Elliott-Wave Fibonacci Spread Trading

Presented by Ryan Sanden

The inevitable disclaimer:

Nothing presented constitutes a recommendation to buy or sell any security. While the methods described are believed to be effective in the long run, no guarantee of efficacy is being made. Trading involves risk. I will in no way be responsible for any decisions or trades made as a direct or indirect result of this material. Full understanding of all trading instruments and exchanges is the sole responsibility of the trader.

Ryan owns positions in the following related securities discussed herein: SDS
Principles of Market Trends

- Markets move in trends.
- Movements with the trend are called “impulses”.
- Movements against the trend are called “corrections”.
- Trends eventually change.
Principles of Market Trends

- Trends depend on their *time frame*.
- Green = uptrend
- Red = downtrend

6 Trends
Principles of Market Trends

- Trends depend on their *time frame*.
- Green = uptrend
- Red = downtrend

48 Trends
Principles of Market Trends

- Trends depend on their *time frame*.
- Green = uptrend
- Red = downtrend

1 Trend
Principles of Market Trends

• Trends depend on their *time frame*.
• Green = uptrend
• Red = downtrend

Which is correct? They *all* are. Which you trade is up to you.

Planning to trade one trend while acting on movements in another trend is called a *trend relativity error*. It is one of the most common trading mistakes.
Principles of Elliott Wave Theory

Markets tend to advance in 5 waves, and retrace (correct) in 3 waves.

Larger-degree uptrend (higher time frame trend is up)
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Principles of Elliott Wave Theory

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Larger-degree downtrend (higher time frame trend is down)
Principles of Elliott Wave Theory

Markets tend to advance in 5 waves, and retrace (correct) in 3 waves.

Larger-degree downtrend (higher time frame trend is down)
These structures “repeat”.. That is, they connect together:

If I take away the colors and labels.. It really looks like the stock market. Yet, the underlying order is there if you know what to look for.
They don’t just infinitely repeat. That would be too easy. Really, they combine to make “higher degree” waves. So, what looks like repetition is really just larger degree waves unfolding.
An Idealized Market
Major Degree Waves – “The Big Trend”
Intermediate Degree Waves – “The Major Moves”

Sub-divisions of major degree waves.
Minor Degree Waves – “The Daily Wiggles”

Minor Degree Waves
Sub-divisions of intermediate degree waves
Nested Waves. Elliott-Wave “map” of the market.
Nested Waves. Elliott-Wave “map” of the market.

Intermediate 1 of Major 1

Minor 4 of Intermediate 3 of Major 1

Minor A of intermediate 2 of Major 1

Intermediate B of Major 2
S&P 500 Example:

(Market Top)

Daily Bars.
September 2007 through January 2008
Q: That’s Wonderful. How can I use this knowledge?

A: The better we can predict where we are in the structure, the better we can predict the next move in the market.

For example, let’s pretend that the above chart is “now”. We can see enough to clearly identify the above wave count.

We just finished a “2” of the of the “green” waves, and now we expect a “3” of the green waves. Therefore, we are bearish. This is true even though the casual observer looks at the chart and sees a bottom!
Q: How do we know when we’re wrong?

A: This is a very important question. When we don’t have a firm opinion of the market anymore, we should exit the trade. This becomes a stop loss. The waves offer natural stop loss points!

So, we can draw the waves as best as we think. Then, if the market hits our stop loss, then we will wait until we have a new clear picture to trade.

Sometimes we’re wrong about the wave count. That’s OK. We’re right often enough to make this methodology worthwhile.
Fibonacci

To make life easier, each wave has a “target” region for where it should end. We use Fibonacci relationships to plot these on the chart in advance.

For example, Wave 2 target is 50%-78.6% of Wave 1:
Green Wave 1 down is finished. Currently in Green Wave 2 up.
This wave should end somewhere between $145.99 and $150.71. ($147.94 is best.)
Getting an “ABC” from here would be ideal…
That would be a reversal.
Now, we have to “project” a likely extent for Wave 3:

Wave 3 is generally 1.000 to 1.618 of Wave 1, projected from the end of Wave 2. This is technically named an “alternate price projection”.

```
1

2

100%

161.8%
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Although it’s a little more tricky, we can project time the same way:

Wave 3 is generally 1.000 or so (in time) of Wave 1, projected from the end of Wave 2. This is technically named an “alternate time projection”.

1

2

1
Combining these, we can get a general idea for price and time:
Looks like we’re shooting for 123 to 133 sometime in the middle of January.
Price and Time Targets for Various Waves

Note: There are others! I am just presenting basic ideas here.

<table>
<thead>
<tr>
<th>Wave</th>
<th>Price</th>
<th>Time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wave 1</td>
<td>Can’t be projected. This wave is created by fundamentals and is how fundamentals drive the market.</td>
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</tr>
<tr>
<td>Wave 2</td>
<td>50% to 78.6% of Wave 1</td>
<td>Around 61.8% of Wave 1</td>
</tr>
<tr>
<td>Wave 3</td>
<td>100% to 161.8% of Wave 1, projected from end of Wave 2</td>
<td>Around 100% of Wave 1, projected from end of Wave 2</td>
</tr>
<tr>
<td>Wave 4</td>
<td>38.2% to 61.8% of Wave 3</td>
<td>Around 61.8% of Wave 3</td>
</tr>
<tr>
<td>Wave 5</td>
<td>100% of Wave 1, projected from end of Wave 4</td>
<td>Around 100% of Wave 1, projected from end of Wave 4</td>
</tr>
<tr>
<td>Wave A</td>
<td>Can't be projected. This wave is created by fundamentals and is how fundamentals drive the market.</td>
<td>Can’t be projected. This wave is created by fundamentals and is how fundamentals drive the market.</td>
</tr>
<tr>
<td>Wave B</td>
<td>50% to 78.6% of Wave A</td>
<td>Around 61.8% of Wave A</td>
</tr>
<tr>
<td>Wave C</td>
<td>61.8% to 161.8% of Wave A, projected from end of Wave B</td>
<td>Around 100% of Wave A&lt;sub&gt;31&lt;/sub&gt;, projected from end of Wave B</td>
</tr>
</tbody>
</table>
How it played out:
Review of Process (thus far)

• 1. Label Waves
  – Determine Bullish or Bearish
  – Determine Stop Loss

• 2. Perform Price and Time Projections
  – Get an idea for approximately where and when we should expect trend reversal.
Entries

Reversal Day
• Close below today’s open (red candle day)
• Close below yesterday’s close (down day)
• Stronger signal if it made a new high as well.
Entries

Projected Resistance

Stop

Risk

Sell Short on Close
Entries

Projected Resistance

Stop

Loss 😞

Stopped Out
Entries

Projected Resistance
Entries

Projected Resistance

Reversal Day
Entries

Projected Resistance

Stop

Risk

Sell Short on Close
Entries

- Stop
- Risk on Principal
- Paper Profit
Credit crisis was actually a novice accounting mistake. Oops.
Trailing Stops

N-Day high or N-Day low. N is a number.

For example:

• 3-Day high
• 1-Day High
• 2-Day Low

3-Day High:
Highest high of last 3 days prior to and including the extreme point, non-inclusive of “inside days”.

Inside Day:
A day whose range is “inside” the previous day’s range.

Extreme Point
Trailing Stops

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3

3-Day High

Extreme Point
Exits

Stop Risk

Nearest Minor Pivot
Exits

Stop

Risk

Nearest Minor Pivot
Exits

Nearest Minor Pivot exceeded
Exits

New Stop (3-day High)

Old Stop

Exceeded Pivot – Move to Trailing Stop

Profit

Paper Profit
Exits

Trailing Stop (3-day High)

Profit

Paper Profit
Exits

Profit :-/
Exits – Towards Price Target

Projected Support Levels
Exits – Towards Price Target

Projected Support Levels

Trailing Stop
(3-day High)
Exits – Towards Price Target

Projected Support Levels

Trailing Stop (3-day High)
Exits – Towards Price Target

Projected Support Levels

Getting Close: Switch to 2-day high.
Exits – Towards Price Target

Projected Support Levels

Region Hit: Switch to 1-day High
Exits – Towards Price Target

Projected Support Levels

Region Hit:
Switch to 1-day High
Exits – Towards Price Target

If this is a major collapse, we want to hang around for it. Therefore, we continue with the tight trailing stop instead of just taking profit immediately.

Region Hit: Switch to 1-day High
Exits – Towards Price Target

Projected Support Levels

Reversal Day-Close trade. Go long?
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

Reversal Day—But we missed it. Should have sold short, but I didn’t see it. Still good profit potential left though. What now?

Potential profit. However, risk is too large to enter now (stop loss too far away).
Trend-Continuation Entries

Inside Day Trend-Continuation Entry

Inside day. This day’s range is “inside” the previous day’s range.

Sell Short if price exceeds this

Stop loss goes here
Trend-Continuation Entries

Outside Day Trend-Continuation Entry

Outside day. This day's range is “outside” the previous day’s range.

Stop loss goes here

Sell Short if price exceeds this
Trend-Continuation Entries

Projected Resistance Levels

Projected Support Levels

Reversal Day that we missed
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

Reversal Day that we missed
Trend-Continuation Entries

Projected Resistance Levels

Outside Day

Reversal Day that we missed

Projected Support Levels
Trend-Continuation Entries

Projected Resistance Levels

Stop loss will go here

Enter if we go below this

Projected Support Levels
Trend-Continuation Entries

Projected Resistance Levels

Stop loss will go here

Enter if we go below this

Projected Support Levels
Trend-Continuation Entries

Projected Resistance Levels

Stop loss will go here

Enter if we go below this

Projected Support Levels
Trend-Continuation Entries

Projected Resistance Levels

Entered here

Projected Support Levels

Stop
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

Stop
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

Stop
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

Stopped Out

Figures.
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels
Trend-Continuation Entries

- Projected Support Levels
- Projected Resistance Levels
- Inside Day
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

Enter if we go below this

Stop loss will go here
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

Enter if we go below this

Stop loss will go here
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

Enter if we go below this

Stop loss will go here

Another Inside Day!
Trend-Continuation Entries

Projected Resistance Levels

Stop loss will go here

Enter if we go below this

Projected Support Levels

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Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

Stop loss will go here

Enter if we go below this

Entered at the open
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

Stop
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

Stop
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

Stop
Trend-Continuation Entries

Projected Resistance Levels

Projected Support Levels

Stop
Trend-Continuation Entries

Projected Resistance Levels

Projected Support Levels

New Stop 3-day High
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

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Projected Resistance Levels

New Stop 3-day High
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

Getting Close: 2-day high
Trend-Continuation Entries

Projected Support Levels

Projected Resistance Levels

Reversal Day-Exit

Projected Support Levels
Trend-Continuation Entries

Projected Resistance Levels

Projected Support Levels

McDonalds files Chapter 11 on credit losses.
Bear Market S&P 500 Activity

• We will now go through a step-by-step walkthrough of the entire Bear Market, from the beginning.

• It will begin very detailed, but eventually just show the method is working.
Note: I am deliberately counting this section differently from at the beginning of this presentation. And it still works! This shows the versatility of these techniques.
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Choosing the Spread

Here’s our example from before. We said we are expecting approximately $123 to $133 sometime in the middle of January.

Always target the worst-case scenario: Assume the stock goes to $133. We therefore want a bear put spread with the short put at $133. For long put, choose an ITM option with strike above stop loss. The more ITM, the better.
Choosing the Spread

So, we have established a bear put position:

SPY @ $144.84. (Dec 11, 2007). Stop @ $150

Long Put: Jan 2008 $160
Short Put: Jan 2008 $133

At VIX = 30, the following are the most likely prices:

Long Put: $16.37
Short Put: $1.44
Put Spread: $14.93

(Spread is better when extrinsic value in short option is greater than extrinsic value in long option)

If we hit stop at expiration (worst-case scenario):

Long Put: $10.00
Short Put: $0.00
Put Spread: $10.00

If we hit profit target tomorrow (again, not as good as if it happens next month):

Long Put: $27.15
Short Put: $5.13
Put Spread: $22.02
Choosing the Spread

If we hit profit target at expiration:

Long Put: $27.00
Short Put: $0.00
Put Spread: $27.00

So, if we are right, spread will be worth between $22.02 and $27.00, which, considering the original spread cost was $14.93, represents profits of 47% and 81%.

If wrong, spread will be worth $10 and will represent a loss of 33%.

If we hit stop tomorrow (not as bad):

Long Put: $12.26
Short Put: $0.70
Put Spread: $11.56 (loss of 23%)
Risk Management

If we risk our whole account every time, eventually we’ll be wrong three times in a row and lose 50% three times (thus losing 87.5% of the account). That’s not good.

We solve this by only risking 3% of our account on any trade.

We said the risk in the spread was 33%.

To position size, simply divide 3% by 33%: 0.03 / 0.33 = 9.1%

Therefore, we can buy 9.1% of the account on this option spread. The rest should be held in cash. On a $100,000 account, we buy $9100 of this spread. Since the original spread price was $14.93, we buy a 6-contract spread.

If we are right, we should get a return between 47% to 81%. We’ll say 65% for sake of argument.

65% return on 9.1% of your account is 5.9%.
For intermediate-term investing, you will trade a spread around 10 times per year. (Wrong 10 times: -26%).
Special Thanks To:

Dynamic Trading, by Robert Miner

Little of anything presented today is original. I now credit my primary source
And direct you to this book for more detailed instruction if you are still interested.
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