

TRADING INDICATOR BLUEPRINTS

EFFECTIVE USE OF THE
MOST POPULAR TRADING
INDICATORS



Trading Indicator Blueprint

Effective Use of The Most Popular Trading Indicators!

By Netpicks.com

TRADING INDICATOR BLUEPRINT

Whether you are a new or experienced trader, you are probably familiar with the multitude of trading indicators available.

I know when I started trading almost a decade ago, virtually every indicator ended up on my charts at one time or another.

And it was frustrating!

You may be able to relate to:

- Always searching for the “perfect” combination of indicators for high probability trading setups.
- Tweaking inputs over and over again trying to “fit” the indicator to past price to match the perfect trade.
- Looking to “catch the turn” to avoid adverse excursion and to take every pip or tick the market is willing to give.

Adverse Excursion

The amount of loss an open trade takes before completion with profit or a loss.

The hard truth is that PERFECTION does not exist in trading.

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Neither does the perfect indicator or perfect setting.

You can use indicators as part of an overall trading system and although that requires a lot of work and testing, it can be done!

So where do you start?

The Truth About Indicators

The majority of indicators use price in their mathematical calculations before plotting on your chart.

That is a KEY point to understand!

Indicators are derivatives of price (unless you are using a volume calculated indicator) and the majority of times, you can see in price what the indicator is telling you (you will see that later).

The second part to that is that indicators can be broken down, in a broad sense, to two distinct categories:

- Trend Indicators
- Momentum Indicators

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Trend indicators, such as moving averages, simply smooth out the past price data and give an indication of the overall direction of the market.

You may look at the slope of the moving average and only trade in the direction of the slope.

Other traders may determine which side of the moving average price is on the majority of time and only trade in that direction.

Momentum indicators, such as the MACD (moving average convergence divergence) measure the rate of change in the price of the instrument.

If price is moving up rapidly causing a greater interval-interval price change, the momentum indicator will register a reading to tell you that the momentum in the instrument is changing to the upside.

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When price is above the solid black moving average, you would only look for buying opportunities on this time frame and if using multiple time frame trading, lower time frames.

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Reverse that rule when price is below the moving average.

You can also look at the slope of the black line:

- If slope is up, only buy setups are considered
- If slope is down, only sell setups are considered
- If moving average is sideways and cutting through the price bars/candles, stand aside and wait for an obvious trend

The bottom of the chart has the standard MACD indicator applied to show momentum in the instrument.

Using the multi-colored line (the fast line of the MACD) to gauge momentum you can see that:

- Trend can be up while momentum turns down which does not automatically mean to look for short trades
- There are times where trend changes coincide closely to the momentum change (these can make some great trading setups)
- When the two lines of MACD are tight, price is not in an obvious trending state.
- When the fast line is far away from the horizontal line, this can indicate an extreme move in price that you can also see in price

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The truth is that an indicator can give you a ton of information (often conflicting) and that causes a huge issue with traders.

WARNING: Too much information will lead to paralysis by analysis!

On the previous chart, we are using two indicators and already there is some conflicting information that can lead traders astray.

1. Momentum turning down while price is in an indicator uptrend.
2. Trend turns down long after momentum causing price to be far away from the turn.
3. Price shows different trend structure before indicator trend turns

It gets worse!

Many traders are not happy with just two indicators.

They need **MORE** confirmation so they put on a few more indicators to confirm what the other indicators (plus price) is telling them!

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Longer term moving averages, usually three to highlight trend direction of different time periods including short, medium, and longer term trend.

Traders usually overlay all three averages on the same chart.

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Longer Term Moving Averages

The most popular averages are the 20, 50, 100 period simple moving averages.

They will also use an oversold/overbought indicator to determine if price is at an extreme.

Oversold / Overbought

The theory that a market can have **too long** or **too sharp** of a run in one direction and must correct. The market can remain in these conditions longer than you can remain solvent and OS/OB shouldn't be your main driver of a trade.

You can't forget the trend lines and the very popular support and resistance lines that traders add as well.

It all becomes a huge jumble of information that is almost impossible to decipher with any consistency.

Indicators are supposed to make your job easier.

Not harder.

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Traders plot different indicators that use the same base ingredient (price) calculated differently to give them a different answer to the same question.

Traders plot indicators without understanding what the indicator is telling them nor the subtleties and nuances that indicators have.

Worst of all....

They are used without a concrete trading plan that comes after back testing and forward testing the trading concept.

4 Effective Indicators You Should Know

You now know that indicators are mostly derived from price through a mathematical calculation.

You know that it is very easy to misuse trading indicators through excessive additions to your trading chart.

You are aware that indicators come in two distinct flavors; trend determination and momentum.

It is vitally important to ensure that any reliance on indicators as part of a trading system comes with a complete understanding of the indicator and used as part of a tested trade plan.

Now that I have put that warning out loud and clear, it's time to go over four indicators that I and many other traders have found extremely useful (*some would say "vital" to their trading*).

One indicator I won't cover is volume. I wanted this blueprint to be useful across a wide variety of instruments and Forex does not have a reliable indication of volume.

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After all, the FX market is not centralized and for many traders, the market is actually your retail broker.

Moving Averages

These are probably the most recognizable indicators to traders as the majority of charts you will come across will have at least one of them.

Simply put, a moving average is simply an average of price over a specified look back period. The most popular periods are 20, 50, 100 but the truth is there is no “magic” number in isolation.

Look back period is how many bars are considered during the calculation.

There are different calculations depending on the type of average you are using and the most popular types are:

- SMA (simple moving average)
- EMA (exponential moving average)

The SMA is just a standard calculation of the average of the last X bars. The EMA front weights the more recent price data.

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Don't get caught up in endless hours of testing to see which type is better any more than you should trying to find the perfect look back period.

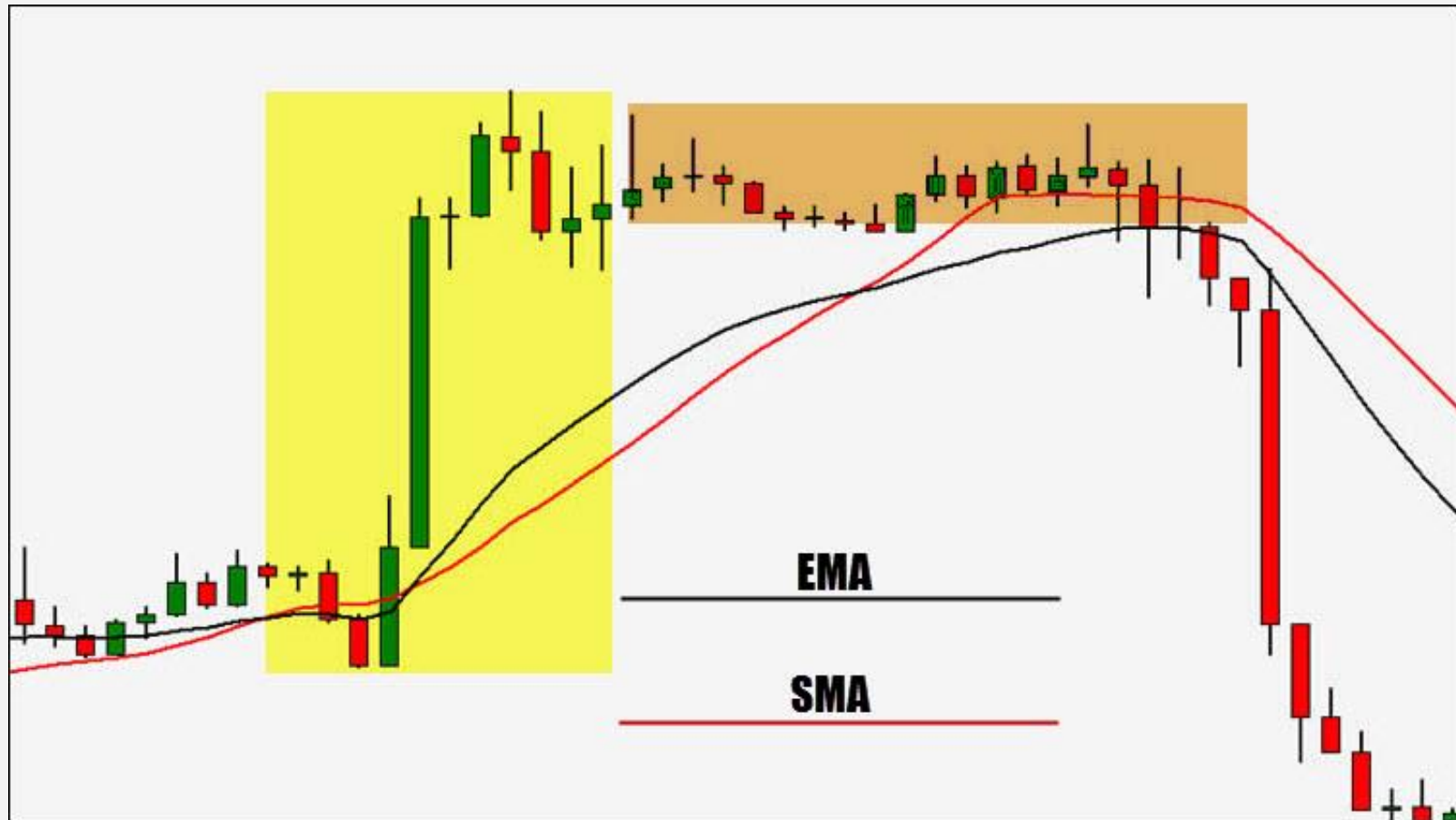
1. Shorter look back periods will have more sporadic moves
2. EMA reacts faster to sudden price moves but slower to find balance when prices does
3. This chart shows a yellow highlighted area that had an extreme move in price. The EMA reacts quickly to the move while the SMA has a gradual climb.

The orange highlight shows quite a balance in price and the SMA has gone flat while the EMA continues with a slope.

These are nuances that many traders don't think of but show that unless you can statistically find an edge in one over the other, it really doesn't matter what you use.

The caveat that whatever you use you be consistent with, applies

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I want to mention something else.....

Support and resistance using moving averages.

You've heard something along the lines of "X has found support at the 50 period moving average" as if the average **WAS** support.

It isn't.

We are drawn to lines and patterns on charts and it is extremely easy to see where price bounced off an area of X moving average.

We tend to ignore where it doesn't happen.

We tend to add weight to where it does happen that solidifies that that 20, 34, 50 or whatever number is having an effect on price.

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You can see where the faster SMA crosses the slower SMA and price pulled back to the average and found “support”.

These are perfect pullbacks and offered four great opportunities.

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These must be the popular settings because price bounced perfectly from them, right?

No. I scrolled to a random time on the chart and used 37 & 63 SMA.

They were just random numbers.

A clue for you though - look to the left.

Price pulled back into structure areas to the left of the chart.

The fact that the random numbered moving averages were in the location, could be, well, random. (plus a simple function of the calculations and price finding pauses allowing the average to actually catch up to price).

Are they useless then? Take a look at this chart.

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A moving average, in this case the often talked about 50 SMA, is being used as a **trend indicator**.

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The indicator will smooth out price and can quickly give you a broad view of the direction in price using slope or price position.

The up arrow shows the **average sloping up** and also that price is clearly **above the average**. In a broad sense, you'd look at this time frame as up and perhaps use that when trading lower time frames.

The average slopes down and price is below so you may consider short trades.

We then get the **average cutting through price**. This indicates a market in balance and perhaps you may want to stand aside or simply choose another instrument or time frame.

Remember as mentioned earlier, this is dependent on the look back period you are using so ensure you take that into account.

So as a trend indicator, there is some usefulness to them.

Is that it?

What about trade determination?

When we talked about trend and averages, you saw that when the market is in balance, price can hug the moving average.

The point is not that it hugs it but that it comes close to it.

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When price is far from it, it is out of balance.

Let's take a look.....



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I picked a random number (44) to use for the SMA and my rule will be to not sell when price is far away (how far is subjective so you may want to make a rule) and need price to find balance near the average.

This works better in the normal impulse/corrective trends. Markets that pull away too far and with a larger number moving average, it may take a while for price to come back close for a trade setup.

Price comes out of a period of chop, the average turns down and with price below the average we look for a rally to short.

You can see on the first two shorts what would have happened if you shorted after the red momentum candle. Trade went into a losing position quite fast.

We wait for a pullback close to the average, look left for structure, and use some type of entry to take a short.

The last setup is tricky however price wasn't finding acceptance at the higher prices so shorting is still a possibility. Price action may have kept you out of trading this move or had you trading a range method.

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Moving averages without context and in isolation are not a high probability trading tool with exceptions laid out.

If using moving averages for a trading system ensure you have other variables in play as part of a complete trading plan.

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Keltner Channels

A Chicago grain trader named Charles Keltner created these channels and along with Bollinger Bands, they have become extremely popular. (Various tweaks by Linda Bradford Raschke)

Actually, there are some traders who use the Keltner and Bollinger Bands combined on the same chart but that won't be covered in this blueprint.

What's great about channels are they can highlight extremes from an agreement in price which can be very helpful in setting up a trading opportunity.

Keltner channels encompass price and can be a quick visual reference to the current trend.

That's not the best part.

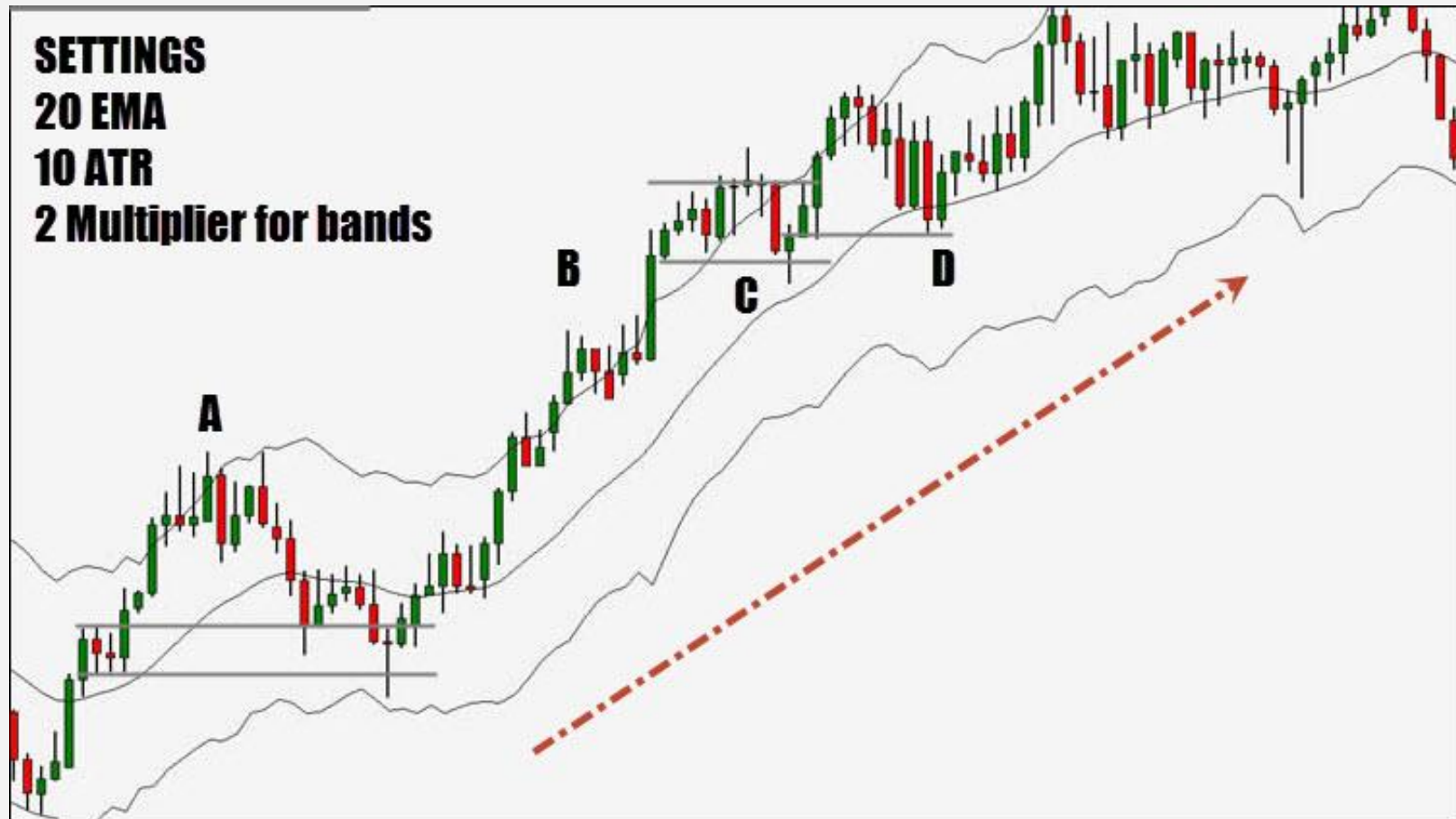
Since the encompass price, any move towards either extreme or even better...a flash outside the channel, can act as a signal for you to take notice.

Remember there is a moving average contained in the Keltner and as we covered earlier, a move away from a moving average is something to take note of.

As covered in the moving averages section, a longer Keltner MA will be less volatile than a smaller setting.

We should get to a chart.

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As a trend determination tool, it is easy to see that the trend is up on this chart. Higher trading odds would be buying dips in price.

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Here's a tip:

Buying pullbacks or selling rallies should not be done without a strong impulse leg before the correction.

One quick measure of the strength is highlighted at “A”. Price rallies to the upper band and the strength drives it outside of the bands.

Overextensions will lead to a correction (not always immediate) and this could have you ready to take a trade when price comes back somewhere around the middle of the channel

That could be your cue to see if a setup is apparent.

The grey lines represent a structure area where price pulls into. Price ranges, failure test of the lows (good entry points in context), and then continues upwards.

Let's assume you took that trade long.

What you see at “B” is strength in this market as price slides up the upper band. If in a position, you'd want to manage this trade with the expectations that extreme strength could have a strong adverse move.

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Markets alternate between impulse and corrective moves. When price is sliding outside the band, the normal ebb and flow is not present on the chart. Be on alert for a change of state in the market when you see this.

You just don't know when it will happen.

As you can see, the channel has pointed out the extreme nature of this uptrend which then puts you on alert (if in a trade) that a strong correction could be around the corner.

Price is still outside the channel at "C" and then starts to range. This ranging activity allows the moving average to catch up to price which may have you thinking it's a legitimate pullback to the average.

It isn't. It is a range play and this is where understanding the nuances of your trading indicators comes into play.

Price pulls back at "D" into the moving average and structure at "C".

But what is really happening?

The Keltner Channel has given a sign that price is trading at extremes as price travels outside and alongside the upper band.

Notice how close the pause in price at "C" and "D" are compared to previous action.

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Those two combined, is a Keltner / price action heads up that this move may be coming into a correction and trade management is paramount.

We just covered taking a with-trend trade on a pullback after price shows travel outside of the channel and then returns to the middle supported by price structure to the left.

The KEY is to see price in an extreme state by going outside the channel in a trending market.

Then ask yourself if the preceding impulse move is as strong as the other impulse moves in the trend. Then find your set up.

What about fading the extreme?

Fading the move outside of the channel is possible but you must see an **extreme move** and not simply a poke outside the channel.

What is an extreme move?

Extreme is a subjective term so you'd want to ensure you have rules in place so you are not simply guessing or seeing something that isn't truly happening.

Our brains look for patterns so you must ensure that whatever you are looking for fits a definitive definition.

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While price near the top/bottom of the band may be considered extreme, it can also be considered as part of the ebb and flow of a trending market.



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Price was in a sideways range for 43 days before breaking to the upside with strength as evident simply by looking at the candles.

A slight pullback that was probably untradeable due to the shallowness and then price rockets again outside the channel.

- Range breakout with momentum
- Price outside channel with multiple closes
- Perfect reversal candlestick.

This is perfect context for taking a fade off of the extreme.

The Keltner Channel has multiples uses and with what we covered, you could start scrolling through charts to get familiar with this indicator.

1. Price sliding and outside channels, shows strength.
2. Look for pullbacks to somewhere in the middle for a possible opportunity and needing perhaps structure support.
3. Fading is possible when price is showing extreme moves not only outside the channel but also tipping its hand with a reversal type of candle.

Points To Consider

The Keltner Channel can be a powerful tool but you must take the time to study price reactions at certain points of the indicator.

Blindly fading extremes or buying/selling weakness and strength is a fast path to disaster.

Ensure you have fully tested whatever way you intend to use the Keltner and are using a trading plan taking into account your trade setups, risk, and trade management.

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Stochastic Oscillator

George Lane brought us this oscillator and it has become a staple in many trading plans covering many instruments.

There is a fast and slow version of the Stochastic. I find the fast version very ragged in appearance and will only cover the slow version in the blueprint.

Stochastic is a two line oscillator consisting of:

- %K – Periods used in calculation. (14)
- %K Slow or Fast %D – Smoothing factor (3)
- %D Slow – Periods for moving avg of K (3)

There are also two main lines of 20(30) and 80(70). These refer to an oversold and overbought condition.

Those two conditions are the most abused use of this indicator so let's cover those first.

- Oversold – Price has fallen in the instrument below its true value.
- Overbought – Price has risen in the instrument above its true value.

Looking at those two definitions, you can probably already see how these levels are used – and abused.

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Buy when the market is oversold.

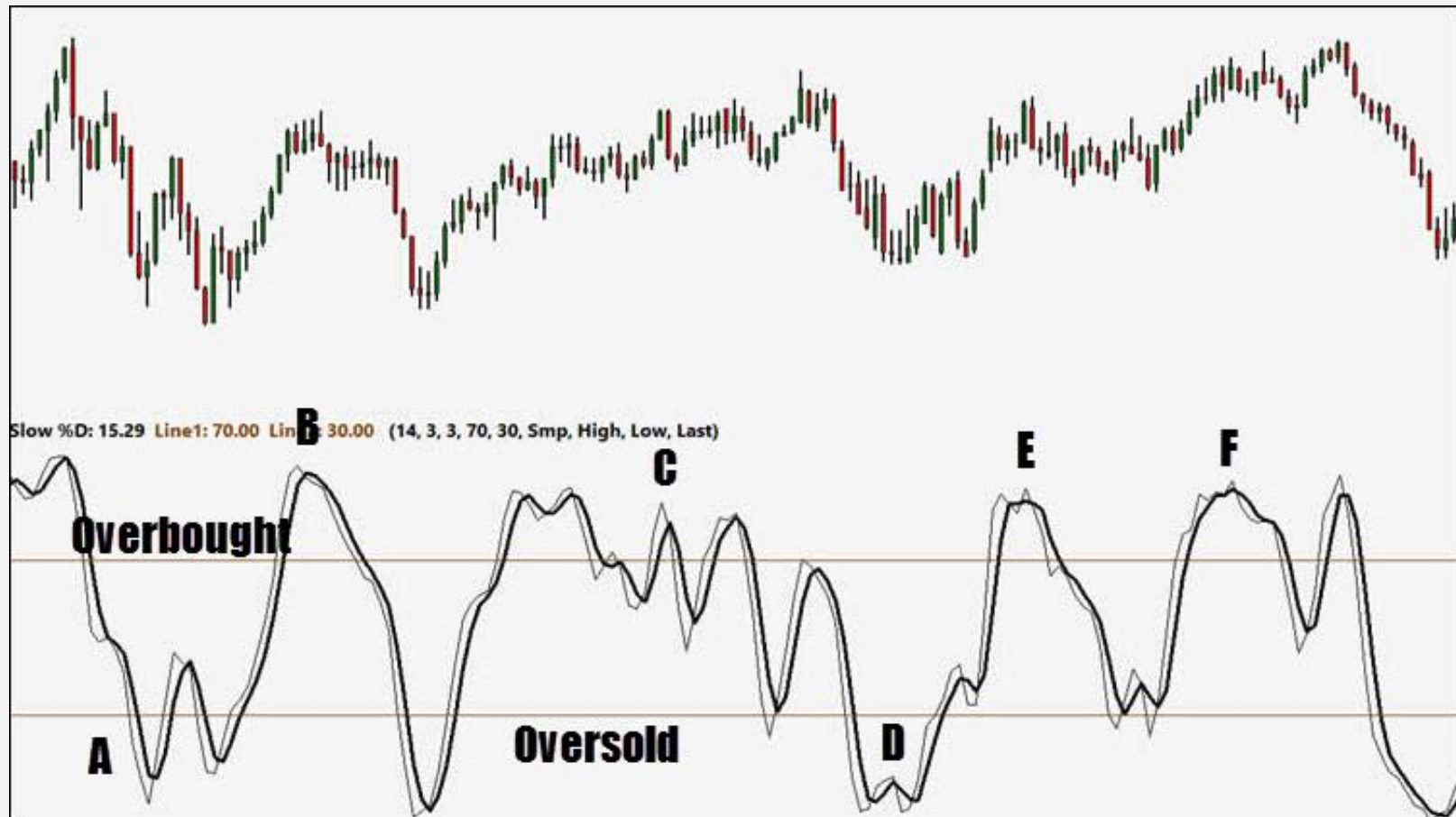
Sell when the market is overbought.

It's that simple, right?

Not really.

Take a look at the following chart and you will see that it is not as cut and dried as some will want you to believe.

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- A. Price reached oversold and a buy would have given you a little and then momentum pushes to the downside taking you out.
- B. Hits overbought and if you sold, you sat through some nail biting times.

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- C. Price is again overbought but any downside move was extremely limited.
- D. Ranging price action again at oversold
- E. Overbought with limited downside.
- F. Overbought, dip, swing high taken out, finally a drop.

These OS/OB levels are useful but not to just blindly take a position at. Ignoring context such as trend and where it takes place on the chart (i.e. structure), your trading will be extremely painful.

The easiest way to use OS/OB is in context with the trend. If you are in a buy trade and the market becomes overbought, don't add to your position until the market works off that condition.

Just reverse that for short positions.

You can also use that condition to ensure your trade management won't have you giving too much back if price reverses on your position.

While it is not an invitation to execute a trade, OS/OB conditions are also not to just exit your position either.

Another often abused method of using oscillators like the Stochastic is **divergence**.

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- Bearish Divergence: Price makes a new high. Stochastic makes a lower high
- Bullish Divergence: Price makes new low. Stochastic makes a new high

Just like OS/OB, you can see how it's easy to simply execute when these divergence conditions are met.

It's not the right thing to do.



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The arrow on the left shows that price pushed higher and then reversed. At that point you can pinpoint where the Stochastic made its high.

Price revisits the high and takes out the previous high. Looking at the oscillator, it didn't follow price into new highs but marked a lower high.

Divergence has taken place.

Do you just short this market when divergence occurs?

No. Any condition in the market that you deem provides an opportunity must only be acted upon after you have tested the condition for an edge.

This condition however can have you tighten stops on any open long positions as well as avoiding executing any long position until (or if) there is price acceptance above the new high.

While outside the scope of this blueprint, there is a setup for a trade once price fails to keep the high.

The move on the left was the pivot after a very mature trend to the upside. The red candle at the peak provides a very good visual clue of the selling at that level making this a prime potential resistance area.

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Markets love to probe above and below significant points for potential interest as well as stop runs.

The test of the level has a tiny red candle break the high and reverse.

That sets up the entry into a potential move to the downside.

Trend And Trigger

There are two usages that some will find more interesting and that is using the Stochastic for trend determination and a trigger.

What's really great about the trend usage is you are taking the trend from a higher level and taking setups on the lower level in that direction.

A trigger is simply what you need to get you into a trade after the setup has been located.

No trigger. No trade. It's that simple.

On this chart, we have candles representing a 15 minute chart and a Stochastic for that same period.

The bottom Stochastic is from the 60 minute chart showing us the trend direction.

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Since we are using Stochastic for trend and taking that trend from a higher time frame, we will take setups on our trading chart (15 minute) even if higher time frame is overbought/oversold.



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During the uptrend, we have an ascending trend line and at “A” price pulls back to test. As the same time, we have the top Stochastic hooking and crossing to the upside.

That is our trading trigger supported by the trend line setup.

Trend Stochastic is hugging the overbought border and the lines are tight together. We still take long setups.

Price pulls back to an area at “B” that was once resistance just off to the left of the screen capture, broken, and is now testing for support.

At the same time, the top Stochastic is hooking and crossing to the upside.

That is our trading trigger supported by support and in line with the prevailing trend on the higher time frame.

Points To Consider

You can see there are many valuable uses for the Stochastic from the simple trend usage to the slightly more complex OS/OB conditions. However, you must test.

Like every indicator talked about so far, context matters and without that, success will never be consistent.

Moving Average Convergence Divergence (MACD)

Out of the many indicators available to traders, the MACD is the one I like the most.

From trend determination to momentum and swing analysis, it is a great addition to any trading plan.

There are so many settings you can use as well as the calculation type of the moving average that could be a blueprint in itself. For this blueprint, I am going to focus on the standard MACD settings.

The MACD breaks down into the following components:

1. Fast Line
2. Slow Line
3. Zero Line
4. Histogram (something I don't use)

Exactly as the name implies, we look at the diverging (pulling away) of the moving averages from each other as well as the converging (coming together) of them.

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I have applied moving averages to the price area to better show how the MACD works. This chart will show how you can gauge momentum as well as use the MACD for trend.

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The MACD indicator is labeled:

1. The MACD line (12 day EMA – 26 day EMA)
2. The signal line (9 day EMA of 1)
3. Zero line

The solid vertical line shows the crossover of the MACD line and the signal line. This indicates momentum is shifting to the upside.

How would that play into a trade plan? After testing, you would have to decide if you would take action on any open position (in this case a short position).

Would you use any cross back of the MACD and signal as a trade trigger? Again, you would still need to test that as well as have a setup to position against.

Now look at the dotted vertical line.

You can see the MACD crosses the zero line and the averages on price cross and point to the upside.

You can use this as trend determination tool, a trade trigger against a setup, trade management tool, or whatever testing has shown to have value.

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Remember using the Stochastic to look at divergence? The MACD has that same usability but again, context makes a big difference in the outcome.



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We can see price was in a range and the MACD on the left puts in a swing level along with price. Price goes back into the range.

One great trading setup is when price is in a range and then there is a movement out (in this case) to the upside in what is an overall downtrend in price that is just off to the left of this chart.

At the same time, the movement out of the range on the right puts in a higher high but the MACD puts in a lower low. Divergence is in play in the context of a down trend plus a failure test of the resistance zone of the range.

You could make an entire trading plan out of this one setup.

Where you may find the MACD particularly exciting is when using multiple time frame trading.

I am going to walk through using two time frames with the MACD. The higher time frame will be to determine the momentum trend as well as when to avoid this particular market.

On the lower time frame, let's look at the setups that are in line with the higher momentum and use the MACD as a trigger into a trade.

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We are going to look at an intra-day trend using the 60 minute chart so you can see more of the changes that take place.



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Remember, this is the momentum trend we are looking at on an intra-day basis. You can see the overall price trend is heading down but in certain areas of the chart, there are opportunities on lower time frames for trades to the upside.

We are only concerned with the cross of the fast/slow lines although you could use the zero line as a confirmation of the trend. I generally ignore the zero line.

The yellow highlighted areas show where the fast/slow lines are tight together. Compare that to the price action and you can see that we have choppy/ranging price.

While there can be opportunities on lower time frames while the higher time frames are chopping, you may run into whipsaws when trading in tight MACD conditions.

Whipsaws are when price is darting back and forth without a clear direction. Many traders get caught trading these conditions flipping their bias long/short and simply churn their account to zero.

Look for conditions where the lines are sloping and are spaced apart as opposed to sideways and tight.

Now that we identify the higher time frame trend, let's drop down to a lower time frame and pick up where the previous chart left off.

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I picked a not so perfect chart because much of the time, perfection does not exist in trading.



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The vertical green line is where the higher time frame made the obvious fast/slow line cross. The chop zone represents where we saw the tight MACD and this area had a lot of wicks and wild swings in both directions.

The first green box is a range with a breakout pullback play. The MACD and signal line came close to touching but again, it wasn't perfection. Your trading plan will need a rule about what to do in that case.

We are able to connect two points to a trend line (I consider a swing point valid when a low/high is taken out) and price pulls back and starts to bounce. The MACD has a slight cross and then crosses back to the downside. This could be your trigger.

You can see our MACD crosses back to the upside telling us on this time frame, momentum has clearly shifted.

We don't look to buy as our higher time frame momentum trend is still down.

Price pulls back to an area of congestion with a strong momentum break to the downside. Many would consider this a "supply zone" simply by the strength of the move away from the zone.

Price reverses directly below the zone, MACD cross show momentum to the downside PLUS the MACD bouncing off the zero line.

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You can see that we had our trend in place and simply looked for setups/triggers on the lower time frame.

While the MACD settings of 12, 26, 9 are out of the box settings, many people use modified settings including 3, 10, 16 and 8, 17, 9.

As with any indicator, there is nothing magical about those settings. Longer settings simply lag further behind the price.

Points To Consider

Fast settings can give you more opportunity with the higher risk of getting into choppy trading conditions. You will need to test your settings alongside your preferred trading setups.

Using multiple time frames in your trading assures you are trading within the context of the stronger chart time frame including zones of interest such as support and resistance that are generally more “respected” in the bigger picture.

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Indicator Wrap-Up

We covered a lot of ground throughout this blueprint and it is clear that indicators do offer an aid in your trading decisions **but the value is only determined by HOW they are used.**

If you were to simply apply an indicator without any testing as to what makes up your trading decisions, you will never find consistency or overall success.

Testing is an **extremely important but often overlooked** aspect of trading. Not only must you test an individual indicator but if using more than one, how does the information from one influence your outlook on the information from another?

- What influence does price action have in relation to your interpretation of the indicator?
- What influence does price structure have in relation to your interpretation of the indicator?
- Where do you enter?
- Where do you take profit?
- Where are you placing your stop?
- Trade management and risk parameters?

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The preparation that goes into designing a trading system with a read edge is time consuming and often very frustrating. This frustration leads people to begin trading long before the system is ready to go.

You must take your time.

You must back test in various forms of market conditions.

You must forward test in live markets to ensure that your trading plan is actually able to be executed in the “heat of battle”.

Designing your trading system with the aid of indicators is a lengthy and challenging journey especially if you are new to trading or a frustrated “veteran”.

But once you’ve designed and tested....**as long as you stick to your proven trade plan**....you give yourself the opportunity to call yourself a successful trader.

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