

# The Anatomy of Elliott Wave Trading

When 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.

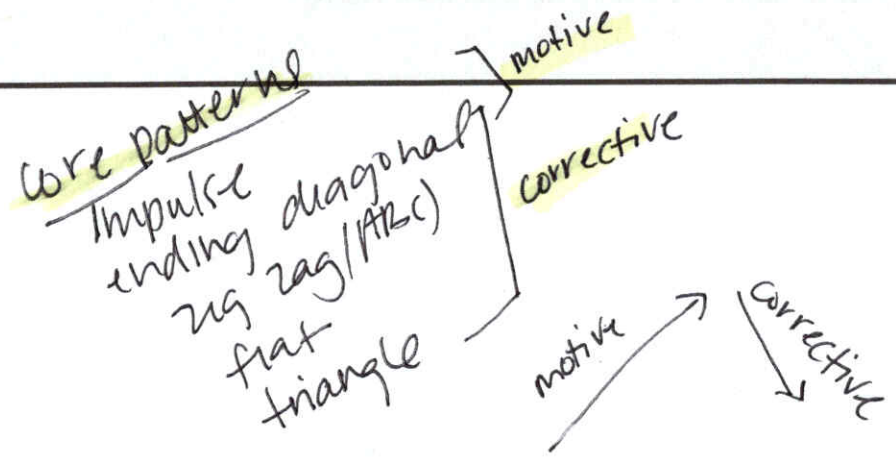
When it comes to trading, there is no right way or wrong way—only your way. One trader's tolerance for risk will be starkly different from another's, just as time frame, portfolio size, and markets traded will also be different. Thus, the guidelines offered within this chapter on how to trade specific 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.

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

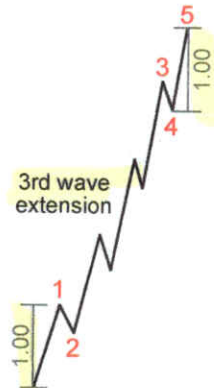
What traditional technical studies simply don't offer—high-confidence price targets—the Wave Principle again provides. When R. N. Elliott wrote about the Wave Principle in *Nature's Law*, he stated that the Fibonacci sequence was the mathematical basis for the Wave Principle. Elliott waves, both impulsive 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,



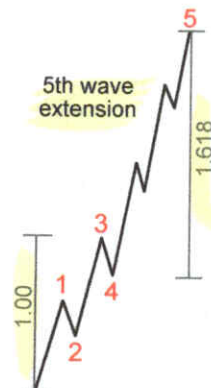
**Figure 1.4**  
Source: *Elliott Wave Principle*.

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

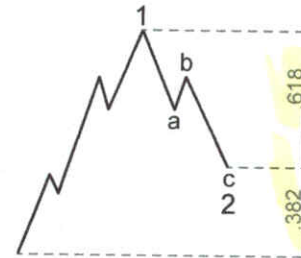
Also, corrections often retrace a Fibonacci percentage of the preceding wave. These Fibonacci-derived regions allow traders to set profit-taking objectives and identify areas where the next turn in prices will likely occur (see Figures 1.5 and 1.6).



**Figure 1.2**  
Source: *Elliott Wave Principle*.

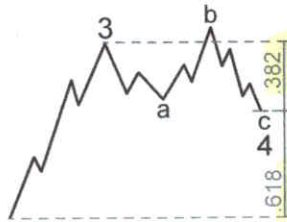


**Figure 1.3**  
Source: *Elliott Wave Principle*.



**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.

Impulse waves only

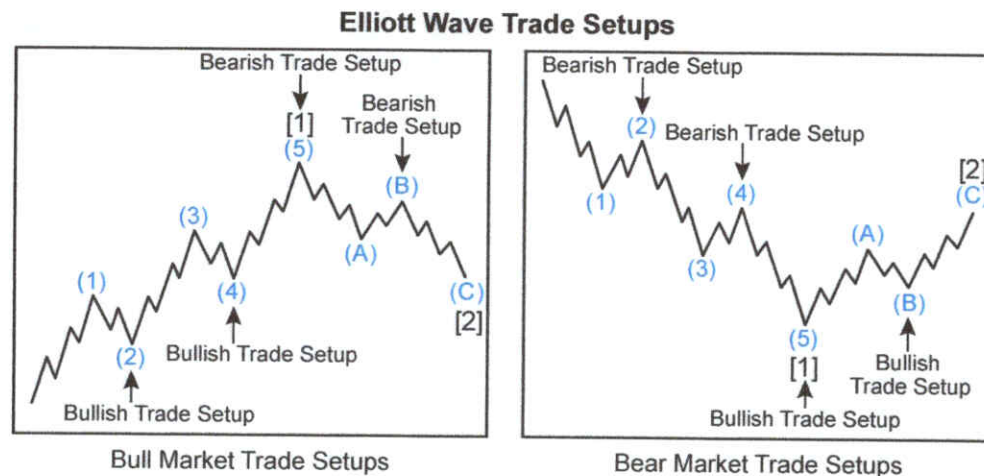


Figure 1.7

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.

**Impulse Wave**

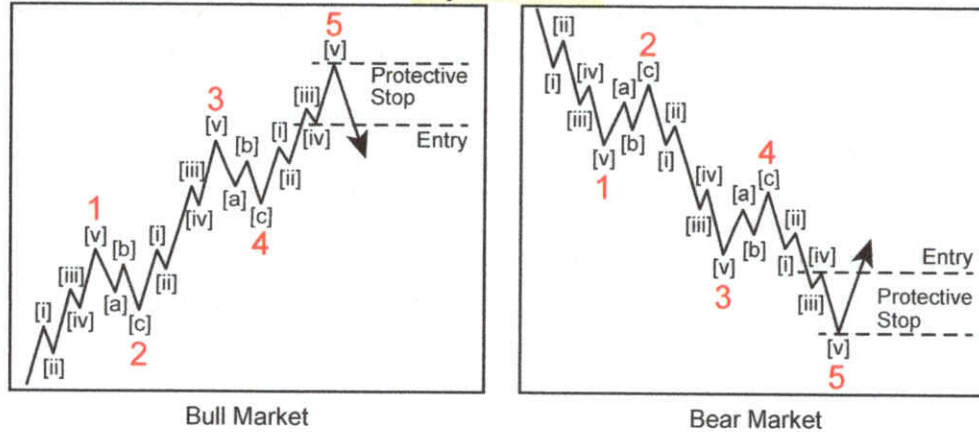


Figure 1.8

**Ending Diagonal**

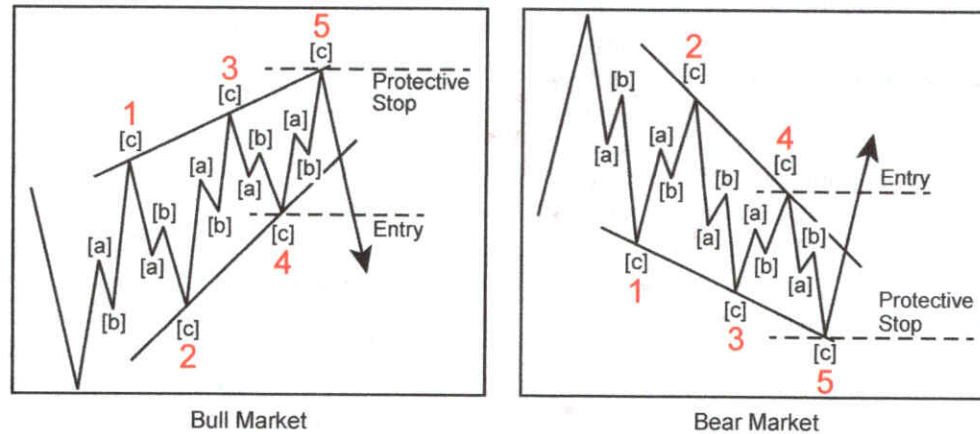


Figure 1.9

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

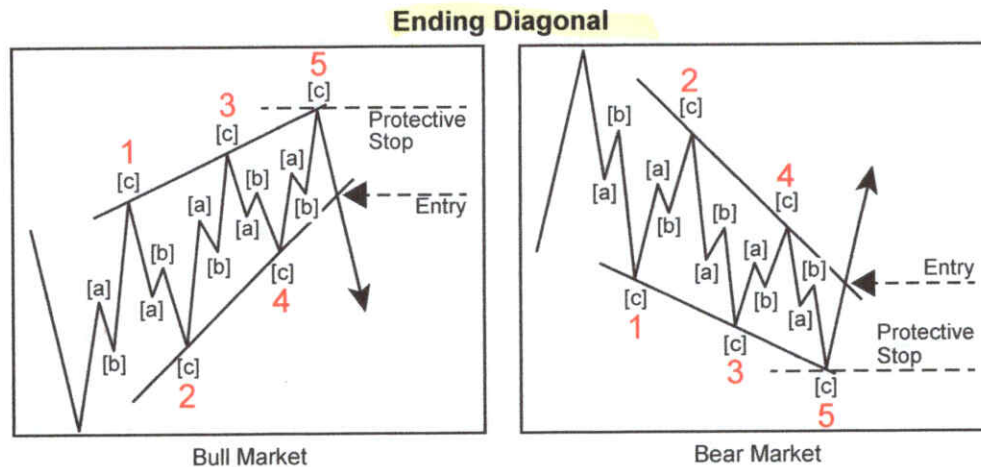


Figure 1.10



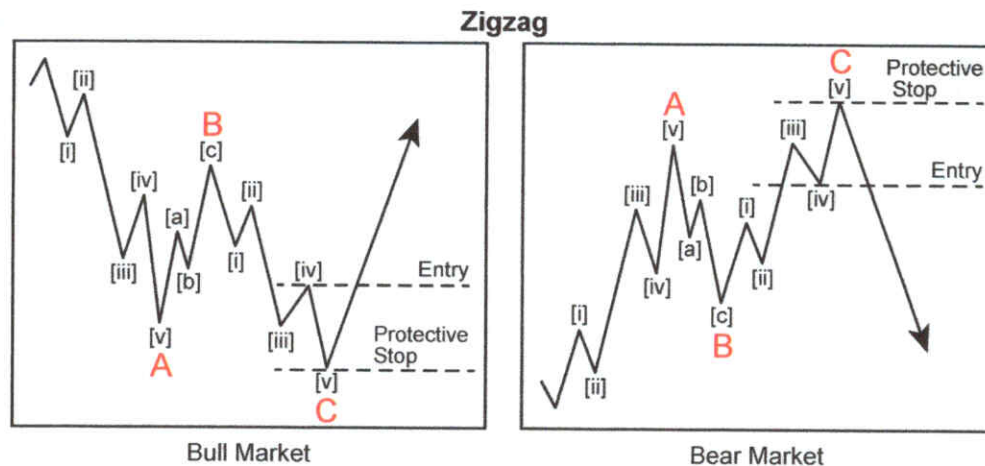


Figure 1.11

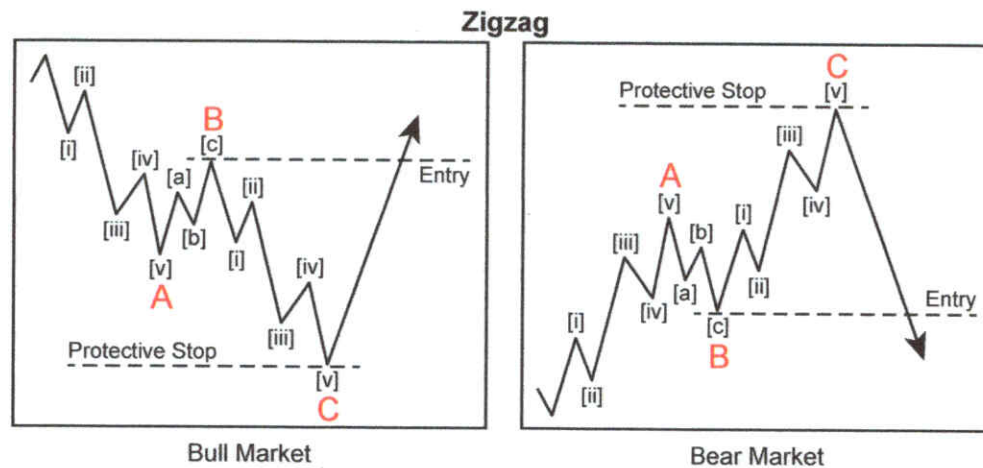


Figure 1.12

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

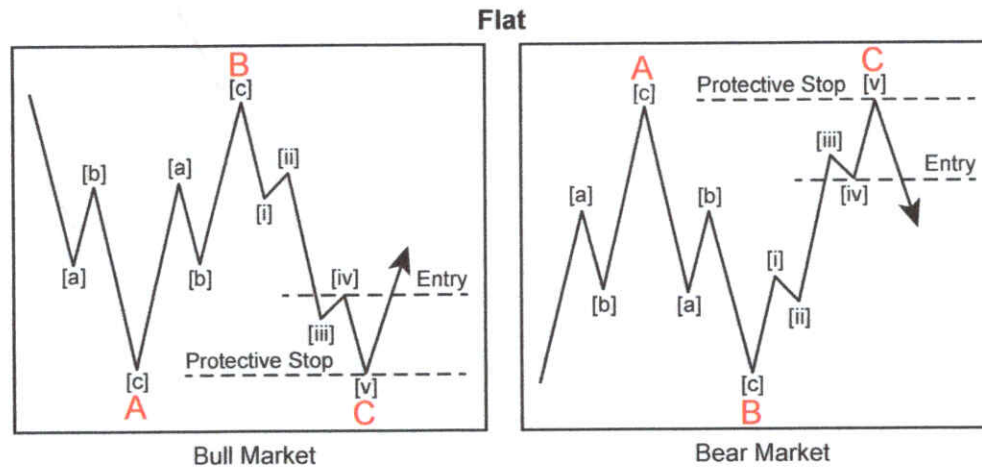


Figure 1.13

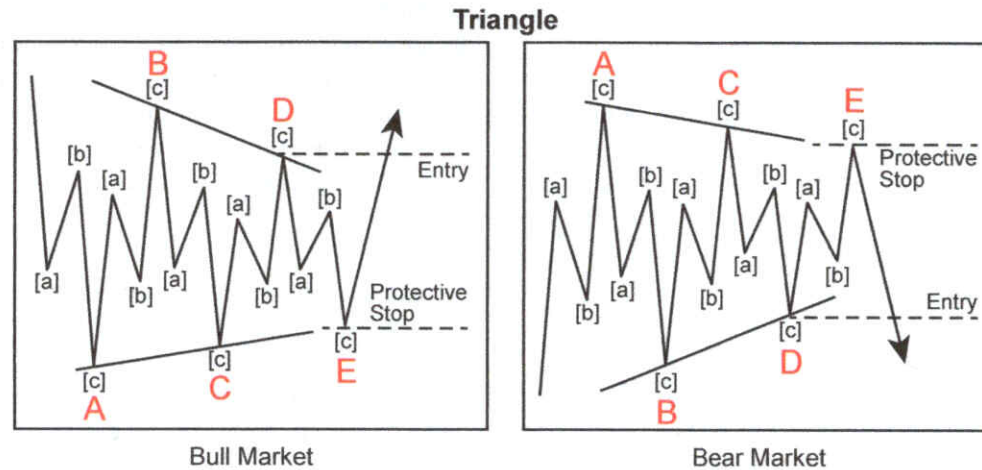


Figure 1.14

### 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



Impulse waves identify bigger trend

Impulse = 5 waves  
Countertrend = 3 waves

## How Zigzags and Flats Set Up a Trade for the Next Impulse Wave

The three essential parts of a trade are analyzing price charts, formulating a trading plan, and managing the trade.

### Trading a Zigzag in Caterpillar (CAT)

In Caterpillar (CAT), we'll examine each component to better understand why CAT offered a high-confidence trade setup.

#### 1. Analyzing the Price Charts

When it comes to trade setups, it doesn't get much easier than the price chart of CAT from April and May 2011. As you can see in Figure 2.1, prices fell in five waves from 116.55 to 108.39. This wave pattern was significant because impulse waves identify the direction of the larger trend. Thus, this five-wave decline in CAT

implied further selling to come that would take prices below 108.39 in either wave (C) or wave (3).

The subsequent rally in CAT that developed in three waves supported this analysis. Countertrend price action typically consists of three waves, so I knew to expect another move down in CAT. Moreover, the three-wave advance in CAT traveled to 112.47 to retrace 50 percent of the previous sell-off. That 50 percent is a common retracement for corrective waves. Also nearby was 112.84, the price level at which wave C equaled a .618 multiple of wave A, which is a common Fibonacci relationship between waves C and A of corrective wave patterns.

The only question at this point was whether the move up from 108.39 should be labeled as wave (B) or wave (2). From a short-term trading perspective, this question was academic because, either way, the trade objective was a price move just under 108.39. A

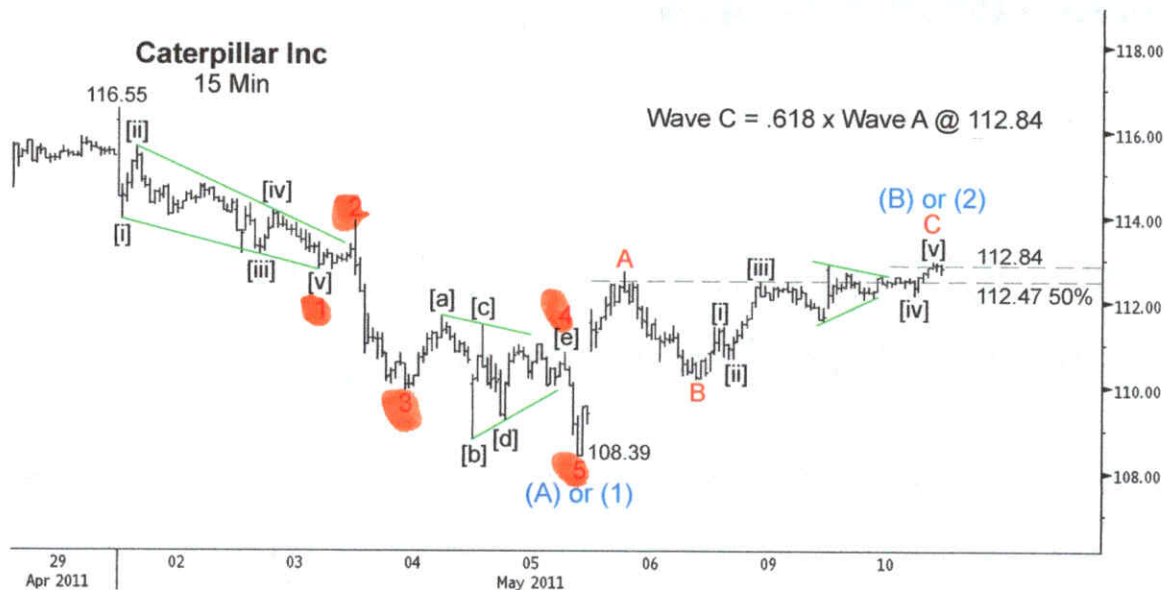
#### KEY POINT

Impulse waves identify the direction of the larger trend.

#### KEY POINT

Countertrend price action typically consists of three waves.

29 2011  
5-3-5



**Figure 2.1**

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**DEFINITION:**  
**zigzags**

A zigzag is a simple three-wave correction that subdivides into wave A (five waves), wave B (three waves), and wave C (five waves).

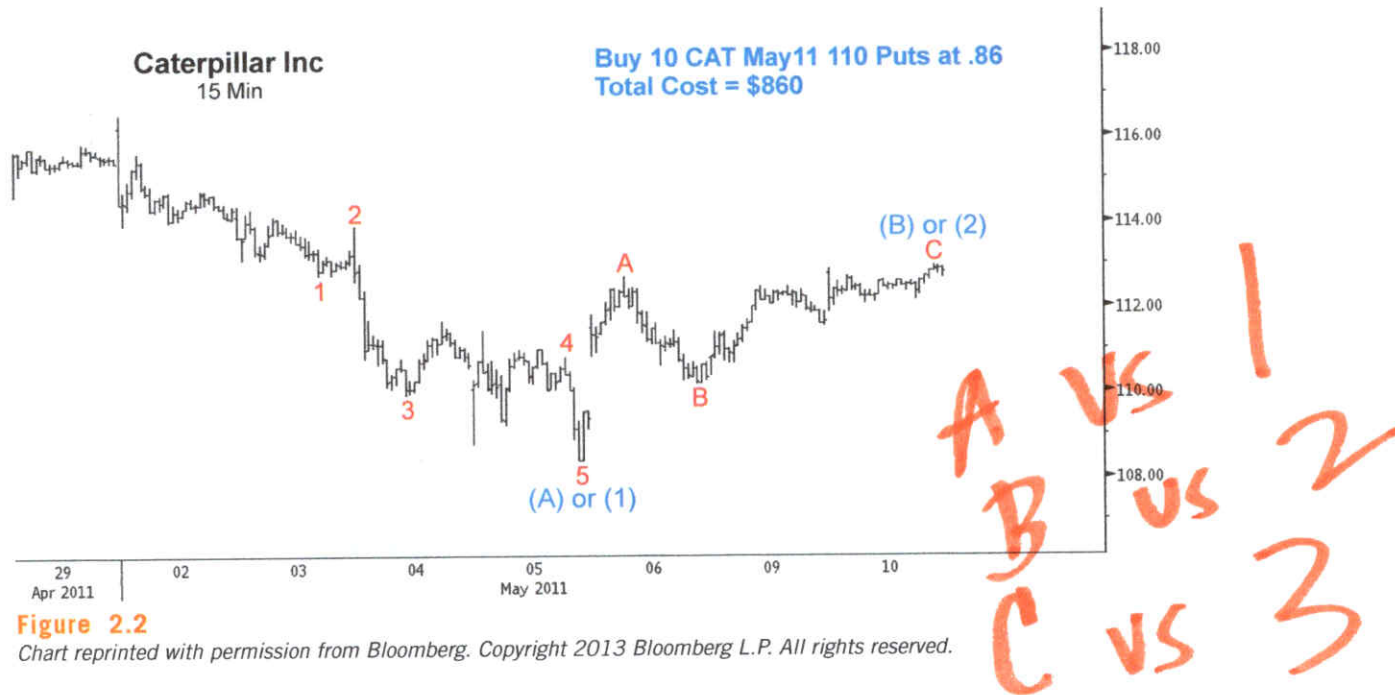
final observation about the corrective rally: The slope of wave C in this case was shallower than the slope of wave A. A shallow wave C slope, which demonstrates a decrease in momentum, is a harbinger that the larger trend is resuming. These shallower slopes within zigzags are so common that they are almost a qualifying characteristic of the pattern.

By applying the most basic Elliott wave analysis to the price chart of CAT, I could see five waves down and

three waves up into Fibonacci and structural resistance at 112.47–112.84. That meant that odds strongly favored a sell-off below 108.39 from near current levels. So, the question at that point was how best to capitalize on this information.

**2. Formulating a Trading Plan**

In Figure 2.2, I chose to trade this setup using options, specifically, by purchasing 110 puts on May 10, 2011, at



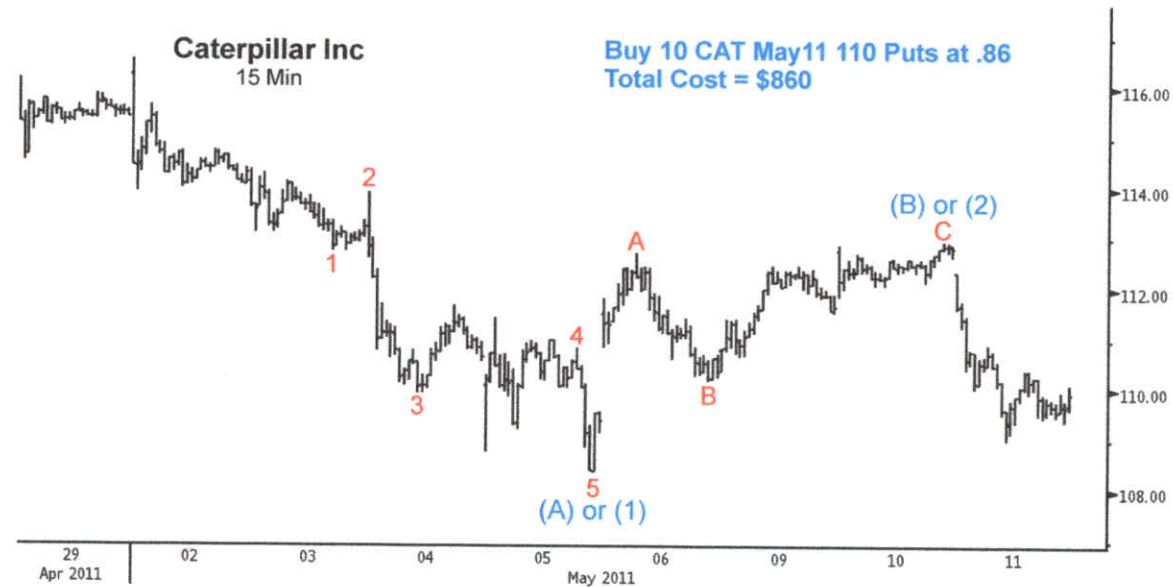
86 cents apiece. These options were scheduled to expire on May 20, 2011, so there were only eight trading days left on these puts. Considering that these options were to expire in just a matter of days, this kind of trade is *extremely risky*, and only the most seasoned and risk-aware trader should consider doing it.

Since the initial sell-off in CAT from 116.55 to 108.39 transpired in four days, here was my thinking at the time: If the next wave down proved to be wave (3), then I would see prices fall farther in a shorter period of

time; if the upcoming decline proved to be a (C) wave, then the upcoming sell-off would most likely be shallower and take more time. Even if CAT were to unfold in wave (C) and take twice as long as the initial decline, it would still trade roughly at \$104.81, the level at which waves (C) and (A) would be equal by options expiration.

Again, it is important to understand that due to waning premium, an options trade should *not* be taken with the idea of holding the trade over a long period of time for a sizable move down. The idea was simply





**Figure 2.3**

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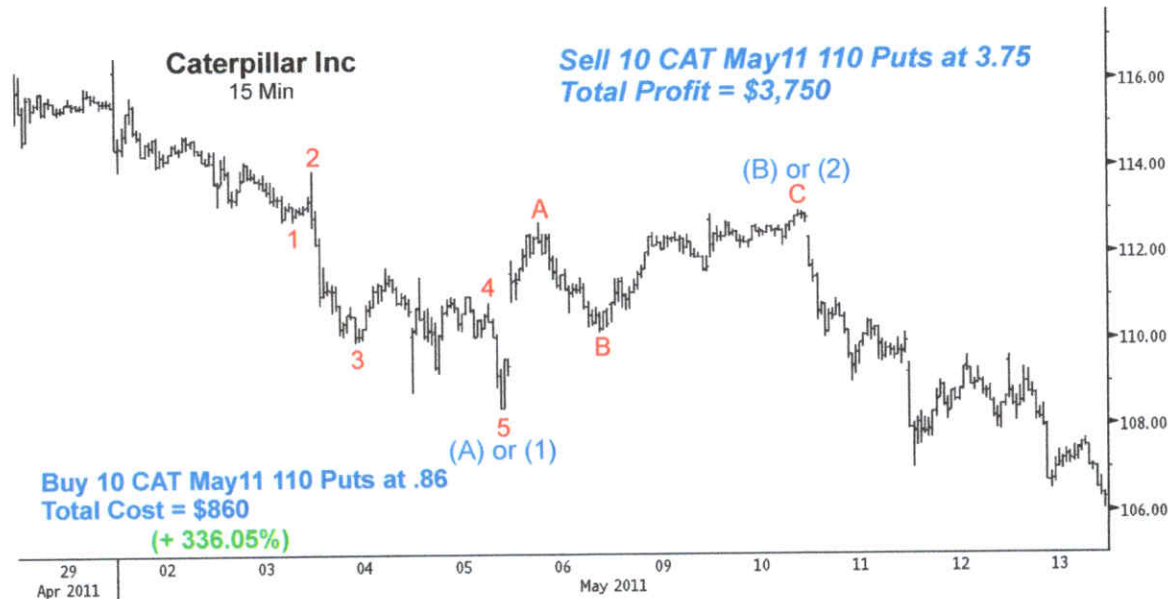
to catch a short-term move below the May 2011 low of 108.39 over three to five trading days.

### 3. Managing the Trade

The day following our analysis and entry, CAT fell sharply (see Figure 2.3). As a result, the value of the position increased substantially. In retrospect, it would have been prudent to exit the trade entirely or at least

partially the day after the swift decline. However, since the original analysis called for a move below 108.39, I decided to hold the position.

During the next few days, CAT continued lower. On Friday, May 13, 2011, I exited the position for a 336.05 percent return (see Figure 2.4), selling the options that were originally purchased at 86 cents for \$3.75 apiece.



**Figure 2.4**

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Yes, the percent return in this trading example is exciting. What is even more exciting, though, was its genesis. This trade began by simply recognizing an impulse wave and a zigzag. It did, however, take some knowledge of Fibonacci ratios and multiples to identify a high-probability reversal zone for CAT's corrective advance. The final step in this successful trading equation was to use the knowledge derived from the

analysis to determine a good way to leverage the information. In this case, we set up an options trade.



**Video:**

To watch a video on how to identify high-confidence trade setups by looking for three-wave moves within parallel lines, go to:  
[www.wiley.com/go/elliottwavevg](http://www.wiley.com/go/elliottwavevg)

## KEY POINT

Always ask first, "Do I see a wave pattern I recognize?"

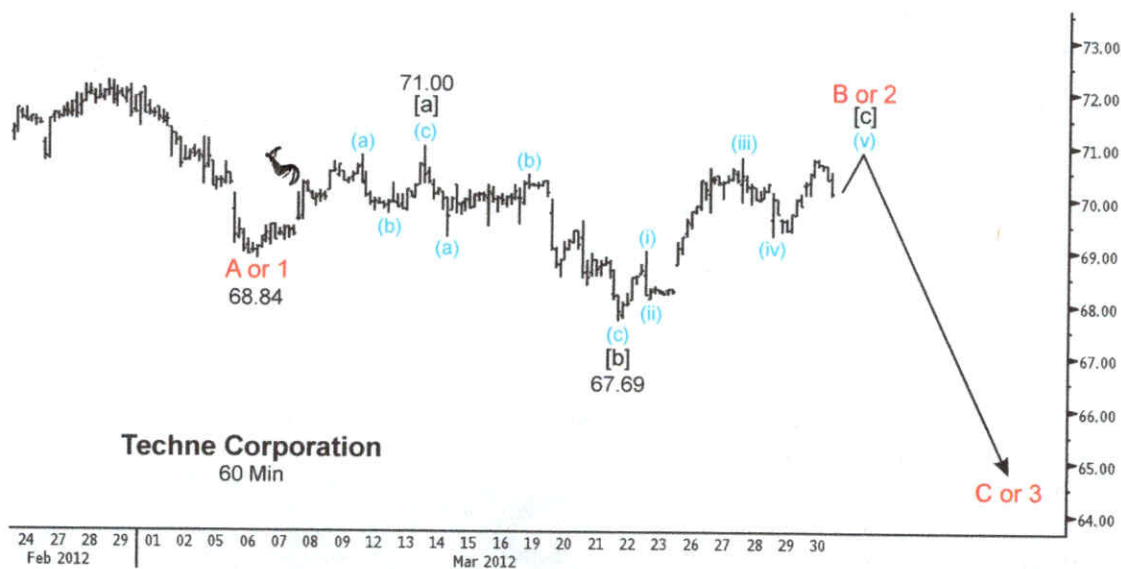
## Trading an Expanded Flat in Techne Corp. (TECH)

When looking for a trading opportunity, I always begin by asking myself one simple question: **Do I see a wave pattern I recognize?** If the answer is yes, then it's time to delve a bit deeper into the price chart. If the answer is no, then it's time to quickly move on to a different chart.

### 1. Analyzing the Price Charts

In March 2012, I recognized a possible pattern that could turn out to be an expanded flat on a price chart (see Figure 2.5) of Techne Corp. (TECH). Specifically, what caught my eye was the three-wave advance from 68.84 to 71.00, followed by the three-wave decline to 67.69.

This up-down sequence was significant because there are only two Elliott wave formations that would apply—either an expanded flat or a running triangle.



**Figure 2.5**

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Considering that the subsequent advance already had four of the required five waves to complete an impulse wave, odds strongly favored an **expanded flat** as the operative wave pattern in TECH.

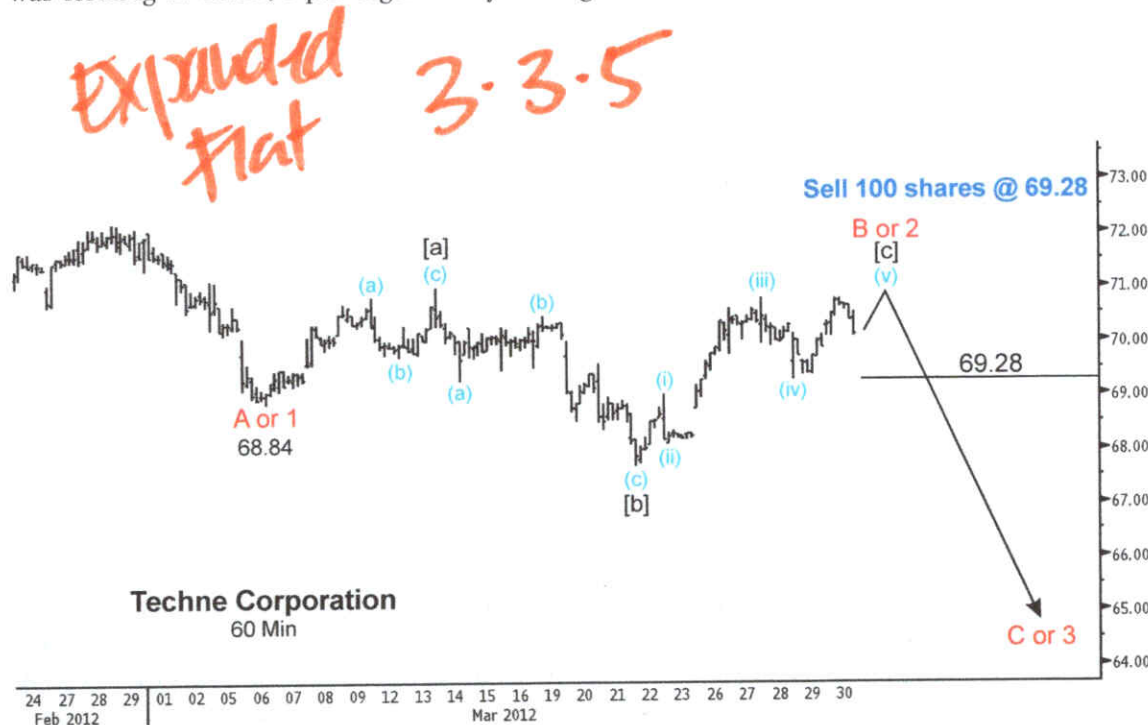
## 2. Formulating a Trading Plan

Working with the hypothesis that an expanded flat was forming in TECH, I put together my trading

plan, which was to sell 100 shares of TECH on a move below the extreme of wave (iv) at 69.28 (see Figure 2.6). As mentioned in Chapter 1, the guideline for entering a trade when the operative pattern is a flat is to enter when prices move through the extreme of wave four of C. This conservative approach should help prevent you from trying to pick tops or bottoms.

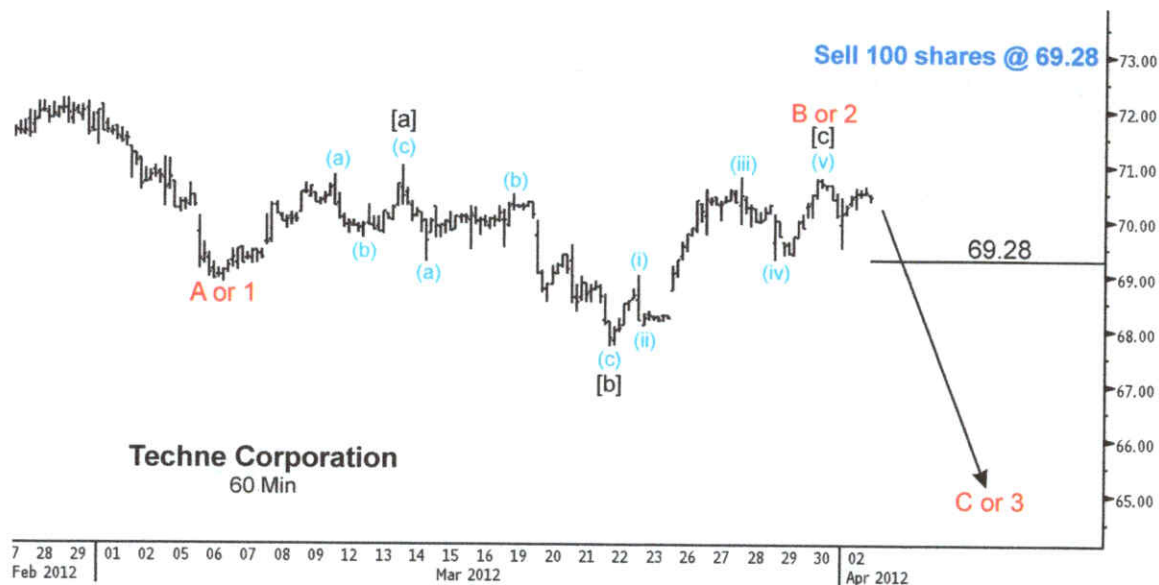
### DEFINITION: expanded flat

An expanded flat is a simple three-wave correction that subdivides into wave A (three waves), wave B (three waves), and wave C (five waves), with wave B ending beyond the starting point of wave A.



**Figure 2.6**

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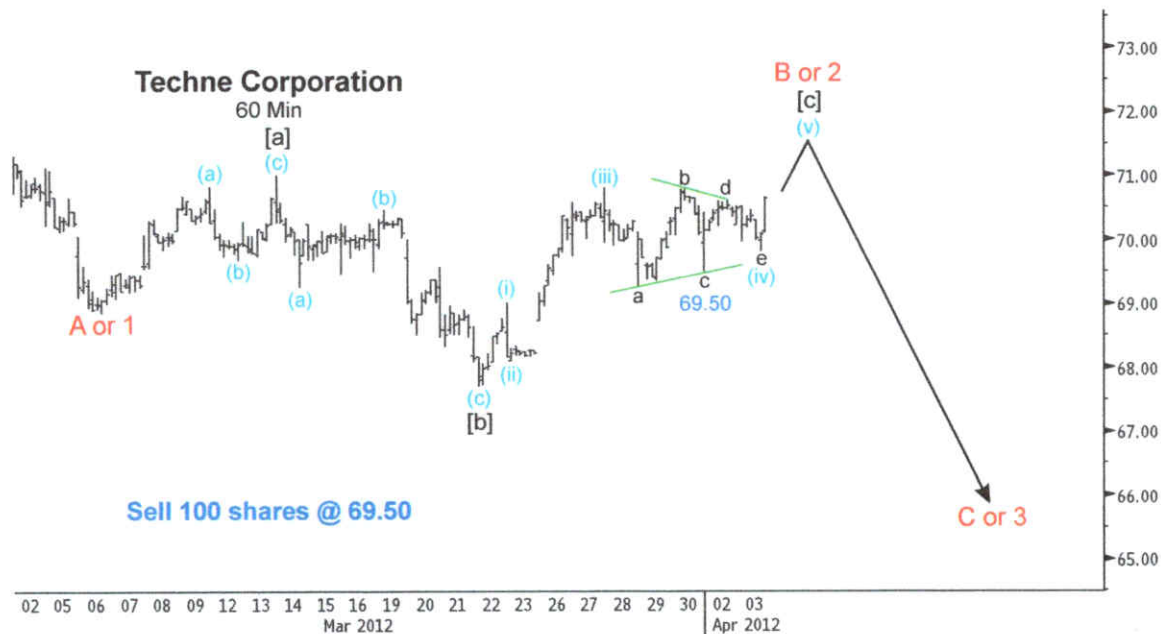


**Figure 2.7**

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In the days that followed the original analysis, TECH rallied to 70.78 (see Figure 2.7). The prior extreme, wave (iii), was 70.80, which made wave (v) a small truncation. When waves that normally make new price extremes fail to do so, it's called a truncation in Elliott wave analysis. For example, wave

five normally terminates beyond the extreme of wave three. When a wave truncates, it suggests that there is hidden or underlying pressure to either buy or sell. Even though the wave pattern ended on a truncation, the order remained the same: Sell 100 shares at 69.28.



**Figure 2.8**

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Following the 70.78 peak in TECH, prices moved sideways (see Figure 2.8). This type of price action argued against a fifth-wave truncation and supported the notion that a triangle was taking shape in the fourth wave. Triangles may form independently only in waves four, B, or X, which means that they

always precede the final wave of a sequence. Thus, since I believed that the waves would develop into an expanded flat, identifying short-term price action as a triangle made sense at this juncture. So, it was time to raise the sell order from 69.28 to 69.50, the extreme of wave c of (iv).



**Figure 2.9**

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As you can see in Figure 2.9, subsequent price action in TECH did not unfold according to plan. It no longer looked like a triangle. In fact, the labeling that identified the 70.78 peak as a truncated fifth wave seemed to have been correct all along. The open order at 69.50 was triggered on April 4, 2012, with an initial protective stop

placed at 70.66. Why there? Because it represented the extreme of wave [ii]. One of the three cardinal rules of impulse waves is that wave two may never retrace more than 100 percent of wave one. Thus, my logic was that if another second wave were to develop in wave [iii], it would hold below the previous second wave at 70.66.

## How a Triangle Positions You for the Next Move

**S**ideways price action and converging trendlines often signal a triangle pattern.

### **Trading a Triangle in Gold (GCA)**

Let's look at a good example of one in gold (GCA) to see how to trade a triangle (see Figure 3.1).

In late 2007, gold formed a contracting triangle, as indicated by the wave structure of the sideways price action in November and December and by the converging trendlines that connected the extremes of waves A and C, and B and D.

This chart also illustrates the entry guideline for trading a triangle, as discussed in Chapter 1, "The Anatomy of Elliott Wave Trading." The guideline suggests waiting for prices to break the extreme of wave D of the pattern (822.8 in this example) and then placing an initial protective stop at the extreme of wave E (788.1 in this example).

Yet, to ensure that prices are clearly trading above the extreme of wave D, the level for the order to buy 5 mini-gold contracts is set at 825.0 rather than 822.9. This practice of placing an order a few ticks above or below a significant level helps to prevent *entering* a position prematurely.



**Figure 3.1**

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### Smart Investor Tip

The practice of placing an order a few ticks above or below a significant level may prevent entering a position prematurely.

Recall that triangles may form by themselves only in the wave four, wave B, or wave X positions. So, we could label the larger price move alternatively as an A-B-C correction in which the triangle is wave B. Until further price action, this bearish

labeling in Figure 3.2 is just as plausible as the bullish labeling in Figure 3.1.

If this bearish labeling were indeed the operative wave pattern in gold, then we would still employ the same entry guideline by trading against the extremes





**Figure 3.2**

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of waves D and E. In this example, though, because the extremes of waves B and D are so close, it's best to enter the trade at a break of the 780.0 level to trigger a short position on five mini-gold contracts. If filled, the

initial protective stop would be the extreme of wave E at 811.4, assuming that E was over.

At first glance, it might seem confusing or self-defeating to analyze this chart with both a bullish and



**Figure 3.3**

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## KEY POINT

Having buy-side and sell-side trades operating simultaneously prepares you to adapt to ever-changing market environments, which in turn allows you to take advantage of the trading opportunities that financial markets offer.

a bearish outlook (see Figure 3.3). Quite the contrary; having both a bullish and a bearish outlook makes it possible to formulate dual trade plans. If 825.0 were to be penetrated, our bullish trade plan would be initiated and five mini-gold contracts purchased.

Conversely, were 780.0 to give way, then the trade would be a short position and five mini-gold contracts would be sold.

Louis Pasteur, inventor of the process of pasteurization, once said, “Chance favors the prepared



**Figure 3.4**

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mind.” I believe that having buy-side and sell-side trades operating simultaneously allows you to do just that—it prepares you to adapt to changing market environments, thus allowing you to take advantage of trading opportunities that financial markets offer.

Four trading days later, prices moved up, and our buy-side trade plan would have been engaged when gold rallied through 825.0 (see Figure 3.4). How simple was that? All we had to do was sit back, let the market show its hand, and then trade. This example shows precisely why I prefer a “ready, aim, aim, aim . . .





**Figure 3.8**

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Yet instead of wave 4 unfolding as a zigzag or a flat and testing Fibonacci support at 843.0, it took the shape of a contracting triangle and moved sideways over the next week (see Figure 3.8).

At this juncture, it is important to remember the most critical trait of triangles: They always precede the final move of a sequence in either the wave four, B, or X positions. Thus, this small triangle in gold implied that



**Figure 3.5**

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fire” approach to trading versus one that is more anticipatory. Furthermore, the price action that took place between December 20 and December 26 would have allowed us to raise our initial protective stop from 788.1 to 797.1, thereby lessening our risk. (Remember, the trader’s primary responsibilities once a position is initiated are to lessen risk



**Figure 3.6**

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instance, we would have raised the protective stop in gold to 815.0.

Prices hit the third-wave target of 858.1 on January 2 (see Figure 3.6). In response to this move, we would have raised the protective stop on the position quite dramatically from 815.0 to 845.0. Since wave 3 had already achieved a 2.618 multiple of wave 1, odds were that the upside was limited and that the next

significant move would be down in wave 4. So, rather than weathering a wave 4 correction, which could have been deep or time-consuming, it would have been more desirable to set a tight stop to allow us to lock in a significant profit on the position at that point.

Based on intraday price action the following day, it appeared that wave 3 of (5) had finally ended at 872.9.





**Figure 3.7**

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With wave 3 done, the next task would have been to establish a target for wave 4. The most common Fibonacci retracement for fourth waves is a .382 multiple of wave three, which implies that gold would

have been vulnerable to a corrective sell-off to near 840.51. Thus, in order to protect open profits on this position, the protective stop would have been raised from 845.0 to 855.2 (see Figure 3.7).



**Figure 3.9**

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the upside would be limited in wave 5 and that it was time to become even more aggressive managing risk. Therefore, we would have ratcheted the protective stop even tighter to 860.0, then 875.0 (see Figure 3.9).

Figure 3.10 shows what happened next. Our position in gold would have been stopped out on

January 9, when prices traded below 875.00. The result? In nine trading days, gold had rallied more than 6 percent, which would have provided a handsome profit of \$1,660.00 per contract.

This trading example is my favorite to show how to use the Wave Principle in real time because, first



**Figure 3.10**

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and foremost, it illustrates the awesome power of a simple question: *Do you see a wave pattern you recognize?* As I discussed in the trading example of Techne Corporation (TECH) in Chapter 2, I begin each trade by asking this question. As we review this gold trade, take a look at Figure 3.1 again and ask

yourself, “Do I see a wave pattern I recognize?” I’m sure you will agree that the most obvious Elliott interpretation is a contracting triangle because of the sideways price movement and the converging trendlines.

I also like this trading example because, initially, we couldn’t be confident which direction the market

### KEY POINT

Even with two equally viable wave counts—one bullish and one bearish—the Wave Principle helps to formulate dual trading plans, a benefit that other forms of technical analysis simply do not offer.

would take. There were two equally viable wave counts, one bullish and one bearish. Even so, the Wave Principle helped us to formulate dual trading plans that prepared us for a trade regardless of market direction. That's a benefit that most other forms of technical analysis simply do not offer.

### Trading a Triangle in Dell

A triangle as wave four within an impulse wave provides a great setup for trading wave five. The challenge

is to determine when the triangle has ended. Let's look at an example in Dell Inc. that occurred in early 2008 to see how we could have traded it.

Figure 3.11 shows a chart with the impulse wave in Dell unfolding to the downside.

On this daily bar chart from the morning of Wednesday, March 26, we can identify the first four waves of an impulse wave that began at 30.77. The fourth wave appears to be a completed contracting triangle. Triangles always precede the final actionary wave in the



**Figure 3.11**

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direction of the main trend at the next higher degree. Therefore, we would expect wave (v) to thrust downward from here, if the triangle has finished. Had we been trading that morning, we would have shorted Dell to take advantage of this fifth wave to the downside. Let's run through how to estimate a price target for wave (v), using the post-triangle thrust measurement.

Extend the a-c and b-d trendlines back to the origin of wave a and draw a vertical line that connects the two trendlines at that point (see Figure 3.12). The length of the vertical line defines the width of the triangle. In this case, it equals 3.03. Next, subtract 3.03 from the end of wave e at 20.81 to get an estimate of 17.78 for the end of wave (v).

### KEY POINT

The post-triangle thrust measurement serves as a minimum estimate for fifth waves. A significant move beyond this measurement normally leads to a prolonged fifth wave.



**Figure 3.12**

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**Figure 3.13**

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**Video:**

To watch a video on how to estimate the target price for the thrust out of a triangle, go to:

[www.wiley.com/go/elliottwavevg](http://www.wiley.com/go/elliottwavevg)

Another way to estimate the end of wave (v) is to use a trend channel, as shown in Figure 3.13.

To use the trend-channel method, draw a line that connects the termination points of waves (ii) and (iv) and then draw a parallel line from the termination

# Using Ending Diagonals to Trade Swift and Sharp Reversals

A swift and sharp reversal follows an ending diagonal—and that is what makes it an excellent trade setup.

## Trading an Ending Diagonal in the Dow (DJIA)

If there is one Elliott wave pattern to get excited about trading, it's an ending diagonal. This pattern is rare in markets, and novice analysts tend to anticipate diagonals far too often. The pattern allows for tight stop placement, so that errors are not costly. This terminating pattern shows up in the fifth-wave position of impulse waves and in the wave C position of A-B-C formations. Once an ending

diagonal terminates, get ready for a swift and sharp reversal in price. That sharp reversal is what makes this wave pattern my favorite. You can see what I mean in these two hourly charts (see Figures 5.1 and 5.2) of the Dow Jones Industrial Average (DJIA) from April 1998.

In Chapter 1, “The Anatomy of Elliott Wave Trading,” I described three different ways to trade this pattern, ranging from conservative to extremely aggressive. The extremely aggressive technique is based on each impulse wave of an ending diagonal being smaller than the previous one. To exploit this characteristic, a trader could take a position as wave five develops with a protective stop at the point at which wave five becomes longer than wave three.

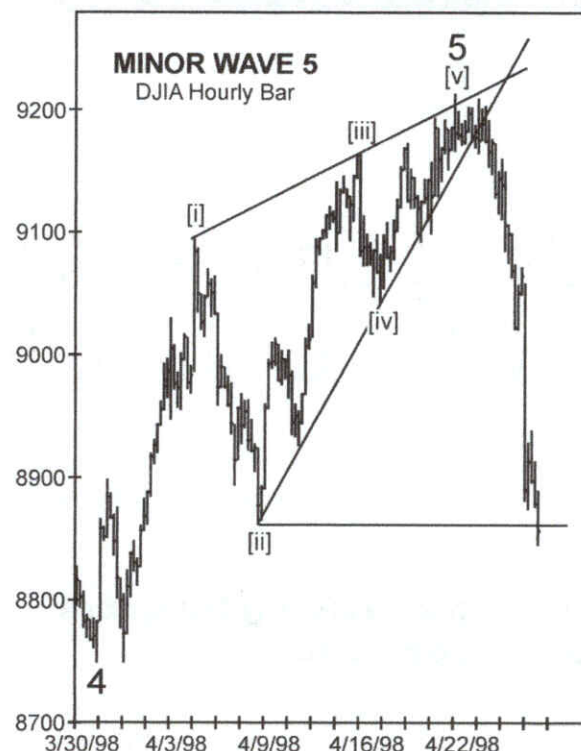
### KEY POINT

Ending diagonals can form as the fifth wave of impulse waves and as wave C of flat and zigzag corrections.





**Figure 5.1**  
Source: Chart courtesy Elliott Wave International.



**Figure 5.2**  
Source: Chart courtesy Elliott Wave International.

### Smart Investor Tip

The guideline for an ending diagonal provides a good example of how the Wave Principle can let a trader know exactly where his or her analysis is wrong.

If we apply this trading technique to this hourly price chart (see Figure 5.3) of the Dow, a trader would short the market as wave [v] develops from 9041.9 and place a protective stop at 9344.8. That's the point at

which wave [v] would become longer than wave [iii], which would negate the labeling of the pattern as an ending diagonal and indicate that a different pattern was forming. Notice the Wave Principle's ability to





**Figure 5.3**

Source: Chart courtesy Elliott Wave International.

let a trader know exactly where his or her analysis is wrong.

A less aggressive way to trade an ending diagonal would be to wait for a decisive break of the trendline connecting the extremes of waves two and four. On



**Figure 5.4**

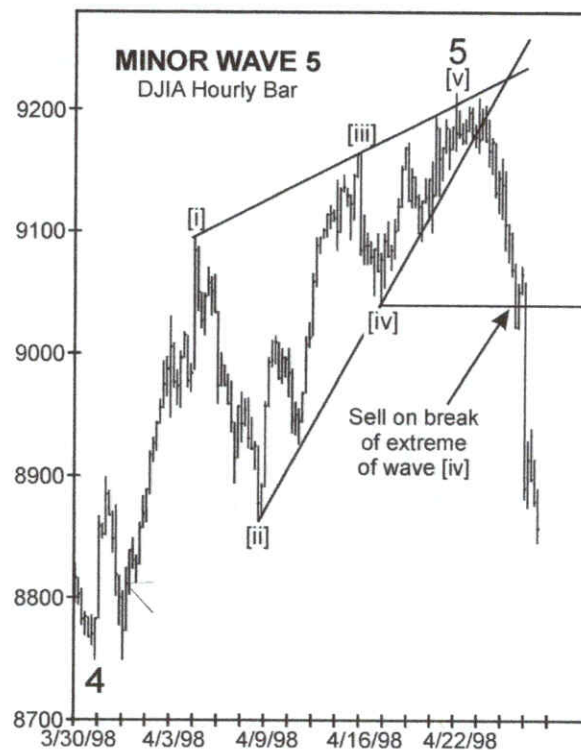
Source: Chart courtesy Elliott Wave International.

this Dow chart (see Figure 5.4), that event occurred the next day, on April 23.

The most conservative approach for trading ending diagonals is to wait for the extreme of wave four to give way before initiating a trade. On

### Smart Investor Tip

The conservative approach for trading ending diagonals is to wait for the extreme of wave four to give way before initiating a trade.



**Figure 5.5**

Source: Chart courtesy Elliott Wave International.

### Smart Investor Tip

The slightly aggressive approach for trading ending diagonals is to wait for a break of the trendline that connects the extremes of waves two and four.

this chart (see Figure 5.5), you can see that the Dow moved beyond the extreme of wave [iv] on April 24.

The aggressive approach appeals to some temperaments and has the advantage of allowing for a close stop. The delayed approach benefits traders by preventing them from trying to pick tops and bottoms and by helping them to base their trading decisions

more on supportive price action and somewhat less on conjecture.

Regardless of your trading style, ending diagonals are worth looking for because they are easy to identify *and* they offer high-confidence trade setups. In our example, this terminating pattern introduced a 350-point decline. Traded either aggressively or conservatively, this trade setup would have been profitable.



**Figure 5.6**

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## Trading an Ending Diagonal in Broad Soft (BSFT)

Figure 5.6 illustrates another example of a fifth-wave ending diagonal and its swift and sharp reversal, this time in Broad Soft (BSFT). To trade this ending diagonal aggressively, a trader would have sold shares of BSFT as wave 5 developed (point M on Figure 5.6). The protective stop would have been set at \$46.43, the

level at which wave 5 would have become longer than wave 3.

Taking a less aggressive approach to trading this pattern, a trader would have waited for a break of the trendline that connects the extremes of waves 2 and 4 (point N). BSFT moved through this level on May 4, 2012, which means a trader would have entered the trade in the low \$41.00 region. The protective stop for this entry guideline is the extreme of the ending diagonal at \$45.32.

### KEY POINT

Regardless of your trading style—aggressive or conservative—ending diagonals are worth looking for because they are easy to identify and they offer high-confidence trade setups.



**Figure 5.7**

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Figure 5.7 shows how a conservative entry would not have worked due to a price gap. The low of the day on Friday, May 4, was \$40.65, which was 3 cents above the extreme of wave 4 at \$40.62. Come Monday morning, the stock gapped down more than 17 percent to open at \$33.75. So, opting

for the conservative entry technique would have caused a trader to miss out on this trade altogether, because prices never traded at \$40.62. Even so, these price charts of BSFT illustrate quite well the swift and sharp reversal that often follows ending diagonals.