<u>Using Divergences to Keep Out of Bad Trades</u>

The American Football season just came to an end with my team getting close to the championship but falling short again. I am a big fan of the Indianapolis Colts and we keep having a groundhog day season year after year but it is still fun to watch. We have one of the better quarterbacks in the league named Peyton Manning who is renowned for his hard work ethic as well as his mental and physical ability on the field.

One of the things he is known for is beginning each play with up to three possible plays to run and trying to switch into the best one at the line of scrimmage based on the formation that the defense of the other team is in prior to the ball being snapped. He will check out the other team and then let his team know what the play will be using different code words and hand signals. This is called an audible for you International readers.

When he is done calling the play and the ball is snapped they do their best to execute the play and move the ball forward. When the audible results in a good play everybody loves the quarterback and says how great and smart he is. When the play turns out poorly or if he has a series of poor plays he is the biggest sham in the league and everybody cant understand why he just doesn't go up and just start the play instead of changing it every time.

Manning's philosophy regarding making so many play changes is that he doesn't want to waste a play. If the original play that the coaches called doesn't look like it will work against the formation the defense is showing he will switch out of it into a higher percentage play. I for one am happy to have that asset on my team as are the coaches. When you watch other teams play without such capability you see a lot of wasted plays.

Well, we as short-term traders have similar tools that we can use to keep us out of wasted trades and they are called divergences. I locate the divergences I use with a MACD indicator but the idea is applicable to most indicators. Many systems have been designed based on divergences alone and they can be quite successful.

The way I use divergences is mostly as a warning system. Divergences tell me two things about possible market conditions. First is that the trend I am following could be coming to an end. The second is that the trend I am following may be a very strong trend and possibly worth milking for a large trade.

Every trend will end in a divergence on some time frame the question is what do you do about it. I follow a trend following system usually in my short-term futures trading. Those who follow my system know that there are a series of rules that need to be met before a trade is entered. Approximately 70% of the time that those rules are met and a trade is entered it will be a winner. There are times though that a trade is doomed from the beginning just because it is fighting a divergence that is telling us that the trend is coming to an end. It is hard to incorporate divergences into a rule set because by nature they are more subjective and not everyone will see them.

One way to improve the results of any trading system is by becoming aware of divergences and when they come along make a discretionary decision not to take a trade setup.

Lets assume we are using a basic trend following system where we buy or sell short pullbacks to a 21-period simple moving average on a daily chart based on whether the price is above or below the moving average. Below is a chart of the NASDAQ 100 Index ($NDX).

Chart courtesy of www.stockcharts.com

We can see in late April the price closed below the 21-sma at which point using the system we might be waiting for a pullback in order to get SHORT the market. If we follow the system blindly we would sell blindly at the end of May when price worked its way back up to the moving average. That trade would quickly turn into a loss as the price advances over the 21-sma. If however we noticed that the MACD formed a positive divergence we would have the choice to not take the SHORT trade and wait for another trade. That particular setup is not the best example since the period where the divergence set up is rather short but the idea still holds.

We next see how the price advance steadily in June before pulling back to the moving average and allowing a LONG trade. At the end of the LONG trade another divergence is formed warning us of a possible trend change. That being the case we have the option to not take the next trade which also would have been a loser. Price declines in July and pulls back to the moving average in August setting up a SHORT trade. It too formed a divergence with MACD at the end of the trade which led to an extended advance through the rest of 2005.

In the beginning phases of that extended advance a negative divergence was formed which did lead to a penetration of the moving average, however brief, but not a trend change. This is the second information that we can learn from divergences. When there is a clear divergence and a trend change does not occur then there is a strong possibility that a strong extended trend is underway.

Us traders of the 1-minute NQ see this all the time when we are in runaway mode. There can be divergences all the way up the advance and the thing to learn from the information is that there is more safety in finding a place to get on the trend rather than picking a top or bottom whatever it may be.

The extended trend in the chart example eventually does end with a divergence in December but only after several more smaller divergences throughout the year. This chart or theoretical system may not provide the best example but I think there is something useful in learning how to recognize divergences that can keep us out of poor trades. Here are a few of my observations regarding divergences. Hopefully they can be of some use to you.

1. MACD Divergences are most reliable when they cross the zero line in between the peak and the failure peak. Such as the two in June and August in the chart.
2. When you take a divergence signal and trade counter trend and end up getting stopped out there is a good chance that a strong trend is underway. Change your thinking of trying t find a top or bottom and see if there is a place to get on board the trend. The worst that can happen is that you will be wrong, but getting onboard a runaway trend early is worth the risk. (provided your system allows for such trading)
3. A MACD divergence on a time frame five times higher than your time frame is hard to overcome and it can feel like a battle trying to trade against it.
4. Allowing a trade to pass because of a divergence and having that trade work out the way it was suppose to anyway is not really a terrible thing. (see number 2). We should not place too much mental weight on any one trade but instead look at the collection as a whole.

Recognizing and applying divergence discretion to your trading system can be a valuable tool and worth the time and effort to learn. I hope you and your families have a great week. Trade well!

Please let me know if you have ideas that you would like to see written about in this space in future issues.