

## Combining Indicators

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## Introduction

In the first class we categorized a few indicators by Trend and Direction. There's a plethora of indicators out there and they can be overwhelming. By separating indicators into categories a trader simplifies the process of learning.

In the first class we also learned about some specific indicators, namely, the MACD, DMAs, and the DMI/ADX.

In this class we'll cover two topics. First, we'll learn what indicators *not* to combine. This topic is as important as learning the proper indicators to combine, as you'll see. Second, we'll take a few indicators and combine them into a trading system.

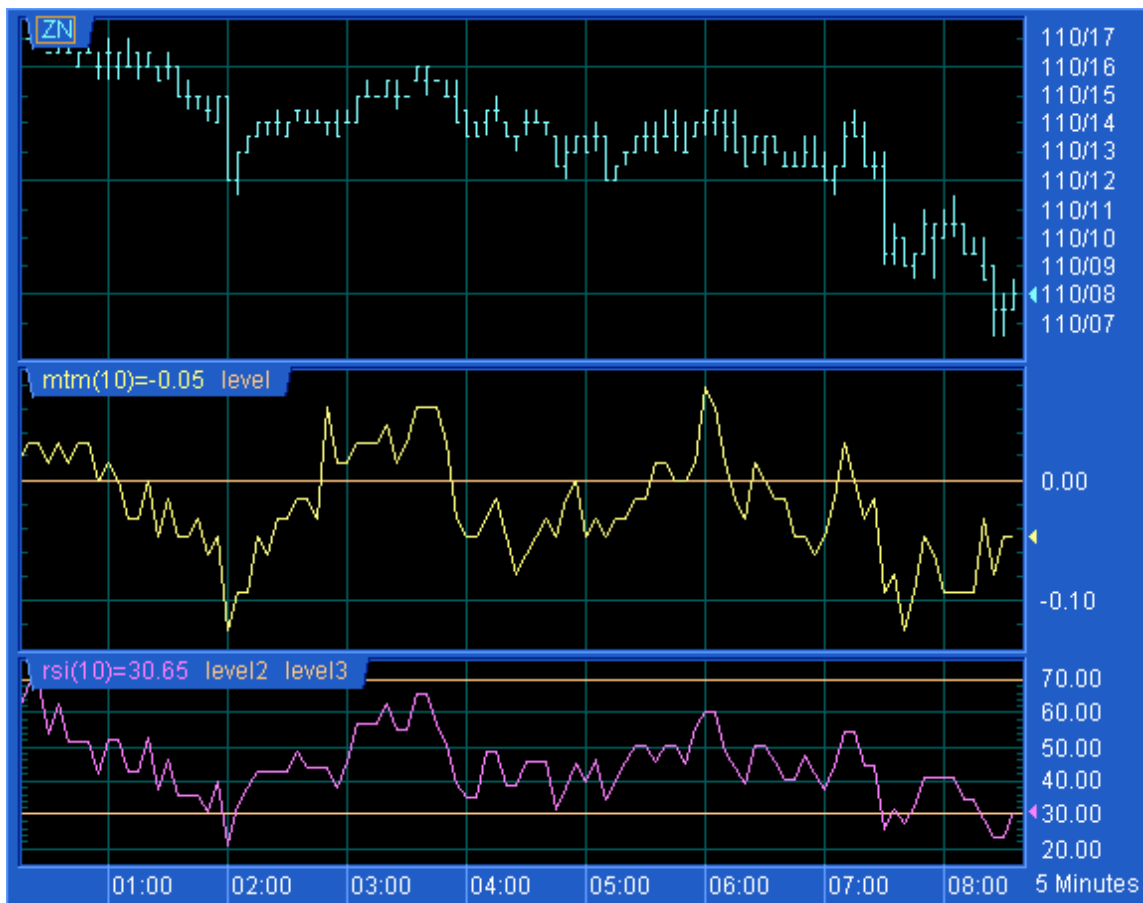
## What Indicators You Shouldn't Combine

When applying several indicators to a chart, looking for just the right combination, there are several indicators that should not be used together. Most of the information within this topic will be quoted from *The New Technical Trader*, by Tushar S. Chande and Stanley Kroll. (Therefore I will not be citing the book, just referencing.)

However, Chande is the writer I'm most interested in. He was one of the first analysts to apply and write about Adaptive Moving Averages (AMAs), back in the early 1990s. Since then, he has written two new books which I highly recommend. (There's a list at the end of this paper. One of the things Chande analyzed, in the book, is the statistical correlation between the indicators discussed below. This is the subject of this topic.

Among certain indicators there's a correlation. Meaning, don't use them on the same chart because they are relatively one in the same. Here's a list of the indicators that you *shouldn't* use on the same chart:

## Momentum and RSI



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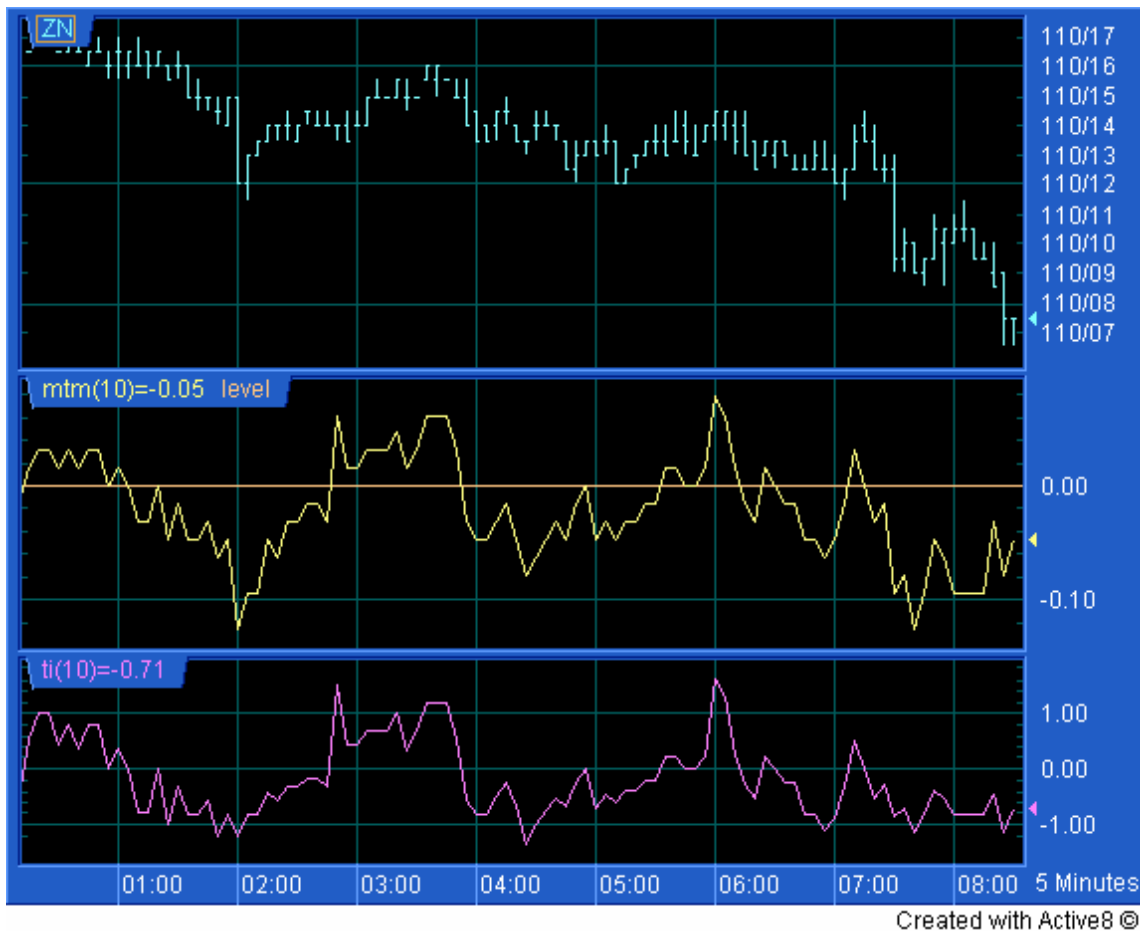
**RSI stands for Relative Strength Index**

## Momentum and Stochastic



**k** is the **FAST** part of a stochastic and **d** is a **SLOW** part of a stochastic. Fast or slow, it doesn't matter. They're the same within the context we are reviewing.

## Momentum and CMO (Chande Momentum Indicator)



**ti** stands for *Trend Index*. It's another name for the CMO

## RSI and Stochastic



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**d** stands for SLOW Stochastic.

### ***RSI and Plus Directional Index (DX+, or, ADX, or Directional Moving Indicators)***



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**diplus, diminus, adx are all one indicator combined. This indicator was created by Welles Wilder.**

### ***%R and any of the above***



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**wms stands for the Williams %R. It was created by Larry Williams. The chart above shows an example of %R and the RSI.**

## CMO and ADX



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## CCI (Commodity Channel Index) and ADX

## Stochastic and CCI (Commodity Channel Index)



What do all the indicators, shown above, have in common? They can be categorized as oscillators. In the book *The Futures Game* by Teweles and Jones, they define an oscillator as ‘a family of indicators that measure price changes not price levels’.<sup>1</sup>

Oscillators are mainly used to show excessive movements in price change. Once these excessive movements are marked by an oscillator a trader acts accordingly. If the oscillator is showing overbought, you sell.

Many oscillators have overbought/oversold lines built into them. You can see these lines in the chart above. Looking at the CCI oscillator, you’ll notice that it is reaching 100. That 100 level signals overbought. You’d look to sell the market when that 100 level is reached. (Again, let me state, I rarely use one indicator. I’d never use an oscillator by itself.)

Our goal is to combine certain indicators to create a system. Let’s move on to doing just that.

The following is a list of the *types* of oscillators shown in the charts above:

- Standard Oscillators
  - RSI, Stochastic, %R
- Price Momentum Index Oscillators
  - Momentum, ADX, CMO, CCI

## Combining Indicators that Create a Trading System

If you were to use the oscillators together, nothing bad would happen to your trading; the charts just wouldn't produce any additional information and you'd be wasting your time and screen-real-estate. What I like to have up on a chart is a mixture of a leading, lagging, and/or coincidental.

Leading, lagging and coincident indicators are simply another way to categorize. They're mixtures of trend, directional, and momentum indicators.

Here's a list of trend, directional, and momentum indicators. Take an indicator from number 1, and then take another from number 2. Combine them on a chart and you've got a system. You combine them to reinforce a trading signal.

1. **Bollinger Bands, Moving Average, Trend Line, MACD**
2. **Oscillator, Stochastic, %R, CMO, ADX, RSI, CCI, Detrend**

Let's combine some indicators to create a system that I've used on and off again for six-years. They are based on the work of Joe DiNapoli.<sup>ii</sup>

### ***DiNapoli Concepts***

Joe DiNapoli places indicators into three categories: leading, lagging, and coincidental. He's one of the best at teaching how a trader should apply indicators to the market. Let's utilize some of his concepts so you can apply them immediately in your trading.

## Short term trading method you can use with any liquid contract in any time frame(s)

I need to introduce one more indicator:

- The Detrend Oscillator (DO)
  - used as entry tool



The DO is placed in the bottom window in histogram form and is set to 7.  
The DO will be the last indicator needed to enter a trade.

We can look at the system above in a different way. I've always stated that a trader should know 4 things before a trade is placed.

1. why am I getting in?
2. where am I getting in?
3. where is my stop?
4. where is my profit?

The system on the chart is going to answer those questions, as you'll see.

**Charts used**

For this system, you must use two charts. One that defines the longer term trend and the other will be used to give you the trading signal.

1. Long-term trend chart: 30-min
2. Trading signal chart: 5-min

**Indicators used**

DMA – Displaced Moving Average (Leading indicator, Trend indicator)

- used for defining
  - why I'm getting in
  - where I'm getting out (stop and profit)

MACD – (Lagging indicator, Trend indicator)

- used for defining
  - why I'm getting in
  - where I'm getting out (stop and profit)

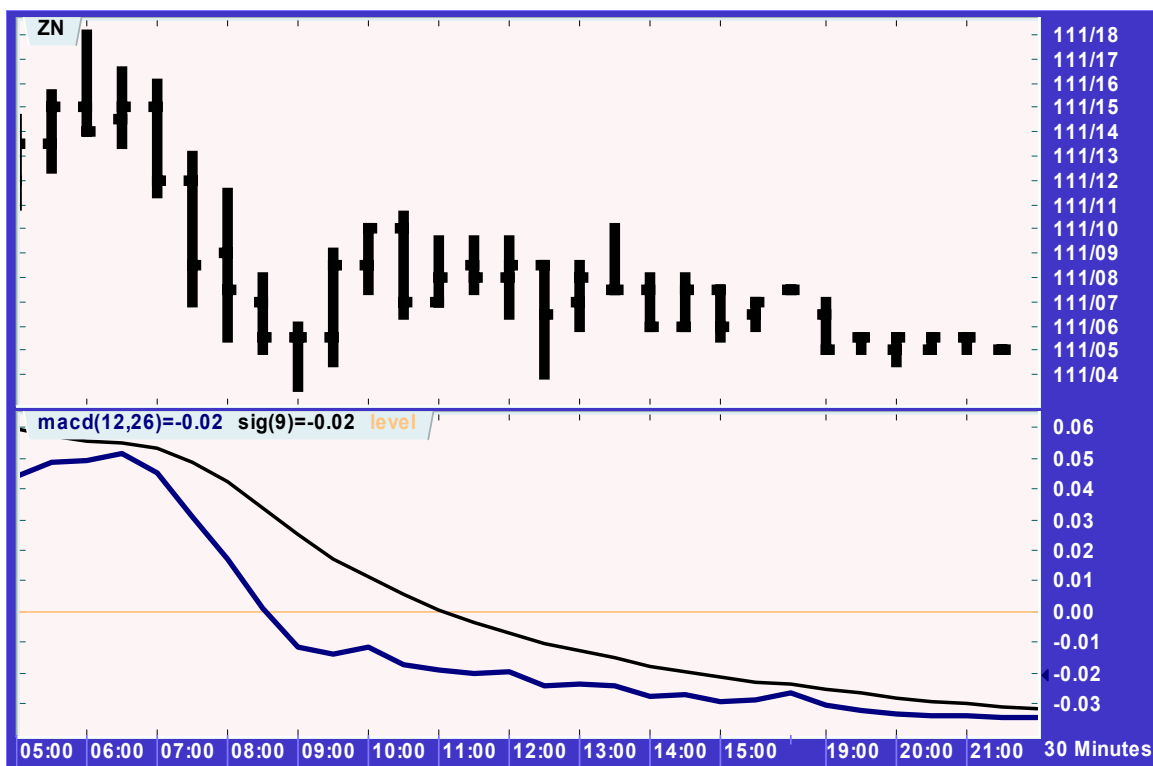
Detrend Oscillator – (Leading Indicator, Oscillator)

- used for defining
  - where I'm getting in

## The 30 Minute Chart

The 30-min chart below shows the MACD. The chart is used to define the long-term trend. The signal line, sig (9) is lower than the macd (12, 26) line so the trend is down.

[note: on the 30 minute chart I use 12,26,9 as inputs as opposed to 20, 40, 10 on a 5 minute chart]



## The 5 Minute Chart



Let's go over the indicators on this chart.

1. MACD
  - set at 20,40,10
2. DMAs
  - 7x5
  - 25x5
3. Detrend Oscillator
  - set at 7

## Rules

I'm looking for several indicators to give me a signal before I get in the market. Specifically, I'm looking for 2 *whys* and 1 *where*.

- why am I getting in? (1<sup>st</sup> why signal)
  - the 30-min chart's macd is negative (down trend)



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- why am I getting in? (2<sup>nd</sup> why signal)
  - the 5-min chart's macd is negative (down trend)
  - Don't worry, we'll come back to this chart and go into more detail. All you need to understand, now, is that the signal was met. It's where I drew the line in the macd window.



- where am I getting in? (where signal)
  - the detrend has reached the sell point
  - read on and I'll explain this signal



In the bottom pane is the detrend. There are 2 points that I'm concerned with. (Stay with me, this is the hardest part to understand).

- 1<sup>st</sup> point is the 'X'
  - I drew an X in the middle of the detrend window on a specific bar
  - That bar represents the LAST highest level the detrend reached WHEN THE MACD WAS IN ITS PRIOR TREND.
    - Look above the X in the detrend window to the MACD window. Notice that the MACD was in an UPTREND.
  - The detrend is used as an entry indicator so you don't get caught buying the high or selling the low of a move.
- 2<sup>nd</sup> point is the line I drew that goes up and down
  - Sell Entry Rule, using the detrend
    - Sell when the detrend hits the LAST highest level made in a prior trend.
    - That level was reached on the detrend bar where I marked it with a line going up and down, BUT YOU MUST WAIT FOR THE BAR TO CLOSE. THEN,
      - Sell at next bar at open.
      - Read on
  - Waiting for the bar to close.
    - All signals are taken only if they are achieved after the bar closes.

- If you think about it, when we are watching the market trade on a certain bar, that bar is ticking up and down. Any associated indicator is also ticking up and down.
- We wait for the bar to close before taking the signal.
- Now, let's go over that chart one more time.

In the next class, we'll begin with where our stop loss and profit targets are.

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References:

**The New Technical Trader: Boost Your Profit by Plugging into the Latest Indicators (Wiley Finance Editions)**

by [Tushar S. Chande](#), [Stanley Kroll](#)

Further Reading:

1. **Beyond Technical Analysis: How to Develop and Implement a Winning Trading System, 2nd Edition**  
by [Tushar S. Chande](#)  
([http://www.amazon.com/exec/obidos/ASIN/0471415677/qid=1100890091/sr=2-1/ref=pd\\_ka\\_b\\_2\\_1/102-2813698-1962508](http://www.amazon.com/exec/obidos/ASIN/0471415677/qid=1100890091/sr=2-1/ref=pd_ka_b_2_1/102-2813698-1962508) )
2. **The New Technical Trader: Boost Your Profit by Plugging into the Latest Indicators (Wiley Finance Editions)**  
by [Tushar S. Chande](#), [Stanley Kroll](#) ([http://www.amazon.com/exec/obidos/tg/detail/-/0471597805/qid=1100890091/sr=1-2/ref=sr\\_1\\_2/102-2813698-1962508?v=glance&s=books](http://www.amazon.com/exec/obidos/tg/detail/-/0471597805/qid=1100890091/sr=1-2/ref=sr_1_2/102-2813698-1962508?v=glance&s=books))

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<sup>i</sup> ibid p168

<sup>ii</sup> See Joe's Book, *Trading DiNapoli Levels*