Elliott Wave Trading In The Real World

Partially excerpted from the book Dynamic Trading

Dynamic Trading, my comprehensive new book, includes an extensive 84 page chapter on the practical application of pattern analysis based on the Elliott wave principle. The **practical** application of Elliott wave analysis is a powerful tool for the trader and investor. Note I emphasized **practical**. Almost nothing has been written how to actually apply Elliott wave analysis to make real day-to-day trading decisions until the publication of **Dynamic Trading**.

Elliott wave analysis and trading strategies is much more simple than many people have been lead to believe. **Dynamic Trading** includes two very concise and easy to follow Elliott Wave Checklist Tables that quickly and easily allow the trader to identify the Elliott wave position in any market. That is if there is a current Elliott wave position.

This tutorial will not describe the Elliott wave basics of trend and counter-trend or wave counts. Many readers are already familiar with the typical counts. This tutorial includes an excerpt from end of chapter three of **Dynamic Trading**. While the comments are directly concerned with the practical application of Elliott wave analysis, they apply to anyone who believes their analysis or trading approach accurately describes all markets, all of the time.

Excerpted From Chapter 3 of Robert Miner’s Book, Dynamic Trading

And Now For Another Opinion

While Elliott wave analysis is relatively objective with specific rules and guidelines, pattern analysis does require the thought, knowledge and judgment of the trader. Much more so than time and price analysis. Any analyst who has studied wave patterns on charts for a length of time knows that it ain’t over till it’s over. I don’t care how ideal the pattern looks. Wave five can extend just when you thought it was all over. That ideal ABC correction can all of a sudden go haywire and twist and turn for days, weeks, even months.

When we begin to expect a market to continually unfold in an ideal Elliott wave pattern is when we have lost track of the practical value of

Elliott wave analysis. The purpose of Elliott wave analysis is not to identify and label every twist and turn in any particular market, all of the time.

> **Elliott Wave Analysis Objective**
> The objective of Elliott wave analysis for traders and investors is to identify specific set-ups based on pattern that have a high probability outcome and a specific market activity that will invalidate the anticipated outcome!

If you demand more of Elliott wave analysis than this, take out your checkbook and keep it out. You will have a very costly experience!

This chapter has described the patterns found in markets that are the most consistently reliable in identifying the market position and the most probable outcome from the current position. I have also described what are the most consistently reliable price relations between the various waves that allow us to project the price zones with the greatest probability of support and resistance and pattern termination.

How often will we be able to place the position of the market within the context of Elliott wave patterns as has been described here? About 50% of the time!

The major failure of analysts who primarily rely on Elliott wave to make trading recommendations or forecasts is their attempt to put all market activity, in all markets, all of the time within the context of Elliott's wave patterns. When this is attempted, the wave counts frequently become an outrageous exercise in hallucinogenic imagination with X waves all over the place, waves related to each other that are no way in any symmetrical relationship within the pattern and, generally, forced wave counts that don't relate to the concepts of Elliott's Wave Principle by any stretch of the imagination. Successful traders are rarely guilty of these imaginary, forced counts, as they do not lead to profitable trading decisions. They only feed the ego of the analyst. Traders and investors must deal with the reality of market activity, not dreams and illusions.

The trader who wishes to incorporate Elliott wave pattern analysis into his or her trading plan must recognize and admit to him or herself when the market pattern does not fit into one of the relatively simple impulse or corrective patterns. When this is the case and the time and price analysis does not provide sufficient information to make a trading decision, that market must be ignored as a tradable market until the position does become clear!

Don’t Become An Elliott Wave Obsessive

Recall that at the beginning of this chapter, I stated that one of the most important objectives of Elliott Wave analysis is to distinguish if the market is in a trend or counter-trend position. I also stated above that a clearly identifiable Elliott Wave pattern is usually only evident about 50% of the time in most markets. When a market is not unfolding in one of the specific impulse or counter-trend patterns described in this chapter, the rules, guidelines and general characteristics of impulse and counter-trend patterns will often strongly suggest whether the market is in an impulse or counter-trend position. That is a valuable piece of information itself.

Do not become obsessive with having to make a specific wave count if one is not obvious. The road to trading and investing ruin is littered with Elliott-Wave-Obsessives who would leave no chart unlabeled. The harder you have to work to apply a wave count the less likely it is to be a valid count and the more likely you will believe it to be a true when in fact it is only an illusion of your label-obsessive mind. Some day, I’m sure there will be EWA (Elliott Wave Anonymous) groups throughout the country where Elliott-Wave-Obsessive analysts will find help.

Beware Software Programs With Automatic Wave Counts

In recent years, software programs have been developed with extensive and complex algorithms (mathematical rules) that supposedly provide Elliott wave labels automatically on any data chart. If a software program provides an Elliott wave count on each and every data file, the program (and its programmer) assumes there is a valid and practical Elliott wave count on every data series, at any time. The program is *forced* to provide a wave count, even when none logically exists. A forced wave count is not only misleading, but will prove very costly to the trader who foolishly takes action on this irrelevant information.

Beware of forced wave counts, whether they are made by you, an Elliott wave analyst or a software program.

And Now For the Real Elliott Wave Story

The beauty and significance of R. N. Elliott’s work is that he recognized that markets are composed of groups of people that respond as crowd behavior in the same way that other social groups respond to a cycle of events. There is a *process* that evolves in almost every cycle of crowd behavior that runs its course. This *process* results in a fairly predictable pattern of behavior of cycles of optimism and pessimism. This process and pattern of behavior is represented on price charts of financial markets, as the price charts are simply reflections of the state of the psychology of the group participating in the market.

Throughout the course of R. N. Elliott's work developing his Wave Principle, it is obvious he continually looked to refine and expand upon the guidelines of his wave principle as applied to the markets. In Elliott's earlier work, there were no X waves, there were no "rules" and there was no mention of Fibonacci numbers or ratios!

Elliott developed his theory over less than a ten year period from the late 1920's to the latter half of the 1930's. It was in 1938 that Elliott's first monograph, *The Wave Principle*, was published by Charles Collins and the following year that Elliott was commissioned to write a series of articles on the principle for *Financial World* magazine.

It is these early works of Elliott that I find the most valuable. Here is found the spirit of the fundamental truths of what Elliott discovered about pattern and process in the cyclic development of the financial markets, unencumbered with the need to explain every little twist and turn on the financial charts. There were no X waves, no complex corrections, *just fives and threes*. Occasionally, a fourth wave traded into the territory of wave one. Occasionally, a third wave was the shortest impulse wave. *The form was more important than any rules*. The process would not be denied.

From 1938 - 1946 Elliott published his educational and forecast letters (*R. N. Elliott's Market Letters*, edited by Robert R. Prechter, Jr.). In these letters it became evident that Elliott felt he must show his theory to be right under all conditions, at all times. In these letters we find that he made his theory fit whatever market activity unfolded. There are some pretty wild counts in these letters. Here we are introduced to the dreaded X wave (actually a **#** wave) which mysteriously shows up whenever a market correction does not comply with a three (ABC) or five (ABCDE). No correction will be denied its count!

It is also during this time that Elliott begins to expound on the Fibonacci number series. Elliott's knowledge of Fibonacci number and ratio is elementary, at best. While he demonstrated some of the Fib counts and ratios relating to some market activity of time and price, this aspect of market activity was obviously not well thought out or researched by Elliott. After what can only be considered a brief study of number, ratio and geometry, Elliott was amazed and thrilled that he had discovered the "secrets of the universe" and the great "laws of nature", all conveniently available on the shelves of his local bookstore, courtesy of Jay Hambridge, Samuel Coleman, Manly P. Hall and others. (A little irreverence is due all great men in order to maintain perspective and avoid idolatry.)

What is the point of this brief history of R. N. Elliott? The practical application of Elliott's Wave Principle to trading and investing decisions has its strengths and weaknesses. Elliott did not describe a "law of the markets" with inviolate rules. With a limited history of data and within a fairly short period of time, Elliott recognized an important process that developed in the cycles of market activity. He recognized that the form of this process was fairly regular, which allowed for a certain degree of predictability of future behavior. He recognized that markets have a fairly, consistent symmetry of ratio based on the Golden Mean (1.618). He suspected (rightfully so) that this was the same process and same proportions that are evident in almost all natural growth processes outside crowd behavior.

When Elliott died in 1948, the understanding and application of his principle of form and ratio in the financial markets was really only in its infancy. Since the time of his death, far more has been written about Elliott and his Wave Principle than Elliott wrote himself. Market analysts over the years have had the opportunity to study thousands of charts of many more markets than did Elliott. The great value of his principle has been demonstrated time and again, as well as the frequent weaknesses.

Knowledge is never static. There is never the final word on anything. Today, we find that Einstein's Theory of Relativity may not be the inviolate law it has been accepted to be for most of the century. How can we say that Elliott's Wave Principle may also not be as complete and inviolate as some would like us to think?

In light of the above discussion, here are a few comments and suggestions that will help the analyst, trader and investor to apply Elliott's Wave Principle in a practical manner.

Elliott Wave "Rules"

There are none according to Elliott in *The Wave Principle* monograph. The three "inviolate" rules of labeling wave patterns were developed after his death in order to make his principle and its application more acceptable to the left brain junkies who believe life unfolds with predictable, mathematical precision.

Why then have I described and illustrated these rules throughout this chapter? They are usually not violated in real-time market activity. They provide an objective guide to understand market position and to make objective decisions. Implement the rules in your wave counts.

Occasionally, you will be betrayed by the truth of the market which does not always follow the rules, but more times than not the "rules" will keep your view of the market in proper perspective.

Experience will provide the knowledge and intuition when to break the rules. But don't be too quick to do so.

If you are going to violate the three so-called "inviolate rules" of Elliott wave analysis, *be consistent regarding those violations*. For instance, let's take the rule that a wave four of a five wave impulse sequence may not trade into the price range of wave one. I only consider that rule violated if the suspected wave four closes within the closing extreme of wave one, not trades into the intraday range. I know of other traders who have thoroughly studied markets and only consider a trade greater than 10% into the wave one range of many markets as a violation of the wave four-wave one overlap rule.

So-called Elliott wave purists, or, as I call them, traditional Elliott wave analysts, would say that expanding the parameters of this rule in either of the above ways is not trading R. N. Elliott's Wave Principle. I'll let you decide what you want to call it. The Elliott wave purists are mostly academic advisors who do not apply the principle successfully to their own trading or investing and have generally been creamed in the stock market in the last few years calling the top of the market more frequently than the full moon cycle.

Elliott provided a firm and original foundation for pattern analysis in the markets. Don't hesitate to expand on Elliott's work when your market research proves it necessary and profitable.

Trend or Counter Trend?

The most important piece of knowledge a trader can have is a confident idea of trend direction. Elliott's work is very helpful in this regard, as Elliott wave patterns each relate to trend or counter-trend. Trends unfold in five waves. Counter-trends usually unfold in three waves or a series of three waves.

Market Position

Elliott wave patterns will frequently provide a clear indication of the position of the market within the trend or counter-trend and what activity should follow to complete the trend or counter-trend pattern. Having a confident idea of trend direction, the position of the market within the trend and the likely activity that should unfold prior to the termination of the current trend signals to the trader which side of the market to trade, short or long. There can be no more valuable information.

Alternate Counts

A very important factor of Elliott wave analysis is that it usually provides for an obvious “alternate count” if the market invalidates the “preferred count” or the first assumption of the position of the market. If a market does not unfold as anticipated because it violates one of the rules or guidelines associated with its current position, the trader may then have a firm conviction of what the new position of the market is which will allow him or her to take an alternate trading or investing action.

Do not abuse alternate counts. When a market does not unfold as anticipated by the Elliott wave analysis and there is no reliable alternate count that fits within a reliable wave structure, the trader must then admit that the position of the market is not clear and avoid forcing a count just for the sake of having a count. There will be many times when a market should be avoided because the pattern of the market does not fit within a reliable structure.

Cash Stock Indexes versus Other Markets

Almost all of Elliott’s research and analysis was done on the cash stock indexes, primarily the DJIA. The Wave Principle is a reflection of mass or social psychology. It is best reflected by a large group of people from a wide variety of backgrounds with a single interest. Of all the financial or futures markets, this is best reflected in the stock market, and it is in the stock market indexes that we find the Wave Principle most applicable on a consistent basis over the greatest variety of time periods.

Long Term versus Short Term

Fortunately for traders, the Wave Principle and its catalogue of patterns are most consistently evident in short to intermediate term degrees, a few days to a few months. This is particularly true of commodity markets. If you have ever seen an attempted wave count of a 20-30 year or longer monthly chart of soybeans for instance, you have probably seen a great lesson in futility and imagination!

Yet, the individual bull and bear trends that typically last one to three years in agricultural markets usually unfold in the basic fives and threes, trend and counter-trend even in the panic, weather markets. The intermediate term trends often unfold in text book Elliott wave pattern and price projections! Just don’t try to explain how the five-wave, two year bull trend fits into the fifty year cycle from an Elliott wave perspective. It doesn’t.

Cash versus Futures

Ideally, all wave counts should be done on cash prices to avoid the distortions that are inevitable in continuous futures prices. Today's price of a futures contract includes adjustments due to carrying charges, interest charges, etc. No future's contract price represents today's idea of value except on expiration day. Cash charts are much less likely to violate the "rules" than futures charts.

Other than individual stock and stock index analysis, most wave counts are done on futures contract data including long term, continuous data because this data is much more available from data services than long term cash data. Ideally, the analyst will double check his or her work on cash data to see if the form and pattern are the same as the continuous futures data.

Closing Price versus Daily Price Range

While most of our work is done using the time and price of swing extremes of the daily range of data, daily closing prices should be carefully considered for wave counts. This will become evident when the rules come into play. If there is no other evidence related to pattern to contradict a five wave impulse count other than Wave-4 trade during the day into the range of Wave-1, check closing prices and only consider the count to be invalidated if Wave-4 makes a daily close within the closing range of Wave-1.

Objective versus Subjective

Because Elliott's Wave Principle and its application is not 100% objective like time and price projections, it has been derided by many as useless and little more than guess-work. This is particularly the tack taken by system junkies and system promoters who live under the illusion that market activity and a successful business of trading or investing may be reduced to a mathematical algorithm that will provide them with keys to profits with no strain on the brain.

Elliott's Wave Principle and its catalogue of patterns and guidelines provide an objective method to recognize the position of a market most of the time; be prepared for the most probable outcome of the current market position on a consistent basis, and; provide for the specific market activity that will invalidate the current opinion. The Wave Principle requires study, thought, knowledge and, yes, even occasionally, judgment. Every successful business requires this. If you are under the illusion that you can succeed in the business of trading or investing without knowledge and the occasional application of judgment based on that knowledge, you probably don't remember the 60's! And, probably don't care and should get a job and a haircut.

When the market is not unfolding in a clearly recognizable pattern within the context of the Elliott Wave Principle, do not force a wave count just for the sake of having a wave count. Trading and investing will only be successful when you recognize that action is only taken when the market is in a position that places the probabilities clearly on your side. There is no place for guesswork or ambiguity. Only your own, personal patience and discipline will provide for success.