



Slipka Trading Group, Inc.
The Novice Traders Broker

Special Report

Two-Legged Trading Strategy Improving the 1-2-3 Approach

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What is the Two-Legged Trading Strategy?

I am now starting my 36th year trading commodities. During my career as a trader, I have noticed a trading pattern that occurs quite regularly. I call it the Two-Legged trading pattern. I believe that often a market moves in two legs. The first leg may come out of some double-bottom low for instance. It may, for example, move up 8 points, over 15 days, at a 45 degree angle. It will then correct by amounts usually equal to 25%, 33%, 50%, 61%, and 66% of the initial move. These are common percentages that technical traders consider significant mathematical numbers. Of course they may be significant simply because so many traders think they are, and thus they create a self-fulfilling prophecy. Regardless of why, the fact remains that it happens. (You'll see this more in a moment).



Chart 1



Chart 2

After the correction occurs, the market then puts in a second leg. Often this second leg is almost identical to the first one. In our example we used a market that was up 8 points, over 15 days, at a 45-degree angle. This is what we would expect the second leg to do. Occasionally, markets will add a third leg and even a fourth one, but these are generally shorter, and don't last as long. Some might argue that the Two-Legged formation is merely a subset of an Elliot Wave pattern. While that may be true, I consider the Two-Legged pattern much less complicated, very easy to recognize, and simple to trade.

The Two-Legged pattern can also be the beginning of a 1-2-3 setup. In fact, it starts out looking like the 1-2-3 trading strategy, but the rules for trading it are a bit different. I do believe though that the rules of the Two-Legged Trading Strategy can be superimposed on the 1-2-3 program to improve the latter's performance.

To see what a Two-Legged pattern looks like, refer to Charts 1 & 2. Chart 1 is the March 2004 Sugar contract. Notice that a double bottom was formed from the lows of 10/13/03 and 11/3/03. The 5.82 low of 11/3/03 marks our 1-point. Over the next 17 days the market moves up at a 60% angle to a 2-point high of 6.46 on 11/20/03. This is a price appreciation of .64 points. From the 6.46 high, the market corrects to our 3-point low of 6.10 on 11/25/03. This is a .36 point retracement of our up move, and as a percentage, equals 56%, a little more than half.

We now have enough information to predict the high of the second leg, should it come. From the low of 6.10, we add .64 points (the amount of the first leg), to get a predicted high of 6.74. This should occur roughly 17 days after the 11/25/03 low, which would be on 12/12/03.

So how did we do? The high of the second leg was 6.79 and occurred on 12/10/03. Not bad. Now let's look at another example.

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Chart 2 is the March 2004 Lumber contract. A double bottom low was formed from the two lows of 10/20/03 and 11/6/03. The 11/6/03 1-point low was 283.40. The market then moves up over 19 days to a 2-point high of 326.40 on 11/25/03. The total advance was 43.00 points. The market corrects to a 3-point low of 293.40 on 12/11/03. This is a 33.00 point or 77% retracement of the first leg. This retracement was more extensive than most.

We can now measure our profit objective. We add 43.00 points to the 3-point low of 293.40. This gives us a target price of 336.40, which should occur around 12/30/03. On 1/6/04 the market exceeded our target by .10 points when the market hit a high of 336.50. This objective occurred seven days later than expected. I suspect that was in part caused by the effects of the New Year's holiday.

What are the trading rules for the Two-Legged Trading Strategy?

The rules are quite simple. For a long position, after seeing a double bottom low, measure the distance of the first significant up-leg. Initiate the first buying position when the market corrects 40% of the first leg, measuring from the high of the first leg. Add a second position at the 60% retracement level, and place your sell-stop at the 80% level, should the market correct this far.

In our sugar trade, we would have had orders to buy at 6.20 and 6.08, with a stop at 5.95. The

market low was 6.10, so you would have owned only the first contract buy at 6.20. Our stop was not hit, and we only had to risk .10 points (6.20 entry – 6.10 low) on this trade. Our objective of 6.74 was achieved. This would have created a .54 point profit. The reward/risk on this trade was 5.4:1, which is excellent.

For lumber, our buying points would have been 309.20 and 300.60, with a stop at 292.00. The market low of 293.40 got very close to our stop, but held. In this example, we would have entered the market at both buy points (309.20 and 300.60), for an average entry price of 304.90. This means we would have had a risk of 11.50 points per contract. Our profit objective was reached for an average gain of 31.50 per contract. This trade would have produced a 2.7:1 reward/risk ratio, which is very good and more than meets our minimum money management criteria of 2.0:1 reward/risk.

One additional rule that I want to add is this. Once in the trade, if the market breaks out of the 2-point high, then raise your stop to breakeven. Further, as you approach the profit objective, raise the stop again, to the number 2-point.

For short position simply reverse the above rules.

Now nothing is perfect, and the risks can be relatively high with this trading approach. For instance, while the risk for the above sugar trade was small, only .10 points or \$112.00, the risk for the lumber was much larger. At 11.50 points, which equals \$1,265 per contract, times two, this means you would have seen a drawdown in your account of \$2,530 at the worst point in the trade. This must be taken into account when considering trading this program.

Further, I would predict that only 40% of these trades will be successful. However, past performance is no guarantee of future results. I would suggest that you track the recommendations I will put out and see for yourself.

At 40% winners, this means that you could suffer a series of consecutive losses that could cause a considerable drawdown in your account. Therefore, you must remember that futures' trading involves risk and may not be for everyone. However, we have designed this system with good money management criteria in mind. We have targeted a 2.7:1 reward/risk performance criterion as a minimum requirement for success. This is the level required for a system that produces 40% winners. If we meet this performance requirement, we will have a successful trading program.

I will soon begin publishing, on a regular basis, my Two-Legged Trading Strategy recommendations and send them to you. If you would like to not receive these alerts, please let us know.

If you have any questions you can call me at 800-481-1613 or email me at peter@slipkafutures.com.

Kindest regards,
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Commodity futures and options investing is speculative and involves substantial risk of loss. Only risk capital should be invested. Commodity futures and options trading is not for everyone.



Chart 1



Chart 2