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Nick McDonald is a leading independent trader with a global following via the company he founded, www.tradewithprecision.com. A specialist in technical trading strategy for any market and any time frame, Nick possesses a unique approach to modern technical trading which forms the basis of the strategies that he teaches. Nick is in high demand as a speaker on the global trading circuit with speaking engagements on multiple continents each and every year.

The Path to Trading Success

PART 5: PRICE ACTION MASTERY – PART 1

The previous articles (TRADERS´ 09/2012-12/2012) in this series helped you to establish whether you wish to be a day or swing trader and which market, or markets, you are going to trade. We have also covered the difference between technical analysis and a trading strategy. You hopefully now appreciate that you need to combine a number of technical ingredients in order to have a sound trading strategy. We will now begin to explore the different types of technical ingredients you can use to develop your own trading strategy. As we are chartists our technical ingredients will fall into one of two categories: 1) the study of price action or 2) the study of technical indicators/oscillators.

➔ PRICE ACTION VS. INDICATORS/OSCILLATORS

Price action is the term given to the movement of a security's price i.e. the historical prices a security has traded at as plotted on a price chart. These price movements can be plotted on a chart in various forms with candlesticks been the most popular.

Indicators are calculations based on the price or volume of a security and are used as a secondary measure to the actual price movements of the security. Examples of indicators are moving averages, RSI, MACD, Stochastics and Bollinger Bands.

The author considers price action the most important of these two categories as its the purest form of data. When that data is plotted on a chart the trader is viewing it in its original form. Every trader in the world is looking at the same price data which allows you to work out how other traders are likely to react and you can take advantage of that.

Indicators take the pure price data and put it through a series of calculations and convert it into another form. It now becomes a secondary measure of price and consequently often lags behind price. Remember that the indicator itself would not exist without the price and bear that in mind next time someone tries to tell you that indicators are more important than price – this is illogical in the author's view!

Whilst he still uses indicators he only uses them as a confirmation to what price is already telling him, sticking with his strategy vs. recipe analogy, indicators are like the icing on the cake.

As the author considers price action the most important technical tool he is going to dedicate the next three articles to what he calls price action mastery. He believes if you are to truly master price action then there are six key areas you must master. In this article we will discuss the first two: 1) Optimal chart structure and 2) Trading with the trend.

OPTIMAL CHART STRUCTURE

Optimal chart structure is an extremely simple but powerful concept. Often a trader will focus so intently on finding a particular set up that they ignore what

F1) AN EXAMPLE OF A CHART TO AVOID

This chart clearly does not have optimal chart structure. On a regular basis there are large unpredictable gaps in the price and also wild intraday swings in price. Both of these aspects dramatic reduce the predictability of future price direction.
Source: TradeStation

F2) PRICE ACTION TREND ANALYSIS

A series of higher highs and higher lows forms an uptrend. The point at which the price breaks down through the blue line (which we have drawn on the chart) identifies the exact point where the trend changes from an uptrend to a downtrend. It is at that point where we objectively know we are going to have a lower high and a lower low.
Source: TradeStation

the chart is doing around them. Would you prefer to trade your set up in a smooth flowing trending chart or an erratic range bound chart? Without any hesitation we would choose the smooth flowing, trending chart as that makes the task of predicting the likely future direction so much easier.

Consequently the first thing we do when we open a chart is to assess whether it has optimal chart structure. If it doesn't then there is no use wasting any more of our time even looking for a set up. When trying to grasp the concept of optimal chart structure it is often easier to think of which charts to avoid. We want to make sure we keep away from charts which have no clear trend, lots of gaps in the price, candles with big wicks/shadows or erratic price action.

F3) OPTIMAL BULLISH CHART STRUCTURE

This security's price action has a clear series of higher highs and higher lows. There are no extremes of buying or selling and no erratic or uncertain price behaviour. There is just steady buying momentum. Which all leads to the security's future price action being much more predictable.
Source: TradeStation

TREND ANALYSIS

Trend analysis is typically the least understood form of technical analysis. So often the author hears traders say "price is above the 200 moving average so it's in an uptend" or "price is above the sloping trend line I have drawn therefore it's in an uptrend".

The only correct and objective way to truly assess trend is through use of price action and in particular identifying higher highs and higher lows for an uptrend and lower highs and lower lows for a downtrend.

Assessing the pure price action without any manipulation or conversion of the data is the only way to truly assess the trend of a security – it is technical analysis 101 yet most people still fail to get it right because they think it's less important as its just 'the basics'. But the truth ist: The basics done VERY well are where the money gets made. Will buying the very best golf clubs make a newbie golfer hit better shots when he or she does not yet know how to grip the club?

Once we have identified a chart with optimal chart structure and established its trend only then will we begin to assess whether any of our strategies are setting up. We will only take trades in the direction of the trend.

Trading with the trend offers by far the highest probability of success and it also offers the highest potential rewards.

In Figure 3 is an example of an optimal bullish chart structure with a clear uptrend. Trading charts such as this will dramatically increase your chances of success.

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PREVIEW

In next month's article we will continue to discuss price action mastery and introduce two more key price action technical ingredients: 1) price support/resistance and 2) price retracements.