**Introduction to Donchian Channels**

In my testing of thousands of trading ideas over more than 25 years of technical analysis, one of the most effective approaches is to buy meaningful support and sell significant resistance. Many traders hand draw their key support lines (where the stock has recently held up before) and also note a security's overhead resistance (where sellers have emerged in the past).

I find RIchard Donchian's innovation of Donchian Channels can save a lot of time and effort to automatically mark the relevant support and resistance over any given "lookback" period.

I like to use a shorter-term Donchian Channel in the context of the longer-term trend. One of the breakthroughs in trading Donchian Channels for me occurred when I realized that trades performed better when I bought support in an uptrend while selling resistance in a downtrend.

Many traders have been gored in recent years trying to pick a top in the bull market, when it's much easier to buy the pullbacks in the uptrend until the long-term trend shifts to the downside. And there are always plenty of stocks in downtrends too which in turn can set up plenty of bearish opportunities as well. You just have to know where to look.

Most comforting of all, I tested my modified Donchian Channel approach on the Dow Jones Industrial Average over the last 90 years on TradeStation. I figure that while recent history may be a better gauge, it can't hurt to see if the method works in other bull, bear and sideways periods. And as you'll note in the charts below, the results were well beyond my expectations:

Equity Curve Line

Equity Curve Line - $INDU Daily(4/29/1925 16:00 - 4/28/2015 16:00)
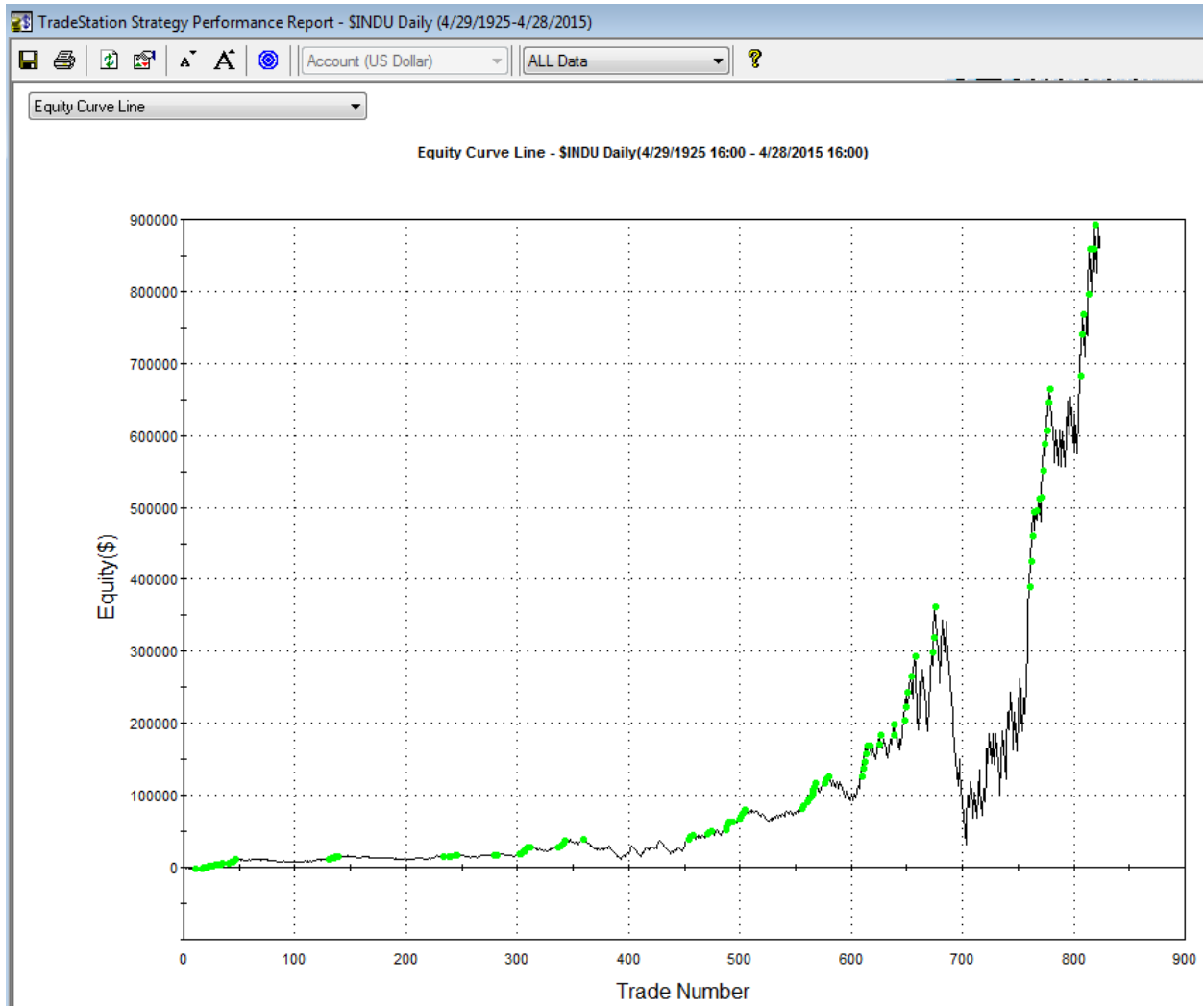
Past performance is no guarantee of future results. Backtest does not include commissions.

Even more impressive, while the Dow Industrials hit a peak around 400 in the Roaring Twenties, then crashed to 41 in the depths of the Great Depression, you know it's been a massive bull market overall since then. With the Dow around 18,000 these days, you'd think that this would only work over time on the bull side. But as the chart below shows, bearish trades made good money too with the BigTrends Donchian Channel system! In fact, the size of winners vs. losers was even bigger on average on bear moves, meaning you can expect more dramatic gains quickly when you are right on bearish signals.

TradeStation Performance Summary   Expand ⌄

	All Trades	Long Trades	Short Trades
Total Net Profit	$858,766.00	$649,799.00	$208,967.00
Gross Profit	$3,769,604.00	$2,614,322.00	$1,155,282.00
Gross Loss	($2,910,838.00)	($1,964,523.00)	($946,315.00)
Profit Factor	1.30	1.33	1.22
Total Number of Trades	823	491	332
Percent Profitable	39.98%	45.62%	31.63%
Winning Trades	329	224	105
Losing Trades	494	267	227
Even Trades	0	0	0
Avg. Trade Net Profit	$1,043.46	$1,323.42	$629.42
Avg. Winning Trade	$11,457.76	$11,671.08	$11,002.69
Avg. Losing Trade	($5,892.38)	($7,357.76)	($4,168.79)
Ratio Avg. Win:Avg. Loss	1.94	1.59	2.64
Largest Winning Trade	$68,724.00	$68,724.00	$50,973.00
Largest Losing Trade	($71,438.00)	($71,438.00)	($28,298.00)
Max. Consecutive Winning Trades	7	6	7
Max. Consecutive Losing Trades	15	12	18
Avg. Bars in Winning Trades	12.91	13.95	10.69
Avg. Bars in Losing Trades	8.95	9.64	8.15
Avg. Bars in Even Trades	0.00	0.00	0.00
Max. Shares/Contracts Held	100	100	100
Total Shares/Contracts Held	82400	49200	33200
Account Size Required	$332,870.00	$208,628.00	$217,357.00
Return on Initial Capital	858.77%		
Annual Rate of Return	2.54%		
Return Retracement Ratio	0.13		
RINA Index	376.75		
Trading Period	89 yearss, 1 Month, 26 days		
Percent of Time in the Market	35.11%		

Past performance is no guarantee of future results. Commissions not included. Also note that technically you cannot buy the Dow Jones Industrial Average (DJIA) directly, so you should focus not on the dollars (which are backtested based on theoretically buying or selling 100 shares on each signal), but rather focus on the principle that money can be made on both sides of the market, even in a long-term uptrend.

You can see another important lesson in the above data. It doesn't take a high winning percentage to make a lot of money in the markets if you can get more out of your winning ideas while cutting your losers relatively quicker. Many traders are under the mistaken impression that they need win rates of 70% to 80% to make money consistently. The reality is that trend-based systems that offer you good risk/reward entry points can be very effective, as they will gain typically twice what they lose. That 2-to-1 ratio is what I usually look for in evaluating new trading opportunities.

A Bullish and Bearish Example

I translate my Donchian Channel system into specific options trades via my **Afternoon Channel Trader** alert service. I've adapted to now send these alerts on Friday afternoon before the markets close, so subscribers can get a jump on the action before a potential gap on Monday morning. But even for those who don't see the trades on Friday, there is often still a chance to enter the trades the next day on Monday just after the markets open.

Because there are bull and bear markets happening in individual stocks all the time, I've grown fond of the "pair trading" approach using Donchian Channels. Most every week I'm able to find both a new bullish call option to buy near support, while also buying a put option on a different stock after a bounce into resistance. This helps reduce general market risk, as I then care more about how each stock is behaving relative to its short-term Donchian Channel.

Here's an example of an alert I issued on Friday afternoon March 13th, 2015:

March 13, 2015
1:45 PM EST

BTO the Amgen (AMGN) March (Week 4) 150 Call (AMGN 150327C150) at 4.80 or better

Stop on an intraday trade under 3.35

Target 6.25 on the first half position

Also,

BTO the Pandora Media (P) April 18 Put (P 150417P18) at 2.00 or better

Stop on an intraday trade under 1.40

Target 2.60 on the first half position

Trade Well,
Price Headley

The Amgen (AMGN) bullish trade was based on the stock holding support near 153, with an official intraday lower Donchian Channel reading at 152.58. When I saw this biotech stock holding there amid a down market, I realized it was no longer wanting to drop and was ready to rally. The short-term upper Donchian Channel target was 161.48, and the stock blasted up there on beyond the following Monday, for a 70% gain in just 2 trading days.

Amgen (AMGN) Daily Chart with Donchian Channel Buy Signals
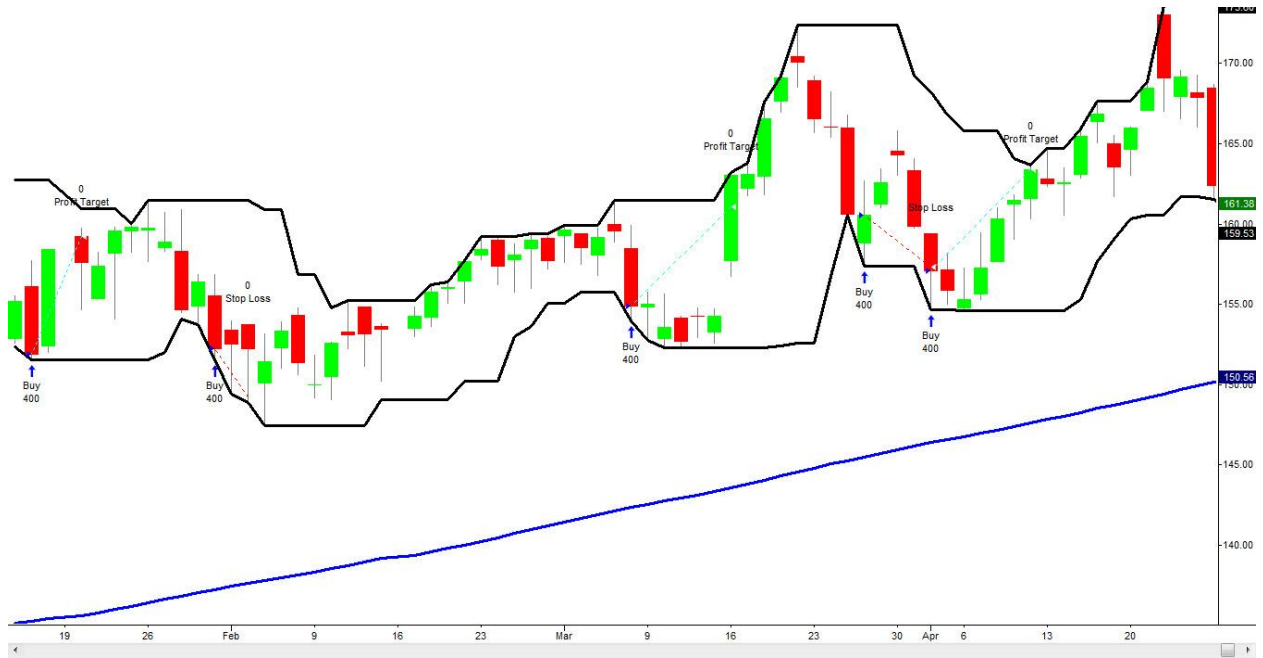
Meanwhile, online streaming music provider Pandora (P) has just bounced up showing off a pattern that I call the "one day wonder". The stock would have these massive 1-day (or yes, sometimes 2-day) rallies that looked like quick bursts of short covering (the bears rushing to buy back their positions to protect profits). These brief sharp rallies told me that the risk/reward was right for a bearish put purchase, betting on the stock dropping back down. For Pandora shares, the initial drop came the next trading day, and we booked half our position at a +30% gain. From that point, I start tightening my stop on the rest of the position and we exited the 2nd half for a +7.5% gain. So while the whole trade averaged about +19%, the key is that we reduced risk but gave our subscribers a chance to catch a bigger pay day, while protecting profits nicely.

Pandora (P) Daily Chart with Donchian Channel Sell Signals

Conclusion

You can see that while there will be trades where you stop out quickly if the support or resistance is not holding as expected, you can create very attractive lower risk and higher reward trade setups using Donchian Channels the BigTrends way.

Feel free to contact us if you'd like more information on the *Afternoon Channel Trader* alert service, either via email at clientcare@bigtrends.com or call us toll-free at 1-800-BIGTRENDS (800-244-8736).