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Want to Survive Trading? Understanding Support and Resistance is key.

When it comes to trading effectively, there are many different strategies that work. Trend trading(see our lesson on that), counter trend trading, short term day trading, swing trading, penny stock trading, blue chip stock trading. There are many more. At F&C we preach that trading strategies usually work well on certain sets of stocks, or on certain time frames. This is usually true and as you progress and start to develop your own personal trading strategy, you'll start to see on what assets your strategy works best, and on what time frame as well. With that said, there are some fundamentals to trading that all traders must understand, and that most traders use in one form or another. Support and resistance (S&R for short) is one of those fundamentals. Unlike highly tailored strategies that require customization, support and resistance is one of the tried and tested basics and it is a good place to start if you are new to trading. As you progress as

a trader, you will see that S&R will follow you along in the journey and will provide you with quality market information, even at very advanced levels of trading. Why is this so?

Support and resistance is part of what traders call price action trading. What price action trading is, is a form of trading that does not rely on indicators, like Bollinger Bands, Oscillators, MACD, etc. Price action trading, also called naked trading, uses only the information found on the chart, without any overlays. Surprisingly, this form of trading is the simplest and also one of the most effective, used by beginners and experts alike. S&R is part of price action, and this is why it is at the cornerstone of many much more advanced strategies. Learn it well, and you will have a tool in your trading tool box that you can use for years to come.

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Price Action - *Definition: The actual movement of a securities price, as shown on a chart. Price action trading attempts to put order to the movements of the securities by using highs, lows, and consolidation areas as areas of support or resistance*

What actually is support and resistance? Well, there are a couple of definitions, But the one that is truly important to traders is: support levels are areas where falling price action is likely to pause, take a breather, and either continue lower, or

revert and head upwards. Depending on larger time frames (take a look at our lesson on trading via top down analysis), these are areas where a long trade may be appropriate, or where a short trade may be appropriate if price action breaks the support. We call this a short sell breakout. Figure 1 puts this idea into perspective. In figure 1 we can see a green triangle. That area represents a

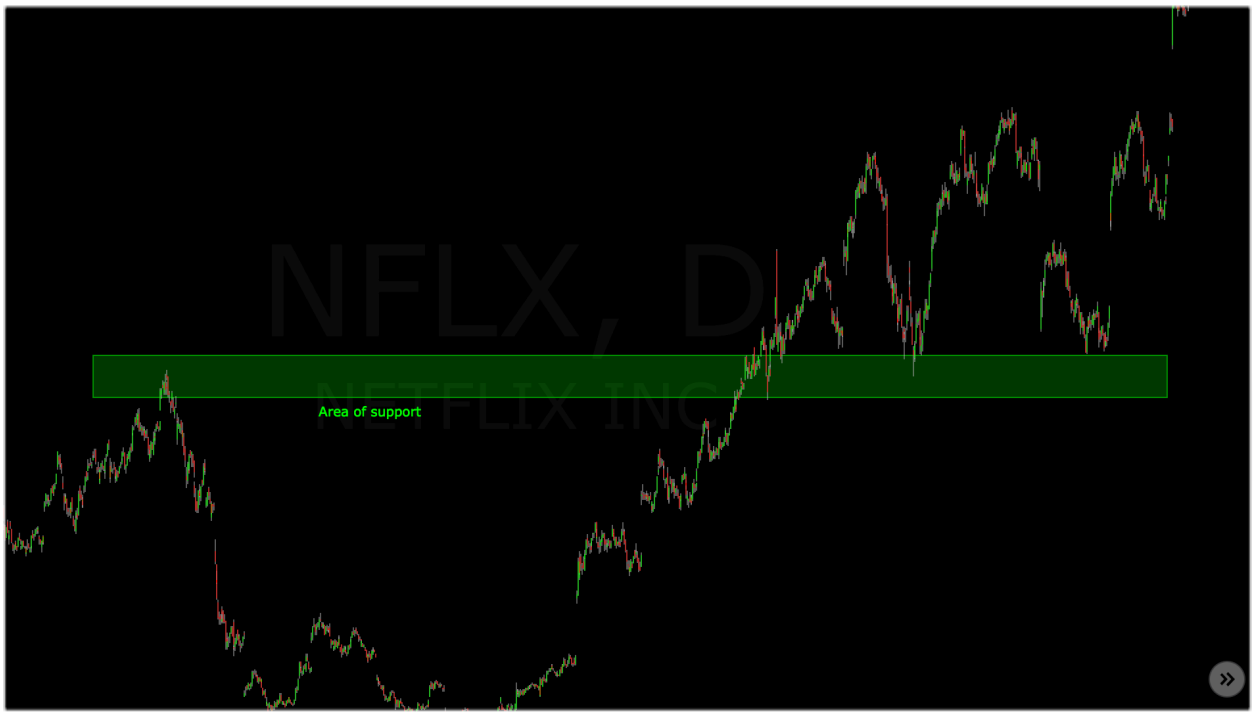

FIGURE 1 - CHART PROVIDED BY TRADINGVIEW.COM

support level. At the left of the screen, price action makes a relative high. Price then dips below that level. As price action reverses and begins to trend upward, we can see how previous highs can become support once price action moves above them. Once price action crosses the relative high, shown by the green rectangle, what happens? Well, price falls once, and then a second time, both

times stopping at the green rectangle before continuing higher. This is a level of support and it is a good place to enter long position trades when price action touches these levels.

What about resistance? Well, lets take a look at the same chart, but this time, lets add a red rectangle, representing a resistance level. This is shown in figure 2, below. In figure 2, we can see another relative high, shown as the first high after

FIGURE 2 - CHART PROVIDED BY TRADINGVIEW.COM

the previous high in the green rectangle. This new high represents an area that could potentially become support or resistance. We do not know until the market

shows us (side note, always keep that in mind. You don't know anything until the market confirms it. Do not let your ego get in the way of trading. Let the markets guide the way). As price action then falls, and comes back up to the high, what happens? Price action struggles to move higher. It stays within the red rectangle and tries to break free 1, 2, 3 times and finally, on the 4th attempt, it breaks higher. What can we learn from this? One, we can learn that previous highs can either be support or resistance. This brings me to another point: once resistance is broken, it usually becomes support for price action that is trading above it. Same with support: if price breaks below support, that support level will usually turn into resistance. Two, we can also learn that once price action breaks passed a level of resistance, as it did on the very far right of the screen, price action usually continues higher. Three, how do we trade this? Well, lets start with the left of the screen and move right.

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First we have a high put in at the green rectangle. Of course, at the time we have no idea it will be the high, but as price falls below, we take note of this high. Price continues and reaches the first high again, show when price first reenters the green rectangle at the right of the screen. We could have easily estimated that this could have been a level of resistance, since price was bellow it. If we would have entered a short, this would have been a losing trade since price continued higher. That is okay. As long as proper risk management and stop losses are used (refer to our lessons on both of those) losses in trading are completely normal and part of the game. As price breaks the first high, and our stops are

triggered, it would have been smart to switch positions and go long. Why? Because once a high is broken, it usually changes from resistance to support, just like the high in the green rectangle did here. This would have been a winning trade. If we missed this trade, we could have also taken a trade once price retraced back into the green rectangle. Why? Because we know at this point that the high in the green rectangle represents support. We would have had two chances to go long, since price retraces back into the green rectangle twice. Okay, those are our trade opportunities in the green rectangle. What about in the red rectangle?

Well, price first enters and puts in a high where the arrow is pointing in figure 2. Nothing we really can do about that. Price then falls downwards, back into the green rectangle, but we already talked about those trades. We are focusing only on the red rectangle. What happens next? Price moves back up and enters the red rectangle for the second time. At this point we can assume that the previous high (the one the arrow is pointing at) is going to be resistance, since price actions is trading under it. Guess what? Bingo, the high acts as resistance. Price breaks only ever so slightly above the high before crashing down. This would have been a good short trade. Price then enters the red rectangle again, once again breaking slightly above the highs before crashing back down. This time it crashes all the way back down, touching the top of the green rectangle. Another excellent short trade opportunity. What happens next? Price enters the red rectangle again and again it crashes down. Another good short trade. Then again

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the price reenters the red rectangle and following 3 good trades, we would most likely have traded it short again. This time though, price breaks through and continues higher. As long as we had stop losses in place, we would have been stopped out and would have taken only a small loss. Nothing compared to the profits we would have made from the successful trades.

What does this tell us? For one it tells us that taking losses is okay. As long as we trade confidently, with a strategy, and we use stop losses and risk management, the winning trades will outweigh the losing trades.

I can already hear you asking yourself, and me, “Well thats all good and fancy, but how would I have known when to exit for profits? First when prices enters the red rectangle and falls, it goes down all the way to the green rectangle, then the next time it falls, it only goes down a slight distance outside of the red rectangle, then it falls once again all the way to the green rectangle. How do I know when to exit with short sell profits? I want to maximize my profits.”

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Good question, and there are 2 good answers to it.

1. You can use scaling. This means exiting a set amount of your position, say 50% at a predefined level: lets say once you've experienced a 3% price move. The other 50% of your position you would hold, either until price action moves back to your entry point, or until it continues in your direction to another predefined level: lets say once you've experienced a 10% price move. If this

strategy would have been used, you would have been able to exit with profits on all of the short trades and you would have expanded your profits for the longer move down.

The Drawback of this: The main drawback with this method is increased commission charges, since you are now placing more trades. This is negligible if you are a trader with a larger account, or if you trade on longer term time frames, and capture larger moves in price.

2. You could have also just had a predetermined exit point where you exit for profits: lets say 5% in price action movement. Anytime a trade crosses the 5% mark, you exit. You don't care what happens afterwards because your strategy, which you've backtested, calls for an exit at 5%. When you ran the backtesting you knew that if every one of your profits is 5%, you cover your losses and make a desired profit. This can be true based on either your win/loss ratio or the dollar amount won VS. the dollar amount lost for your strategy (it doesn't have to be 5%, it's whatever percentage works with your strategy, hence why F&C PREACHES PREACHES PREACHES the importance of a backtested strategy, please please please do yourself a favor and refer to our lesson on that).

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All in all, support and resistance is a tool that new traders and expert traders can make use of and it is a tool that gets used frequently here at Finance & Chocolate. Simply using support and resistance, coupled with a solid risk management plan,

good use of stop losses, and emotional discipline can make for a powerful trading strategy that is both effective and profitable. How you use this tool, along with the other trading tools you have in your trading backpack is up to you. The possibilities and combinations are endless, just like the opportunities in the market. Finance and Chocolate wants to wish you the absolute best in your trading journey. May you find success and prosperity in your trading, and in your life. We'll chat with you in the next lesson.

Always remember, trade smart, everyone.

- F&C

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