

Understanding a Volatility Breakout System!

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Volatility Breakout systems are designed to take advantage of sharp jumps in price action. The trader is not concerned with forecast or analysis; he is only concerned with the immediate price action after a breakout.

Characteristics.

I measure the characteristics or conditions of volatile markets by the difference or spread between two moving averages, percent rate of change, gap openings, or an increase in the daily (weekly, monthly) range and my proprietary %C indicator.

Volatility breakout systems are based on the working premise that if the market moves a certain amount in one direction, a certain measure in a single direction or a particular percentage from a previous price level pointing one way, the odds favor some continuation of the move in the same direction for a period of time. The continuation period depends of the time frame being traded: day trade or swing trade for example or and the type of breakout pattern used.

The most well know breakout methods are day trader patterns. As day traders we look for range days: a trading session where the market opens on its low and closes on its high and an intraday breakout takes the trader long. Alternately, the market opens on its high and closes on its low and an intraday breakdown takes the trader short. As a natural rule ALL day trading systems exit no later than end of day but can exit anytime from entry to the end of day.

Keeping in mind a sense of proportion, a swing trade breakout system is looking for anything longer than a day range to capitalize on. A range week for example can be defined where the open on Monday is at the low of the week and the close Friday at the high of the week and the inverse is true for a down range week. Just like the day trader, the swing trader has a breakout signal that takes it long or short to take advantage of the range. As a side bar, Monday does not need to be the opening day and set-ups for a two or three day range can be used.

Two primary technical rules.

So with a breakout system, a trade is always taken in the direction that the market is moving at the time. It is usually entered via a buy or sell stop or with trade robots at the orders are executed at the market. The bit of continuation that the trader is playing for is based on time-tested principle of technical analysis: that "momentum tends to precede price". This working premise goes back to technical analyst like 1970's trade advisor Marty Zweig, in that a surge of momentum is followed by price. Another rule I have written and expanded upon many times is a extrapolation from Elliott Wave Theory: the rule of Alternation, Where the Elli titian uses "Alternation" to validate their description of corrective waves, the rule is much more pervasive in trading, I have sited that the behavior of the market is one that cycles from rest to motion and

back to rest. In other words the market tends to alternate between a period of equilibrium (a balance in the forces of supply and demand) and a state of disequilibrium or imbalance between supply and demand. When the market is not balanced, the trader witness's increases in measurements in the patterns mentioned above. More important to traders, it causes an expansion of the high/low range. It is during these periods of expansion that the market is seeking new levels. It is this breakout behavior that's causes the system to enter a trade. On the other hand and for contrast it is when your TV pundits smile and label the markets with price stability, that the market condition is not good for trading.

Basic Breakout Systems.

There are several ways to create short-term volatility breakout systems. I have compiled a good number of them over the years. The different types of systems based on a variety of bands, support and resistance, pivots and gap definitions.

For example my original system %C-DT was a channel breakout, which is simply buying a percent of range for the last "N days" plus the high with my %C as a filter. Another way to create short-term volatility breakout systems is to use an inside day breakout pattern where one buys the high or sells the low of the previous bar, a 1-period channel breakout is actually being used for the trigger.

The most famous long-term breakout system adapted by Richard Dennis originally developed by Dick Donchian was the 4-week channel breakout. All breakout systems seem to test profitably while some may need some fairly wide protective stops. Naturally some performed better than others and a few meet some very high standards.

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Jack F. Cahn, CMT
TraderAssist@

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Skype me today at traderassist
or call 800-618-3820 or (0) 617-5444-5762

U.S. Office: 7500 West Lake Mead Blvd. Suite 9-151, Las Vegas, NV 89128.
Phone: 800-618-3820, Cell 561-676-8167, Fax 509-356-1824
Australian Office: Box 991 Mooloolaba Beach, QLD. Australia 4557
Phone: 61-7-5444-5762, Cell: 61-4-2811-9889

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