

# Trade Setups

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# The Anatomy of Elliott Wave Trading

**W**hen teaching the Wave Principle, I begin each class by stating that analysis and trading represent two different skill sets. Although you may be a talented analyst, that does not mean you will be a successful trader and vice versa. I learned the hard way over many years that skilled analysis is a mastery of observation, while successful trading is a mastery of self.

When it comes to trading, there is no right way or wrong way—only your way. One trader’s tolerance for risk will be starkly different from another’s, just as time frame, portfolio size, and markets traded will also be different. Thus, the guidelines offered within this chapter on how to trade specific Elliott wave patterns are just that—guidelines, but ones that have served me well for many years.

My best advice to you as you look for a trading opportunity is to start your search by asking the

question, “Do I see a wave pattern I recognize?” You should look for one of the five core Elliott wave patterns: impulse wave, ending diagonal, zigzag, flat, or triangle. These forms will become the basis of all your trade setups once you learn to identify them quickly and with confidence.

An even simpler question to ask is, “Do I see either a motive wave or a corrective wave?” Motive waves define the direction of the trend. There are two kinds of motive waves: impulse waves and ending diagonals. Corrective waves travel against the larger trend. The three kinds of corrective waves are zigzags, flats, and triangles. If all you do is identify a motive wave versus a corrective wave correctly, you can still identify some useful trade setups.

In this chapter, we will examine how to use key components of analysis and trading to help you

## KEY POINT

**Analysis is a mastery of observation, while successful trading is a mastery of self.**

become a better Elliottician and a consistently successful trader. Specifically, we will examine how the Wave Principle improves trading, which waves are the best to trade, which guidelines to use for trading specific Elliott wave patterns, and why the psychology of trading and risk management—what I call the neglected essentials—are important.

## How the Wave Principle Improves Trading

Every trader, every analyst, and every technician has favorite techniques to use when trading. Let's go over why the Wave Principle is mine.

### How the Wave Principle Improves Upon Traditional Technical Studies

There are three categories of technical studies: trend-following indicators, oscillators, and sentiment indicators. Trend-following indicators include moving averages, Moving Average Convergence-Divergence (MACD), and Directional Movement Index (ADX). A few of the more popular oscillators many traders use today are stochastics, rate-of-change, and the Commodity Channel Index (CCI). Sentiment indicators include put-call ratios and Commitment of Traders report data.

Technical studies like these do a good job of illuminating the way for traders, yet they each fall short for one major reason: They limit the scope of a trader's

understanding of current price action and how it relates to the overall picture of a market. For example, let's say the MACD reading in XYZ stock is positive, indicating the trend is up. That's useful information, but wouldn't it be more useful if it could also help to answer these questions: Is this a new trend or an old trend? If the trend is up, how far will it go?

Most technical studies simply don't reveal pertinent information such as the maturity of a trend and a definable price target—but the Wave Principle does.

## Five Ways the Wave Principle Improves Trading

Here are five ways the Wave Principle can benefit you and improve your trading:

1. The Wave Principle identifies the trend.
2. It identifies countertrend price moves within the larger trend.
3. It determines the maturity of the trend.
4. It provides high-confidence price targets.
5. It provides specific points of invalidation.

### 1. Identifying the Trend

“... action in the same direction as the one larger trend develops in five waves...”

—*Elliott Wave Principle* by Frost and Prechter

The Wave Principle identifies the direction of the dominant trend. A five-wave advance identifies the

overall trend as up. Conversely, a five-wave decline determines that the larger trend is down. Why is this information important? Because it is easier to trade in the direction of the dominant trend, since it is the path of least resistance and undoubtedly explains the saying, “The trend is your friend.” I find trading in the direction of the trend much easier than attempting to pick tops and bottoms within a trend, which is a difficult endeavor and one that is virtually impossible to do consistently.

## 2. Identifying the Countertrend

“... reaction against the one larger trend develops in three waves...”

—*Elliott Wave Principle* by Frost and Prechter

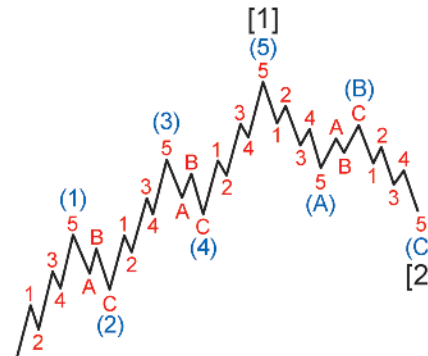
The Wave Principle also identifies countertrend moves. The three-wave pattern is a corrective response to the preceding impulse wave. Knowing that a recent move in price is merely a correction within a larger trending market is especially important for traders because corrections give traders opportunities to position themselves in the direction of the larger trend of a market.

Being aware of the three basic Elliott wave corrective patterns—zigzags, flats, and triangles—enables you to buy pullbacks in an uptrend and to sell bounces in a downtrend, which is a proven and consistently successful trading strategy. Know what countertrend price moves look like, and you can find opportunities to rejoin the trend.

## 3. Determining the Maturity of a Trend

As R. N. Elliott observed, wave patterns form larger and smaller versions of themselves. This repetition in form means that price activity is a fractal, as illustrated in Figure 1.1. Wave (1) subdivides into five small waves yet is part of a larger five-wave pattern. How is this information useful? It helps traders recognize the maturity of a trend. If, for example, prices are advancing in wave 5 of a five-wave advance and wave 5 has already completed three or four smaller waves, a trader knows that this may not be the best time to add long positions. Instead, it may be time to take profits or at least to raise protective stops.

Since the Wave Principle identifies trend, countertrend, and the maturity of a trend, it's no surprise that the Wave Principle also signals the return of the dominant trend. Once a countertrend move unfolds



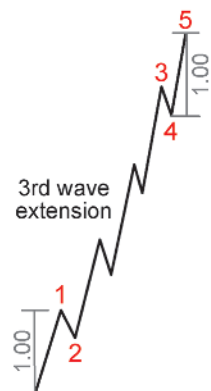
**Figure 1.1**

Source: *Elliott Wave Principle*.

in three waves (A-B-C), this structure can signal the point where the dominant trend has resumed, namely, once price action exceeds the extreme of wave B. Knowing precisely when a trend has resumed brings an added benefit: It increases the likelihood of a successful trade, which is further enhanced when accompanied by traditional technical studies.

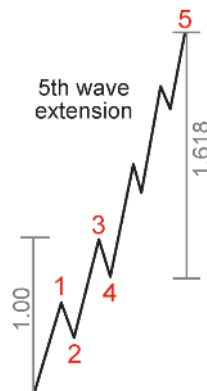
#### 4. Providing Price Targets

What traditional technical studies simply don't offer—high-confidence price targets—the Wave Principle again provides. When R. N. Elliott wrote about the Wave Principle in *Nature's Law*, he stated that the Fibonacci sequence was the mathematical basis for the Wave Principle. Elliott waves, both impulsive and corrective, adhere to specific Fibonacci proportions. For example, all three motive waves tend to be related by Fibonacci mathematics, whether by equality, 1.618,



**Figure 1.2**

Source: *Elliott Wave Principle*.



**Figure 1.3**

Source: *Elliott Wave Principle*.

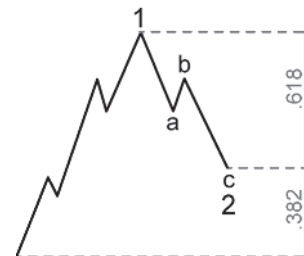


**Figure 1.4**

Source: *Elliott Wave Principle*.

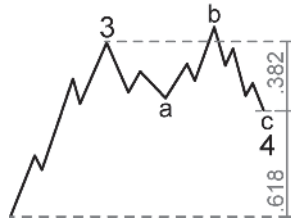
or 2.618 (whose inverses are .618 and .382). See Figures 1.2, 1.3, and 1.4.

Also, corrections often retrace a Fibonacci percentage of the preceding wave. These Fibonacci-derived regions allow traders to set profit-taking objectives and identify areas where the next turn in prices will likely occur (see Figures 1.5 and 1.6).



**Figure 1.5**

Source: *Elliott Wave Principle*.



**Figure 1.6**

Source: *Elliott Wave Principle*.

## 5. Providing Specific Points of Invalidation

Wave analysis provides a specific point of invalidation, which is the level at which an interpretation is no longer viable. Knowing when you are wrong is perhaps a trader's most important piece of information.

At what point does a trade fail? Many traders use money management rules to determine the answer to this question, because technical studies simply don't offer the answer. Yet the Wave Principle does—in the form of these three Elliott wave rules for impulse waves:

*Rule 1:* Wave 2 can never retrace more than 100 percent of wave 1.

*Rule 2:* Wave 4 may never end in the price territory of wave 1.

*Rule 3:* Out of the three impulse waves (waves 1, 3, and 5), wave 3 can never be the shortest.

A violation of any of these rules implies that the operative wave count is incorrect. How can traders use this information? If a technical study warns of an upturn in prices, and the wave pattern is a second-wave pullback, the trader knows specifically at what point

the trade will fail: a move beyond the origin of wave 1. That kind of guidance is difficult to come by without a framework such as the Wave Principle.

## The Four Best Waves to Trade

Here's where the rubber meets the road. Waves 3, 5, A, and C are the most advantageous to trade, because they are oriented in the direction of the one larger trend. Odds favor traders who are long in bull markets (and short in bear markets) versus short sellers in bull markets (and buyers in bear markets). Overall, trading in the direction of the trend is the path of least resistance.

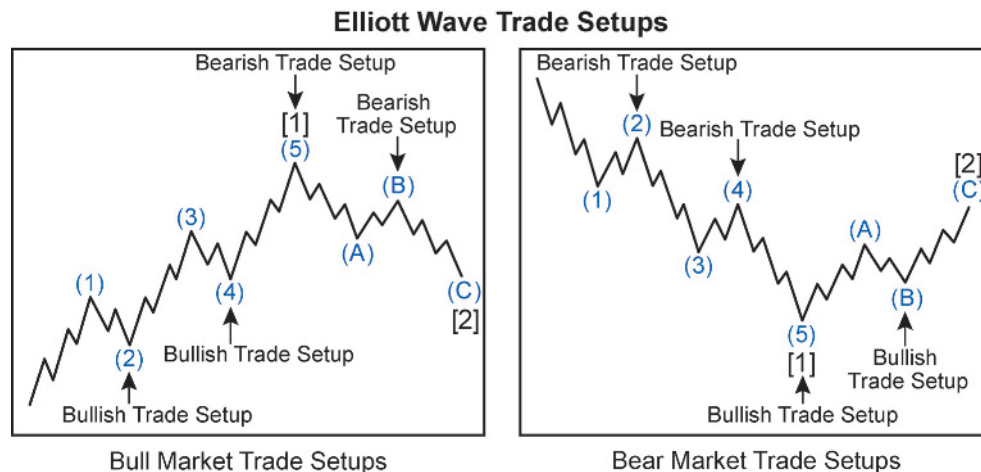
The Wave Principle helps to identify these high-confidence trades in place of lesser-confidence setups that traders should ignore. Remember, five-wave moves determine the direction of the larger trend, while three-wave moves offer traders an opportunity to join the trend. So in Figure 1.7, waves (2), (4), (5), and (B) are actually setups for high-confidence trades exploiting waves (3), (5), (A), and (C).

For example, a wave (2) pullback provides traders an opportunity to position themselves in the direction of wave (3), just as a wave (5) rally offers them a shorting opportunity for wave (A). By combining the Wave Principle with traditional technical analysis, traders can improve their trading by increasing the likelihood of a successful trade.

Technical studies can pick out many trading opportunities, but the Wave Principle helps traders discern which ones are more likely to be successful.

## KEY POINT

**Knowing when you're wrong on a trade is as important as knowing when you're right.**



**Figure 1.7**

This is because the Wave Principle is the framework that provides history and context, current information, and a peek at the future.

## Elliott Wave Trade Setups

This next chart (see Figure 1.7) shows bullish and bearish versions of trade setups. In each, waves (2), (4), (5), and (B) are trade setups that introduce the four primary Elliott-based trading opportunities. These corrective waves offer the trader an opportunity to rejoin the larger trend. In such trend trading, a trader buys pullbacks in uptrends and sells bounces in downtrends.

## When to Trade Corrections

Corrective waves offer less desirable trading opportunities because of their potential complexity. Impulse waves are trend-defining price moves in which prices typically travel far. Conversely, corrective wave patterns fluctuate more and can unfold slowly while taking a variety of shapes, such as a zigzag, flat, expanded flat, triangle, double zigzag, or combination. Corrections generally move sideways and are often erratic, time-consuming, and deceptive. Thus, it is emotionally exhausting to trade corrections, and the odds of executing a successful trade during this type of price action are low.



Even though I view corrective waves and patterns as providing low-confidence trade setups, there are times when I would consider trading them—but it depends on the potential duration of the correction. If I count five waves up, for example, on a 15-minute price chart of Crude Oil, I do not consider waves 2 or 4 to be viable trading opportunities. I prefer, instead, to wait for waves 2 and 4 to terminate before entering a position. Let's say, though, that we have a market that has also formed an impulse wave, but it has taken weeks or months to do so. In this instance, waves 2 and 4 would form over many weeks and might offer traders many short-term trading opportunities.

## Guidelines for Trading Specific Elliott Wave Patterns

Before we review guidelines for trading specific Elliott wave patterns, here is my most important analytical and trading rule: **Let the market commit to you before you commit to the market.** In other words, look for *confirming price action*. Just as it is unwise to pull out in front of an oncoming car on the basis of its turn signal alone, it is equally unwise to take a trade without confirmation of a trend change.

The following guidelines incorporate this idea and benefit the trader in two ways. First, waiting for confirming price action tends to decrease the number of trades executed. One of the biggest mistakes traders make is overtrading. Second, it focuses attention on higher-confidence trade setups. If a trader believes

that a particular market is topping—and appropriate price action does indeed corroborate this belief—then the trader is more likely to execute a successful trade.

## Impulse Waves

Whenever an impulse wave is complete, the Elliott wave guideline regarding the depth of corrective waves applies:

“[C]orrections, especially when they themselves are fourth waves, tend to register their maximum retracement within the span of travel of the previous fourth wave of one lesser degree, most commonly near the level of its terminus.”

—*Elliott Wave Principle* by Frost and Prechter

Although that guideline may sound complicated, it's easy to follow in real trading. The trading technique is to enter on a break below the extreme of wave (iv) of 5 (see Figure 1.8). Doing so prevents top picking and requires the market to take out a prior swing low to act as initial evidence that the impulse wave is indeed finished. Set the initial protective stop at the extreme of the price move.

## Ending Diagonal

The guidelines for entry and initial protective stops for ending diagonals are similar to those for impulse waves: Wait for a break of the extreme of wave 4 before taking a position, and place the initial protective stop at the extreme of the price move (see Figure 1.9).

Remember, these entry techniques demonstrate a conservative approach that I think of as “ready, aim,

### Smart Investor Tip

Let the market commit to you before you commit to the market.

### Smart Investor Tip

Waiting for confirming price action allows traders to use an evidence-based approach and to focus their attention on higher-confidence trade setups.

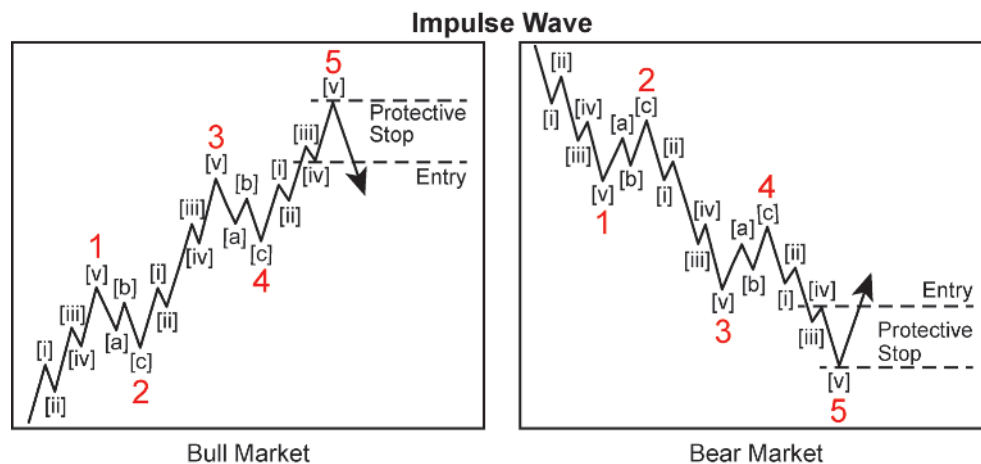


Figure 1.8

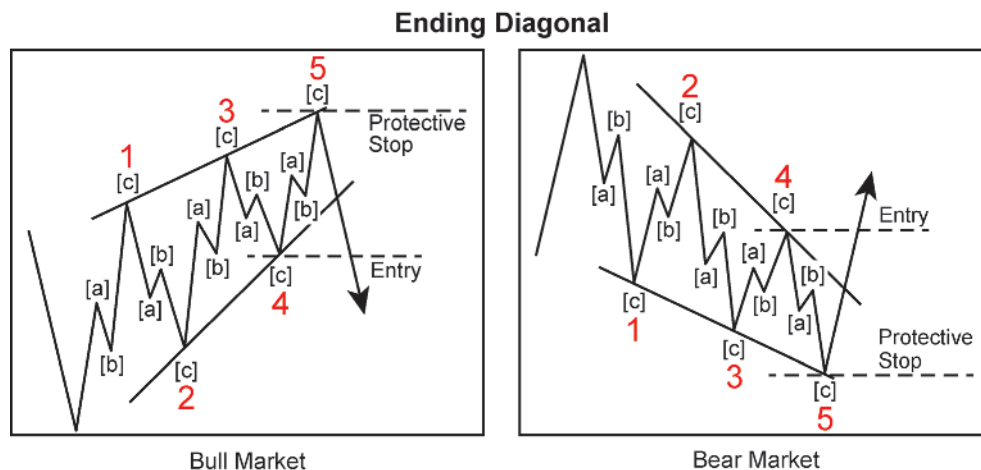


Figure 1.9

aim, aim . . . fire” trading. But if you are a more aggressive trader, how do you enter an ending diagonal trade setup? One approach is to enter on a decisive close beyond the trendline that connects the extreme of waves 2 and 4. In this instance, the initial protective stop placement is the same, the extreme of the pattern (see Figure 1.10).

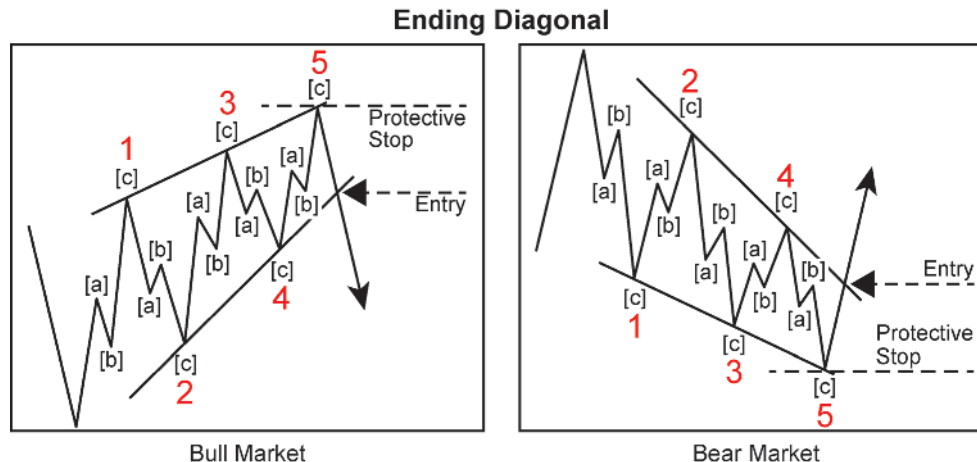
If you define yourself as an out-and-out aggressive trader, here’s an entry technique for you. More often than not, wave 3 of an ending diagonal is shorter than wave 1. When this is the case, the rules state that wave 5 cannot be longer than wave 3, since even within an ending diagonal, wave 3 may never be the shortest wave among waves 1, 3, and 5. Thus, you can begin acquiring positions or scale into a position as

wave 5 is forming. The protective stop under this aggressive entry technique would be the point at which wave 5 becomes longer than wave 3, since the Wave Principle identifies that as a specific point of invalidation.

## Zigzag

The first of two guidelines for entering a trade during a zigzag is on a break of the extreme of wave [iv] of C, provided this level is beyond the termination of wave A (see Figure 1.11).

A second entry guideline is to wait for the extreme of wave B to give way before taking action (see Figure 1.12). The initial protective stop is then the extreme of wave C. This conservative approach



**Figure 1.10**

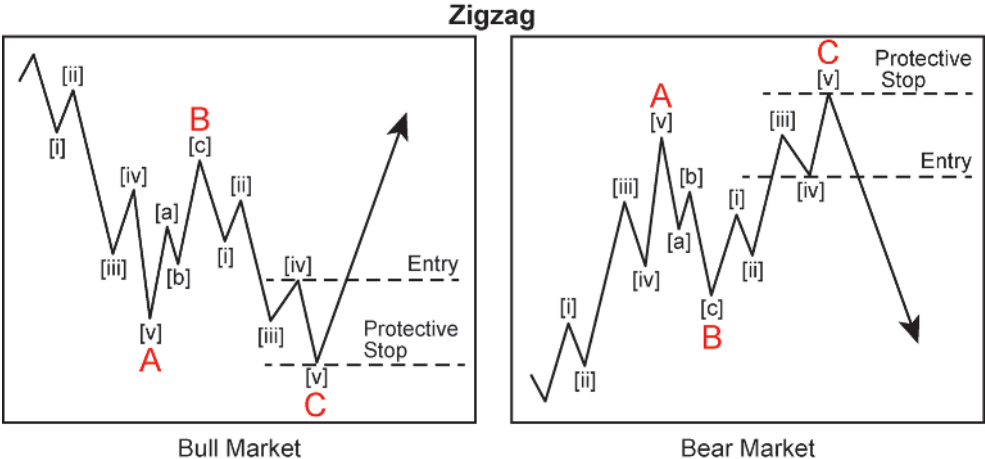


Figure 1.11

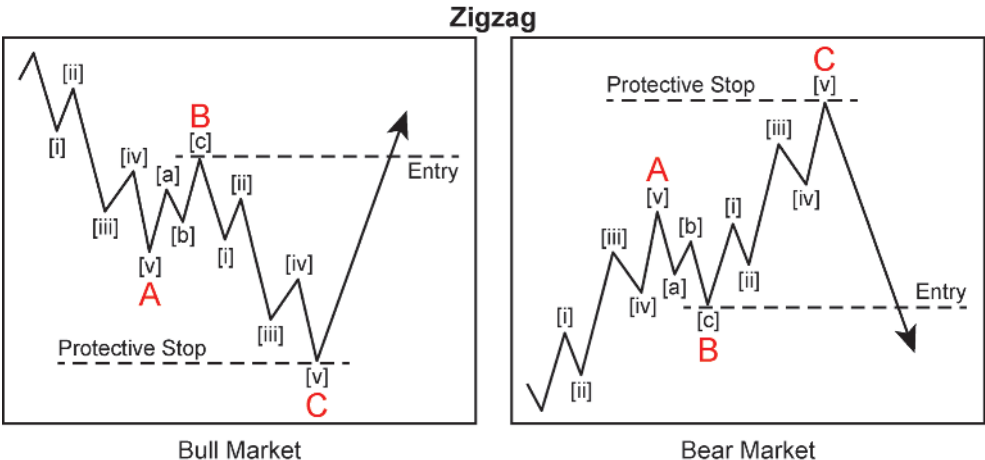


Figure 1.12

prevents picking tops or bottoms without sufficient evidence.

Ideally, traders will take these guidelines and adapt them to their own specific trading style. In fact, using a zigzag as an example, an even more conservative trader could wait a bit longer before entering and demand a five-wave move through the extreme of wave B followed by a corrective wave pattern.

### Flat

Since the final wave of a flat correction subdivides into five waves, the recommended entry technique is similar to that of an impulse wave: Wait until prices exceed the

extreme of wave (iv) of C to enter a trade (see Figure 1.13). This approach is not used with zigzags—where wave C also subdivides into five waves—because in a bullish zigzag, for instance, wave (iv) of a C terminates *below* the extreme of wave A, whereas in a bullish flat, it tends to form *above* the extreme of wave A.

### Triangle

The final guideline applies to triangles (see Figure 1.14). A triangle is a sideways price move—typically bounded by converging trendlines—that subdivides into waves A, B, C, D, and E. The entry guideline is to wait for prices to break the extreme of wave D and place an initial protective stop where wave E

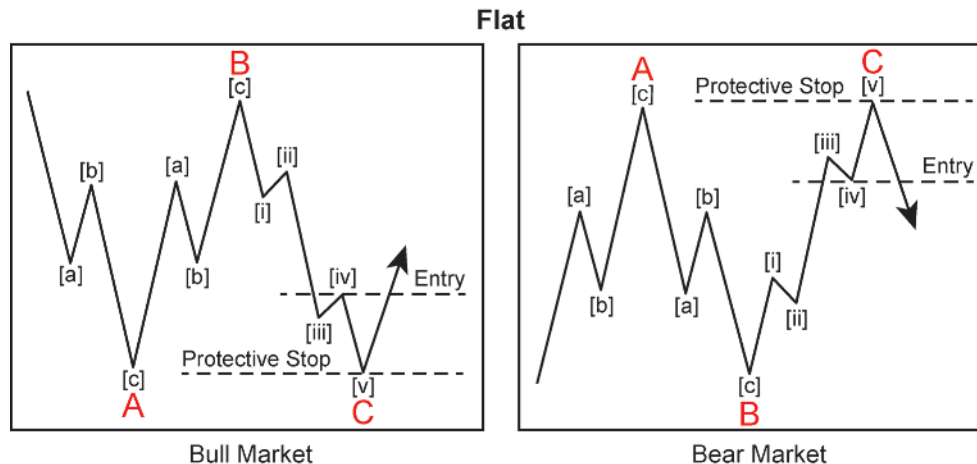
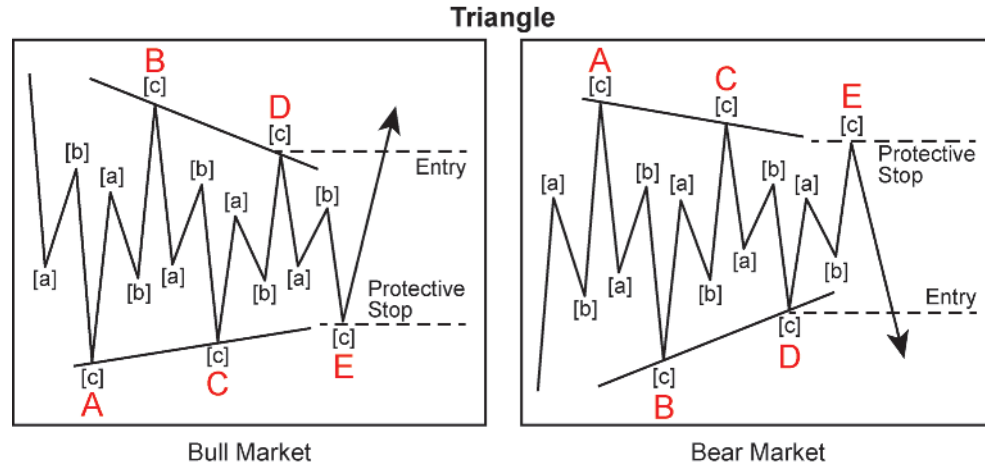


Figure 1.13



### Figure 1.14

### Smart Investor Tip

**The psychology of the individual is the key to becoming a consistently successful trader.**

## DEFINITION:

## Risk to reward

**Risk-Reward Ratio** is a ratio used to compare expected returns against the amount of risk taken. In line with market convention, risk-reward ratios are expressed in terms of total reward per one unit of risk.

terminates. I do not endorse a more aggressive entry technique because triangles are sometimes deceptive: Since they can form in the wave 4, B, or X wave positions, what may appear to be a bullish fourth-wave triangle could actually be a bearish triangle B wave.

A trader with a more aggressive trading style will most likely enter a position well before prices penetrate the termination point of wave D. If so, I recommend using the extreme of wave A as an initial protective stop rather than the end of wave C. It is not uncommon in equities or thinly traded markets for intraday price action to exceed the extreme of wave C and reverse.

## The Neglected Essentials— Risk Management and the Psychology of Trading

When discussing how to become a consistently successful trader, two subjects you don't hear enough about are risk management and the psychology of trading.

Because the topic of risk management is critically important to the success and longevity of a trader, let's briefly discuss risk-reward ratios and trade size.

## Risk-Reward Ratio

**Risk to reward** is a ratio that quantifies the risk versus the reward of a trade. If you buy XYZ stock at \$50.00 with

the expectation that it will appreciate to \$51.00, your expected reward is \$1.00. If the protective stop on this position is \$49.00, the risk-reward ratio for this trade is 1:1—you're risking \$1.00 to make \$1.00. If the protective stop is \$49.90, then the risk-reward ratio is 10:1.

Note: Even though it's called a risk-reward ratio, the ratio is conventionally stated with the reward figure first. So, in this example, even though risk is 1 and the reward 10, the ratio is stated as 10:1, rather than 1:10. This explains why a 3:1 risk-reward ratio is desirable. It's actually a reward-risk ratio.

A high risk-reward ratio is desirable as a function of probabilities. Let's say that you're right about the market 70 percent of the time, and the risk-reward ratio on each of your trades is 1:1. Thus, out of 10 trades, seven trades were closed with a \$1.00 profit, while three were exited with a \$1.00 loss. The bottom line is that you walked away with \$4.00. What do you think will happen if we increase the risk-reward ratio from 1:1 to 3:1 and decrease the probability of being right from 70 percent to 40 percent? With this 3:1 ratio, for the same \$1.00 profit, four winning trades would net \$12.00. If we then subtract \$6.00 in losing trades, we walk away with a \$6.00 profit.

This difference shows how important the risk-reward ratio is—by decreasing the probability of winning trades from 70 percent to almost half (i.e., 40 percent) while increasing the risk-reward ratio, you increase profitability by 50 percent. A misconception about trading is that a trader need be right only on the direction of the market to make money. This is not entirely correct. As you've just seen, a trader can be right as little

as 40 percent of the time and still succeed, provided he or she keeps an eye on the risk-reward ratio.

## Trade Size

How large a position should a trader take? The risk on a single trade should never exceed 1 to 3 percent of the total portfolio size. Retail traders tend to balk at these small percentages, while professional traders embrace them. Thus, at 1 percent, for every \$5,000 a trader has in a trading account, he or she should risk only \$50 on each position. For example, a trader with \$10,000 in his account can take either two trades where the risk is \$50 apiece or one trade in which the risk is \$100. Many traders fail at trading because they simply don't have sufficient capital in their trading accounts to take the positions they want to take.

If you do have a small trading account, though, you can overcome this challenge by trading small. You can trade fewer contracts, trade e-mini contracts, or even penny stocks. Bottom line, on your way to becoming a consistently successful trader, you must realize that *longevity* is key. If your risk on any given position is small relative to your total capital, then you can weather a losing streak. Conversely, if you risk 25 percent of your portfolio on each trade, after four consecutive losers, you're out of business.

## The Psychology of Trading

While I consider risk management to be an essential component of successful trading, the true key is psychology—that is, your individual psychology. Let's

### Smart Investor Tip

Trades that offer less than a 3:1 risk-reward ratio should be avoided.

### Smart Investor Tip

Successful trading requires a methodology and the discipline to follow the methodology.

review a number of psychological factors that prevent traders from becoming consistently successful: lack of methodology, lack of discipline, unrealistic expectations, and lack of patience.

Whether you are a seasoned professional or just thinking about opening your first trading account, it is critically important to your success that you understand how your personal psychology affects your trading results.

### Lack of Methodology

If you aim to be a consistently successful trader, then you *must* have a defined trading methodology—a simple, clear, and concise way of looking at markets. In fact, having a method is so important that EWI founder Robert Prechter put it at the top of his list in his essay, “What a Trader Really Needs to Be Successful.” Guessing or going by gut instinct won’t work over the long run. If you don’t have a defined trading methodology, then you don’t have a way to know what constitutes a buy or sell signal.

How do you overcome this problem? The answer to this question is to write down your methodology. Define in writing what your analytical tools are and, more important, how *you* use them. It doesn’t matter whether you use the Wave Principle, point and figure charts, stochastics, RSI, or a combination of all of these. What *does* matter is that you actually make the effort to define what constitutes a buy, a sell, your trailing stop, and instructions on exiting a position. The best hint I can give you about defining your trading

methodology is this: If you can’t fit it on a 3" × 5" card, it’s probably too complicated.

### Lack of Discipline

Once you have clearly outlined and identified your trading methodology, you *must* have the discipline to follow the system. A lack of discipline while trading is the second common downfall of many aspiring traders. If the way you view a price chart or evaluate a potential trade setup today is different from how you did it a month ago, then you either have not identified your methodology or you lack the discipline to follow the methodology you have identified. The formula for success is to consistently apply a proven methodology.

### Unrealistic Expectations

Nothing makes me angrier than those commercials that say something like, “\$5,000 properly positioned in Natural Gas can give you returns of over \$40,000.” Advertisements like this are a disservice to the financial industry as a whole and end up costing uneducated investors a lot more than \$5,000. In addition, they help to create the psychologically sabotaging mindset of having unrealistic expectations.

Yes, it is possible to experience above-average returns trading your own account. However, it’s difficult to do it without taking on above-average risk. So, what is a realistic return to shoot for in your first year as a trader—50 percent, 100 percent, 200 percent? Whoa, let’s rein in those unrealistic expectations. In my opinion, the goal for every trader the first year out should



be *not to lose money*. In other words, shoot for a 0 percent return your first year. If you can manage that, then in year two, try to beat the Dow or the S&P. These goals may not be flashy, but they are realistic.

### Lack of Patience

The fourth psychological pitfall that even experienced traders encounter is a lack of patience. According to Edwards and Magee in their seminal book, *Technical Analysis of Stock Trends*, markets trend only about 30 percent of the time. This means that the other 70 percent of the time, financial markets are not trending.

This small percentage may explain why I believe that, for any given time frame, there are only two or three really good trading opportunities. For example, if you're a long-term trader, typically only two or three compelling tradable moves in a market present themselves during any given year. Similarly, if you are a short-term trader, only two or three high-quality trade setups present themselves in a given week.

All too often, because trading is inherently exciting (and anything involving money usually is exciting), it's easy to feel that you're missing something if you're not

in a trade. As a result, you start taking trade setups of lesser and lesser quality and begin overtrading.

How do you overcome this lack of patience? Remind yourself that every week there will be another "trade of the year." In other words, don't worry about missing an opportunity today, because there will be another one tomorrow, next week and next month . . . I promise.



#### Video:

To watch a video on the importance of patience and persistence in your trading, go to:  
[www.wiley.com/go/elliottwavevg](http://www.wiley.com/go/elliottwavevg)

### For More Information

Learn more at your exclusive Reader Resources site. You will find a free online edition of *Elliott Wave Principle* by Frost and Prechter, plus lessons on Elliott wave analysis, how to trade specific patterns, and how to use Fibonacci and other technical indicators to increase your confidence as you apply the Wave Principle in real time. Go to: [www.elliottwave.com/wave/ReaderResources](http://www.elliottwave.com/wave/ReaderResources).

### Smart Investor Tip

**Stick with realistic expectations.** For instance, the goal for every trader the first year should be *not to lose money*. In other words, shoot for a 0 percent return during your first year.

## Test Yourself

Answer the following True/False questions:

1. Analysis and trading employ the same skill set.
2. Wave analysis identifies the direction of the trend, based on the direction of the impulse wave.
3. The Wave Principle offers traders points of invalidation where they can re-evaluate where their analysis may have gone wrong.
4. Wave 2 can sometimes retrace more than 100 percent of wave 1.
5. A complete Elliott wave cycle consists of nine waves.
6. From origin to termination, waves 2 and 4 offer high-confidence trading opportunities.
7. An aggressive approach to trading an ending diagonal is to wait for the extreme of wave 4 to give way.
8. If you look for confirming price action, then you are letting the market commit to you before you commit to the market.
9. The entry guideline for trading a zigzag is to wait for the extreme of wave B to give way.
10. A risk to reward ratio of 1:1 is ideal.

**Answers:** 1. False 2. True 3. True 4. False 5. False 6. False 7. False 8. True 9. True 10. False