Capitalizing on Continuation Patterns

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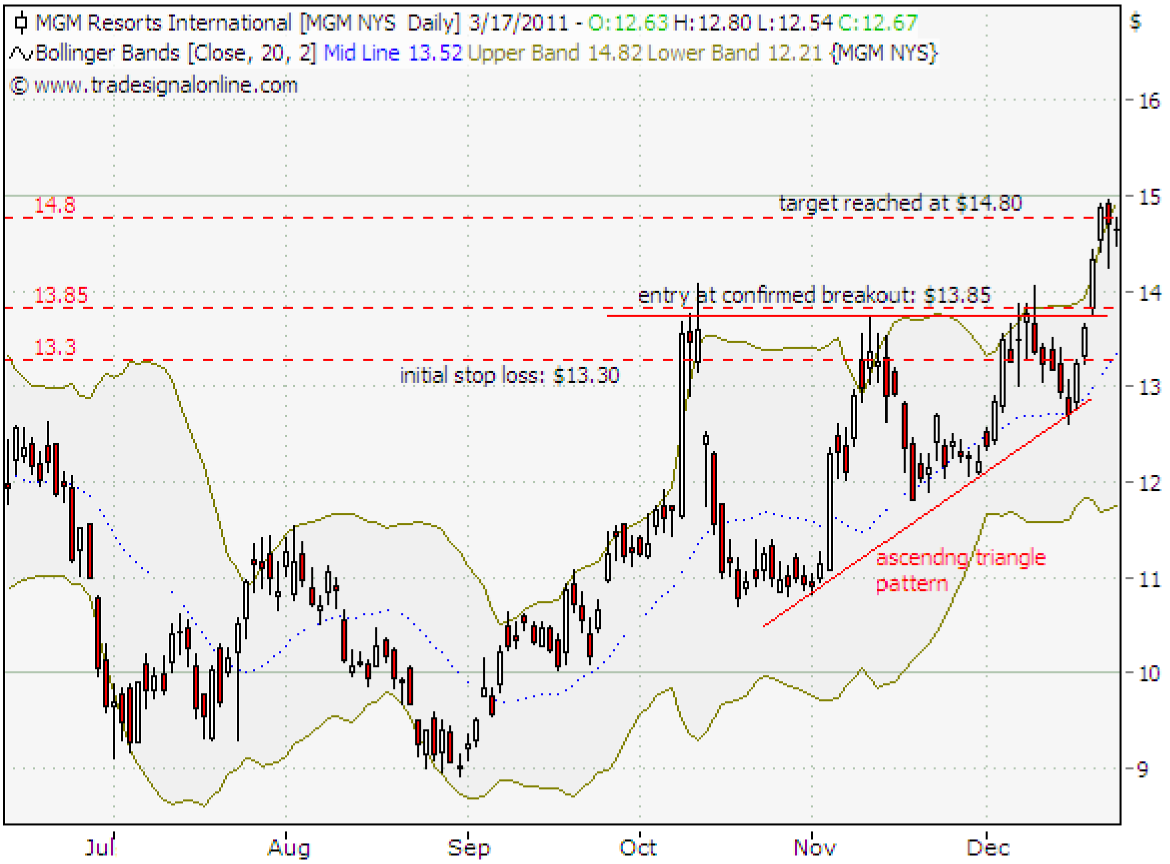
Technical analysts seek to identify and capitalize on patterns, or tendencies, in stock charts, and of particular interest to me is the tendency of stocks to continue trends, either up or down. Stocks that have broken out (or down in the case of shorts) go through periods of consolidation ahead of the next move, and identifying these consolidations and key entry points can optimize the chance of winning trades.

This strategy is built on the assumption that, as the adage goes, the trend is your friend and that pauses in trends will usually resolve in continuations of those trends. This, of course, requires that these pauses, for the most part, are sideways, in the form of triangles, flags, pennants, rectangles, or wedges, and that the stock price remains range-bound, building pressure ahead of the next release.

An example of this is an ascending triangle pattern, as seen in the MGM Resorts International (MGM) chart from mid-December 2010. MGM had been consolidating out of a big upmove that had taken it from 9 in late August 2010 to nearly 13 3/4 in mid-October, a more than 50% move. It tested its key 13.80 resistance level a couple of times since October, but couldn't break through, with the stock each time retracing to a new higher low. This created the ascending triangle pattern whose upper horizontal trend line -- the key 13.80 resistance level -- appeared ready to be broken as the lower line angled toward it.



While the ascension of the triangle suggested the stock was poised to break out, there was, of course, no guarantee. So, rather than anticipate and risk the stock backing off or continuing sideways, forcing us to hold longer than we'd like, we set a "buy stop" price at 13.85, just above the resistance line, in order to be positioned should the stock break out. MGM, in fact, did hit 13.85, and accelerated to our target of 14.80 the very next day.

In another example of a bullish consolidation, Developers Diversified Realty (DDR) narrowed nicely for three months in a symmetrical triangle, converging towards the apex. As the stock edged up towards the top of the narrowing channel, we put in an 11.55 buy stop order, just above the top of the upper trendline. The stock proceeded to explode from there in early October into our 12.71 target area.

The use of buy stops is a critical component of a strategy such of ours that capitalizes on continuation patterns. A buy stop is an order to enter a trade at a price above where the stock is at currently. It enables traders to wait for the stock to come "up" to the buy price as evidence of continued momentum. In our strategy, we use the hours after market close to study the day's patterns and prepare what's called Buy Stop Limit Orders before the next trading session. This involves setting a buy stop just above the previous day's high, as well as setting a limit, or maximum entry, price. The use of a limit price avoids chasing a stock should it gap up too high. Conversely, short trades use Sell Stop Limit Orders, setting entry points below previous day lows.

Our Buy Stop Limit Orders are day orders, and thus if the stock opens below the buy stop price and fails to reach it during the session, the trade is canceled. Sometimes the trade set-up is reinitiated for the following or subsequent sessions, but often a new, more promising chart set-up is selected for the next day, as a failure to meet the expected breakout often results in a dissolution of the upward pressure.

We also cancel trades if the stock opens above the limit price, as a retracement from there back to the buy stop price is a move in the opposite direction (and our strategy looks to capitalize on momentum, not bottom-fish).

Likewise, if the stock moves below the stop loss price before hitting the buy stop, we cancel the trade because of the break in momentum and because any snapback from there up to the buy stop would be considered too quick a move and subject to additional consolidation.

A recent chart on McGraw-Hill (MHP) shows how an ascending triangle just like MGM can sometimes fail to follow through as expected, and how our strategy works to avoid entering a bad trade. MHP had been making higher lows since late November 2010, narrowing towards its upper trendline resistance just below 39.15. Setting our buy stop at 39.15 in a pre-open order in early March, we were positioned in case of a breakout, but also protected when the stock failed its third test of that level. The stock dropped below our stop loss price, cancelling out our trade. No harm, no foul, and the capital that would have been tied up or lost in the trade was free to use the next day in another bullish continuation pattern.

We set the stop losses in our trade orders mostly in the range of 3-5% below entry. If the position is filled and moves lower, we're protected. If the position advances, we raise the stop. When a stock rises 1% above its entry prices, stops are moved to 0.2% above entry to lock in a profit. Targets are 4-12% above entry, and usually follow the direction of the ascending trendline, such as the 14.80 level in the MGM example. Using this strategy, for every 10 trades, 2-3 stocks tend to continue their trend, yielding a 10%-12% gain, while other picks are exited at a small 0.2% gain to 2-3% loss.

One additional risk management strategy we use is determining the number of shares. We determine the number of shares for a trade through a formula that ensures that no more than 2% of the account level is risked in a trade. The formula is 2% of the account level divided by the difference between entry price and stop loss price. For example, with a $30,000 account and a trade with a $0.50 difference between entry and stop loss, the number of shares would be 600 (2% of 30,000) divided by 0.50 -- which comes to 1200 shares. If stopped out for a $0.50 loss, the loss is no more than 2% ($600) of account value.

In sum, our strategy plays the trend, but through the use of buy stops we maximize our chance of entering a trade on a breakout with the trend resolving in our favor. There are many times these trends don't move our way, but most often the trade is cancelled by then and we are safe to trade another day.

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