TRADING FOR A LIVING

Psychology
Trading Tactics
Money Management

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III

Classical Chart Analysis

18. CHARTING

Chartists study market action, trying to identify recurrent price patterns. Their goal is to profit from trading when patterns recur. Most chartists work with bar graphs showing high, low, and closing prices and volume. Some also watch opening prices and open interest. Point-and-figure chartists track only price changes and ignore time, volume, and open interest.

Classical charting requires only a pencil and paper. It appeals to visually oriented people. Those who plot data by hand often develop a physical feel for prices. Computers speed charting at a cost of losing some of that feel.

The biggest problem in charting is wishful thinking. Traders often convince themselves that a pattern is bullish or bearish depending on whether they want to buy or to sell.

Early in this century Herman Rorschach, a Swiss psychiatrist, designed a test for exploring a person's mind. He dropped ink on 10 sheets of paper and folded each in half, creating a symmetrical inkblot. Most people who peer at these sheets describe what they see: parts of the anatomy, animals, buildings, and so on. In reality, there are only inkblots! Each person sees what's on his mind. Most traders use charts as a giant Rorschach test. They project their hopes, fears, and fantasies onto the charts.

Brief History

The first chartists in the United States appeared at the turn of the century. They included Charles Dow, the author of a famous stock market theory, and

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William Hamilton, who succeeded Dow as the editor of the *Wall Street Journal.* Dow's famous maxim was "The averages discount everything." He meant that changes in the Dow Jones Industrial and Rail Averages reflected all knowledge and hopes about the economy and the stock market.

Dow never wrote a book, only the *Wall Street Journal* editorials. Hamilton took over the job after Dow died and struck a blow for charting when he wrote "The Turn of the Tide," an editorial following the 1929 crash.

Hamilton laid out the principles of Dow theory in his book, *The Stock Market Barometer.* Robert Rhea, a newsletter publisher, brought the theory to its pinnacle in his 1932 book, *The Dow Theory.*

The decade of the 1930s was the Golden Age of charting. Many innovators found themselves with time on their hands after the crash of 1929. Schabaker, Rhea, Elliott, Wyckoff, Gann, and others published their research during that decade. Their work went in two distinct directions. Some, such as Wyckoff and Schabaker, saw charts as a graphic record of supply and demand in the markets. Others, such as Elliott and Gann, searched for a perfect order in the markets—a fascinating but futile undertaking (see Section 6).

In 1948, Edwards (who was a son-in-law of Schabaker) and Magee published *Technical Analysis of Stock Trends.* They popularized such concepts as triangles, rectangles, head-and-shoulders, and other chart formations, as well as support and resistance and trendlines. Other chartists have applied these concepts to commodities.

Markets have changed a great deal since the days of Edwards and Magee. In the 1940s, daily volume of an active stock on the New York Stock Exchange was only several hundred shares, while in the 1990s it often exceeds a million. The balance of power in the stock market has shifted in favor of bulls. Early chartists wrote that stock market tops were sharp and fast, while bottoms took a long time to develop. That was true in their deflationary era, but the opposite has been true since the 1950s. Now bottoms tend to form quickly while tops tend to take longer.

The Meaning of a Bar Chart

Chart patterns reflect the tides of greed and fear among traders. This book focuses on daily charts, but you can apply many of its principles to other data. The rules for reading weekly, daily, hourly, or intraday charts are very

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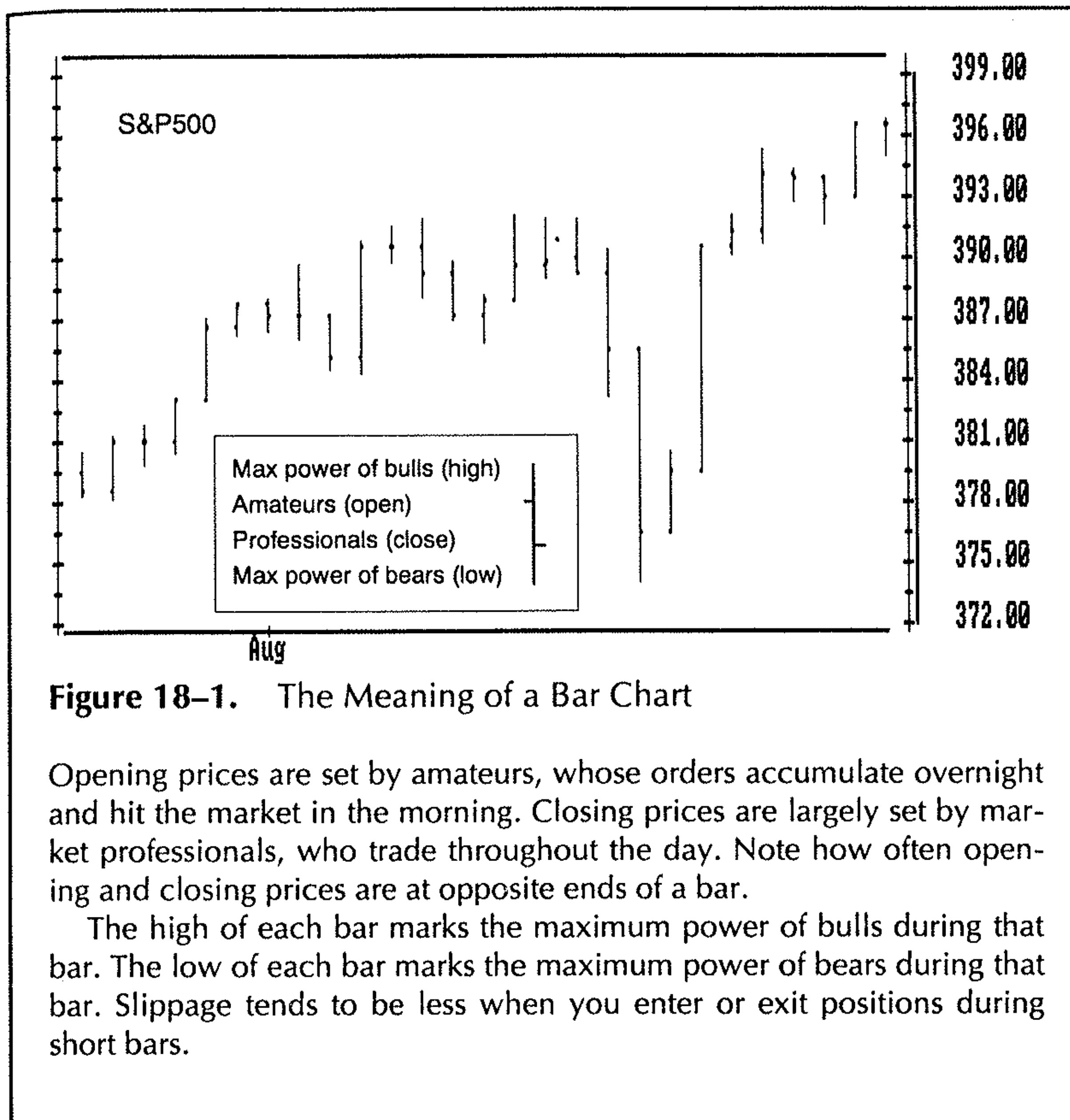

Figure 18–1. The Meaning of a Bar Chart

Opening prices are set by amateurs, whose orders accumulate overnight and hit the market in the morning. Closing prices are largely set by market professionals, who trade throughout the day. Note how often opening and closing prices are at opposite ends of a bar.

The high of each bar marks the maximum power of bulls during that bar. The low of each bar marks the maximum power of bears during that bar. Slippage tends to be less when you enter or exit positions during short bars.

expressed in action. Each price bar provides several pieces of information about the balance of power between bulls and bears (Figure 18-1).

The **opening price** of a daily or a weekly bar usually reflects the amateurs' opinion of value. They read morning papers, find out what happened the day before, and call their brokers with orders before going to work. Amateurs are especially active early in the day and early in the week.

Traders who researched the relationship between opening and closing prices for several decades found that opening prices most often occur near the high or the low of the daily bars. Buying or selling by amateurs early in the day creates an emotional extreme from which prices recoil later in the day.

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