Lesson 1 - Why Swing Trade?

Swing trading is an active form of trading lying in the middle between day trading and trend trading. Trend following or long-term trading seeks to hold positions for many weeks or months for every trade. As the name implies, trend following requires a trend. The challenge is finding a trend. Most markets DON'T trend but a fraction of the time. It is said that markets are in congestion, the opposite of trending, as much as 75 to 85% of the time. This does not leave many opportunities to trade.

The opposite end of the spectrum is day-trading. Day traders look to enter and exit a trade between the open and close of the same day. This can require near constant monitoring of price action throughout the day. Sometimes, all day.

What's left? Swing trading! This is trying to capture the waves up and down in the markets. Swing trading is possible in trending and non-trending markets. Thus giving it an advantage over trend-following. Further, constant monitoring of price action intra-day may not be required as is the case with many daytrade systems.

Swing trading takes advantage of the belief that markets act in 2 to 5 day moves on average. A market can have 2 to 5 days up. Followed by 2 to 5 days sideways. Followed by 2 to 5 days down. Then another 2 to 5 days up.

Below is a chart of Sugar for so far in 2014. The Green arrows are when the market is trending. the red arrows are counter-trend moves and the black arrows are congestion. For our purposes here, we define a trend to be a market making significant new daily highs above an upsloping 50 day moving average(shown). Or, making significant new daily lows below a downsloping 50 day moving average.

Hypothetical performance. Past performance is not necessarily indicative of future results.

by Lundy S. Hill

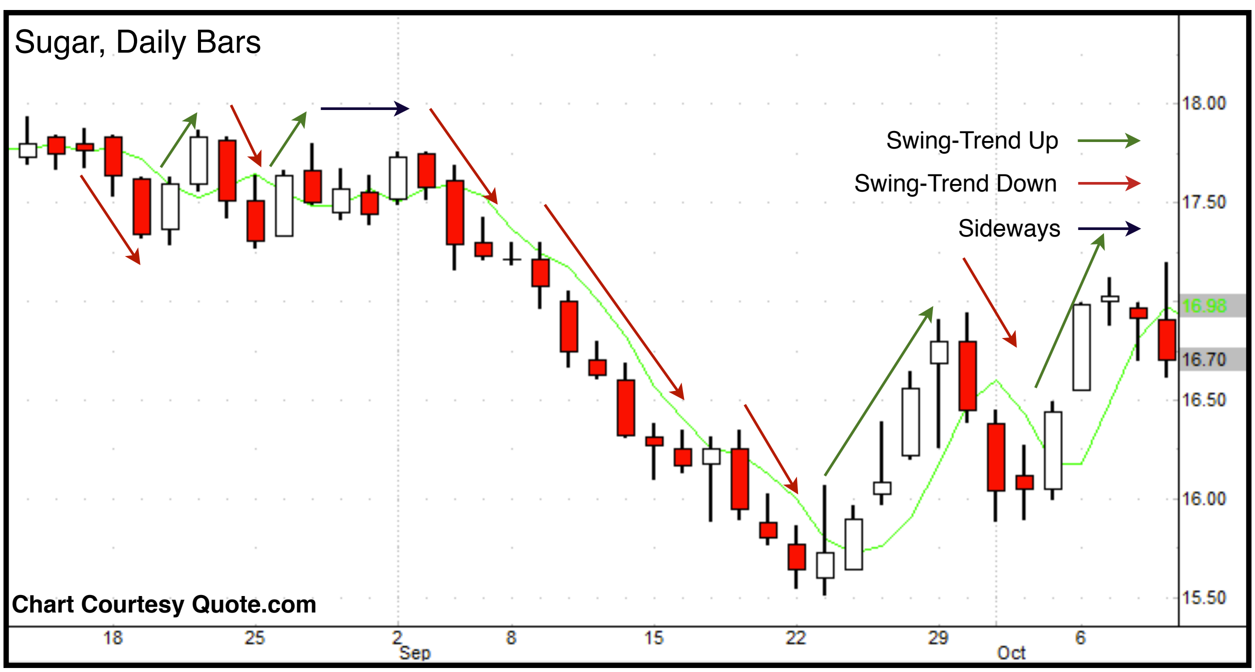
Sugar started the year with a continuation of the downtrend. Then a trend change and an uptrend. Both lasting about three weeks. Then, Sugar showed close to 5 straight months of congestion. This ended with two trending down phases. Ending most recently with a congestion phase. Depending on how close you count, you can see that this market only trended about 35 to 40% of the year thus far.

Of the four numbered trend phases, trend numbers 1, 2 and 4 showed dramatic counter trend moves to end the trend. This wiped out much of a trend followers profits.

This is just one reason I believe swing trading may provide a better approach to trading. If nothing more than diversification to trend followers and day traders. With this method, the trader is looking to capture price moves lasting 2 to 5 days. You can hold a trade longer too. Since we are zooming in on moves of this length, our stop losses may be much tighter. Thus, we hope, to capture a greater percentage of the moves the market gives us.

Below is the daily chart of the March 2015 Sugar contract. We have zoomed in on just the last three months of price action. Let's walk through this chart. The chart starts with what the trend-follower would call congestion. Looking closer, we see several 2 to 3 day moves both up and down. The active swing trader may be able to capture a portion of each of these.

The red arrows are swings down. The green arrows are swing ups. And, the black arrow is a sideways congestion pattern. It is apparent that at this level of "granularity" the market can offer the more active swing trader many more opportunities.



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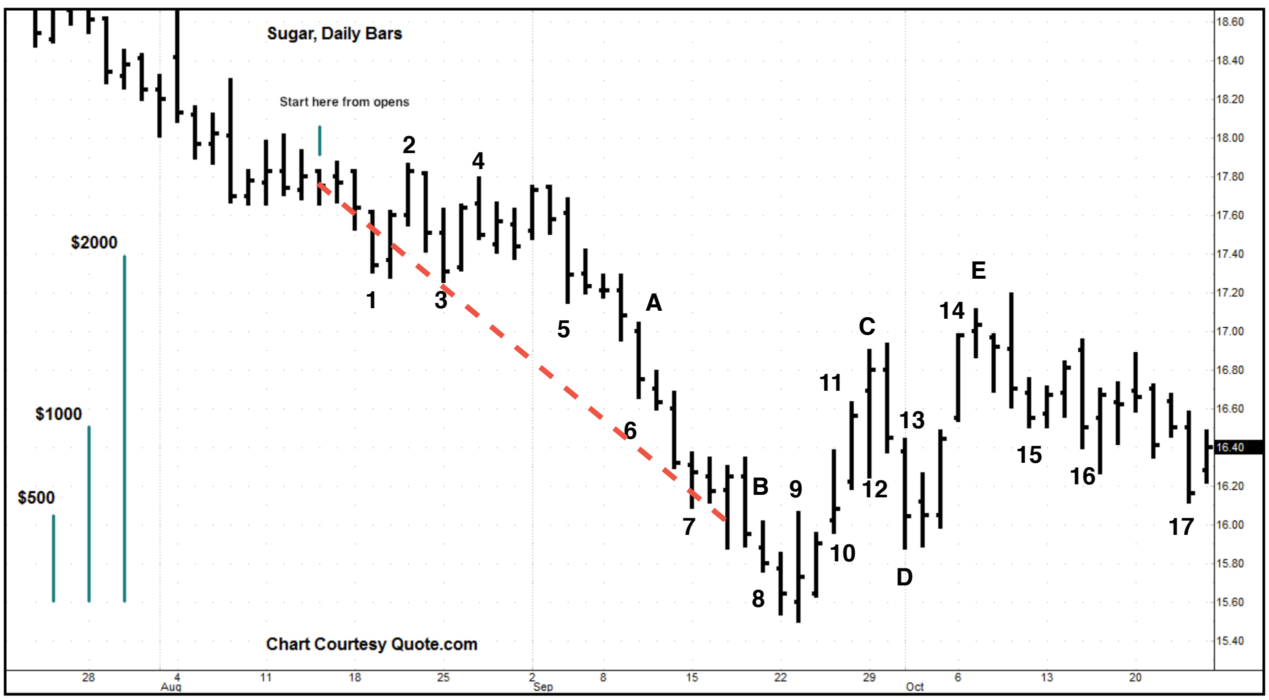
My father has always said "take a business man's profit." A food vendor can try to sell his hot dogs for $20. He may sell 1. Chances are that he won't. He will probably sell many, many more at $5. It is similar with trading. There are many more opportunities to make $500 than there are to make $2,000.

The following chart shows the frequency of $500, $1000 and $2000 moves in the recent action of the Sugar market. Here we are looking at moves of different dollar amounts from daily opening prices starting on August 14, 2014. Moves of $500 are numbered. Moves of $1000 are lettered. The one $2000 move is shown via a red dotted line. Once a trade has reached the designated profit amount, we move forward to the next day's open to look for the next move.

In the two plus months of this action, hypothetically, there was one chance to make $2000. There were five opportunities to make $1000. This equates to a total opportunity of $5000. There were 17 opportunities to make a "business man's profit" of $500. This equates to a total opportunity of $8500.



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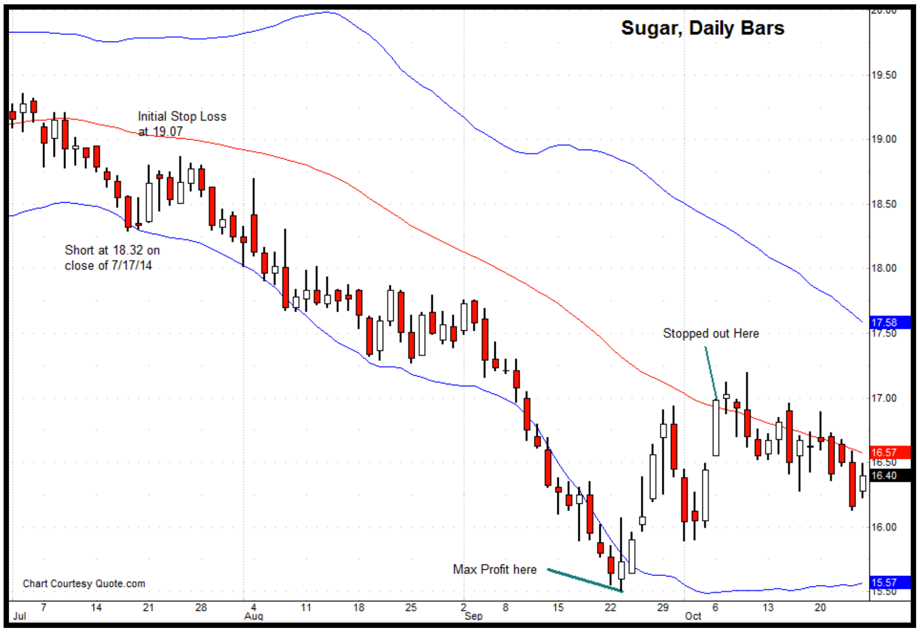
Traders may believe that swing trading is riskier than trend following. It is actually the opposite. Whenever a trend follower enters a trade, it is because of market action viewed to be out of the ordinary noise of daily price action. This means the trade is entered AFTER a considerable price move has ALREADY occurred. The market is "stretched" just as the trade is entered. Further, in order to prevent getting stopped out by minor market noise, the initial stop loss exit should be a considerable distance from the entry. This can mean larger losses compared to swing trading.

Also, when exiting the trade with a potential profit, much of the open trade equity can be given back. Let's use the sugar chart to demonstrate.



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This chart shows a simple Bollinger Band breakout trend following trade. A 40 day moving average with a two standard deviation Bollinger Band is used. A hypothetical short trade is entered on July 17, 2014 at 18.32. This is the first close below the lower bollinger band. The initial stop loss is above the moving average at 19.07. The initial risk is 75 ticks, or $840.

Maximum profit was reach at the low on September 23, 2014. This point was 15.51. This equates to a maximum profit of $3,147. This hypothetical trade was later stopped out at 16.93 on October 6 when price broke above the moving average. A hypothetical profit of 1.39 or $1,557 was made on this trend following trade. A nice amount of profit. But, this trade gave back about half the maximum favorable excursion reached at the low of the move.

This is not a condemnation of Trend Trading. It has it's strengths. Knowing it's weaknesses is one key to overcoming them. Giving back much of it's open trade profits before exiting is one of the main drawbacks. Our Rubicon Trend Following system has found a unique trading tool to try to capture more of the profits and give back less of the hard earned profits. We have found that after outsized moves, the stop loss should be moved in tighter. What is an "outsized" move? We found that a price move of 10 times the average true range qualifies and is a good time to tighten the stop loss.

Comparing this to the previous chart, we see that Sugar had six $500 moves and three $1,000 moves all while our hypothetical Bollinger Band trade is giving back open trade profits before eventually getting stopped out.

A key component of swing trading is knowing when to look for buys and when to look for shorts. In Lesson 2, we will zoom in even more to learn which days are "Buy Days" and which are "Sell-Short Days." This can dramatically help in getting a good entry to swing-trades.

Please email questions and comments to Lundy@Staffordtrading.com.

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