

Private Trader: Rules for Trading Price Channel Breakouts

March 5, 2015

Note

The price channel breakout screening method is adapted from the Turtle Trading system. See a description of the original system and its rules [here](http://timbovee.com) at the Private Trader website: timbovee.com.

Goal

I'm a trend trader. I've found that, sadly, I can't predict the future. So my strategy is to jump on a trend when I see it, and to hop off when it seems to be faltering.

Pools:

These rules apply to trades in stocks and exchange-traded funds. Such an equity is called a "symbol" in this trading plan.

Sizing

A position consists of no more than four units. Each unit is valued at one-hundredth (1%) of capital designated for this strategy divided by the 20-day Wilder average true range, with all values rounded down if needed. The initial position consists of from one to four units. If the initial position is less than four units, the position may be added to using the method described in Additions below until the size reaches four units.

Definitions

- 2N: Twice the value of N (q.v.)
- Adjusted Yield: The average yield on successful trades multiplied by the success rate.
- Bear Mode: Describes a symbol that has given a confirmed entry signal to the downside.
- Breakout Day: The day the price moves beyond the 20-day price channel.
- Breakout Level: The level of the 20-day price channel boundary crossed by the price.
- Bull Mode: Describes a symbol that has given a confirmed entry signal to the upside.
- Busted Roll: A potential roll negated by an exit signal.
- Current Primary wave: An upward correction in the S&P 500 that began Oct. 4, 2011 from 1074.77. (See the "Elliott wave system of counting" definition, below.)
- Confirmation: A breakout is confirmed if the symbol trades beyond the breakout level on the day after breakout day.
- Data Period: The entire span of the data set, which as of this writing begins on Jan. 2, 2009, around the time that the broad markets began recovering from their Great Recession crash.
- Discretion: Setting an entry or exit signal at a point of resistance on the chart as close as possible to the applicable price channel. Elliott wave analysis will be used in determining the appropriate resistance point. (Note that these rules use "resistance" for both upward and downward reversals, disregarding the common term "support".)

- Earnings Day: The first trading day after earnings are announced. (For example, if earnings are published after the close on Monday, earnings day is Tuesday. If they are published before the open on Monday, earnings day is Monday. Earnings published during the trading day are treated as though they had been announced before the open.)
- Elliott wave system of counting: A method of assessing market trends, as developed by [Ralph Nelson Elliott](#) and published in 1938, and as elaborated by [Robert Prechter](#) of [Elliott Wave International](#).
- Expiration Channel: The channel with boundaries as defined on the day a position's options expire.
- Ex-Dividend Day: The day a stock goes ex-dividend.
- Failure Rate: The percentage of total breakouts resulting in losing trades.
- N: The current 20-day average true range, an indicator developed by J. Welles Wilder
- Neutral Mode: Describes a symbol in bull or bear mode that has closed beyond the 10-day price channel in a direction opposite the bull or bear mode and confirmed the signal by closing beyond the breakout level the next day.
- Post-Dividend Day: The fifth trading day after the date a stock goes ex-dividend (with the day after ex-dividend day counted as the first of the five).
- Price channel: Two lines on a stock chart, one at the level of the highest high of the past designated number of periods (20 days, for example), and a second at the level of the lowest low of the designated number of periods. The lines move independently with the passage of time. Also known as a Donchian price channel.
- Reset Day: The day after the first trading day following an earnings announcement. (For example, if earnings are released after the close on Monday, the Reset Day is Wednesday. If earnings are released before the open on Monday, the Reset Day is Tuesday. Releases during the trading day are treated as though they had occurred before the open.)
- Resistance level: A reversal point on the chart where the price reverses and moves opposite the previous direction.
- Signal Level: The point at which a signal for entry or exit is given; the crossing of a 20-day or 10-day price channel boundary or a stop/loss point.
- Success Rate: The percentage of total breakouts resulting in profitable trades.
- Trending Modes: Bull mode and bear mode.

Entry

An entry signal occurs when the price breaks beyond the boundaries of the 20-day price channel. A confirmed entry signal moves a symbol into one of the trending modes, either bull mode or bear mode.

Once an entry signal based on the price channel has been given, the trader may exercise discretion by setting the entry point at a resistance level on the chart as close as possible to the price channel.

I scan for breakouts after the market close.

For all such breakouts, I calculate the number of times each symbol has broken out in the same direction during the current trend, defined as the current Primary wave of the S&P 500 under the Elliott wave system of counting, and the number of those breakouts that produced a profit.

If half or more of the breakouts were profitable, the symbol is analyzed for exclusion on account of earnings or dividends.

The number of profitable breakouts divided by the total number of breakouts is called the "success rate", and its inverse is the "failure rate". I also calculate the average yield on the profitable trades and the average loss on the unprofitable trades.

I calculate an adjusted yield by multiplying the average yield on successful trades by the success rate.

Earnings Exclusions

A symbol breaking out within 30 days of a scheduled earnings announcement is disqualified as a potential trade.

If a symbol breaks out on Earnings Day, no entry is allowed until the day after Reset Day, and the Reset Day price channel boundary is treated as the confirmation level (rather than using those levels on Earnings Day).

Dividend Exclusions

If a symbol breaks out on Ex-Dividend Day, no entry is allowed until a breakout on Post-Dividend Day, and the Post-Dividend Day price channel boundary is treated as the confirmation levels (rather than using that level on Ex-Dividend Day).

News Exclusions

Symbols that break out the day of or immediately following a major news announcement may optionally be excluded from trading on those grounds. The decision to trade or not will be based on a judgement of the degree to which continued price movement is likely, a highly subjective call.

Trading is disallowed in the case of symbols that are in the process of being acquired.

Preferences

A symbol that has survived through the exclusions phase is ranked according to a series of preferences. Unlike the prior analysis, these are more in the nature of likes and dislikes rather than strict rules.

In general, preferences is given to

- Higher share volume
- Higher option open interest
- High success rates both within the past year and for the entire data period.
- High adjusted yields both within the past year and for the entire data period.
- Return on equity of 15% or higher for bull trades or below 10% for bear trades.
- Lower debt/equity ratios.
- Higher institutional ownership

I also look at the price/sales ratio and how analysts are rating the symbol, although they aren't important in my final decision. I also look at the story behind the stock: What's the business plan? Do I understand what they do?

Confirmation

If a stock has survived my screens and preferences, there is one final step: It must trade above its breakout level on the day following the breakout. Symbols that retreat within the 20-day price channel won't be traded.

Stop/Loss at Entry

Set an initial stop/loss of 2N from the entry point.

Exits

An exit signal occurs when the price closes beyond the 10-day price channel opposite the direction of the trade.

The signal must be confirmed by a close beyond the exit-signal level the next trading day, in the same manner as entry signals. (See the Confirmation section, above.)

Once an exit signal based on the price channel has been given, the trader may exercise discretion by setting the exit point at a resistance level on the chart as close as possible to the price channel.

Trading Vehicles

For positions based on the equity and exchange-traded fund pools, the initial position can be either long or short shares, long calls or puts, or short vertical spreads (bull put spreads, bear call spreads) with the break-even point set near or at the initial stop/loss point (2N from the entry price), at the trader's discretion.

I give preference to short vertical spreads, where available, for both the initial position and additions. My second preference is for long shares or, where available, short sales.

Rolls

A hedged position consisting of options (such as short vertical spreads) may be rolled into a new position upon the profitable expiration of an old one if the stock price is trading beyond the 20-day price channel boundary as it was at expiration (the 20-day expiration channel). All units held in the old position may be rolled into the new one in a single order.

If the stock is trading within the expiration channel, then the roll must be delayed until the price breaks anew beyond the expiration channel. All units can be rolled upon the break beyond the 20-day expiration channel, no matter how long the delay has been.

If during the delay the price moves beyond the 10-day price channel in the direction opposite the proposed trade, the potential for a roll is negated ("busted") and the position may not be rolled. Instead, the symbol can be traded again only upon the occurrence of a new entry signal according to the rules given in this document.

Once a roll signal based on the price channel has been given, the trader may exercise discretion by setting the signal point at a resistance level on the chart as close as possible to the price channel.

Watchlist

A symbol of interest that I'm not yet willing to trade may be placed on the Watchlist. It is removed if the price closes beyond the 10-day price channel in the direction opposite the proposed trade and confirms the signal by trading beyond the signal point the next day..

Once a removal signal based on the price channel has been given, the trader may exercise discretion by setting the signal point at a resistance level on the chart as close as possible to the price channel.

Disclaimer

Tim Bovee, Private Trader tracks the analysis and trades of a private trader for his own accounts. Nothing in this blog constitutes a recommendation to buy or sell stocks, options or any other financial instrument. The only purpose of this blog is to provide education and entertainment.

No trader is ever 100 percent successful in his or her trades. Trading in the stock and option markets is risky and uncertain. Each trader must make trading decision decisions for his or her own account, and take responsibility for the consequences.

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