Trading with Bollinger Bands

with

Toni Turner

www.toniturner.com
A Brief Introduction . . .

Toni Turner
President
TrendStar Trading Group, Inc.

A Beginner’s Guide to Day Trading Online
A Beginner’s Guide to Short Selling (video)
A Beginner’s Guide to Short-Term Trading

Website: www.toniturner.com
How About You?

- Where are you in your trading career?
- What time frames do you trade?
- Do you use fundamental analysis as a decision support tool?
- Do you use technical analysis as a primary decision support tool?
- Do you currently use Bollinger Bands?
- What additional indicators do you use?
Today’s Topic… *Bollinger Bands*

- Where they are used
- Time frames
- Basic Concepts… how they work
- Combining them with other indicators
- What they are
  - Identify price patterns
  - Confirm trends
  - Locate high-probability setups, entries and exits
Bollinger Bands
What they are...

- Created by John Bollinger in early 1980’s
- Consist of upper and lower envelopes, or bands, plotted in and around the price pattern of a stock or index
- Expand and contract according to volatility
Question: On a relative basis, are prices high, or low?

Answer:
– Prices are high at upper band
– Prices are low at lower band
Bollinger Bands . . .

- **Base**: middle band is usually 20-period moving average.

- **Upper band**: spread above that MA by volatility measure known as “standard deviation.” Default set at 2 standard deviations.

- **Lower band**: middle band less same volatility measure.
Bollinger Bands... the formula

FIGURE 4

Bollinger Bands Formulas

\[ \sigma = \sqrt{\frac{\sum_{j=1}^{N} (X_j - \bar{X})^2}{N}} \]

\[ \bar{X} = \frac{\sum_{j=1}^{N} X_j}{N} \]

Upper Band = \( \bar{X} + 2\sigma \)
Middle Band = \( \bar{X} \)
Lower Band = \( \bar{X} - 2\sigma \)
Let’s Translate That!

Upper band

Defaults:
• 20-period MA
• Bandwidth = 2 standard deviations

Lower band

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Bollinger Band Applications . . .

- Decision Support Tool for: stocks, indices, options, commodities, financial futures, currencies, and mutual funds.

- Effective Time Frames: years, quarters, months, weeks, days, hours, minutes, ticks!
Three Primary Uses

- **Pattern recognition**
  - Recognize double tops, head-and-shoulders, double bottoms

- **Reversal signals**
  - Identify early warning signs of reversals

- **Trend analysis**
  - Detect trend continuation and conclusion
Bollinger Bands (BB) *Basic Concepts*

- Used to compare price and indicator action to arrive at buy and sell decisions
- Confirming indicators should not be directly related to each other
- Price can, and does, walk up the upper BB and down the lower BB
Bollinger Bands (BB)

Basic Concepts . . . continued

- Tags of bands are *not necessarily* buy/sell signals

- Closes outside BBs can be *continuation signals* if confirmed by other indicators

- Contraction (The Squeeze) is followed by Expansion, is followed by Contraction….
Basic Concepts

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Basic Concepts . . .

- BBs are based on a simple moving average. Default is 20-period MA with 2 standard deviations.
- Default contains 95% of price action
- Works well on most time frames
- Longer term: 50-period MA, 2.1 std. dev.
- Shorter term: 10-period MA, 1.9 std. dev.
Time Frame: Weekly Chart

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Time Frame: 15-Minute Chart

Gulp!

Check out volume

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Time Frame: 5-Minute Chart

Head-and-Shoulders

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**Strategy: Double Bottom-Bottom Fishing**

- Locate stock basing by forming a double bottom (time frame—your choice).

- First bottom may penetrate lower BB.

- Second bottom *may be lower* than prior bottom (!), but *may not penetrate* band.
**Strategy: Double Bottom-Bottom Fishing**

- Other indicators must show bullish divergence.

- Confirming break to upside must be on high volume.

- Place protective stop just below recent bottom.
Double Bottom-Bottom Fishing

10 point day!
Double Bottom-Bottom Fishing
Shorting Strategy: Double Top Head-and-Shoulders

- Locate stock forming Double (or Triple) Top, or Head-and-Shoulders

- First top, or left shoulder + head, will penetrate upper BB

- Second top, or right shoulder, *may not* penetrate upper band
Shorting Strategy: Double Top

**Head-and-Shoulders**

- Additional indicators show bearish divergence
- **Double Top**
  - Second pivot: Sell short as stock falls below *low of high day*
  - Final leg: Sell fall of fall below middle pivot of “M,” or support area
  - Low risk: Wait for throwback rally to fail
- **Head-and-Shoulders**
  - Sell short as stock breaks neckline
  - Low risk: Wait for throwback rally to fail
Sell Short Double Top

Throwback rally
Sell Short Head-and-Shoulders

(Right) COST - Costco Wholesale Corp. Bar Volume MA (P=20) UP (P=20) DN (P=20)

Tag

No tag

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Strategy: Identify Market Tops

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**Strategy: Play “The Squeeze”**

- Locate a stock in a “tight Squeeze”
- Identify prevailing trend
- Scan additional indicators to prepare for possible entry
- Once in, set trailing stop
Play “The Squeeze”

Yessssssssss!

Head Fake!

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In Conclusion . . .

- Bollinger Bands help you, the trader and/or investor, to identify price patterns, trend direction, and reversals.

- This knowledge aids you in placing well-thought out, disciplined, low-risk trades.

- Remember…your first priority is always to conserve your capital!