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TRADING TOOLS:
Spread & Pairs Trading
Equity Curve analysis
3-Drive Pattern
The Dragon Pattern
Inside Bar with the MACD
Kagi Charts
Momentum Reversals

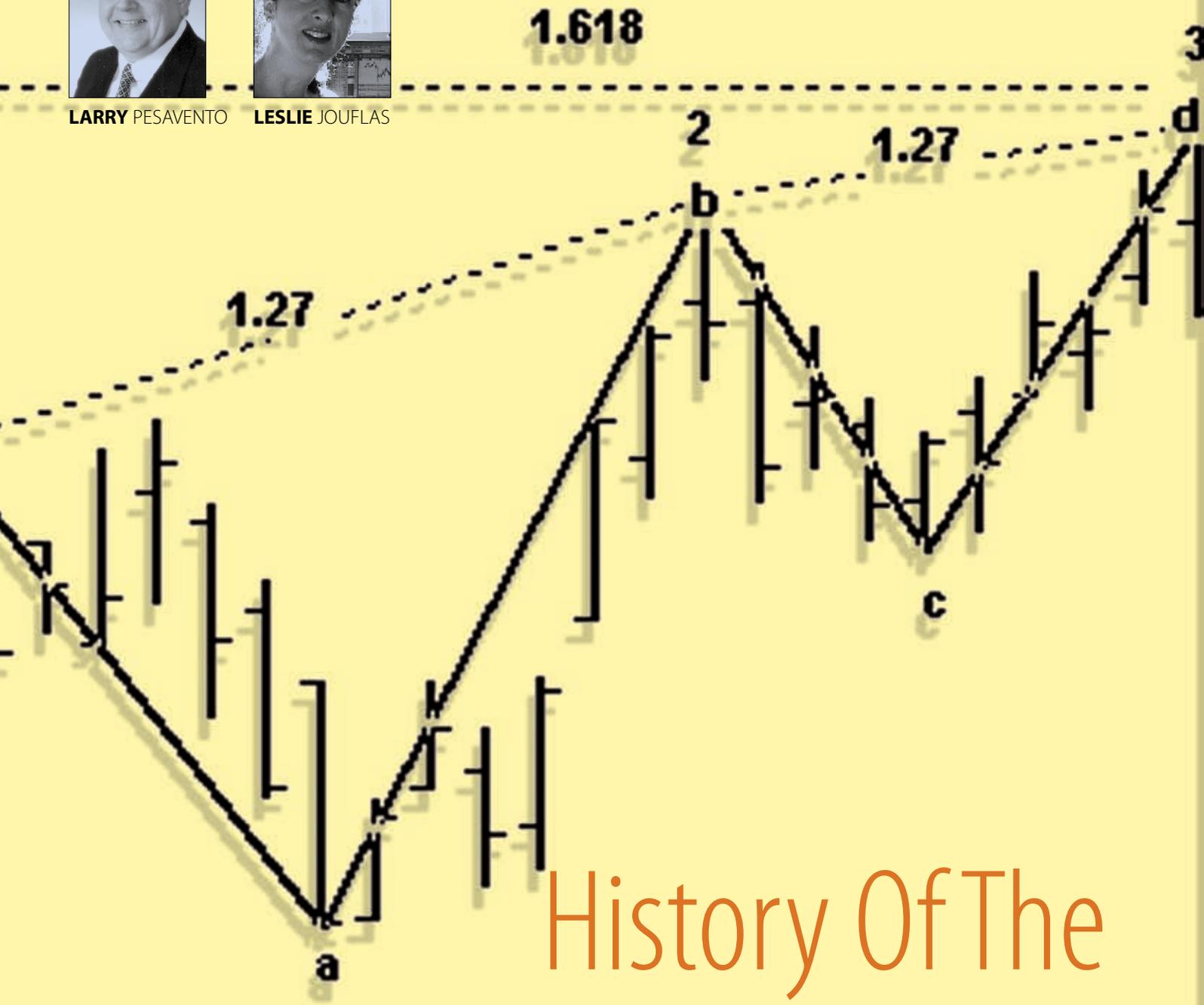**LARRY** PESAVENTO   **LESLIE** JOUFLAS

History Of The
3-Drive Pattern

An excerpt from *Trade What You See – How to Profit from Pattern Recognition* by Larry Pesavento and Leslie Jouflas, this article discusses the 3-Drive pattern as identified by William Dunnigan. This is an easily recognized pattern that can provide low-risk/high reward trading opportunities at market tops and bottom

FIGURE 1 – Three evenly spaced symmetrical tops in an uptrend and bottoms in a downtrend. There is an AB = CD present in the 3 Drive pattern.

Very little is written about the 3-Drive pattern in pattern recognition books. Most likely, the first written mention of anything resembling this pattern was by a man named George Cole. Although Cole mentioned this pattern in his book, Keys to Speculation, written in 1936, he did not accurately describe it. H. M. Gartley came closer than anyone to describing this pattern as the Expanding 5-Wave Triangle in Profits in the Stock Market. Wells Wilder, a popular author on trading, sold Gartley's 5-Wave Expanding Triangle pattern as a trading system called 'The Reverse Point Wave' for $2500.

William Dunnigan was a stock investor from Santa Barbara, California who wrote two well-known trading systems in the 1950s. One was called 'The Dunnigan One Way Method' and the second was 'The Dunnigan Thrust Method.' These systems were written as the U.S. stock market was evolving as one of the most prestigious financial exchanges in the world. This was at a time when investors were still regaining their confidence after the Crash of 1929. Dunnigan called this the 3-Drive Pattern and it is likely that he was the first to name this pattern.

John Hill from Futures Truth, a publication dedicated to honesty in the futures business, brought this pattern to the attention of Larry as a mentor and friend in the 1970s. It is a good trading pattern although it does not appear in all time frames as frequently as other trading patterns.

Pattern Description

The 3-Drive pattern is simple in its structure and should be easy to identify visually on a chart in any timeframe. It consists of three evenly spaced tops in an uptrend or three evenly spaced bottoms in a downtrend. The 3-Drive pattern also contains an AB = CD as shown in Figure 1. It is generally found at tops or bottoms and is the final push up or down before a reversal takes place. It should be noted that this pattern does not always signal a major reversal. It may signal the end of a swing in the trend with a correction rather than a full reversal. If it is a correction, it is likely an
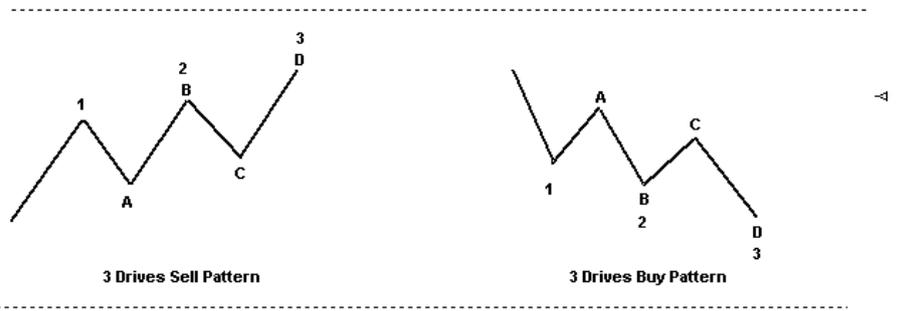
AB = CD pattern or retracement pattern will form following the third drive.

It is important to watch the reaction of the correction pattern for clues. If the correction pattern fails, then the trader may suspect that the trend is over. It is not uncommon with reversals to see very sharp moves up or down from this pattern. Refer to Figure.3 for an example of a correction pattern and Figure 4 for a reversal from the completion of the 3-Drive pattern.

Pattern Structure

The drives (tops and bottoms) of the pattern are numbered 1, 2 and 3. Each drive is consecutively higher or lower than the

last, consecutively higher in a 3 Drive to the top pattern and consecutively lower in a 3 Drive to the bottom pattern as shown in Figure 1. The distance from the top or bottom of drive 1 to the top or bottom of drive 2 should be 1.27 or 1.618 extensions. This is the same for the top or bottom of drive 2 to drive 3. It is important to remember that the market may fall a bit short of these levels or may go just a bit further. The important thing is to watch for a symmetrical pattern to form. There may also be an extension number of 1.27 or 1.618 measuring from drive 1 to A and completing at drive 3. Refer to Figure.2 for an example.
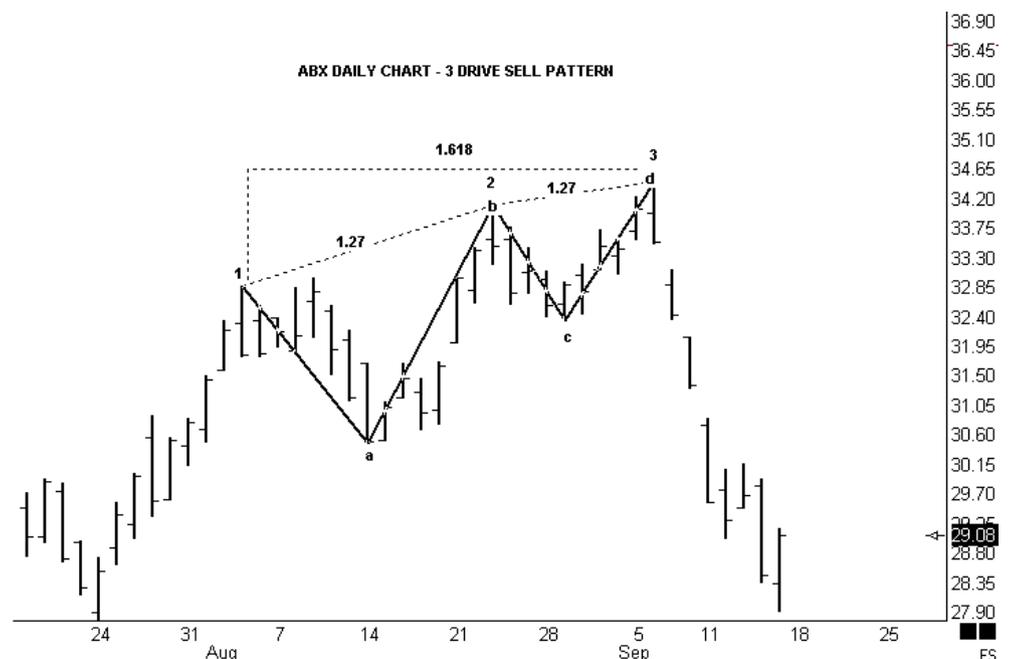
The retracements at points A and C that

FIGURE 2 – The top of drive 1 to drive 2 and from drive 2 to drive 3 is a 1.27. The extension measuring from drive 1 to A and completing at drive 3 is a 1.618 extension.
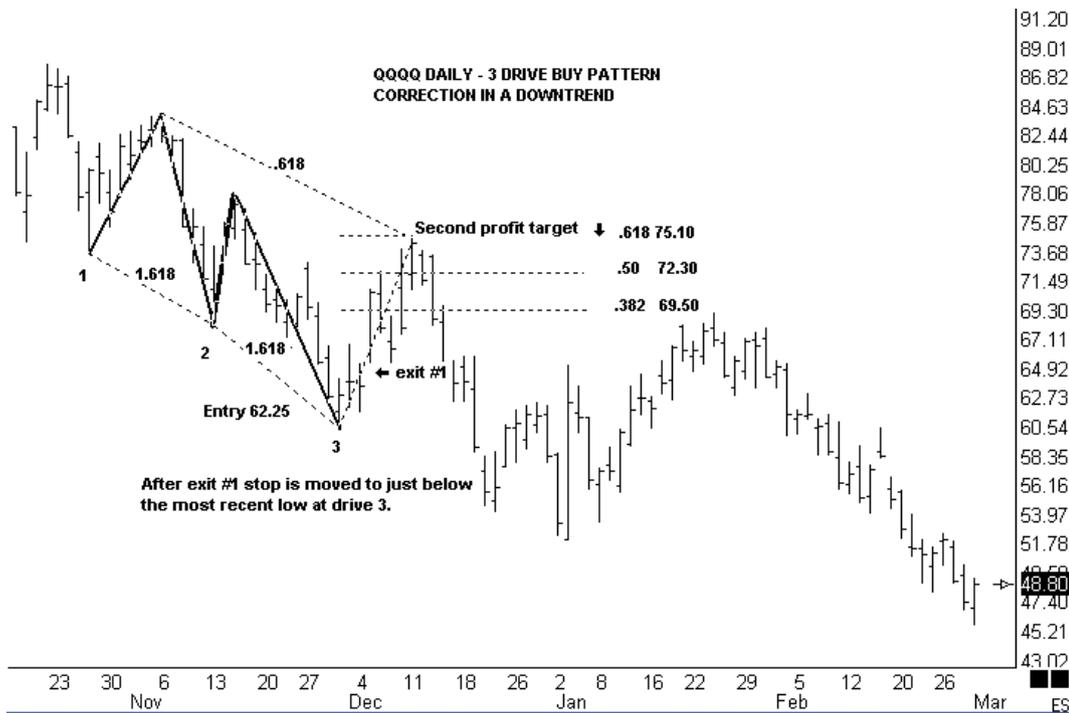
Figure 3 – Trade Setup #1 is an example of a 3-Drive pattern being a correction in a trend rather than a reversal pattern.

form the AB = CD should be a Fibonacci retracement, ideally at the .618 or the .786. If a retracement at the .382 is formed, it is a sign of a strong trend. These drives should appear symmetrical to the eye and jump out visually. If the trader has to force the pattern, it is probably not a 3-Drive pattern.

There should also be time symmetry from point A to drive 2 and from point C to drive 3. It should take each of these legs approximately the same number of time bars to form. Some of the items to watch for that would invalidate this pattern are:

1. Drive 1 above or below drive 2. (Above in a sell pattern and below in a buy pattern.)

2. Drive 2 above or below drive 3. (Above in a sell pattern and below in a buy pattern.)

3. C below or above A or B above or below D.

4. Extensions that extend past the 1.618, as the 3 Drive pattern is forming will usually result in a failed pattern.

5. Large price gaps that appear as this pattern is forming in the direction of

the established trend, especially towards the completion of drive 3, are a sign that the pattern is not valid. The trader should wait for further confirmation of a top or bottom or the formation of another pattern.

Important Characteristics Of The 3-drive Pattern

The 3-Drive pattern is similar to the butterfly pattern because it is very symmetrical. There are three areas of symmetry to study and learn to successfully identify and trade this pattern.

Price Symmetry – Symmetry of price should be equal in the formation of the legs from A to drive 2 and from C to drive 3.

Time Symmetry – The 3 Drive pattern will have near perfect symmetry where the upswings or downswings are close to the same number of time bars. If the time bars are not exact, they should be close to a Fibonacci ratio that can be calculated by dividing the number of time bars in each leg. Example: 5 time bars in the AB and 8 time bars in the CD. 5 divided by 8 = .625.

Visual Symmetry – The pattern should

be very aesthetic to the eye. 3-Drive patterns that are asymmetrical or that are forced should be viewed with suspicion. By force, we are referring to the market technician trying to force the pattern where it does not exist based on the elements outlined in the Pattern Structure section of this chapter. If the pattern does not look symmetrical, it is probably not valid.

Pattern Psychology

All patterns are formed by crowd psychology and it is interesting and educational to study what forms any particular pattern. The 3-Drive pattern is slightly different in its psychology as it has three tops or bottoms that must form to complete the pattern as compared to most patterns with one or occasionally two in the case of double bottoms and tops.

It is a natural phenomenon that bulls are the most bullish at the tops of markets and bears the most bearish at the bottom. When this occurs, there is usually an unusual amount of news that accompanies these tops and bottoms in favor of the excess bullishness and bearishness.

The 3-Drive pattern goes through an extended process to bring in new buyers or short sellers too early at tops with successive waves and new sellers or new buyers at bottoms that are too early. The pattern generally makes the final wave as the last buyer has bought at the top and the last seller has sold at the bottom. This is the when the market will appear absolutely the most bullish or most bearish. The last push up or down to form the last gasp in the market is almost like a game of hot potato and the market has just passed the last hot potato to the last market participant before it changes direction.

Then, as the market changes direction each new low below the latest swing high in an uptrend has more bulls trapped. Conversely, each new high above the previous swing low has more bears trapped.

This can add fuel to a rally or decline because of position liquidation. It is not usually until a new trend is well underway that the news media will also change direction.

Trading The 3-drive Pattern Example

Setup #1: 3 Drive Buy pattern

Market: QQQQ Daily

Shares: 200

The completion point on this 3-Drive buy pattern was at the 1.618 level. This was determined by the previous 1.618 from drive 1 to drive 2 and was repeated from drive 2 to drive 3. Although the number of time bars is not the same, they are a close ratio with 6 bars in the first leg down of the pattern and 10 time bars down on the second leg: 6 divided by 10 = .60.

The risk in this trade is very small because of the completion point at the 1.618. The trade entry is at $62.25 and a stop can be placed $60.25, which is $2 per share below the recent low.

Risk Free Trade

The first profit target is equal to the risk at $64.25 and the stop can be moved up to just below the most recent swing low at $60.40. The assumption is that by placing the stop just below the most recent low, the market would be telling us that this pattern is failed at that point.

The stop would be trailed on this trade, the trader must keep in mind that this is a daily chart and allow for the market to move up and down and give it enough room and not trail the stop too closely. The market did reach the second price objective at the .618. This particular 3-Drive pattern is only a correction in a downtrend and the market turned down from the .618 and made new lows. Although this trade did turn out to be a correction in a downtrend and not a reversal, it was very profitable. This trade would
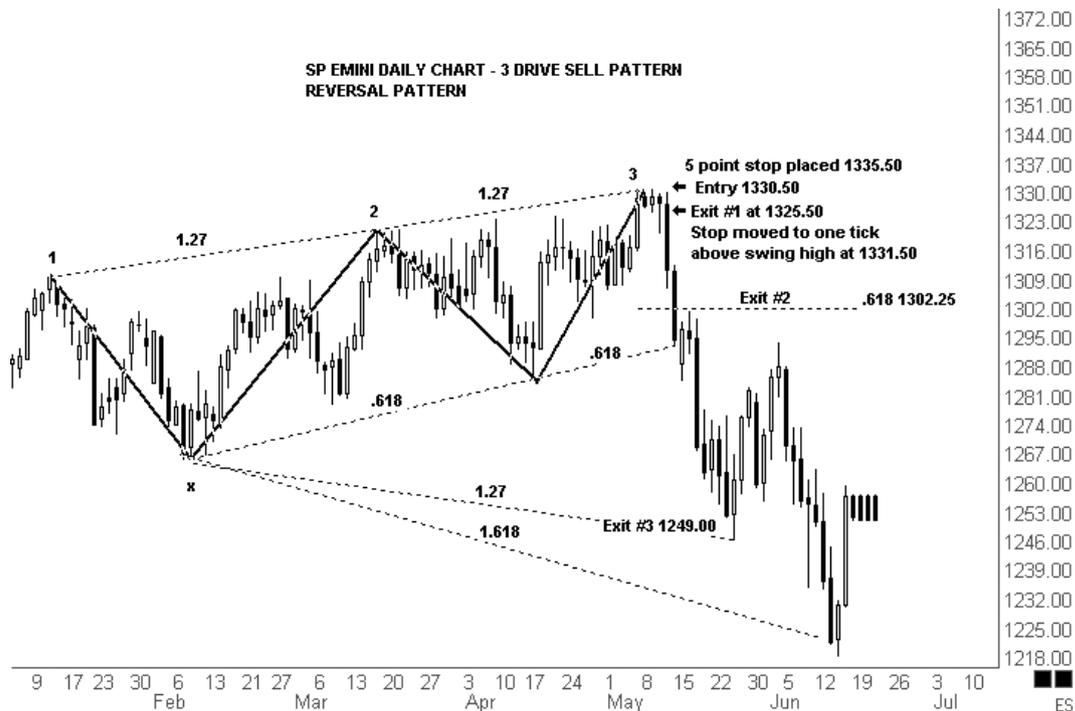

Figure 4 Daily SP 500 3 Drive reversal pattern

have netted $14.75 per share with very little risk.

Figure 4 shows a reversal in the daily chart of the S&P 500 E-mini. This was a low risk entry that proved to be a good rewarding reversal pattern.

This pattern is a great pattern for trading for several reasons:

1. It is a visually easy pattern to identify

2. The risk can be quantified and is a low risk trade

3. More times than not, the pattern will turn quickly from the third drive

4. Profit objectives make it a excellent risk/reward setup

This article is an excerpt from Trade What You See – How to Profit from Pattern Recognition by Larry Pesavento and Leslie Jouflas, Wiley & Sons Publishing, 2007.

Larry Pesavento is a trading tutor and 40 years veteran of the markets. During his career he has been a member of the Chicago Mercantile Exchange, supervised Drexel, Burnham, Lambert's commodity department in Los Angeles, traded on and off the floor and has

trained over 800 traders. Larry can be reached at larry@tradingtutor.com or via his website www.tradingtutor.com

Leslie Jouflas began trading in 1996 and left a 17 year airline career in 2000 to pursue a full-time trading career. Leslie has studied many trading methodologies including Elliot Wave, options strategies, momentum trading, classical technical analysis and Fibonacci ratios and patterns.

She began trading stocks, and options on stocks, and now trades futures and commodities with an emphasis on the S&P 500 market. Leslie manages private accounts as well as trades her own private account.

She is co-author of Trade What You See – How to Profit from Pattern Recognition, Wiley & Sons, 2007. This book outlines specific pattern recognition trade setups and illustrates in a "how to" manner many examples of trade management.

She teaches live workshops and moderates the Live Trading Room at www.tradingliveonline. com. Leslie can be contacted at leslie@ tradingliveonline.com where additional information can be found on various coaching and teaching programs.