The Awesome Trading System
(2nd Edition)

By Victor Chan Wai-To

Note: You may freely distribute this ebook as long as you do not alter the content of it.

Warning: There is a risk of loss in trading. The content of this e-book is educational and it does not guarantee you to make profit in trading. You are responsible for your own trading decisions and outcomes.

Table of Contents

Introduction –
The Very First Step

After winning the 1984 US Trading Championship, market analyst Robert Prechter wrote an article about the five things which he considered essential for successful trading. Among the many things, the very first one is a method. "I mean an objectively definable method. One that is thought out in its entirety to the extent that if someone asks you how you make your decisions, you can explain it to him, and if he asks you again in six months, he will receive the same answer." Prechter also commented that "a simple 10-day moving average of the daily advance-decline net, probably the first indicator a stock market technician learns, can be used as a trading tool, if objectively defined rules are created for its use." (Prechter, 1986)

This is what I have in mind when I created the Awesome Trading System. I want to layout a simple trading plan for a beginner to have something to start with, so that they can immediately fulfill the first element of successful trading – having a system with well-defined rules. The ideas presented in this system are by no mean novelty. They are an accumulation of wisdom I have collected from different traders in the past. That being said, there are also original thoughts on my part. For example, my use of the indicators is quite different from the original rules outlined by their creator (i.e. Williams, 1995, 1998). There is more on that in the indicator section.

However, this ebook is not just about a list of rules of a system, because just having a system is not enough. I am sure that you have heard about the saying that trading is 90% mental. The second half of this ebook is devoted to aspects of successful trading that are unrelated to the system itself, and hopefully it will convince you the importance of money management, understanding probability and being skeptical of your own ability to make money.

To assist you carry out the system on a daily basis, in the appendix there are two daily spreadsheets which help you follow the markets everyday with this trading plan. Writing your own trading journal everyday with this spreadsheet is simply the best way to improve your result.

Good luck with your trading.

Victor Chan Wai-To
August 2010

The Indicators

The Awesome Trading System uses two indicators: the Awesome Oscillator (AO) and the Accelerator Oscillator (AC). Both were developed by Bill Williams (1995, 1998). Here are the formulae of both indicators.

The Awesome Oscillator (AO):

AO = 34-Bar Average of Median Price – 5-Bar Average of Median Price
Median Price = (High + Low) / 2

The Accelerator Oscillator (AC):

AC = Present Value of AO – 5-Bar Average of AO

The uses of the two oscillators here are very different from the original use by Williams. Here AO is used to determine the underlying trend and AC is used to determine short-term over-bought or over-sold conditions.

The Rules of the System

<u>Timeframe:</u>

- For daily chart or above.
- For spot forex, best to use broker with GMT.

Below are the rules for long. For short just do the opposite.

<u>Setup (Long):</u>

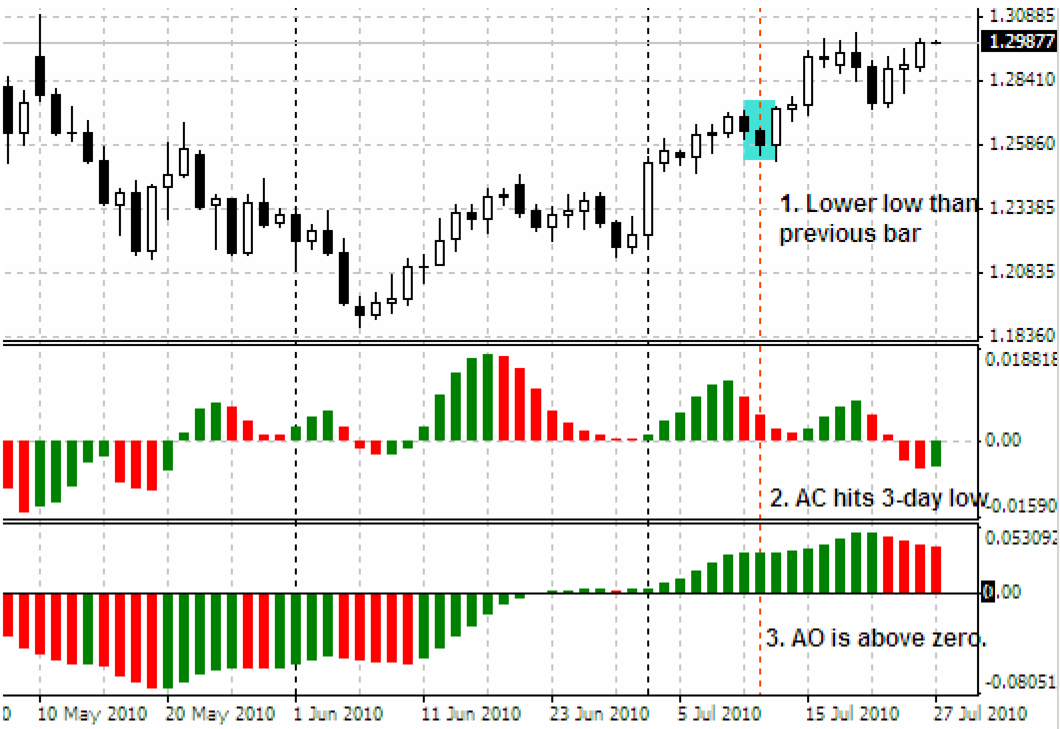
For the last closed bar (i.e. yesterday's bar):

A. The value of AO is above zero.

B. AC hits 3-day low.

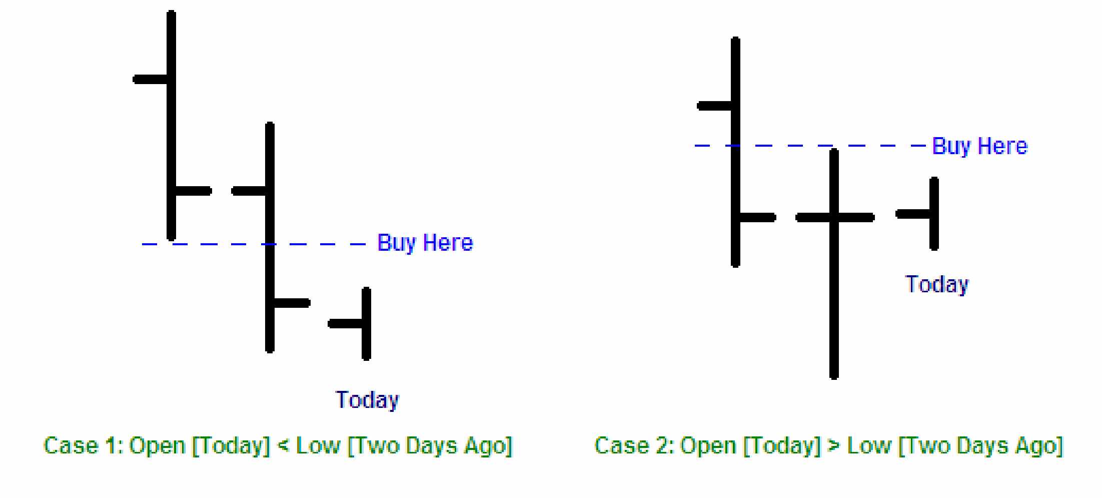
C. Yesterday's low is lower than that of two days ago, not counting inside days.

Here is an example of a long setup on 12th July, 2010:



<u>Entry (Long):</u>

- *If today's open is lower than the low two days ago:*
  Place a buy stop at the low two days ago.
- *If today's open is between yesterday's high and the low two days ago:*
  Place a buy stop at yesterday's high.



- *Cancel an unfilled buy stop order when:*
  I. AO goes below zero.
  II. A new buy entry signal appears at a lower level.

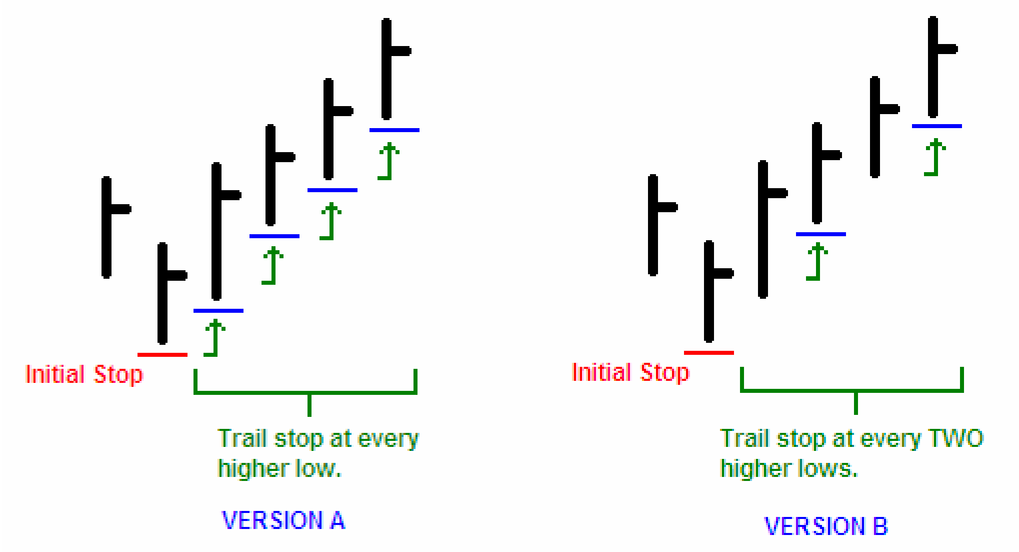
<u>Exit (Long):</u>

✧ Place an initial stop loss just below the low of yesterday, say, 30 pips below that low. You may replace the margin of 30 pips with whatever you find appropriate in the markets you trade.

✧ When there appears a new daily low that is higher than the initial stop, move the stop forward to just below where that new higher low is. Inside days are not counted. Repeat this process of trailing stop whenever a new higher low appears.

✧ If you are more aggressive, you may trail the stop for every two higher lows formed instead just one.

✧ (Optional) Exit when four consecutive increasing (green) AO bars appear.



Money Management

"What more can I tell you? You have just been handed the keys to the kingdom of speculative wealth."

— *Larry Williams (2006), on money management.*

Money management is a very important element of trading, because it protects us from the unexpected giant drawdown that had eaten many traders alive. Here are the formulae used in the Awesome Trading System for determining lot sizes:

For Spot Markets:

Lot Size (Long) = (Risk % x Balance x Stop) / (Entry – Stop)
Lot Size (Short) = (Risk % x Balance x Entry) / (Stop – Entry)

Example:

Suppose your account balance is \$100,000 and 5% is the maximum risk in each trade. In a trade you longed EURUSD at 1.2260 and placed an initial stop at 1.2140.

Lot Size = (5% x \$100,000 x 1.2140) / (1.2260 – 1.2140)
= 500,000 (round down to the nearest standard lot)
= 5 standard lots or 5:1 leverage

For Spread Betting or Futures Markets:

Lot Size = (Balance x Risk % x Minimum Unit) / |Entry – Stop|

Using the same example as above, but this time in a spread-betting account with a minimum bet size of \$10 per unit (0.0001):

Lot Size = (5% x \$100,000 x 0.0001) / (1.2260 – 1.2140)
= \$40 per unit (round down to the nearest \$10 per unit)
= 4 times of the minimum bet size

In both cases, always round DOWN to the nearest smallest lot or bet size possible. Don't enter a trade if your margin does not allow the calculated lot size.

On Discretion – It's All about Probability

"I teach students to look for an 80/20 trade. That means that you should feel in your gut that you have a 4 in 5 chance of winning as the trade sets up. People fail as traders because they take these 50/50 or 60/40 trades that look 'okay.' You can't really make any money on a long-term basis making trades like that."

– Dick Diamond (in an interview with Elliot Wave International, undated)

Even the most "disciplined" traders are not that dogmatic about following the rules. Curtis Faith, the most successful student of legendary trader Richard Dennis, wrote about how he gradually went from "sticking to the rules" to simply "eyeballing the chart" as he became experienced (Faith, 2010). He and other students of Dennis used a 10-week breakout trend-following system: they bought when the price got above the 10-week high and exited when it dropped back below the 4-week low, and vice versa.

In the beginning, Faith studiously plotted all the data and checked the rules everyday. Then, as he gained experience, he realized that all he had to watch for was breakouts of the 10-week range and ignored everything in between. After some more time, he had another insight that there was nothing magical about the 10-week high or low. It was the key support/resistance level that had been in place for a 10-week-ish period – against which a breakout would mark an important psychological shift of the market.

Once he realized that, he was no longer dogmatic about the rules. He simply eyeballed the chart and whenever he saw a breakout against an important level, he would go for it even if that was not completely qualified by the rules. In other words, upon the realization of the logic behind the system, Faith was no longer limited by the artificial rules that might otherwise prevent him from making a high probability trade.

Currency trader Dirk du Toit (2009) once expressed an opinion that the reason to enter or exit a trade is all about your feeling on the trade. At first I was taken aback by the comment because it sounded so undisciplined and emotional, but now I was able to comprehend its true meaning. The purpose of a system is to obtain a probabilistic edge, but since market conditions change constantly, there will be times when: a) the signaled trade doesn't seem to have a high reward-to-risk ratio, and b) the rules seem to have failed to identify a trade with high winning probability. As long as you can protect yourself with sound money management, it is up to you to exercise discretion as a trader to break the rules sometimes.

Conclusion – Under-trade and Under-bet

Now I have given you a system. In theory, you just have to select the suitable markets, make high probability trades, manage your risk and you will get rich in the end. But things are never that simple, otherwise everyone is rich.

The reason is this: the future never behaves like the past, and you cannot predict what will happen all the time. This is a critical truth that a trader should know.

After a period of winning streak, most traders would get depressed during an inevitable period when they were not as successful. They cannot understand why they are unable to perform like before. This is exactly when many traders lose discipline. They want to take "revenge" and forget all about money management. Most get destroyed in the end. A loss of respect of the potential danger of the game is probably the number one killer of traders.

To paraphrase Proverb 9:10 of the Bible, it is fair to say that the fear of the market is the beginning of wisdom, and the traders who practice money management have understanding.

In closing, please read the following comment by the famous trader Larry Williams (2006):

"This is the way life as a trader works: we develop a system or trading strategy, polish it off and start trading expecting the future to be like the past."

"It never will be, ever. And seldom will the future be better."

"Thus, what we need to do is under-bet our system or approach. Do not put as much money behind the system as the numbers from the past suggest you can. For most of us a 5% risk factor is all that 's needed to do rather well in this business."

"Under-trade, under-bet and you will be overwhelmed with your results."

References

Du Toit, D. (2009). *Bird watching in lion country* (2nd Edition). Commercial material available on 1st August, 2010: http://www.bird-watching-in-lion-country.com/

Elliot Wave International (n.d.). *Q&A with Dick Diamond*. Retrieved on 1st August, 2010: http://www.elliotwave.com/specialoffer/trading_course/q_a.htm

Faith, C. (2010). *Trading from your gut: how to use right brain instinct & left brain smarts to become a master trader*. Upper Saddle River: FT Press.

Prechter, R. R. (1986). *What a trader really needs to be successful*. Retrieved on 1st August, 2010: http://www.elliotwave.com/club/protected/pdf/8611.pdf

Williams, B (1995). *Trading chaos* (1st Edition). Hoboken: John Wiley & Son Inc.

Williams, B (1998). *New trading dimensions*. Hoboken: John Wiley & Son Inc.

Williams, L (2006, June 10). *Picture perfect trades*. Paper presented at a seminar in Sydney, Australia.

Appendix 1: Daily Spreadsheet (Currencies)

Date: ____________________

Pairs	EUR$	$JPY	GBP$	$CHF	$CAD	AUD$	NZD$
Setup (Long / Short)							
Entry and Stop (Levels)							

Date: ____________________

Pairs	EUR$	$JPY	GBP$	$CHF	$CAD	AUD$	NZD$
Setup (Long / Short)							
Entry and Stop (Levels)							

Date: ____________________

Pairs	EUR$	$JPY	GBP$	$CHF	$CAD	AUD$	NZD$
Setup (Long / Short)							
Entry and Stop (Levels)							

Date: ____________________

Pairs	EUR$	$JPY	GBP$	$CHF	$CAD	AUD$	NZD$
Setup (Long / Short)							
Entry and Stop (Levels)							

Date: ____________________

Pairs	EUR$	$JPY	GBP$	$CHF	$CAD	AUD$	NZD$
Setup (Long / Short)							
Entry and Stop (Levels)							

Appendix 2: Daily Spreadsheet (Blank)

Date: ____________________

Markets							
Setup (Long / Short)							
Entry and Stop (Levels)							

Date: ____________________

Markets							
Setup (Long / Short)							
Entry and Stop (Levels)							

Date: ____________________

Markets							
Setup (Long / Short)							
Entry and Stop (Levels)							

Date: ____________________

Markets							
Setup (Long / Short)							
Entry and Stop (Levels)							

Date: ____________________

Markets							
Setup (Long / Short)							
Entry and Stop (Levels)							