Breakout Trading

PART 1 OF 4

AlanHull.com

Correspondence can be forwarded to ActVest Pty. Ltd. ABN 44 101 040 939 at 85 Chase Road, North Warrandyte, Vic. 3113, Australia or via our website at **https://alanhull.com**

What is breakout trading?

Breakout trading is about capturing a rally that follows a period of consolidation. The 'breakout' is the point where the price leaves the consolidation region and begins to rally, see the example below.

The price pattern you see in the chart is typical of many breakouts. So let's take a closer look at it.

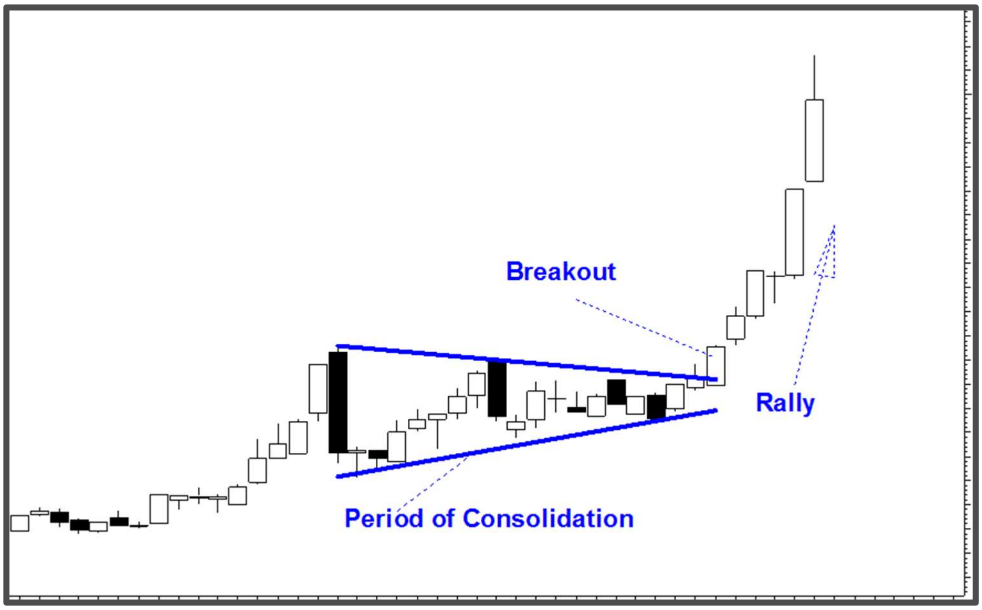
There are three parts to the overall breakout pattern.

1. The period of consolidation
2. The breakout
3. The rally

Of course, 'the rally' is where profit is taken from the market. But the other 2 parts – 'the period of consolidation' and 'the breakout' - identify the potential trade. These are the parts to look for when scanning the market for breakout trades. The period of consolidation provides the set up for the trade and the breakout is the trigger. Together they provide the entry signal into the trade.

This sounds simple, and it is. Furthermore, breakouts can happen all the time in the market and this is to our advantage. The strategy provides plenty of opportunity to profit!

Now we'll look at some more examples and explore when and why the breakout pattern occurs.



The Breakout Pattern

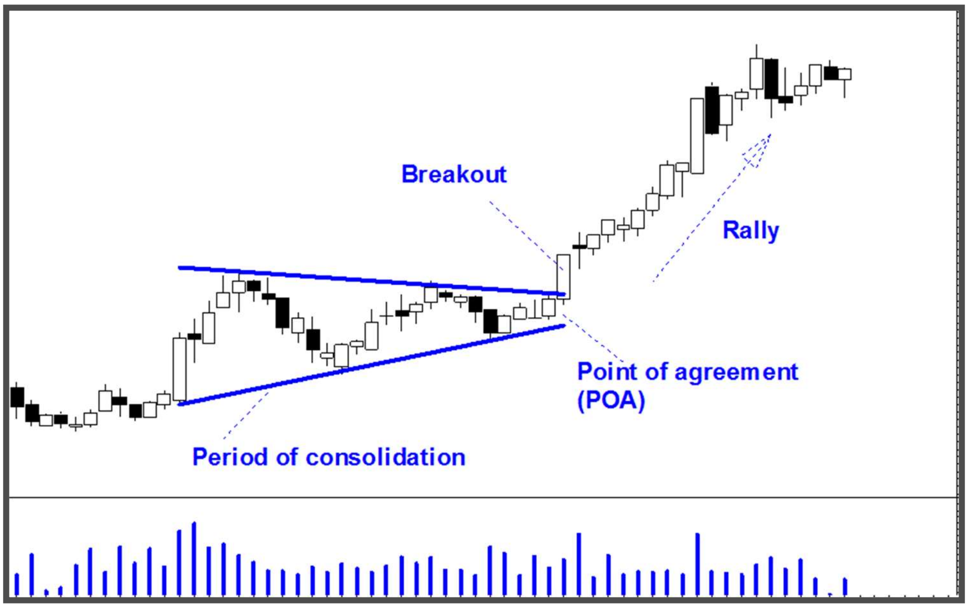
Why do breakouts occur?

The first part of the breakout pattern is the period of consolidation. When the consolidation is narrowing inwards it's a very powerful pattern. This is because markets cannot narrow inward for ever – they must breakout at some point!

In the example below you can see the period of consolidation narrowing inwards because the trend lines are converging. The narrowing behaviour is the market coming into a point of agreement (POA). This means the market participants are content to neither buy nor sell the share, and so activity in the market drops away.

However, a market cannot remain standing still for long. When the price doesn't move much, liquidity can become a problem. The worst that can happen is the market continues diminishing to the extent that it ceases to exist.

Usually, this doesn't happen. Instead, markets breakout - sometimes in a dramatic fashion - as activity returns to the share. In the example below the breakout was clear and decisive, and signalled the beginning of the rally that followed.

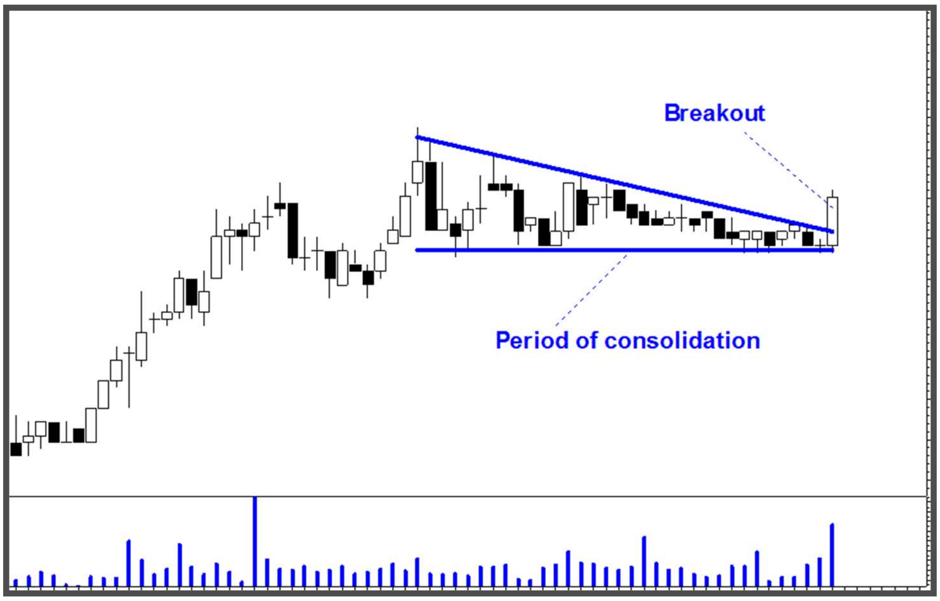


A Breakout & Rally

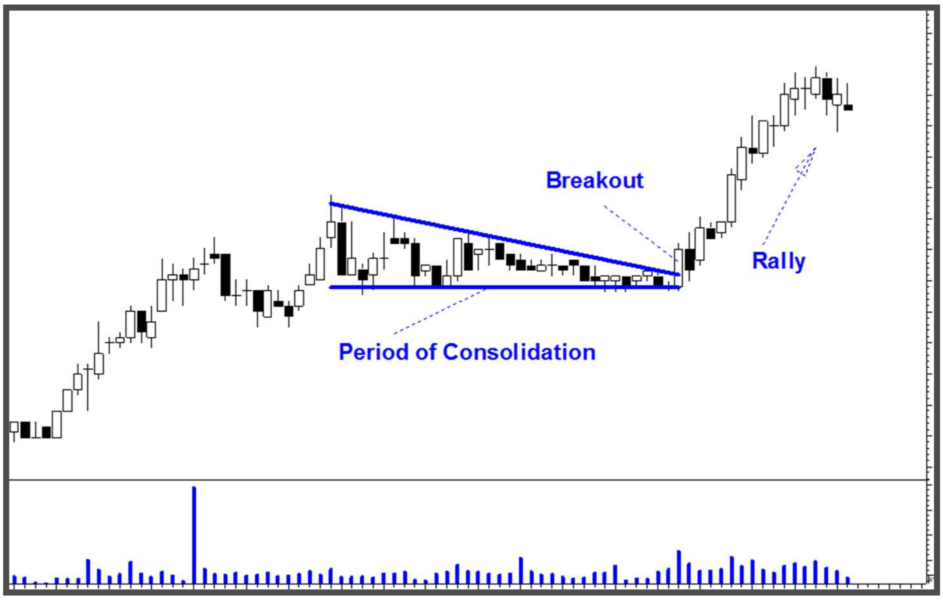
Entering a breakout trade

A developing point of agreement means a reduction in market activity. Therefore it is worth waiting for the breakout to actually occur before entering the trade.

The two charts below show the same breakout pattern. The first shows the price right after the breakout occurred. This shows what the chart would look like at the entry signal for the trade. Typically, entry in the trade would be in the week following this entry signal. The second chart below shows the rally that followed.



At the breakout - the entry signal



The rally following the breakout

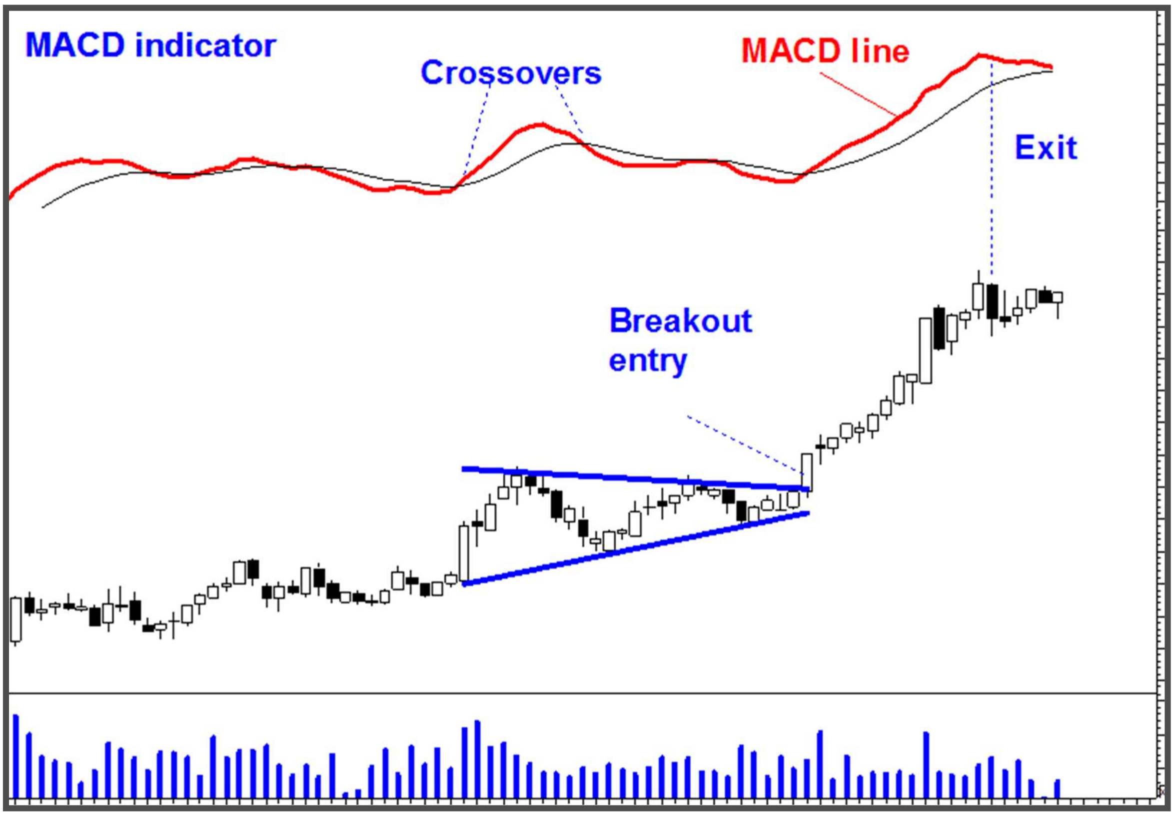
Exiting a breakout trade

Hopefully you're getting the feel for what breakout trading is all about. It is about catching a relatively short term rally after a period of consolidation. So, we need an agile exit strategy to match the entry and lock in profits quickly.

The best way to do this is with momentum because it gives a timely indication of when the breakout rally is slowing. The moving average convergence divergence (MACD) indicator measures momentum. This is a popular indicator available in virtually all modern charting software programs.

We won't go into the detail of the MACD construction here but we will explain how it is used in breakout trading. If you would like some background information on the MACD indicator, or any other technical indicator in this strategy please see the detailed explanatory notes available at my website, www.alanhull.com/breakout-trading

The commonly accepted use of the MACD is to act on crossover signals. However, for breakout trading we take a different approach and concentrate solely on the direction of the MACD line for an exit signal, see the chart below as an example. While the MACD line is rising, stay with the trade. But when the MACD line turns down it indicates that the momentum is slowing and so it's time to exit the trade.



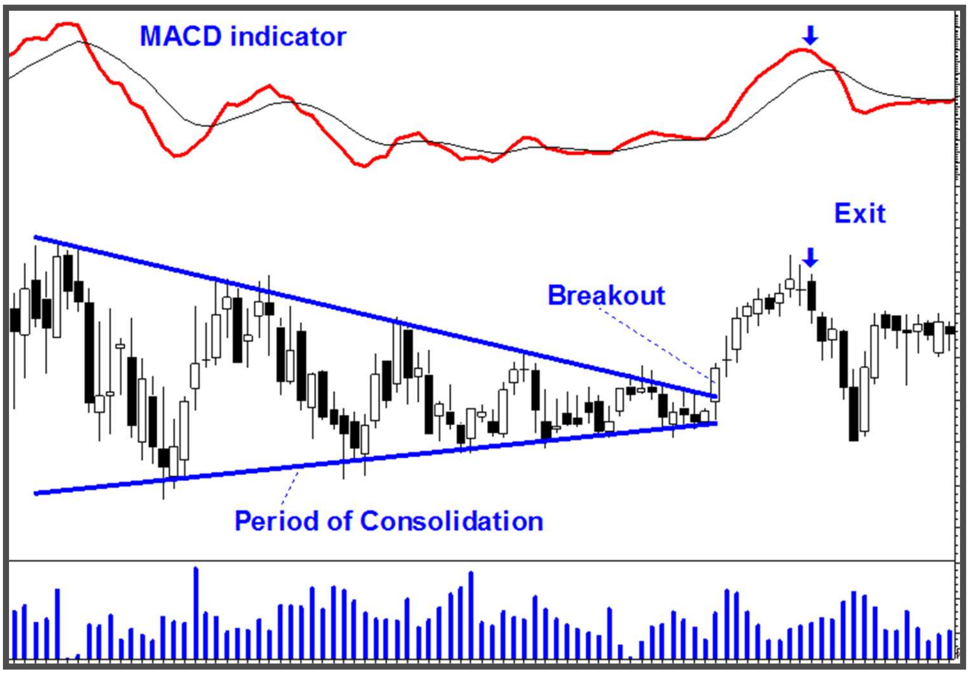
Breakout pattern with MACD indicator

When do breakouts occur?

A good way to illustrate the dexterity of the MACD momentum exit is with the next example. Here is a breakout trade in what is essentially a non-trending, sideways market.

No significant trend developed here at all, yet there was a clear period of consolidation that narrowed inwards towards a point of agreement and was followed by a strong breakout and rally. The momentum indicator signalled a timely exit that would have produced a profit.

Breakout patterns also occur in different time frames. Alan prefers trading on a weekly basis because it is easy to manage and quite lucrative. But breakouts do occur in other time frames as well, such as in daily charts and even monthly charts.

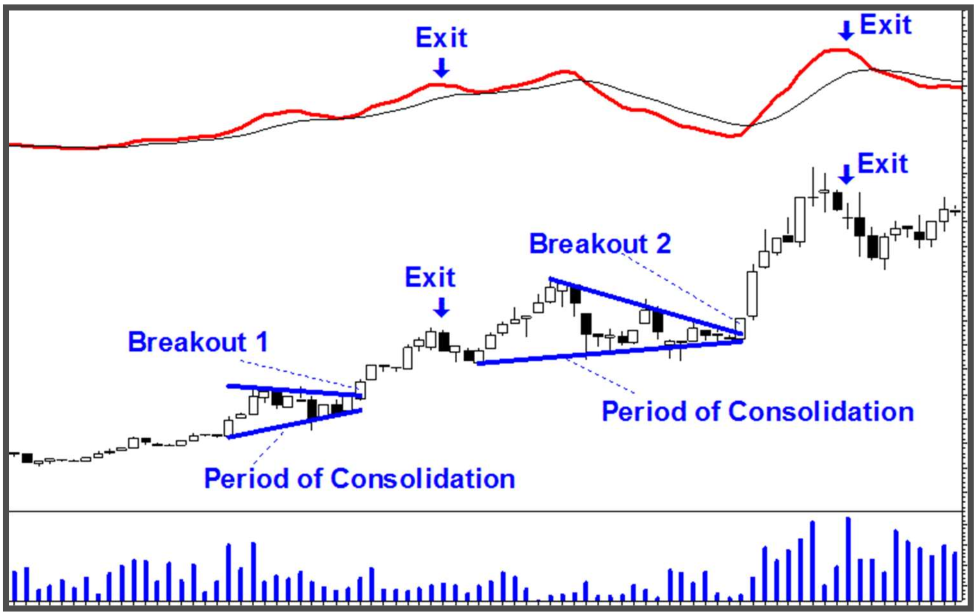


Breakout trade in a sideways market

Breakouts occur in trending markets too

The example below shows two breakout trades that occurred within a trending environment. While Alan prefers to trend trade if he's confident that a trend exists, sometimes it may not be clear if there is a trend, particularly at the beginning of one.

This is why breakout trading is a particularly handy partner to trend trading - it can get you into trades much earlier.

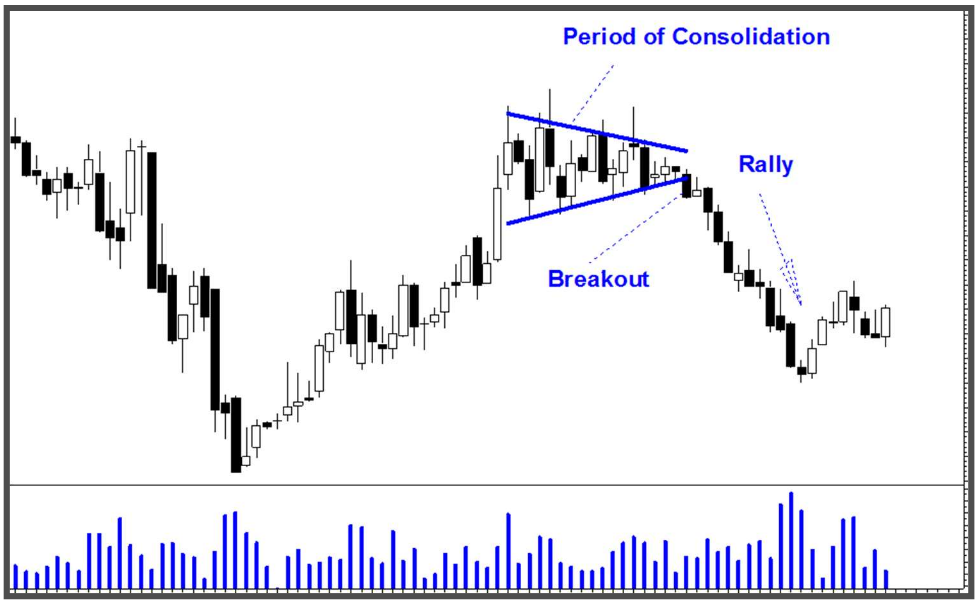


Breakout trades in a trending market

Breakouts can occur to the down side

Breakouts to the down side do not happen as often as breakouts to the up side because the stock market isn't symmetrical in behaviour; it has a greater tendency to rise than fall.

However, downward breakouts do occur sometimes and can be traded with short selling should a trader choose to take these opportunities. Below is an example of a downward breakout followed by a downward rally.

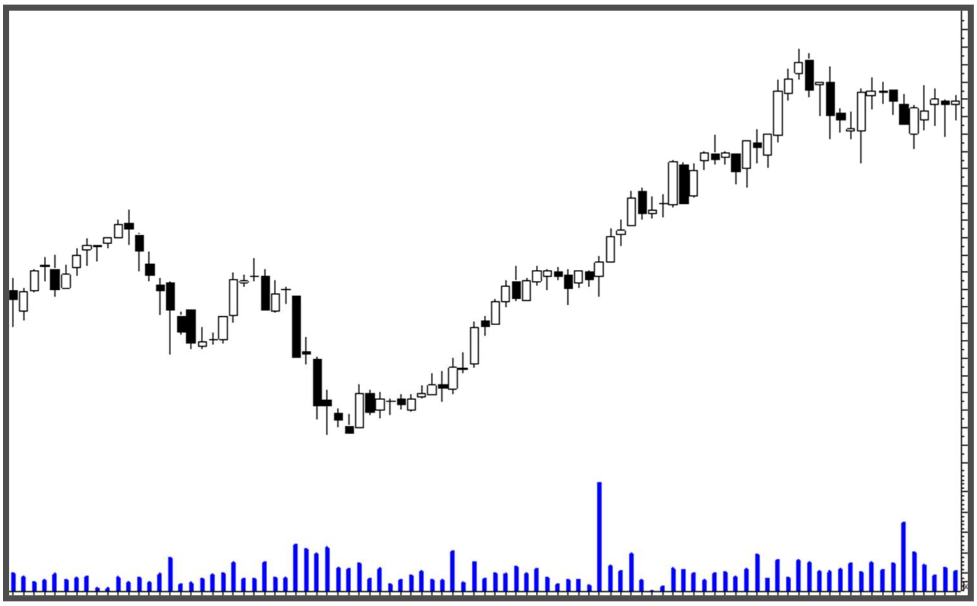


Breakout to the downside

Exercises to help you learn

During this course you've seen breakouts occurring in various situations, plus the basics of the entry and exit signals. In part 2 of this course we'll look at some specifics of valid breakout patterns. Until then, have a look at the 2 charts below. See if you can identify any breakout patterns and rallies within them. Look for periods of consolidation (triangular shaped) followed by a breakout and rally. We'll discuss these charts next time…

Exercise 1 - Can you see any breakout patterns here?



Exercise 2 - Can you see any breakout patterns here?

Sample Newsletter

Along with these course notes are a sample of the Breakout Trading Newsletter. These newsletters (4 in total) run consecutively and will give you an idea of how the system works. You'll see new breakout trades appearing in each edition and previously identified trades in-progress or finishing.

Throughout the course most of the elements you see in the newsletter charts and data tables will be explained. In the final part of the course there is a complete run through of the newsletter components. This will bring it all together so you'll see how this strategy operates simply and effectively.