

## **THE FRACTAL— THE BREAKAWAY TRADE**

Many experienced traders say that making money in trading the markets is easy; what is difficult is keeping it. The pattern of all markets is that they spend most of their time going nowhere and only a small amount of time (15 to 30 percent) in identifiable trends. Traders who are not on the floor and/or not specialists have a tough time while the market is not moving. Most traders have a tendency to place their stops too close to the market and consequently get whiplashed. Still, the greatest potential for profits occurs when the markets are trending. Therefore, our first consideration is to *not be left out* of any significant trend move. Remember, this is the first of our five entry systems, and it is the first signal we take after the Alligator starts to awaken.

### **FRACTAL BREAKOUT**

As we saw in Chapter Three, we want to stay out of the market and "keep our powder dry" until the Alligator is hungry and starts his search for food (either higher or lower prices). We do not take any trades until this first fractal is triggered. Let's take another look at a typical stock and/or commodity market (Figure 4—1).

#### **A Typical Trading Market**

Figure 4-1 shows typical "generic" market action. The market spends from 70 to 85 percent of its life going nowhere. In that portion of

Figure 4-1 A typical trading market.

market action, most traders lose; about the only ones making profit are traders on the floor who are fading the market in a very short time period. The most crucial point is where the last bottom (low point) occurs. My trading techniques, including the five magic bullets, are the best we have ever seen for finding any bottom or top. The Alligator will help us to get in on a real trend and stay out of most range-bound trading that eats away at our profits.

### **THE FRACTAL PATTERN**

The fractal pattern is a simple one. The market makes a move in one direction or the other. After a period of time, all the willing buyer~, have bought (on an up move) and the market falls back because of a lack of buyers. Then some new incoming information (Chaos) begins to affect the traders. There is an influx of new buying, and the market, finding that place of equal disagreement on value and agreement on price, moves up. If the momentum and the buyers' strength are strong enough to exceed the immediately preceding up fractal, we

Figure 4-2 The fractal pattern.

would place an order to buy one tick over the high of the fractal. Let's examine some typical fractal patterns. In Figure 4-2, you see an idealized fractal setup in Pattern A. The technical definition of a fractal is: a series of a minimum of five consecutive bars where the highest high is preceded by two lower highs and is followed by two lower highs. (The opposite configuration would be applicable to a sell fractal.) One way to visualize this is to hold your hand outstretched in front of you with your fingers

spread and your middle finger pointing up. Your fingers are your five consecutive bars, and your middle finger is the highest, creating a fractal formation. In an up fractal, we are interested only in the bars' high, and in a down fractal, we are interested only in the bars' low. It is important to note the following restrictions:

1. If the current bars' high is the same height as the middle or high bar, it does not count as one of the five bars necessary to form a fractal. For a buy fractal, you must have a high that is preceded by two lower highs *and* followed by two lower highs. For a sell fractal, you must have a low that is preceded by two higher lows *and* followed by two higher lows.

2. Up and down fractals may share bars. The same bar can be part of both an up and a down fractal.

Note that Pattern B fulfills all the requirements for a fractal. The two preceding and the two following bars can have any high, so long as that high is not higher than the middle bar (finger). Pattern B then is both an up fractal and a down fractal because both preceding bars and both following bars are inside bars when compared to the middle bar of the fractal. Pattern C shows another formation that creates both an up fractal and a down fractal. As shown, these fractals may "share" bars. Pattern D requires six bars to form an up fractal because the fifth bar has a high equal to the previous highest high. The working definition is repeated here for emphasis:

**A fractal must have two preceding and two following bars with lower highs (higher lows in a down move). In a buy fractal, we are interested only in the bars' high. In a sell fractal, we are interested only in the bars' low.**

Fractals tell us a great deal about the "phase space" of the market's behavior, but we can improve our trading by knowing how a fractal's behavioral functions change as the market moves from high to low and back again. Once a fractal is formed, it will always be a fractal, but the role it plays depends on its location in relation to the Alligator's mouth. Figure 4-3 shows both a buy and a sell fractal. If the buy signal is above the Red Balance Line (the Alligator's Teeth), we would place a buy stop one tick above the high of the up fractal. If the sell signal is below the Red Balance Line, we would place a sell stop one tick below the low of the fractal sell signal. It is essential to understand that we would not take a fractal buy signal if, *at the time it is hit*, the price is below the Red Balance Line. Likewise, we would not take a fractal sell signal if, *at the time it is hit*, the price is above the Red Balance Line. This is the best method we have found to filter out nonprofitable fractal trades. Once a fractal signal is formed and is valid in relation to its position outside the Alligator's mouth, it remains a signal until it is hit or until a more recent fractal signal is formed.

Figure 4-3 The initiating fractal.

Figure 4-4 shows a variety of fractal patterns. Fractal buys are in the upper section and fractal sells are in the lower section. Remember that although a fractal formation may be triggered, it has to be filtered through the Alligator. In other words, you would not take a buy if the fractal is below the Alligator's teeth, and you would not take a sell if the fractal is above the alligator's teeth. Figure 4-5 provides a quick review of fractal characteristics. The underlying structure of the market is the Elliott Wave, and the underlying structure of the Elliott Wave is the fractal. Being able to locate fractals properly allows a trader to be profitable trading the Elliott Wave without having to know which wave the market is currently in. A fractal is always a change in behavior that is caused by new incoming information (Chaos). A fractal is always a breakout signal, so you would expect some satisfaction soon because you are buying the high or selling the low. (In other words, you have the world's worst trade location with the greatest potential loss.) In later chapters, you will see how to overcome this possible disadvantage and turn it into what we refer to as the "low rent district."

### **Practice in Locating Fractals**

Mark the following fractals on Figure 4-6:

A. Locate the one buy fractal and the two sell fractals that are inside the box. B. Locate the buy fractal and sell fractal inside the box. C. Locate the two buy fractals and sell fractals. n. Locate all the buy and sell fractals.

Check your answers against the answers in Figure 4-7

Figure 4-7 Answers to fractal practice page.

### Answers to Practice Page

As shown in Figure 4—7:

- A. There is one buy (B) and two sells (S).
- B. There is a buy and a sell on the same bar.
- C. There are two buys and two sells inside the box.
- D. Here is a good example of a trending market. Note that all the fractal buy signals were hit but none of the fractal sell signals was hit.

In this practice exercise, we are not taking into account the location of the Alligator. Our purpose at this point is to gain the ability to recognize the fractal buy and sell signals. Now let's examine another practice chart and locate the fractal buy and sell signals.

Figure 4-8 Practice page to Locate fractal buy and sell signals for coffee.

Figure 4—8 is another chart to practice on. Remember, we are not considering the Alligator at this point. Try to learn how to recognize the fractals quickly and easily. Pay particular attention to all the fractals that are hit. Figure 4-8 is a good bullish example. Had you traded this coffee market on a daily basis, using all five dimensions outlined in this material, you would have realized profits of over \$~00,000 in two months. In Figure 4-9, you will see how the fractal signals contributed to this very profitable trade. Study Figure 4-9 carefully. The market constantly gives opportunities like this coffee move. Using my trading techniques and/or software, you will know exactly what order to place, where to place it, where to protect your equity, how to allocate your assets, and when to take profits. Both the buy and sell fractals are marked in Figure 4-9. Notice that during the entire 3 1/2 months none of the fractal sell signals was hit and all of the fractal buy signals were hit except the very highest

### TABLE 4-1 Results of Trading Only the Fractal Signals on Figure 4-9 (December 16-March 10).

#### Date

16-Dec 2-Jan 8-Jan 23-Jan 29-Jan 4-Feb 14-Feb 20-Feb 26-Feb 10-Mar

### Figure 4-9 Answers to the practice page.

bar. Table 4—1 indicates the entry dates and profit from the fractal signals on the coffee chart shown in Figure 4—9. In Figure 4-10 (coffee) and Figure 4—11 (Dell Computer), we have combined fractal signals with the Alligator to aid us in trade discrimination. Remember from Chapter Three that we only want to take signals outside the Alligator's mouth, and we always wait until the first buy or sell fractal is hit before taking any of the other four possible signals. In Figure 4-10, notice that the fractal

buy at number 1 was the first fractal outside the Alligator's mouth that was hit. Notice also that points a and b are both sell fractals outside the Alligator's mouth but neither of these was hit. After the first fractal buy, we would take any and all buy signals that are hit. As long as the prices stay on the top of the Alligator's mouth, we would not even bother to determine where the sell signals are because we will not take any sell signals when the price is above the Alligator's mouth. This makes taking signals very easy, simple, and efficient.

<b>Fractal</b>	<b>Points</b>
10825	6240
11605	5640
11665	5590
13405	3840
13725	3520
14205	3040
16390	855
16605	640
16::~C5	340
17245	
Total Pts.	29705
	\$111,393.75

**Figure 4-11** Combining the fractal signals with the Alligator in a DeLL Computer stock chart.

In Figure 4-12 there are four charts. For practice, see whether you can locate all the "valid" fractal buy and sell signals. Remember that the middle line (which we color red on actual charts) is the Teeth line, and we take any fractal buy signal that is hit above this line and any fractal sell signal that is hit below it. It is also vital to understand that the critical factor is where the signal is HIT, as opposed to where the signal is FORMED. If the signal is hit outside the Teeth, we take that trade no matter where the fractal might have been formed. On the charts in Figure 4-13, these valid buy and sell signals outside the Alligator's teeth are marked with up and down arrows. The arrows signify where the middle bar of the fractal is located. The entries are when that signal is hit. In the Harley Davidson chart in Figure 4-14, there are nine valid fractal signals. Remember that a valid signal must be moving away from the Alligator's mouth. All the price bars are above the Alligator's mouth, so we would not take any sell fractals. We do not want to feed the Alligator. It should be obvious at first glance that we would not want to be short at any point during the time period of this chart. (The answers are shown on Figure 4-15.) The numbers on Figure 4-15 locate the nine valid fractal buy signals for the Harley Davidson stock during this period. To test yourself, identify nine fractal sell signals that would not have been taken because they are above the middle line (Teeth) of the Alligator's mouth. Using the Alligator as your "odds maker" should greatly enhance your trading profits and keep you in tune with the current movement of any markets in either stocks or commodities.

### **FRACTALS "INSIDE" THE ALLIGATOR'S MOUTH**

To make sure that you understand trading inside the Alligator's mouth, here are a couple of charts demonstrating how to trade in this situation .

Figure 4-13 Answers to the valid fractals in Figure 4-12. Only the fractals that are hit are marked with arrows.

In Figure 4-16, a Coca-Cola stock chart, point A is not a valid buy fractal because, on the last bar, the fractal price is still below the middle (Teeth) line of the Alligator's mouth. Point B, however is a valid fractal sell signal because it is below the Alligator's Teeth (middle line). Figure 4-17, a chart of Liz Claiborne Inc., illustrates how an invalid fractal signal becomes a valid fractal signal. In Figure 4-18, the buy fractal is below the middle line (Teeth) of the Alligator and, when formed, is not a valid buy signal. However, after the fractal is completed on the bar previous to the one labeled 1, it becomes a valid buy fractal signal because the middle line (Teeth) is below the fractal buy signal. Had any one of the bars numbered 1 through ~ gone above the fractal buy, it would have been taken. Figure 4—18 is another example of how an invalid fractal signal becomes valid. A fractal buy signal at point 2 is well below the Alligator's middle line (Teeth) when it is triggered at point 3. Point 3 forms another buy fractal signal at the vertical line labeled A. The intersection between horizontal line 3 and vertical line A is just below the

Figure 4-18 How an invalid fractal signal becomes valid.

Alligator's middle line (Teeth) and therefore is not a valid buy signal at line A. However, at line B, it becomes a valid signal because, if it were triggered, it would be above the Alligator's middle line (Teeth). This example, combined with the previous examples, should illustrate how the Alligator becomes your decision and odds maker when trading either the stock or commodity markets. You may wish to download our free fully functioning demo from the Internet and practice with other charts. It is very important to be able to recognize all fractal buy and sell signals and to determine whether they are valid.

## SUMMARY

In this chapter, we have examined the "phase space" signal we label as a fractal. A fractal is a behavioral change and must be evaluated according to what is happening in the overall view of a market. The technical definition of a fractal is: **A minimum of five consecutive bars where the highest high is higher than the previous two bars' highs and also higher than the following two bars' highs.** The opposite is a sell fractal. Our first signal entry into any market is always the first fractal outside the Alligator's mouth. Once this signal is hit, we will take any and all signals that are triggered in that direction. At this point, you should understand and be able to locate quickly any buy or sell fractal signals. You should also be able to tell at a glance whether a signal is valid, depending on its relationship to the Alligator's mouth. Remember to keep this slogan in your mind:

~o not ~ad tha alligator!

In the next chapter, we will examine another aspect of the underlying structure of the market: the market's momentum. We will use the best indicator that we have ever seen in over 40 years of active and successful trading. This is the only true leading indicator we have ever found. Because it is such a great leading indicator, it is comparable to reading tomorrow's *Wall Street Journal* today. The reason this works so well is: price is actually the last thing that changes in the market. Momentum changes before price, and we will learn to use momentum in the next chapter. I strongly urge you not to read further until you have made fractal recognition second nature to you.