

HOW TO TAKE OUT OTHER PEOPLE'S STOPS FOR FUN AND PROFIT

**... or just avoid having
your own taken out!**



**by Dr. Barry Burns
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Top Dog Trading

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INTRODUCTION

Have you ever had the eerie feeling that “the market” knew exactly where your stops are ... and was purposely going to get them?

Has it ever felt like there was a camera in your computer directly tied to the exchanges and that the floor traders were watching what you were trading and then doing everything in their power to defeat you?

Does it happen often that you take a trade, get stopped out, and then the market immediately moves in the direction of your initial trade?

Don't despair!

Every trader has had feelings similar to these.

I've even had traders tell me they were totally convinced that their broker was watching their trades and taking trades against them, forcing them to fail.

Sometimes it truly seems uncanny how a person can be so “perfectly” wrong!

I remember going through this experience early in my trading career. No matter what I did, the market seemed to do the opposite. I tried many different approaches and none of them worked. They all seemed so “perfectly” wrong!

So I decided that since everything I was doing was wrong, the answer was simple. All I had to do was take my rules and completely reverse them! Buy when my rules said sell, and sell when my rules said buy!

That should turn a losing method into a winning one shouldn't it?

Of course that didn't work either. Go figure!

But this Special Report is about one subset of that topic: Having your stops taken out too frequently.

Those words “**too frequently**” are key, and there's no percentage I'm assigning to it. The answer to what “too frequently” lies in your own win/loss and risk/reward ratio at the end of the week, month, year.

There's no way to know what the market is going to do after you enter a position, and that's the purpose of stops. So in one sense, your stops are MEANT to be hit!

Your stops relate to your win/loss ratio, and your expected win/loss ratio will vary according to your trading style.

Trend traders expect a win/loss ratio lower than 50/50, but their risk/reward ratio is very favorable. They get stopped out when the trend doesn't materialize or continue, and since the market only trends about 20% of the time, they accept a low win/loss ratio.

Scalpers, on the other hand, are just going for the quick buck. They generally aren't looking to make more than they're risking on any given trade. Therefore they must have a superior win/loss ratio since the dollar amount of their losses is as great as, or even greater than their wins.

It's also important to realize that you must measure your statistics over a long period of time. Getting stopped out a lot during one week of day trading means very little and isn't statistically significant. The market may not have been in favorable conditions for your trading method that week (i.e. a consolidating market for a trend trader).

Every method will naturally have drawdown periods. These are normal and do not necessarily reflect badly on your stop placement strategy.

WHERE DO YOUR STOPS BELONG?

Where do your stops belong? My answer to that can be summarized in this little rhyme:

“They belong where you're wrong.”

For example, I trade using technical analysis and I primarily trade price patterns that have indicator support. My stops therefore belong where the price pattern would be broken because then the pattern I'm trading no longer exists.

In other words, the reason for my entry has been invalidated and so I should no longer be in the trade. It's as simple as that.

The patterns I trade are very **objective** patterns. There's not much room for **subjective** interpretation. It's either there or it's not.

Where my stop goes is also very objective.

So I need to place my stop where the pattern is broken because when that happens, I no longer have a REASON for being in the trade.

If I move, or remove my stop because I “think” or “feel” the market is going to come back, then I've moved from OBJECTIVE trading to SUBJECTIVE trading. A disastrous mistake!

None of us places stops because we hope they are hit. We place them because we acknowledge that our method and our rules don't always work. The market can do anything at any time. It's a wild animal and will never be tamed.

Not only “knowing” this, but ACCEPTING this on a deep psychological level is absolutely mandatory to become a successful trader.

All of this is to say: Don't be afraid of your stops being taken out, and don't be sad when you're stops are taken out. And if your method is proven over time, then don't feel that you did anything wrong if your stops are taken out ... as long as you're following your time-tested trading rules.

BOTTOM-LINE: You will never completely avoid having your stops taken out!

TIMING

I hired a CME floor trader to work with me for 10 days in Chicago. Although I could never trade his methodology specifically, I learned a lot from him that I still use to this day.

One of the things he told me that I'll never forget:

“Most people are right, at the wrong time.”

We worked on that concept a lot while I was there. It simply means that most people can see when the market is trending, when it's consolidating, when there are double tops, double bottoms, etc.

And the more obvious it is, the less likely it is to work ... THEN.

You see, the pros (you know, the people with all the money) want to get in first.

Simple buy low, sell high concept.

So if the market has already moved up and they're not in yet, then they won't bring their big volume to buy. They refuse to be last to the party. So they either wait, or they may even use their weight to take the market DOWN temporarily.

This is especially practiced on the trading floors. It's called “stop running,” and yes, it really does happen, and yes again, it is intentional.

They want to take out the buyers that are already in the market (which is done by taking out their stops), and THEN the pros will come in and buy ... making them first to the party (at a lower price). After the market starts moving up, then the little guys jump back in, and their volume moves the price higher again.

It's a way of “cutting in line!”

BUT HOW DO THEY KNOW WHERE THE STOPS ARE?

It isn't rocket science. You know where the stops are too, although you may not know that you know!

So let me show you how easy it is:

Below is a 5 minute chart of the S&P emini.

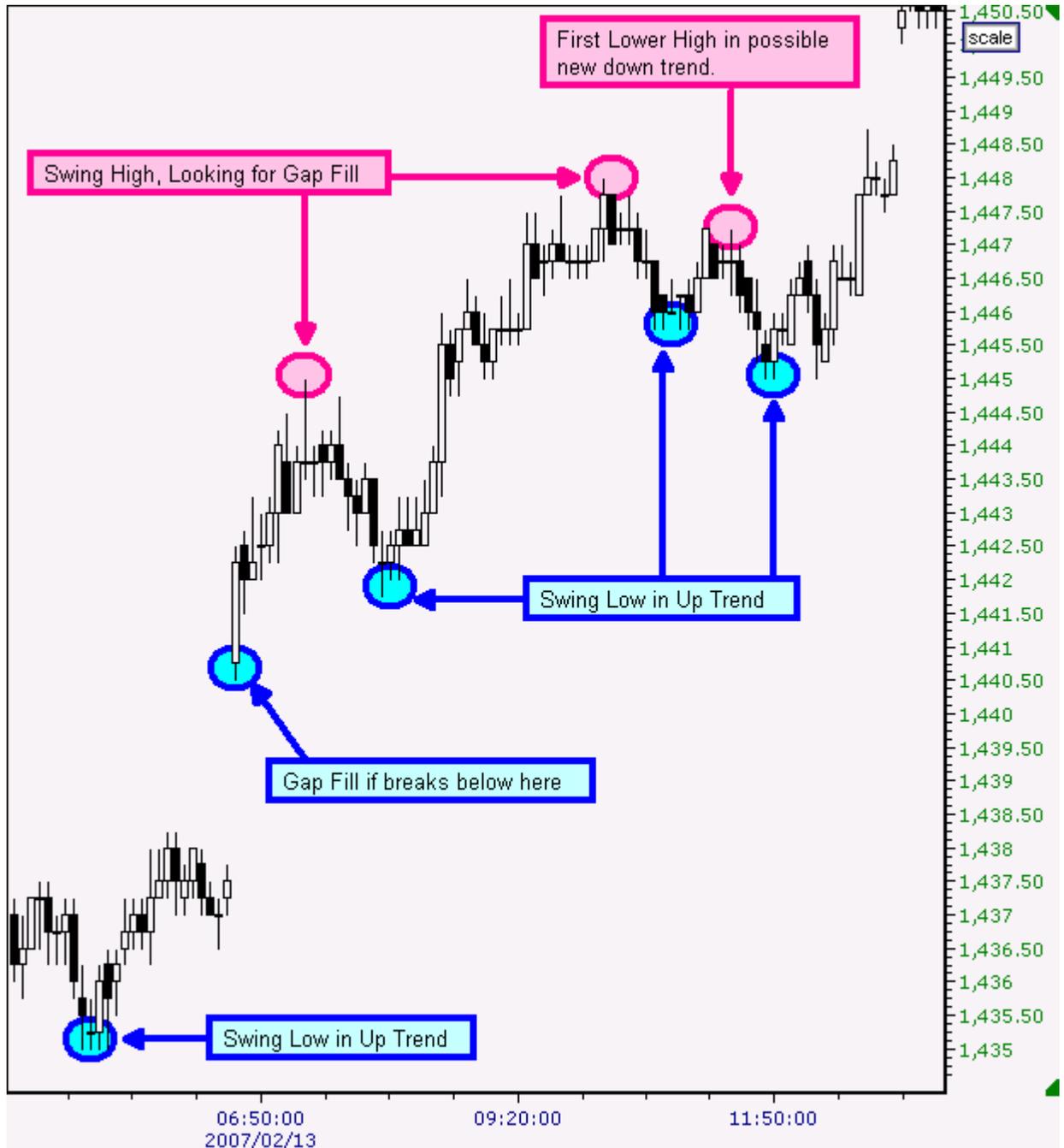
Have some fun, take a pencil and mark where you would guess people may have placed their stops.

Do it now before you look at the next page (don't cheat!).



Chart created with NeoTicker © 1998-2006 TickQuest Inc.

Here's my analysis:



Generally, stops are placed at swing highs and lows. Of course there are different scales of highs and lows depending on the time frame you're viewing.

That gets us started, but it's not quite as simple as that.

Although it's likely that there are some stops at most every swing high and low on every time frame, not all of those are significant for "stop running."

Sometimes stop running is just a way to scalp some quick money. But when it's used to take a directional position in the market, to "cut in line," then you need to look at "significant" swings.

So, how do we measure "significant" swings?

There are 3 rules of thumb:

1. Use higher time frames.
2. Look for volume coming in around the swings.
3. Look at the "reason why" people would enter around that swing.

Let's look at these in more detail one-by-one:

1. Only use swings on higher time frames.

A swing high/low that only appears on a 1 minute chart is not significant for 3 reasons:

- a. The extremely short time frames are very "noisy," meaning that the fluctuations on those time frames isn't very meaningful for the longer term movement of the market.
- b. Most people that trade them are scalpers, jumping in and out of the market, so they aren't the kind of people that are taking longer-term positions that would get "caught."
- c. Most people, especially big-volume traders, do not trade off such short-term time frames. So there isn't a lot of "volume" getting in and out at those swings.

For these reasons, you want to use longer-term time frames to evaluate where stops may be placed (5 minute would be the shortest for day traders, and daily charts would be the shortest for swing traders).

If you use a 15 minute chart to watch for stop placement, you are more likely to be right simply because the swing you see on a 15 minute chart will include swings that traders of 1 minute, 3 minute 5 minute and 10 minute charts are all trading. You simply have more traders placing positions and placing stops at these levels because it includes traders from more time frames.

2. Look for volume coming in around the swings.

Professional traders say that the market is "perverse" by nature. What they mean is that it will hurt the most people in the worst way. There's no demon making this happen, it's simply the nature of a mass-market auction.

Building on this principle, look for the swings where a significant amount of volume came into the market. Those swings are likely to have more stops placed above/below them than swings which don't have much volume to them at all.

You need to be careful with this rule:

- ✓ Very little volume means that it isn't an area where many people entered.
- ✓ A large amount of volume could indicate professional buying, and therefore stop running is less likely to occur.
- ✓ A huge amount of volume could be an exhaustion pattern.
- ✓ A "medium" amount of volume is the best indicator that a good number of retail traders (amateurs) are placing orders and at level (and their corresponding stops below that swing low).

This rule is the trickiest and there's no number I can give you for the right amount of volume. It will vary for each financial instrument you trade. It's simply relative to previous volume levels at previous highs/lows. With practice you'll begin to get a feel for the volume patterns, especially if you trade the same instrument every day.

3. Look for the "reason why" people would enter around that swing.

Here's where your technical analysis skills come into play. Look for what is "obvious" to most people ... and realize that if it's that obvious it has a good chance of not working.

Trend retraces, consolidation breakouts, gap closes, and double tops/bottoms are great examples.

The professional trader is not so simple. He or she is always trying to "find the loser," meaning that they watch for these obvious patterns and look for indications that they're going to fail. Sad to say, but due to the perversity of the market, the places where other people get hurt, provide the best low-risk, high-reward entries.

Once you learn to do this, you'll find that you're taking trades in exactly the opposite manner than you used to, but with more finesse.

The reason my experiment of trading exactly opposite to my signals didn't work (as described early in this special report) is because some of those opportunities were good to trade against, and some were not (as explained by these 3 rules of thumb).

Next we'll look at how you can not just avoid having your own stops taken out as often, but you can also use this knowledge to enter trades against amateurs and make money!

HOW TO TAKE OUT STOPS FOR FUN AND PROFIT

First, let's look at some typical scenarios for stop running. These are price patterns that are so obvious to amateurs, they are often doomed to fail. That means these are patterns you can trade AGAINST given the right circumstances.

By the way, I have to make one quick disclaimer before I "trash" people's favorite price patterns! I'm not saying that these price patterns are not good nor am I saying they can't be traded. Under the right circumstances they are indeed very viable.

DOUBLE TOPS/BOTTOMS



Here's a nice Double Bottom. The market is clearly bouncing off the support of the previous low and we have a bullish candlestick showing reversal off the bottom, getting ready to explode to the upside for HUGE profits!



Chart created with NeoTicker © 1998-2006 TickQuest Inc.

Oops! That lovely "Double Bottom" didn't hold! How come?

First, the market was EARLY in a trend. Trading trend reversal patterns have a very low probability of success at any time. They are one of the lower win/loss ratio trades you can take. When they do work, their risk/reward ratio is great, but most amateurs don't have the mental fortitude to trade a setup that wins less than 50% of the time and they don't have the confidence to hold on to winning positions for huge gains.

Most importantly, remember this:

Every continuation of a trend is a failed Double Bottom or failed double top!

Every time a trending market retraces and then continues on to make a new high or low in the direction of the trend, it's testing the last high/low.

Many amateurs trade those as double tops/bottoms (because they don't know the details of how to trade those patterns). But many pros are actually entering or adding to their positions at those points.

Why?

Because the break of the low of the supposed "double bottom" is where the amateurs have their stops, and because the pros are trading with the trend, which is the path of least resistance.

I've been in chat rooms day after day, week after week and month after month ... in fact it's gone on for YEARS and I'm continually amazed at how consistently amateurs are trading against the trend trying to catch the top or bottom.

One of my teachers called this "Kamikaze" trading. And he's right, it's suicide! But even after I've pointed this out to trader after trader, they STILL continue to do it!

I've witnessed this to be such a consistent pattern that I've come to the conclusion that there's something in human nature that makes people do this over and over again. It's definitely one place to find loser after loser!

So how do you know when you should trade with or against these patterns?

First, go back to our 3 rules of thumb detailed above:

1. Use higher time frames.
2. Look for volume coming in around the swings.
3. Look at the "reason why" people would enter around that swing.

Next, look for confirming or non-confirming energy from other sources.

1. What is the price pattern and indicator pattern on a higher time frame? Does it support or contradict the price pattern on the shorter time frame?
2. What do the internal indicators show (\$TICK, \$ADD, \$VOLD)?
3. Is this a first, second or third attempt at the same price action? The first attempt is least likely to succeed. The second and third are the most likely to succeed.

TREND RETRACES

One of the most well-known trade setups is to look for an established trend, then wait for the market to retrace and jump in.

That's a great strategy.

Unfortunately, everyone and his parakeet is trying to do the same thing. And that means ... you know! The market isn't going to make it that easy!

But it also provides some high probability scenarios if you have the patience to only take trend retrace patterns where someone has already gotten stopped out!

Continue on to the next page for a little exercise with this pattern.



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We want to get in early on a new trend. It looks like we may have it. We've closed the gap up, and are moving down aggressively.

We had a bounce off the last major swing low, and logical place for the market to retrace in the new trend.

We enter short after the market retraces and starts to move down again, so we can "sell high" and look to "cover low" after the trend continues down.



Gosh darn! It didn't work too well. The market hit support a second time and bounced up and took out our stop.

HEY! That's a Double Bottom! The market broke the high between the 2 lows, so let's just stop and reverse, take a long position, and we're sure to turn a loser into a winner!



What the ...?

Dag Nab It! Our trend retrace didn't work, then our Double Bottom didn't work. Stopped out twice in a row. Unbelievable. Someone must be watching what we're doing and making us lose money no matter what we do!

Ever have this happen to you? Here's why, and how you can minimize it in the future.

FIRST: A simple retrace in a trend is not as reliable as a complex retrace (A,B,C pattern). This has to do with people's stops being taken out, so more buyers can come into the market. If

everyone has already shorted the market, then there's no one left to short and so the market can't go down any further.

Therefore, short sellers must be taken out so that they can later come back in and move the market down more. They are "taken out" by having their stops hit.

Do yourself a favor and watch for the opportunities where the market has a complex retrace, taking out the previous high/low of the retrace (and the corresponding stops) and then continues in the direction of the overall trend. This is a perfect example of catching people being "**right at the wrong time.**"

SECOND: The first retrace in a trend is indeed a high probability trade. However when we took at that first retrace, we didn't have an established trend yet. The market had not made a lower high or a lower low. So that was NOT a trend trade!

THIRD: The Double Bottom trade was NOT technically a Double Bottom.

A "Double Bottom" is not simply a pattern where one swing low comes in around the same level as the previous swing low. Since the Double Bottom pattern is a reversal pattern, it isn't valid unless there is an extended trend. Again, there was no trend at all yet at that point in the chart. Therefore the trade was not a valid one because the analysis was too simplistic (okay, it was dead WRONG).

THE HIGHER TIME FRAME

One of the best ways to stay out of trouble and catch other people doing stupid things, is to keep an eye on higher time frames.

Higher time frames have less noise and are more reliable than shorter time frames.

Patterns on short-term charts can be very deceiving. Trading off a single 1 minute chart is like flying blind.

Leave that for the amateurs.

Even if you're a short-term trader, you always want to have the edge of seeing the "birds-eye" view of the market. Many times there's only one high probability direction to trade a market and it's smart to let the short-term trades in the other direction go by without your participation.

Keep your power dry until your short-term setups align with the long-term charts.

Then you can use the short-term traders stops as your entries!



Chart created with NeoTicker © 1998-2006 TickQuest Inc.



Chart created with NeoTicker © 1998-2006 TickQuest Inc.

Hmm. That looked pretty good. What went wrong?

Look at the chart on the next page and you'll see that this so-called "up trend" was actually just a retrace in the longer-term (2,000 tick) charts down trend!

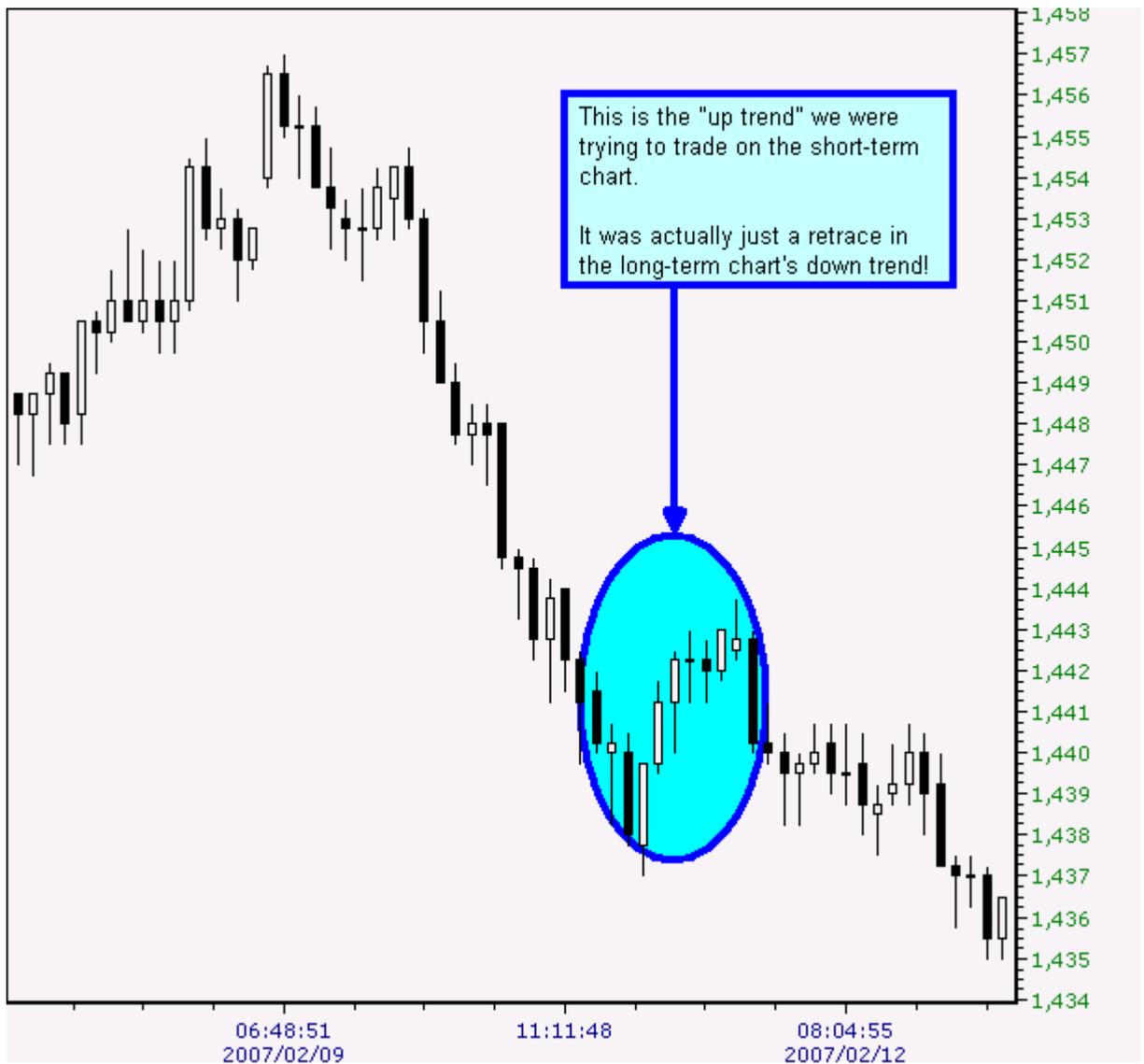




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Above is a swing trading example. We've clearly made a lower high and a lower low on the S&P Daily chart. We're below the 50 MA (the red line) and it's moving down. It looks like the beginning of a new bear market. Should you sell short and load up on Puts?



Chart created with HeoTicker © 1998-2006 TickQuest Inc.

As you might have guessed, that pattern on the Daily Chart FAILED. Why? Because we got it EXACTLY WRONG! But by looking at the Weekly Chart you could have seen that it was actually a bottoming pattern of the complex retrace (A,B,C) on the longer term time frames up trend! Especially note the Stochastic indicator of the Weekly we against your short trade on the Daily chart. Look for stops on the Daily charts and use them to enter against the amateurs!

CONCLUSION

In a brief Special Report like this I don't have the space to go into all the details of how I personally trade these principles. However you have enough here to apply to whatever trading methodology you may currently be using. Adding just ONE of these tricks to your trading can increase your trading profits tremendously.

If you'd like to learn my personal trading method, including the exact trading rules I use, **you're entitled to a DISCOUNT because you purchased this Special Report.**

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