

## CHAPTER 8

# The Mighty Alligator

*Our Compass and  
Odds Maker*

*In this early part of the twenty-first century, we have a choice to either be a part of the last generation of traders and investors using linear (ineffective) techniques, or the first generation using effective nonlinear (chaotic) techniques.*

### GOAL

***To learn how to construct a compass to guide our market journey into profit territory.***

### UNDERSTANDING NEW INCOMING INFORMATION (CHAOS)

One of the keys to profitable trading is to understand that new incoming information is what moves the markets. If there is no *new incoming information* (other words for chaos), the market is dead and there would be no significant movement of price in either direction. The market would be a straight horizontal line. The problem is that no one can examine and evaluate all the new incoming information as pertains to its ability to move price up or down. Our trading group has completed more than 20 years of

intensive research into applying the new science of chaos (along with quantum physics, holography, cybernetics, nonlinear dynamics, information theory, and Fractal geometry) to the world of stock and commodity trading.

After processing literally millions of iterations, our research resulted in a simple visual representation that we call “the Alligator.” The Alligator serves as a compass to keep us trading in the appropriate direction regardless of which way the immediate price is moving.

The Alligator is a personification of this process and influences every signal in our trading arsenal. This book is the third that we have written on this subject as new and more profitable tools have come to the surface. Our first book, *Trading Chaos*, published in 1995 (Wiley) is still valid and profitable in the market. Our second book, *New Trading Dimensions* (Wiley, 1998), enlarged on the first book and included newly discovered concepts to increase the profitability of our techniques. Now we invite you to witness and use our latest, most efficient and profitable strategies. Everything written and used in the previous books is still profitable and now it becomes even easier to be a consistent winner in all the various markets.

The question arises, how can these techniques work in all markets and in all time frames. The answer is that our trading and investing techniques are based on human nature rather than economic data. The markets are quite different now than when our earlier books were published, but the earlier techniques still work because human nature changes extremely slowly, if at all.

We will demonstrate both the setup and how to use this valuable tool while trading. This chapter describes the Alligator, what it does, how to construct it, and how it influences our entries and exits.

## **A TRADER’S BIGGEST PROBLEM**

---

Trading is likely the most exciting way to make a living or accumulate a fortune. You are your own boss and your own worst enemy. You alone must deal with the frustration of your own choices. If you lose, there is no one else to blame. You made the losing decision, even if that decision was to let someone else make your decisions or to follow someone else’s approach. However, if you win, you do not have to say thank you to anyone. You are not obliged to anyone except yourself. There is no political agenda nor anyone to whom you must cater. The term *politically correct* does not need to be in your vocabulary.

But here is the problem. Most of the time, the market goes nowhere. Only 15 to 30 percent of the time does the market trend, and traders who are not on the floor make nearly all of their profits by being in a trending market. The Alligator is, without question, the best indicator of when a trend begins and how long it will endure.

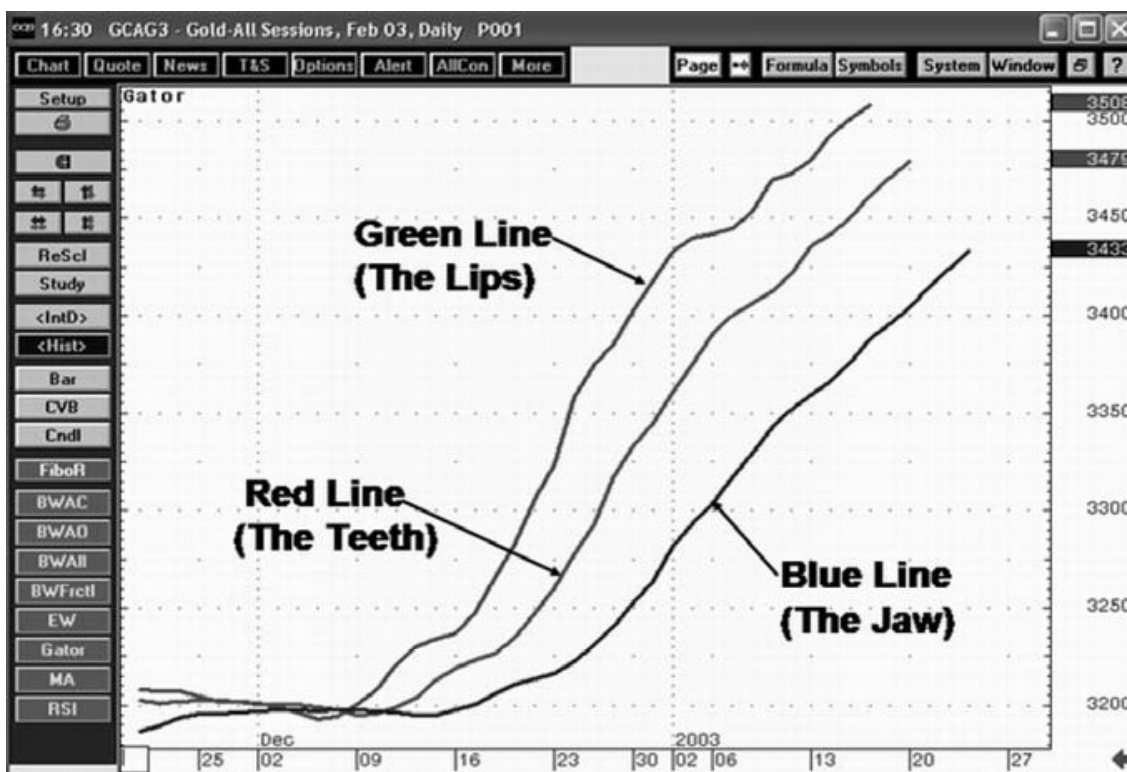
The Alligator is:

- An integrated approach to monitoring the market's momentum
- A simple indicator to trade only with the current trend
- A protection device to not lose money during a nontrending market
- An advanced indicator to signal the end of a current trend.

Here is our problem: We do not want to spend our time and resources entering and exiting a market that is going nowhere. If the market is going nowhere, then opportunity is *no-where*. We want to change that statement to opportunity is "now-here." Our technique for moving that hyphen over one letter is the Alligator.

## WHAT IS THE ALLIGATOR?

Basically, the Alligator is a combination of Balance Lines using Fractal geometry and nonlinear dynamics. (See Figure 8.1; because this book does not include color, you may want to visit to our Web site to see how it looks



**FIGURE 8.1** The Alligator.

in color.) The Blue Line that we call the Alligator's jaw on Figure 8.1 is the Balance Line for whatever time frame is on the chart. The (blue) Balance Line is where the market would be if there were no new incoming information (chaos). The distance between this line and the current price is an indication of how the traders interpret this new incoming information.

The Red Line is the Balance Line for one significant time frame lower. Significant in this case is approximately one-fifth of the time frame on the chart. So, roughly, if the time frame on the current chart is a daily and refers to the Blue Line, the Red Line would approximate an hourly chart. Remember that these lines are simulations that were discovered and created by a mainframe computer with a confidence level of more than 99.5 percent. This confidence level means that you may miss not more than 1 out of 200 trades that would be created by a mainframe using nonlinear feedback calculus.

The Green Line is the balance line for still another significant time frame lower. Again, it would be approximately one-fifth of the time frame of the Red Line. So if the chart we are examining is a daily, the Red Line would approximate the hourly chart and the Green Line would approximate a 5 to 10 minute chart.

Putting this another way, as seen on Figure 8.1, the Blue Line is where the market would be on the daily chart, the Red Line is where the market would be on an approximately a one hour chart, and the Green Line is where the market would be on an approximately 5- to 10-minute chart. Remember these time values are approximate and not connected to clock time. All lines are drawn using current price sequences. You do not need three different time charts.

New incoming information would first affect the Green Line, followed by the Red Line and finally by the Blue Line. To personify the Alligator a bit more, we refer to these lines as follows: The Blue Line represents the Alligator's jaw, the Red Line represents the Alligator's teeth, and the Green Line represents the Alligator's lips. As you become more familiar with this notation, the Alligator seems to take on a life of its own. The Alligator then becomes an excellent guide as to when to get into a market and when to wait for it to get hungry, which happens when it starts to open its mouth. Remember, the purposes of the Alligator are to

- Provide an integrated approach to monitoring the market's momentum on three different time frames in one chart.
- Provide a simple indicator to know when a trend starts and stops.
- Create a protection device so as to not lose money during a bracketed, range-bound market.
- Provide an advanced indicator to signal the end of a trend.

**ALLIGATOR ANATOMY 101**

---

Once more, the Blue Line is where the price would be (in the current time frame of the chart) if there were no new incoming information. When significant new information appears to the market participants, the price bars will move away from the Blue Line. As stated previously, the Green Line will move first, followed by the Red Line. Last, the Blue Line will move. It obviously takes more information to move the Blue Line than either the Red or Green Line.

At any given time, probably not more than 1 percent of all the outstanding shares in stocks and contracts in futures are actively trading. The other roughly 99 percent of share and contract holders are not out there buying and selling. Most shares and contracts are being held away from the trading action.

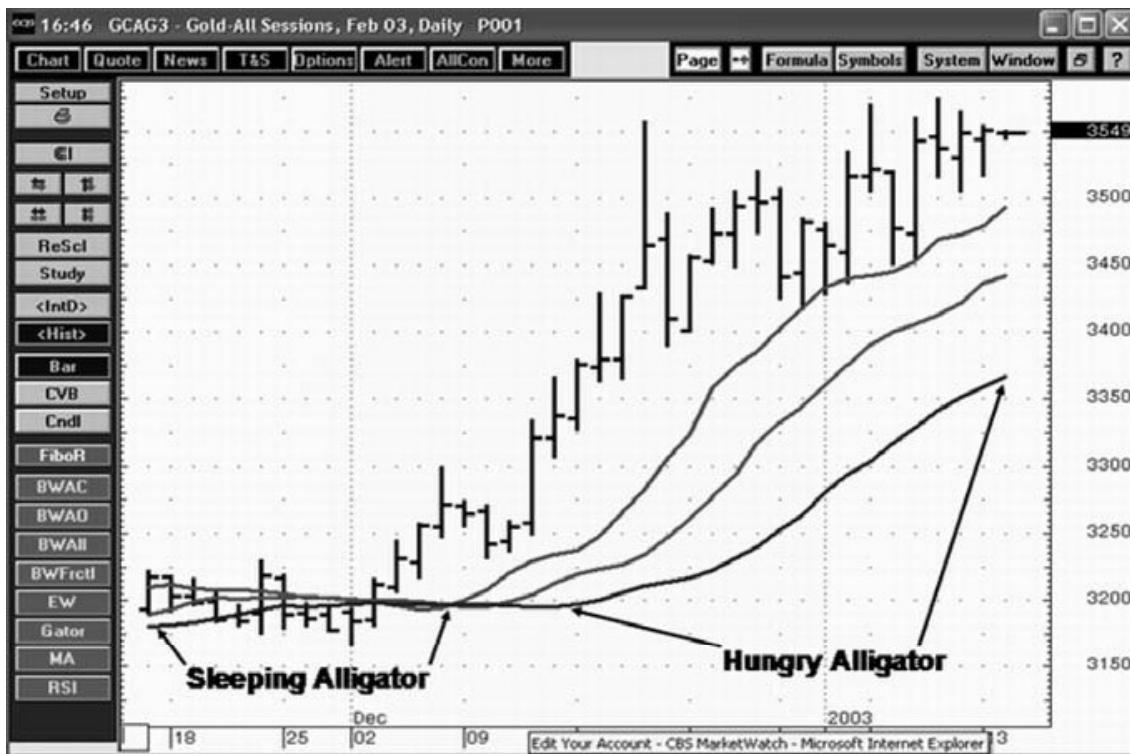
During these periods the market is stuck in a small trading range. The same small pool of shares and contracts are trading back and forth among the active short-term and or professional traders. It is just a tiny fraction of the outstanding shares and contracts flipping back and forth, often for tiny gains and losses. In this kind of market, the three balance lines will intertwine, indicating that you basically want to stay out, because there is no new incoming information that will significantly move the markets. The markets easily achieve balance with this kind of thin trading, and that is why we see moves squashed at the nearest support and resistance points.

It takes fresh information, or a bigger catalyst, to bring in shares held by those who trade less frequently. The information has to be new and ideally unexpected to get more people in the fray and to expand the number of shares or contracts traded. It is this fresh new information that brings in a bigger supply of shares and contracts that creates the streaky trend movements in the markets as either supply or demand takes control.

This information helps to explain why thin trading can be particularly tough. The markets can be buffeted around more easily by smaller events and news flow and can stop and reverse—or achieve balance—before most people realize what is happening. They therefore tend to miss out on the best and most profitable trends.

The mighty Alligator will take care of us in either of the foregoing scenarios. The Green Line will be the first indicator that significant amounts of shares or contracts are coming into the markets and are biased in one direction.

The gold chart (Figure 8.2, which is the same chart as Figure 8.1 with the prices added) illustrates these two different phases of the market where the new incoming information was positive and created an upward trend, indicated by the separating lines and noted as the Hungry Alligator. In the



**FIGURE 8.2** The Alligator on a gold chart.

lower left-hand corner, you can see the Sleeping Alligator, where most traders lose their money. So the big idea is to stay out of the market when the Alligator is sleeping and to be in the market when the Alligator is awake and hungry.

The Eurodollar chart shown in Figure 8.3 is another perfect example of a sleeping Alligator that “awakens” hungry and begins to “eat” prices. Notice during most of this up move, the prices stay above the Alligator’s lips (Green Line), keeping you in this trend move for quite a ride up!

In the same vein, Figure 8.4 illustrates what happens when the new incoming information is bearish enough to move the market lower. The Alligator, by opening its mouth (separation of the Green, Red, and Blue Lines) to the downside, gives us the opportunity to sell short for a sizeable profit potential.

Notice in Figure 8.5 how the trading range illustrated by the sleeping Alligator is ended as the Alligator opens to the downside for this steep down move. Again in this example, the prices are away from the Alligator’s lips, indicating a strong trend move downward.

Figure 8.6 shows an extended sleeping Alligator in a bracketed market. We never want to disturb the Alligator while it is sleeping, so we do not enter new positions until the Alligator wakes up hungry! If you try to trade this market while the Alligator is asleep, you will surely lose money due to the choppy market conditions.

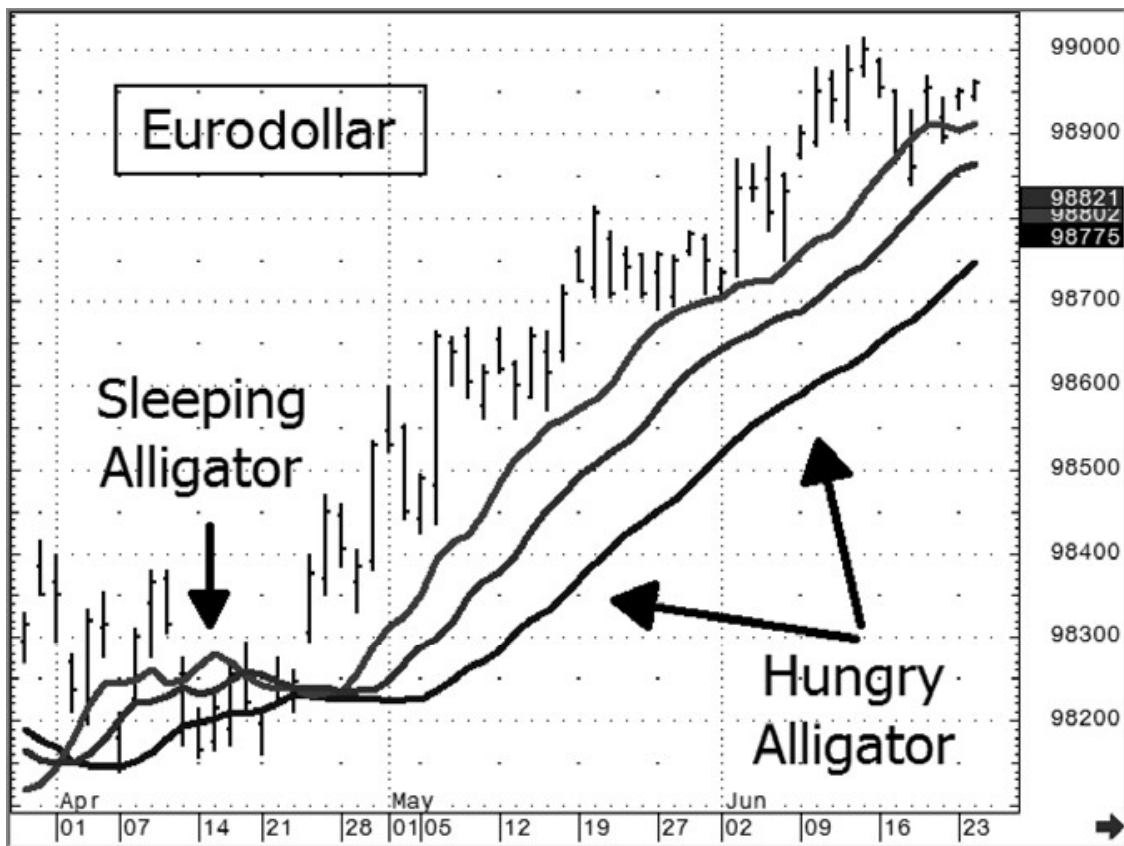
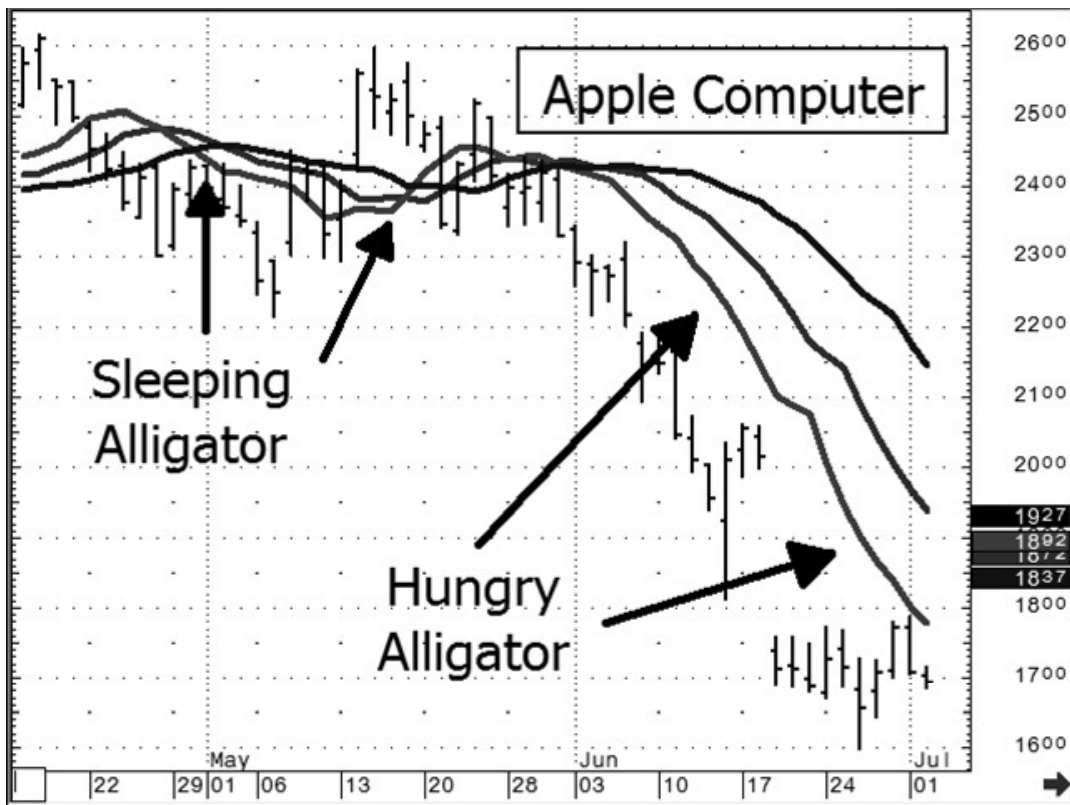


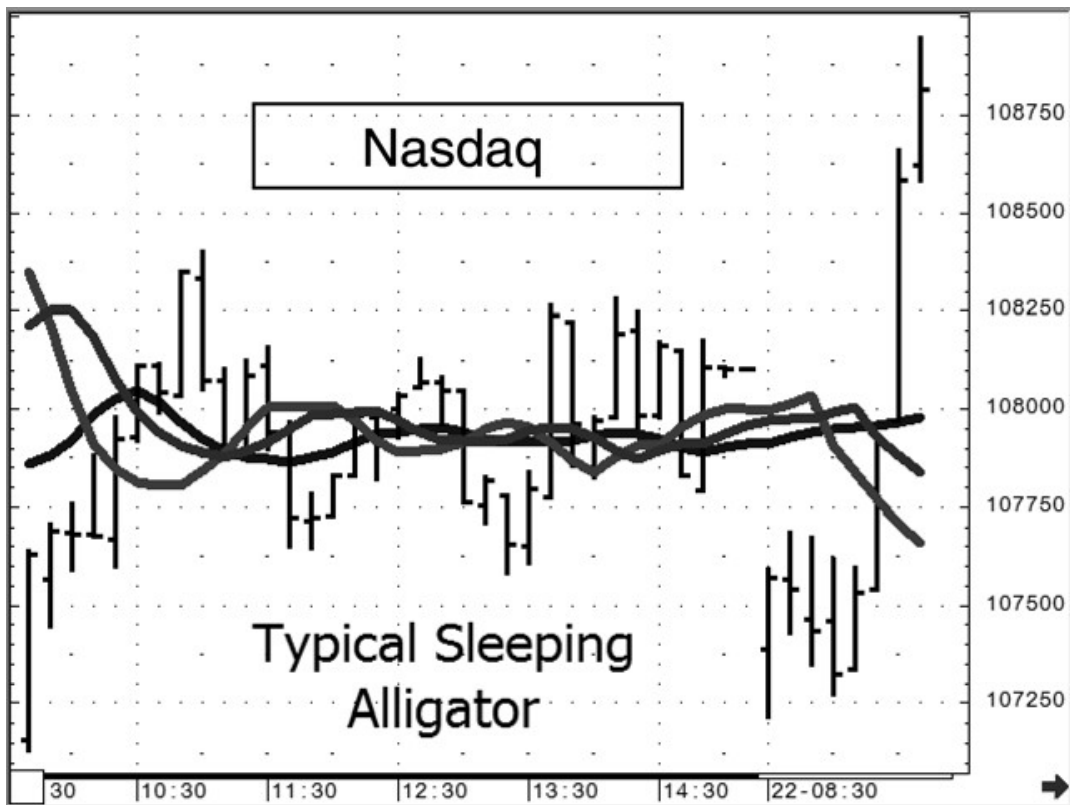
FIGURE 8.3 The Alligator on a Eurodollar chart.



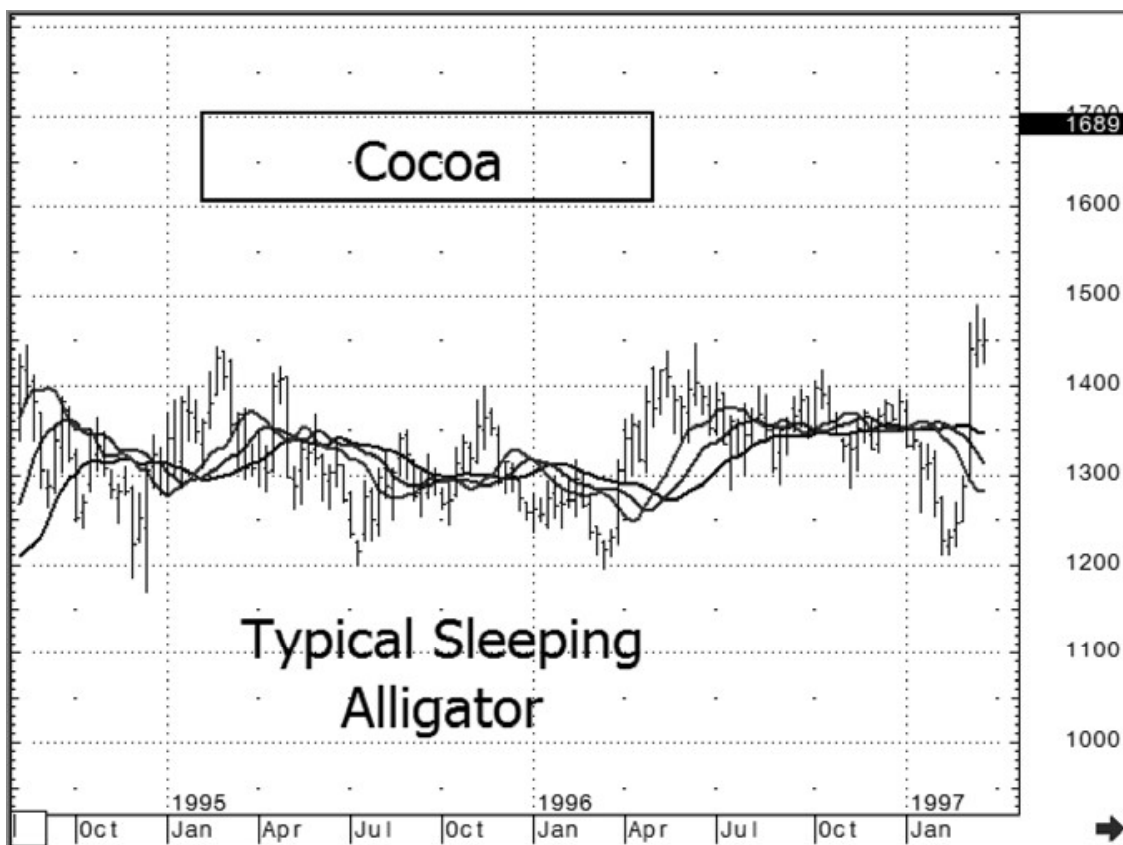
FIGURE 8.4 The Alligator on an AOL Time Warner chart.



**FIGURE 8.5** The Alligator on an Apple Computer chart.



**FIGURE 8.6** The sleeping Alligator on a Nasdaq chart.

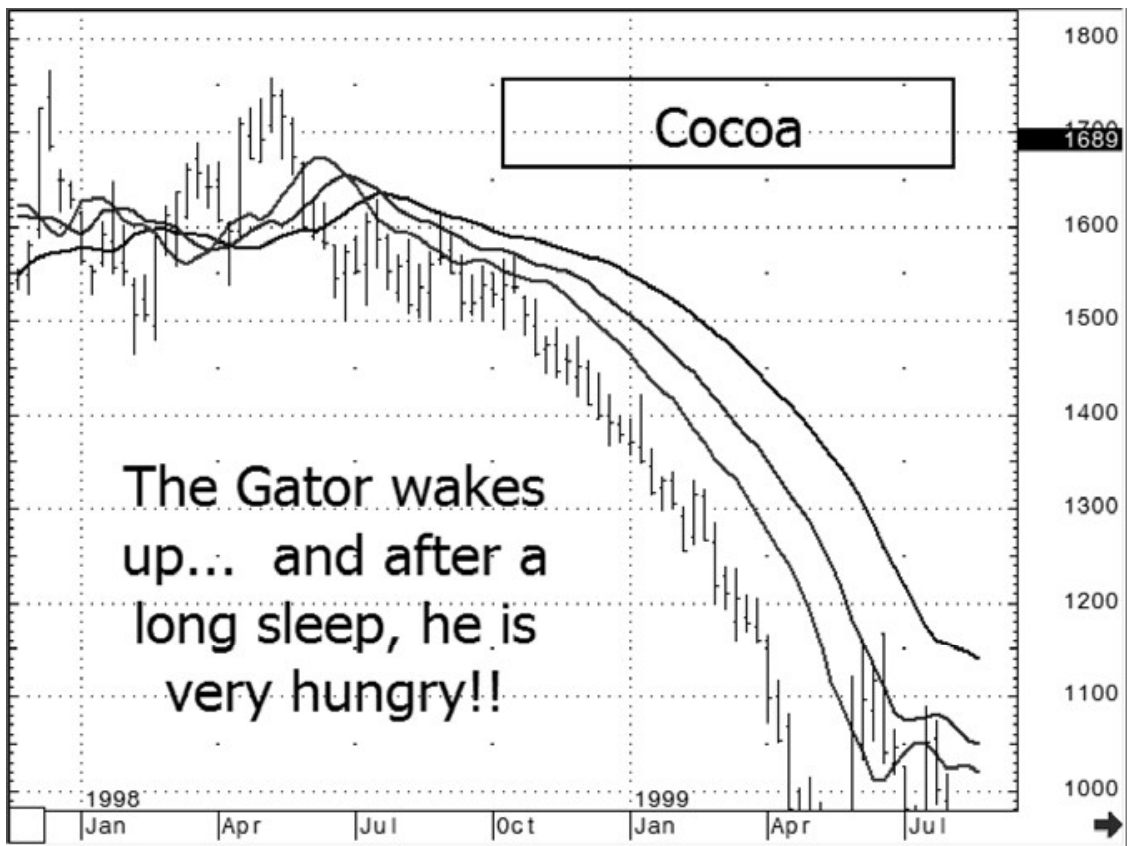


**FIGURE 8.7** The sleeping Alligator on Cocoa chart.

Another example of markets to stay away from is shown in Figure 8.7. This weekly cocoa chart shows an Alligator that has been asleep for more than two years in this time frame. Our experience shows that the longer the Alligator sleeps, the hungrier it will be when it awakes!

As we watch the continuation of the previous cocoa chart in Figure 8.8, when the Alligator finally awakens after a long sleep, it is very hungry and a long, strong down move ensues for more than a year! Trading along with the Alligator keeps us on the right side of the trend and allows us to profit from most of the down move.

Remember,  
The Blue Balance Line is where  
the current price would be  
if there were no  
new incoming information,  
also known as  
**chaos.**



**FIGURE 8.8** The hungry Alligator on cocoa chart.

## CONSTRUCTION OF THE ALLIGATOR

The constructions of the Balance Lines are (Figure 8.1):

- Blue Line—a 13-bar smoothed moving average offset 8 bars into the future
- Red Line—an 8-bar smoothed moving average offset 5 bars into the future
- Green Line—a 5-bar smoothed moving average offset 3 bars into the future

These moving averages are available on most market charting programs and are also available on Investor's Dream, our proprietary software. You are welcome to download a free demo of this advanced charting software, which includes an abundance of historical data from our Web site at [www.profitunity.com](http://www.profitunity.com). Note that all three of these averages are displayed on the same chart overlaid on the price bars.

A smoothed moving average is often calculated and displayed differently by various charting programs. The smoothed moving average calculation that we use is the one included in Commodity Quote Graphics (CQG) ([www.CQG.com](http://www.CQG.com)). Custom programming is sometimes needed in other charting applications to accurately reproduce the smoothed moving average as used by CQG. Profitunity Trading Group does provide some preprogrammed versions of all our indicators to our students for other charting programs such as TradeStation and MetaStock.

## LOOK TO THE FUTURE

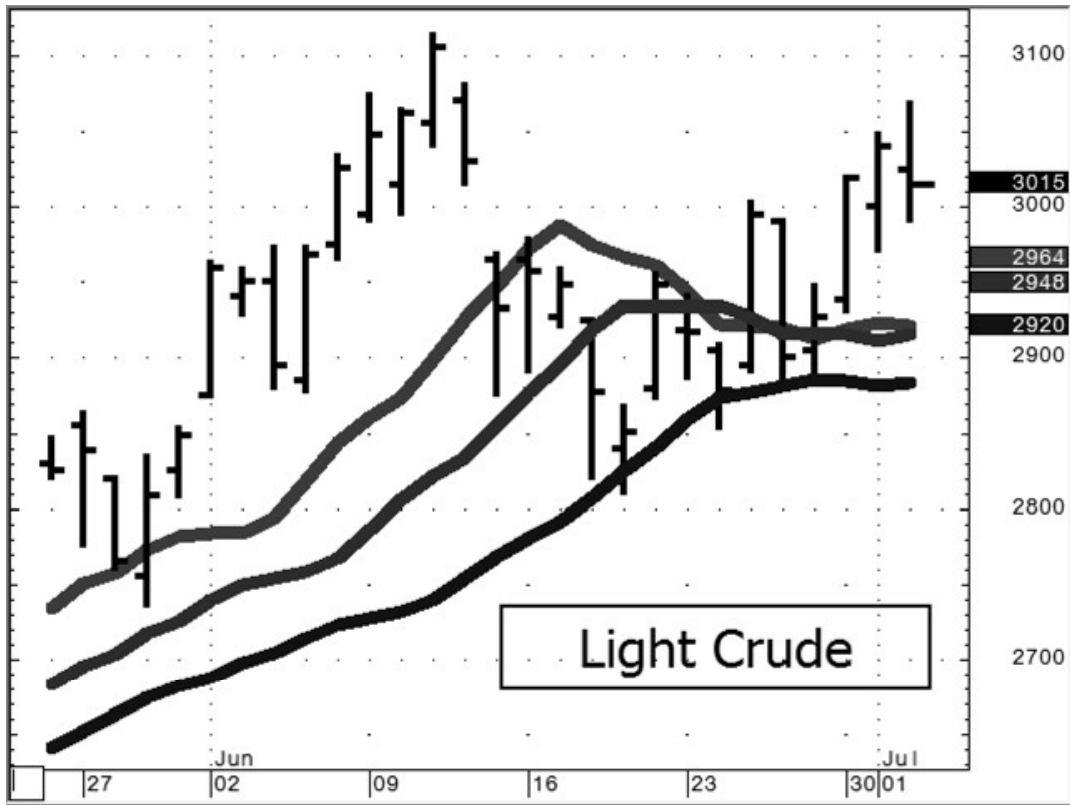
---

After reviewing Figure 8.9, we understand that the Alligator is made up of lines that are offset into the future. Now consider another way that this information can help us. Look closely at Figure 8.10. Note that the Alligator seems to be going to sleep as indicated by the average lines coming together on the right side of the chart. But this chart does not tell the whole story. Because the Alligator is offset into the future, wouldn't it be great to see the rest of the Alligator that is offset to the right of the price bars? Maybe it could give us an indication of the future price movement?

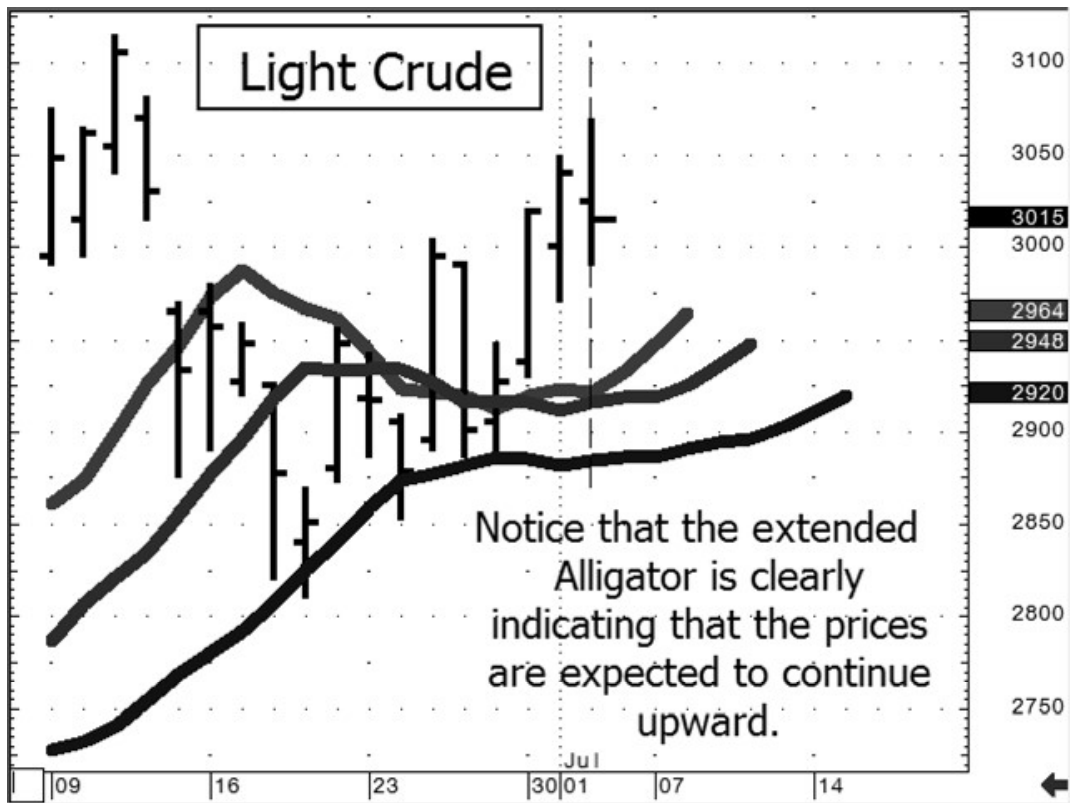
After studying the current position of the Alligator in Figure 8.10, look at the same chart in Figure 8.11. Now we easily and clearly see that the Alligator is suggesting that the up move is going to continue! Look at the difference in what the Alligator is telling you when it is displayed into the future on a chart; that is certainly information you need to know. Several charting applications (including our own Investor's Dream, CQG, and TradeStation) allow displaying the Alligator into the future.

- **Jaw Line (Blue):** The Balance Line for the current time frame displayed on the chart. It is a 13-bar smoothed moving average offset 8 bars into the future.
- **Teeth Line (Red):** The Balance Line for one significantly shorter time frame. It is an 8-bar smoothed moving average offset 5 bars into the future.
- **Lip Line (Green):** The Balance Line for still one more significantly shorter time frame. It is a 5-bar smoothed moving average offset 3 bars into the future.

**FIGURE 8.9** The Alligator setup.



**FIGURE 8.10** The Alligator on light crude chart.



**FIGURE 8.11** The extended Alligator on light crude chart.

## THE ALLIGATOR ON THE PRICE CHART

Again, Figure 8.2 is the same chart as in Figure 8.1, except prices have been added. Notice that when the offset moving averages are intertwined (Figures 8.6 and Figure 8.7), the Alligator is asleep, and the longer he sleeps the hungrier he gets. When he awakes from a long sleep, he is very hungry and chases the price (Alligator food) much farther because it takes more prices to fill his stomach. This terminology is rather unusual for describing market movements, but it creates an accurate picture of what is happening.

Whenever the Alligator has had enough prices to eat, he starts to close his mouth and begins to lose interest in eating. (An open mouth indicates the Alligator is eating prices, and the closed or intertwining mouth indicates the Alligator has had enough for a while and is resting or sleeping.) At this time you want to start taking profits from the trend move. Then you simply sit back, let the Alligator take a nap, and get back into this market when the Alligator starts to awaken again.

The Alligator keeps us out of choppy markets and gets us into every significant move. It is the best trading tool for following the trend we have experienced—ever. In Chapter 9 we refine our early entries even closer to a trend change by going inside the chart and examining the individual price bars and correlate that with both the Alligator and the momentum oscillator.

Another simplification allowed by using these Balance Lines is that we can trade the Elliott waves without the necessity for accurate wave counting. If the current price bars are outside the Alligator's mouth, we are in an impulsive wave of one degree or another. If the price is meandering around the Balance Lines, we are in a reactive wave of one degree or another.



### SUMMARY

This chapter introduced the idea of using the Alligator to sharpen up entries and exits and cut down on whiplashes. What moves the markets are traders responding to new incoming information (chaos). The Blue Balance Line is where the price would be on this time frame if there were no new incoming information. In other words, the markets only move when chaos is present. If there were no chaos, the markets would be static. Our job is to ferret out the characteristics of this new incoming information and to use it to our advantage while trading.

These lines were first determined by mainframe computers using nonlinear feedback calculus to determine the appropriate dimensions and offsets that could be placed on personal computers. The lines have a level of confidence

above 99.5 percent, which means that using these lines as opposed to a main-frame computer doing the actual calculations, you would miss no more than 1 out of 200 trades determined by the computer and extremely complicated mathematics.

In Chapter 9, we examine the first of our three wise men whose job it is to get us into a new trend very early by taking a countertrend trade. At this point, you should thoroughly understand the workings of the Alligator and the three different Balance Lines. You should also understand how to determine when the Alligator is sleeping and when it is eating.