Trading Stocks Using Classical Chart Patterns

A Complete Tactical & Psychological Guide for Beginners and Experienced Traders

Over 100 chart examples
Detailed entry and exit strategies
Emphasis on managing risk
The mental game

BRIAN B. KIM
For my family.
PART I - A FRIENDLY INTRODUCTION ............................................... 1
  CHAPTER 1  Our Goal..................................................................... 3
  CHAPTER 2  Trading vs. Investing vs. Gambling............................ 9
  CHAPTER 3  Emotional Detachment and
               Acknowledging Our Limitations........................................ 12
  CHAPTER 4  Basic Trading Tools.................................................. 21

PART II - CLASSICAL CHART PATTERNS ....................................... 25
  CHAPTER 5  Head & Shoulders Top ............................................ 27
  CHAPTER 6  Head & Shoulders Bottom ....................................... 40
  CHAPTER 7  Continuation H&S Bottom ....................................... 61
  CHAPTER 8  Rectangle .................................................................. 67
  CHAPTER 9  Ascending Triangle................................................... 75
  CHAPTER 10 Descending Triangle................................................ 91
  CHAPTER 11 Symmetrical Triangle.............................................. 96
  CHAPTER 12 Continuation Pennant (Small Triangle) ............... 133
  CHAPTER 13 Ascending Wedge.................................................... 141
  CHAPTER 14 Descending Wedge.................................................. 145
  CHAPTER 15 Flags and Channels............................................... 155
  CHAPTER 16 H&S Top Failure.................................................... 171
  CHAPTER 17 Double Bottom .................................................... 183
  CHAPTER 18 Horn Bottom ......................................................... 186
  CHAPTER 19 Diamond............................................................... 190
  CHAPTER 20 Second and Third Effort....................................... 193
  CHAPTER 21 Support and Resistance........................................ 195
  CHAPTER 22 Pattern within a Pattern...................................... 203
  CHAPTER 23 Pattern Failures and Mutations........................... 214
  CHAPTER 24 Do Not Gamble on Earnings Reports.................. 225
  CHAPTER 25 Being Out of Position: Not Trading
               No Matter How Promising the Set-Up and Breakout........... 228
PART I

A FRIENDLY INTRODUCTION
CHAPTER 3

Emotional Detachment and Acknowledging Our Limitations

Survival is the only road to riches.

Peter Bernstein

We are often taught, wrongly, to avoid failure at all cost

This chapter, in my very immodest opinion, is the most important chapter in the book.

Discussing the distinction between trading and investing and gambling highlights the most important foundation of this book and for traders: the utmost importance of risk management by limiting our losses and keeping our trading capital intact.

If risk management is so important, then why do so many traders fail to manage risk and suffer big and sometimes irreversible losses?

Because we are reluctant to admit that we are wrong. We live in a competitive world where failure is not celebrated. Traders think that honoring their stops and getting out of a trade at a relatively small loss, repeatedly, means they are admitting, repeatedly, to the world that they are life failures. So we refuse to honor our stops and fail to cut our losses by exiting our position. Instead, we stay in until “we break even.” We don’t want to admit failure on a trade because we are smart and smart people don’t lose, especially money. Yet trading using classical charting principles almost guarantees that we will have more losing trades than winning trades.
The point is not to have more winning trades than losing trades. The point is to have several $100 winners swamp many more $10 losers.

**In short, we have to be willing to fail, and fail often.** If we think about it, we cannot accomplish anything worthwhile in life without being open to failure. Let me stress the following: I am not saying that we have to risk financial ruin to be a successful trader. Quite the contrary. As I have said and will repeat many times throughout the book, traders’ first and only priority is financial survival by keeping their trading capital intact through even lengthy losing streaks to be able to bet on advantageous trade set-ups after gaining experience. I repeat: I do not mean bankruptcy when I say a trader must be willing to fail. Successful trading is about being wrong and losing money on many trades and yet being profitable overall because the losses are only a small fraction of our capital.

**We may not reach our goal – and that is fine**

In addition to expecting to lose on most trades, I think it is very important for traders to acknowledge the possibility that we might not make it as traders. Unless we acknowledge the possibility of failure, we will be so caught up in “making it” and getting rich as traders that it will be impossible to trade well. How can we trade with a clear mind and a laser-like focus on honoring our stops, limiting our losses, and acknowledging losing trades day after day if we tell ourselves that our life and our self-worth depend on every trade? That is too much pressure for anyone.

This destructive potential applies to everything in life. It is impossible to succeed in anything worth accomplishing if we are afraid of failing because we will be too afraid to try or try half-heartedly and timidly.

Don’t get me wrong. Trying our best is a good thing. But thinking that our life and our self-worth depend on succeeding as a trader or anything else is a different thing and harmful.

There is nothing wrong with learning about the markets, gaining experience in the markets with minimal loss in savings, and deciding our interests lie elsewhere. If you find the financial markets to be as fascinating
as I do, then by all means apply yourself diligently and with purpose to become an investor, trader, or whatever kind of market participant you wish to be. But do not let the markets become a destructive obsession. There are so many more things in life that are far more important.

**Diversify financially**

So how do we avoid becoming dangerously obsessed with the markets? How can we push ourselves to follow a strict risk-management process that gets us out quickly from losing trades? How can we avoid thinking that our livelihood, life savings, and self-worth depend on the next trade being profitable?

One way is to not have all of our eggs in one basket. We should trade with only a portion of our savings.

Another way is to have some income, whether a part-time or full-time job or our own business. Anything will do. There is dignity in all labor. Making money outside of trading will increase our chances of trading well. Why?

First, the money we earn will be a source of psychological comfort and strength. We will not be so dependent on trading profits to pay our bills.

Second, because our electricity or car payment doesn’t depend on “getting out even,” getting lucky, making money on the next trade, or making money on most of our trades, we are far more likely to trade correctly by doing the right things, mainly by honoring our stops and cutting losses as quickly as possible.

Third, doing other things and having other interests and will get our mind off the markets and that is a good thing. Trading is a mentally and physically demanding activity because we must constantly fight and control our emotions. Traders need regular breaks.
Diversify mentally

Ironically, not caring so much and thus trading with detachment is likely to make us better traders. Experienced and skilled traders know that even a string of losses results in only a small drawdown of their capital if they strictly limit their risk. Thus, they do not worry about every dollar and do not obsess over getting out of a bad trade only after breaking even. They quickly cut their losses and move onto better opportunities. They remain calm through winning and losing streaks. They are not too excited about profits nor anguished by losses. They focus on trading well and cutting losses on the next 1000 trades and beyond. This virtuous cycle is every trader’s goal.

In short, not caring so much about the outcome of any individual trade is the second crucial foundation that complements risk management in the trader’s toolkit.

By all means traders should put much effort into studying the markets and controlling their emotions. We must exercise strict discipline to trade only compelling set-ups. But after all the preparation, study, and deliberation, we have to let go. We have to say to ourselves and believe, “I am bigger than this trade. My life is much more than how this trade turns out or even whether I succeed as a trader.” This exercise is not just a mental trick to make us better traders. It is the truth. Do we want our lives to be defined by a series of trades, no matter how profitable? Or even a lifetime of successful trading? Do we really think we are a failure if we don’t succeed as a trader? It would indeed be a low bar to define our life based on a series of trades or whether we make it as a trader. We have a much better chance of succeeding as traders if we don’t make it our sole occupation, passion, and interest.

I often think a 5th grader could be a formidable classical chartist likely to outperform most adult traders. The kid hunts for well-formed chart patterns and picks one. After entering a trade, the mentor tells the kid: okay, go out and play. Explore the playground. Ride your bike. Just go have fun and forget about this trade. Eat five scoops of ice cream. Play catch or
tag. Linger in the yard as the sun sets. We’ll come back in a couple weeks and see what happened. If the trade was profitable, so be it. If the trade failed, then we’ll move on to the next compelling chart pattern. This would be an excellent trading routine.

Yes, we should devote serious effort to studying classical charting but we must also live our life. The truth is that the best books on classical charting are not difficult. The principles and suggestions are logical and straightforward. The great difficulty is remembering and following the rules because our emotions will constantly push us to bad trading practices. We will find it necessary to constantly review and remind ourselves of good trading practices because we tend to forget so easily and we are so very stubborn. We are our own worst enemy.

So I am suggesting that we be open to the possibility that we may not be successful over the long run as a chart trader. I believe this acknowledgement increases my chances of being a successful trader over the long run. By trading with just a portion of my savings, pursuing other opportunities and interests, and continuously acquiring diverse skills and knowledge, I am not so emotionally caught up on the success of my trading. And this detachment is crucial to trade well.

Some readers might ask if such acknowledgement of our limitations sets us up for failure. There is a chance that we will not commit seriously to studying the markets and trading well if we have other plans. Wouldn’t it be better to say there is no turning back once we start trading? I don’t think so. Optimism is good, but it must be balanced with planning and prudence, especially in trading. All of us will fail at many things in life, and some of us may not become successful traders. Failure in trading doesn’t make us a bad person, nor should it mean losing our savings. But I believe a “do-or-die” attitude in trading makes a large financial loss much more likely. We should be mature enough to tackle a new challenge like trading without confusing the necessary dedication and patience with a destructive “my self-respect depends on making a fortune in trading” attitude. Mix energy and dedication with intellectual modesty, maturity, and perspective. Adopting this outlook is not preparing for failure but wisely
acknowledging that we cannot know everything and that it is smart to prepare for contingencies.

**Benjamin Graham’s doubts about fundamental investing**

Let me make one more appeal for intellectual modesty in all our endeavors. Consider what Benjamin Graham, a great investor and Warren Buffett’s teacher, said about his profession (picking individual stocks with the goal of beating the broader market) in his book *The Intelligent Investor*:

> [W]e must consider the possibilities … of making *individual* [stock] selections which are likely to prove more profitable than an across the board average. What are the prospects of doing this successfully? We would be less than frank … if we did not at the outset express **some grave reservations** on this score. … [T]here is considerable and impressive evidence … that this is very hard to do, even though the qualifications of those trying it are of the highest. (emphasis added)

If the founder of value investing acknowledges the stiff and perhaps insurmountable challenges of stock picking, then perhaps classical chartists should also consider the limitations of charting. Graham did not say that it was impossible to beat the market although I think he came very close to saying so. He said it was very difficult to beat the market and that intelligent investors must not take unintelligent risks while trying. “Margin of safety” was one of Graham’s contributions to investing. By investing in stocks with a built-in margin of safety, and it is not easy to find such stocks, investors reduced the risk of losing money but were not guaranteed of beating the market. Similarly, traders can increase their odds of, but never guarantee, long-term success by minimizing their losses and only making bets on chart patterns with a highly favorable reward-to-risk possibility.

The point of quoting Graham is not to say that Graham urged stock pickers to abandon fundamental stock analysis and become classical
chartists. He did not. My point is that intellectual modesty is important. Realize that we are wrong often and that we do not have all the answers. It is wise and prudent to not stake all of our savings on one investment or trading approach.

**Benjamin Graham on chart trading**

Genius is eternal patience.

*Micelangelo*

So few succeed in the market because they want to get rich quickly.

*Jesse Livermore*

What Graham did say about technical analysis and charting in *Security Analysis*, his foundational book on fundamental investing, is very interesting and informative:

Undoubtedly, **there are times** when the behavior of the market, as revealed on the charts, carried a definite and trustworthy meaning of particular value to those who are skilled in its interpretation. If reliance on chart indications were confined to those really convincing cases, a more positive argument could be made in favor of ‘technical study.’ But such **precise signals seem to occur only at wide intervals**, and in the meantime **human impatience** plus the exigencies of the chart reader’s profession **impel him to draw more frequent conclusions from less convincing data**. (emphasis added)
The point is not that Graham embraced charting although it is very interesting that Graham, the father of fundamental analysis, said that charting can be useful. Graham’s critique points to one of the most important ingredients for success in trading, investing, and many things in life: patience.

As traders, we will periodically lose focus and discipline and make suboptimal bets. We were too impatient to wait for the charts to tell a clear picture. Then we are eager to make up the losses by making more bets on unfavorable set-ups. We are afraid that if we don’t trade these suboptimal patterns then the market will not offer any more trading opportunities. We lose more money and the destructive cycle continues. And we are too exhausted mentally and financially to take advantage of the inevitable reappearance of favorable set-ups.

If there is only one thing we get out of this book, that one thing should be the confident knowledge that there will always, always, and always be new trading opportunities. Be patient. The market is not going anywhere. Patience gives us the ultimate freedom to place bets only on favorable trade set-ups. It is accurate to describe the trader’s routine as not one of constantly trading but mostly waiting, observing, and waiting some more and only intermittently entering trades. Incidentally, when on a losing streak, closing all positions and walking away from the screen for a couple of days or even weeks can be very helpful. The market, and new opportunities, will always be there.

Let’s conclude. The most important way I recognize my limitations – that I may be momentarily lucky, that classical charting may be a trading approach with deep flaws that I don’t know about, or that even if classical charting is an effective trading method I may not be good enough to consistently profit from it over the long run – is that I diversify my savings. Regardless of market conditions, I only trade with a portion of my savings.

Knowing that I have a financial cushion gives me the confidence to take calculated risks. And informed speculating is none other than taking risks that offer a potentially large gain at the risk of a relatively small loss.
Wrap up

Experienced traders may skip Chapter 3 where I discuss the most basic tools of trading.

I wrote Chapter 3 because I wanted everyone, including people who have never looked at a stock chart, to feel comfortable learning about trading stocks using chart patterns. While my goal was not to write an encyclopedia on trading, my goal was to give the novice trader as inviting a learning environment as possible.

My goal is not to make all of us classical chartists. My goal is to do my best to help us decide whether we might consider trading stocks using classical charting. If we decide after reading this book that trading is not for us, then we should be proud of having made the effort to explore a new idea.
PART II

CLASSICAL CHART PATTERNS
The first classical pattern we’ll look at is the Head & Shoulders top pattern. A H&S top can form after a significant uptrend and indicates a possible trend reversal that leads to a price decline.

**Boeing: 2-year H&S top**

The following weekly chart, where each price bar represents a week’s price range, shows a massive textbook H&S top that formed in Boeing from May 2006 to June 2008 with a decisive breakdown that penetrated the neckline in late June 2008:

![Figure 1](image-url)
A valid H&S top pattern must have 3 peaks with the middle peak, the head, rising above the shoulder peaks and the two shoulders must have some overlap in price, and the more overlap the better. The pattern should form after a significant rise in price. That is, a reversal pattern must have something to reverse. A H&S top’s neckline connects the bottom of the left shoulder to the bottom of the head. A H&S top is completed when prices decisively close below the neckline after forming the right shoulder.

Beyond these essential features, there are many variations to the H&S top. As we gain experience looking at charts, we will learn to focus our attention on well-formed patterns and ignore the rest.

Every chart offers important lessons. Some of the takeaways from Boeing’s H&S top are:

First, we, especially beginners, should strive to trade only chart patterns that are as well formed as this H&S top. Of course just because a pattern is textbook-perfect doesn’t mean the pattern will work and be profitable. In fact, even “perfect”-looking patterns will fail most of the time. The point is that we should not force meaning onto charts where there is none. We must not project our hopes, dreams, and wishes onto charts. Classical chart patterns that are potential candidates for trading should be clearly defined and easy to spot. There was no doubt when looking at Figure 1 that Boeing was forming a possible H&S top pattern.

Second, a weekly chart is a valuable way to see the big picture. Though I make almost all entry and exit decisions based on a stock’s daily chart, I always check the weekly chart to get a sense of the overall context in which a pattern is forming.

This massive H&S top in Boeing was so big that a trader would have likely missed this topping pattern if looking only at a daily chart. It would have been a case of losing sight of the forest for the trees. And while such big patterns are not very common, they are common enough to justify the regular review of weekly charts.

Third, and this point will be stressed many times, we must be patient. Many patterns take months and sometimes, like Boeing’s H&S top, years to develop. While there are many shorter patterns ranging from days to
several weeks discussed in this book, know that significant reversals of trend take time to develop. Also note how prices entered a narrow trading range for three months after breaking down through the neckline. Three months is a long time to be staring at our screen everyday waiting for the big move down. The smart trader would enter the trade, set a stop, and go do other things. Of course Boeing’s stock could have moved up and triggered our stop-loss order. If so, so be it. We incurred a small loss and would move on to other set-ups.

**Apple: 5-week H&S top**

Our next H&S top is a 5-week pattern that formed in Apple from September to October of 2012. This H&S top was small in size but not in effect as it started a 40% price decline in Apple shares:

![Figure 2](image_url)

What can we learn from this pattern?

First, every principle has exceptions. While major reversal patterns can take months or years to develop, they can also form quickly as it did in
Apple. Thus, we must never place a bet without regard to risk relying on a rule that is “supposed to work.” There is no such thing. Price is the ultimate rule.

Second, we should never ignore H&S patterns, including small ones. H&S patterns are one of the most reliable classical patterns. They are also one of the most versatile patterns because if a H&S top doesn’t work, a “H&S top failure” is a distinct pattern that can offer compelling trading opportunities. We’ll cover H&S failure patterns in Chapter 16.

Third, notice that prices broke down through the neckline of the H&S top and the 1-year trendline at the same time. Such interesting coincidences are common in classical charting. The fact that these two developments coincided did not guarantee that the pattern would work. But, at least in my mind, these twin developments increased the likelihood of a powerful trend reversal.

Fourth, note the hard retest of the neckline. **Retests are price reversals after breakout that re-challenge the breakout boundary.** Here, after breaking down through the neckline of the H&S top, prices reversed and closed slightly above the neckline before breaking down in a sustained downtrend. Some retests lead to pattern failure while others stop at or short of the breakout boundary. All retests challenge our poise. We cannot know if or when retests will occur. We must be ready for them.

After we view some more charts to get a feel for classical chart patterns, we will discuss in depth how we can enter trades and set stop-loss orders. There is no rule that works ideally every time. For now, know that retests of key pattern boundaries happen often and that the only thing we can control is our entry and stop points.

Lastly, let’s discuss short sales of stocks. Shorting allows a trader to profit from price declines in stocks. Since there are both bullish (pointing to a possible increase in price) and bearish (pointing to a possible decline in price) classical chart patterns, buying and shorting stocks allows us to use the full range of classical charting tools.

That said, I understand some of us may be apprehensive about shorting a stock, especially if we have never done so. I was unfamiliar with the
concept of shorting when I started to trade. Some of us may have ethical objections to shorting. We don’t have to short stocks, but we should make our decision after learning about shorting, and, if we are open to it, trying some very small short sales to gain familiarity. We should decide based on knowledge rather than fear. And if we decide to add shorting to our trading kit, we can always trade a smaller size when shorting as I usually do.

ICA: 11-week H&S top

As noted, there are many variations to each classical pattern. The following H&S top in ICA, a Mexican construction company, shows one of my favorite variations in a H&S top:

**FIGURE 3**

First, note the head of this 4-month H&S top was itself a smaller H&S top pattern. I find this pattern-within-a-pattern very interesting just as a visual phenomenon. It can also have great practical value as it can offer us the opportunity to enter a trade earlier than otherwise. For example, here, we might consider shorting shares upon the completion of the smaller H&S top pattern, then perhaps shorting additional shares upon completion of
the larger H&S top. Every situation will be different, and just because we have a pattern-within-a-pattern does not mean we will have an early, or any, entry opportunity. And we must remember that even the most promising textbook patterns fail, and fail often.

Second, note the down-sloping neckline. Necklines and key boundaries need not be perfectly horizontal. They can be up-sloping or down-sloping. I prefer to trade patterns with boundaries that are as horizontal as possible because they clearly indicate the major highs and lows that must be overcome for a decisive breakout. We will talk more about the merits of horizontal vs. slanting pattern boundaries in later chapters.

Third, despite there being many legitimate and compelling variations to the textbook H&S pattern, we should try, especially as beginners, to stick as much as possible to trading patterns that resemble the textbook form. Too often traders label a chart as a H&S top even though none of the basic requirements of the pattern are met. Traders who appear in the media are not immune from making this error. I think it is beneficial to follow the principles spelled out by Schabacker and Edwards & Magee, especially regarding pattern shape. I do not follow everything that the founders of classical charting say in their books, but I do follow their physical requirements for the classical patterns.

LifeLock, Inc.: 2-month H&S top

The next H&S top is a chance to apply what we learned from Apple’s H&S top. We see LifeLock breaking down from a H&S top, and this breakdown coincided with the breaking of a yearlong uptrend line:
TRADING STOCKS USING CLASSICAL CHART PATTERNS

FIGURE 4

...but is that a H&S top forming? Never ignore possible H&S patterns, especially those that form next to significant trendlines.

FIGURE 4.1

The next chart zooms in on the H&S top and breakout area:

Let’s talk about how much we might risk on a trade. It seems most professional traders risk no more than 1% of their trading account on a
single trade. I think most traders and especially beginners should not risk more than 0.4% to 0.8% of their account on a trade. While our risk tolerance and trading capital will vary, we must pursue risk management and the limitation of losses as our most important goals. For example, if our trading account is $50,000, we should risk no more than $200 (0.4% of $50,000) to $400 (0.8% of $50,000) on any individual trade. These are general guidelines and I think the more cautious we are, the better.

Let’s use the next chart that shows a H&S top that formed in QQQ, the ETF that tracks the Nasdaq 100 index, to see what these risk guidelines mean in terms of the nuts and bolts of entering and exiting a trade.

Classical patterns form in the major stock indexes and the ETFs that track them just as in individual stocks. I always watch closely the index ETFs – SPY for S&P 500, QQQ for Nasdaq 100, DIA for Dow Jones Industrial Average, and IWM for the Russell 2000 index – to get a sense of the overall market. While I trade mostly individual stocks, I also know that most stocks move with the overall market. So if the market indexes are dropping sharply, then I will be more cautious about trading bullish set-ups.

QQQ: 6-week H&S top

The following chart shows a H&S top that formed in QQQ, the ETF that tracks the Nasdaq 100 index, from August to October 2012:
If we have a $30,000 trading account and we don’t want to risk more than 0.7% of our account on any single trade, then we have $210 (0.7% of $30,000) to risk on this H&S top. Let’s say that we decide to short shares at the breakout day’s closing price of 67.26. Where might we place our buy-to-cover stop order that will cut our losses should the breakout reverse and the pattern fail? I use the last day rule, a concept I learned from Peter L. Brandt, to place most of my stops. How does it work? For short trades, we place our stop just above the high of the last day in which prices traded above the breakout boundary. For long trades, we place our stop just below the low of the last day in which prices traded below the breakout boundary.

Here, following the last day rule would mean placing a stop just above 68.18, say, at 68.20 or so. Some of us may prefer to give more cushion to our stops. If we do, then we must keep our potential loss within our maximum risk tolerance. Note that a buy-to-cover stop order at 68.20 is very close to and barely above the neckline of the H&S top. A stop at 68.20 seems at risk of getting triggered by mere normal price volatility in QQQ. Indeed, QQQ experienced a hard retest after breaking down through the neckline. While prices did not close above the neckline, they did trade...
above it by trading as high as 68.30. Placing a stop at 68.20 or even 68.25 meant we got stopped out.

By the way, there is absolutely nothing wrong with getting stopped out. Remember, classical chartists can have more losing trades than winning trades and still be profitable overall. Risk management, not profits, is our priority. So getting stopped out for a very modest loss means we are managing risk.

As we noted, every rule has exceptions. While I faithfully apply the last day rule in most of my trades, the particularities of this H&S top meant we had to consider placing our place a stop a bit farther away from the neckline to account for normal price volatility, including a possible retest. So we modify the last day rule. Here, I would look at the price range on the day before the breakout. The closing price on the day before the breakout was 68.35. Placing a stop just above this closing price, say, at about 68.37 or 68.40, is a reasonable choice. If we want even more leeway, then we may choose to place a stop just above the high of the day before the breakout. Remember that the more leeway we give a trade, the more likely we have to use a smaller position to keep our possible loss under our maximum-risk limit.

Every chart presents different entry and exit scenarios. Still, I have found in my trading that the last day rule usually works very well by placing my stop at a reasonable distance from the breakout boundary and from normal volatility and from even the reach of hard retests. When the last day rule does not produce a satisfactory stop point, I improvise. How I improvise is far less important than that I keep my possible maximum loss within my risk tolerance. Sometimes we’ll just have to pick a spot. Nothing can protect us from prices just barely triggering our stop and then reversing and making a powerful run. We must not let such events frustrate us too much. Such hit and runs will happen to everyone no matter what rule we use to place our stops. There is nothing magical about the last day rule. It is simply a trading tool to manage risk. Some trades work out and others will not. We must accept this reality. Such ever-present uncertainty is the price we pay to limit our losses and stay in the game long enough until we gain
enough experience to take advantage of great market conditions. Remember, there will always be other trades.

Let’s go back to the QQQ set-up. Let’s say we decide to place our stop at 68.37, just above the closing price of the day before breakout. We shorted shares at 67.26 and placed our stop at 68.37. That means we are risking $1.11 for every share of QQQ that we short. If we have a $30,000 account and we want to risk no more than 0.7% on any single trade, then we have $210 to risk for this trade. Divide $210 by $1.11, the distance in dollars from 67.26 to 68.37, and we get 189.1. So we can short 189 shares and likely limit our potential loss to $210 at our chosen entry (where we shorted) and exit (where we may buy to cover) spots. I always like to stay under my maximum risk, so I would short only about 180 shares. Of course, we may choose to further reduce our position size. A 180-share short position is the maximum size given our risk parameters.

There are several more points to discuss.

First, trading commissions will be another cost. If our broker charges us, say, $8 per trade, that means our round trip trading cost will be $16. Commissions add up. They are another reason why we should trade only compelling set-ups.

Second, we may lose more than we had planned if a stock gaps up or down. A gap up happens if, after we shorted 180 shares of QQQ at the closing price of 67.26 and placed a buy-to-cover stop at 68.37, the next day QQQ starts to trade at, say, 69.50. This overnight price jump up that produced a gap between today’s and yesterday’s price bars is called a gap up. An overnight jump down in price is a gap down. The result is that instead of losing only $1.11 a share, we would be stopped out with a loss of $2.24 for every share we shorted for a total loss of $403.20 plus trading commission. We lost almost twice as much as we were willing to risk on this trade. This scenario doesn’t happen often but it is common enough that we must always be mindful of it and is one more reason why we must always diversify our trades and never bet our entire stake on one or even a series of trades. It is perfectly acceptable and expected to lose more than we had planned on some of our trades. What is important is that such greater-
than-expected losses, which are unavoidable at times for everyone, mean nothing more than minor additional losses.

Third, we might have noticed that I did not include the volume bars for the charts we have analyzed so far. I have included volume bars in later charts where I thought volume was one of the decisive factors in making a trading decision. But I personally have found that volume is often not a decisive factor in many of my trades. Edwards & Magee stress the importance of volume. And volume is often a vital clue, especially in situations when the volume conforms to the textbook descriptions laid out by Edwards & Magee. But I have found that textbook classical patterns form and work a lot of times without volume confirmation. So, volume, while important, is only one factor in my decision-making and the lack of volume confirmation doesn’t disqualify a pattern to me. In short, volume is like any other factor in trading and classical charting: it is not a guarantee that “must” and “should” work. Prices will do whatever they want to do. Risk management is the only thing we can control.

However, volume is always a crucial factor in thinly-traded or low-volume stocks. Thin stocks tend to be more volatile and more risky. I often pass on a promising pattern developing in a low-volume stock because the extreme volatility makes entering and exiting a trade within my risk parameters so difficult. The lure of thin stocks is that powerful moves happen quickly and thus we may make a lot of money quickly. But I have found that it is much easier to lose a lot of money quickly with thin stocks. So I usually stay away from them.

Fourth, where might we take profits if the trade is successful? So far, we have concentrated, properly, on placing our stop orders so that we limit our losses if the trade fails. While risk management is our first goal, we trade to make money, and taking profits is an important skill. Classical charting provides a general guideline for taking profits in the form of the size of the pattern that launches the up or down move. The height of a classical pattern’s widest point is used to project or “measure” the possible up or down move from the breakout point. So, in the H&S top pattern in QQQ, we measure the distance from the top of the head to the neckline and
project that distance down from the breakout point. This measurement is the minimum move that could happen.

But, again, as with all “rules” in classical charting, these profit-projections are general guidelines. As I have repeated and will repeat many more times, the only thing traders can control is risk management. Patterns, even after decisive breakouts, fail often. When prices, after a decisive breakdown from a textbook H&S top pattern, reverse and go straight up, we must take our small loss according to our pre-determined stop-loss level and get out of the trade. We must not stay in the trade and refuse to take our now rapidly-growing losses because “the measurement rule guarantees that prices will soon go in the right direction (down) again and produce the projected profit.” Wrong. The only guarantee in the financial markets is that risk, indeed catastrophic risk, is everywhere. Traders work with this harsh reality, but traders can do so on their terms by always diversifying their trades, always honoring their pre-determined stops, and getting out with a small loss if the trade doesn’t work out.

We said that the general rule is that the projected move is the minimum move that could happen. Look again at the small H&S top that produced a massive 40% decline in the price of Apple shares. The takeaways from Apple’s H&S top are that we should never ignore a H&S top pattern whatever its size and that there is no correct answer as to when to take profits. There was no way to know that this small H&S top would lead to a 40% decline. If we took profits after a 20% decline and happily looked elsewhere for other trade set-ups, then we should not be angry or embarrassed about the stock continuing to drop. Even here we must remember that there will always be more opportunities.
CHAPTER 6
Head & Shoulders Bottom

The head and shoulders bottom pattern is just that: a H&S top pattern turned upside down.

Caesars Entertainment: 5-month H&S bottom

Here is our first H&S bottom pattern:

The H&S bottom has three valleys with the middle valley, the head, deepest. Note how this H&S bottom’s right shoulder took the form of an ascending triangle. We will discuss ascending triangles in Chapter 9. So we have another pattern-within-a-pattern and a decisive breakout from the ascending triangle coincided with the breakout from the H&S bottom. As
we will see here and in other charts, the more powerful the breakout, the more difficult it can be, and sometimes too risky, to enter the trade. The next chart focuses on the breakout from the right shoulder:

Caesars Entertainment’s stock jumped 11.5% on the breakout day. Buying shares at around the closing price of the breakout day and placing our stop just below the low meant risking over 11% of our position. That is a lot to risk and I would avoid trading such a set-up unless the pattern was very promising and the breakout decisive. As this H&S bottom had good form and produced a decisive breakout, I would look to trade this breakout if I can buy a reasonably-sized position while staying within my risk limit.

If our trading account is $50,000 and we don’t want to risk more than 1% of our account on any single trade, that means we have $500 to risk on this trade. Entering at 8.71 and placing a stop at 7.80 means risking $0.91 on every share of CZR stock we buy. We divide $500 by $0.91 and get 549. So, we can buy around 540 shares for $4703 and stay under our maximum risk barring any gap downs in price. (I usually round down to account for commissions and to get an even number.) I think this entry and
stop-loss placement constitutes a prudent and promising trade given the pattern and breakout.

There are alternative entry and exit strategies.

One option is to buy a larger position at the closing price of 8.71. Assuming the same $50,000 account, how do we risk no more than 1% of our account on this trade? We move our stop up and place it closer to the horizontal upper boundary of the ascending triangle. If we raise our stop to, say, $8.08, rather than putting it at $7.80, then we can buy 790 shares for $6880 and stay within our $500 maximum risk. I did not use a magic formula to pick 8.08 as an alternative stop placement. I picked 8.08 because it seemed reasonably far below the upper boundary of the ascending triangle to not get triggered too easily by normal volatility. That said, a hard retest or even just normal volatility has a much higher chance of triggering a stop at 8.08 than at 7.80. If our higher stop survives, then we make more because we have a larger position. But if prices trigger our stop and then turn around and shoot up, then we lose $500 and miss a 60% surge in two days. We took a calculated risk and lost. But we traded the set-up well. We took a good swing at a compelling set-up while staying within our risk parameter. We suffered a minor loss and we move on to the next promising pattern. We cannot control prices. We can only control how we manage risk.

There is a second option. We can place a buy-stop order in anticipation of a breakout from the right shoulder. So far we have discussed stop orders in the context of getting out of a trade if the trade doesn’t work. Stop orders can be also be used to enter trades. In the H&S tops discussed above, we could have placed a stop order to sell short a chosen number of shares at a level somewhere below the necklines. Such an order would be filled by our brokers if prices traded at that level.

For Caesars Entertainment’s H&S bottom, we can place a stop order to buy a certain number of shares at a price somewhere above the upper boundary of the ascending triangle right shoulder:
Let’s say we choose to place a buy-stop order at 8.30, which is above the horizontal boundary of the right-shoulder ascending triangle and just below the slightly ascending neckline of the larger H&S bottom. If prices trigger our buy-stop order at 8.30 and continue to go up to break out of the H&S bottom, then we have the advantage of having entered earlier at a lower price. Entering earlier means that we can buy a larger position and still place our stop below the low of the breakout day. If we have a $50,000 account and faithfully follow the maximum 1% loss per trade rule, we have $500 to risk on this trade. Entering the trade at 8.30 and placing our stop at 7.80 means I can risk $0.50 per share. We divide $500 by $.50 and get 1000. We can buy 1000 shares, which is a 25% larger position than buying at 8.71 and using a higher stop, for $8300 plus commissions and yet give our position much more cushion to survive normal volatility and even hard retests. We also have the potential to earn significantly more profits should the trade work.

Important point: whenever I use a stop order to enter a trade, I always use it as part of a One Triggers Another (OTA) order. For example, the night before what may be the breakout day for Caesars Entertainment’s
H&S bottom, I enter a stop order to buy 1000 shares at 8.30 that, when triggered, enters another order, a stop-loss order that will trigger if the breakout fails and prices decline to my pre-determined stop level. Every trade must have an exit order, a sell stop for a long position and a buy-to-cover stop for a short trade.

**Drawbacks to using stop orders to enter trades**

As with any trading tool, buy-stop and short-sell-stop orders do not always work well. Here are some of their drawbacks.

First, our buy-stop order could be triggered by a false breakout or an out-of-line price move. These are price moves that spend only part of the day outside the pattern boundary and then retreat back inside the boundary by the end of the trading day. These retreats can also trigger our stops. Again, there is nothing wrong with being stopped out for a small loss. As we know, we must be ready to take many small losses. But losses can add up, and more importantly, they can exhaust us mentally. **And preserving our mental capital is just as important as safeguarding our trading account.** Every trade is a calculated leap of faith. While we can keep risk at manageable levels by always diversifying our trades and following other prudent rules, we still need confidence to take swings at set-ups. **If we lose our nerve, then we cannot trade well.** Repeatedly getting stopped out by false breakouts will weaken our trading psyche. So when the real breakout happens, we feel too spent financially and psychologically to make an appropriate bet. We have lost our nerve. And the inability to take calculated risks can be just as frustrating as a string of losses.

Thus, there are advantages to waiting towards the end of the trading day to see if prices will close decisively above the pattern boundary and then manually entering a trade. The closing price is the most important price because it indicates where many traders felt comfortable holding their positions over night. My experience has been that most trades, including many of the best set-ups, gave me plenty of time to enter manually toward the end of the breakout day. Looking at the charts above, we did not have
to use stop orders to short the H&S top patterns in Apple, LifeLock, and QQQ. We could have entered around the closing price towards the end of the breakout day.

Of course, there will be set-ups when not using a stop order to buy or short will mean missing the trade because it would be too late and too risky to enter after prices have broken out and travelled far away from the boundary. But that’s trading. We catch some, and we miss some. If we miss a breakout from a pattern that we’ve been watching for weeks, months, or even years, we have to remember that there will always be more and better opportunities. So when, not if, we miss a trade, we must quickly move on.

The second potential drawback to entering a trade using a stop order is our old enemy: gap ups and gap downs. Actually, we can think of gap ups and downs as valuable friends because the ever-present possibility of price gaps forces us to never risk too much on any trade. As we will see, devastating price gaps of 40% and 50%, while rare, do occur. Such a huge loss on a position that represents 8% or 10% of our trading account will sting but overall is still a very manageable setback. But a 50% loss on a position that represents our entire account is far, far worse and something that we must avoid through prudent diversification and risk management.

Coming back to Caesars Entertainment, let’s say that the stock price had opened at 9.50 on the breakout day after an overnight gap up and then immediately reversed and dropped straight down back into the pattern and triggered our stop. (In real life the stock opened at 7.85 and closed at 8.71 on the breakout day.) If we had a buy-stop order for 1000 shares at 8.30, then we would find that this buy-stop order, which is a market order that triggers at the current trade price, was filled once prices were at or above 8.30. Since the stock, after the overnight gap up, started to trade at 9.50, our buy-stop order was filled at 9.50. We paid $1.20 more than we had planned for each of our 1000 shares. And when our stop was triggered at 7.80, our losses were $1.70 per share compared to the $0.50 per share that we had allotted for this trade.

The result is that we lost $1,700 on this trade. If we have a $50,000 account, a $1,700 loss represents a 3.4% loss of capital. Such a loss stings,
but it need not be anything more than that. Our trading account is still essentially intact and we simply move on.

We cannot predict overnight price gaps, but we can still mitigate their potential damage. One way is to only rarely use stop orders to buy or short. Another way is to use a smaller position size when using a stop order to potentially enter a trade. We can always add to our position if circumstances permit.

If we feel that a potential breakout from an explosive pattern seems “catchable” only through a stop order to buy or short but we prefer to enter a trade manually, then we can simply not trade. It takes much wisdom, patience, and strength to pass on a trade. It will be easier to pass on a trade if we remember that there will always be more opportunities.

A couple of other takeaways from this H&S bottom in Caesars Entertainment.

First, always look for patterns within larger patterns. The smaller pattern can give us an early entry point and also help us identify and make sense of the larger pattern.

Second, most patterns take time to develop. This H&S bottom took five months to form.

Third, breakouts can move very fast. So fast, in fact, that we may miss it or we may decide to not trade it. Our task is not to trade every breakout. Our task is doing the right thing, and that can mean not trading a breakout.

**Callidus Software: 10-month H&S bottom**

This H&S bottom’s right shoulder was a rectangle pattern:
Let’s again assume that we have a $50,000 trading account and we don’t want to risk more than 1% ($500) of our total capital on any single trade.
Entering at the high (5.20) of the breakout day and placing our stop just below the low, say, at 4.84, means we risk $0.36 a share, which still allows us to buy almost 1390 shares ($500 divided $0.36) for about $7,200. Such an entry and exit gave us the possibility but never a guarantee to profit significantly from a continued breakout from a promising pattern while placing our stop reasonably far away from the upper boundary of the right-shoulder rectangle to survive retests and significant volatility.

If the breakout in Callidus Software reversed and we were stopped out, this losing trade cost us about $500 from our $7,220 position. That’s a 6.9% loss on our position but a 1% loss of our trading account. Most traders, especially beginners, would be wise to keep our maximum possible loss on any individual trade under 1% of our total account. As noted, it seems most professional traders stay under the 1% figure. If I were starting out again, I would try to keep my loss on any single trade to under 0.5% of my account. We will lose the most money when we lack experience in the markets. We need time to learn, and we might as well lose less money when we are at our worst.

Quarterly earnings reports

All publicly-traded companies report their financial results every three months. We must watch for upcoming earnings reports. It is entirely unpredictable how investors and traders react to earnings reports. A “good” earnings report can be seen as bad if there wasn’t enough good news. A “bad” earnings report can be seen as good if there was less bad news than expected. Moreover, stock prices can crash even after an objectively good earnings report for any or no reason. There is no way to predict the market’s reaction to earnings releases. Thus, we should not enter a position just before an earnings release nor hold a position through an earnings report.

Even if it seems prices are about to break out of a promising pattern, I stand aside and wait if an earnings report is to be released soon. It can be frustrating to not trade a promising breakout because of an imminent
earnings release. But we must stand aside because the utter unpredictability of the market’s reaction to earnings means that we have no way to manage risk. Here, again, it helps to remember that there will always be other patterns to trade.

Here, the market reacted favorably to Callidus Software’s earnings report. The stock jumped the day after earnings were released. It was not until the next day prices went up again and broke through the upper boundary of the rectangle right shoulder and decisively closed above it. The timing of the earnings release and the market’s reaction to it were favorable. The market’s reaction was not so positive as to cause an explosive breakout that made entering the trade too risky. Prices increased strongly but still in a controlled pace that gave traders plenty of time to buy shares at prices that offered a favorable reward-to-risk possibility. Also, we could have more confidence in the breakout because the uncertainty surrounding the earnings release was out of the way. Note also that the volume on the breakout day was heavier than in previous days. Such volume confirmation makes it more likely, but never guarantees, that the breakout is significant.

There are no guarantees in trading except that we will lose a lot of money if we do not respect risk. One factor that increased the risk on this trade was that Callidus Software is a relatively low-volume stock. I consider stocks whose daily volume is often under 100,000 shares to be thinly traded. And I usually avoid stocks whose daily volume is often under 50,000 shares as they can be even more volatile. We can refer to a stock’s Beta to get a sense of the stock’s volatility but I rely mostly on what I see on the chart: CALD shares often had wide daily trading ranges. For example, the stock jumped 7.6%, 8.8%, 5.5%, and 3.9% in the days around the earnings report and breakout. Isn’t that good for the trader who owns this stock? We must remember that what goes up quickly can come down even faster. There was no guarantee that the breakout from this H&S bottom would work even after prices closed decisively above the upper boundary of the right-shoulder rectangle. The market could have changed its initial positive reaction to the earnings report and pushed down prices anytime after breakout. And relatively low-volume stocks can crash very quickly.
Given this risk in low-volume stocks like CALD, a fine idea is to trade a smaller size here. We don’t have to risk our maximum on every trade. Maybe we decide to risk only 0.5% or even less. Or perhaps we decide to skip this trade. That is perfectly acceptable as well. We always have a choice. Nobody forces us to trade. We need to evaluate every breakout with one overriding question in mind: do we have a favorable entry spot that limits risk?

As we’ve repeated many times already and as we will and must hear many more times: our number one task as traders is to manage risk and not to make money. Put another way: concentrate on doing the right thing rather than making money. When we manage risk in a systematic way, we will be able to trade for the long run.

The financial markets are always unpredictable, and quarterly earnings reports add another layer of risk and volatility. We can avoid the market’s unpredictable reaction to earnings reports by simply not trading through earning releases. And risk and unpredictability are compounded in low-volume stocks.

**Hewlett-Packard: 10-week H&S bottom**

The next chart shows quarterly earnings reports producing very volatile price moves in Hewlett-Packard shares:
I know what many of us are thinking because I had the same thought: those 12% and 17% one-day price jumps seem too good to pass up so I’ll just hold my position through earnings releases and hope that the market reacts positively to the earnings news. But these price increases could just as easily have been comparable or worse price drops. Indeed, Hewlett-Packard’s stock declined by more than 12% on the third earnings report shown on the chart.

Recall our discussion about the distinction between informed trading and outright gambling. Informed trading is about entering at a spot on the chart that maximizes potential gains while defining and limiting risk. Yes, we expect to have more losing trades than winning trades. Yes, price gaps, up or down, unrelated to earnings news mean sometimes we lose more than we had planned. Yes, all financial activities involve risk. But we must not think that just because the financial markets are synonymous with uncertainty that there aren’t degrees of risk. Trade entries and exits that are likely to keep losses within our risk parameters are not the same thing as taking a position before an earnings report on simply the hope of a positive
market reaction to the news. We have no way to quantify the market’s future reaction to a report the contents of which we know nothing about.

That said, some of us (or is it all of us?) will, hopefully only occasionally, gamble on earnings reports. We should not do it, but some of us will give in to the temptation. If I were to hold a position through earnings reports, the following situation would be the only instance when I would consider doing so. The next chart focuses on the left portion of Figure 8 where the H&S bottom formed:

**Figure 8.1**

We have a H&S bottom and a breakout on a gap up in price. My experience has been that breakouts on price gaps tend to work more often than not. That said, we must never go all-in on any single pattern no matter how promising the breakout. Even textbook-perfect patterns fail often. Here, the gap-up in price was just another factor to consider when deciding whether to trade this pattern. I would trade this pattern given the symmetry of the H&S bottom (the left and right shoulders were about the same size), the breakout on a gap up, and a favorable entry spot. As noted on the chart, we risked about 2.3% of our position had we bought shares
around the closing price of the breakout day and set our stop somewhere reasonably below the neckline.

If we had bought shares upon the breakout, we gained about 15% on our position in the next two weeks. Then prices traded in a narrow range for the next month and the quarterly earnings report was to be released soon. What now? The correct thing to do is to sell our entire position and book a 15% profit. But we are human, and we want more. If we are going to gamble, then we should do so with only a very small position. In this case, we would get lucky as the stock jumped 12% on the earnings report. Yes, we can do the wrong and irresponsible thing and get lucky and make money. But we will run out of luck and take a large hit to our trading capital if we continue to take such gambles. Doing the right thing means doing the unexciting thing over and over: honoring our stop, not chasing a missed breakout, not gambling, and just waiting. Doing the right thing doesn’t guarantee profits, but it is the best way to be a long-term player in the trading game, and longevity is the best way to be profitable in the long run.

Lannett Co.: 5-month H&S bottom

Our next chart is another variation of the H&S bottom:
Note that the right shoulder of the H&S bottom is much smaller than the left shoulder. While symmetry between the left and right shoulders is one of the defining traits of a textbook H&S pattern, as with all pattern “rules,” there are exceptions. A H&S bottom such as this one where the right shoulder is significantly smaller than the left can launch a powerful move. It is as if the stock is itching to get moving and doesn’t have the patience to form a right shoulder that is of similar size to the left shoulder.

Note also that this pattern gave us plenty of time to enter the trade. We could have bought shares toward the close of the breakout day or anytime during the next day. It was not necessary to use a buy-stop order to trade this breakout.

So was it as easy as buying shares once prices closed above the neckline of the H&S bottom? The major strike against this pattern was that the stock was very thinly-traded. Less than 20,000 shares traded per day on many days during pattern formation. As noted, I usually avoid stocks whose average daily volume is less than 50,000 shares. And I would recommend that beginners avoid entirely such low-volume stocks. As we gain experience, we may decide to trade, very carefully, some patterns that form
in thin stocks. If I were to trade this H&S bottom pattern, I would use a position that was at most 30% to 40% of my normal position size.

Would I trade this set-up using a smaller position? Yes. The 6-month H&S bottom looked very promising with a clearly defined left shoulder and head. Another reason is that, despite the low volume, the stock traded relatively “cleanly,” especially during the formation of the right shoulder. Thinly-traded stocks can jump wildly around and make risk control very difficult if not impossible. A stock’s chart looks clean to me when there are few price gaps unrelated to pattern breakouts. As noted, breakouts on price gaps support but does not guarantee the validity of the breakout. The charts of some volatile stocks have price gaps almost every day. In contrast, Lannett’s stock traded cleanly and in a tight range during the weeks leading up to the breakout.

Of course explosive volatility can appear anytime, especially in thin stocks, but the clean price action and low volatility during the formation of the right shoulder would be an important factor in support of not eliminating this pattern from my list of trade candidates. Yet it is perfectly acceptable to pass on this pattern because of the stock’s low volume and the risk that accompanies a thin stock. Again, I recommend beginners to trade only stocks whose average daily volume is at least 200,000 shares.

**Penn Virginia Corp.: 8-month H&S bottom**

The next chart shows another pattern-within-a-pattern. Note how the breakout from the small symmetrical triangle launched the breakout from the larger H&S bottom:
Now let’s zoom in on the right shoulder area:

The breakout from the 4-week symmetrical triangle that constituted a portion of the right shoulder of this H&S bottom was an ideal spot to go
long. This entire set-up – from the year-long H&S bottom pattern (the lengthier the build-up, the more powerful the breakout may be), the symmetrical-triangle right shoulder that offered an opportunity to enter early, and the textbook breakout on heavy volume – was very promising. Indeed, I would seriously consider risking more than my standard maximum risk and buy a larger position size. That said, I would still not risk more than 1.5% of my account even on such a promising pattern because there are no guarantees in trading. There are no rules that are supposed to work. This enticing H&S bottom that seems so promising? The market could care less as it can crash prices even after a decisive breakout. The pattern boundaries we draw are just that: nothing more than lines that we use as trading tools. The market and prices will do what they do. They are never wrong.

Always be cautious

By now we may have noticed a recurring theme. We discuss some exciting aspects of classical chart trading and then immediately remind ourselves of the utmost importance of caution. We may wish it were otherwise but catastrophic risk lurks everywhere in trading and the financial markets. If we are not careful, then we may lose it all. But we need not be pessimistic. We can learn to implement an uncompromising risk management strategy that allows us to be long-term players in the trading game. The only thing standing in the way of prudent risk management is ourselves.

Compelling set-ups such as this H&S bottom in Penn Virginia Corp. should motivate us to do the utmost to preserve our capital for the really promising charts. Such patterns can reaffirm our passion for trading. Of course we don’t know which set-ups will work as even textbook patterns fail often. But one decisive winner can make up for many more small losses and produce overall profitability. If we lose our capital on suboptimal trades by chasing missed breakouts, entering at unfavorable spots, or just gambling outright, then we will be too exhausted financially and mentally to place a meaningful bet when a truly compelling pattern emerges.
I have experienced this painful situation many times. After losing money chasing breakouts and trading poorly formed patterns, I have simply lost the nerve to make a meaningful bet on the next promising trade. Then I watch from the sidelines as this pattern launches an explosive and very profitable trend. I get more frustrated. I chase this breakout by entering at a spot that carries more risk than my maximum-loss limit. I get stopped out and lose more money. I have lost not only my nerve, but also my detachment and my form. I am in a destructive cycle of negative feedback loops. When traders are in this situation, and all of us will be in this situation from time to time, we can exit our positions, walk away from the screen, and take a break from the market. We must rebuild our mental strength. We must regain our nerve, perspective, and balance. We must take our time. The market will always be there when we are ready to trade again.

Constantly reminding ourselves that there will always be more great set-ups can help us not chase missed breakouts and also give us the confidence to take a break. Even if we missed this Penn Virginia set-up, the existence of this and many other exciting patterns should remind us that we will always have the opportunity to make a comeback. The key is to be still standing when favorable market conditions reappear. And effective risk management keeps us in the arena.

**United Community Banks: 7-month H&S bottom**

Our next example shows yet another variation to the H&S bottom pattern. This time, the right shoulder took the form of a small H&S bottom:
The next chart focuses on the right shoulder:

**Figure 11.1**

Breakout from both the overall H&S bottom and H&S bottom right shoulder. Breakout day high was 9.10 and low was 8.81.

H&S bottom neckline.

This 8-month H&S bottom’s right shoulder was itself a smaller H&S bottom.

If you entered long at the breakout, you were up around 8-9% just before the quarterly earnings release.

Here, we again have a situation where the next earnings report was to be released not so long after the breakout. If we bought shares around the
closing price of the breakout day, we were up by about 8-9% on our position right before earnings release. What should we do? An almost 10% profit in less than a month is a good trade. I would sell my entire position, book my 10% profit, and move on to other set-ups. But the reality is that we are all susceptible to the temptation to gamble on earnings reports. And if we choose to gamble, and it’s a choice as no one is forcing us to stay in this trade through the earnings report, I think we should gamble with no more than one-third of our original position.