INTERVIEW

Trading With The Elliott Wave

Doing The Wave With Jeffrey Kennedy

Jeffrey Kennedy is chief commodity analyst at Elliott Wave International (EWI). With more than 20 years of experience as an analyst and trader, he writes and edits Futures Junctures, a premier forecasting package that focuses on Elliott wave analysis of the commodity markets. Kennedy also leads Elliott Wave Junctures, EWI's newest educational service, and provides daily video lessons on the *Elliott wave, technical analysis and trading.*

In addition to being published in Stocks, Futures and Options *magazine,* Traders' World *magazine, and* The Technical Analyst, *he has appeared on Yahoo Finance's "Breakout" and Business News Network's "Berman's Call." He is also an adjunct instructor in the quantitative and computational finance program at the Georgia Institute of Technology, where he teaches technical analysis.*

STOCKS & COMMODITIES *Editor Jayanthi Gopalakrishnan and Staff Writer Bruce Faber spoke with Kennedy on October 10, 2012.*

When I look for a potential trade, I always begin with the wave principle. That is my canvas.

Jeff, can you tell us about what you do?

I am the chief commodity analyst at Elliott Wave International (EWI). I'm pushing 20 years at EWI, actually. I have been counting waves for 20 years. I consider myself an Elliottician, but even though I use the wave principle as my primary technical tool, I am passionate about technical analysis as a whole. I love Steve Nison's work with candlesticks. I love John Bollinger's work with Bollinger Bands. I love J. Welles Wilder's work with relative strength index (RSI) and even Andrew Cardwell's influence on the RSI as well as Gerald Appel's moving average convergence/divergence (MACD). I am familiar with all the great names in the industry, and I have been fortunate enough to actually meet some of these people over the years.

So even though I am a trained Elliottician and the wave principle is my primary technical tool, I still find great value in a lot of the other disciplines that technical analysis has to offer. In fact, I teach technical analysis at one of the local universities, Georgia Tech. If I can make it back this year, it will be my fourth year teaching there for their graduate-level class in option trading and technical analysis. I teach a portion of that. I love technical analysis.

How did you get started in this business?

I got into it because I thought this was the place to be. I was fascinated with Wall Street, and stockbrokers and currency traders, the final years I was in college. I wanted to be the guy who really knew what was going on. At the time I didn't want to be a broker because they basically have marching orders that their brokerage house gives them to follow.

The analyst, on the other hand, seems to know what's going on. It is the stock market analyst who understands what is going to go up and what is going to go down. That is why I zeroed in on the analysis side of the business versus sales or being a broker.

I live near Atlanta and became familiar with the wave principle and Robert Prechter's organization, Elliott Wave International (EWI). I joined them in the summer of 1993 and have been here ever since, and have enjoyed every moment of it.

Can you tell us about the Elliott wave?

The Elliott wave principle was developed by Ralph Nelson Elliott in the mid-1930s. What he observed was that the stock market moves in these recognizable patterns that are essentially fractal. Basically, the wave principle is a form of technical analysis based on pattern recognition and crowd psychology. Within the actual discipline of the wave principle are two types of waves. The wave principle primarily gives the analyst and trader a tool to view price action. That context is provided by one of two waves: motive waves and/or corrective waves.

There are five basic or five core wave patterns that I work with as an Elliottician. Within the motive wave family, there are two waves: an impulse wave and an ending diagonal. Within the corrective wave modality or the corrective wave family, you have three. You have a zigzag, what we call a flat, and then we have a triangle. Those are the five core wave patterns that Ralph Elliott identified. These patterns again are fractal in nature. You can pull up a one-minute price chart of the S&P and you can see these fives and threes.

Impulse waves, which are motive waves, develop in five wave structures or five wave forms. Corrective wave patterns, like zigzag and flats, unfold in three waves, which are identified as waves A, B, and C. It is not uncommon for Elliotticians to hold conversations using phrases like, "We have a nice five up here" or "We have a nice five down here." What we mean is that with five waves up we know the trend is up. If we have five waves down, we know the trend is down. As a trader, because I do both, I look for those three wave countertrend moves, or those corrective wave patterns.

In other words, I look for the zigzags, the flats, and the triangles, because what I like to do, both as an analyst and as a trader, is identify a trending market, and if it is an uptrending market, I like to focus on buying the pullbacks and wait for those corrective waves to unfold. Conversely, in a downtrending market, if I see three wave rallies, those are my opportunities to sell the market. If the reader is simply familiar with those five patterns, it will serve them well. [*Editor's note:* Information on those five patterns can be found at www.elliottwave.com/club/educational-resources.aspx.]

Doesn't that require a lot of patience?

The primary value of the wave principle is that it provides a context for the analyst or trader to view price action. It lets you know, for example, within an impulse wave you have five waves labeled 1, 2, 3, 4, and 5. That fifth wave move is the final move within the sequence. There are very few tools that allow you to identify that this move up, a final push up, is a terminating wave. The wave principle allows you to do that. Again, it provides a context for price action. As such, it is not a trading methodology.

I go all over the world teaching people about the wave principle. I've been to India, South Africa, Australia, Singapore, Hong Kong. I encounter people who, when I ask, "Do you find value in the wave principle?" they answer with "Yes, I love it." But when I ask, "Do you have difficulty trading it?" they also say they do. The reason why is simple. The wave principle, as it stands, is not a trading methodology. You are utilizing the wrong tool for the wrong job.

Then what is it?

The primary value of the wave principle, and it says this in the A.J. Frost and Robert Prechter book *Elliott Wave Principle*, is that it provides a context to view price action. Now the wave principle can be adapted, which is what I have focused on as an Elliottician. I think about what Ralph Elliott would have done if he had lived another 10 or 20 years. I think he would have been very aggressive at actually applying what he uncovered about the market, more from a trading perspective. That is what I focus on here at EWI. I look at things like where do you get in, where do you get out, and where do you pull the trigger on a trade. The wave principle answers these questions, but again, it takes time and practice to understand the tool.

Now trading, that's a different conversation because I am as passionate about trading as I am about technical analysis. What I have learned about trading is that it is all about psychology. Some of the people I admire the most with regard to the importance of trading psychology would be Mark Douglas in his book *The Disciplined Trader*, and Van K. Tharp in some of his books. I admire both men greatly because they have hit the nail on the head with respect to what it takes to be a consistently successful trader — psychology.

That is one thing I say quite often when I teach: it is the man, not the tool. Say I give two people a pencil and paper; it doesn't mean they can write like Shakespeare. Granted, they both have the same tools, but not the same skill. Similarly, if I give two people two technical tools or disciplines, they are not going to come up with the same results. That is why it takes time, practice, realistic expectations, and talking to other people who are experienced.

Analysis is the mastery of observation. If you are an analyst or an Elliottician, you are looking at the markets and theorizing what could happen.

I've made a lot of expensive mistakes as an analyst and as a trader, but I have also learned some very valuable lessons. It is just part of the learning curve with what we do as traders and analysts. Again, my heart is in the wave principle. I value it greatly, but it takes some understanding what it can and cannot do.

My primary focus at EWI is not to just teach people about the wave principle, but how to apply it in a real-world trading environment.

You said you liked other technical indicators. Do you use them in combination with the wave principle to help you make entry and exit decisions?

Absolutely! Analysis is the mastery of observation. If you are an analyst or an Elliottician, you are looking at the markets and theorizing what could happen. Trading, on the other hand, is more immediate. It is more of a mastery of your self, your emotions, your mind, and your money.

The primary focus of a trader is not what could happen, but what is happening. There is the distinction between a good analyst and a good trader. A good analyst has to evaluate probabilities of what could happen. A good trader has to focus on what is happening, and take advantage of that.

When I look for a potential trade, I always begin with the wave principle. That is my canvas. I am looking for patterns that I recognize. In fact, I'll go through, say, 100 stock charts and ask myself, "Do I see a pattern I recognize?" If I go through a few dozen, I will find one or two with very clear Elliott wave patterns. At that point I begin to apply my other tools. Say we have a five-wave advance that is followed by a three-wave decline. That three-wave decline is what an Elliottician would refer to as a zigzag or a five-three-five pattern.

Once I see my three-wave decline, what I do next is to go to the intraday price charts and make sure that each wave of that structure has the appropriate subdivisions. It is a five-three-five pattern, so in wave A, I want to see five waves that don't overlap. In wave B, I want to see a three-wave price move, and then in wave C, I want to see another five-wave move. Ideally, I would like to see, because we are dealing with a zigzag, the slope of wave C actually be more shallow than what is experienced in wave A. Now I pull in my momentum indicators.

Which ones?

I will usually look at RSI, MACD, or MACD histogram. I do that because I want to see divergence in price and divergence in momentum. Say I am using the RSI. Where wave C should terminate beyond the extreme of wave A, I want to see the value of RSI when that extreme of C is being made. I want to see a bullish divergence. I use my momentum indicators to confirm that this is indeed an A-B-C structure. Momentum should be decreasing as wave C forms.

Say I have bullish divergence between price and RSI, or price and MACD, or price and MACD histogram. At that point I like to pull in some additional tools, like if I can count five waves down in wave C, I have divergence. The price move to the downside is contained within parallel lines, a key characteristic of countertrend price action. If I have identified the end or the termination point of wave C, I'd like to see a bullish engulfing pattern or maybe a morning star reversal pattern.

When I am applying these different disciplines, it helps me build a case. I can say, "We have a classic five-up, three-down from an Elliott wave perspective. I have a bullish divergence, or the appropriate momentum signatures present." This supports the conclusion that prices are going to go up.

Then, where I believe that the termination point of wave C has come into play, I should see further confirming price action of my assessment by seeing the proper reversal candlestick patterns. Better yet, if I see them on multiple time frames. As Steve Nison teaches, it is great when you have a bullish engulfing pattern on the weekly chart level, and within those five trading days you might experience a morning star reversal pattern on the daily chart level. That is how I like to combine the multiple disciplines that technical analysis offers.

Technical analysis is a rich field of study. A lot of the work that Robert Edwards and John Magee did with flags and pennants, and head and shoulders, is just as applicable today as it was then. I talk about head and shoulders in much of my own writing.

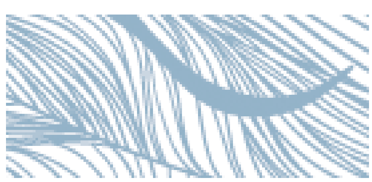
There was an excellent example of a very nice head and shoulders in soybean meal from a few weeks ago. It is one of the markets I follow. I follow about 20 commodity markets, the primary markets, and about 150 stocks fairly regularly.

That's a lot of markets.

When I teach at Georgia Tech I always begin by saying, "With respect to market analysis, you have three primary disciplines: you have quantitative analysis. You have fundamental analysis. And you have technical analysis."

One of the many benefits of technical analysis, because I am looking for patterns, is that I can look at the Australian dollar, or the Aussie–New Zealand cross. But within just two or three minutes or a few clicks of my mouse, I can be looking at gold and give you a confident opinion of the direction of gold. Then with a few clicks on my quote screen, I can begin looking at, and give you an educated opinion on, say, Apple and Google stock.

One of the benefits of technical analysis and the wave principle is that it allows you to go across multiple time frames and multiple markets quickly. A technician can look at several markets and give you an opinion about those markets in a matter of minutes.



Let's talk about money management. What kind of money management strategies do you apply?

The term *money management* is very much like the term *technical analysis*. It is a catchall phrase that includes a number of different ideas. My style of trading is very conservative from a money management point of view. I follow what most professionals do, which is never risk more than 1% to 3% of your portfolio on any given position. I am a big fan of not trying to take a trade that does not offer a better than one-to-three risk/reward ratio. If I am going to risk a dollar, I want to make three. I don't want to risk a dollar to make a dollar.

Then again I very much like the idea of waiting for confirming price action. I am a trend trader. I like to find trending markets, and if it is going up, I like to buy pullbacks. If it is going down, I like to sell bounces. I am not a fan of picking tops and bottoms. I am more than happy to let, say, a few percentage points go, or even get within 10% of the top or 10% of the bottom. Trying to catch the top is an ego game. Whenever your ego is involved, it never ends well, which is what Tharp and Douglas mention in their works about psychology.

I recommend most people to be extremely conservative with their trading. Depending on what vehicle you trade, it can be extremely risky. For example, if you trade options, that is a highly leveraged game. It is a complicated game because now you have the greeks involved — theta, delta, gamma, and time. You have to be right not just in market direction, but also your timing.

Futures markets are highly leveraged markets and you have to focus on money management, or at least pay heed to it. Think of it this way. You can make $20,000 in a day trading natural gas because you can lose $20,000 in a day trading natural gas. Most people, unfortunately, shouldn't trade because they simply do not understand the risks inherent in what is involved. It is easy to lose. You are not always right. That is why risk management is so important.

The big boys, the professionals, the money managers with hundreds of millions, or billions of dollars, follow the 1% to 3% rule because by being so conservative in asset allocation, they are trading for the long run. They are not necessarily trading for the next trade. They just want to make sure that they still have a seat at the table next quarter or next year, because if they can still sit at the table next year they are going to be able to make a comeback. They are confident of that. They are basically trading for longevity.

What about the small traders?

A lot of the time, the small traders tend to get excited about the potential profit, so they go all in more frequently. They may get lucky two or three times in a row, or maybe even five or six times. Then there is that one big trade that wipes them all out. So they have to step back or sit out for a while until they can put together another trading account and go back at it.

Risk management is all about consistency. It is all about longevity. It is like going back to the story about the tortoise and the hare. You want slow or small consistent profits. I think Mark Douglas in his *Disciplined Trader* speaks specifically about that — the importance of focusing on small consistent profits rather than trying to hit a home run every time you get up to bat, or every time you take a trade.

A lot of people have the misconception that trading is about making easy money. There is nothing easy about successful trading. It is hard work. Some days I wish I had a manual labor job to be guaranteed a paycheck. What we do as technicians, professional analysts, and professional traders is *very* hard work. The ones who are consistently good, year in and year out, tend to be your hardest workers.

Unfortunately, a lot of people get glassy-eyed about "if I had bought those options then, I could have made 10 times my money, or multiplied my money by 400% or 500%." Well, that is true, but you cannot play the "what-if" game.

Being an analyst and trader involves two totally separate skill sets. As an analyst, you are a master of observation. You are focusing on what *could* happen. As a trader, your primary focus is on what *is* happening. Regardless of whether you think the market's about to top, if the trend is up, as a trader, you've got to play it. Divergence is a great example of what I am referring to.

As an analyst, if I am looking at a momentum tool, and I see divergence, well, that is suggestive of market weakness. As a trader, I have to focus on what *is* happening, not what *could* happen.

If I see the daily trend is up, I have to buy the market. How do I resign myself to the fact that I have divergence, which means a decrease in momentum, a possible weakness, and a possible trend change? I have to focus on what is happening as a trader and the trend is up. How do I reconcile that?

This is where risk management comes into play. For example, you are allowed to play the buy side to the tune of $100,000. If you are seeing divergence begin to enter the market, you may say to yourself, "I have to trade the trend, and the trend is up, but because of this divergence, I am not going to go all in."

So you only go in 50%, or maybe even 20%, but if you invest as much as 75% to 80%, you have to have a very tight stop on the position. That is how risk management comes into play, and how you focus on what is happening and reconcile what is happening as a trader. But you also have to take into consideration what could happen when you are wearing your analytical hat and see that potential for divergence because there are markets I have seen where the divergence continues for six months. Analysts trade what *could* happen, whereas traders trade what *is* happening.

Given that you follow about 20 commodities and about 150 stocks, which ones do you mostly trade?

I don't trade many commodities at all. My official gig at EWI is as chief commodity analyst. My primary focus is on the commodity markets — that is, the softs, the grains, and livestock. Maybe once a year, I might take a shot at a commodity. I simply do not trade the commodities, and the reason is because I analyze them. I am also a newsletter writer, so I write about what I see in the markets on a daily basis.

I don't like to trade the markets I analyze is because I don't want to be biased. I don't want to be bullish in coffee and write bullishly about coffee. I don't want to overshadow my opinion or my analytics simply because I have a position in the market. That way I can sit back and say, "Okay, this is what I see." I tend to trade individual equities and some of the exchange traded funds (ETFs). I like stocks and primarily trade those either outright or through options.

Trying to figure out Elliott waves often seems to be like a guessing game. What happens when you get an A-B-C and the C turns out not to be a C and the C is about 40 yards down the road?

It goes back to something simple. Remember when I was saying whenever I look for a trade I look for a pattern I recognize? I can go through about 100 stock charts looking for a good wave pattern I recognize. When it comes to trading, it is all about quality, not quantity. When you are looking at a price chart, you are truly looking for a textbook example. You are looking for a pattern that jumps off the price chart and without question you know that it is a five-wave up, or a three-wave decliner. You know that it is a flat or a triangle.

The bottom line is when I am looking at a price chart and for an Elliott wave pattern, I want to be able to identify it within a matter of milliseconds or maybe one or two seconds. If I spend much more time than that, my mind is wired to look for something else.

That brings us to another important aspect, something I have learned over the years. If you are looking at a price chart and you don't see a pattern that you recognize (Figure 1), *then you look at a different price chart*. You never trade gray. You have to know what is going on. You have to see a pattern you recognize.

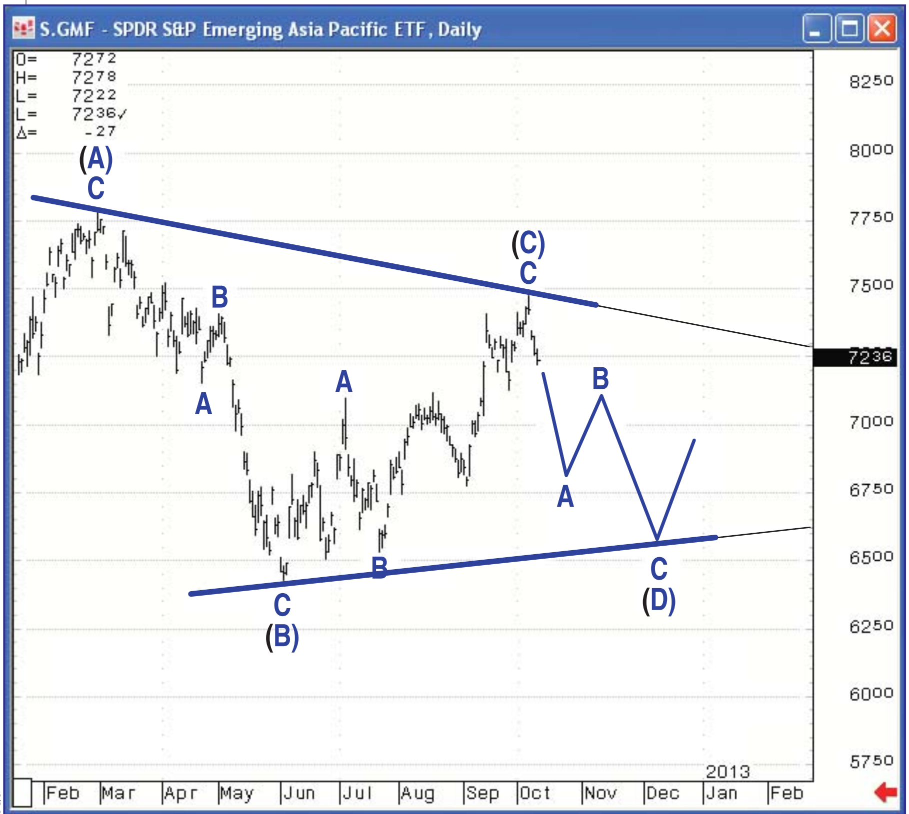


FIGURE 1: AN EXAMPLE OF A PATTERN THAT IS UNCLEAR. This market is thinly traded, appears to be working a triangle, and the underlying patterns leave a lot to be desired.

FIGURE 2: AN EXAMPLE OF A PATTERN THAT IS CLEAR AND TRADABLE. MGM is unfolding in five waves from this year's high. Subsequent price action is wave 5 and should continue to near $8.00.

You trade black. You trade white. But you never trade gray. If there is a doubt, if you don't see anything that is clear, you move on to something that is. That is one of the things nice about being a small trader, or what makes trading fun. You can look at 500 different stocks, and out of 500 stocks I can find one wave pattern that is clear like the one you see in Figure 2.

Having said that, I can look at any price chart and give you a wave count. But just because you can count a price chart or label a price chart, according to the wave principle, doesn't mean you have a high-probability trade on your hands. That is a very important distinction between academia and the real world.

Thank you for speaking with us, Jeff.

SUGGESTED READING

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