EP09: Moving Average Systems

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Announcer: *Two traders, Darren and Walter, pull back the curtain on profitable trading systems, consistent money management, and profitable psychological triggers. Welcome to the 2 Traders Podcast.*

Walter: In this episode of the two trader's podcast, Darren and I looked at that Swiss Army knife tool that traders used, call them moving average. We looked at how you can use a moving average to both: find exit for your trades, find entries for your trades and even how to analyze the market. Darren argues that the moving average is actually more valuable than support resistance, and he'll explain why. Darren also reveals why when price moves across a moving average, you should definitely pay attention. How you can even take the simplest of all moving averages and create your own trading system. And finally, we wrapped up today's session when Darren dives deep into the problems that traders run into when they see illusory moving average relationships on the chart and how you can avoid these. All these and more in today's episode of the two trader's podcast.

Walter: Welcome back to the 2 Traders Podcast. Walter, I've got Darren on the line. Hey Darren.

Darren: Hello Walter.

Walter: Today Darren, we're going to talk about the moving average. I'm reminded of this intelligence test or maybe a pseudo intelligence test where they give the subject a paper clip and they say, "Tell me all the different ways that you can use a paper clip." The idea is ... I think it's actually more of a creativity test, but the idea is that the person who's more creative can actually come up with many different ways to use a paper clip other than the obvious, right? My thinking was today we're going to jump into the moving average. You thought it was a great idea. Today we're going to talk about the moving average and all of the different ways that you might use a moving average in your trading. I'll start off by saying I've got a list of them here. Maybe we can ping-pong back and forth, if that works for you. I'll just do one. One way to use a moving average is that you can watch ... and when I first learned this, I thought it was amazing. You can use the direction that the moving average is pointed as an exit system, as an exit strategy.

Let me give you an example. Let's say you're in a buy trade. You've got probably a really low moving average, like an 8 or something like that, moving average. You're in a buy trade and you want to know when to get out. What you do is you wait until the 8 moving average actually turns down. It'll be moving up of course for most of your trade if you're in a strong uptrend. It might go flat and just stay horizontal, but as soon as the market closes and you actually see that 8 moving average dip down and actually angle downward, then you close the trade. That's one use for a moving average. Can you give us one as well, Darren?

Darren: Yeah, one of my favorites is using the moving average as a dynamic trend line. You know the sort of classic trend line entry. You wait for the trend line to break, and then you wait for price to pull back to the trend line. That's where you look for your entry and essentially use a moving average the same way. Pick something around the middle. I like the 50 simple moving average, wait for price to break over the moving average and then pull back and then take your entry there. It's just a simple trend line system. You can even use the break back over the trend line as an exit, although I'm not as keen on it as I am for an entry. Use it as a trend line, wait for price to break over, and then pull back towards it. It doesn't have to touch it, just any pull back, and then use that for your entry.

Walter: Cool, all right. I've got another one. In this way, I think this reminds me of a system that I used a long time ago. It was exciting for me because it was the first time I actually made money in the markets. What I did was I had a bunch of moving averages, but you can do this with just two. You might have a really low, like a 10 moving average and maybe a higher one like a 50. What you do is you just wait for them to both be pointed in the same direction. They could both be pointing up for example in an uptrend. Then you wait for the market to collapse, so what happens is the lower moving average moves toward the higher one, and then when it gets there, it bounces off of it.

You get in on a trade right on that bounce when the two moving averages sort of compress and come closer together. Then the lower moving average, the 10, or 8, or 6, or whatever it is, it sort of turns away from the 50 and you get in there. Because what you'll see, of course, in most uptrends and many downtrends is you'll see the market ... these moving averages spread apart, get close together, spread apart, get close together. You can use that rhythm and time your entries based on that. That's another unique way I believe and fun way to use moving averages to time your entries. Any other moving average thoughts, Darren?

Darren: Yeah, another one very similar to that that I like where you use say like a 50 and a 30 or a 50 and a 20 moving average, and you look for, one, something that's trending. You've got a nice slope in moving averages. Then you look for price to pull back into that pocket that the gap in between the moving averages. You look for your entry there. If you kind of prefer a more, a good value entry, and you like to get deep retrace entries, that's a really good sort of value place to look to enter. You wait for a trend to develop, and then you look for a pull back into the gap between the fast and the slower moving average.

Walter: That's great. Here's one that they say, I don't know if this is true, but they talk about institutions using this really high moving average. Usually it's like the 200 is what they say. They say, "Well, if the market's above the 200, we know we're in an uptrend. If it's below it, we know we're in a downtrend." Now, of course, the market can jump around and stay up and down and up and down around the 200 as well, but the interesting thing about the 200 is it's really slow to move up or down, so it kind of just sits there and it's kind of like a zero point for a lot of traders where they see this as the line in the sand, and we know the market's turned when it closes below the 200 or goes back above the 200. That's another way to use a moving average. Do you have any other ones, Darren?

Darren: Well, the final one that I know that somebody uses is it's very good to trail your stop behind. If you like to use trailing stop and you're the sort of person that wants to sort of shoot for the sort of runners and the bigger wins, then it's a really good market. A lot of people tend to trail less stops behind the price. It's not very good because that swing point you're trailing behind is generally a key support and resistance level that people are watching and institutions like to push price through to collect the stops. Instead, use a moving average for your trailing stop. You'll find that you keep in those long runners much, much longer.

Walter: Excellent, excellent. There's one more thing that I thought of. If you're a trader who likes to find those turning points, so you're always kind of looking for that reversal, that swing, that swing high, swing low, and you really want to hook into those, what you might do is you just wait for the moving average to turn around. It doesn't have to cross or anything like that. You might use something else, like maybe you see it go to like a double top or a historical level that usually reverses that in your thinking. What you might do is wait for that moving average to turn around. If it's going up, it just starts to bend and turn lower, then you get into the trade. What that means is that you're going to get in a little bit later than some others might, but it's also more like that it's confirming ... it's got more movement, more closing prices are behind your direction. It's a little bit safer for some people than trying to get in immediately and getting burned. That's another way to use moving averages. What are your thoughts about the moving average? Are you using it right now in your trading?

Darren: Yeah, I've kind of always used moving averages really. It's a way of looking at the bigger picture of price. I really like them. Essentially, really, price if you put your line chart on instead of your candlesticks or your bar chart, then essentially that's a one period moving average anyway. We're kind of always ... we're kind of already using a moving average. It's just kind of saying let's have a look at the slightly bigger period. You know something I noticed once ... it was quite fascinating was when a time frame crosses the moving average, you generally have reversal candle pattern on the higher time frame. If you find a spot on your chart where the H4 has crossed over the moving average, you'll invariably see some sort of outside bar on the weekly chart, or some sort of reversal candlestick pattern on the weekly chart. That happens for all of the time frames. Essentially the moving average is just giving you a little look at the higher time frame as well, which is another way of looking at it really rather than just a line, you know?

Walter: Yeah, that's a great tip. There you go. You would see that happening on the lower time frame, and then you would ... and then I suppose later on obviously you would look up to the higher time frame and see that sort of reversal set up. Is that right?

Darren: Well yeah, it's kind of like you were saying when say you see the H4 chart and there's a double top. If you wait for it to cross the moving average as well, then it's almost like a confirmation that the higher time frame has turned as well now. You get a hint from the price action on your time frame, and then when it crosses the moving average, that's kind of like a second confirmation, and a really good way of timing entries like you said.

Walter: Yeah, yeah. It's excellent. I love the line chart, which is, as you say, it's a one moving average on the close. That's probably one of my favorite charts. I think that people listening to this ... I challenge you to take a look at the line chart, which again, it's the one moving average as you say. Come up with a system because I believe you can just by observing what happens on the line chart. I think that's a great place to start for somebody who's wanting to simplify their trading, but kind of still want to have that feeling like you're relying on an indicator. You know, you don't want to totally get out of it, so you are, in essence, looking at an indicator. It's a one moving average on the close. That's a great place to start if you want to set yourself up with a really simple system. Any final thoughts on moving averages?

Darren: No I think that is it really. They're a great tool. Like you were saying then, don't be put off because it's an indicator because it's essentially a higher time frame price chart being shown on your lower time frame. It's priced as well, and it can be really, if you use it simply, it can be a great tool I think.

Walter: Yeah, it's great. As you say, it's sort of like a holistic view because you're getting all of these candles are being put into the line that's moving today. It's not just looking at what's happening today. Unless, of course, you're looking at the line chart. But what you're seeing though in that line is all of ... like if you're looking at the 20 moving average, right? All of these ... the last 20 candles are all sort of part of this line. It's really good for people who tend to focus in and forget about the big picture, and they don't approach the markets holistically. If you have a moving average on there, you can't avoid that because it's obviously all that is going into the line. It's a really good way to see recent activity in the market. It's a great tool, great tool.

Darren: Yeah, can I just make one final point, Walter?

Walter: Of course, yeah.

Darren: There is one thing that I don't believe in. This is this idea that price is attracted to the moving average. That to me is complete tosh because we know that price moves the velocity of price changes. It's just logic that it's going to return to the moving average. I mean, if it never returned then that would be something worth talking about. I hate it when people say that the price is attracted to a moving average like a 100 or a 200. It's just inevitable. To me that's logic. The other one is that people say that price consolidates around a moving average. Again, that is just a complete optical illusion that's going on in your head. If you get a marker and go past, go back … whatever's on your screen, mark all the consolidations, and I bet you whatever you want, you're going to have a lot more consolidations that are not at the moving average than you are at the moving average.

It's just something about those two elements coming together, the price and the other line, basically, that this little optical illusion … your brain picks up on that. It discounts all the other information. Yeah, I see that a lot in trading where people kind of see stuff. They kind of blank out what they don't want to see, and they kind of believe this tiny little bit of information. There are some fallacies about it as well. Think logically about what it's really showing to you.

Walter: Yeah, that's great. You know what, Darren, I think maybe in our next episode we can dive into more of these optical illusions and fallacies because there are plenty of them out there. Does that sound good to you?

Darren: Yeah, that's great. I'd like to do one of those next time definitely.

Walter: Yeah, next time let's jump into that. I think that will be a really fun podcast. Until then, Darren, thanks so much for your time. I really appreciate it. We will see you in the next episode.

Darren: Cheers, Walter. Goodbye.

Walter: Bye.