Learn to Trade Breakouts Like a Pro

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Trading breakouts are one of the simplest trading strategies you can apply to make some quick profits in the market. However, if you do not know how to trade breakouts the right way, this simple thing may turn out to be the most challenging and confusing strategy. After all, simple is often not as easy as it sounds.

Since most asset prices, including Forex pairs, tend to stay within a tight range for the majority of the time, trading breakouts are often compared to fishing. With fishing, you know that there are abundant fish in the water, you just need to be patient. Similarly, as traders, we are aware that the market consolidates like over seventy percent of the time and a breakout in either direction is going to happen sooner or later, we just need to be patient about it.

Beware of Bull Traps and Bear Traps

Besides a lack of patience among beginner traders, they are also prone to get fooled by market makers who love to create false breakout and creates “bull traps” and “bear traps.”

How many times have you seen the price breaking above the range, but the next day, it not only resumed the consolidation? Well, if you have placed a buy order as soon as the price broke above the range, and took a loss, then you were a victim of a bull trap. By contrast, if you placed a short order after the market broke below the range, then found that it was a false signal as well, well, that is called a bear trap.

You see, large institutional and professional traders often have more access to information than the retail traders like ourselves. We rely on news, but before someone writes the news, these big players get that same information, and they get to act faster than us. When a trader at a large bank know that news would turn the Forex pair bearish 20 seconds earlier than everyone else, he or she can manipulate the market with large orders to create a false impression that the market is going up. As soon as the news is released to the public, the asset price will resume its logical course.

Meanwhile, the trader at a bank can get into the trade at a much better rate because of the initial deceit. While it sounds morally wrong, Forex is a free market and this kind of strategies are very common and accepted way to “trap” smaller traders.

Falling for a false breakout is part and parcel of your trading career, and you need to accept that you will lose a few trades here and there due to these false signals. Professional traders also often lose money while trading breakouts. The difference between beginner and professional trader is; professionals have a strategy to identify a false breakout, and they lose very little capital when they are wrong. On the other hand, when they are right, they win big to make up for those small losses and come out as a winner after a series of trades.

How to Avoid False Breakouts and Trade Like a Pro

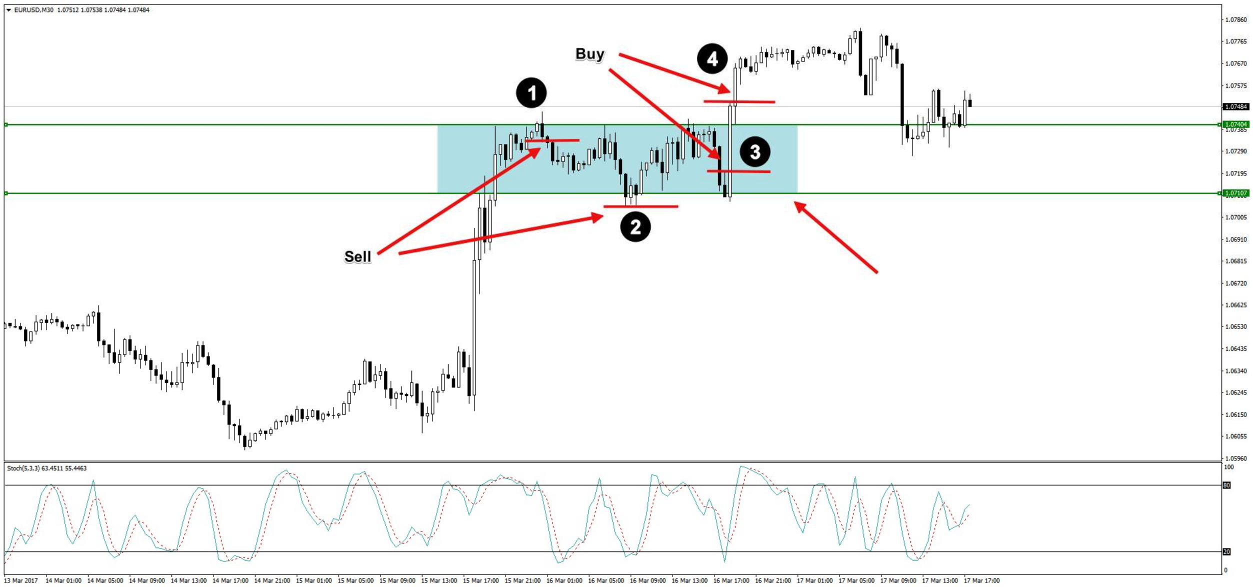

Figure 1: How to Trade Breakouts Like Professional Traders

If you are placing a market order to enter the market as soon as the price of the asset penetrates outside the range, then you are trading breakout like a novice trader.

There are two ways to trade a breakout properly. You can buy low at the bottom of the range like the trade no. 3 in figure 1, or sell high at the top of the range like trade no.1, where the price was rejected by the support and resistance, respectively. Here, you would enter at the break of the previous candle.

This way, you are hoping that by the time the price would break out, your trade would already be "in the money." If you had taken trade no. 1 in figure 1, by the time the price penetrated below the bottom of the range, your trade would have made some decent profit on the trade. If the breakout is false, as it is, you will not lose any money. A similar situation happened with the third trade, where you would have bought at the bottom of the range, and when the real breakout happened, you were already in a risk-free trade!

The second way you can trade breakouts is waiting for the price to actually break out of the range. However, instead of buying or selling as soon as the price penetrates above or below the range, you should wait for the price to close above the range first. Once the price has closed above the range, you should place a pending buy order above the high of the bar that broke out, as we did in trade no. 4 in figure 1.

Similarly, when the price broke and closed below the range, you should have placed the sell order once the low of the bar that closed below the range, like in trade no. 2. However, in this case, the price did not penetrate below the low of the bar, and turned out to be a "bear trap." Regardless, your pending sell order would not have triggered, and you would not lose the trade!

Conclusion

If you follow the two methods we discussed by illustrating four sample trades in figure 1, your win rate would be way better than most traders trying to trade breakouts in the market. However, you need to keep in mind that trading breakouts, like any other strategy, ultimately depends on your money management strategy.

If you can maintain a 70% win rate, which is very likely, if you trade the way professional traders do and yield a reward to risk ratio of just 1:1, you would still be more profitable than 95% of the traders, who consistently lose money.