



Waverly
Advisors

Trading the Unexpected: Pattern Failures

December 16, 2013

Outline

- What does “unexpected” mean?
- The psychology of trading the unexpected
- Developing the mental skills to handle trading surprises
- Two ways to think about the unexpected
 - When the unexpected happens to you
 - Using the unexpected to motivate and set up trades
- Specific failure patterns



What Is Unexpected?

- There is not an easy answer.
- A significant body of academic work suggests that markets usually fit random walks very well.
 - Less true in higher frequency (i.e., intraday) data
 - There is also contradictory evidence
- This is not to say that markets are random, but they might be more random than many traders would like to believe.



Step One:

- Is to realize that markets are probably much more random than you think.
 - Patterns have less of an edge
 - Tendencies are not as strong
 - There is more noise and randomness than you wished
- What are good probabilities for a pattern?
 - 90%?
 - 80%?
 - 55%



The Key Idea

- You are trading against the expectations of the crowd
- For a technical trader, this means trading against the inherent tendencies in technical patterns in the market.
 - But this requires some assumptions
 - Patterns have an edge
 - Other market participants are trading with the pattern
 - They will panic if the pattern doesn't “work out”
- Assumptions are necessary but dangerous.
 - Spend time thinking about your assumptions



A Non-Technical Example

- Trading a stock against an earnings number.
- Background
 - Companies normally report earnings (and other financial figures) four times a year (quarterly).
 - Earnings often contain valuable information about the future prospects of the company, so stock prices can have large changes around earnings.
 - Some stocks are more carefully watched than others.
 - Analysts (sell side and independent) make estimates about what the earnings will be, based on analysis of the company, the market, conversations with management, etc.



Trading Earnings

- The following are (usually) known in advance
 - Past history of the company's reports
 - Expectations of the current report
 - Date and time of the current report
- What might we logically expect?
 - If the company beats earnings (i.e., the reported number is higher than analysts' estimates) the stock will go up.
 - If they miss earnings, the stock will go down.
- Sometimes it doesn't work like this. Why?



Trading Earnings Expectations

- Especially for much-watched and heavily analyzed stocks, there are two numbers:
 - The “official” estimate
 - This is never as easy as it seems—it’s a composite.
 - The “whisper number”, or what traders are really expecting.
- A stock can beat earnings but still go down, sometimes drastically
 - Maybe they missed the whisper number?
 - Maybe people simply expected them to beat more?
 - Maybe there are other factors
- When expectations are disappointed, large and volatile price changes can happen.



Trading Unexpected News Items

- Large moves in the market can be accompanied by news items, or sometimes not.
- Large shocks can be either contra to the existing trend, or with that trend.
- In general, contra-trend shocks tend to be absorbed into the trend.
 - The shocks tend to be reversed.
- In general, shocks not accompanied by news show weaker tendencies for reversal.
 - These may be the ones you need to be concerned about, from a risk management standpoint.
 - Why should this be so?



The Psychology of the Unexpected

- As technical traders, what do we really trade?
- Most people will say “patterns”, but is this true?
- “...we do not trade patterns in markets—we trade the underlying imbalances that create those patterns.” (TAAS, p 7)
- Opportunity comes when the public’s perception of an event diverges from the actual probabilities.
 - But this can be very difficult to quantify.



Two Perspectives on Psychology

- The crowd's psychology
 - Reflected in sentiment and technical patterns
 - Can be gauged by analysis of news and blogs, but be careful of doing this anecdotally.
 - Algorithms to do this look at hundreds of thousands of data points each day. How many blogs do you read?
 - People panic when surprised.
- The individual trader's psychology
 - The edge comes from standing apart from the crowd.
 - Important to understand the crowd,
 - But have the self-awareness to not get caught up in it.



Be Good at Being Wrong

- Even the best traders are wrong a lot.
- Understand the relationship between win rate and reward/risk ratio.
 - Very high win rates (>90%) are possible only with smaller reward/risk ratios.
 - Rather low (25% or less) win rates can be profitable with higher reward/win ratios.
- Your trading plan should embrace every contingency



Fail to Plan... Plan to Fail

- What will you do when a market suddenly turns and hits your stop?
- What will you do when a market gaps beyond your stop?
- When will you tighten your stop?
- Is there ever any time you will loosen your stop?
- Will you ever give your stop more time if hit?
- How will you deal with errors?
 - Buying or selling too much
 - Buy instead of sell and vice versa
 - Executing in wrong market or contract
- There may not be one right answer (some are better than others), but you must plan for events like this.



The Role of Mental Rehearsal

- In many performance disciplines, drills are important.
 - Basic skills can be done without thinking
 - Repetition is key
 - Someone with training will often react first and then think.
 - Someone without training may react without thinking, but it's helpful if the right reactions are trained!
- Traders can get there through experience.
 - Experience takes time and costs money.
- Mental rehearsal can be a helpful shortcut.



Mental Rehearsal

- Be very careful what you train.
 - Do you want to be more aggressive?
 - Fearless?
 - Patient?
- Any of these could be good, but be careful what you ask for.
 - If you train it, you will get it.
 - Practice doesn't make perfect. Practice makes permanent.
 - Perfect practice makes perfect.
- Decide what the correct reactions are, and then rehearse them mentally.



How to Do It

- Take a quite time away from the market. Eliminate distractions as much as possible.
- Write down what you plan to train.
 - What are the triggers? (E.g., a stop being hit)
 - What is the desired reaction? (E.g., exit immediately)
- Imagine yourself in the situation where the trigger happens.
 - How do you see yourself acting?
 - How do you feel?
 - Pay attention to the emotional charge.



Defusing the Emotional Bomb

- When you find yourself in a situation where you have an emotional reaction (in rehearsal)...
 - Allow yourself to experience the emotion.
 - Invite yourself to experience it fully.
 - If you are anxious or tense, let your body respond.
 - Breathing, muscle tension, etc.
- Then imagine yourself letting the emotion go
 - Control your breathing. The mind/body connection works both ways.
- Then imagine yourself handling the situation correctly with no emotional charge.
 - Free and clear.
- Repeat often and journal your experiences.



Visualizing?

- Some people consider this visualization work, but be careful.
- It is not necessary to visualize (“see”) yourself.
 - Different people have different aptitudes for visual imagination.
 - If you have a natural tendency toward another sense, let it take the lead.
 - Try to experience as fully as possible, incorporating all experiences and senses.
- This is why “imagine” is better than “visualize”.

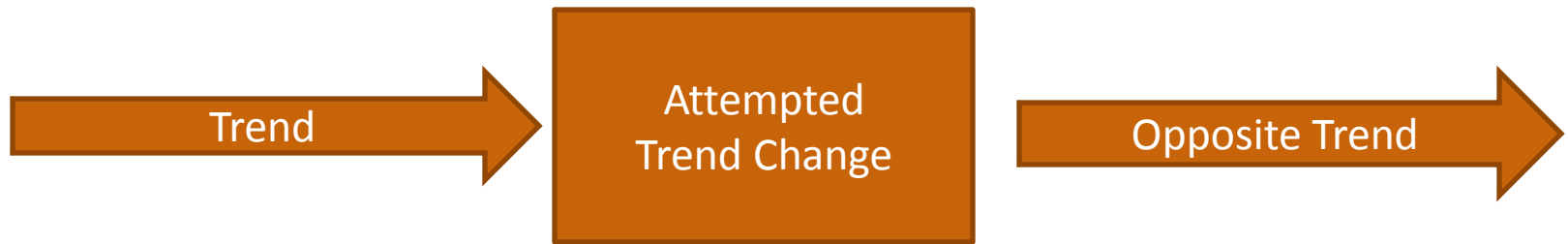


Shifting Gears...

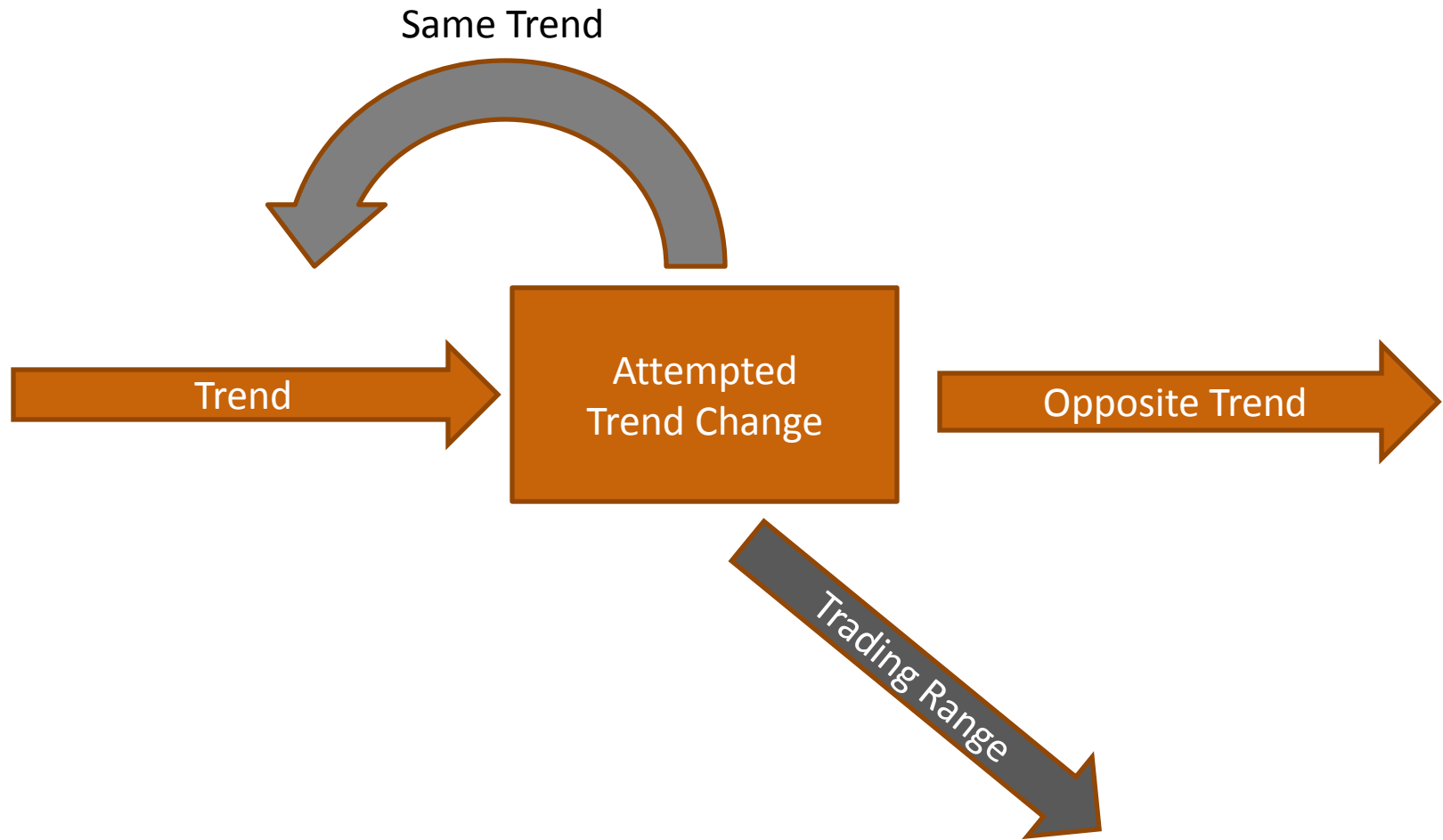
- Planning for the unexpected is an essential part of trade management,
- But we can also use unexpected developments to set up trades.
- It is possible to structure an entire trading program around this idea.



Attempted Trend Change



Attempted Trend Change Failures



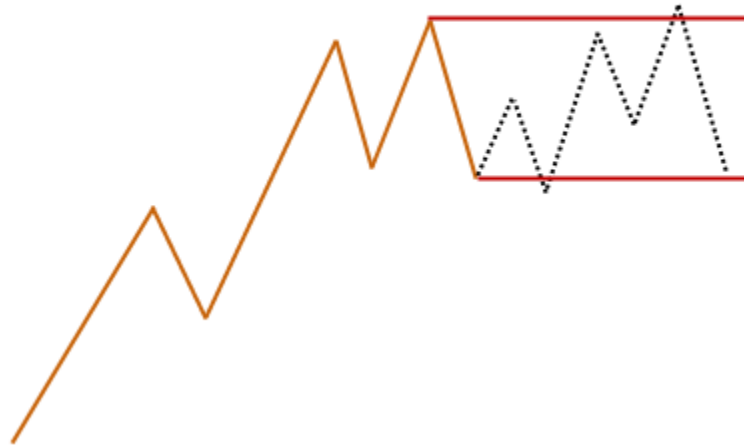
Attempted Trend Change



Expectations...



Possible Failure (to Range)



Possible Failure (to same trend)

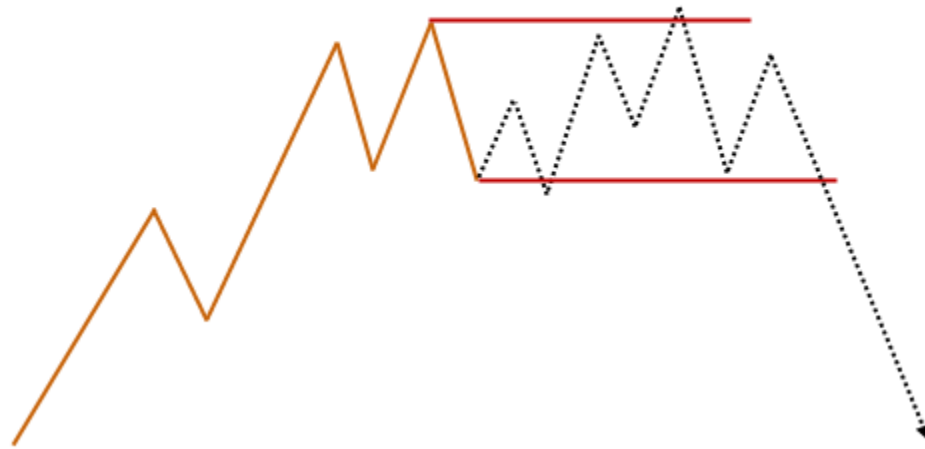


These Failures Are Relative

- What were you expecting?
- Were your expectations in alignment with the probabilities in the market?
- How many other traders shared these expectations?
- How do you know?



Is This a Failure? Or Simply a Trend Reversal?



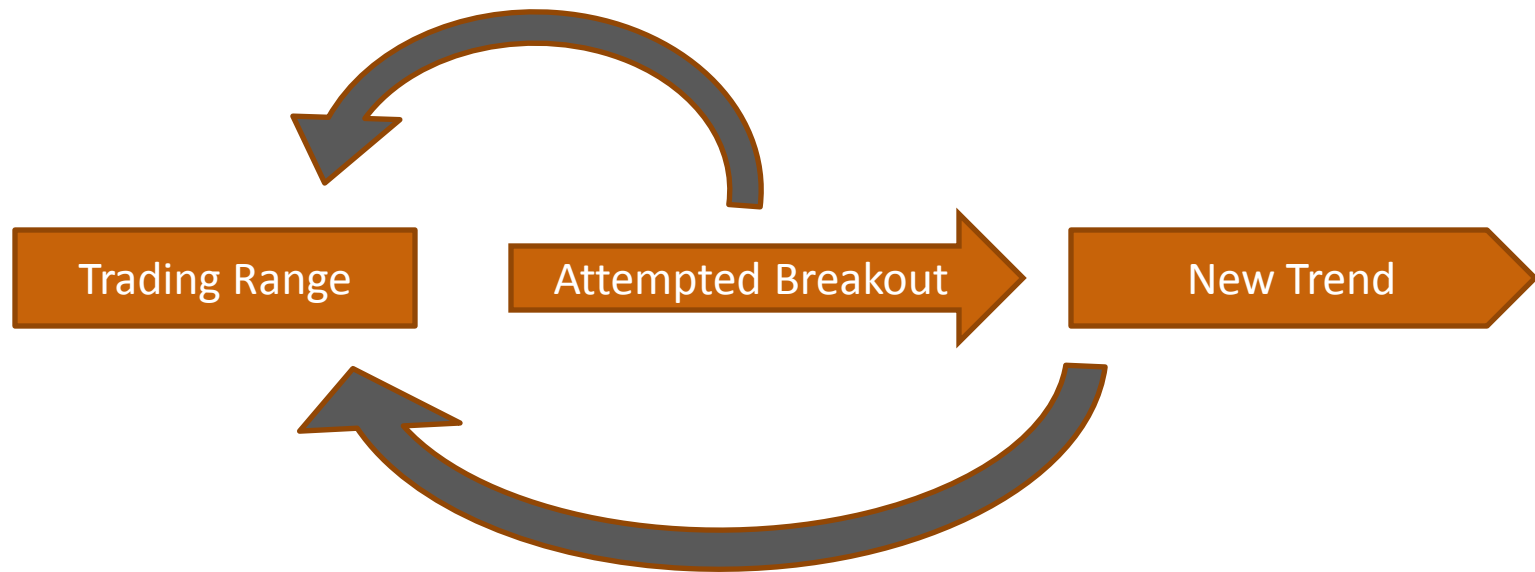
Attempted Breakout



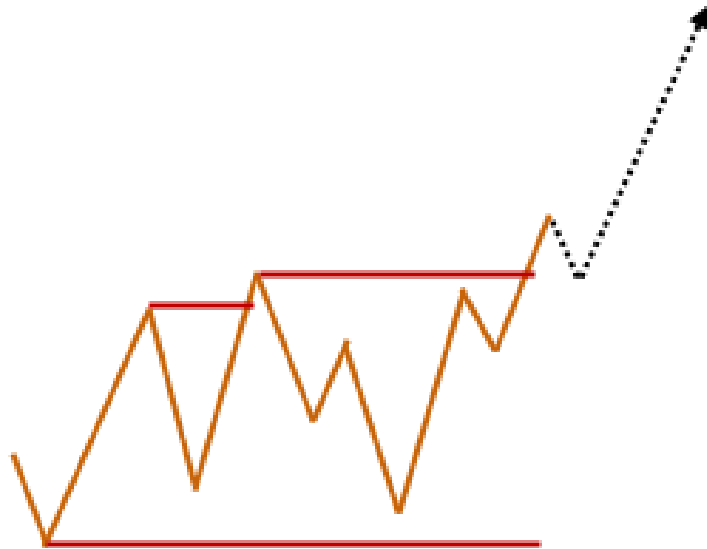
Attempted Breakout Expectations



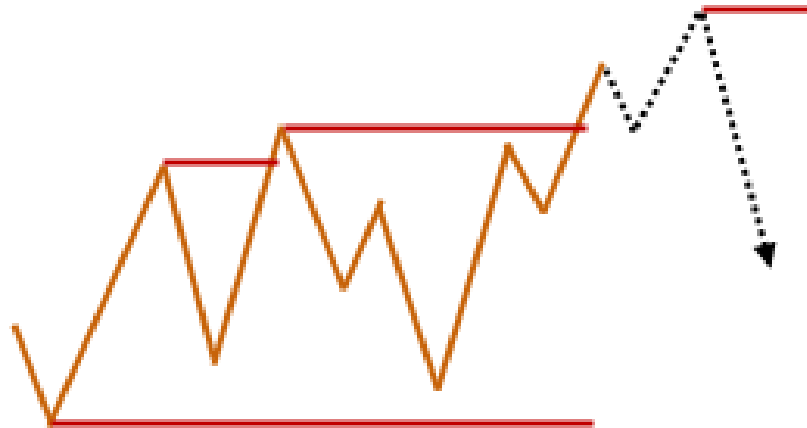
Attempted Breakout Failures



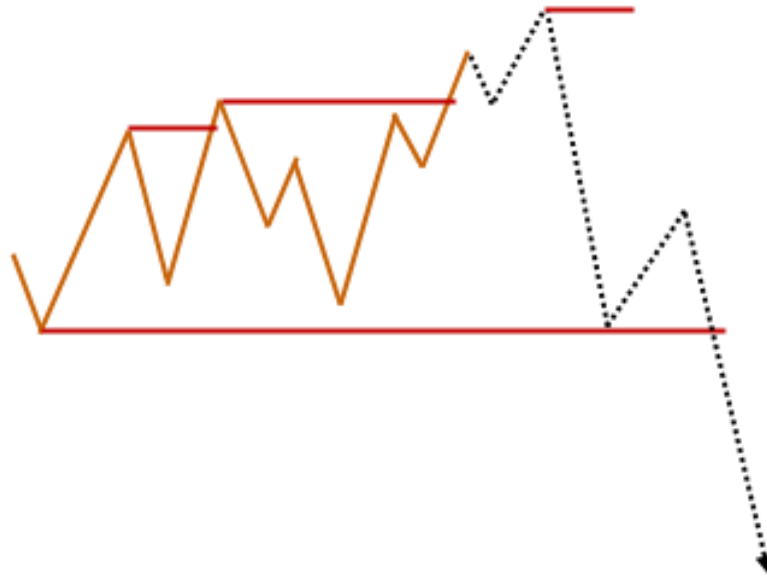
Attempted Breakout: Expectation



Attempted Breakout: Failure



Failure or Expectation?



Summary of Structural Failures

- Intact Trend
 - Fail into Range
 - Fail into Trend Reversal
- Attempted Trend Reversal
 - Fail into Range
 - Fail into Trend Continuation
- Attempted Breakout of Range
 - Fail back into Range (Range expanded)
 - Fail into opposite Trend
 - New Trend can Fail



Trading Failures

- Failed breakouts
- Failed pullbacks
- Failures at HOD/LOD

- Consider carefully: what is a failure?
 - Does the pattern actually have an edge?
 - Are people trading it? Is it really driving price movement?
 - At what point does it become silly?
 - Can we trade failed failures??
 - ... failed failures of failures???



Failed Breakout

- Can fail at breakout point
 - Failure test entry!
- Can fail at first pullback



Failed Breakout: Failure Test



Pullback Failures

- Failure at previous pivot high/low
 - Not truly a failure, but S/R holds against the trade.
- Failure as strong contra momentum emerges
- Failure by going flat after entry



Pullback Failure: At Previous Swing



Pullback Failure: By Strong Contra Momentum



Pullback Failure: Goes Flat After Entry



Failures for Short-Term Traders

- Know the tendencies in your market
- Know what happens after big days or big extensions
 - This varies, depending on the asset class
 - It is crucially important to understand the tendencies of your chosen market.
 - Different asset classes show different blends of mean reversion and momentum.
 - So do different timeframes.
- One of the strongest intraday tendencies is the failure around established highs (HOD) and lows (LOD) of the day.



Trading HOD/LOD Failures

- Many traders fade moves to highs and lows.
- How to trade failures?
 - Trade breakout of HOD/LOD.
 - Trade the first pullback following the breakout.
 - Or... trade a failure failure
 - Pullback sets up outside HOD/LOD and then fails back inside.
 - The newly established HOD/LOD becomes a reasonable risk point.



Summary


- Failures can offer powerful trading opportunities
- Groups of trapped traders may scramble to adjust positions, driving prices into sharp, clean moves.
- But it is important that we adjust our own expectations.
 - Understand the statistics so you know what is really expected.
- Work to develop the psychological skills to act decisively and with flexibility.



Waverly Advisors' Research

- Tactical commentary highlighting potential extremes.
- Specific trade entries in climaxes.
- Using climaxes as a filter to avoid lower-probability with-trend trades.
- Specific stock screens published daily:
 - Consecutive closes
 - Extremes
 - Big Movers
 - Historical Big Movers (published weekly)



 WILEY Trading

MARKET STRUCTURE,
PRICE ACTION, AND
TRADING STRATEGIES

THE
ART AND SCIENCE OF
TECHNICAL
ANALYSIS

ADAM GRIMES



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Waverly Advisors, LLC:

Research Products

Tactical Playbook – Available on Interactive Brokers

- Written for the active trader on the daily/weekly timeframes
- Exact trade recommendations
 - Hybrid systematic-discretionary methodology
- In-depth technical “drill down” into a set of markets.
- Bigger-picture overview of all liquid asset classes.

Tactical Portfolio Outlook– Available on Interactive Brokers

- Written for the longer-term manager
 - Addresses both the allocator and the longer-term active trader.
- Emphasis on executing with ETFs in a long-only and long-short environment
- Focus on Equities, Equity Sectors, and other asset classes
- Macro perspective on risk factors and major economic events.

Options Market Outlook – Contact Waverly Directly

- Proprietary, quantitative analysis of options market
- Incorporates both volatility and directional analysis
- Macro risk factors and cross-asset perspective
- Actionable trade ideas



Contact:



Waverly Advisors

228 Cedar Street
Corning, NY 14830

(607) 684-5300

www.waverlyadvisors.com
info@waverlyadvisors.com

Adam Grimes

CIO, Quantitative Analysis, Risk Management
grimes@waverlyadvisors.com

Andrew Barber

CEO, Macroeconomic Analysis
barber@waverlyadvisors.com

Damon Krytzer, CFA

Managing Director, Portfolio Construction & Management
krytzer@waverlyadvisors.com

Chris Noye

Managing Director, Head of Sales
noye@waverlyadvisors.com

