INTRODUCTION

The concepts, methods and systems presented in this book are the result of many years of study and research in the market. The approach is strictly technical and the results are definitive. The purpose of this book is not to entertain, but rather to equip the reader with specific concepts, tools and indexes to use in trading the markets.

Nothing in this book has been taken from a previous author's work. What you are about to read is original. I have tried to present the material in such a way that it will be readily understandable to the beginning trader as well as the seasoned professional who is familiar with systems technology. This is a difficult task. I realize that the beginner may find himself reading through the text several times in order to completely comprehend the material and the computer whiz kids will find the information overly simplified; however, I think the average trader will find the material set out in a way that is reasonably easy to follow.

The programmable calculator, due to its relatively inexpensive cost, is readily becoming an indispensable tool for the technical trader. All of the systems and indexes in this book can be programmed on most of the programmable calculators now on the market. Usually the dealer who sells programmable calculators also has personnel capable of writing programs to be used in the calculator and it should be easy for this person to program your calculator for any or all systems in this book.

Following any of these systems with a programmable calculator is extremely simple. Just punch in the latest price data, push the compute key and the answer will appear either on a register or on a printout in less than a second.

Most programmable calculators also have the capacity to store a particular program and data on a magnetic card; thus, by changing magnetic cards, you can go from one system to another in a matter of a few seconds.

The systems in this book have been programmed for the SHARP 365-P and the TEXAS INSTRUMENT TI-59 programmable calculators. For these units, I can supply the program on magnetic cards with operating instructions for any or all systems in this book for a nominal charge.

DIVISION OF CONCEPTS

This book is divided into ten different sections. The reason for this division is that each section can be studied independently of any previous or following section, except for Section I.

Section I should be read first, as it pertains to certain basic tools and definitions which apply to all following sections. For instance, if your initial interest is in directional movement, you may read Section I first and then skip to Section IV without having to first read Sections II and III.

However, **before beginning to trade** any of these systems, be sure to read Sections IX and X. The Table of Contents classifies the sections as described above.

WORK SHEETS

For each index and system presented in this book, a daily work sheet has been developed to facilitate following the method on a daily basis.

With the exception of the **Relative Strength Index**, which is a chart interpretation technique, all other indexes and systems can be followed using only the daily work sheets. It is not necessary to construct charts, although some traders may want to use charts as visual aids.

At the end of each section, an example of the index or system is worked out using the daily work sheet. If reading through the text does not give you an immediate grasp of the method, then it will all fall into place when you follow the example on the daily work sheet.

A blank copy of each work sheet is provided in the Appendix so it can be reproduced on any standard office copier and used in following the particular system on a daily basis.

CHARTS

Although it is not necessary to construct charts to follow the systems in this book, most technical traders subscribe to a good chart service.

I prefer the COMMODITY PERSPECTIVE charts because each commodity and currency is printed on a separate sheet 13 inches high and 10 inches wide. Ample space is provided after the last price bar to up-date the chart for the following week. These charts are received each Monday morning and are updated through the previous Friday.

An example of the COMMODITY PERSPECTIVE chart is presented with the **Relative Strength Index** in Section VI. If interested in using this type of chart, a subscription is available from:

Investor Publishing, Inc.
327 South La Salle
Chicago, Illinois 60604

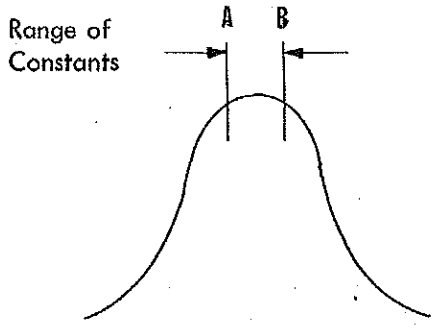
PARAMETER RANGES
(An infinite number of systems)

One of the problems in presenting a definitive technical system to a number of traders is the fear of the trader that others are trading the same system, causing a concentration of orders at the exact same point; thereby resulting in bad fills. This problem has been alleviated where possible by giving a range of parameters. Each trader can choose his own parameters and constants to use with the system **within the range given.** The differences in the end result will be insignificant.

For an example of this, suppose that a parameter for a hypothetical system states that a *Long* trade is to be exited on a 30% retracement from a new High to point P. The constant is then .30. In other words, measure the vertical distance from hypothetical point P to the highest point reached while in the *Long* trade. By taking 30% of that distance and subtracting it from the highest point, the stop price is determined.

How did the author of this system determine 30% to be the absolute best distance to use? If he determined the constant using only eight trades on one particular commodity or stock, he would have found that varying the distance just slightly could result in one bad trade and his overall result would be decreased significantly. However, if he determined this constant using 400 trades on each of 20 different commodities, he would have found that the results would be virtually the same if he had used 29% or 31%.There would be very little variation if he had used 28.4% or 31.6%.By using 27% or 33%, he would begin to see a small decrease in the overall profit. By using 20% or 40%, he might see a drastic reduction in his profit.

The results of this hypothetical situation can be compared to a 'bell curve.'



Point A represents the lower end of the range at 28%; Point B represents the higher end of the range at 32%. As long as the trader uses a constant between 28% and 32%, the results over the long run will be about the same.

The 'bell curve' analogy would be applicable to the range of constants given (where possible) for the systems in this book.

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SECTION I

BASICS

BASIC TOOLS

The following bar will quickly be recognized by most traders as that period of time representing one trading day.

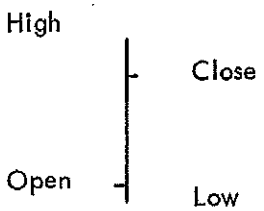


Fig. 1.1

The top of the bar represents the highest price at which the stock or commodity was traded during the day. The low extreme of the bar represents the lowest price at which the stock or commodity was traded during the day. The hash mark on the left side of the bar represents the opening price; the hash mark on the right side represents the closing price.

Reference will be made throughout the book to what is called a LOP and a HIP. LOP is an abbreviation used for LOW POINT. A LOP is any time bar which has a time bar immediately before it, and immediately after it with a higher low.

Fig. 1.2

A HIP signifies a HIGH POINT and is defined as any time bar which has a time bar immediately before it, and immediately after it, with a lower high.

Fig. 1.3

Another configuration which will be used constantly is a SIGNIFICANT POINT which is abbreviated SIP. A SIP must be defined as either a HI SIP or a LO SIP. The HI SIP is defined as being the highest price reached while in a *Long* trade. The LO SIP is defined as the lowest price reached while in a *Short* trade.

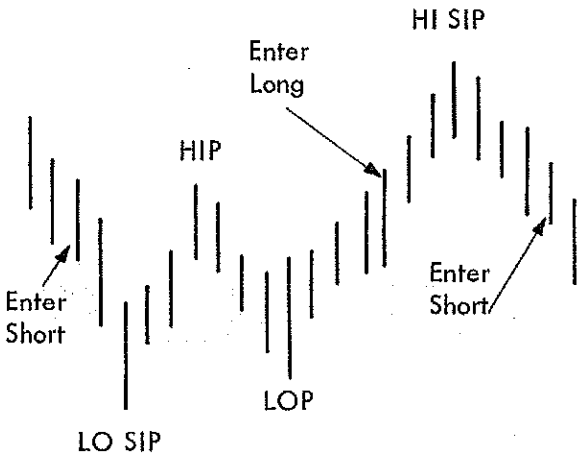


Fig. 1.4

SIC is the abbreviation for SIGNIFICANT CLOSE. The SIC is defined as the extreme favorable CLOSE made while in the trade. If *Long* the SIC is the HIGH SIC which is the highest close made while in the trade. If *Short*, the LOW SIC is the lowest close made while in the trade.

SAR stands for STOP AND REVERSE. This is the point at which a *Long* trade is exited and a *Short* trade is entered, or vice versa. These basic configurations will be referred to repeatedly in the text that follows.

THE MISSING PART OF MOST TECHNICAL TRADING PLANS

Most technical trading plans have two parts:

(1) A technical trading system

(2) A capital management technique

Most technical trading systems are trend-following systems. I believe a trend-following method is the most profitable method to use in trending markets. However, a trend-following method invariably gives back a good part of its profit when the market changes to non-directional sideways movement.

An anti-trend, congestion phase system is profitable in a sideways, non-trending market. However, the profits are smaller, the trades are more frequent and the commissions become a significant factor. When the market changes to a trending mode, the anti-trend system tends to become unprofitable.

In all the years I have spent developing and analyzing technical trading methods, I have yet to see any *one* system that is **consistently** profitable **in all markets.**

The answer then is to devise a rating scale upon which all commodities of interest to the trader can be rated as to whether trending or non-trending. This concept is explained in Section IV entitled THE DIRECTIONAL MOVEMENT INDEX.

There are several other things to consider also. The most profitable trending markets are usually the **volatile** trending markets; that is, the markets that are moving the fastest. This concept is explained in Section III entitled THE VOLATILITY INDEX.

Also, margin requirements and commission charges are factors to be considered.

All four of these factors are **appropriately weighted** and combined in THE COMMODITY SELECTION INDEX (CSI) explained in Section IX. The highest commodities on the CSI scale will be those which:

(1) Are high in directional movement,

(2) Are high in volatility,

(3) Have reasonable margin requirements relative to volatility and directional movement, and

(4) Have reasonable commission rates.

The missing part of most technical trading plans then, is a method for evaluating and determining **which** commodities to trade **when.** The answer presented in this book is THE COMMODITY SELECTION INDEX.

Before we take up some of the heavier concepts such as Directional Movement, Volatility, Momentum, etc., I want to present a relatively simple system which is also very profitable when used in a moving market. It is one of my favorite systems because it squeezes more profit out of an intermediate move (which lasts for two or three weeks) than any method I know. I call it the PARABOLIC TIME/PRICE SYSTEM.

usual for the following up swing to be composed of several small swings as long as the high and low of the main swing are not penetrated. When the low point of 58 was penetrated, the failure swing was completed. On the low of August 15, the failure swing carried up to 41 on the RSI scale. After several small down swings, this point was penetrated on the up side on August 26.

(4) **Support and Resistance:** Trend lines on the bar chart often show up as support lines on the RSI. Notice the support lines made by the low swing points during October and part of November could be used to confirm trend lines drawn on the chart. Depending upon who is drawing the trend line, a breaking of the trend line could have occurred on November 4; however, this was not confirmed on the support line drawn on the RSI.

(5) **Divergence:** Although divergence does not occur at every turning point, it does occur at most significant turning points. When divergence begins to show up after a good directional move, this is a very strong indication that a turning point is near. Divergence is the single most indicative characteristic of the Relative Strength Index. Note that the top made on November 9 was **indicated** by an RSI value above 70 and divergence. It was **confirmed** by the failure swing, breaking out of the pennant formation and breaking the support line.

The Relative Strength Index, used in conjunction with a bar chart, can provide a new dimension of interpretation for the chart reader. No single tool, method or system is going to produce the right answers 100% of the time. A successful trader utilizes several different kinds of input into his decisions. Often the problem is in narrowing this input down to two or three things that work best for him. In this context, the Relative Strength Index can be a valuable input into this decision-making process.

SECTION VII

THE REACTION TREND SYSTEM

The Reaction Trend System is just what the name implies — it is both an anti-trend system and a trend system. The normal mode of operation is the REACTION MODE (anti-trend). In the REACTION MODE, we buy on weakness and sell on strength. The anti-trend mode reverses at each buy point and most sell points. The TREND MODE of the system does not reverse, but exits the market at a trailing stop.

This system provides plenty of action. It will average making a trade about every two or three days. This system capitalizes on the kind of market most systems perform very poorly in; that is, those exasperating markets which have periods of non-directional congestion-type action and suddenly spurt to new highs or new lows. These markets will show up on the lower end of the Directional Movement Index scale.

Characteristically, this system makes money in a non-directional market; however, when the market suddenly becomes directional and moves rapidly, it will automatically go into its TREND MODE and follow the move. When the trend halts, the system reverts to the anti-trend or REACTION MODE.

Before we get into the rules for trading, let's look at the geometry of the system in order to understand the concept upon which the price action points are based. The high, low and close prices for each day generate FOUR PRICE ACTION POINTS for the following day. **These points are good for the following day only.** The four price action points are all based on the **average** of the high, low and close price for the day which is designated $\overline{X}$.

$$\overline{X} = \frac{H + L + C}{3}$$

The four price action points are:

(1) B_1 (Buy Point) = $2\overline{X} - H$
(2) S_1 (Sell Point) = $2\overline{X} - L$
(3) HBOP (High Break Out Point) = $2\overline{X} - 2L + H$
(4) LBOP (Low Break Out Point) = $2\overline{X} - 2H + L$

The geometry for these points is diagrammed in Fig. 7.1

All of the points are generated by three distances, D_1, D_2 and D_3.

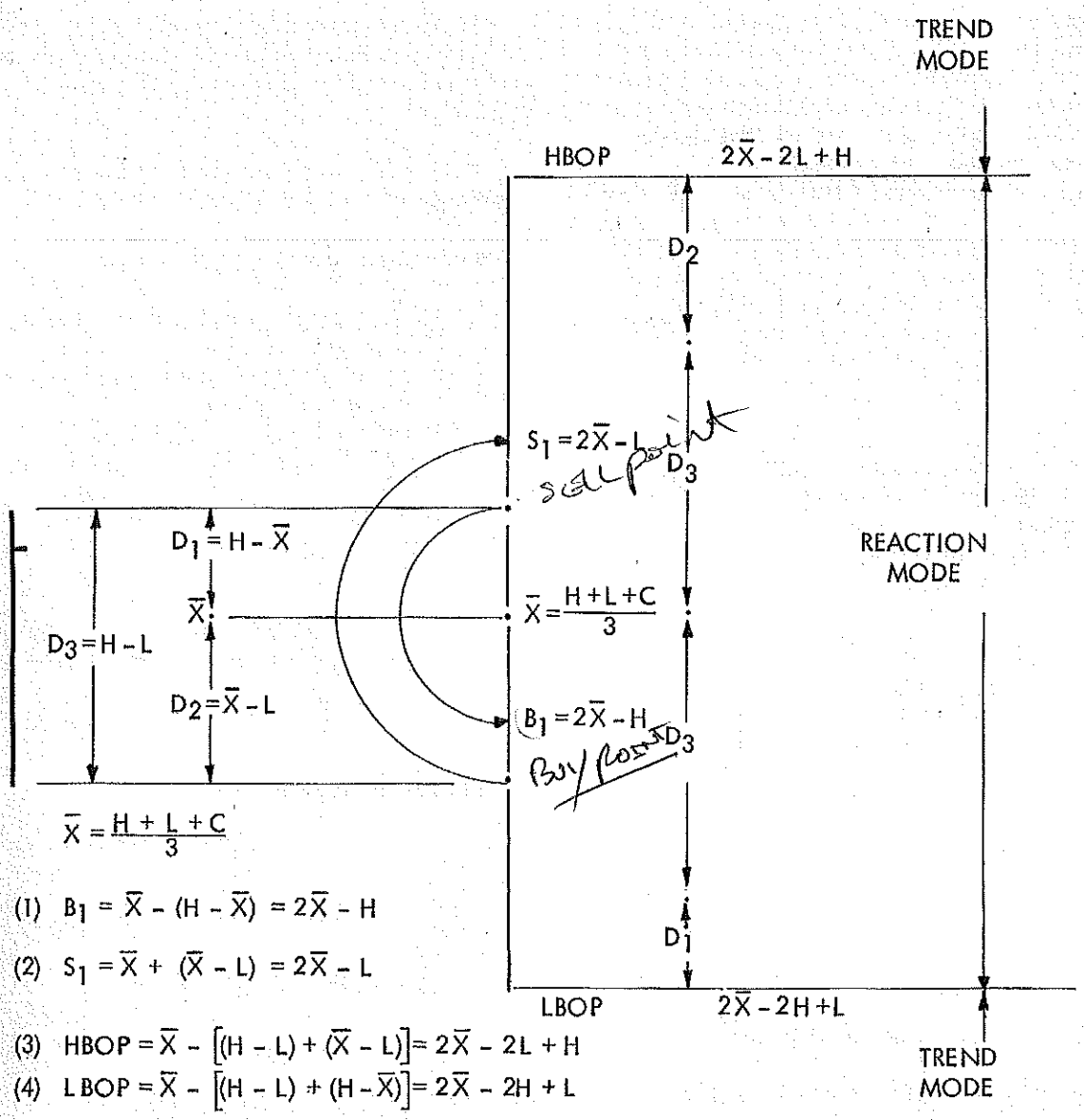
(1) D_1 is the distance from $\overline{X}$ to the high price of the day. The BUY POINT, B_1, is obtained by swinging D_1 through an 180° arc below $\overline{X}$.

(2) D_2 is the distance between $\overline{X}$ and the low price of the day. The SELL POINT, S_1, is obtained by swinging D_2 through an 180° above $\overline{X}$.

(3) D_3 is the distance between the high and low of the day. The HIGH BREAK OUT POINT, HBOP, is the distance D_3 plus D_2 above $\overline{X}$.

The LOW BREAK OUT POINT, LBOP, is the distance D_3 plus D_1 below $\overline{X}$. The $\overline{X}$ is the base point for derivation of the equation of each of the four price action points which are shown in Fig. 7.1

Before we discuss **when** to take a position, let's look at the price action relative to the four price action points. We stated that the normal mode of operation for the Reaction Trend system is the REACTION mode. We also said that the four price action points generated on one day are good for the following day only. We are in the normal REACTION mode when the prices for the next day **stay within the bounds** of the HBOP and the LBOP. In this mode, we buy at point B_1 and sell at point S_1.



(1) $B_1 = \bar{X} - (H - \bar{X}) = 2\bar{X} - H$

(2) $S_1 = \bar{X} + (\bar{X} - L) = 2\bar{X} - L$

(3) $HBOP = \bar{X} - [(H - L) + (\bar{X} - L)] = 2\bar{X} - 2L + H$

(4) $LBOP = \bar{X} - [(H - L) + (H - \bar{X})] = 2\bar{X} - 2H + L$

Fig. 7.1

If the price for the next day should **go through** the HBOP or the LBOP, the system is then automatically in TREND mode. Once in this mode, the stop becomes the most distant price of the previous two days. (If the price should go through the HBOP, the trailing stop is the lowest low made for the previous two days. If the price should go through the LBOP, the trailing stop is the highest high made for the previous two days.) We follow the price in the direction of the breakout with the trailing stop. When the price reacts enough after the breakout to trigger the trailing stop, we exit the market at the trailing stop. We then go back into the REACTION mode and remain until another breakout occurs.

This system is based on what appears to be a repetitious peculiarity of random price movement. This is the three-day-up-two-day-down phenomenon. This phenomenon is most

prevalent in a non-directional market or a lazily trending market. For some reason, random price movement appears to take longer to increase than it does to decrease. This appears to be indicative of most price action; that is, the down moves are more severe and of shorter duration than the up moves. Often a good directional move starts with a significant increase in range on the first day of the move. When this happens, the breakout points will be exceeded and the system will go into TREND mode and follow the move until the first reaction occurs — at which time the system automatically reverts to the REACTION mode.

Now let's discuss the question of WHEN to enter the market. We look back over the price action for the last two or three weeks and select the **significantly lowest price** (Fig. 7.2).

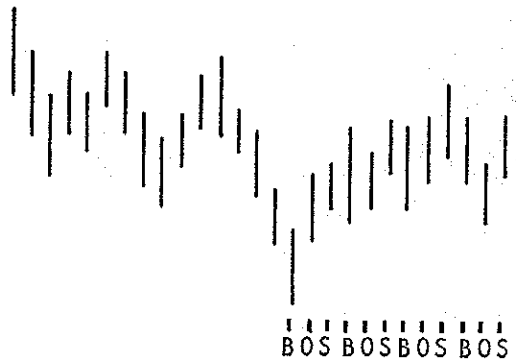


Fig. 7.2

We place a "B" under that day.

We place an "O" under the following day.

We place an "S" under the next day.

We designate all following days in the sequence, "B", "O", "S", "B", "O", "S", "B", "O", "S". (This represents nine days of the sequence.) We continue to designate all of the days in this sequence until we get to today.

If the market is in a general down trend, we can pick out the **significantly highest price** for the last two or three weeks and label the high point "S". The next day of the sequence would be "B", the following day, "O", etc.

An alternate method to begin the "B", "O", "S" sequence would be at a PHASING change or confirmation (after a breakout) which we will explain later.

Following are the **basic** principles for trading the REACTION TREND SYSTEM.

For trading the REACTION MODE:

(1) *Long* (BUY) positions are initiated **only** on a "B" day.
(2) *Short* (SELL) positions are initiated **only** on an "S" day.
(3) NO positions are initiated on an "O" day **except** those initaited by the breakout points, HBOP or LBOP.
(4) *Long* positions may be closed out on an "O" day or reversed on an "S" day.
(5) *Short* positions are reversed on a "B" day.
(6) The target and reverse point for a position initiated at B_1 is always S_1.
(7) The target and reverse point for a position initiated at S_1 is always B_1.

For trading the TREND MODE:

(1) Breakout points, HBOP and LBOP, are **stop and reversal** points for open positions in the Reaction Mode. They are also **entry** points for a new position. Any position initiated at HBOP or LBOP is taken on **any** day it occurs.
(2) The **stop** for any Trend Mode position is always the trailing stop. This Trailing Stop is **not** a reverse.

Now let's discuss how these rules are used. Assuming that we have designated our previous days as either "B", "O", or "S", we are ready to begin trading the Reaction Mode of this system. Suppose, however, that tomorrow is an "O" day. We cannot **initiate** a position on an "O" day, so we calculate the four price action points for the following "S" day. On the following "S" day, we can only go *Short*, and then **only** if the price touches the S_1 sell point. Assume that the price touched S_1 and we go *Short* (Fig. 7.3), Day 2.

On Day 2, the price went down and penetrated the B_1 target; however, we do not

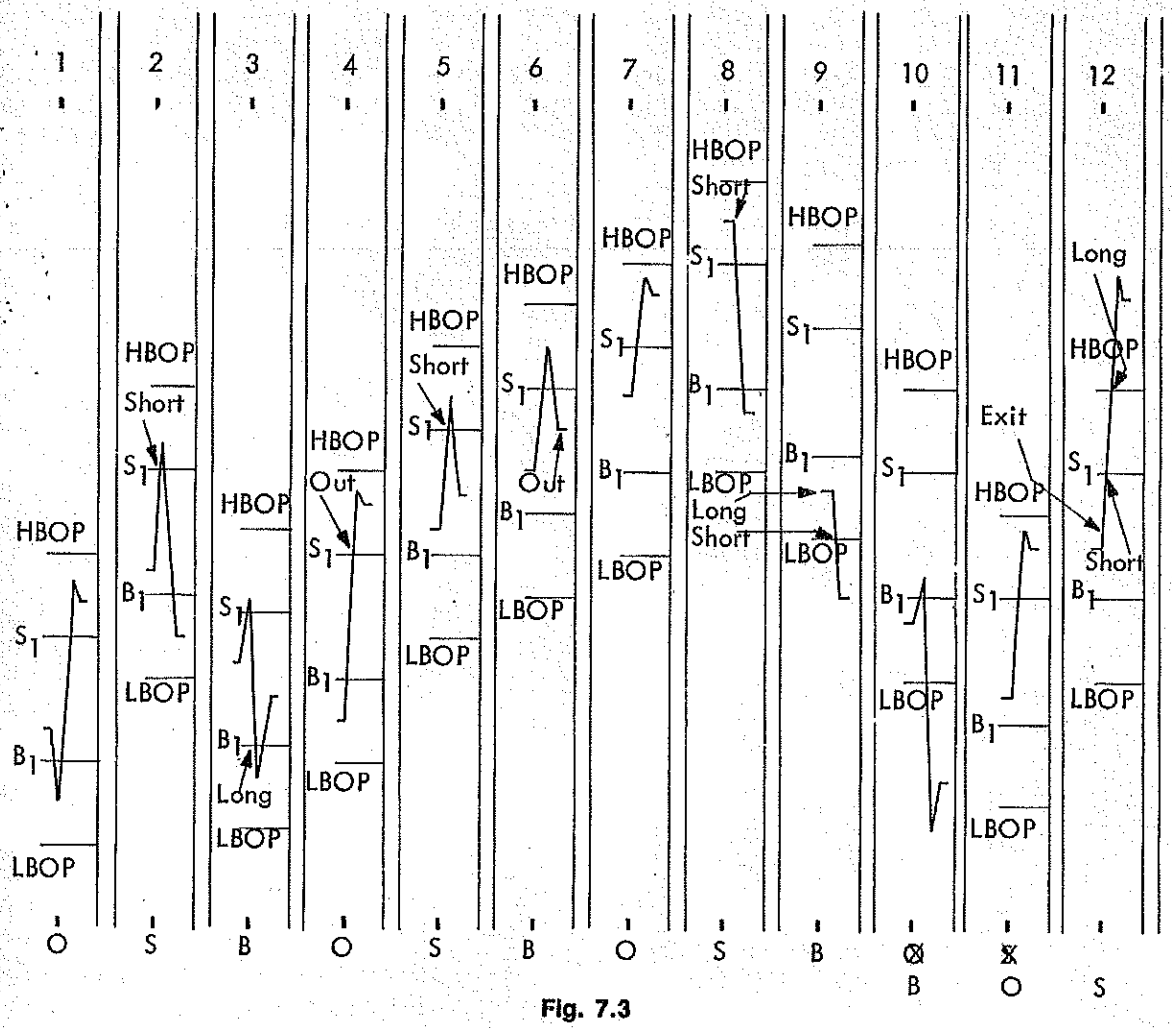


Fig. 7.3

take profits on day of entry. We must wait for the following "B" day to take profits and reverse at B_1.

On Day 3, a "B" day, the price came down, touched the B_1 buy point and we reversed to *Long* because we can only buy on a "B" day.

On Day 4, the price continued up, went through the S_1 point and we took profits at S_1 because **S_1 is a target only on an "O" day.** We cannot reverse and/or initiate a new position on an "O" day while in the Reaction Mode.

On Day 5, an "S" day, we go *Short* at S_1.

On Day 6, a "B" day, the B_1 price is not touched; therefore we exit the market on the **close** of Day 6.

On Day 7, an "O" day, we cannot initiate a new position unless the price penetrates one of the breakout points; in which case, we **would** initiate a position, enacting the Trend Mode and using the trailing stop. This did not occur; therefore, we continue in the Reaction Mode.

On Day 8, an "S" day, the price opened **above** the S_1 point, so we went *Short* on the open. The price then went directly down through the B_1 point and closed on the low. Since we do not exit a trade on the day it is initiated (unless the price penetrates one of the breakout points), we remain in the trade on Day 8.

On Day 9, the price opens **below** B_1; therefore, we went *Long* on the open, reversing the previous *Short* position. The price continues to drop, goes through the LBOP and we go *Short.* We are now in Trend Mode and will follow this *Short* trade with the trailing stop.

On the day of the breakout, we use the highest high of the two previous days as the trailing stop. After the market closes, we compare the high made today and the high made yesterday. The higher of the two will be the trailing stop to use for tomorrow.

On Day 10 and Day 11, we remain in the *Short* trade. The trailing stop was not touched.

On Day 12, the price reacts and we exit the market at the trailing stop (which was the high made on Day 11). We **do not reverse**. We are now back in the Reaction Mode (Anti-trend).

PHASING TECHNIQUE

(For use **only after** a Trend Mode Trade)

Now we come to a very important part of this system which has not yet been explained. This part is the PHASING TECHNIQUE, and here is the rule:

(1) The day on which the **lowest** price was reached while in a *Short* TREND MODE trade (initiated by LBOP) is designated as a "B" day; or

(2) The day on which the **highest** price was reached while in a *Long* TREND MODE trade (initiated by HBOP) is designated as an "S" day.

Notice that the lowest price reached while in the *Short* Trend Mode trade was made on Day 10; therefore, Day 10 (which was previously an "O" day) is redesignated as a "B" day. Maintaining the same sequence, Day 11 is then designated as an "O" day, etc.

Here is another important point. Suppose on Day 11 the price had continued to go up and had broken through the HBOP. In this case, we would have gone *Long* at the HBOP which would have put us in the Trend Mode. Our trailing stop for Day 11 would have been the low on Day 10. **It is therefore possible to go from the *Short* Trend Mode to the *Long* Trend Mode and vice versa without initiating a trade in the Reaction Mode.**

Day 12 is an "S" day. We go *Short* at S_1; however, the price continued to go against our position and broke through the HBOP. We reversed and went *Long* at the HBOP. We are now back in Trend Mode and following the price **up** with the trailing stop.

Let's say that the price continues to go up for two more days, reacts, and we exit the market at the trailing stop. We are now back in the Reaction Mode. We must, at this point, ascertain that our phasing is correct. The day upon which the highest price was reached will be an "S" day. If it happens to be an "S" day under the previous phasing, then no change is made; however, if it is **not** an "S" day under the previous phasing, then it must be designated as an "S" day and the phasing continued in the sequence "B", "O", "S", "B", "O", "S", etc.

One other important thing. Can a Reaction Mode trade be initiated on the same day that a Trend Mode is stopped out? The answer is YES . . . if there is at least one day between the lowest or highest day, and the day the Reaction Mode trade is initiated.

If we are stopped out of a *Short* Trend Mode trade, the lowest day will be a "B" day and the following day must be an "O" day, which means that a Reaction Mode trade cannot be initiated until the following "S" day. Conversely, if we are stopped out of a *Long* Trend Mode trade, the highest day will be an "S" day and the following day will be a "B" day. However, **no position can be taken on the "B" day because it cannot be ascertained until the close** that the previous day was, in fact, the highest day.

Now that we have a basic understanding of the system, we will set out the complete rules. Study these rules in light of the previous discussion and then we will recap the procedure, cover the mathematics and work through an example on the work sheet.

REACTION TREND RULES

GENERAL:

Begin trading in REACTION MODE. Switch to TREND MODE on any day that the price crosses a breakout point, HBOP or LBOP. Stay in TREND MODE until stopped out at the trailing stop. **Do not reverse** at the trailing stop. Adjust PHASING if necessary and resume trading in the REACTION MODE.

REACTION MODE:

PHASING:

(1) Find a **significant low point** two to three weeks prior to initiating the first trade. Designate the day of this low point as a "B" day. Designate all following days in sequence, "O", "S", "B", "O", "S", etc.

(2) If a previous high point is most significant, then designate that day as an "S" day and continue the sequence "B", "O", "S", etc. The initial phasing may also be determined by the following Rule (3).

(3) Whenever the price penetrates a breakout point, HBOP or LBOP, adjust, if necessary, the phasing as follows:

(A) Designate the **highest** day while in a *Long* TREND MODE trade as an "S" day and continue the sequence, "B", "O", "S", etc.

(B) Designate the **lowest** day while in a *Short* TREND MODE trade as a "B" day and continue the sequence, "O", "S", "B", etc.

ENTRY:

(1) *Long* at B, on a "B" day **only**.

(2) *Short* at S, on an "S" day **only**.

EXIT: (non-reversing)

(1) From a *Long* position:
(A) At S_1 on an "O" day.
(B) At CLOSE on an "S" day if S_1 (reverse point) is not touched.
(C) Do not exit on day of entry except at LBOP which is a **reverse** on **any** day.

(2) From a *Short* position:
(A) At CLOSE on a "B" day if B_1 (reverse point) is not touched.
(B) Do not exit on day of entry except at HBOP which is a **reverse** on **any** day.

REVERSE:

(1) From a *Long* position:
(A) At S1 on an "S" day.
(B) At LBOP on any day.

(2) From a *Short* position:
(A) At B1 on a "B" day.
(B) At HBOP on any day.

TREND MODE

ENTRY:

(1) *Long* at HBOP on any day.
(2) *Short* at LBOP on any day.

EXIT:

(1) From a *Long* position at the trailing stop. (The lower of the two previous day's lows.) This is a stop only — not a reverse.
(2) From a *Short* position at the trailing stop. (The higher of the two previous day's highs.) This is a stop only — not a reverse.

REVERSE:

None in Trend Mode.

Before we explain the mathematics for this system, let's review the options we have for each day:

On the "B" day, let's assume we went *Long* at B_1. On this day, we do not exit at the S_1 price action point. We will exit on the "B" day **only** if the price goes against us enough to cross the LBOP, at which point we will reverse to *Short.* Let's say that the price moved in our favor on the "B" day. When the market closes, we take the high, low and close price and generate the price action points for the following day, which is an "O" day.

On the "O" day, we have two options. If the price moves far enough in our favor to touch S_1 we will take our profits and get out of the market — we will **not** reverse. If the price goes through a breakout point, we will enter the Trend Mode and follow the price with the trailing stop. If the price does not reach S_1 on the "O" day nor does it go through a breakout point, then no action is taken on the "O" day. When the market closes, we calculate the price action points for the following "S" day.

On the "S" day, we **must** exit the *Long* position one way or another. On the "S" day, there are three options available to us. If the price continues to go in our favor and touches the S_1 sell point, we will **reverse** our position at that point. If the price crosses a breakout point, we will follow the Trend Mode. If the price does neither of these, we will **exit on the close**, but **will not reverse.** In this case, we will plan to go *Long* the following "B" day at B_1. (If the price does **not** go down enough on the "B" day to trigger B_1, we will stay out of the market.)

Now let's say that on the "S" day we are reversed at S_1. As soon as we are reversed, our stop is the HBOP which is a reverse to put us *Long* in the Trend Mode. If the price drops down and crosses B_1 on the "S" day, we **do not exit** but stay with the position. Let's say that when the market closes on the "S" day, we are still *Short.* We calculate the price action points for the following "B" day.

On the "B" day we **must** exit the *Short* position one way or the other. If, on the "B" day, the price goes down and touches B_1, we will reverse from *Short* to *Long.* If this happens, the stop will be the LBOP which is also a reverse to put us in the Trend Mode with a *Short* position. However, if the price on the "B" day **does not** go low enough to reverse our open *Short* position at B_1 and **does not** go high enough to reverse into the Trend Mode at HBOP, then we will exit the market on the **close.** If this happens, we could not take a new position on the following "O" day but would wait and try to take a *Short* position on the "S" day at S_1. If the price never reaches S_1 on the "S" day, we will still be out of the market and would attempt to enter *Long* at B_1 on the following "B" day.

On **any** day that the price crosses either the HBOP or the LBOP, we are automatically in Trend Mode and follow **only the Trend Mode rules** until stopped out by the trailing stop.

Normally, we would enter Trend Mode on a reversal or new entry from the Reaction Mode trade; however, it is possible, if we are **not** in the market while the system is in Reaction Mode, that the price could **open above** the HBOP or **below** the LBOP. In this case, we would enter either *Long* or *Short* as applicable. This is the only way we could enter the Trend Mode without reversing from the Reaction Mode if we were not in an open position.

Now let's look at a hypothetical example illustrated on the following chart and work sheet.

The prices for Day 1 are as follows:

High: 51.50 Low: 50.50 Close: 50.50

The prices for Day 1 are used to calculate the price action points for Day 2.

DAILY WORK SHEET

THE REACTION TREND SYSTEM

DATE		OPEN	HIGH	LOW	CLOSE	$\bar{X}$	$2\bar{X}-H$ B_1	$2\bar{X}-L$ S_1	$2\bar{X}-2L+H$ HBOP	$2\bar{X}-2H+L$ LBOP
1	S	51.00	51.50	50.50	50.50					
2	B	50.50	51.00	50.00	51.00	50.83	50.16	51.16	52.16	49.16
3	O	51.00	51.20	50.50	51.00	50.67	50.34	51.34	52.34	49.34
4	S	51.10	51.50	50.50	50.50	50.90	50.60	51.30	52.00	49.90
5	B	51.00	51.00	50.10	51.00	50.83	50.16	51.16	52.16	49.16
6	O	50.50	50.50	49.00	49.50	50.70	50.40	51.30	52.20	49.50
7	S	49.50	49.50	48.00	48.00	49.67	48.84	50.34	51.84	47.34
8	B	48.00	48.50	47.50	47.80	48.50	47.50	49.00	50.50	46.00
9	O B	47.20	48.20	47.00	48.20	47.93	47.36	48.36	49.36	46.36
10	O	48.50	49.50	47.70	49.50	47.80	47.40	48.60	49.80	46.20
11	S	49.80	50.50	49.00	49.20	48.90	48.30	50.10	51.90	46.50
12	B	49.00	49.75	48.80	49.40	49.57	48.64	50.14	51.64	47.14
13	O	49.50	50.30	49.30	50.30	49.32	48.89	49.84	50.79	47.94
14	S	50.00	50.80	49.60	49.80	49.97	49.64	50.64	51.64	48.64
15	B	49.80	50.50	49.20	50.20	50.07	49.34	50.54	51.74	48.14
16	O	50.00	50.20	49.50	50.10	49.97	49.44	50.74	52.04	48.14
17	S	49.80	49.80	48.90	48.90	49.93	49.66	50.36	51.06	48.96
18	B	49.00	49.50	48.50	49.20	49.20	48.60	49.50	50.40	47.70
19	O	49.50	49.80	49.00	49.20	49.07	48.64	49.64	50.64	47.64
20	S	49.00	49.70	48.80	49.30	49.33	48.86	49.66	50.46	48.06
21	B	49.40	49.85	49.00	49.20	49.27	48.84	49.74	50.64	47.94
						49.35	48.85	49.70	50.55	48.00
22	O	49.50	50.00	49.00	49.50					
23	S	49.50	50.00	49.00	49.50	49.50	49.00	50.00	51.00	48.00
24	B	49.50	50.00	49.00	49.50	49.50	49.00	50.00	51.00	48.00
25	O	49.50	50.00	49.00	49.50	49.50	49.00	50.00	51.00	48.00
26	S	49.50	50.00	49.00	49.50	49.50	49.00	50.00	51.00	48.00
27	B	49.50	50.00	49.00	49.50	49.50	49.00	50.00	51.00	48.00
28	O	49.50	50.00	49.00	49.50	49.50	49.00	50.00	51.00	48.00
						49.50	49.00	50.00	51.00	48.00

COMMODITY ________________ CONTRACT MONTH ________________

ENTRY	EXIT	P&L	ACTION and ORDER
50.16			Accum
51.30	51.30	+1.14	
50.16	50.16	+1.14	+2.28
49.50	49.50	-.66	+1.62
	48.50	+1.00	+2.62
50.10			
	49.60	+.50	+3.12
50.64			
49.34	49.34	+1.30	+4.42
	48.90	-.44	+3.98
48.60			
	49.64	+1.04	+5.02
49.66			
	49.20	+.46	+5.48
50.00			
49.00	49.00	+1.00	
	50.00	+1.00	
50.00			
49.00	49.00	+1.00	
	50.00	+1.00	

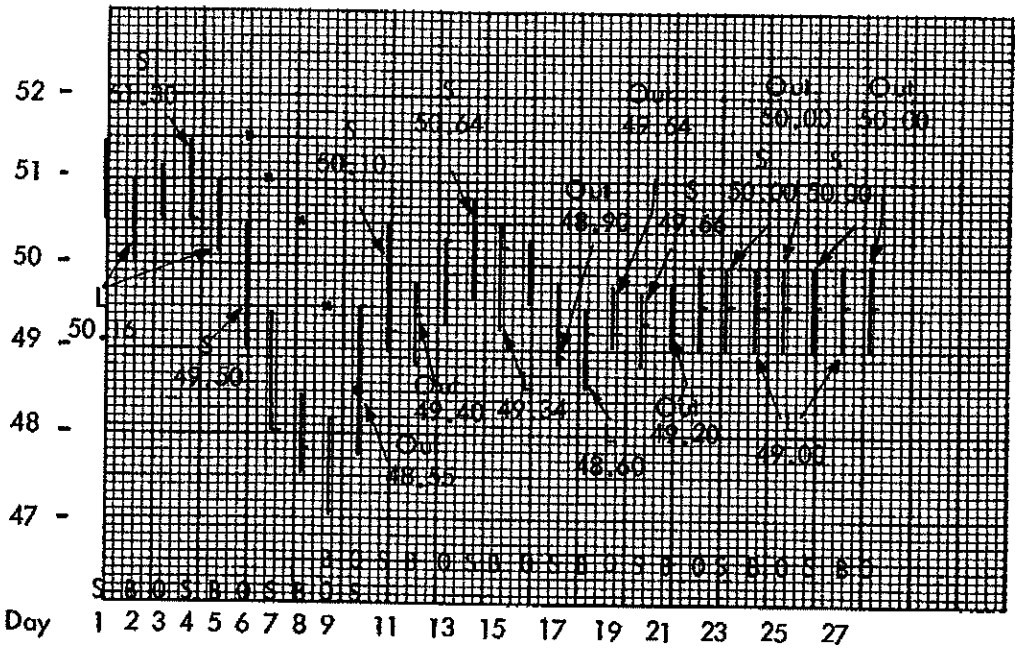


Fig. 7.4

$$\overline{X} = \frac{H + L + C}{3}$$

$$= \frac{51.50 + 50.50 + 50.50}{3}$$

$$= \frac{152.50}{3} = 50.83$$

(1) $B_1 = 2\overline{X} - H$
$= 2(50.83) - 51.50$
$= 101.66 - 51.50 = 50.16$

(2) $S_1 = 2\overline{X} - L$
$= 2(50.83) - 50.50$
$= 101.66 - 50.50 = 51.16$

(3) $HBOP = 2\overline{X} - 2L + H$
$= 2(50.83) - 2(50.50) + 51.50$
$= 101.66 - 101.00 + 51.50$
$= 52.16$

(4) $LBOP = 2\overline{X} - 2H + L$
$= 2(50.83) - 2(51.50) + 50.50$
$= 101.66 - 103.00 + 50.50$
$= 49.16$

Now that we have calculated the four price action points for Day 2, we insert them in the appropriate columns on the line for Day 2. For this example, we will assume we have determined that Day 1 is an "S" day and therefore, Day 2 is a "B" day.

Since Day 2 is a "B" day, we are concerned with only three of the four price action points; i.e., B_1, LBOP, and HBOP. On the following "B" day, we will attempt to go *Long* at 50.16. The stop and reverse is the LBOP at 49.16

On Day 2, the price touches B_1 and we go *Long* in the market at 50.16. After the market closes this day, we calculate the four price action points for Day 3, which is an "O" day. On the "O" day, we will attempt to exit the market at S_1 if reached.

On Day 3, the high was 51.20 so we did not reach the S_1 target of 51.34. We calculate the four price action points for Day 4 and note that the S_1 for Day 4 is 51.30.

On Day 4, the price hit S_1 and we reversed our position to *Short* at 51.30. We also gave the broker our stop and reverse point, the HBOP at 52.00.

Day 5 is a "B" day and we reverse the *Short* position to *Long* at B_1, 50.16. The stop and reverse point after taking the *Long* position is the LBOP at 49.16.

On Day 6, the price falls out of bed and dives through the LBOP at 49.50. We go *Short* at this point and are now in Trend Mode. We immediately give the broker the stop for today of 51.50, which is the higher high of the two previous days.

Our trailing stop for Day 7 is 51.00.

On Day 8, the trailing stop is 50.50. On Day 9, the trailing stop is 49.50. On Day 10, we are stopped out at the trailing stop at 48.50. Since this is a Trend Mode trade, we do not reverse but simply exit the market at the stop. The first thing we must do after being stopped out of a Trend Mode trade is to check the phasing to see if it needs to be adjusted. The lowest day while in the Trend Mode trade was Day 9, which was an "O" day according to the original phasing. After the market closed on Day 10, we can recognize Day 9 as being the **lowest** day while in the *Short* Trend Mode trade. We therefore designate Day 9 as a "B" day, Day 10 as an "O" day, and Day 11 as an "S" day, etc.

Having just exited the Trend Mode, we are automatically back in Reaction Mode. Day 10 is an "O" day; therefore, we initiate no trades on the "O" day unless, of course, the price penetrates the HBOP or LBOP.

On Day 11, the price hits S_1 at 50.10 and we go *Short* at this price.

Day 12 is a "B" day and we want to cover the *Short* position at B_1, which is 48.64. However, the price does not get that low, so we exit the market on the close that day. We do not take a *Long* position unless the B_1 price is touched.

Day 13 is an "O" day and since we are not in the market, we must remain neutral until the following "S" day unless the price goes through the HBOP or LBOP.

On Day 14, we go *Short* at S_1 at 50.64.

On Day 15, the following "B" day, we reverse our *Short* position at B_1 and go *Long* at 49.34.

Day 16 is an "O" day and we hold our position because the S_1 target was not reached. (Notice that S for Day 17, the "S" day, is lower than for Day 16. This is because the move on Day 16 did not carry throug and therefore produced a lower target for Day 17.)

The price on Day 17 still did not hit the reduced target, so we exited on the close that day.

On Day 18, a "B" day, the price touches B_1 and we go *Long*.

On Day 19, the following "O" day, the S_1 target of 49.64 is reached and we exit the market at that point. We do not reverse.

On Day 20, we go *Short* at S_1 at 49.66.

On Day 21, the B_1 of 48.84 is not reached, so we exit the *Short* position on the close at 49.20. Notice that this system often produces a profit even when the B_1 or S_1 points are not reached.

Day 22 is an "O" day, so no new positions are initiated since the price did not cross the HBOP or LBOP.

Now, just for fun, let's see what happens when we have an absolute sideways market; that is, the high, low and close price for each day is identical. Since Day 22 is an "O" day, the first position we can take is on Day 23.

We go *Short* at S_1 at 50.00. The following day, we reverse at B_1 at 49.00. On Day 25, an "O" day, we take our profits at 50.00 and are out of the market. On Day 26, an "S" day, we go *Short* at 50.00. On Day 27, we go *Long* at B_1, 49.00. On Day 28, an "O" day, we exit the market at 50.00, which is S_1. This hypothetical example shows the inherent characteristics of this system which enable it to be profitable in a very low directional non-trending type of market. Often this type of market is the "lull before the storm," that is, it precedes a dramatic breakout one way or the other. If you are in the market with the system when the breakout does occur, there is no way you can miss it.

For simplicity in the preceding example, we entered the market at the breakout price and exited at the trailing stop price. However, when trading this system in the actual market, always **increase** the distance of these points by several ticks. These points are:

(1) HBOP
(2) LBOP
(3) TRAILING STOP

Even though it may take several readings, I hope this System has been presented so it is understandable to the reader.

Following is a chart of May 1977 Soybean Meal which shows the system trading in this type of market. I think you will agree that this system is worth the effort it may take to master it.

Reaction Trend System — May 1977 Soybean Meal

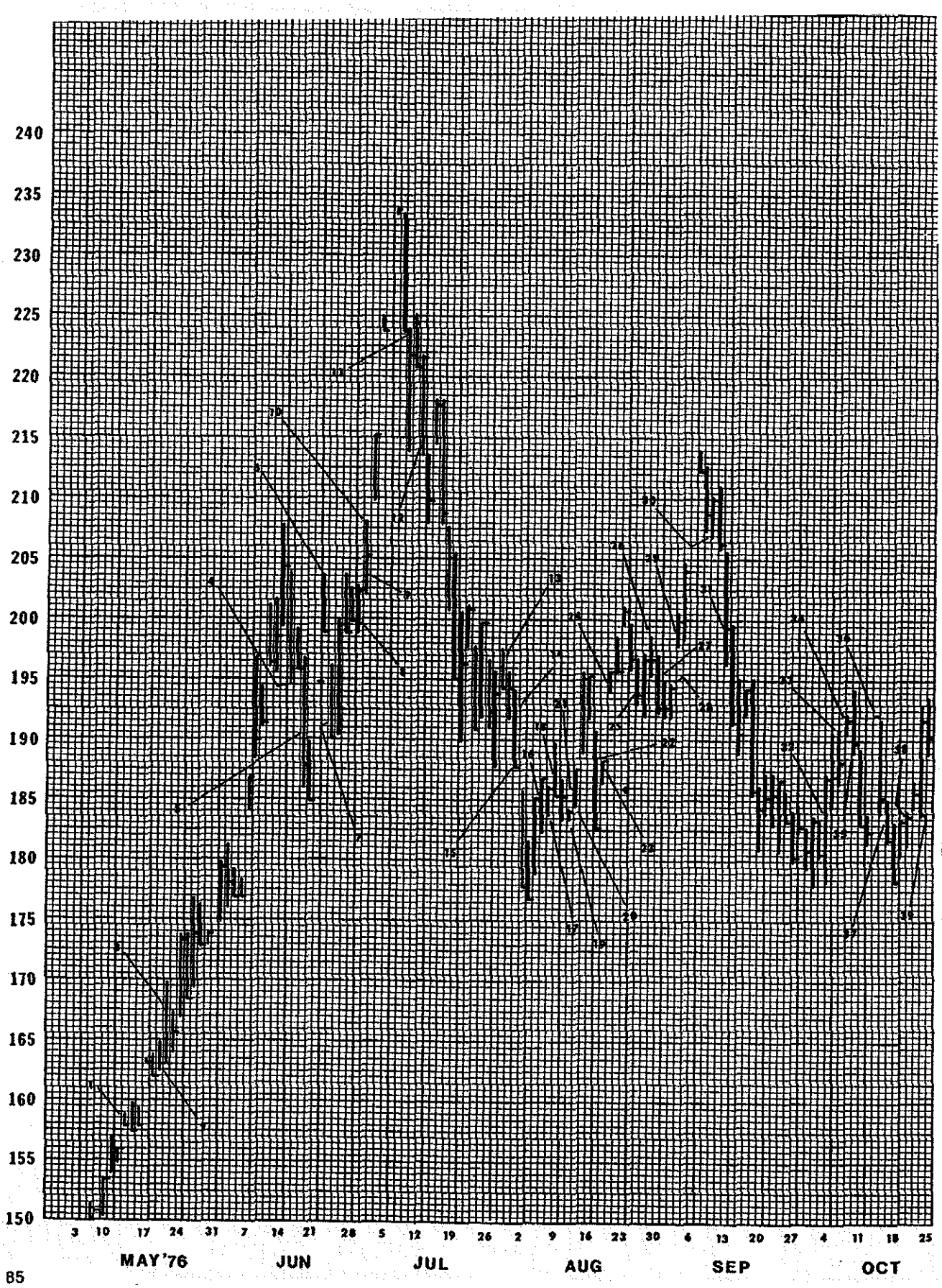
Chart No.	BOS Sequence	Position	Price	Entry/Exit Signal	P & L	Accum
1	O	L	159.00*	HBOP		
2	B	Out	162.70*	T-stop	+ 3.70	
3	O	L	167.90*	HBOP		
4	O/B	Out	194.80	T-Stop	+26.90	+30.60
5	S	S	191.10	LBOP		
6	S	Out	204.00*	T-Stop	—12.90	+17.70
7	B	S	192.10	LBOP		
8	S	Out	201.00*	T-Stop	— 8.90	+ 8.80
9	S	S	204.00	S_1		
10	S	L	208.20	HBOP	— 4.20	+ 4.60
11	S/B	Out	223.50	T-Stop	+15.30	+19.90
12	S	S	214.80	LBOP		
13	S/O	Out	197.20	T-Stop	+17.60	+37.50
14	B	L	192.30	B_1		
15	B	S	188.10	LBOP	— 4.20	+33.30
16	O/S	Out	185.70	T-Stop	+ 2.40	+35.70
17	B	L	184.00	B_1		
18	O	Out	187.30	S_1	+ 3.30	+39.00
19	B	L	183.60	B_1		
20	O	Out	184.70	S_1	+ 1.10	+40.10
21	O	L	185.90	HBOP		
22	O	Out	188.80	T-Stop	+ 2.90	+43.00
23	S	S	188.30	S_1		
24	B	Out/L	194.50*	B_1/HBOP	— 6.20	+36.80
25	O/B	Out	194.00*	T-Stop	+ .50	+37.30
26	S	S	199.00	S_1		
27	B	L	195.30	B_1	+ 3.70	+41.00
28	S	Out	195.00**		+ .30	+41.30
29	B	L	198.90	HBOP		
30	S/B	Out	207.30	T-Stop	+ 8.40	+49.70
31	S	S	198.60	LBOP		
32	S/B	Out	184.20	T-Stop	+14.70	+64.30
33	S	S	190.70	S_1		
34	B	B	192.00*	B_1	— 1.30	+63.00
35	O	S	189.20	LBOP		
36	O/S	Out	192.50*	T-Stop	— 3.30	+59.70
37	B	S	190.00*	LBOP		
38	O/S	Out	183.90	T-Stop	+ 6.10	+65.80
39	O	L	189.90	HBOP		
40	O	Out	188.80	T-Stop	— 1.10	+64.70
41	B	L	189.00*	B_1		
42	S	Out/S	190.50*	S_1	+ 1.50	+66.20
43	O	Out	191.70	T-Stop	— 1.20	+65.00
44	S	S	182.50*	LBOP		
45	S	Out	182.70	T-Stop	— .20	+64.80
46	S	S	188.60	S_1		
47	B	Out/L	193.20	HBOP	— 4.60	+60.20
48	O/S	Out	192.30	T-Stop	— .90	+59.30
49	B	L	190.60	B_1		
50	O	Out	194.10	S_1	+ 3.50	+62.80
51	B	L	193.30	B_1		
52	O	Out	195.50*	S_1	+ 2.20	+65.00
53	O	L	198.00	HBOP		
54	O	Out	200.00*	T-Stop	+ 2.00	+67.00
55	S	S	200.20	S_1		
56	S	L	202.40	HBOP	— 2.20	+64.80
57	B/S	Out	197.80	T-Stop	— 4.60	+60.20
58	S	S	199.30	S_1		
59	B	Out/L	198.50	B_1	+ .80	+61.00
60	O	Out	200.80	S_1	+ 2.30	+63.30
61	S	S	200.50	S_1		
62	B	Out	204.20**		— 3.70	+59.60
63	S	S	207.40	S_1		
64	B	Out/L	205.30	B_1	+ 2.10	+61.70
65	O	Out	209.40	S_1	+ 4.10	+65.80
66	S	S	213.40	S_1		
67	B	Out	215.30**		— 1.90	+63.90
68	S	S	215.50	S_1		
69	S	L	217.70	HBOP	— 2.20	+61.70
70	O	Out	213.30	T-Stop	— 4.40	+57.30
71	S	S	215.00	S_1		
72	B	Out/L	214.00	B_1	+ 1.00	+58.30
73	S	Out/S	217.30	S_1	+ 3.30	+61.60
74	B	L	212.30	B_1	+ 5.00	+66.60
75	O	Out	213.00	S_1	+ .70	+67.30
76	O	L	215.90	HBOP		
77	B/O	Out	210.00	T-Stop	— 5.90	+61.40
78	S	S	214.30	S_1		
79	B	Out/L	208.90	B_1	+ 5.40	+66.80
80	S	Out	210.70**		+ 1.80	+68.40
81	B	L	209.10	B_1		
82	O	Out	209.60	S_1	+ .50	+69.10
83	S	S	210.80	S_1		
84	B	Out	212.40**		— 1.60	+67.50
85	S	S	214.80	S_1		
86	B	Out	213.20**		+ 1.60	+69.10
87	B	L	211.20	B_1		
88	O	Out	211.30	S_1	+ .10	+69.20
89	O	L	213.00	HBOP		
90	S	Out	236.30	T-Stop	+23.30	+92.50
91	S	S	234.20	S_1		
92	B	L	234.00	B_1	+ .20	+92.70
93	S	S	238.60	S_1	+ 4.60	+97.30
94	B	L	237.50	B_1	+ 1.00	+98.30
95	O	Out	238.50	S_1	+ .90	+99.20

* Open
** Close

Recap: Reaction Trend System
(May 77 Soybean Meal)

Trades: 36 profit (64%)
20 loss (36%)
56 total

Profits: 174.70 points profit
75.50 points loss
99.20 points total profit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MAY'76
JUN
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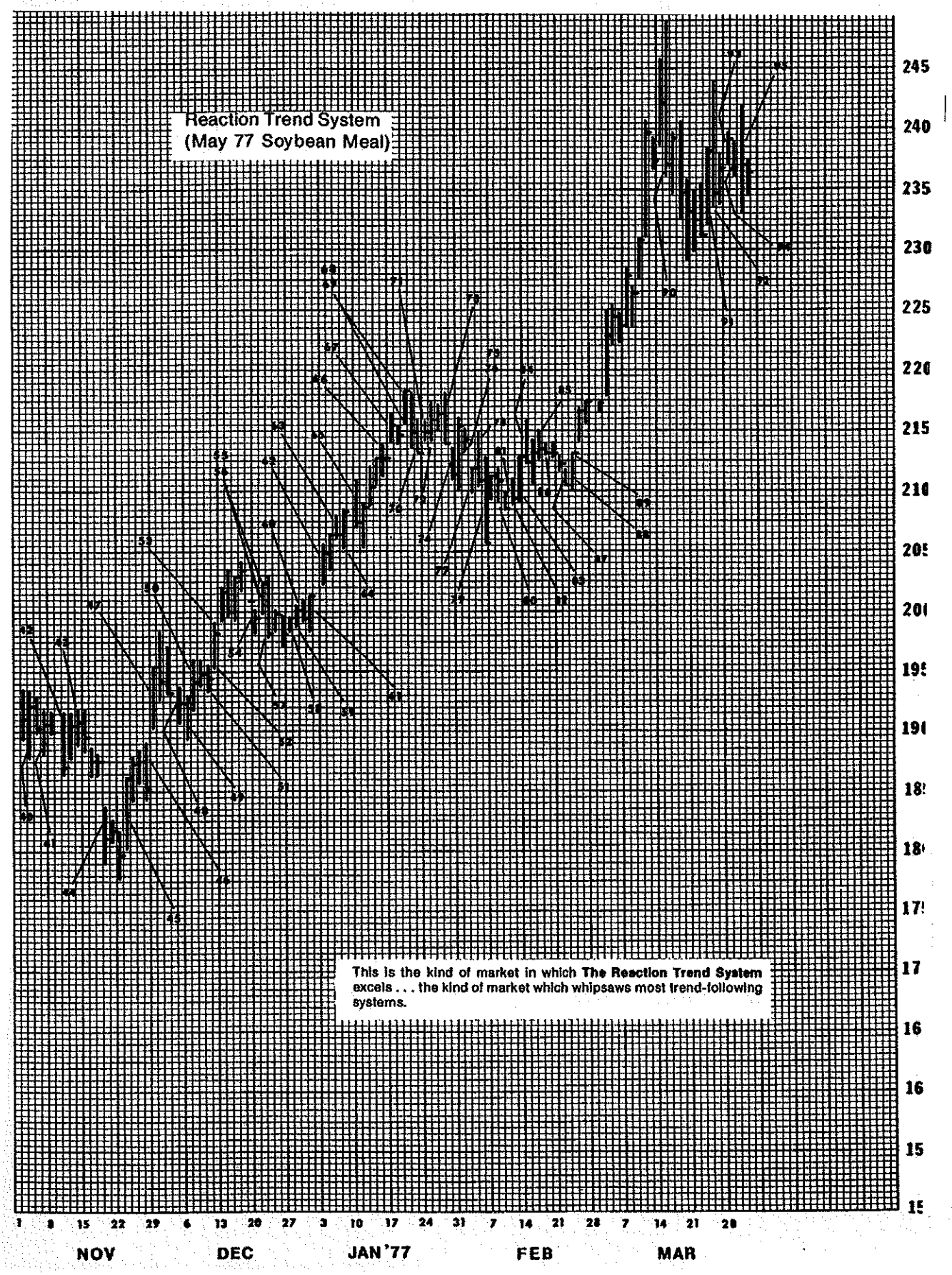
Reaction Trend System
(May 77 Soybean Meal)
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1 8 15 22 29 6 13 20 27 3 10 17 24 31 7 14 21 28 7 14 21 28
NOV
DEC
JAN'77
FEB
MAR
This is the kind of market in which **The Reaction Trend System** excels . . . the kind of market which whipsaws most trend-following systems.

SECTION VIII

THE SWING INDEX

One of the smartest technicians I know put me on the trail of this method with the following statement:

> "Somewhere amidst the maze of Open, High, Low and Close prices is a phantom line that is the REAL market. This line is also indicative of the REAL swings the market is making."

After some study, I concluded that if each day's action could be evaluated definitively, within constant parameters, the phantom line could be revealed. The problem was to compare each day's action within the day and with that of the previous day and relate this action to an absolute.

The problem is compounded by the fact that there are no less than 28 points of evaluation within a two day period. The 16 following points can be compared **between the two days.** The subscript "1" is for the first day, the subscript "2" is for the second day:

H_2H_1	H_2L_1	L_2O_1	O_2C_1
L_2L_1	H_2O_1	L_2C_1	C_2H_1
O_2O_1	H_2C_1	O_2H_1	C_2L_1
C_2C_1	L_2H_1	O_2L_1	C_2O_1

The following six points can be compared **within each day:**

H_1O_1	L_1O_1	H_2O_2	L_2O_2
H_1L_1	L_1C_1	H_2L_2	L_2C_2
H_1C_1	O_1C_1	H_2C_2	O_2C_2

After devising and testing innumerable approaches, the following factors were isolated as the most indicative:

For an UP day, the most indicative PLUS factors are as follows:

(1) Close today above previous close.
(2) Close today above open today.
(3) High today above previous close.
(4) Low today above previous close.
(5) Previous close above previous open.

For a DOWN day, these same factors would have a MINUS value.

These factors were then weighted and evaluated relative to the highest or lowest possible value and defined on a scale with absolute limits.

(1) The highest value for a day would be LIMIT UP from a LIMIT UP day.

(2) The lowest value for a day would be LIMIT DOWN from a LIMIT DOWN day.

(3) A zero value would be a NO CHANGE day from a NO CHANGE day.

(4) The absolute limits would be +100 and —100.

The following equation was derived to satisfy these prerequisites:

$$SI = 50\left[\frac{C_2 - C_1 + .5(C_2 - O_2) + .25(C_1 - O_1)}{R}\right]\frac{K}{L}$$