A Stochastic

TRADING STRATEGY

Webster's defines stochastic as involving or showing random behavior. A quick check of its Greek roots shows that it comes from a word that means "target" or "aim". Literally, "pointed stake".

The stochastics used to measure the markets attempt to "put a stake in" at those points where they are overbought or oversold. The random behavior they attempt to measure is this: Markets in an up trend tend to close closer to the high than the low, and vice versa.

The two lines in any stochastic are both moving averages. To calculate a stochastic, you must first decide what the period will be. A period is defined as the number of bars on any given chart used to calculate the stochastic. In this strategy, we use a period of 14, meaning we are using the last 14 bars to calculate the stochastic.

Once we have our data set at 14 periods, the first moving average is calculated. It is called %K. %K is just a moving average of the 14-period data set. %D is the next line in the stochastic, which is a "smoothed" moving average of %K. In shorter terms, the %D is a moving average of a moving average.

The stochastic oscillator available with the eSignal application used in this strategy does a comparison, based on a mathematical formula, that shows where a security closed in relation to the price range of that security over a specified period of time. The three variables of the oscillator formula (as used in the eSignal stochastic) are defined* as follows:

%K Periods (Length, in eSignal)	– Number of time periods of the stochastic calculation (In eSignal, this is the first %K study property.)
%K Periods (Length, in eSignal)	– The variable that, depending on the value used, controls the internal smoothing of %K (for example, 1 = a fast stochastic; 3 = a slow stochastic) (In eSignal, this is the second %K study property .)
%D Periods (Length)	– Number of time periods in a calculation of a moving average (%D) of %K. (In eSignal, this is the third study property , %D.)

This strategy makes use of stops, both protective (to help minimize your risk if the trend reverses) and trailing (to help you keep any profit you've made by lagging behind the day's prices; trailing stop also has a protective component).

A Stochastic Trading Strategy for Buys

All the example charts are using ES, the symbol for the E-Minis.

1. Identify a market in any timeframe whose stochastic is <20.

14	1	3	80	20
%K	%K Smoothing	%D	Upper Band	Lower Band

2. Wait for a market to have 3 consecutive intraday lower lows or any combination of two lower lows and an inside bar **..

3. On bar 4 only, buy 1 tick above the bar 3 high.

4. When filled, your initial protective stop should be near the bar 3 low.

5. As the position moves in your favor, trail your stops.

Study Properties / Explanation

In this strategy, we tend to allow for a little more breathing room on our stops because of the upside potential of the move.

*As defined in Technical Analysis from A to Z by Steven B. Achelis (New York: McGraw-Hill, 2001), p. 321

** An inside bar is one that has a range within the range of the previous or next bar. (So, the example charts here show the inside bar as having the same high as the previous bar but a low does not go as low as the previous bar's low.)