is that the corrections are smaller in price than the movement upward. Therefore, the overall trend is up.

Also in Figure 1, we can see that some waves have been labeled one through five. Waves 1, 3 and 5 are called impulsive waves. Waves labeled 2 and 4 are called corrective waves.

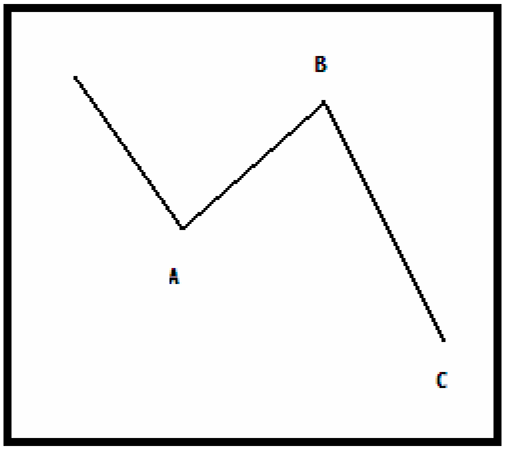

Figure 2

In Figure 2 we can see the basic three wave corrective sequence of an Elliott Wave. This corrective sequence follows the five wave sequence in figure 1. Corrective wave sequences are labeled A, B and C. Labeling corrective waves this way helps to differentiate them from an impulsive wave sequence.

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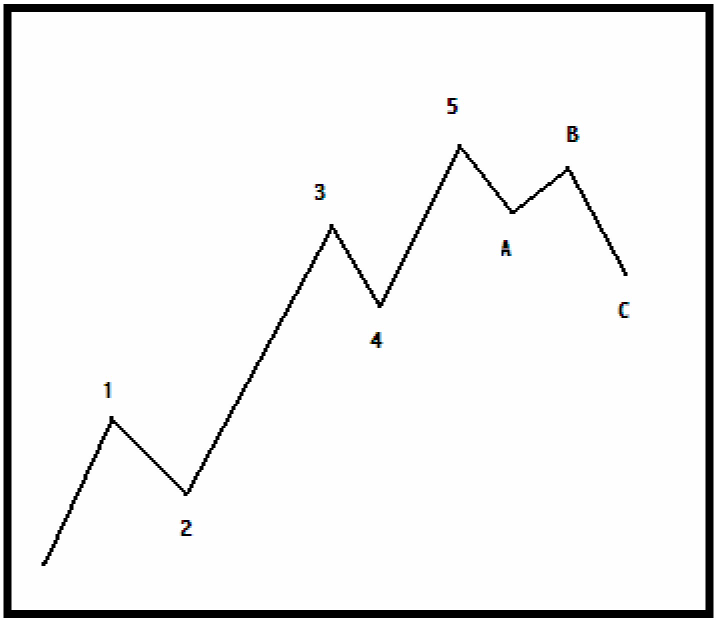

Figure 3

In Figure 3 we have joined the impulsive wave sequence in Figure 1 with the corrective wave sequence and Figure 2. Combining the two sequences together gives us a complete market cycle. In this case, we have a bullish impulsive wave sequence. But, we may also encounter a bearish impulsive wave sequence.

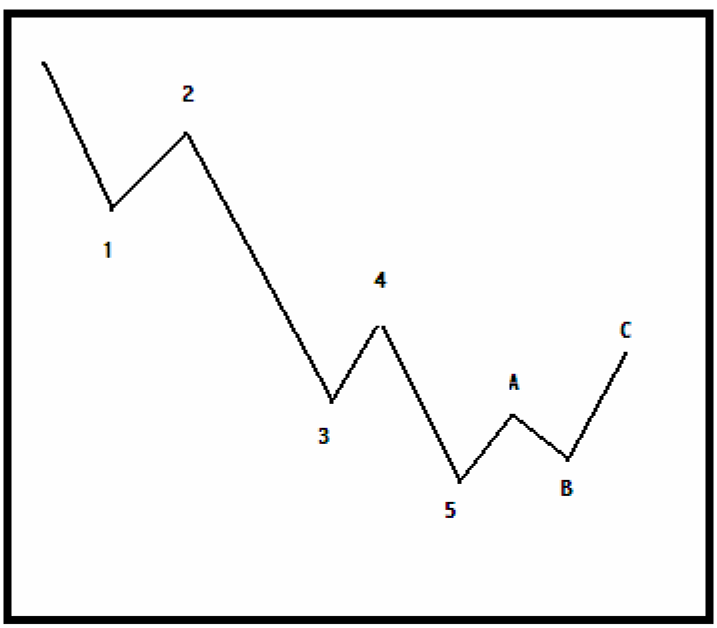

Figure 4

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In Figure 4, we can see a bearish impulsive wave sequence followed by a bullish corrective wave sequence. This may seem similar to the example in Figure 3. The difference is that in Figure 4 the impulsive wave is moving in a trend that is down. This shows us that the Elliott Wave model will function in a bullish or bearish market.

So what does all this mean?

When a trader finds that a wave 5 is unfolding, for example, they can anticipate that the current market trend may end soon and position themselves to take advantage of this information. Other assumptions could be made based of the wave patterns found in the Elliott Wave sequence. However, the Elliott Wave it is not a magic bullet. Simply because we find these patterns on a chart does not mean that the market must move in our anticipated direction. But, when we are able to examine the market direction using the Elliott Wave we are able to anticipate the next market wave. This allows us to anticipate the market movement and form an opinion as a basis for placing our trades. Whether traders use the Elliott Wave or some other trading methodology, incorporating some type of technical analysis can help in determining market direction.

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Figure 5

In Figure 5, we see a daily bar chart of Broadcom (BRCM). Notice that the market is currently in a corrective wave 4 (noted by the large red 4 on the right). Note also that we have smaller minor wave counts noted in blue. It is common to find smaller wave counts inside of larger wave counts. If all of this seems confusing, just remember that this stock is currently in a correction of it's in a bullish Elliott Wave sequence.

Now, the next logical question is what can we do with this type of information? If we were trading the stock we would look to time our entry. However, since an IntrepidTrader also allows us to incorporate options trading into our methodology, we have another possibility. In the next example, we will look at a credit spread for this stock.

A credit spread is created by purchasing one option and selling another option for a net credit to our account. In this case, since we are in a bull trend that is correcting, we will consider a bearish call spread. If you are unfamiliar with what a bearish call spread is, I will do my best to explain how this spread makes money and why it is probably a better trade for most traders than simply purchasing the stock. A full and detailed explanation as to how all this type of option spread makes money is beyond the scope of this brief explanation.

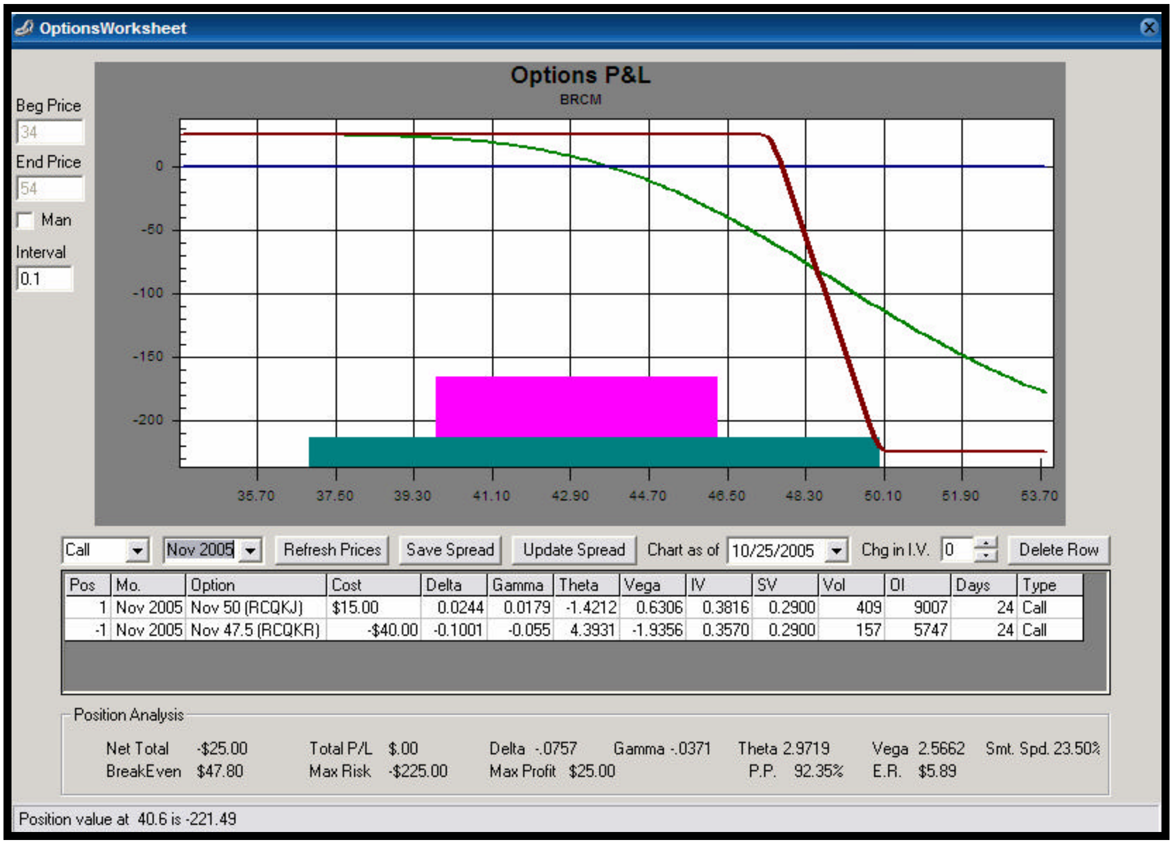

Figure 6

Since Broadcom is currently in a wave 4, we know that the current bullish trend is correcting. This means that the stock is currently moving against it's main trend. This correction began around $47.75. Therefore, we want to consider credit spreads where we are selling a call option (for a bearish call spread) at around $47.50 and, to limit our risk, we might consider purchasing a call option at $50. In this case, let's assume that we sold our $47.50 call for $40 and bought our $50.00 call for $15. The net would be a $25 credit to our accounts.

In Figure 6, we have a risk graph of the $47.50 / $50.00 Bear Call Spread. Below the graph is some additional information about the analytics of our spread. Notice the high probability of profit for this spread. There is over a 90% chance that this spread will make money over the next 24 days. This probability is based in part on the current volatility in this stock. If we collect the full credit, we will have a return of 11% for the 24 day period.

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Conclusion

Learning about Elliott Wave analysis will enable us to gage the over all mode of a market. As such, we can use it as a basis for forming an opinion to place our trades. When we combine the Elliott Wave with certain types of option spreads we can create trades with a high probability of making money. This probability is not based on an analysis of what has happened in the past, but an analysis of the statistical probability of what will happen in the future based on the current volatility in the markets.