

# Managing Your Trades With Elliott Wave

*When you should take a position, where should you take a gain, and when should you call it quits? Here's how you can identify where you should close your positions.*

by Ryan Henry

The easy part of investing in stocks is getting into a trade. You study the chart, understand the company's business and fundamentals, find your buy point, and then dive in with big expectations of what's to come. But what's next? How do you know when to take your gains off the table, or more importantly, when to tuck your tail and run when it goes against you? Many traders know that you simply have to protect your investment with a stop level, because regardless of how much sweat and tears you put into your research, there will be plenty of times when it just doesn't matter and the stock goes the other way. The answer for many has been to use a trailing stop, say, 5% below their entry point. This seems like a reasonable conclusion because it defines your risk at a reasonable level. But who's to say that the stock didn't cue up a 5% pullback, just to reload for the next up leg? Using an arbitrary target and stop level will get you arbitrary results. Hopefully it works out in your favor, but if it doesn't, you don't really know why or what the stock is really telling us. There's a better way. You have to have a full understanding of your expectations from a stock move, based on what should and shouldn't happen if the pattern being traded is what you think it is. No theory can provide you these answers as succinctly as the Elliott Wave Theory. When used in conjunction with Fibonacci retracement and extension levels, you're left with a wealth of knowledge about what a stock chart is telling us, when the time is right to take a position, where to take a gain, and when to call it quits because what you thought was going to happen is not. The purpose of this article is to demonstrate how you can access this information for yourself so that there are bonafide reasons for closing gains and taking losses at very specific and purposeful points. Let's run through an actual trade that was recommended to my subscribers to detail every step of the process.

## *Finding the stock*

When I look for trade possibilities, it begins with the simplest of premises. In basic terms, I want to find a chart that displays a large trending move, followed by a countertrend move. The Elliott Wave Theory defines exactly what a trending move looks like and what a countertrend move looks like on a chart. A trending move is called an impulse. These moves tend to be sharp and

direct. Elliott tells us that trending or impulse moves play out in five phases or waves. A countertrend move is called a correction. These moves are much less direct than impulses. They tend to carry price more sideways than up or down, move in slower fashion, and basically lack any real purpose. Elliott tells us that countertrend or corrective moves play out in three phases or waves or a similar variation. When we find a chart that possesses an impulse followed by a correction, our setup is born.

Our next order of business is to confirm that the countertrend move has retraced a Fibonacci portion of the trending move. This may sound like a complicated process, but it's actually very straightforward. Many books have been written on the concepts laid forth by the great mathematician Leonardo Fibonacci, but all we're concerned with at here are the natural retracement percentages that stocks gravitate towards. Directly to the point, we are looking for a correction that has retraced anywhere from 38.2% to 61.8% of the impulse move. If the correction has retraced less than 38.2% of the impulse, we can't be certain that the impulse has completed. If the correction has retraced more than 61.8%, the stock is no longer a candidate to be traded because we can't be certain that the trend we're looking to play is still intact. Once these parameters are met, we have a trade setup with real and well-defined potential. This setup comes together across the stock universe all the time. One example is Expedia. It traced out a large trending impulse over the course of five weeks in July and August. The trending impulse was followed by a choppy, less-directional corrective move that retraced about 38.2% of the impulse.



*In August 2010, price action on EXPE told us that further upside strength was coming, courtesy of an impulse up followed by a corrective pullback that retraced 38.2%.*

## *Buying the stock*

The goal when entering any long trade is to get in at the lowest point, right before the stock is ready to explode. Essentially, as soon as it's clear that the corrective pullback has completed and another trending move is beginning, we make our move. In the case of Expedia, we used 25.00 as our entry point because a move to this level would represent a new high for the move, which would immediately suggest that the next up leg has begun. Expedia, reversed higher after retracing 38.2%, and moved up through 25.00 in purposeful fashion. This triggered our entry point. Now what?



*EXPE moved impulsively above 25.00 to indicate that the next leg of the uptrend had begun. This was our cue to go long.*

### Creating a target level for the stock

When entering this trade, our expectations are very clear cut. We are looking for another up leg that is similar to the one that is already on the chart. According to Fibonacci mathematics, we know that up legs within an uptrend often relate to one another in size. Some times, the second up leg will be 61.8% the size of the first up leg. Sometimes it will be 161.8 or 261.8%. But much more often than not, the second leg will be nearly equal in size to the first up leg. It is this relationship that we use to create a target for the move. Let's continue the Expedia example. The first up leg traversed approximately six points during a five-week time span. This tells us to expect the second up leg to move about the same distance. Since the second up leg began at 22.50, our target is placed at 28.50. There is nothing arbitrary about this level. While the move may be smaller or bigger, we know that its natural tendency is to complete the second up leg near 28.50. That makes things a whole lot easier when it comes time to take gains off the table – no second guessing or what ifs, just an objective level where we have a reason to cash in.

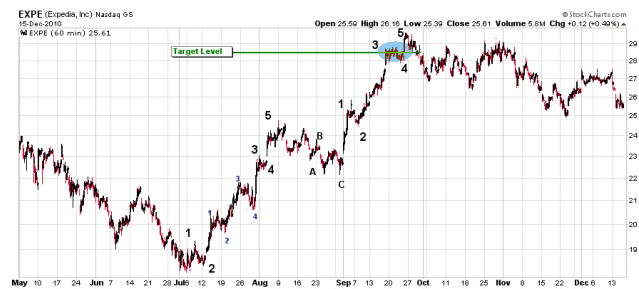
### Creating a stop level for the stock

Because our expectations of a move are so concise, we know exactly what should happen and what should not happen if our expectations are correct. What should happen is Expedia should trace out another impulsive advance up to 28.50, because that's what the setup indicated. What shouldn't happen is a reversal back down that wrecks the trending potential of the new up leg. Specifically, we know that price has no business retracing more than 61.8% of the new up leg at any point in time. If it does, it means that our expectations are incorrect, either because the new up leg has completed prematurely or because our wave labeling isn't correct. Either way, we have a very specific reason to close the position and take our medicine. In the case of Expedia, we knew that a move back below 23.50, which was a 61.8% retracement of the new up leg to that point, would indicate that our expectations were incorrect. This is where the initial stop level was placed.



*The initial stop level is placed at 23.50 on EXPE, because a move below this level would indicate that our expectations are incorrect.*

As the up leg continues, we can constantly advance our stop level to represent a 61.8% retracement. If this level is taken out at any point, we know it's time to walk away. This keeps risk as tight as possible, while also knowing why we'd take a loss should price reverse direction. When there's a very specific reason behind taking gains and losses, it becomes much easier to maintain objectivity. When the stop level is an arbitrary percentage, you have an excuse to justify giving the trade some leeway. That, of course, is the formula for compounding losses.



*EXPE met expectations by tracing out another impulse up that was similar in size to the initial impulse up.*

With Expedia, expectations were met dead on. The stock traced out a second up leg that covered about seven points. The gain was taken at our 28.50 target level. This is where the setup projected to, and so that's where we exited. Since then, the stock has reversed and moved lower.

The key in trading stocks is fully understanding your expectations. This allows you to know what the stock should do and what it shouldn't do. And when we know that, the rest is easy.

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