

Teodosi's Simple Oscillator-based System

("Forex Strategies Revealed" - Simple System #8)

<http://forex-strategies-revealed.com>

-DISCLAIMER-

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Readers must ensure they thoroughly understand the strategy and all the concepts involved AND personally confirm the accuracy of all statements for their own benefit before they trade. No correspondence will be entered into.

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System Type:	Momentum based.
Currency pairs:	GBP/JPY, USD/JPY (try EUR/JPY, AUD/JPY) the GBPJPY has one of the highest daily average ranges. In a single move it may make more pips than any other commonly traded pair; however, watch the large spread.
Chart Time frame:	1-hour, 4-hour (shorter time-frames give many false signals)
Indicators:	Slow or Full Stochastic (5,3,3), RSI (7), plus Candlesticks.
Trading Time:	Monday 1000-2000, Tue-Thur 0400-2000, Fri 040-1200 (all USA EST). On Mondays, don't trade until after 1000 and only trade on Mondays if there is a really attractive trading opportunity.
Risk:	1% (2% maximum)

This system mainly uses expertise with candlesticks and momentum indicators to identify market reversals. The Stochastic and RSI are the indicators used to identify possible breakouts.

In any system, there are two major types of entry. The first is for aggressive traders, an immediate entry without waiting for the current (signal) price candle to close. The second method is to wait until the current price (signal) candle has closed and then enter the trade at the next bar if conditions have not changed and the signal remains valid. This method is more deliberate and may prevent excessive "false" entries.

Entry Rules – Long: Enter long in a strong downtrend when the RSI and Stochastic are indicating an oversold market (the 25 line) and a bullish candle has closed at or above the halfway point of the previous bearish candle (see Diagram 1 below).

It may be that the second (signal) candle does not immediately follow the first candle; a "delay" of 2-4 candles between the first candle and the signal candle is acceptable (see Charts 1 & 2).

Entry Rules – Short: Enter short when there is a strong uptrend and the RSI and Stochastic are indicating, or are close to indicating, an overbought market (the 75 line) and a bearish candle has closed at or below the halfway point of the previous bullish candle. A delay of 2-4 candles is fine.

In other words, there is either the beginning or the confirmation of a trading signal when the RSI and Stochastic are in the overbought or oversold zones - or close to them. The complete entry confirmation comes with the addition of the correct candle formation.

Stop Loss: Set at +/- 100 pips. If the stop is hit no opposite positions should be taken until a new entry signal is formed. A trailing stop is a good idea.

Profit Target: (at least 150-170 pips or let profits run)

Exit rules: In a short trade with an oversold RSI and Stochastic and the new up-candle has closed at 50% of the last down-candle – exit (BUY) and look for a new trade setup. Trades are closed when there is a signal to initiate an opposite trade or at a profit target.

Candle Identification

On the relevant chart, identify the last closed candle and then compare it to the next candle being formed. If the current closed candle is bearish and the next candle starts bullish and then closes at or above the half-way point of the previous bearish candle, this is the BUY entry signal.

See Diagram 1 below for examples of bearish followed by bullish candles. Simply reverse the colours below for an idea of bullish following bearish candles and the SELL signals.

The following are valid entry candle combinations:

- Black (bearish) followed by white (bullish) – as in Diagram 1 below,
- White (bullish) followed by black (bearish),

Note that the following are NOT valid candle combinations:

- bullish followed by bullish, and
- bearish followed by bearish.

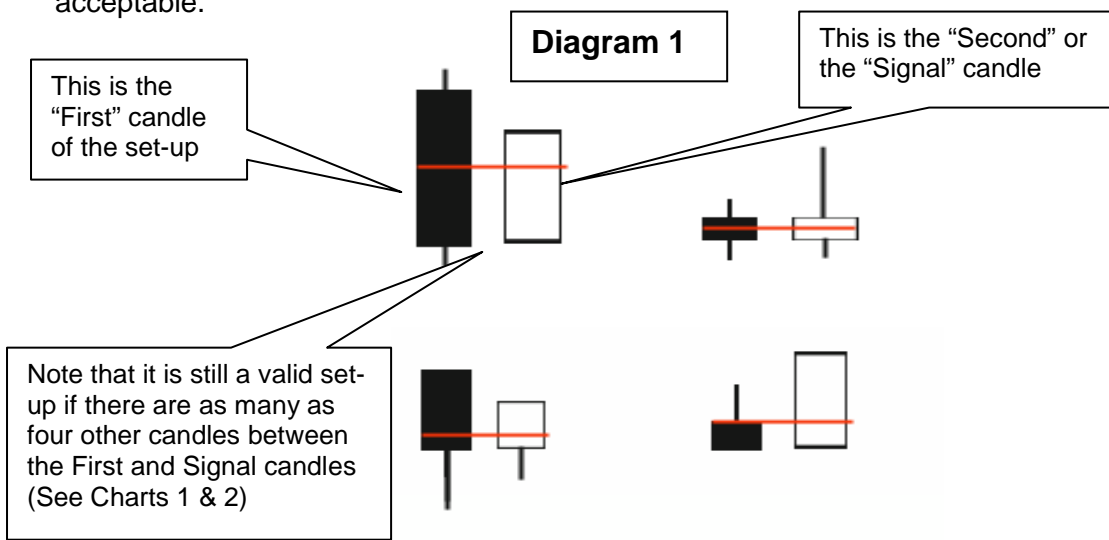
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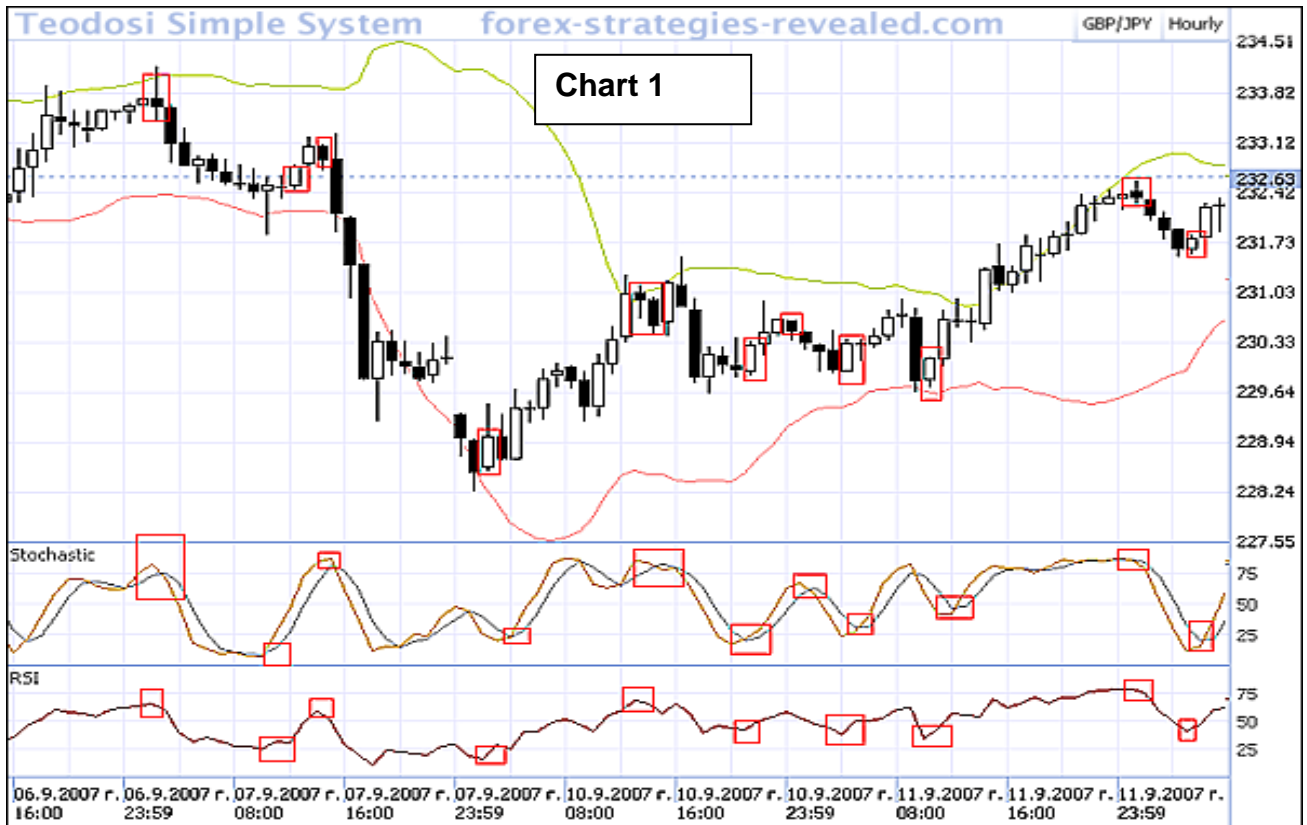
All the examples in Diagram 1 illustrate how a bullish (white) candle has closed above the halfway line of the previous bullish (black) candle. The halfway value includes the first candle's wicks. Note that it is the closing price of the second candle that is critical; the shadows of the second candle are not taken into account.

Overbought & Oversold Values for Candle Validations

It is not necessary for the RSI and Stochastic lines to be in, or close to, the overbought or oversold zone when the signal (second) candle appears. The main objective is to observe all the signals (candle formation, RSI and Stochastic) in close order on the chart. It doesn't matter which comes first. Values of 30 and 70 would qualify as being "very close to the zones" for candle validation (this has to be at the traders' discretion, taking into account their experience and level of risk tolerance). A delay of 2-4 candles after the appropriate RSI and Stochastic signals is also acceptable.



Charts 1 shows typical entry signals for this system.



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Forum Contributions & Recommendations

1. Additional Indicator - SAR: Try a Parabolic SAR set to 0.1 and 0.01. Open two trades every time changes in the dots are observed. Set the first trade with a 50-pip limit and the second trade with a 100-pips limit, with stops just to the new dot. The appealing thing about the dots is that it is rare to ever get an immediate retracement which hits the stop loss.

2. Additional Indicator - CCI: Try using a 30-minute chart and add a third indicator, the CCI14, to the RSI and slow Stochastic. Adding the CCI14 is just to gain pips on corrections of 20 - 30 pips and sometimes 50 pips.

Go short once it reaches a value of 393 or go long at values of -203 or nearby. The system works on downtrends and uptrends. However, only use the CCI14 to gain pips on corrections, it is quite dangerous to short during uptrends and vice versa.

Be aware that whenever the original system is modified, the change alters the system's rules and the effective result is a new customized system for each modification. Keep it simple.

3. RSI Values: It may be that the RSI only has to pass the 50 level on the way up or down, rather than being "close to 75 or 25" in order for the rules to apply. Be aware that waiting for the RSI to cross 50 is a more conservative approach that, in many cases, would lead to a significantly delayed entry. However, traders who do not mind missing a few early entry pips, should be able to use the 50-level approach with success if they prefer to get the additional confirmation for an entry,

4. Market Phases: The strategy has been found to work well in a ranging market, but not so well in a trending market.

5. MACD: Others found that when the market is trending it best to add a MACD and wait for a cross to confirm a direction change.

6. Warning: It is strongly recommended that beginners to stay clear from the GBP/JPY pair because of its high volatility and low liquidity. This pair is for experienced traders with very sound money management rules, who may profit greatly.

7. Other Currency Pairs: The system can certainly be used for other currency pairs. However, trading with other pairs usually means smaller price shifts comparing to the GBP/JPY, which will ultimately mean less pips per trade and possibly more break-even trades. Other than that, trading other pairs should be fine. It may be wise to use smaller stops, around 50-60 pips. The system was implemented for the GBP/JPY because this pair has a wider daily range and therefore trading profits are expected to be larger.

9. Indicator Levels: An observation has been made that the RSI and Stochastic must first cross the 50 level before moving into the oversold (30) or overbought (70) zones in order for these signals to be valid before the candles can be used for entry.

10. Entry: An additional trading edge may be achieved by looking for divergence between price and the Stochastic after the signalling candle (as in Teodosi's original rules), and then entering.

11. A successful user suggests these refinements:

- **Indicator Values:** The values for overbought and oversold lines should be slightly different between the Stochastic and the RSI. Set the Stochastic to 75 and 25, and the RSI to 70 and 30 (it has been noted that the RSI rarely hits 75 or 25).
- **Pullbacks:** Do not enter immediately on the next candle after getting the signal as there is almost always a pullback that will give a better entry. These pullbacks will usually reach the middle of the signalling candle, and will increase the amount of pips for the trade. This also goes for exits; wait until the pullback to exit.
- **Stop Loss:** Don't alter the 100-pip stop loss, it is "uncannily perfect" for this system. Every time the user tried to make the stop smaller than 100 pips, they were stopped out on a pullback before the intended move came.

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- **Breakeven Stop:** When sitting on more than 100 pips of profit, move the stop to breakeven. If the profit reaches 200 pips, move the stop to 100 pips of profit, and so on.

12. Indicator & Signal Delays: Sometimes the RSI may cross 75 up to thirty minutes before the Stochastic indicates overbought. Then, perhaps up to one hour later, the candle signal may appear (this scenario is based upon going short), but by that time the RSI and the Stochastic may have dropped below the line, *however, the candle is still a valid entry signal*. A delay of 2-4 candles is fine.

13. EMA Additions: One user found that adding 10, 25 and 50 EMA lines helps adhere to the trending rules. The system then becomes a mixture the basic EMA-crossover method and Teodosi's candle formations. Do adding the extra indicators there is a lot to monitor, but the 10 EMA crossing the 25 EMA confirms the move. The 50 EMA allows the current trend to be observed and indicates which way the market is likely to move. Back testing this method seems to have the potential for massive gains. One trade was nearly 300 pips.

14. Candlestick Types: A user advises that the candlesticks described are effectively "Dark Cloud" and "Piercing Line", and asks if other reversal patterns, such as "Harami", "Abandoned Baby", "Morning Star", "Evening Star", "Hammer", "Doji", etc, can be used as well. He also thinks that it may be best to look at a daily chart for trend direction and only trade with the main trend, rather than taking retracements (However, Teodosi's system is a retracement system). Additionally, it doesn't matter what the candle formation is called, the important requirement is for presence of the appropriate signalling candle combination.

15. Time-frames & Indicators: A user suggests that for better results, try checking the RSI and Stochastic on a daily chart for confirmation. For example, if a sell signal appears on a 1-hour chart then check the daily chart and if both the RSI and Stochastic are overbought then SELL. Use the reverse for BUY confirmations.

16. Stops: Try a stop loss set at previous swing high/low and move it only when a trade shifts into positive territory and makes +30 pips or more. Then move the stop to breakeven and allow the trade to run. Expressed another way, the stop is simply set at the lowest/highest point to the left of the signal candle. This high/low is often found within the previous 1-2 candles.

17. Exits: Once the stop is set as in point 16 above, wait until the Stochastic lines cross against the position for the first time and immediately take half or two-thirds of any profit and let the rest run and exit the remainder by strategy rules.

18. Stops: A trailing stop should be placed behind the last closed candlestick, or, in order to stay in a trade longer, place it behind the second-last closed candlestick. Often, in both cases, the exit comes before the move ends; however, the exit will be with profit each time. Do not try and trade the whole trend.

19. Time-frames: A user suggested looking for signals on 1-hour, 2-hour and 4-hour charts. Edward responded that there was an advantage in being able to combine knowledge received from different time frames.

20. Exits. Exiting at Bollinger Bands is possible, and this indicator provides a good visual reference of the price action. A suggestion is to use a trailing stop once the Bollinger band is reached. If the price advances outside the Bollinger bands, it is a good indication of a good rally in an uptrend or a sell-off in a downtrend; therefore it may be attractive to try to stay a bit longer to profit from the move.

In general, if the candle that hits the outer Bollinger Band is relatively long, move the trailing stop to half of this candle's length, because if the move on the Band means a strong continuation (which is usually expected), there would be additional profit. However, if the Band touch/break was the last gasp of the price, take a quick to exit - having given it a chance with the tighter trailing stop.

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21. Stops: It is acceptable use a Parabolic for stops. However, for entries, the Parabolic will be late to confirm the signal.

22. Signals: It is not always necessary to wait for the next candle in the signal pair. In an uptrend, if the price action is near the outer Bollinger Band (20, 2) and the Stochastic and RSI signals are good, then as soon as the first black candle closes half way through the previous candle make an entry. See Chart 2 below.



23. Chart 3 is the GBPJPY on Jan 13, 2010, when a reversal was indicated but did not occur.



Analysis & Recommendation

1. Try to be more conservative; instead of entering immediately on the Close, place a pending order below the signalling candlestick, especially so, when this candlestick is a long one.
2. Get additional clues from the RSI indicator: when the RSI reaches an oversold/overbought level and SHARPLY exits from it – this is a good indication of a reversal. However, when RSI reaches

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an oversold/overbought level and doesn't immediately exit, but trades there for a while, that's an indication and that a trend is not planning to change, and any corrections to it (marked with RSI exiting the oversold/bought levels) will be minor and temporary. ***Also, nothing is certain!***