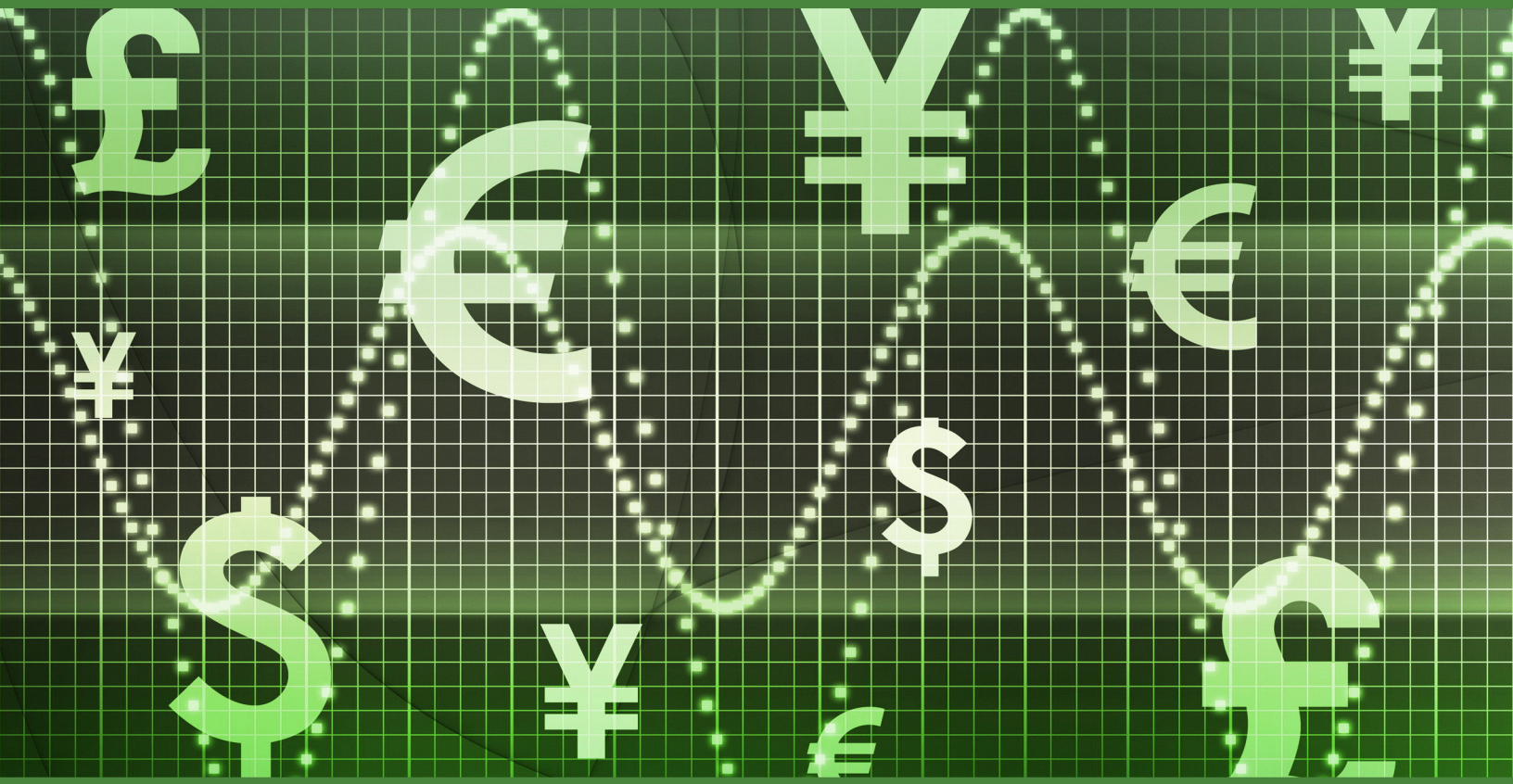
Derek Frey's Inner Circle

HARMONIC MASTER TRADING GUIDE (Part 1)



Understanding Harmonic Trading and Gartley Patterns

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Introduction

*Note: DO NOT skip ahead and implement the plan without first understanding the method. You will short-change yourself and your chance at success if you do not invest the time necessary to learn the method.

Trading is a world filled with lots of opinions and ideas of all sorts. This document is an attempt at cutting through all of the crazy claims and get down to what really determines trading success or failure. The concepts discussed herein are specific to the method of Harmonic Trading, however the concepts

themselves apply to any and all successful trading methods. Most traders fail at least partially due to unrealistic expectations from the outset, so let's start by getting our expectations in line with reality.

Most losing traders say the following statement:
As long as the market is moving there is an opportunity to make money.

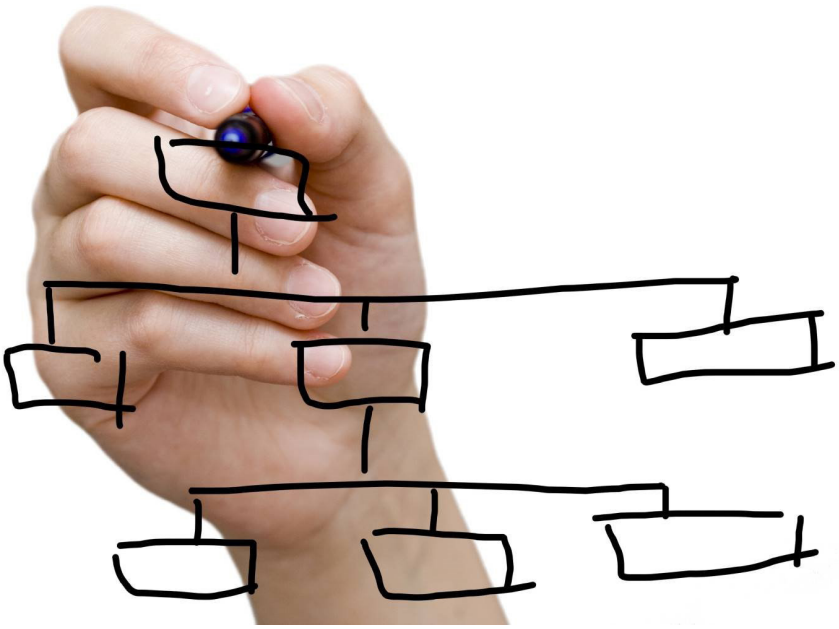
First of all, let's dispel one of the major fallacies that traders believe. Market movement does ***NOT*** equate to opportunity. Market movement alone represents risk, not opportunity. In other words, just because a market is moving does not mean there is a reason to be in it. The market is always moving; however, there are only certain periods of time when probability is on your side. So don't fall into this trap.

Also understand that no method can *guarantee* that your next trade (or next ten trades) is going to be a winner. So if you are someone who is easily discouraged, perhaps trading in general is not for you. Patience and persistence are two qualities in short supply among the 90% of traders who fail. If you are not prepared to work this method for no less than 100 trades, then quit now. You are clearly not committed to success if you are not willing to see something through.

A Master Trading Plan

A Master Trading plan is an essential part of any successful trader's life. Most traders who fail do not have a clear plan, and their failure is at least partially due to this lack of preparation. So let's first talk about why a plan is so important. Do not skip over this section because you think you already know it. If you did, you would not be reading this.

Having a trading plan is the core of your business. It is the plan you will use to become successful. The reason this is so important is because will encourage consistent action, which will then lead to the consistent results that we are all after.



Consistency

Consistency is another word that many traders do not really understand. First of all, it is an action and NOT a result. You do not *get* consistent. You *act* consistently and, over time, you get consistent results. That does not in any way imply that you will win all the time. Consistency only comes from actions, and it is especially important to act this way during the *losing times*. Most traders fail to stick to a plan after a string of losing trades - but this is when sticking to the plan and being consistent is the MOST important.

Any good plan is simple and repeatable. It should inherently tell you not only when, where, and why to enter a trade but, more importantly, when, where, and why to run your stops as well as where your targets should be. You MUST have these three things in order to properly quantify the most important part of any plan which is the risk-to-reward ratio which we will talk about in-depth in a bit.

First, let's look at some of the reasons why 90% of traders fail. Most people take the very same tools and rules that those before them used (and failed with) and are trying to "beat the market."

This is a foolish move and shows how little the person understands about successful trading. The market is not something that can ever be beaten! You either work with it or you get beaten by it. We are never the market's master - it is always ours.

Everyone knows how to make money in the market…buy low and sell high!

It is no secret. The trick is how to know when something is "low" or "high." Most people struggle with this question whether they know it or not! In 20 years of trading, the only way I have found to reliably determine when something is "low" or "high" is through probability.

Probability

So what is probability? Well, most people have been introduced to probability in basic statistics class. We use probability, because we understand that we can never obtain true called CERTANTY. A successful trader accepts the FACT that he or she will NEVER KNOW what is going to happen next. This is at least partially due to the fact that trading is a non-linear dynamical domain. This phrase may be a lot to swallow, so let's define what we mean when we say non-linear dynamical domain.

Non-linear Dynamical Domains

A non-linear dynamical domain is a long phrase that really means: the data we are analyzing comes to us in a seemingly random fashion in infinite amounts. There are

infinite things that can influence it and the rules that govern it are ever-changing. A perfect example of a non-linear dynamical domain is the weather on this planet. This is an important concept to realize and accept.

Until you accept the fact that you cannot have certainty, you will chase after all of those silly auto trading FX robots and methods that claim 99% win ratios and overnight riches, etc. Those claims are, of course, not possible in ANY non-linear dynamical domain…especially markets. So, it is a big first step to accept the idea that you will not win all the time.

Once you make that step, you will realize, "you will realize that if you cannot know anything with certainty, you can at least know its probability." We are all very familiar with probability forecasts in our daily lives in the form of weather forecasts.

Think about it. A weather person never says, "It is going to 78.6 degrees at 11:51 this morning with wind and rain blowing at 13 miles an hour from the SSW." He or she says, "There is a 70% of rain today and the temperature is going to range between 70-80 degrees with gusty winds out of the SW." They do it this way because, as every person knows, weather is an imperfect science and always will be due to its non-linear dynamical nature. So when we talk about probabilities, I want you to think of them the same way you would if you were watching at a weather forecast.

Leverage

Leverage is a very powerful tool. Archimedes said give me a long enough lever and I can move the earth. Unfortunately most people unknowingly abuse leverage. Lehman Brothers is a great example of this. They went down as a firm because

they were the highest levered broker on Wall Street. The Wall Street Journal reported it at 63:1. So if you want to follow their lead into the abyss feel free but I suggest you learn the lesson that they should have known all along.

When you first open a FX account it will ask you what level of leverage you want to use. When you select 100:1 leverage that does not actually mean you are using that much leverage, it is simply setting the maximum you can use.

The important number is the actual amount of leverage used and that is calculated as follows. Simply divide contract size into account value. So, for instance, if you have a 100k contract and 25k in your account, then you are using 4:1 leverage on that trade. You are controlling 100k worth of an asset with only 25k in your account.

Leverage is a tool that has a point of diminishing returns that occurs much sooner than most people realize. This means that is goes from being a helpful thing to a hurtful thing sooner than most would expect. Richard Olsen, the co-founder of Oanda (the FX brokerage based in Switzerland) has recently run a very in depth study that shows the actual point of diminishing returns in the FX markets occurs at roughly 4:1 leverage factor. Over-leveraging your trades is NOT a shortcut to success, but rather an almost guarantee of failure.

Most traders have little to no business using leverage greater than 5:1, and even

that is very high. Many traders start with a very small account and have dreams of turning it into a much larger amount, which itself is not bad. But the idea that you can you can do it in a very short period of time is unrealistic.

Furthermore, many traders use a small amount to start and use that as an excuse for over-leveraging. At the end of the day, there is never a good excuse for over-leveraging an account. Again, all this goes back to having a set of realistic expectations.

I suggest starting trading with ZERO leverage to start. So that means if you have a 10k account you trade just one mini contract with a face value of 10k. Once you become more comfortable with this method of trading, you can begin to ratchet up your leverage if you like, but always remember that less is more and rarely, if ever, should you use more than 5:1.

Risk Management

The next thing that leads most traders to ruin is a lack of clear risk controls. Good risk management also starts with a clear understanding of the reality that we can never know the future with certainty; therefore, we must at least try to protect every trade with some kind of stop order.

Stops can be “gapped,” which is when the price moves through your order without trading at that price and is then filled at the next available price - which is often very far away from where you expected to be filled and can result in larger than expected losses.

Due to this reality, we have to keep leverage low, because sooner or later all traders experience at least one stopgap in their life. The key, of course, is not

letting it end your trading altogether, and the only way to try and prevent that from happening is to keep leverage low.

Most people lack the discipline to employ these two key strategies, using low leverage and stops on EVERY trade, and that is by far the largest contributing factor to the failure of so many traders.

You also need daily, weekly, and monthly trading loss limits and the discipline to stop trading if you hit those limits. Most people should never risk more than 1% of their account on any one trade - and even that is probably too much.

The key here is *less is more*. Think of your max risk the same way you would the max speed in your car. You would not drive your car at max speed every time you get in, if ever, and a trading max is no different.

A Necessary Exercise

The following is a method to help determine what your true risk maximum is. This too is a simple exercise and again skipped by the 90% of traders who fail . The steps are simple and you will feel strange doing this, but you must do it as instructed.

1. Tonight, before you go to bed, go into your bathroom, turn on the light, and look at yourself in the mirror.
2. Repeat out loud while making eye-contact with yourself: "I just lost _____ trading today."
3. Then honestly feel any emotions this evokes. You are likely to get uncomfortable, perhaps even a little angry. This is what you want to expose…
4. If you do this exercise and you feel anything more than complete calm and peace, then you know that the number you filled in the blank above was too much. Repeat this step each night with a smaller number until you reach the point where you can accept the loss and wake up the next morning without it still being on your mind.

You may find that your number is zero and that is OK, but it means trading is not for you. Better to find out through this exercise than the actual loss of money. They real key is to be honest with yourself and find a number you can truly live with. Losing and dealing with it is part of ***successful*** trading. Accept that now and begin to build your method around it.

Having a clear understanding of leverage and risk limits is the most important part of successful trading plan. Make sure you fully understand the above concepts and do the exercise.

Humans Are Creatures Of Habit

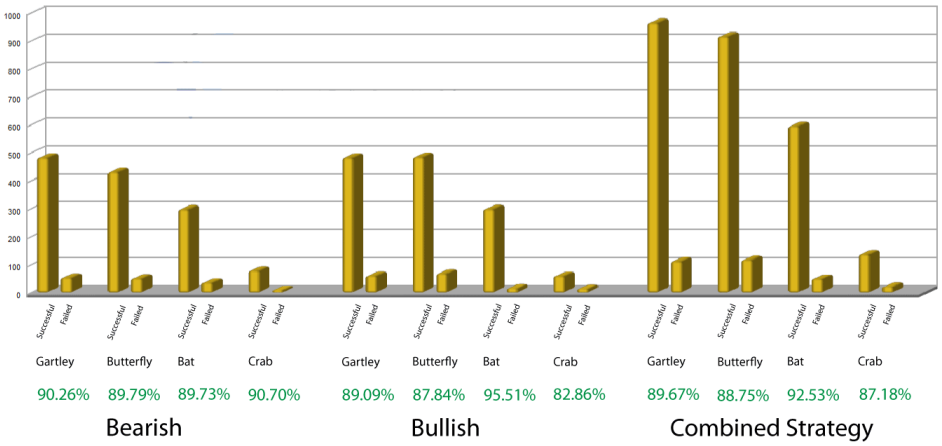
We all know that humans are creatures of habit. Driving to school or work is a perfect example. You do not drive to work or school or the store a different way each time, do you? Of course not, in fact, in the event that there is construction and you are forced to take a detour, we are such creatures of habit we actually get mad at having to change our routine. So, since we are creatures of habit it stands to reason that we might have a certain "pattern of response" to stimuli.

If you learn nothing else remember this one point…chart patterns do NOT repeat themselves per say. *Humans* repeat themselves and we witness that repetition through recurring chart patterns. Too many people see the "tail wagging the dog" and then wonder why they can't make heads or tails of technicals.

Now let's get specific. I use a very old tried-and-true method. This method is built around Gartley-based patterns, also known as "harmonic patterns." The original pattern was discovered in 1935 by H.M. Gartley. Since then, the original pattern has evolved and others have also been discovered. They have all been exhaustively tested to show a consistent 70% win ratio going back over 75 years in all markets and timeframes.

These patterns work for a number of reasons. Part of why they work is the fact that humans repeat themselves time after time, and the study of this repetition is sometimes called the study of cycles.

Bearish Gartley	482
Failed Bearish Gartley	52
Bearish Butterfly	431
Failed Bearish Butterfly	49
Bearish Bat	297
Failed Bearish Bat	34
Bearish Crab	78
Failed Bearish Crab	8
Bullish Gartley	482
Failed Bullish Gartley	59
Bullish Butterfly	484
Failed Bullish Butterfly	67
Bullish Bat	298
Failed Bullish Bat	14
Bullish Crab	58
Failed Bullish Crab	12
Gartley Patterns	964
Failed Gartley Patterns	111
Butterfly Patterns	915
Failed Butterfly Patterns	116
Bat Patterns	595
Failed Bat Patterns	48
Crab Patterns	136
Failed Crab Patterns	20
* 15 Minute and higher timeframes	
Total Alerts	2905



The chart represents the result of a test performed in the Summer of 2009 covering almost 3,000 trades in all major currencies and all time frames from 15 minute to monthly.

You can clearly see that these patterns work the majority of the time. Still, not all of the patterns are worth taking as trades just because probability is good. Favorable probability is NOT enough by itself. We still need a “filter” beyond basic probability. The best filter I have found is simply calculating the risk vs. reward ratio of any trade.

Many methods do not provide a clear methodology for this, but the beauty of harmonic patterns is that they do. We will talk much more about risk reward ratios in a bit.

The Fibonacci Ratio

Let’s first look at the original Gartley pattern itself in-depth. All harmonic patterns are little more than a set of specific Fibonacci retracements or extension ratios that

show up in a certain sequence

Most traders are already familiar with Fibonacci retracements and extension ratios. I would like to briefly mention about why they are used.

The Fibonacci ratio, as it is often called, is not something that the man who it is named after made up or even discovered for himself. It was a ratio that had been discovered thousands of years before him and was handed down through the ages.

Modern mathematicians as well as scientists from almost all fields have since confirmed that this ratio (1.618…) and its respective mathematical parts have been found in nature, music, science, art, geometry - really almost every field - at such a significant rate that they cannot be random events.

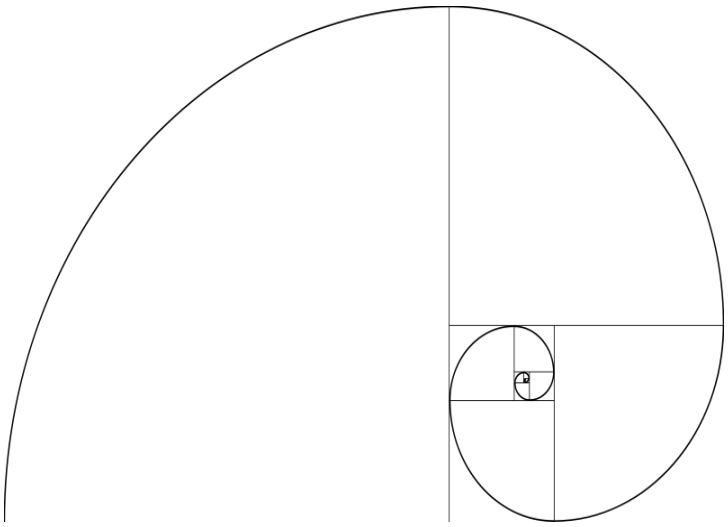
Fibonacci sequences appear in biological settings, such as branching in trees, arrangement of leaves on a stem, the fruitlets of a pineapple, the flowering of an artichoke, an uncurling fern and the arrangement of spines on a pine cone. No scientist can truly say why it is so prevalent, only that it is indeed prevalent.

I could go on for days with examples, but instead I will encourage you to do your own research. Fibonacci numbers and ratios are far more valuable than the vast majority of the other trading tools available *when used correctly*.

Unfortunately, the majority of traders using Fibonacci ratios do so incorrectly and

lack a deeper understanding of why these ratios matter and what they mean.

A Fibonacci spiral in nature



Actual Fibonacci spiral

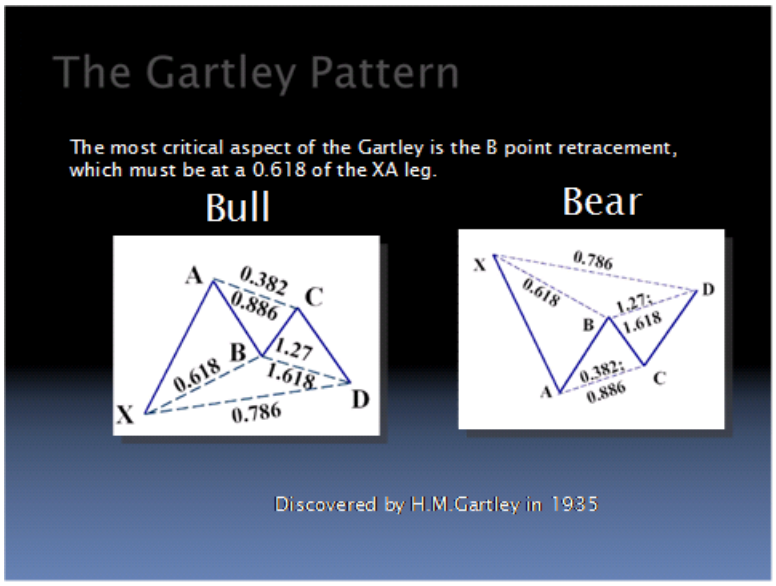
It was discovered that, when these ratios show up in order, the probability of forecasting the next move becomes better than 70% - which is far better than the probability one needs to be successful. Exactly why they work is still debated, but

the fact that they do work is not.

The nice part about technology is that software provided when you joined the Inner Circle will do all of these otherwise tedious measurements for you. Now this is not an excuse to be lazy and not do your homework, but it will save you time.

Gartley Pattern

Below is a diagram of the Gartley pattern. To keep things simple, I will explain the bullish pattern first. The bearish pattern is an inverted bullish pattern, but the ratios and rules are all the same.



In the chart above, the X point represents a recent relative low in a market. From that point the market rallies to the A point, and then begins a normal pullback towards the B point.

Most traders are familiar with the .618 Fibonacci retracement level as it defaults on almost all chart platforms, and here the distance between A and B is usually a .618 retracement of the original move from X to A.

Then, the market begins to rally again from the B point and attempts to retest the former highs at A. This retest will form the C point and can be anything from a .382 – .886 retracement of the prior high at A.

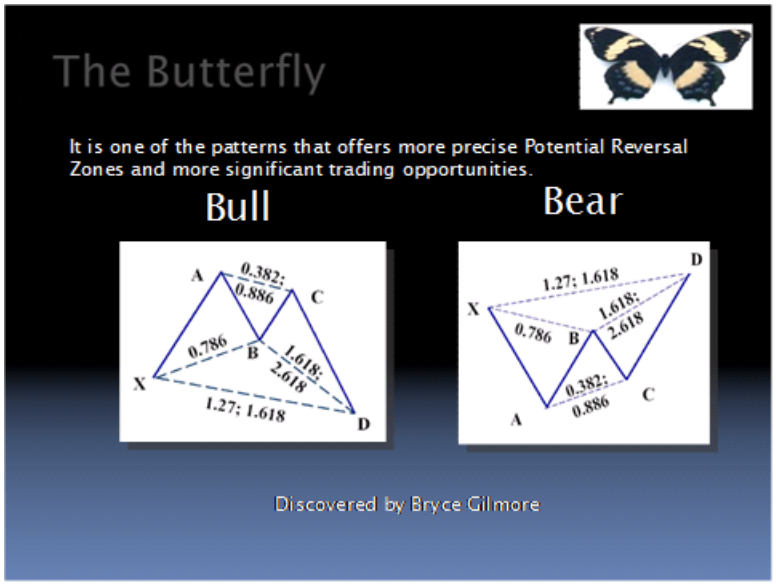
Then, after the market fails to break out above the prior highs at C, you will begin to see it move lower and retest the support at B which will fail until the market moves to the 1.27 – 1.618 extension level forming the D point, which is also called the Potential Reversal Zone or PRZ.

The D point, or PRZ, is roughly a .786 retracement of the original move from X to A and is why we have the dotted line connecting the D and X points at the bottom with .786 on it. So while that all may seem complicated at first; it is really just a recurring sequence of specific Fibonacci ratios.

There are three other harmonic patterns that the software identifies for us. They are the Butterfly, Bat, and Crab patterns. We will take a look at each of them.

The Butterfly

This pattern was originally discovered in 1999 by Bryce Gilmore and is one of the most common patterns you will come across. Notice the key difference between it and the original Gartley is that the D point is below the X point.

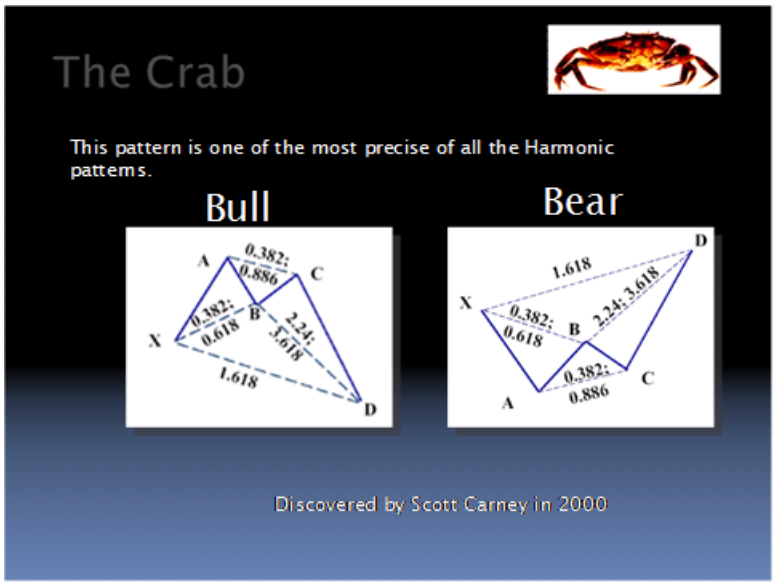


Factors that invalidate the butterfly:

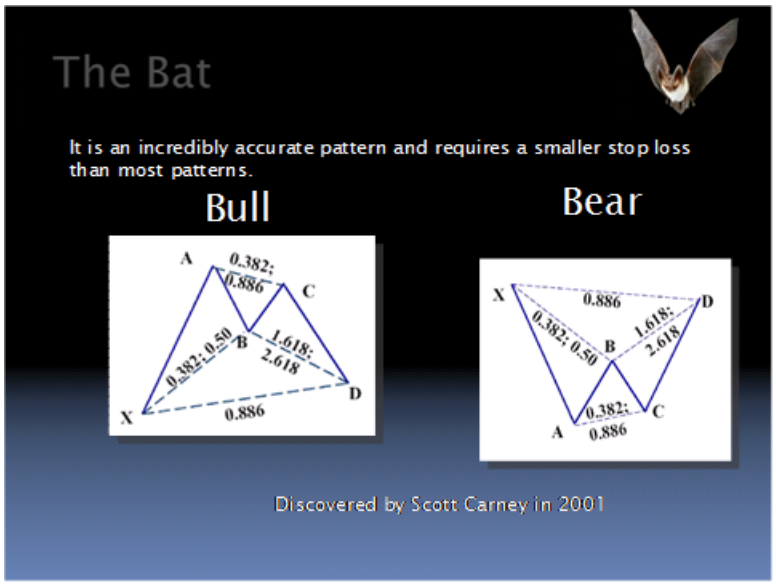
- **An extension move beyond the 1.618 of XA (1.618 expansion is generally the maximum risk)**
- **B point below the X point (for a buy pattern) or above (for a sell pattern).**
- **C above or below the A point**
- **Failure of D to extend beyond X: D must extend beyond X to be a butterfly pattern.**

The Crab

The critical aspect of this pattern is the tight Potential Reversal Zone created by the 1.618 of the XA leg. This pattern requires a very small stop-loss and usually provides an almost exact reversal in the Potential Reversal Zone.



The Bat



This pattern incorporates the 0.886XA retracement, as the defining element in the Potential Reversal Zone (PRZ) also known as the D point. The B point retracement must be less than a 0.618, preferably a 0.50 or 0.382 of the XA leg. The Bat utilizes

a minimum 1.618BC projection. In addition, the AB=CD pattern within the Bat is extended and usually requires a 1.27AB=CD calculation.

These patterns have been found to work in all time frames and all markets. This method can easily be applied to trading stocks, futures, or any other market. You need to decide which time frames you want to work with. Short-term time frames will require you to spend more time in front of the computer and are often more stressful, so keep that in mind. I prefer to trade the 15 minute and 1 hour charts for the most part, but do keep my eyes on all time frames.

So let's assume that the software has identified a pattern for you and you now want to determine if you would like want to take it as an actual trade. This is where the real work comes in, *so pay attention!*

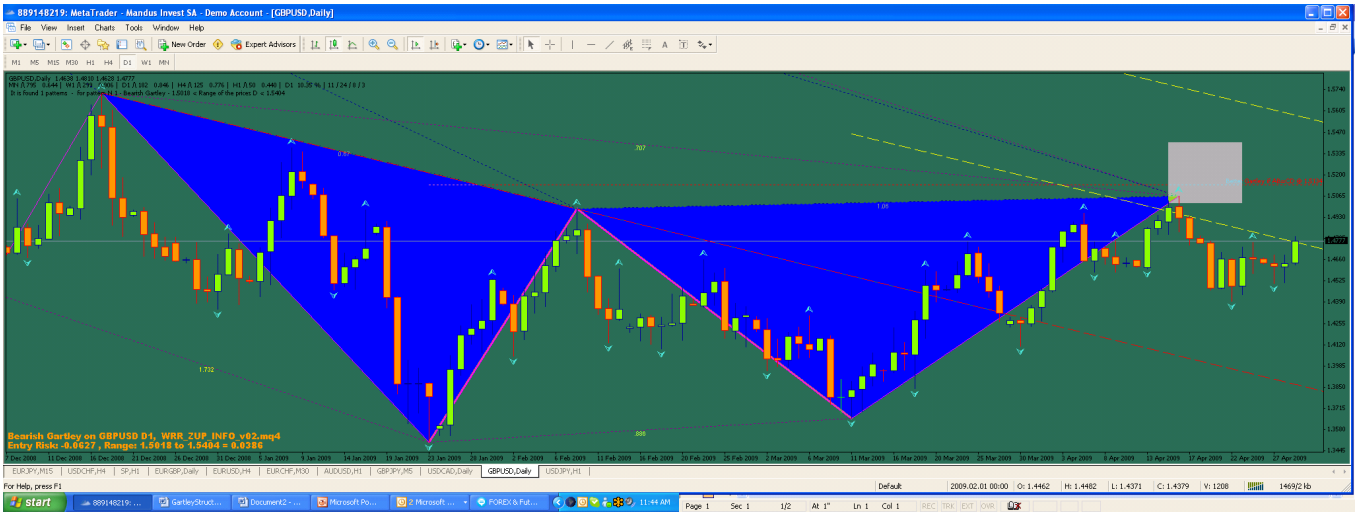
Structure

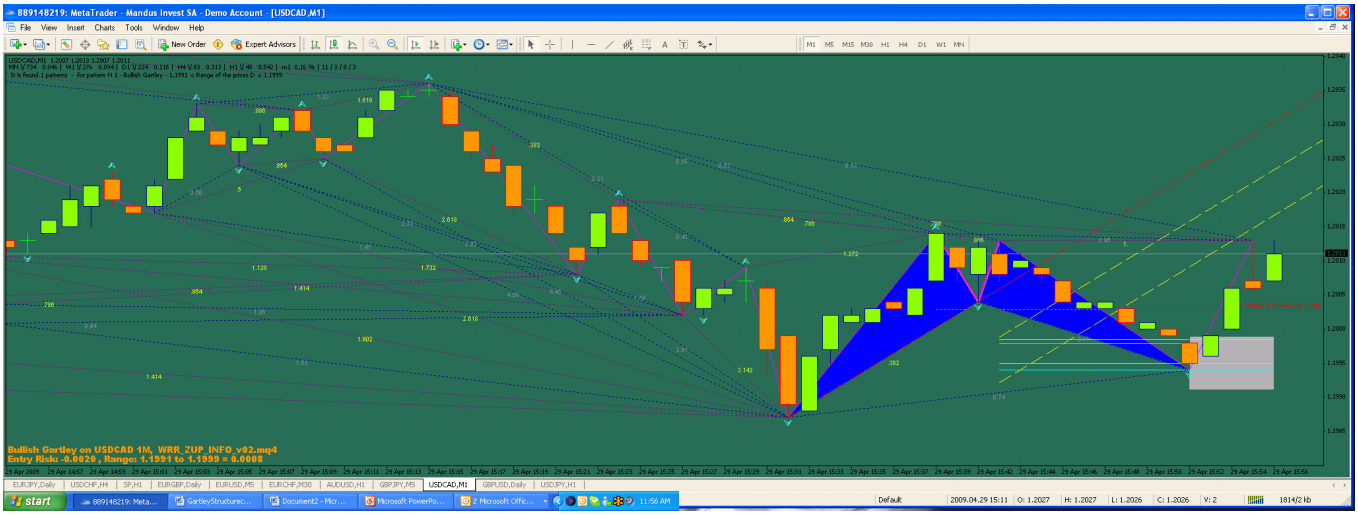
The first thing to look at is the underlying structure of the patterns and ask yourself these questions:

Is it fat or is it flat? Bigger is generally better. We want to see a pattern that was made up of as many individual “bars” as possible. Think of this like the foundation of a house; the more bricks you use the stronger the house is likely to be. So if it is flat, it will have relatively few price bars between each point.

Conversely, a fat pattern has many bars between each point. In the charts below you can see the top one clearly has many more bars between each point than the one below it. However, this does not imply that one will work and the other will not. It is simply a way to assess which ones we want and which we do not.

The reason we do not want the smaller ones is simply because they will rarely give us an acceptable risk-to-reward ratio.





Compare what we call the sub structure vs. the super structure. The super structure is simply all the measurements that the software does for us. Find this by zooming all the way out on your charts and look where the dotted lines with the Fibonacci ratio measurements start.

The sub structure is the pattern itself and will, most of the time, be highlighted in blue.

We will use the same charts from the last example where you can see that the top pattern is also using up most of the available super structure, whereas the bottom one is hardly using any at all.

Again, all this really tells us visually is that the risk vs. reward is more or less favorable.

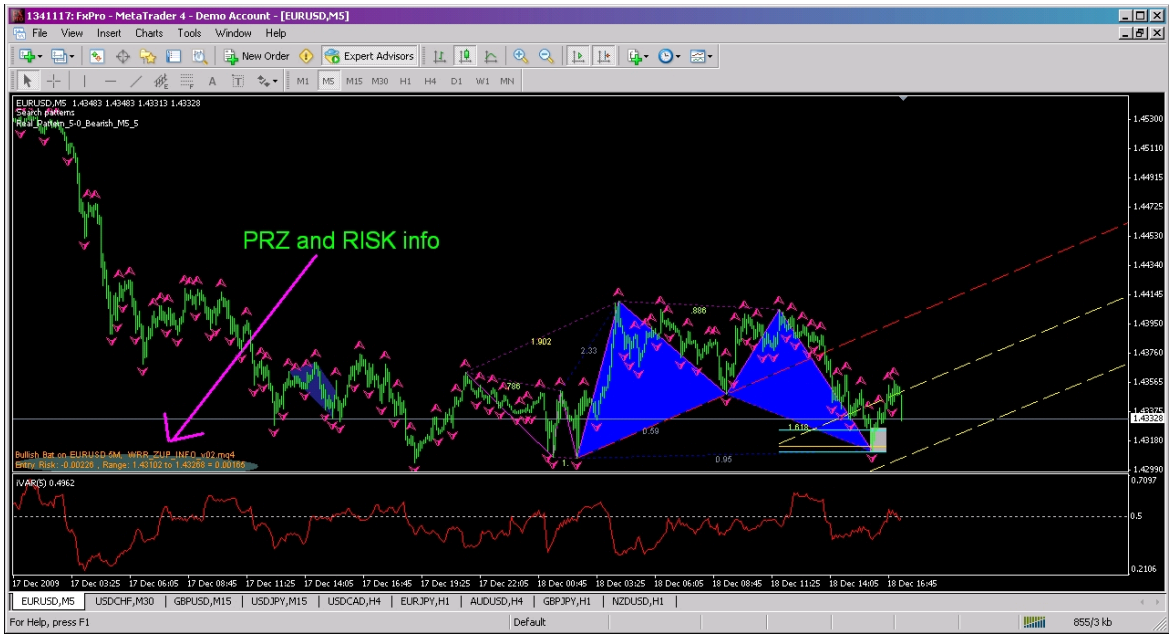

Sub-Stucture
Superstructure
1.34
2.236
2.
1.22
.854
1.414
1.272
0.55
.618
.854

Risk vs. Reward

Now we will discuss risk vs. reward. This is an incredibly important topic as well, so make sure you fully grasp this before you move on. Every trader knows that to be successful you need to "cut your losses short and let your winners run." This is another thing that everyone knows but few are able to practice.

Having a way to calculate *in advance* how much you need to risk to then be able to realize a certain reward is an absolutely necessary part of any successful trading plan. Fortunately, with these patterns this is a rather easy thing to do.

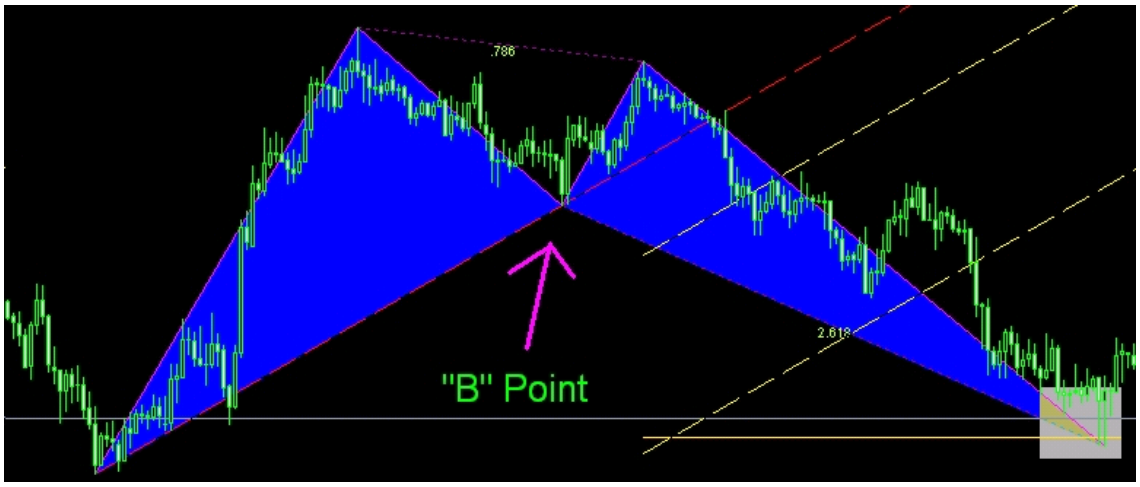
Begin by looking at how large, in pips, the PRZ is. The software does this automatically for you on both the top left and bottom left sides of the chart.



Now simply look up how much you need to risk. Stops should be set somewhere between 13-34 pips outside of the PRZ. For instance, if you have a bullish PRZ that starts at 1.5100 and ends at 1.5050, then stops should be no closer than 1.5037. For calculation purposes, assume your average entry price is going to be the 50% level within the PRZ.

In the above example, our average entry price is going to be 1.5075, the bottom of the PRZ is 1.5050 and we are going to give it 20 pips of “breathing room” for the stop. So our stop will be at 1.5030 for a total risk of 45 pips (50 pip PRZ / 2 = 25 + 20 pips breathing room for stop = 45pips of total risk). Now that we know the risk, we need to calculate the potential reward and then compare the two numbers.

For calculation purposes we use the B point within the pattern. The B point is the center, or “heart,” of all of the patterns.



In our example above, we will assume that the B point is at 1.5200. So, if our average entry price is 1.5075 and the target is 1.5200, then we are trying to make 125 pips on the trade. Next, we simply divide the potential reward by the risk (125 / 45 = 2.7). This means you are attempting to make 2.7 dollars for every dollar at risk.

This does not imply that you will realize the full profit on any trade; it is simply a way to calculate this in a uniform way so that you can compare apples to apples so to speak. For you to consider any trade, the minimum value should be 1.5.

You should NEVER take a trade that has less than 1.0. Doing so is called "negative expectancy" in math and is an almost guaranteed way to lose!

Let's review why risk vs. reward is so important to understand. It may seem complicated at first, but with a little practice you will be able to do all of these calculations in your head in the blink of an eye.

All you really need to do once a pattern is identified is simply look at how big the PRZ is. This represents your risk. Compare that risk to the potential reward, which again is just the distance between average entry price and the B point. Then compare those two numbers and see if the potential gain is 1.5 times or greater than the size of the potential loss. If it is, you have a trade and if not then you don't.

Scaling of Orders

Another risk management technique that almost every professional trader uses is Scaling orders. Scaling an entry order is really nothing more than taking your max trade size and, instead of placing that as one lot, breaking it up into a number of smaller lots.

You then also spread those orders around within the PRZ in such a way that if all are filled we end up with an average price that is close to the 50% level of the PRZ. Whichever scaled orders end up getting filled, the average price between them all is our average entry price.

So, to use the same example again, our PRZ was 1.5100 to 1.5050. If we assume that our max trade size is 100K we would instead place three 30k lots every 20 pips or so: 1.5100 first entry with 30k, 1.5080 scaled order for another 30k, and 1.5060 scaled order for the last 30k.

We do this for a number of reasons. First, the PRZ is a zone and not an exact point,

and we never really know where within that zone the turn will happen. So, by breaking the order up and spreading it around, we are able to simply place our orders in advance and don't have to stare at the screen waiting for the exact turn (which you can never really know except in hindsight anyway).

This does mean that sometimes you will only get one of the levels filled and, therefore, have a smaller trade on, but this too will average out after enough trades. You can always add to the trade as well if you did not get all scales filled. Also, notice that the scales only add up to 90k when my max was 100k. Remember, less is more and if you need to round, always round down on your position size.

Proper Trade Management

Once you have a real trade, your next focus should NOT be making money…yet. The first thing you need to do is reduce, and ultimately remove, the risk from the trade as it works in your favor.

Once you have moved stops to at least break even, *then and only then* can you begin focusing on the money-making side of the trade. We use whichever of the two rules gets us to break even first:

If the market moves 50% of the way towards the B point of the pattern, we move stops up to break even. In the example above, the B point was at 1.5200 and entry was 1.5075, so 50% level would be 1.5137 which is 62 pips above our average entry price.

The other rule is to move stops to break even once the original amount of risk has been overcome. In the example, we had 45 pips in risk, so once the market moved to 1.5120 (which would be a 45 pip gain from our average entry price) we move stops to break even.

In this example we would have moved it to break even when price moved to 1.5120, since, at that price, the original amount of risk has been overcome which happens sooner than hitting the 50% level (rule #1).

Once the stops have been moved to break even and the risk has been removed, you can begin scaling out of your trade by exiting part of the trade at the current price and continue exiting parts of the trade until the B point or stops are hit. Once the target is achieved, you should exit the majority of the trade and lock in profits on any remaining lots by moving stops further in your direction to protect profits.

Occasionally the markets will continue on much further than the B point that we targeted, so having a lot or two on with stops at breakeven or better and holding on in the event that it does make that big move is advisable. But the vast majority of your trades will be singles and doubles. Do not always try to hit the homerun!

Successful trading comes from the consistent application of the above principles. So, in review, after a pattern has been identified, simply compare the risk-reward ratio and if it works out to at least 1.5:1 then you can take the trade.

Make sure you are keeping your risk below your maximum and make sure your maximum is a very small fraction of your overall account. Keep leverage low and be patient.

You will have losing trades along the way. Do at least 100 trades with these rules and then analyze your results.

Calculate and compare your winning trades (including all breakeven trades) with your losing trades and hopefully you will have something at least better than 50/50 win loss ratio. It may not be the 70% shown above, as that is the long-term average and a sample size of 100 trades is very small.

But even just 50/50 can be good enough if your average winner is greater than your average loser, which it should be. To calculate that, simply average all your winning trades including any breakeven trades. Then average all your losing trades and compare those two numbers.

The ratio may not be huge between them but even if you are only wining 1.01 and losing .99 with a 50/50 win loss ratio you could become a millionaire with enough trades. Continually review these numbers every 50 – 100 trades to be sure everything is on track.

If you do not have favorable results after 100 trades, if you are an Inncer Circle or Harmonic Mastery Mentoring Program member, then email me your trade history and I will personally review it and offer suggestions for improvement.

If you are not an Inner Circle or Harmonic Mastery Mentoring member, please visit

http://www.forextradersdaily.com/InnerCircle/mentor or

http://www.forextradersdaily.com/InnerCircle/ to learn more or to get started.

End of Part 1