Spotting Breakouts As Easy As ACD

By Matt Blackman
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Trading guru Mark Fisher is no ordinary market player. The system he teaches is the one he and his 75-plus traders at MBF Clearing Corp. use to make a living on the New York markets day in and day out. Trading everything from basic commodities such as natural gas and crude oil to volatile stocks, his traders brave the commodity pits or work from computer terminals. Does it work? Just ask anyone at Fisher's firm what they think of the system, and they'll tell you it does. (For more on his trading strategies, please see *Market Reversals and How to Spot Them*.)

The Basics

Fisher describes his ACD system and how it works in a book entitled "The Logical Trader". Unlike many in the business of helping traders, he is quite happy to share the system he uses because he believes the more people there are using it, the more effective it will be.

Basically, his system provides A and C points for entry of a trade, and B and D points as exits - hence the name. It is a breakout strategy that works best in volatile or trending markets with a special group of stocks and commodities (those with high volatility work best). He frequently uses natural gas and crude oil as examples in his book, but he also mentions commodities like sugar and a host of stocks. These references are good tip-offs on the kind of markets for which it is good to use the ACD.

Figure 1 – S&P500 Index five-minute chart. Chart provided by Metastock.com. Intraday data by eSignal.com

In the S&P 500 Index five-minute chart in figure 1, which shows the first ten trading days of Mar 2004 with ACD signals, the opening range (OR) (blue lines) is calculated using the range of the first 15 minutes of the trading day. An A up (red line) occurs when the index breaks three points above the opening range. An A down (red line) occurs when the price breaks a set amount below the opening range and stays there. Note that an indicator like the relative strength index can often help confirm buying and selling signals. A sell signal together with negative divergence makes a good sell signal confirmation - see the turndown on the eighth day of the month. If the index were to put in an A up and then break down below the opening range, the trader would reverse his or her position when a

C down was put in, 0.5 points below the opening range low.

A New System Is Born

While working on a system to trade as a graduate student at the Wharton School of Business in the early 1980s, Fisher observed the importance that the opening range held in setting the tone for the trading day. In the case of crude oil (where the opening range at the time was 10 minutes), the opening range was the high or the low of the day between 17-23% of the time. If markets were truly random, and since there are 32 ten-minute periods in the trading day, one would expect the opening range to be the high or the low 1/16 (or 6.25%) of the time (1/32 for high and 1/32 for low). Put another way, the likelihood that the opening range will be either high or low for the day is more than three times what one would expect if market movements were truly random, as has been postulated by the random walk theory. Fisher is not the only person to have discovered this fact. A number of trading systems in use today rely on an opening range for providing clues to directional bias.

Here is how a trader uses the ACD system on a given day. First, he or she monitors world markets about an hour or so before the market opens. This helps him or her get a feel for what traders around the world are doing. Next, it is important to read commodity reports. What reports are coming out today that could have a strong influence on the trader's market? A crude-oil trader, for example, would follow OPEC (Organization for Petroleum Exporting Countries) meetings for any signs of a cutback or increase in production quotas, weather reports affecting oil consumption, the weekly oil inventory report as well as the weekly natural gas storage figures.

Once the market opens, the S&P 500 Index trader, for example, follows the first 15 minutes of the market, which is the opening range (OR) used in the above example, marking high and low horizontal lines on his or her chart for the day. This trader then waits for an A up or an A down to occur. In this case, the index moves above the OR and rises a further three points putting in an A up.

The trader places a stop order and buys the index at the A up. A stop loss would be set below the low value of the OR (B-exit) so that if the market moved in the undesired direction for more than this amount once the trader is in the trade, he or she would get out - best to keep the money to trade another day. If the trade continued in the desired direction for the day trader, he or she would exit the trade near the end of the day.

AC down occurs if the A up signal is generated, but then the index trades down below the opening range. Using the lower limit of the OR (B exit), the trader would exit when this line is penetrated and reverse his or her position (sell short) when a C down was put in. AC down (or C up) moves are far rarer. They are interesting because the later in the day they occur, the more intense the move: the less time traders have to exit a trade on a reversal, the more urgent it becomes and hence the greater the volatility. According to Fisher, this is one instance in which staying in a trade overnight might be a good idea, as markets often experience gaps at the open of the following day.

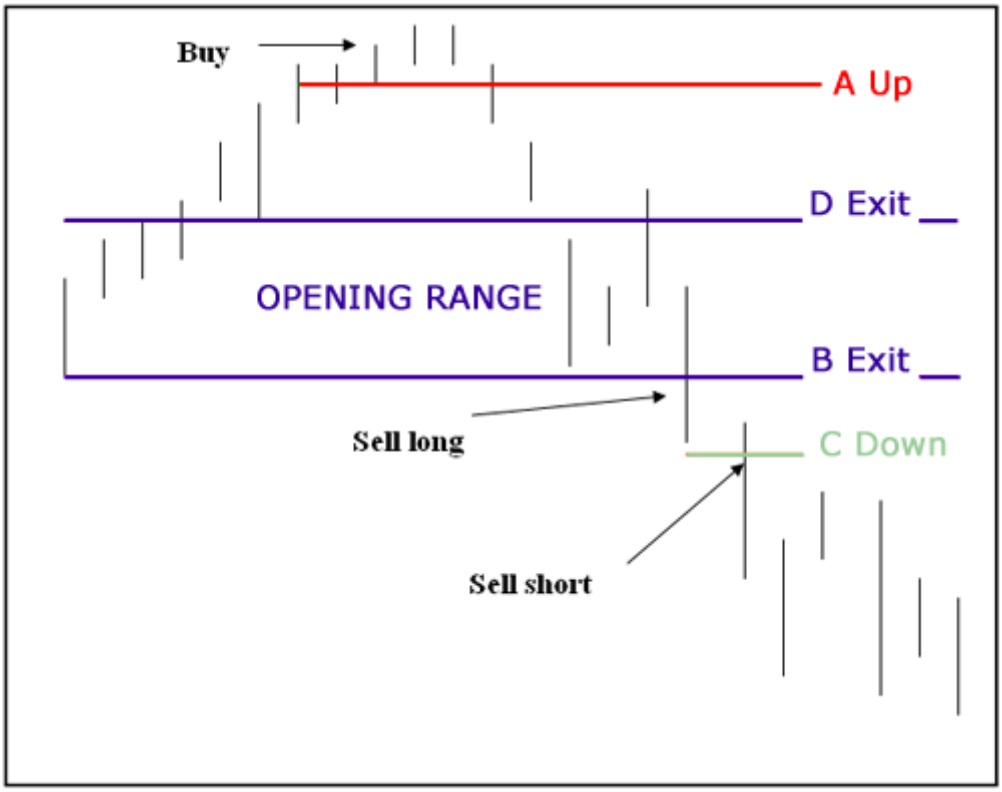

Figure 2 - Chart showing five-minute bars

In figure 2, we see a chart showing five-minute bars, opening range, an A up and C down. The trade was entered when the equity traded at the A up, exited (stopped out) when it traded below the B exit at the bottom of the opening range. A C down trade was entered with a stop (D exit) in case the index closes above the upper limit of the opening range.

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Choose Your Time Frame

The beauty of the ACD system is that it works in almost any time frame. A day trader might use a five-minute period as his or her basis for trading, while a longer-term trader might use daily data.

For a longer perspective, Fisher describes the macro ACD. This still requires reference to intraday data to determine opening range and A up or down, etc. The difference is that now the longer-term trader keeps a tally of the score each day in a running total. Fisher assigns daily values based on market action. For example, if the equity puts in an A up early in the day and never trades below the opening range, the day would earn a score of +2. If it puts in an A down and never closes above OR, he gives it a –2. His daily scale ranges from +4 to –4. A total is kept and each day the new daily value is added while the oldest score 30 days ago is removed. On a day in which the running tally is increasing, the longer-term trader would consider this bullish. The more rapidly the value is increasing or decreasing, the more bullish or bearish the signal.

A full discussion of this strategy is beyond the scope of this article, but suffice it to say that Fisher has found it to work very well in providing his traders with a macro look at the market in which they trade. Those interested in learning more are advised to obtain a copy of "The Logical Trader" or go to Fisher's website. He offers a subscription service to those who would like to get regular information on the values of A and C points on various equities and commodities, as well as details on how to best use his system.

Conclusion - Tip of the Iceberg

The principles discussed here are just a glimpse of how the ACD system works, so before using it, make sure you do more reading and homework. The system is also not a plug-and-play trading strategy that can be used on any equity. Those equities that work best for ACD are highly volatile, very liquid (lots of daily trading volume), and subject to long trends - currencies tend to work very well with the ACD system. Keep in mind that, although we used the S&P 500 Index in the above example, Fisher did say in a telephone interview that it does not work particularly well and that he believes there are far better candidates to trade with the ACD. It is also important to note that it does not work very well on low volatility equities stuck in a trading range.

If you're looking for new and interesting trading ideas to pursue and you aren't afraid to do some work, the ACD system offers another way to look at markets and a method of taking advantage of the daily volatility and trends of stocks, commodities and currencies.

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