Trading With A Visual Roadmap

By Soh Tiong Hum

In this article, our contributor tells us more about how Bollinger Bands can be used by the average short term FX trader.

Bollinger Bands (BB) is a widely-used technical study developed by John Bollinger in the 1980s. It can be used for trading in forex, stock, commodity and options. Made up of three lines, it helps traders to visualize the average value of price as well as an overbought and oversold level. It is powerful enough to be the only indicator used for trading but is also excellent when combined with both momentum-based indicators as well as range-based oscillators.

Trading is challenging and requires great skill of observation and quick thinking. Therefore, traders like to acquire a 'visual luxury' so that market noise can be filtered out. That means knowing instantly what the trend is and where are the optimum zones to buy and sell. Just like driving with markings on the road and kerbs to warn us of out-of-bounds regions, the BB can be a handy indicator for trading safely.

USING THE BOLLINGER BANDS

The Bollinger Bands consists of three lines. In its commonly encountered form, they look like this:

1. A middle line that shows the simple moving average (MA) value of price based on a 'sample' of 20 periods
2. An upper line that shows a level twice the 20-period standard deviation (sigma) of price above the middle line (MA plus 2sigma)
3. A lower line that shows a level twice the 20-period standard deviation of price below the middle line (MA minus 2sigma)

A trader who wants to use Bollinger Bands should take note of the concepts below:

The middle line – The middle line of the BB is a moving average so it serves both as an indication of trend as well as a support and resistance level. As a trend indicator, it tells direction with its gradient. An upward sloping middle line indicates that price is in an up-trending mode. The steeper the line, the stronger the trend is. When the middle line is gentle or flat, the price may be moving sideways or in the midst of reversing the previous trend.

As a support or resistance level, the middle line is a level to watch for. When price oscillates between the outer bands, they may pause and bounce off this middle line.

The outer bands – The outer bands are commonly used as a kind of overbought/oversold indication. Its best use, however, is to show the volatility of price. They act as a pair of channels that will widen or tighten according to price action. The more volatile price is, the wider the bands become. When price movement narrows, the band also tightens.

Trading signal – There are two types of signals commonly in use. The first signal is a contrarian signal: the trader enters a buy position when price falls to the lower band. The target is usually the middle line whereas the high band is considered an aggressive target. The trader enters a short sell position when price rallies to the higher band. The trader will exit when price returns to the middle line. Similarly, the lower band is considered an aggressive target in such a move. When used in such manner, the trader considers the higher band as an overbought and

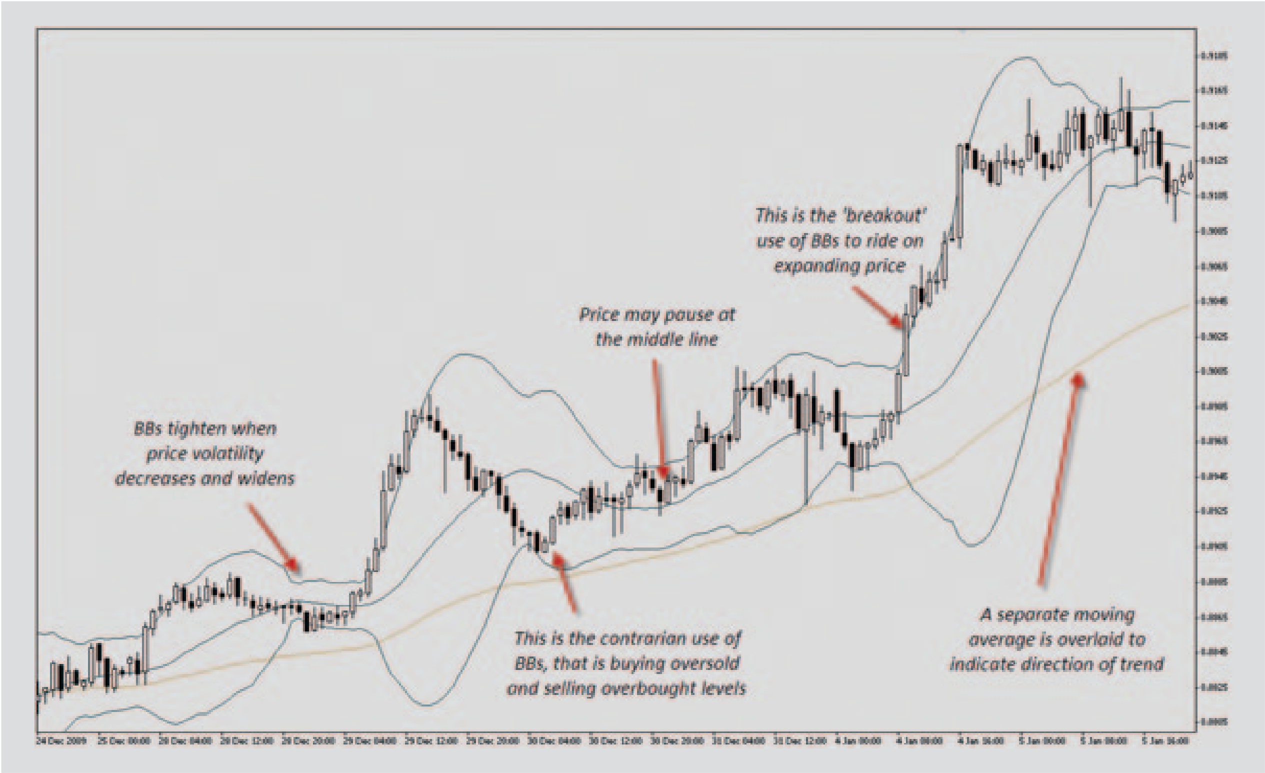

Illustration: Intraday trading the AUDUSD with Bollinger Bands

the lower band as an oversold level.

The second signal is a 'breakout' signal. This is usually used to when the Bollinger Bands tighten drastically. Traders believe that such tightening is a sign of consolidation to be followed by an expansionary phase. At the moment price closes above the higher band, a buy position is entered. When price closes below the lower band, a short sell position is entered.

DRIVING THE BOLLINGER BANDS... IN THE WRONG WAY

Many traders have the mistaken belief that price has a Normal distribution – that is having a bell-shaped graph. This is not true as security prices have no known statistical distribution. The outcome of this wrong belief is that traders will perpetually use the Bollinger Bands in the contrarian mode all the time.

They believe strongly that prices falling outside the outer bands are outliers that occur rarely. They are severely punished when the market enters a trending mode. So a trader with this wrong sight may continuously go short at the higher band when the market is in an uptrend. He will be stopped out of his short positions many times as price makes several new highs.

Other traders attempt to tweak the parameters of the BB in order to achieve a more profitable signal. Traders can encounter several variations that may use a different sample size for the moving average or a different type of moving average used. Please note that traders who personalize their indicators often do so because it is part of a comprehensive personalized strategy. Do not follow unless you know exactly what is going on.

POWER BANDS FOR THE POWER TRADER

Here are some tips that this writer found useful.

1. Use the standard form of Bollinger Bands (20 period Simple MA plus/minus 2sigma) - Traders should attempt to see what the market see so that we can act in concert with everybody else.
2. Add in another moving average to see bigger trend - Put in another moving average so that we can trade 'with-the-trend'. Use BBs to buy oversold in an uptrend and shot-sell oversold in a downtrend.
3. Complement BBs with other indications - In a trending situation, add a momentum-based indicator like MACD. In a ranging situation, an oscillator like Stochastic is a good addition.

Bollinger Bands are a very useful addition to the arsenal of any trader. Like many other technical studies, mastery of the Bollinger Bands can be a fruitful achievement. ■

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