The Awesome Trading System
(3rd Edition)

By Victor Chan Wai-To

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Warning: There is a risk of loss in trading. The content of this e-book is educational and it does not guarantee you to make profit in trading. You are responsible for your own trading decisions and outcomes.

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Update in the 3rd Version

Here are the updates of the 3rd version of the awesome trading system (in November 2010):

- Added an overview of the system at the start.
- More specific rules for automatization of the trading system.
- Added a part for research focus in the current development.
- Non-rules parts are reduced.

Introduction –
The Very First Step

After winning the 1984 US Trading Championship, market analyst Robert Prechter wrote an article (1986) about the five things which he considered essential for successful trading. Among the many things, the very first one is a method:

"I mean an objectively definable method. One that is thought out in its entirety to the extent that if someone asks you how you make your decisions, you can explain it to him, and if he asks you again in six months, he will receive the same answer."

Prechter (1986) also commented that "a simple 10-day moving average of the daily advance-decline net, probably the first indicator a stock market technician learns, can be used as a trading tool, if objectively defined rules are created for its use."

This is what I have in mind when I created the Awesome Trading System. I want to layout a simple trading plan for a beginner to have something to start with, so that they can immediately fulfill the first element of successful trading – having a system with well-defined rules.

However, because just having a system is not enough. The second half of this ebook is devoted to some practical tips of trading, and hopefully it will convince you the importance of money management and being skeptical of your own ability to make money.

To assist you carry out the system on a daily basis, in the appendix there are two daily spreadsheets which help you follow the markets everyday with this trading plan. Writing your own trading journal everyday with this spreadsheet is simply the best way to improve your result.

Good luck with your trading.

Victor Chan Wai-To
August 2010

Overview and the Indicators

The Awesome Trading System is a short-term trading system, where average trades last about 1-3 days. Basically, it is a contra-trend trading system, and the idea is to buy dips in an up move, and sell rallies in a down move. It has conservative entry criteria and does not trade very often, so that sometimes it can actually miss a big move. The positive side is that it does show consistent profit if correct money management is applied.

The ideas presented in this system are by no mean novelty. They are an accumulation of wisdom I have collected from different traders in the past. That being said, there are also original thoughts on my part. For example, my use of the indicators is quite different from the original rules outlined by their creator (i.e. Williams, 1995, 1998), as you can see below.

The Awesome Trading System uses two indicators: the Awesome Oscillator (AO) and the Accelerator Oscillator (AC). Both were developed by Bill Williams (1995, 1998). For most of the trading platforms nowadays, including Meta-Trader, these two indicators are already included in the default indicators, so you don't have to worry about programming them yourself.

That being said, here are the formulae of both indicators.

The Awesome Oscillator (AO):

AO = 34-Bar Average of Median Price – 5-Bar Average of Median Price
Median Price = (High + Low) / 2

The Accelerator Oscillator (AC):

AC = Present Value of AO – 5-Bar Average of AO

In this system, AO is used to determine the underlying trend and AC is used to determine short-term over-bought or over-sold conditions. They are very different from the original use by Williams.

The Rules of the System

Timeframe:

The system works best with daily charts. For spot currencies, it is best to use broker with GMT, as the closing price plays an important part in the system.

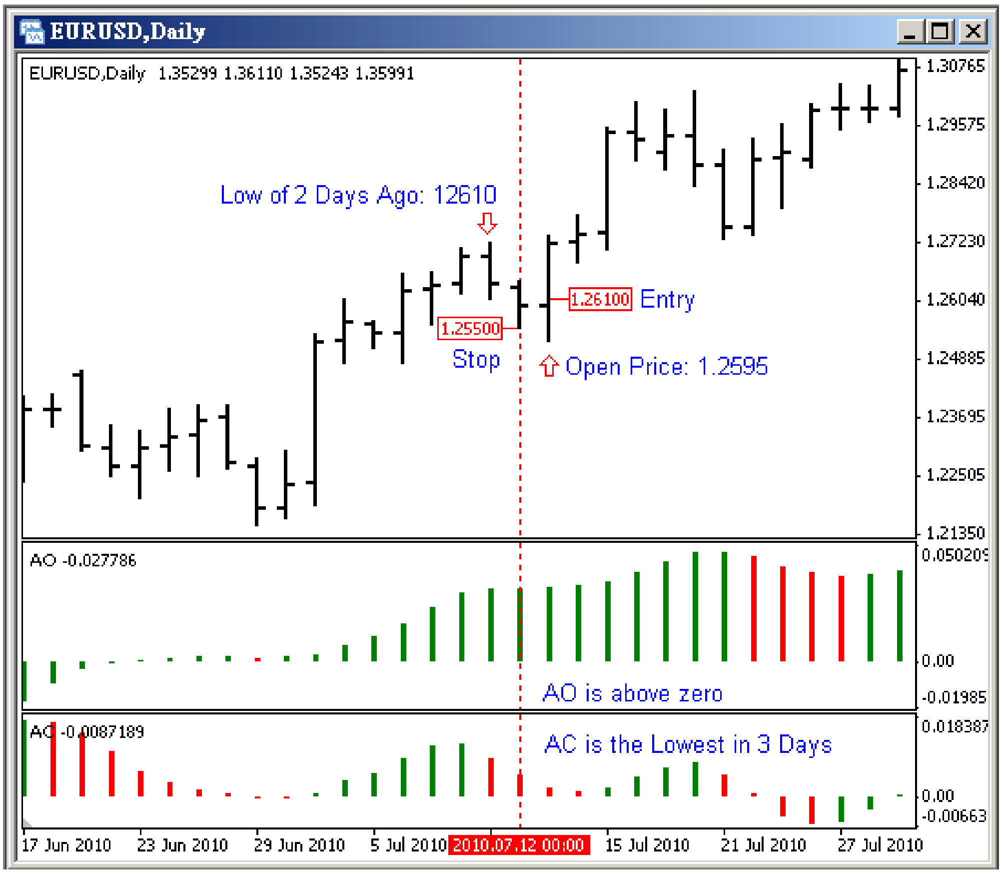
To save space, below are the rules for long. For short just do the opposite.

Entry Criteria:

A. The value of AO of the last closed bar (i.e. yesterday's bar) is above zero.
B. The value of AC of the last closed bar hits 3-day low.
C. The current open (i.e. today's) is below the low of the day before yesterday.

If the above three criteria are met, place a buy stop ("buy-if-hit") at the low of the day before yesterday, and an initial stop at yesterday's low.

Here is an example of a long setup on 12th July, 2010, where long entry was made at 1.2610 on 13th July 2010:



Unfilled Order:

Cancel an unfilled buy stop order when:

I. AO goes below zero, or
II. A more recent buy entry level appears at a lower level.

Targets:

In this system, target is expressed as a multiple of the stop loss distance. If the target multiple was 2, and the stop loss distance is 50 pips, then the size of the target will be 50 x 2 = 100 pips, as easy as that.

Look at the above example again. The stop was at 1.2550, and the entry was at 1.2610. If the target multiple is 2, then target would be at [1.2610 + (1.2610 – 1.2550) x 2] = 1.2707. Research has shown that, over the long haul, a target multiple ratio of 1.5 – 2.0 is best. If you are more confident about the strength of the trend, use a higher multiple.

Yes, you may exit too soon some times, as in the example above, but there is little perfection in this business.

Trailing Stop:

Sometimes, after entry, the price may initially move into our favor, but then suddenly it reverses and goes the other way. Here is a trailing stop system that protects use from such kind of reversals.

- Wait for a daily low to form above the initial stop loss level. Call this low A.
- Wait for a higher low to form above A. Call this low B.
- When a low higher than B appears, call his low C, and so on.
- The rule is: when B appears, trail stop to A. When C appears, trail stop to B, and so on.

Money Management

"What more can I tell you? You have just been handed the keys to the kingdom of speculative wealth."

— *Larry Williams (2006), on money management.*

Money management is a very important element of trading, because it protects us from the unexpected giant drawdown that had eaten many traders alive. Here are the formulae used in the Awesome Trading System for determining lot sizes:

<u>For Spot Markets:</u>

Lot Size (Long) = (Risk % x Balance x Stop) / (Entry – Stop)
Lot Size (Short) = (Risk % x Balance x Entry) / (Stop – Entry)

<u>Example:</u>

Suppose your account balance is $100,000 and 5% is the maximum risk in each trade. In a trade you longed EURUSD at 1.2260 and placed an initial stop at 1.2140.

Lot Size = (5% x $100,000 x 1.2140) / (1.2260 – 1.2140)
= 500,000 (round down to the nearest standard lot)
= 5 standard lots or 5:1 leverage

<u>For Spread Betting or Futures Markets</u>:

Spread betting or future markets do not calculate again or loss by percentage, instead there is a specified dollar-per-point amount in each kind of contract, so the formula is modified:

Lot Size = (Balance x Risk % x Minimum Unit) / |Entry – Stop|

Using the same example as above, but this time in a spread-betting account with a minimum bet size of $10 per unit (0.0001):

Lot Size = (5% x $100,000 x 0.0001) / (1.2260 – 1.2140)
= $40 per unit (round down to the nearest $10 per unit)
= 4 times of the minimum bet size

Conclusion –
Under-trade and Under-bet

"I teach students to look for an 80/20 trade. That means that you should feel in your gut that you have a 4 in 5 chance of winning as the trade sets up. People fail as traders because they take these 50/50 or 60/40 trades that look 'okay.' You can't really make any money on a long-term basis making trades like that."
– Dick Diamond (in an interview with Elliot Wave International, undated)

Now I have given you a system. In theory, you just have to trade the system and you will get rich in the end. But things are never that simple, otherwise everyone is rich. The reason is: the future never behaves like the past. You cannot predict what will happen all the time. This is a critical truth that you should know.

The best traders are not dogmatic about following the rules. Curtis Faith, the most successful student of legendary trader Richard Dennis, recently wrote a book (2010) on how you should combine your common sense with your rules. Similarly, currency trader Dirk du Toit (2009) also expressed his hatred for mechanical rules. Of course there are trend followers who claim to follow their rules religiously, but they actually constantly test and modify their rules, something that we never have time to do.

It is why you should have the courage to suspend trading when it is necessary, and stick to money management. In closing, please read the following comment by the famous trader Larry Williams (2006):

"This is the way life as a trader works: we develop a system or trading strategy, polish it off and start trading expecting the future to be like the past."

"It never will be, ever. And seldom will the future be better."

"Thus, what we need to do is under-bet our system or approach. Do not put as much money behind the system as the numbers from the past suggest you can. For most of us a 5% risk factor is all that 's needed to do rather well in this business."

"Under-trade, under-bet and you will be overwhelmed with your results."

Research Focus

Currently our research on the system is focusing on the following areas:

- Time stops:
  Instead of using fixed targets, we are experimenting with the use of time stops.
- Day of week:
  Is it equally profitable to enter on Monday as on Friday? We would really like to know.
- Multiple exit:
  Is it better to spread out your targets bit-by-bit instead of closing it all at the same time?
- Trend filter:
  We believe that we can use a much better trend filter than the Awesome Oscillator to filter out ranging periods. At the moment, we are playing with the Alligator (yet another indicator by Bill Williams).

We do want programmers with MQ4 programming experience to join us in the research. If you know MQ4 and are interested, please contact us at victor.chan@bristolalumni.org.uk.

● References

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Appendix 1: Daily Spreadsheet (Currencies)

Date: ____________________

Pairs	EUR$	$JPY	GBP$	$CHF	$CAD	AUD$	NZD$
AO (+ or –)							
AC:3-day low (Yes/No)							

Date: ____________________

Pairs	EUR$	$JPY	GBP$	$CHF	$CAD	AUD$	NZD$
AO (+ or –)							
AC:3-day low (Yes/No)							

Date: ____________________

Pairs	EUR$	$JPY	GBP$	$CHF	$CAD	AUD$	NZD$
AO (+ or –)							
AC:3-day low (Yes/No)							

Date: ____________________

Pairs	EUR$	$JPY	GBP$	$CHF	$CAD	AUD$	NZD$
AO (+ or –)							
AC:3-day low (Yes/No)							

Date: ____________________

Pairs	EUR$	$JPY	GBP$	$CHF	$CAD	AUD$	NZD$
AO (+ or –)							
AC:3-day low (Yes/No)							

Appendix 2: Daily Spreadsheet (Blank)

Date: ____________________

Markets							
AO (+ or –)							
AC:3-day low (Yes/No)							

Date: ____________________

Markets							
AO (+ or –)							
AC:3-day low (Yes/No)							

Date: ____________________

Markets							
AO (+ or –)							
AC:3-day low (Yes/No)							

Date: ____________________

Markets							
AO (+ or –)							
AC:3-day low (Yes/No)							

Date: ____________________

Markets							
AO (+ or –)							
AC:3-day low (Yes/No)							