

COUNT BACK LINE STOP LOSS

By Daryl Guppy

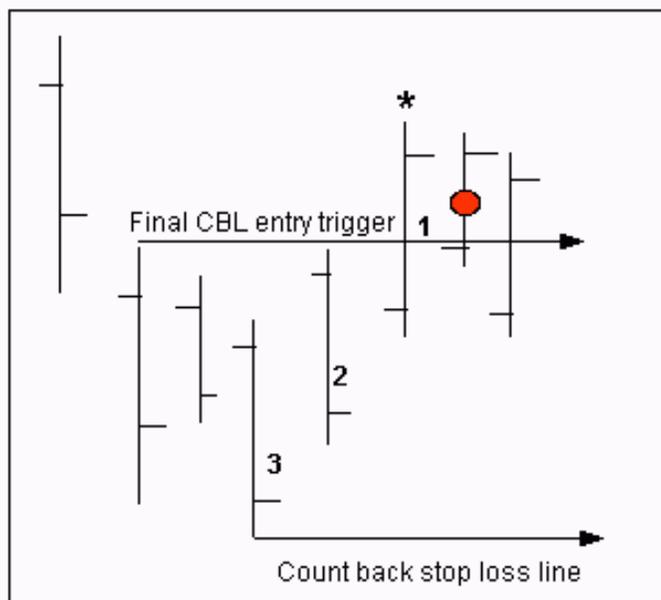
The count back line is used to verify the end of a downtrend and set the conditions for entry into a new up trend. As part of this process the count back line is applied to the highest high in the new trend to calculate a stop loss line. This is an essential part of managing the entry process in a new trade.

The two figures – the entry price and the initial stop loss price – are combined with a position and risk sizing calculation to set the correct limits for the new trade. This week we want to move beyond these applications and examine how the count back line is used initially as a protect capital stop loss line and then later as a protect profit stop loss mechanism. Finally we show how it is used as an exit signal to end the trade as a trend reversal develops.

These notes are prepared in response to readers requests for guidance on the application of the count back line. For traders who use the Guppy Traders Essential charting pack, or tool pack with Metastock, or Ezy Charts, the construction details are unnecessary. These programs have a count back line tool which automatically calculates the placement of the count back lines when the cursor is placed over a price bar. Metastock and Supercharts users have to complete these calculations by hand.

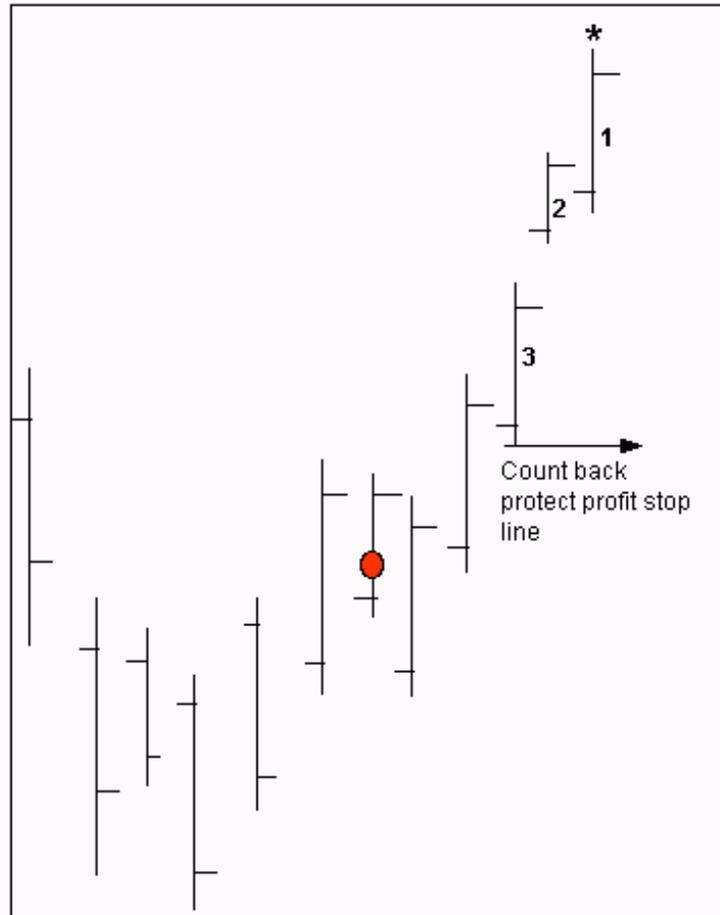
The count back line is a trend following tool which is designed to confirm the reversal of a short term trend and the continuation of an existing trend. This is an important modifier. The count back line is not designed to identify and define a long term trend. We use the MMA for this. The count back line consists of four applications.

- The first is as a trend change verification tool – discussed in previous week.
- The second is as an entry tool with a defined range of safe price levels – discussed last week.
- The third is as a stop loss tool.
- The fourth is related to the stop loss function when it is used as an exit tool.



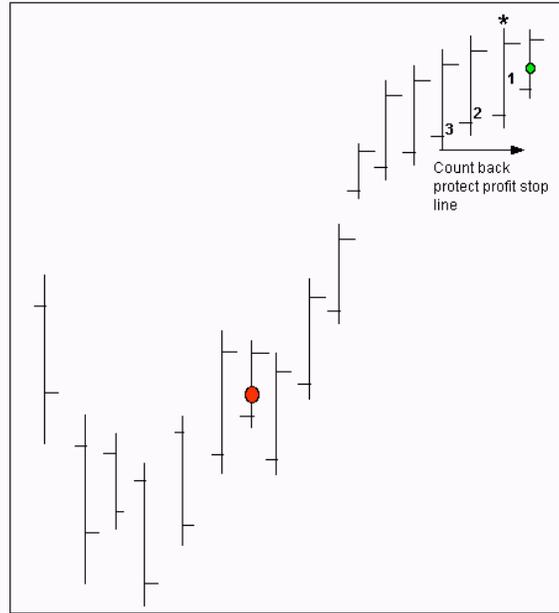
Our objective is not to predict the future, but to put the balance of probability in our favor.

We start this week where we left off last week with a classic stop loss calculation, but add two new days and a red dot showing our original entry point. We have added an additional line to show the final count back line placement for the entry trigger. The entry and the stop loss



As each new higher high is made, the count back line calculation is recalculated. This example illustrates two significant features. The first is the way the gap between bar 2 and bar 3 is ignored. When we encounter a gap we move to the next lowest bar in the current trend. The count back line is designed to give us information about the current trend so there is no value in extending the line all the way across to the left until we hit another trend.

The second feature is the way the nature of the count back line calculation has changed. It is no longer a protect capital stop loss. The count back line is now above the red circle of our entry point. This trade is now fully in profit. If we were to act on the exit signal generated by a close below the count back line the trade would now be closed with a small profit.



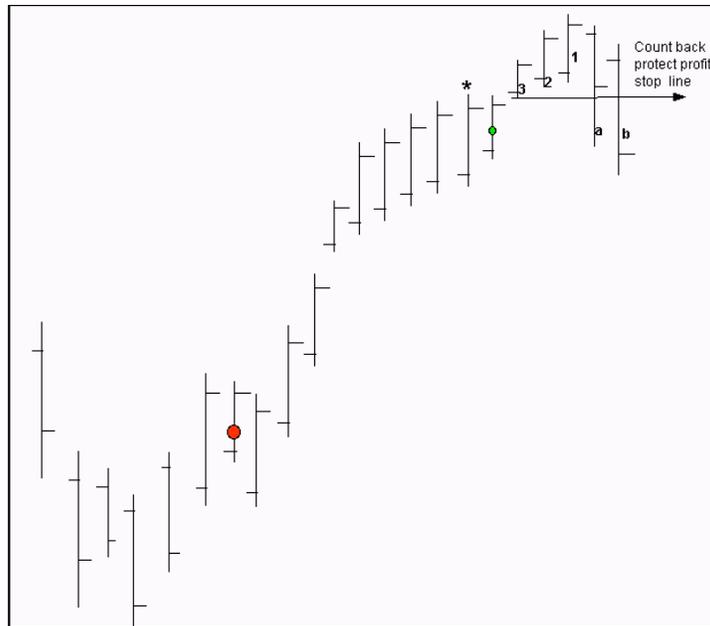
Until the new up trend comes to an end, the count back line now retains this new character and acts as a protect profit trailing stop loss. This change in character also provides a new entry signal in the Grow-Up money management strategy discussed in **Better Trading**.

The count back line can also be applied to a rising trend in mid trend as a way of confirming the trend strength and managing the trade. We do not need to apply it just to breakout situations. The green dot shows an entry point in the developing up trend. The count back line protects profit stop loss for the trade entered at the red dot is used to set the stop loss point at the bottom of bar 3. This bar is significant for both trades. A close below the line suggests the up trend is weakening and signals an exit. The first trader gets out with a profit. The second trader exits with a small loss.

The new trader who entered on the green dot applies the same management techniques as the trader who entered with the red dot. His new trade does not become profitable until the value of the trailing stop loss line rises above the entry point.

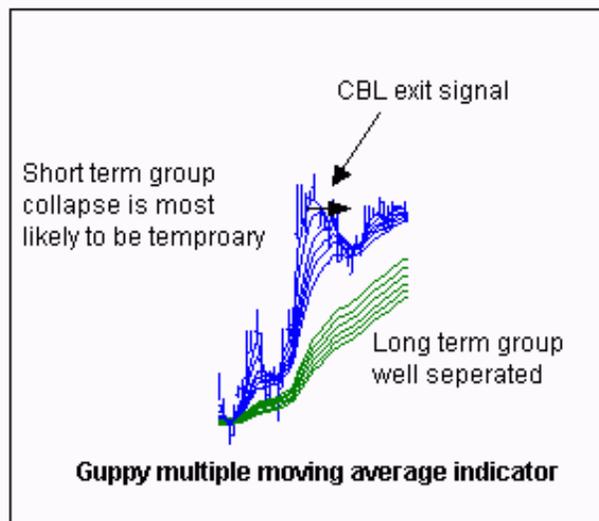
A close below the count back line suggests the trend is changing direction. It is an early warning that it is time to get out. The dip with bar B is not an exit signal because the close is still above the value of the count back line. The close with bar A is below the count back line and signals an exit on the next day of trading.

This is often difficult to act upon because greed gets in the way. This is particularly so if the next day opens higher. We look for excuses to hang on and in certain circumstances, as shown below, this is acceptable. However, generally we should use this as an exit signal unless there are exceptional circumstances. Just as the count back line did not get us in at the very pivot point low of the downtrend; it will not get us out at the very pivot point high of the up trend.



Some traders tend to use the count back line as stand alone indicator and this result in false exits from strong trends. This is a misapplication of the technique. When we applied the count back line as an entry tool we stressed the need to verify the signals with another indicator. We prefer to use the Guppy Multiple Moving Average to confirm the end of the downtrend and the potential for a new up trend. The count back line helps to set exact entry conditions

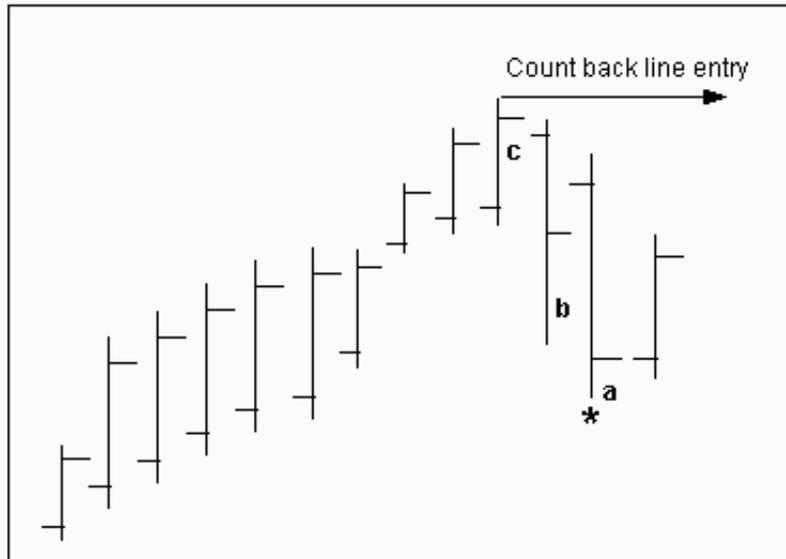
The same thinking is applied to exit signals generated when the count back line has turned into a protect profit stop loss. The signal should be verified with another indicator to prevent false exits.



Traders should note that at the critical point where a downtrend changes to an up trend, we do not verify any exit signal with a second indicator. While the count back line acts as a protect capital stop loss we act immediately on any exit. This is the weakest part of any new trend, and the most dangerous from a trading perspective. The risk of new trend failure is always high so we focus entirely in protecting capital.

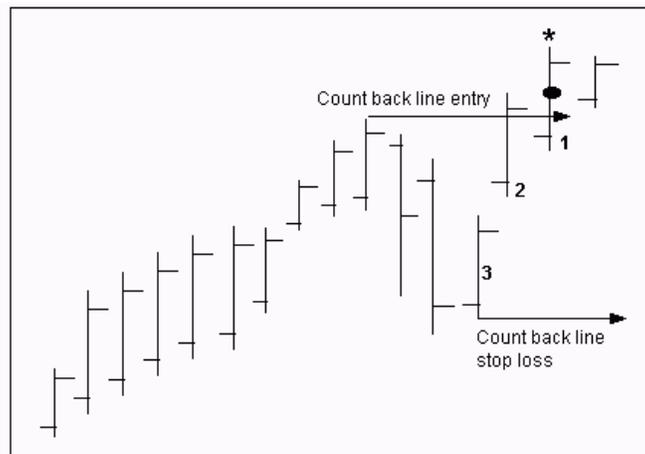
As soon as the exit signal is generated by a close below the trailing stop loss count back line the trader immediately changes the application of the count back line technique. It reverts to

its entry tool application. The significant bar is now the lowest bar in the new trend, shown by the * and marked as bar A. The next two significant bars are shown as bars B and C.



What new trend? The new trend starts as soon as the old trend is finished. The end of the old up trend is signaled by the close below the count back line trailing stop loss, so by definition the new price action is a downtrend until it is able to close above the new count back line applied as an entry tool.

This has several applications. The first is the classic end of up trend exit confirmed by other indicator combinations. In this application we continue following the downtrend down, making a new count back line calculation with every new lower low and looking for a verified signal of a trend change. This takes us back to the very first chart in the first of this series of notes.



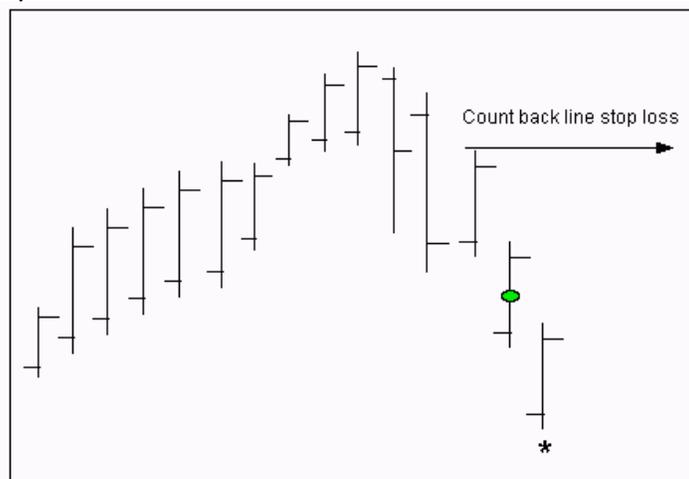
The second application applies to traders working with the temporary dip in a major trend. Here the other indicators do not confirm a trend change. This dip signals the potential for a cheaper entry into an established trend, shown by the black dot. The entry point is confirmed, along with trend strength, by a close above the new count back line. Waiting for this confirmation also adds confirmation to the other trend indicators and reduces the risk in the trade.

As soon as there is a close above the count back entry line the trader immediately applies the count back line as a stop loss tool. The significant bars are shown as 1, 2 and 3. A

new trend has been established and will remain in place until there is a close below the new stop loss line.

This final example shows how the count back line, by itself, can trigger whipsaw entries and exits. It is acceptable in this situation because we are trying to stay with a strong trend as verified by other indicators. This whipsaw condition is not acceptable if we are trying to enter into a new breakout trade.

Verification from additional indicators is an important modifier in the application of the count back line technique.



The count back line applies equally as effectively to trades from the short side as to trades from the long side. In the example shown, the count back line calculation remains the same, starting with the pivot point low in the new downtrend. However, a close above this line no longer signals an entry. For the trader going short with an entry at the green dot, a close above this line signals an exit from short positions because it suggests there is an increased probability that the downtrend has turned into an up trend.

We have just one more application of the count back line technique and that covers its application to IPO trading. We look at this next week.

TRADING TECHNIQUES

CBL STOP LOSS

This stop loss rule uses the range activity of the stock to set a stop loss point. The range is the distance between the high and the low for the day. It is calculated using the Count back Line approach. Taking the most recent highest high in the intermediate term trend the stop loss point is calculated by counting back three lower bars. The horizontal line drawn at the bottom of the third bar is the stop loss point. This stop loss is not related to the 2% rule. The line suggests the conditions where the trend may be weakening. When used with open profits, it provides an exit signal to protect those profits.