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W O R K B O O K



# LIVE @ TAG

Workshop

Full-Conference

## Futures Strategies for Stock Traders

In recent years, Charles LeBeau has been doing a great deal of research on stock trading and has found that knowledge of futures strategies can be extremely valuable to stock traders, particularly in today's volatile markets. In his workshop Charles will explain how various technical trading strategies, originally developed for futures traders, can easily be applied to short term stock trading. This workshop will present reliable entry methods and emphasize the importance of good exits. Futures traders and stock traders interested in technical analysis should find his ideas to be simple, practical and highly profitable. This will be Charles LeBeau's first TAG lecture about stock trading and you won't want to miss it.

### Biography



For more than twenty years Charles LeBeau was employed by E. F. Hutton where he served as Vice President, Regional Futures Director. He is a registered commodity trading advisor (CTA) and a noted developer of trading systems. His book on futures trading is considered a modern classic in technical analysis and, in addition to the English version, this popular trading book has also been published in German, Polish and Russian.

Charles LeBeau is a trader with nearly 40 years of trading experience. He is the co-author of the book *Computer Analysis of the Futures Market* and is the founder of the System Traders Club web site at [traderclub.com](http://traderclub.com). Members of the System Traders Club exchange information and trading ideas on the web site and the Club has rapidly grown to more than 5,000 members in more than eighty countries.

Charles

LeBeau

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# **FUTURES STRATEGIES FOR STOCK TRADERS**

A presentation by Chuck LeBeau

## **TWO IMPORTANT DIFFERENCES BETWEEN TRADING STOCKS AND TRADING FUTURES**

### **1. Market selection**

Because there are less than a hundred actively traded futures markets, futures traders can watch every market so market selection (what to watch) is seldom a problem and futures traders are therefore primarily concerned with timing. However, good futures traders have to be sure to limit their activities to markets with sufficient liquidity for trading and sufficient volatility to produce worthwhile profits.

Stock traders, however, have thousands of stocks to choose from and therefore market selection (what to watch) is a critical element of a successful stock trading strategy.

*Lesson:* Just like futures traders, stock traders must also be concerned about liquidity (minimum volume) and volatility. However, stock traders have a great deal of additional fundamental and technical information that can be used to narrow down the universe of stocks to a more manageable “watch list”. Fortunately there are many stock screening programs and easily accessed data bases that will allow sophisticated stock screening that was not available to the public a few years ago.

Stock traders should also be concerned about the proper timing of entries and exits. When to buy and when to sell are important decisions if returns are going to be maximized.

### **2. Exits**

Futures contracts are continuously expiring and, win or lose; all trades must be exited promptly to avoid problems. Futures traders can not operate using a “buy and hold” strategy. Because holding periods are limited, good futures traders must focus a great deal of their analysis and attention on exit strategies.

Stock traders can hold stocks indefinitely in hopes of eventually making a profit so many stock traders tend to neglect their exit strategies.

*Lesson:* Stock traders should pay more attention to maximizing their profits through the use of well-planned exit strategies. The trading plan should include strategies for taking profits, for cutting losses and for getting out of stocks that are doing nothing. To be most successful, stock traders should focus on maximizing their returns for each day spent in the market and learn how to compound their returns.



## **TWO VALUABLE TOOLS FOR TRADING STOCKS AND FUTURES**

### **An introduction to the Average Directional Index (ADX) and Average True Range (ATR)**

#### **1. The Average Directional Index (ADX) - How it works and how to use it.**

The ADX is not designed to measure the up or down direction of prices. It is designed to measure the amount of directional price movement. The ADX tells us the STRENGTH of the trend – not the direction of the trend.

There are many indicators for telling direction but there are very few that can measure the strength of a trend. The Plus DI and the Minus DI components of the ADX can be used to signal direction. That's why we normally plot the ADX as three lines: Plus DI, Minus DI and the ADX itself.

The level of the ADX is not predictive. The level merely tells us where we have been and doesn't tell us much about where we are going. For example, if the ADX is at a fairly high level like 35 it tells us that there WAS a trend. The trend may be over or it may continue.

To use the ADX in a predictive manner, look at the DIRECTION of the ADX. If the ADX is rising, the trend is still underway and is actually getting stronger. This is the important predictive information that we are looking for. The best trades are signaled when the ADX begins rising from a low level (15 or less). The faster the ADX is rising the more reliable the signal.

In addition to timely entry signals, the ADX tells us a great deal of important information that will improve our trading results. If the ADX is declining we can assume that there is no STRONG prevailing trend and that profits can best be made by buying on dips rather than chasing after breakouts. However, if the ADX is rising we don't want to wait for dips because there may not be any for a while. We want to trade very aggressively when the ADX is rising and trade cautiously when the ADX is declining.

The ADX can be very helpful for perfecting our exit strategies. When the ADX is rising we want to try to hold on to our positions and to take big profits. When the ADX is declining we want to be sure to take small profits before they get away. Also, when the ADX is above 35 and starts to roll over its time to be closing out the position because the trend is probably over.

## 2. The Average True Range (ATR) - How it works and how to use it.

The Average True Range is a very valuable unit of measurement. It shows the average daily range of price movements over a period of time. By reducing common measurements of price movements from the standard units of points or dollars into much more flexible or dynamic units of ATR we can make our systems highly adaptive to changing market conditions. There are many valuable applications of this simple tool and every technical trader should learn how to use it.

First lets look at a simple buy-only system for shares of ABC stock without using ATR. Our over-simplified system will consist of just the bare necessities: an entry, a profit objective and a stoploss. Here are the rules stated in conventional terms:

1. Buy ABC whenever it rises \$1.50 per share from the opening price.
2. Take a profit whenever the profit reaches \$9 per share.
3. Take a loss whenever the loss reaches \$3 per share.

Now lets build the same system using ATR instead of dollars per share. (Assume that the 20-day ATR is 1.5 dollars).

1. Buy when the price rises 1 ATR from the open.
2. Take a profit whenever the profit reaches 6 ATRs.
3. Take a loss whenever the loss from our entry point reaches 2 ATRs.

We now have the original system and a modified version that has substituted ATR for the important variables. The two systems appear to be identical at this point. As long as the ATR remains at \$1.50 per day they both will enter and exit at exactly the same prices.

Now let's assume that the market conditions change and ABC stock becomes extremely active and the volatility doubles so that the 20-day ATR is now \$3 per day instead of the previous \$1.50 per day. Here is a comparison of the original system and the ATR system:

1. Now that the volatility has doubled, the original entry of \$1.50 from the open is now much too sensitive. It will generate too many entry signals since the daily range is now \$3 per day instead of only \$1.50.

However, the entry expressed as 1.0 ATR from the open will adjust automatically and will now require the price to move \$3 per share to generate a new entry signal. The system has automatically adapted to the change in market conditions and the frequency and reliability of our entries remains the same as before.



2. With the increase in volatility, the original profit objective of \$9 per share is much too small for a market that is now moving \$3 per day. As a result of the increased volatility the profits will be taken too quickly and our original system will be missing many opportunities to make much bigger profits than usual.

However the profit target expressed as 6 ATRs has automatically expanded the profit objective per trade to \$18 per share. Significantly larger profits are now being realized by the ATR system as a result of the increased volatility.

3. Now that the prices are moving \$3 per day, the original stop loss of \$3 will be much too close and our stoploss will be hit quite frequently. If we combine these frequent stoploss exits with the fact that the system is also generating too many entry signals, we have a classic “whipsaw” situation and we can expect to encounter a severe string of losses. Our original system is now failing because the market conditions have changed. We need to decide how to fix it or abandon it in a hurry.

However lets look at our ATR version of the system. The stoploss expressed as 1 ATR now sets our stop farther away at \$6 per share so it isn't being hit any more frequently than before. Whipsaws are not a problem and we continue to have the same percentage of winning trades as before because we are adapting to the changes in the market. In fact, our ATR based system is getting better instead of worse. The winning trades are now much larger than before thanks to our increased profit objective. Our ATR system is enjoying a series of unusually large winning trades and is currently making a new equity peak. Viewed in its historical perspective, the ATR system now looks better than ever while the conventional system has failed.

This brief example describes only a few of the many uses for ATR. There are many other ways we can put the ATR to work. The ATR can be used to define trading bands on either side of a moving average. (Try setting the bands at two ATRs on either side of a twenty-day moving average to define a trading range.) The ATR can also be used to define trends. For example, if the current price is 4 or more ATRs above the thirty-day low, the trend is up. If the price is four or more ATRs below the thirty-day high, the trend is down. We can also compare the four-day ATR to the twenty-day ATR to see if the volatility is expanding or contracting. We may want to use this information to follow breakouts from low volatility consolidation areas.

One of our favorite uses for ATR is in our exit strategies. We can not only use ATR for setting profit targets but we can also use it to set some very efficient trailing stops.

## **TWO HIGHLY EFFICIENT EXIT STRATEGIES USING ATR**

### **An introduction to the Chandelier Exit and the Yo Yo Exit**

#### **1. The Chandelier Exit**

Most trailing exits are based on moving averages of closes or the lowest low point of a number of days. Although these popular trend-following exits allow profits to run and offer some protection if there is a change in trend, they both suffer because they lag severely whenever the market starts running away to the upside. The failure of these trailing exits to move up with the prices will eventually result in a large giveback of open profits. It is difficult for any exit based on average prices or lowest-low prices to keep up with a market that is making new highs. As a result our profit taking exits will be much later than they should be.

The Chandelier Exit is unique because it uses the highest prices of the trade to select the exit points. Just like a chandelier hangs down from the ceiling, the Chandelier Exit hangs down from the highest point of the trade. By being fixed to highest prices rather than to the lowest prices or the average prices, the Chandelier Exit can provide unusually timely exits that capture a very high percentage of the open profits.

The most common setting for the Chandelier Exit is to hang the stop three Average True Ranges from either the highest high or the highest close since the trade began.

#### **2. The Yo Yo Exit**

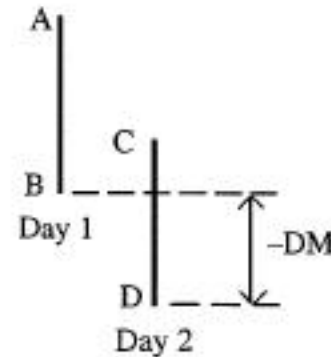
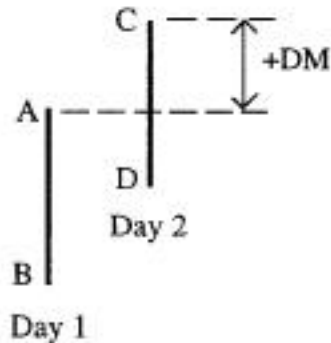
The Yo Yo Exit is not designed to move constantly upward in order to lock in profits. The role of the Yo Yo Exit is very specific and its purpose is simply to detect unusual one-day price action that may signal an important change in trend. The Yo Yo Exit is attached to the most recent closing price and it moves up and down as the closes move up or down. The typical setting is to hang the Yo Yo Exit two ATRs below the most recent closing price.

It is rare for an upward trending market to produce a one-day downward price excursion amounting to two ATRs. (Remember that the average range between the highs and lows of a day are only one ATR.) If a one-day decline of two ATRs does occur it is often a sign that there has been some unusual event or bad news that has caused such an extreme one-day loss. These significant one-day reversals in price are often a sign that a major change in direction has occurred.

Keep in mind the very limited purpose of the YO Yo Exit. It is not intended to trail up and lock in profits. As the name implies, it moves up and down on a regular basis. Because the exit point is so far away from the previous close the prices can decline every day and the exit point may never be reached because it is adjusted downward after each lower close. The Yo Yo Exit must never be used alone. It must always be combined with other exits that offer more protection.

## Calculating Directional Movement (DM)

1. Directional Movement is the largest part of today's range that is outside yesterday's range.



2. Outside days will have both a +DM and a -DM. Use the larger.
3. Inside days have zero DM.
4. Limit days will have a DM measured as in the diagrams above. For example, for a limit up day (first diagram) +DM would be the difference between A and the upward limit reached the next day, C.

For a more detailed explanation, see Welles Wilder's book:  
*New Concepts in Technical Trading Systems* pages 35 – 52.



## Calculating ADX

1. Measure Directional Movement (DM).
2. Measure the True Range (TR), which is defined as the **largest** of:
  - a. The distance between today's high and today's low.
  - b. The distance between today's high and yesterday's close.
  - c. The distance between today's low and yesterday's close.
3. Divide the DM by the TR to give the Directional Indicator (DI).

$$DI = DM / TR$$

The result can be either positive or negative. If positive, it is the percentage of the true range that is up for the day. If negative, it is the percentage of the true range that is down for the day. +DI and -DI are normally averaged over a period of time. Wilder suggests 14 days. The calculation then becomes:

$$+DI_{14} = +DM_{14} / TR_{14} \quad \text{or} \quad -DI_{14} = -DM_{14} / TR_{14}$$

+DI and -DI are two of the three values normally displayed as the DMI. The third is the ADX, which is derived as follows:

4. Compute the difference between +DI and -DI.

$$DI_{\text{diff}} = |[(+DI) - (-DI)]|$$

5. Compute the sum of +DI and -DI.

$$DI_{\text{sum}} = [(+DI) + (-DI)]$$

6. Calculate the DX or Directional Movement Index.

$$DX = (DI_{\text{diff}} / DI_{\text{sum}}) * 100$$

The 100 normalizes the DX value so that it falls between 0 and 100. The DX by itself is very volatile and is not usually displayed.

7. Compute a moving average of the DX to create the Average Directional Movement Index (ADX). Normally, the smoothing is by the same number of days used to calculate +DI and -DI.

For a more detailed explanation, see Welles Wilder's book:

*New Concepts in Technical Trading Systems* pages 35 – 52.

# Calculating Average True Range

**How to calculate Average True Range (ATR).**

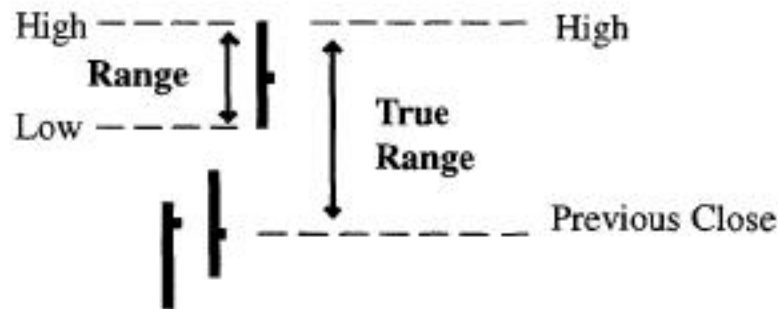
**Range:** This is simply the difference between the high point and the low point of any bar.

**True Range:** This is the GREATEST of the following:

1. The distance from today's high to today's low
2. The distance from yesterday's close to today's high, or
3. The distance from yesterday's close to today's low

True range is different from range whenever there is a gap in prices from one bar to the next.

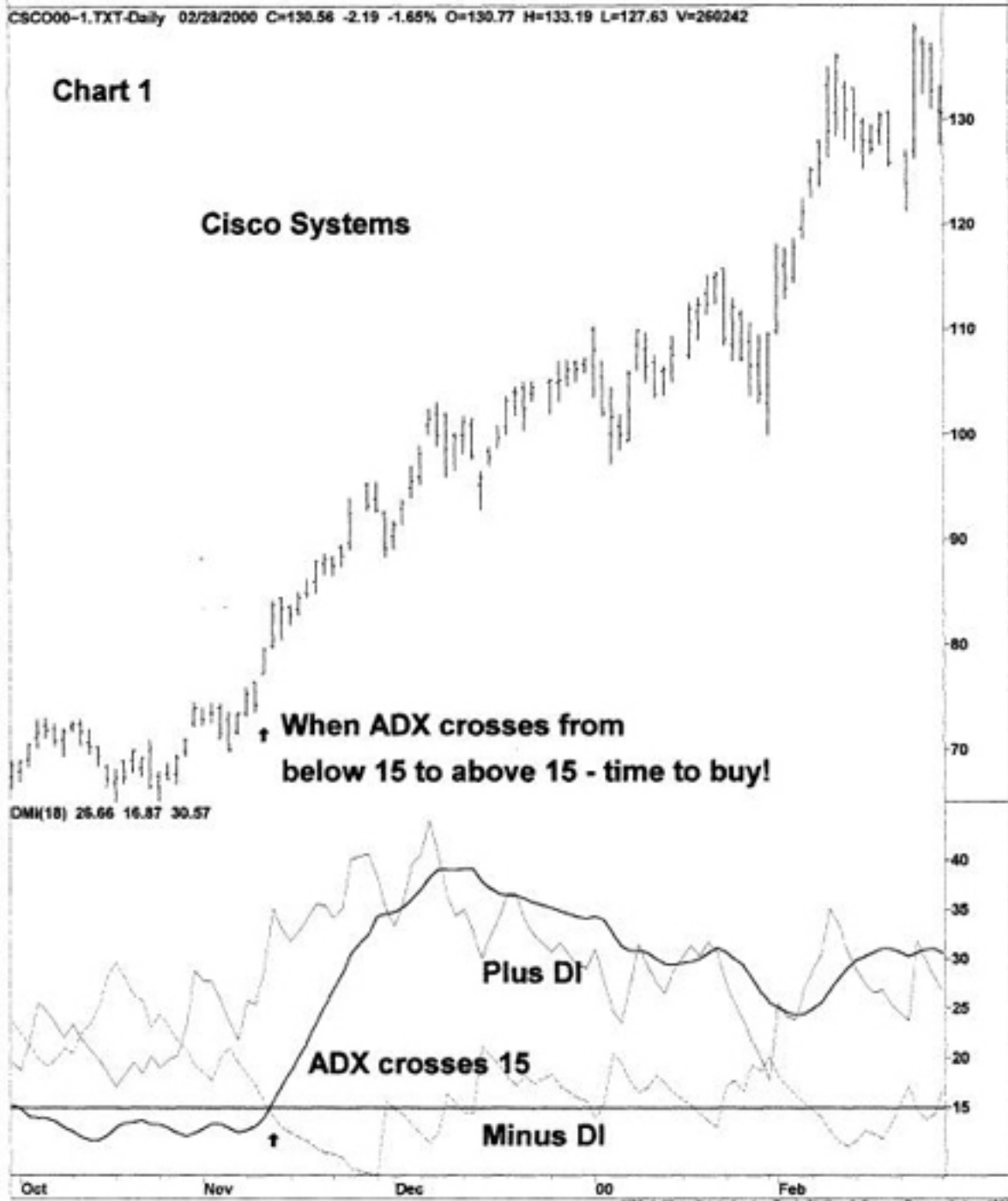
**Average True Range** is simply the True Range averaged over a number of bars.



To make ATR adaptive to recent changes in volatility, use a short average (2 to 10 bars). To make the ATR reflective of "normal" volatility use 20 to 50 bars or more. Unless there is some specific reason to do otherwise, we normally use twenty days to calculate the ATR.

### Chart 1

## Cisco Systems



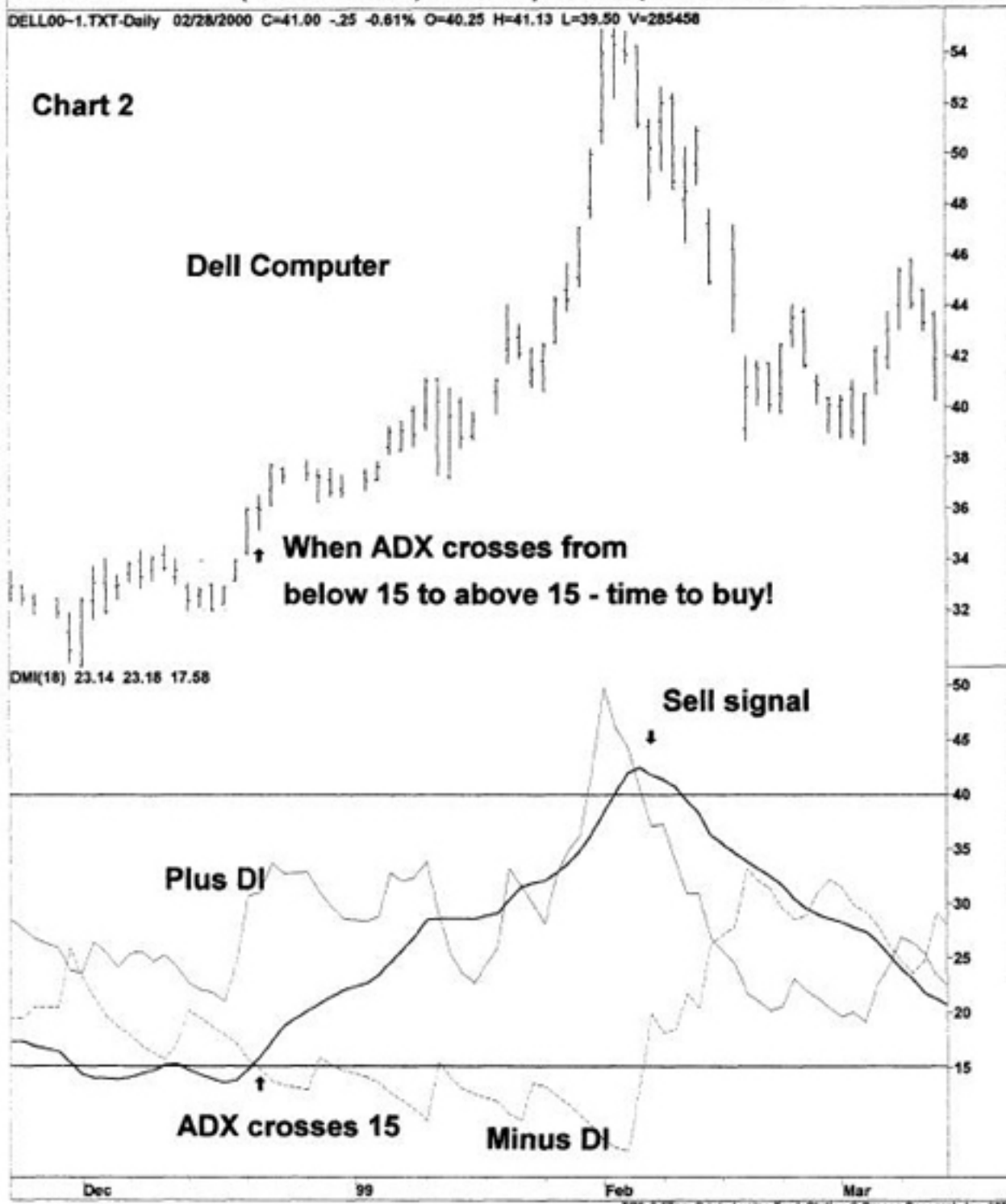
ADX Entry



DELL00~1.TXT-Daily 02/28/2000 C=41.00 -0.25 -0.61% O=40.25 H=41.13 L=39.50 V=285458

Chart 2

Dell Computer



When ADX crosses from below 15 to above 15 - time to buy!

Sell signal

Plus DI

ADX crosses 15

Minus DI

Dec 99 Feb Mar

7:26 3:37pm Printed using Tradestation © Omega Research, Inc. 1999

ADX Entry

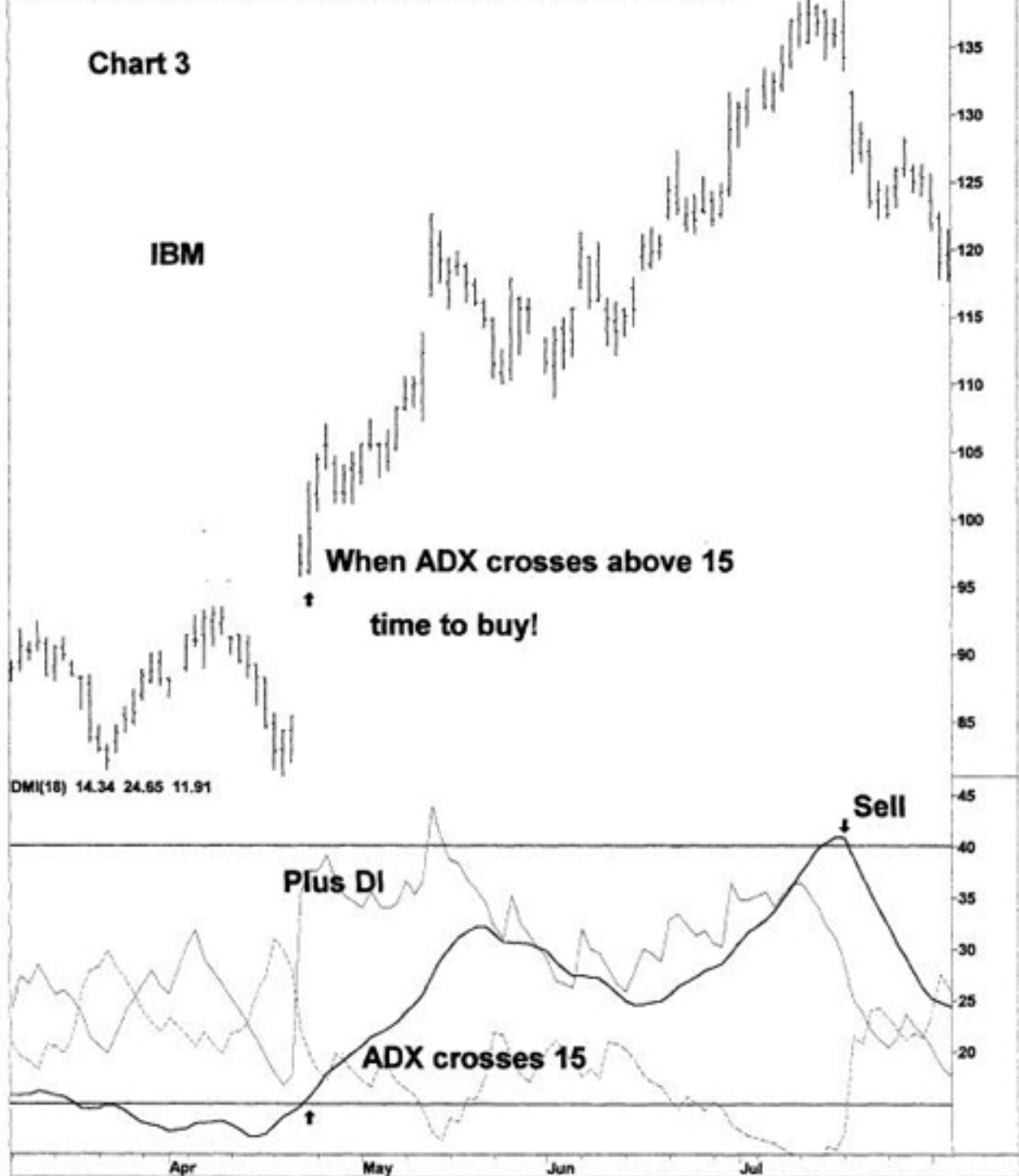
# ADX Entry

03/08/1999

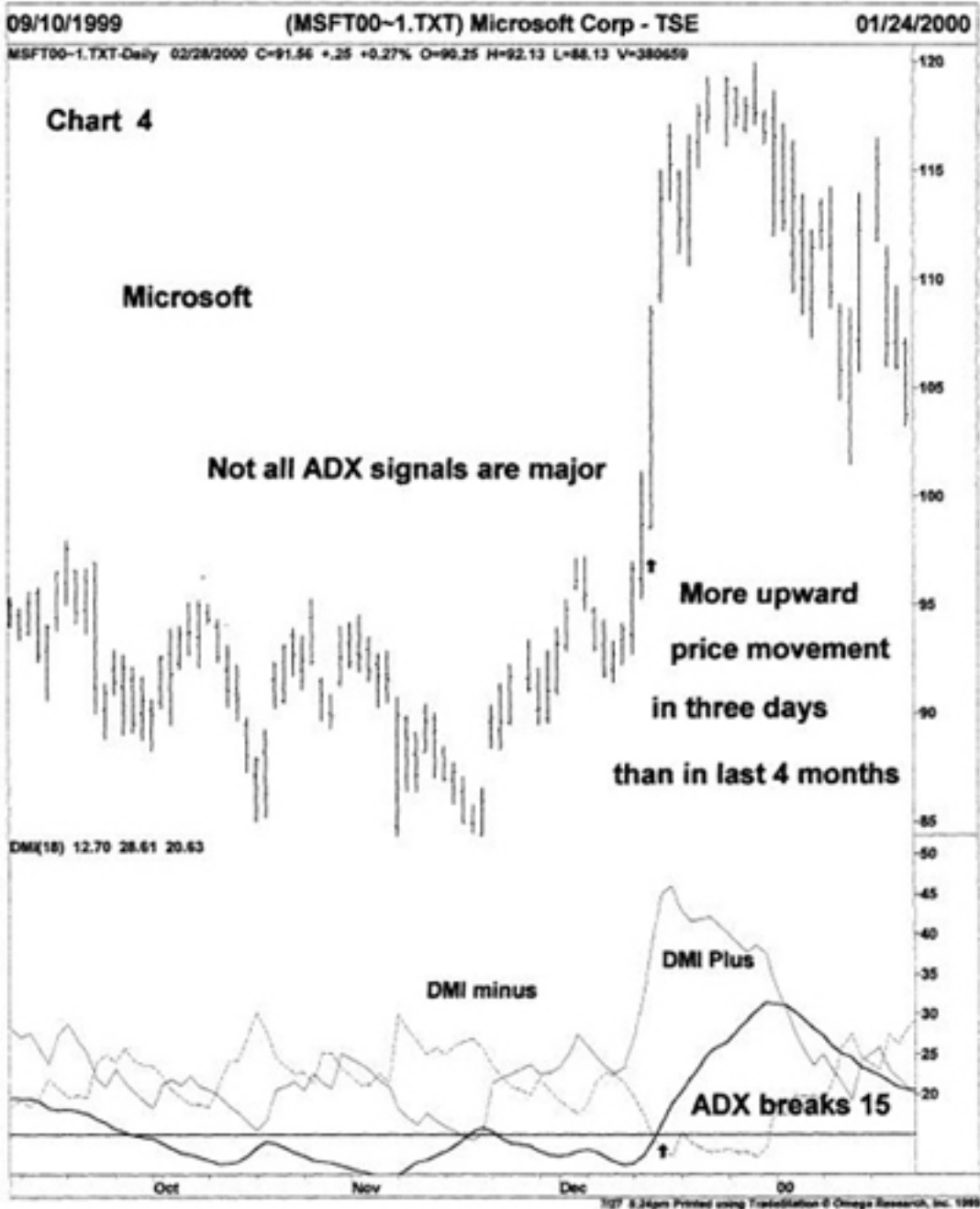
(IBM0000\$.TXT) International Business Mach

08/05/1999

IBM0000\$.TXT-Daily 02/28/2000 C=104.50 -3.50 -3.24% O=104.63 H=106.50 L=103.94 V=84799



ADX Entry - minor move





### Chart 5

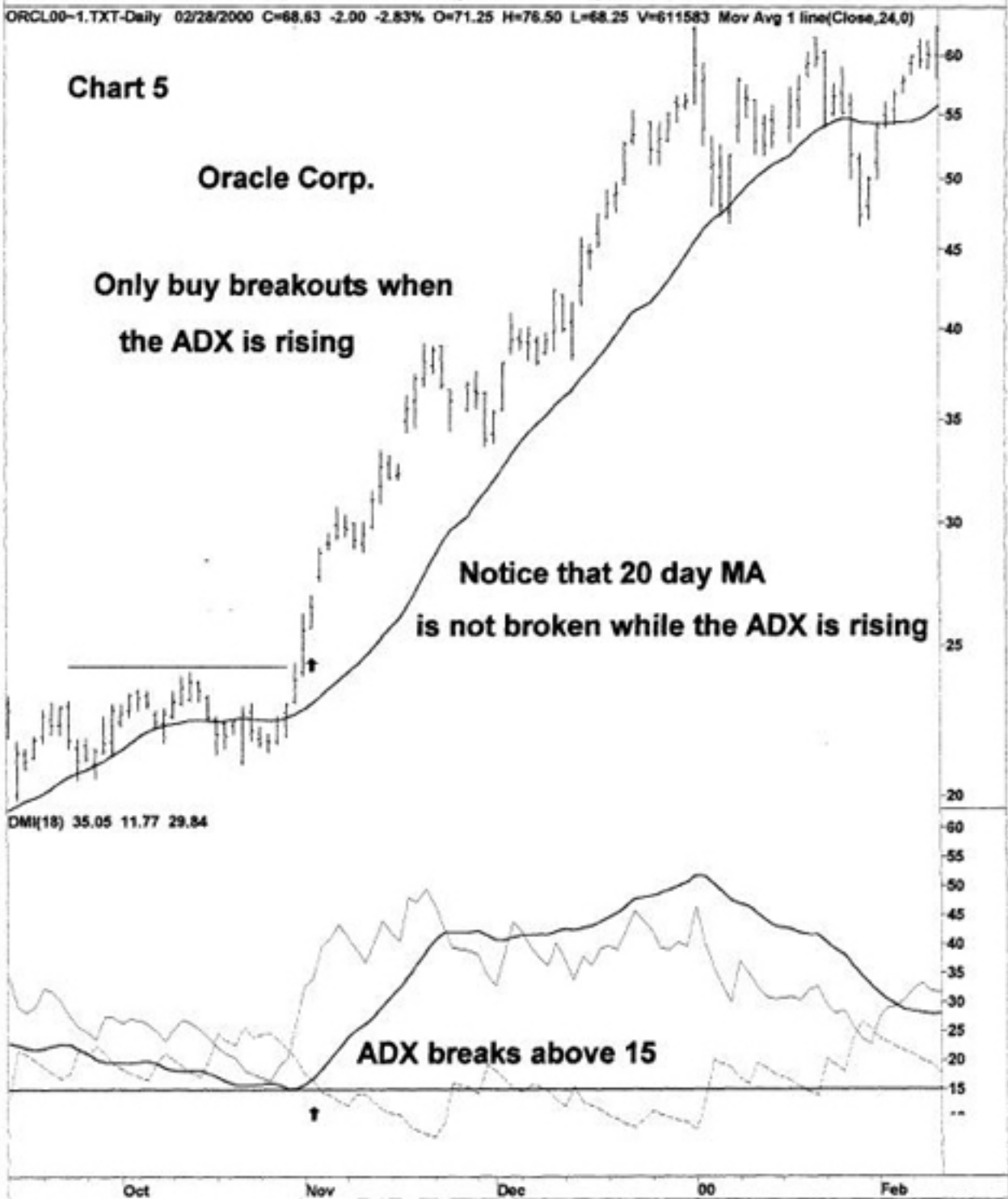
## Oracle Corp.

**Only buy breakouts when  
the ADX is rising**

**Notice that 20 day MA  
is not broken while the ADX is rising**

DMI(18) 35.05 11.77 29.84

**ADX breaks above 15**



**ADX Entry - follow breakouts**

ADX Declines - buy dips

12/04/1998

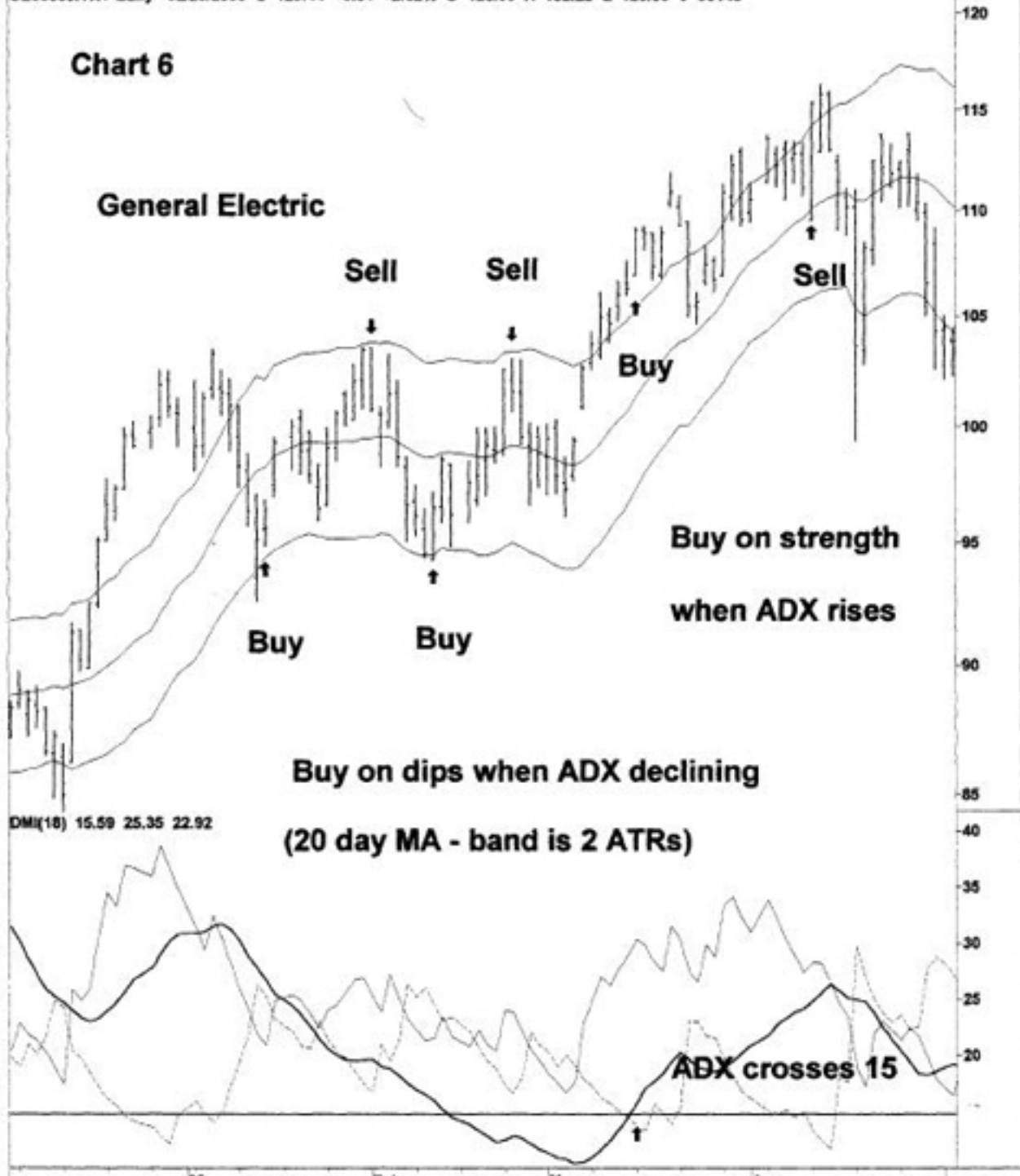
(GE0000\$.TXT) General Electric Co - NYSE

05/05/1999

GE0000\$.TXT-Daily 02/28/2000 C=129.44 +3.31 +2.62% O=126.00 H=132.25 L=126.00 V=90143

Chart 6

General Electric



DMI(18) 15.59 25.35 22.92

Buy on dips when ADX declining  
(20 day MA - band is 2 ATRs)

Buy on strength  
when ADX rises

ADX crosses 15

20 day MA exit

09/30/1999

(CSCO00~1.TXT) Cisco Systems Inc - TSE

02/28/2000

CSCO00~1.TXT-Daily 02/28/2000 C=130.56 -2.19 -1.65% O=130.77 H=133.19 L=127.63 V=260242

Chart 7

Sell close below 20 MA

Cisco Systems

ADX declining - buy dips  
as long as plus DI above  
minus DI

Buy ADX rising

DMI(18) 26.66 16.87 30.57

ADX crosses 15

Plus DI

Minus DI

Oct Nov Dec 00 Feb  
1127 5:24pm Printed using TradeStation © Omega Research, Inc. 1999



# Modified Parabolic Exit

05/10/1999

(INTC00-1.TXT) Intel Corp - TSE

10/07/1999

INTC00-1.TXT-Daily 02/28/2000 C=112.38 -0.87 -0.77% O=111.63 H=114.56 L=108.25 V=237111 Parabolic(.015)

**Chart 8**  
**Intel Corp.**

**The Parabolic Exit**  
Acceleration factor reduced  
from 0.02 to 0.015

**Sell**

Note that Parabolic  
moves up faster than  
20 MA to lock in profits

**Sell**

**Buy**

**Buy**

DMI(18) 25.88 35.51 25.39

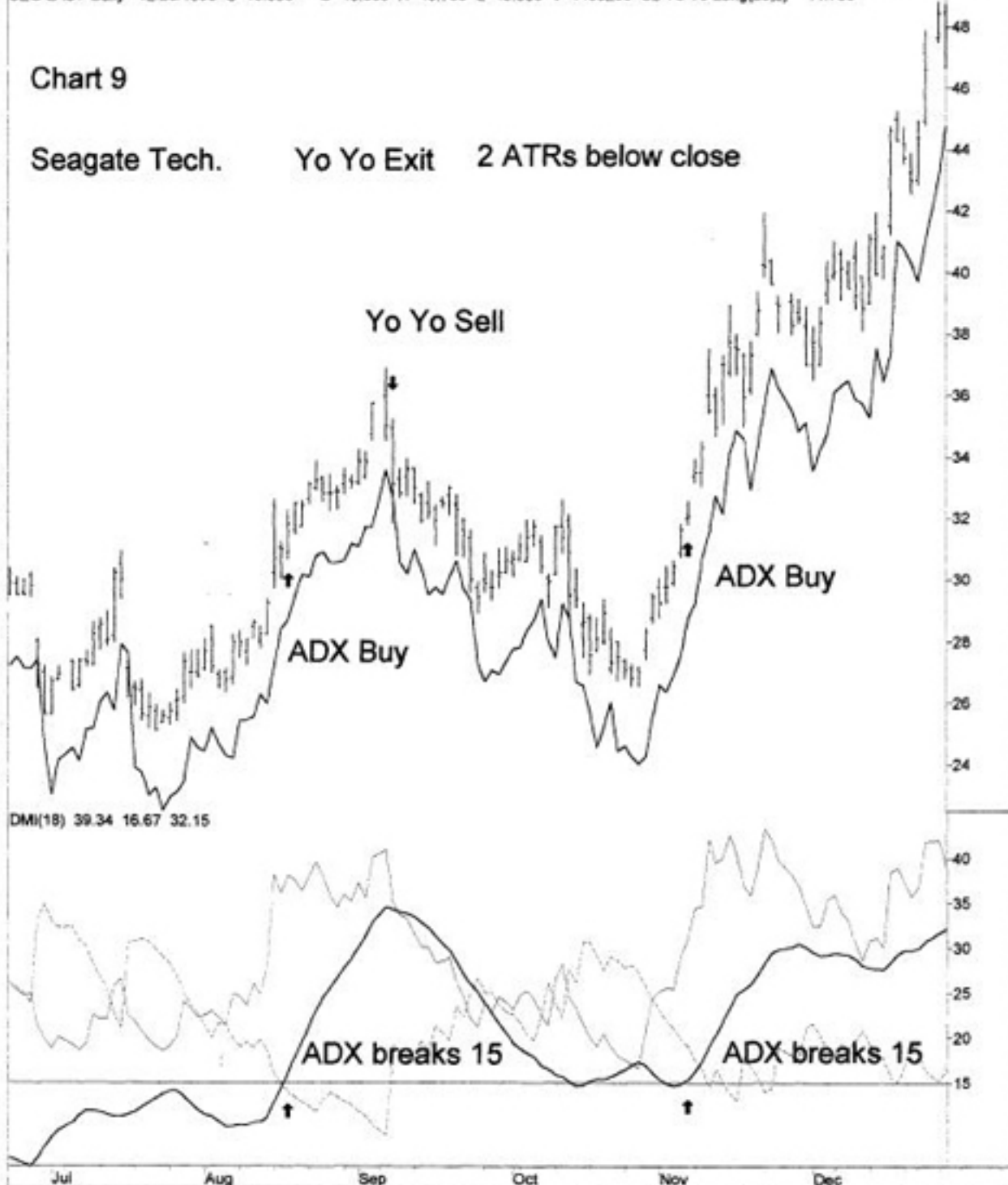
**ADX breaks 15**

Jun Jul Aug Sep Oct

8:30pm Printed using TradeStation © Omega Research, Inc. 1999

### Chart 9

Seagate Tech. Yo Yo Exit 2 ATRs below close



Yo Yo Exit

Chandelier Exit

08/16/1999

(HD) Home Depot, Inc. (The)

12/28/1999

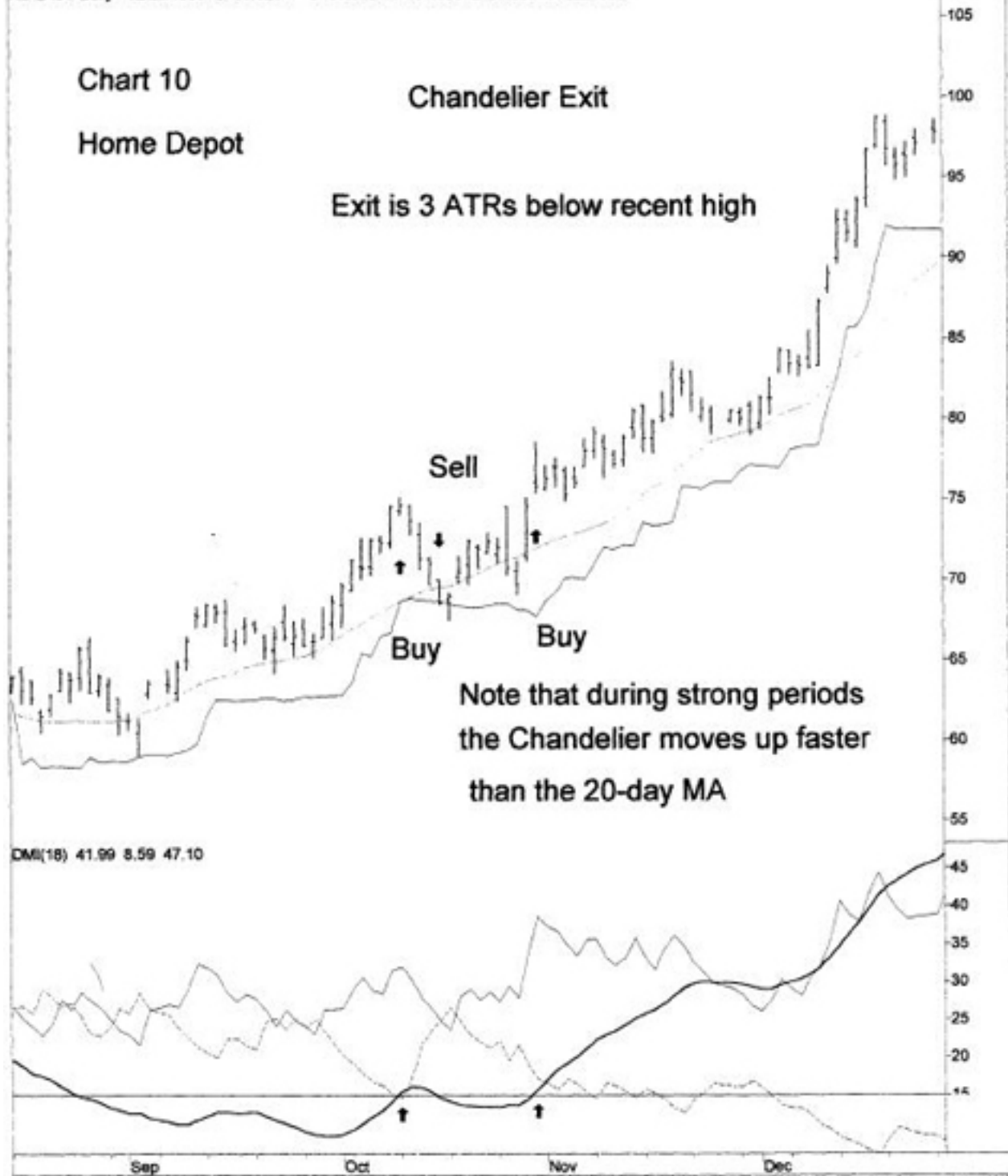
HD LAST-Daily 12/28/1999 C=99.625 O=97.813 H=101.563 L=97.500 V=3224800

Chart 10

Chandelier Exit

Home Depot

Exit is 3 ATRs below recent high



# Chandelier Exit

08/16/1999

(EMC) EMC Corporation

12/28/1999

EMC LAST-Daily 12/28/1999 C=103.750 O=105.000 H=105.000 L=102.875 V=2291900

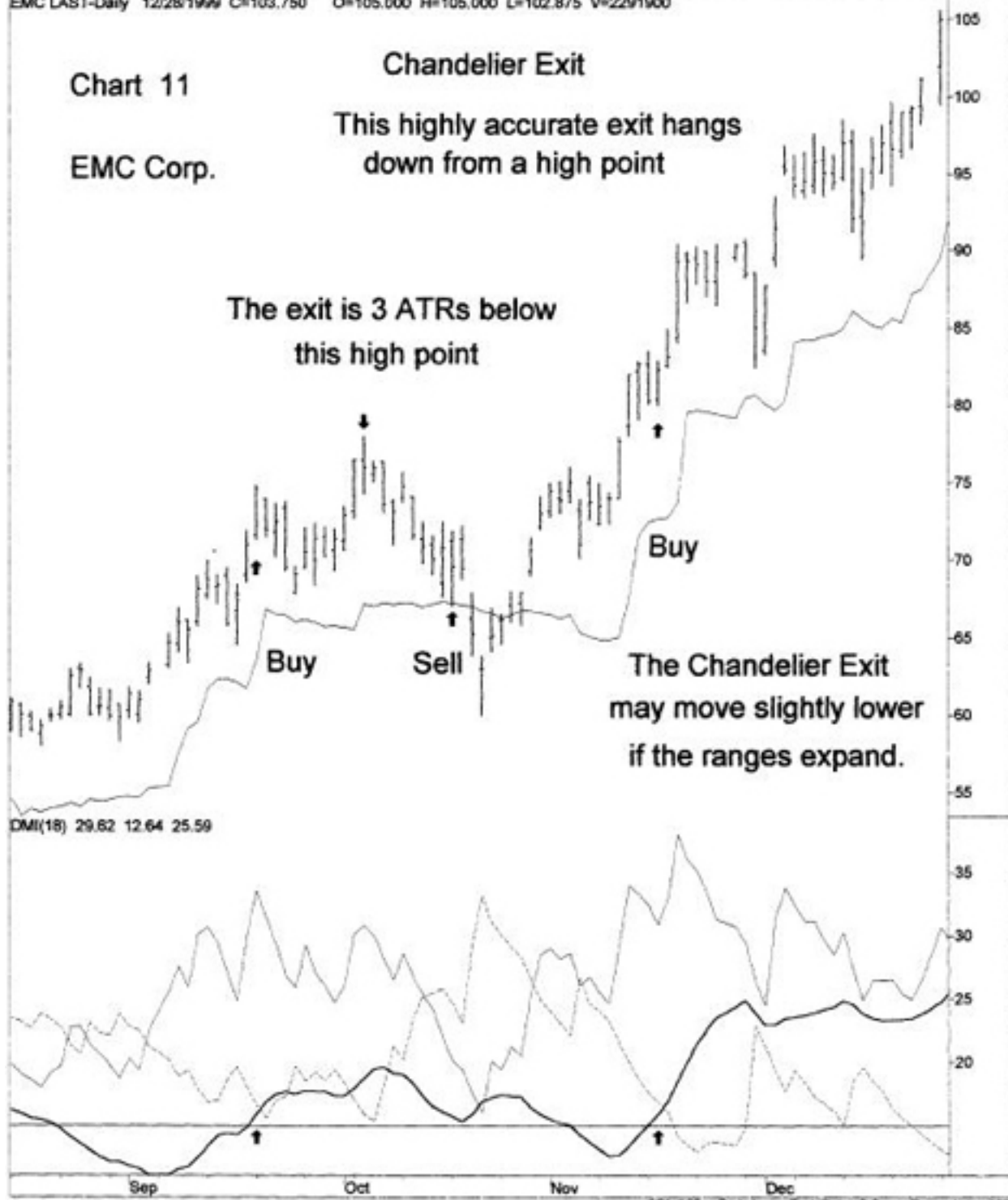
Chart 11

## Chandelier Exit

EMC Corp.

This highly accurate exit hangs down from a high point

The exit is 3 ATRs below this high point



The Chandelier Exit may move slightly lower if the ranges expand.

DMI(18) 29.62 12.64 25.59

6:01 8:30pm Printed using TradeStation © Omega Research, Inc. 1999



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**Contact Chuck LeBeau at (310) 265-9776 or by e-mail at [Chuck@streakingstocks.com](mailto:Chuck@streakingstocks.com)**

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