Red-White-Red

Pattern Trading

Trading with rate patterns can offer a low-risk and highly profitable possibility. Ever-returning formations are easy to describe, and can be easily tested for their profitability. The pattern introduced here does not only awaken associations with the Austrian flag but might also fill up your cash box for your holidays!

Price Pattern

In general, price patterns count as highly profitable investment strategies. You will rarely find a trading professional who does not in some way or another integrate the conclusions he draws from the ever-recurring formations in his trading decisions.

The most famous price pattern is probably the candlestick pattern "hammer". It describes the behaviour of the markets in one day, and shows where and how the open/high/low/close is arranged in the price scale. This in turn allows us to draw conclusions about the market behaviour of the following day.

A hammer is a day in the downtrend, which might lead to a trend reversal. The day begins weak, but then the change comes, the market compensates for the lost terrain and closes near the opening. The chartist does not care about what introduced the reversal in the market direction, the only important thing is that the market removes itself from the daily low and closes where it had already opened. Figure 1 shows this candlestick pattern.

For the next day, this means the following: If the market is able to continue rising and pass the high of the previous day, this is a strong bullish sign and we can think about a long position. If, however, the market begins to fall again and reaches new lows, the intraday trend reversal of the hammer was after all a premature strengthening of the bulls. In case we are already long, we should close our position at the latest at the low of the hammer.

Therefore, a price pattern presents a good possibility of indicating exactly where to place the entry and exit stops. With known stops, it is possible to choose the correct position size – and, as we know, this is the key to a successful trade.

Red-White-Red

The red-white-red pattern is a price pattern which includes three days in total, it does not describe the market behaviour of one day only, but determines the precise sequence of the price development of three successive days. The first day of the price pattern is a falling day, represented as a red candle in the chart. This negative day is followed by new lows and a short break; the market closes above its opening on day two of the price pattern. This day has to be the lowest low of the three days. On the last day of the price pattern there is another

F1) Candlestick Pattern Hammer

Figure 1 shows you twice the appearance of one of the simplest price patterns – the hammers.
The market builds new lows in the cause of the day, but it recovers, and closes near the opening. After the first hammer, displayed in red, the market could build neither a new high nor a new low. The pattern therefore remained without consequences. The second hammer clarifies the idea how it should work. The market further rises on the day after the hammer, we go long at the high of the hammer, and place the initial stop at the low of the hammer.

Source: www.tradesignal.com

F2) Price Pattern Red-White-Red

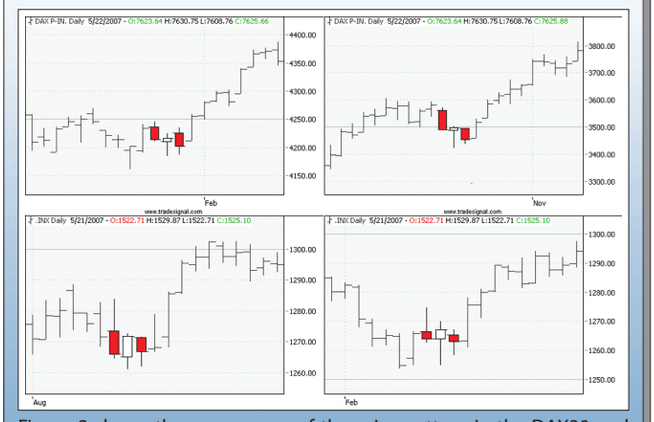

Figure 2 shows the appearance of the price pattern in the DAX30 and S&P500 indexes.
The red-white-red pattern is made up of a total of 3 days. The first and the last day close below its opening, the middle day builds the lowest low of the triplet and closes above the opening price. If the high of the previous two days is exceeded, another breakout to the upside can be expected after three days of indecision. In combination with the correct position size and a consolidated plan for the exit of the position, this pattern can be used for trading profitably.

Source: www.tradesignal.com

negative day. The correction of the previous day is over, though the bears are not strong enough to push the rate below the previous day's low; the market has to trade above the low of the white candle, however close under its opening. In Figure 2 we see several examples of this pattern. The two upper charts show the DAX30 index, both lower charts show the S&P500 index.

The idea behind the pattern, as we can see in the chart, is that a trend reversal is imminent after these three days of indecision and today's higher low. Whether this pattern is significant enough, and how you could trade it, is the content of this article.

Entry

With this definition of the pattern, we know its setup. However, to be able to also make money with such a price pattern, we have to decide exactly where the position should be opened, how large this position should be, and when the position should be closed – hopefully with an appealing profit.

The pattern itself (and this is true for all sorts of price patterns) is not a sufficient reason to jump into the market immediately and build a position. First of all, the market has to confirm the idea; it has to show that the expected uptrend will follow the found red-white-red pattern.

Only when the market exceeds the high of the last two candles, in other words when the bulls clearly have taken over, is it your time to enter the market.

When the market rises above this point and therefore makes a new high, one can no longer talk about selling pressure. The market seems to have made up its mind about direction after three days of indecision. In addition, the low of the white candle of the formation was confirmed by the new high as a "swing low".

In practice, you can realise this entry with the appearance of this pattern by sending a valid stop-buy order to your broker on the high of the last two days for the following day. However, you should only enter the market when it does not already open with a gap above the formation.

Position Size

Paracelsus knew that the dose decides whether it is poison or medicine, and it is similar for us traders when we have to determine the size of the next position.

Before we think about how many stocks we should buy, we have to consider the point at which our trading idea proves false and we have to close the trade in a loss. Hence, we have to define our initial stop and therefore determine the point loss which is possible at maximum for this trade.

As an entry point we decided to go in the market as soon as it is clear that new highs are forming. If this new high proves a bull trap, and the market falls below the low of the white candle, it is clear that in this case the pattern has not worked, and we have to close our positions again.

Therefore, the span between the high of the last two days (= point of entry) and the low of the formation (= worst-case exit) is the risk that we take when trading this formation.

To determine the number of stocks we should buy from these two values, we remember the old money management rule stating that one should never risk more than one percent of one's trading account in a single trade. The number of the stocks we should buy therefore results from the equation: number of stocks = 0.01*trading account / (entry level – exit level). This approach is visualised in Figure 3.

This ensures that we do not ruin our portfolio with several

F3) Position Size

The figure shows a possible entry into a long position at the high of the two last candles of the rate pattern. The worst-case scenario for the first day is when the market takes the old highs, then turns and falls under the low of the formation. The low of the formation is the stop point for the long trade. The position size results from the risk of the trade (28.60-28.04 = 0.56€) and the account size. In case you want to trade this pattern for example with a trading account of 10,000€, you would risk 1% of your capital when you trade 10.000*1% / 0.56 = 180 stocks.

Source: www.tradesignal.com

successive losing trades, on the other hand the position size is large enough to promote the development of our portfolio in case of a win.

Exit

So far I have shown how to recognise the red-white-red pattern, how large the position should be, when to enter the market, and where the initial stop should be placed. However, this will not have made us any money, but merely controlled our risk. In the next step I will show how to minimise our losses, let our profits run, and thereby trade this formation with a positive result.

The entry is usually only a very small step on the way to a successful trade: the money is made with the exit, and therefore most consideration has to be put into this exit. When testing the introduced approach yourself, you will quickly see that you can combine this exit with different price patterns and entries.

We can see successful patterns in the chart immediately ex post, so I want to show a few examples in Figure 4 where this pattern would not have worked. These examples are far more important for the development of the exit than those in which the pattern works as planned. From these we can learn what may happen, and we can then decide on the method by which we can get out of such negative examples with the least possible damage.

The cases in which the market explodes after the appearance of the pattern are not difficult to trade further (see Figure 2), we merely wait and count the money. More challenging are the cases where the market does not go up after all. Should we always wait until we are stopped at the low of the formation, or should we stop with small losses when we realise that it does not work this time, and that we had better wait for the next chance?

We have already talked about the first exit: the initial stop at the low of the formation. The next exit deals with the scenario where we do not see the low of the formation, however neither does the market begin to rise. In this case we close the position if it is not in the plus two days after the entry towards the trading end.

The purpose of this is to eliminate the time risk. The longer we are in the market, the higher the risk that something will happen to our disadvantage. Originally the idea was that the market rises sharply after this formation. If this does not happen, our analysis may have been wrong. It is often better to close the trade, realising small losses, than to wait for our luck and be exposed to the risk of being stopped out with the worst-case scenario loss at the low of the formation.

Tests with the stock market from the Dow 30 and the DAX30 show that with these two exits we will at the very least survive. This strategy does not generate money, but the losses are kept within a limit. However, this strategy can be improved.

With the second exit, the risk was further reduced and those cases where the market did not go up further were dealt with. However, one more risk remains to be considered before we think about making profits.

What if the market rises for a few days, but then turns, and starts to sink? This is what exit number 3 is made for. It is activated from the third day onward, and closes the trade when the market falls back to the entry price. Although nothing is won by this strategy, nor is anything lost, and this is often a small win in itself.

With these three exits, and the correctly chosen position size, we have the risk under control as much as possible, and can turn our attention to how and when to realise profits.

The first exit to profit taking is a simple profit target. Here, the profit is realised automatically when the trade has brought in three times the amount of the initial risk. The initial risk was the distance

F4) When It Does Not Work

Figure 4 shows you four examples where the expected sustainable uptrend did not follow the price pattern. Clockwise: In the first example, the market could only take the high only one day after the appearance of the pattern. Thereupon, it stagnated on a high level. Example 2 shows the case that the market did get above the formation in the first day, then however turned around and fell under the low of the formation. Example 3 presents a similar problem like in example 1: the market cannot decide for the uptrend. Example 4 is comparable to example 2, where the market turns after two days and starts to fall. An intelligent exit should be able to limit losses in such situations.

Source: www.tradesignal.com

F5) Exits

Figure 5 shows you different possibilities to get out of a position. In the first case, the position is closed after 4 days at the entry price. This prevented the exit at the low of the formation. Example 2 shows the lucky case of a time exit. Since the position was not in the win 2 days after the entry, it was closed. Example 3 demonstrates how reasonable a profit target can be. The high opening was used for the exit since it was more than three times the original risk above the entry. In example 4, the position is closed after 6 days at the high of the previous day. The position size was chosen so that at every trade the same money risk was taken (see Figure 3).

Source: www.tradesignal.com

from the low of the white candle to the high of the last two candles of the formation (Figure 3).

We can also work with a lower target. This raises the hit rate in sideways markets, as the target is repeatedly triggered by accidental movements. This does, however, prevent larger profits during trend phases. When we already have a trend-following strategy in use it can be a clever way, otherwise I would choose a target no smaller than double the original risk.

If the target is not reached within about 6 days, I try the exit at the high of the previous day. This usually brings a few extra points of profit compared to the possibility of closing the trade after a fixed time. It is also possible to not wait for a fixed number of days for this exit, but rather try and get out at the high of the previous day as soon as no new high has developed for one to two days. The exit at the entry price always stays active – just in case. In Figure 5 you can see what these exits look like in practice.

Review and Outlook

This article shows us a potentially significant price pattern and a technique to use this pattern in trading. The technique can be extended in many ways, and can be combined with other formations and entry ideas. The exits introduced show the importance of bringing the risk of a trade under control as quickly as possible. We have to close all those trades which do not develop as intended. Not only does this apply to the losers, but also to all those cases in which the market only tends sideways after the expected breakout. Time is also a risk, and if the trade does not develop as intended, it is often best to realise small losses and wait for the next chance.

At the end of the article, do you still really believe that the Austrian flag can predict the behaviour of the markets? Or is it rather the consolidated exit plan and the correct position size which are responsible for the profits?

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