

# Risk/reward trading using Elliott wave

By Steve Griffiths

Many traders regard Elliott wave as a technique that only projects future movement by knowledge of where in a current pattern you are at any particular time. However, because of the unpredictable nature of the markets, many Elliott wave forecasts have been less than reliable, causing many people to question its ability to forecast future movement.

However, it is my belief that this is looking at Elliott wave in the wrong light. What you should be asking is whether Elliott Wave (or parts of it) can be used to identify trade opportunities that allow the trader to enter a trade with a small controlled risk in relation to the profit potential on a new trade. This is very different from asking where will a market be at some point in the future, and then getting disheartened when it does not get there!

I have identified one specific Elliott wave pattern that allows the trader to enter a trade with a small controlled risk. This is the simple ABC correction. This simple pattern has many other benefits which I have discussed in prior articles, so in this one I would like to focus on the ability of this pattern to allow trades to be identified in which the initial risk is kept small in comparison with the potential profits. Over time this allows profits to be larger than losses which, as all traders know, is the fundamental building block for a successful approach to trading the markets.

Let's look at an example of a daily chart of the US stock CCI (chart 1). Here is a recent trade automatically found by MTPredictor (the software I have designed to identify these specific trade set-ups), and was reported at the time in the MTPredictor daily report. It has not therefore been chosen with the benefit of hindsight.

As you can see, the end of the ABC correction was identified allowing a trade entry just as the Wave C low was ending, thereby keeping the initial risk small at only 0.69 points (13.67 – 12.98). A few weeks later CCI had reached the profit target where the profit was 3.43 (17.10 – 13.67) or nearly 5x the initial risk required to take the trade, thereby making the profit large in relation to the initial risk required to take the trade.

This is how you should view profits, not just in pure dollar terms, but as a function of the initial risk that was required to take the trade. In this way you can control your trades.

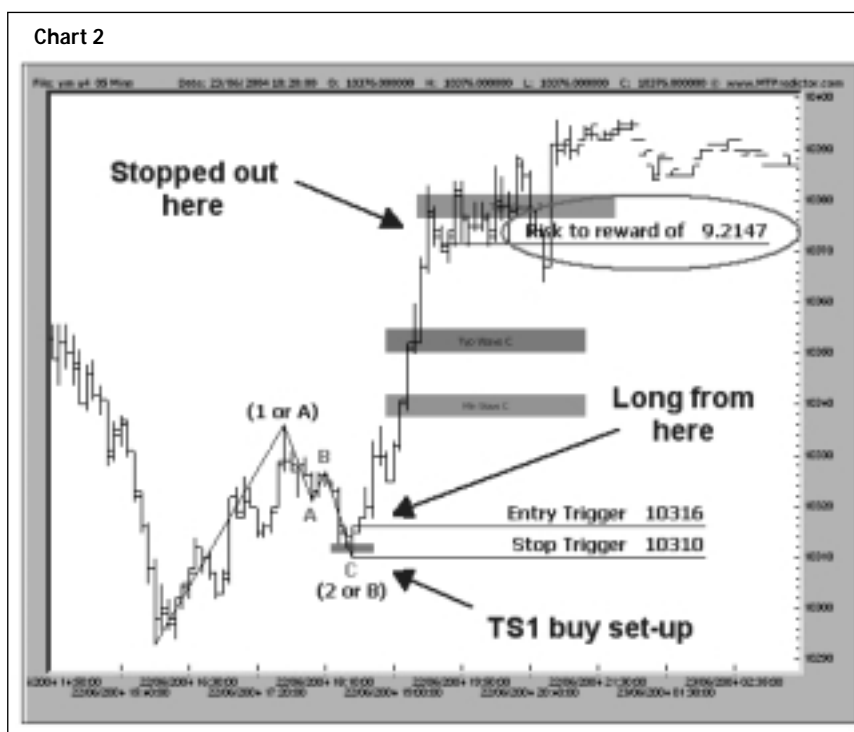
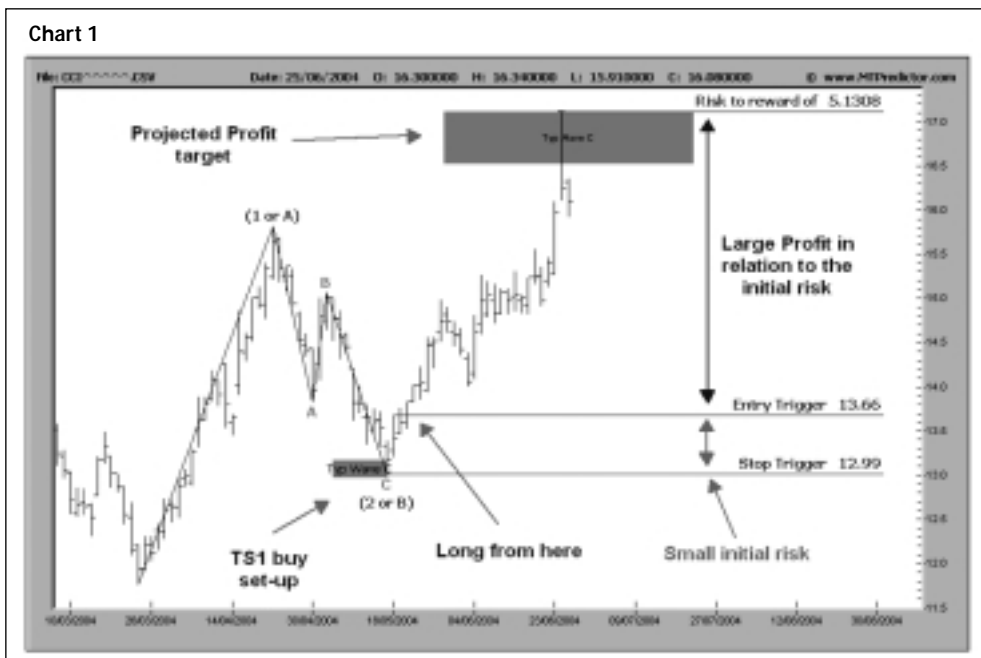
Obviously not all trades are winners; it would be foolish to think so. But keeping such losses small, when they happen, is one of the most important techniques that should be mastered when trading. There are too many traders that focus on the technical side of mastering analysis techniques and forget that trading is all about money management.

I hope you are beginning to see how if you can only identify trades in which the initial risks are small in relation to the potential profits, then it puts you on a solid foundation for a successful approach to the markets.

Chart 2 shows another example on a 5min chart of the Dow Jones:

Again, the same basic principle was applied, looking for trades where the initial risk (or loss) is small in comparison to the potential (or final) profit.

In this example the eventual profit was approximately 9x the initial risk required to take the trade (ignoring slippage and commission). The initial set-up was off the same ABC pattern as the CCI example earlier. However, the most important point is the size of the profit, again, not in dollar terms, but in relation to the initial risk required to take the trade.



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