Capture Profits Using Bands And Channels

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Widely known for their ability to incorporate volatility and capture price action, Bollinger bands have been a favorite staple of traders in the FX market. However, there are other technical options that traders in the currency markets can apply to capture profitable opportunities in swing action. Lesser-known band indicators such as Donchian channels, Keltner channels and STARC bands are all used to isolate such opportunities. Also used in the futures and options markets, these technical indicators have a lot to offer given the vast liquidity and technical nature of the FX forum. Differing in underlying calculations and interpretations, each study is unique because it highlights different components of the price action. Here we explain how Donchian channels, Keltner channels and STARC bands work and how you can use them to your advantage in the FX market.

Donchian Channels

Donchian channels are price channel studies that are available on most charting packages and can be profitably applied by both novice and expert traders. Although the application was intended mostly for the commodity futures market, these channels can also be widely used in the FX market to capture short-term bursts or longer-term trends. Created by Richard Donchian, considered to be the father of successful trend following, the study contains the underlying currency fluctuations and aims to place profitable entries upon the start of a new trend through penetration of either the lower or upper band. Based on a 20-period moving average (and thus sometimes referred to as a moving average indicator), the application additionally establishes bands that plot the highest high and lowest low. As a result, the following signals are produced:

- A **buy, or long, signal** is created when the price action breaks through and closes above the upper band.
- A **sell, or short, signal** is created when the price action breaks though and closes below the lower band.

The theory behind the signals may seem a little confusing at first, as most traders assume that a break of the upper or lower boundary signals a reversal, but it is actually quite simple. If the current price action is able to surpass the range's high (provided enough momentum exists), then a new high will be established because an uptrend is ensuing. Conversely, if the price action can crash through the range's low, a new downtrend may be in the works. Let's look at a prime example of how this theory works in the FX markets.

Figure 1 - A typical example of the effectiveness of Donchian channels

In Figure 1, we see the short, one hour time-framed Euro/U.S. dollar currency pair chart. We can see that, prior to Dec 8, the price action is contained in tight consolidation within the parameters of the bands. Then, at 2am on Dec 8, the price of the euro makes a run on the session and closes above the band at **point A**. This is a signal for the trader to enter a long position and liquidate short positions in the market. If entered correctly, the trader would have gained almost 100 pips in the short intraday burst.

Keltner Channels

Another great channel study that is used in multiple markets by all types of traders is the Keltner channel. The application was introduced by Chester W. Keltner (in his book "How To Make Money In Commodities" (1960)) and later modified by famed futures trader Linda B. Raschke. Raschke altered the application to take into account average true range calculation over 10 periods. As a result, the volatility-based technical indicator bears many similarities to Bollinger bands. The difference between the two studies is simply that Keltner's channels represent volatility using the high and low prices, while Bollinger's studies rely on the standard deviation. Nonetheless, the two studies share similar interpretations and tradable signals in the currency markets. Like Bollinger bands, Keltner channel signals are produced when the price action breaks above or below the channel bands. Here, the trader can initiate profitable trades upon a return to the median or moving average line. (To learn more, see *Discovering Keltner Channels And The Chaikin Oscillator* and *The Basics Of Bollinger Bands*.)

- If the price action **breaks above** the band, the trader should consider initiating short positions while liquidating long positions.
- If the price action **breaks below** the band, the trader should consider initiating long positions while exiting short positions.

Let's dive further into the application by looking at the example below.

Figure 2 - Three profitable opportunities are presented to the trader through Keltner.

By applying the Keltner study to a four-hour charted British pound/Japanese yen currency cross pair in Figure 2, we can see that the price action does indeed return to the moving average within the channels, similar to the Bollinger band study. Placing effective entries, the FX trader will be able both to effectively capture profitable slides and to exit efficiently, maximizing his or her profits. No other example is more visually stunning than the previous decline seen during the week of Nov 2, **point C**. The trader would have been able to capture close to 300 pips in the course of a couple of days after initiating a short position slightly below the 208 price figure.

STARC Bands
Also similar to the Bollinger band technical indicator, STARC (or Stoller Average Range Channels) bands are calculated to incorporate market volatility. Developed by Manning Stoller in the 1980s, the bands will contract and expand depending on the fluctuations in the average true range component. The main difference between the two interpretations is that STARC bands help to determine the higher probability trade rather than standard deviations containing the price

action. Simply put, the bands will allow the trader to consider higher or lower risk opportunities rather than a return to a median.

- Price action that **rises** to the upper band offers a **lower risk** sell opportunity and a **high risk** buy situation.
- Price action that **declines** to the lower band offers a **lower risk** buy opportunity and a **high risk** sell situation.

This is not to say that the price action won't go against the newly initiated position; however, STARC bands do act in the trader's favor by displaying the best opportunities. If this indicator is coupled with disciplined money management, the FX enthusiast will be able to profit by taking on lower risk initiatives and minimizing losses. Let's take a look at an opportunity in the Kiwi/U.S. dollar currency pair.

Figure 3 - A great risk to reward is presented through this STARC bands example in the NZD/USD.

Looking at the Kiwi/U.S. dollar currency pair presented in Figure 3, we see that the price action has been mounting a bullish rise over the course of November, and the currency pair looks ripe for a retracement of sorts. Here, the trader can apply the STARC indicator as well as a price oscillator (Stochastic, in this case) to confirm the trade. After overlaying the STARC bands, the trader can see a low-risk sell opportunity as we approach the upper band at **point A**. Waiting for the second candle in the textbook evening star formation to close, the individual can take advantage by placing an entry below the close of the session. Confirming with the downside cross in the Stochastic oscillator, **point X**, the trader would be able to profit almost 150 pips in the day's session as the currency plummets from 0.7150 to an even 0.7000 figure. Notice that the price action touches the lower band at that point, signaling a low-risk buy opportunity or a potential reversal in the short-term trend.

Putting It All Together

Now that we've examined trading opportunities using channel-based technical indicators, it's time to take a detailed look at two more examples and to explain how to capture such profit windfalls.

In Figure 4 we see a great short-term opportunity in the British pound/Swiss franc currency cross pair. We'll put the Donchian technical indicator to work and go through the process step-by-step.

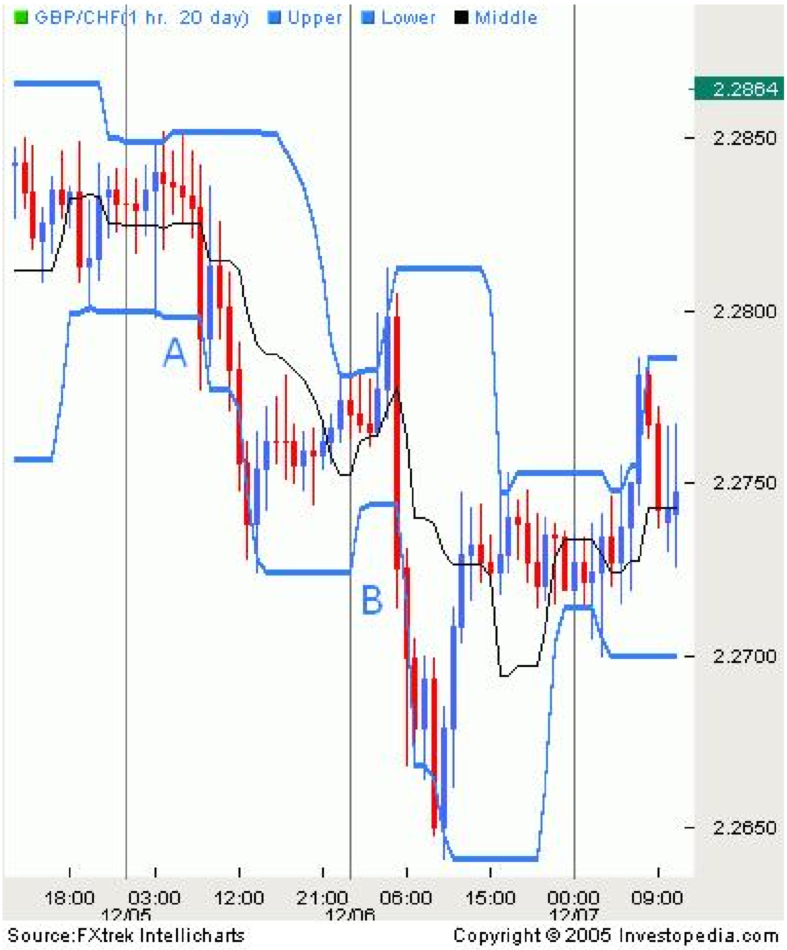

Figure 4 - Applying the Donchian channel study, we see a couple of extremely profitable opportunities in the short time frame of a one-hour chart.

These are the steps to follow:

1. **Apply the Donchian channel study on the price action.** Once the indicator is applied, the opportunities should be clearly visible, as you are looking to isolate periods where the price action breaks above or below the study's bands.

2. **Wait for the close of the session that is potentially above or below the band.** A close is

needed for the setup as the pending action could very well revert back within the bands parameters, ultimately nullifying the trade.

3. **Place the entry at slightly above or below the close.** Once momentum has taken over, the directional bias should push the price past the close.

4. **Always use stop management.** Once the entry has been executed, the stop should always be considered, as in any other situation.

Applying the Donchian study in Figure 4, we find that there have been several profitable opportunities in the short time span. A prime example would be **point A**: here, the session closes below the bottom channel, lending to a downside trend. As a result, the entry is placed at the low of the session after the close, at 2.2777. The subsequent stop will be placed slightly above the high of the session, at 2.2847. Once you are in the market, you can either liquidate your short position on the first leg down or hold on to the sell. Ideally, the position would be held in retaining a legitimate risk to reward ratio. However, in the event the position is closed, you may consider a reinitiation at **point B**. Ultimately, the trade will profit over 120 pips, justifying the high stop.

Defining a Keltner Opportunity
It's not just Donchians that are used to capture profitable opportunities - Keltner applications can be used as well. Taking the step-by-step approach, let's define a Keltner opportunity:

1. **Overlay the Keltner channel indicator onto the price action.** As with the Donchian example, the opportunities should be clearly visible, as you are looking for penetration of the upper or lower bands.

2. **Establish a session close of the candle that is the closest or within the channel's parameters.**

3. **Place the entry above or below the close of the session's candle.**

4. **Money management is applied by placing a stop slightly above the session's high or low price.**

Figure 5 - A tricky but profitable catch using the Keltner Channel

In Figure 5, we apply a Keltner channel to a longer-term daily chart showing the Euro/British pound currency pair. First, we see a pop above the upper band by the price action at **point I**, a first sign of a selling opportunity. As we move ahead in time to **point II**, we see that the candles are moving closer to the upper band, ripe for retracement. Taking that into consideration, we place the entry below **the candle closest to the band when it closes at 0.6829**. The stop is subsequently placed slightly above the high, at 0.6867. Selling momentum takes over and our position, executed at entry, will reap a little under 100 pips for a great risk to reward ratio.

Conclusion
Although Bollinger bands are more widely known, Donchian channels, Keltner channels and STARC bands have proven to offer comparably profitable opportunities. By diversifying your knowledge and experience in different band-based indicators, you'll be able to seek a multitude of other opportunities in the FX market. These lesser-known bands can add to the repertoire of both the novice and the seasoned trader.

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