THE SECRET CODE OF JAPANESE CANDLESTICKS

Felipe Tudela

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The Secret Code of Japanese Candlesticks

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Introduction

Would you like to acquire a powerful trading tool that is efficient and precise? Such a tool exists. It is the foundation to ‘Japanese candlesticks.’ This book is about them. You are about to discover the truth about Japanese candlesticks. It is a truth that no one has ever explained before!

Japanese candlesticks are fashionable. Their exotic nature attracts the public to them and they are surrounded by an aura of arcane science and seem inaccessible to the uninitiated. They have a magic of their own – the magic of an ancient civilization – and also have strange-sounding names – Dojo, Marubozu, etc.

However, they do not work efficiently, except for a very small number of traders. The reason for this is that few people today are willing to study a trading method until they master it. Candlesticks are also difficult to handle, given the diversity of their patterns. Most important is the fact that Japanese candlesticks have a unique master key that must be understood in order to make them work.

We are going to explain this key and illustrate it with practical examples. It will change your way of looking at candlesticks and at markets.

1
The Truth about Japanese Candlesticks

The truth about Japanese candlesticks is very simple. 'Japanese candlesticks' refers to the method that has guided the success of Japanese traders for centuries. Originally, Japanese traders made no use of Japanese candlesticks. They used another method.

From time to time, a contemporary author mentions it briefly, without making it part of his trading or giving it the prominence that it deserves. This method, which was used prior to candlesticks, is not explained in any book. What method was employed by the Japanese traders, who had no use for Japanese candlesticks?

We will come to that soon, but first let us trace its history.

THE ORIGIN OF JAPANESE CANDLESTICKS OR HOW KNOWLEDGE OF THEIR HISTORY COULD TURN YOU INTO A SUCCESSFUL TRADER

Kosaku Sato was born in 1716 during the Tokugawa period in the city of Sakata in the Yamagata prefecture. It was the eighth shogunate. Kosaku Sato was adopted by the Honma family and became known as Sokyu Honma.

Sakata was then one of the main ports and centres for rice distribution. This is where Sokyu Honma built a fortune founded on his study of fluctuations in the price of rice. He developed tactics and strategies that made him an awe-inspiring man in Osaka, Kyoto, and Edo. His personality was charismatic. He was thought of as a 'man of knowledge' and a 'market magician.' His reputation was such that the Emperor bestowed the title of 'bushi' or 'samurai' on him. Sokyu Honma was a strategist and a market warrior[1] whose exploits were celebrated by a popular song of the time:

When it shines in Sakata, its cloudy in Dojima
and in Edo it rains.
Nobody could ever be a Honma,
But everyone would like to be at least a lord.[2]

Sokyu lived to be 87 years old and died in Edo. His trading had been based on a secret method that he had created. This method, passed down from generation to generation, is the subject that we will explore in this book.

SOKYU HONMA'S METHOD

Honma's method has two parts. Neither mentions candlesticks. These two parts are:

(a) the *Samni No Den of the Market*;
(b) the *Sakata strategies*.

These will be explained, but a question remains: 'At what time do Japanese candlesticks make their appearance, since the master makes no mention of them?'

Japanese candlesticks made a late appearance – near the end of the nineteenth century.[3] They were developed at the beginning of the Meiji era in Japan, although their exact origin is unknown. However, there are many hypotheses. One hypothesis suggests that candlesticks were a kind of bar chart that was used by some American traders and was subsequently taken over and developed by the Japanese.

What really matters is that Japanese traders using candlesticks, whatever their origin or power, must use Sokyu Honma's method, above all. Japanese candlesticks exist for one reason – *to refine and give added precision to Sokyu Honma's method*. However, the true method belongs to Sokyu Honma. This method is so simple, so logical, and so powerful in its simplicity that it can perform without Japanese candlesticks. As William of Occam, a Western fourteenth century master logician, said, '*entia non multiplicanda*,' or 'let's keep it simple.'

In the following pages, we will explain this method.

2
The Spirit of Sokyu Honma's Method: The Master and the Disciple

As we learned in the previous chapter, Sokyu Honma developed his method in two parts:

(a) the Samni No Den of the market (the *subjective* part of the method);
(b) the Sakata strategies (the *objective* part of the method).

All great traders possess the same spirit and the same reflexes. Both parts of Sokyu Honma's method prove that he understood the immutable principles of a savvy speculator.

The Samni No Den of the market concerns the subjective point of view – the trader's attitude. The Sakata strategies relate to an objective point of view – the market's basic structures. Both perspectives constitute an indivisible whole, because to operate in the markets implies *a knowledge of the market* and *a knowledge of oneself*. What role does theory play in all of this?

It is here that we must make a distinction between Western and Eastern attitudes. For a Japanese trading master, the acquisition of knowledge is practical and not theoretical. Theory only plays a preliminary role. The passage to practice is immediate. It is practice that will answer the pupil's questions.

A bad habit that is often prevalent among Western students bothers Eastern masters. This habit is asking questions without any real purpose. This is the Western critical attitude. To ask questions is normal when acquiring knowledge, but often questions reveal unattractive aspects of the student – impatience and lack of maturity.

For the Eastern master, true knowledge appears when mental agitation ends. In order to learn, one must concentrate on only one thing and let reality bring its own answers. The practice of any discipline will bring the answers to most questions. These answers will arrive when they should arrive – at the right time. When the student is ready, he will receive the answer.

The market has its own language. Only intensive practice will enable us to know it. We must become familiar with hundreds of cases, until the market becomes part of us – second nature to us.

If the student adopts the opposite approach, he is bound to fail. No wishful thinking is permitted here. Intensive and conscientious practice is the only possible path to success. We say this because Sokyu Honma's two methods must be studied, but, above all, practicing them will give us true knowledge.

Let us now move to the next chapter and study the first part of his method.

3
The Samni No Den of the Market: The Subjective Part of the Method

HOW TO MASTER YOUR TRADING: YOUR FIRST STEP TO SUCCESS

The first part of Sokyu Honma's method, the *Samni No Den of the market*, seeks to develop adequate reflexes and the right attitude of a trader in us. Here is the method and its five rules:

1. Without being greedy, look at past market movements and think about the time/price ratio.
2. Try to buy a *bottom* and sell a *top*.
3. Increase your position after a rise of 100 bags from the bottom or a decline of 100 bags from the top.
4. If your forecast is incorrect, try to recognize your mistake as soon as possible. Then, close your position and stay out of the market for 40 to 50 days.
5. Close 70 to 80 % of your positions, if they are profitable, closing what is left after a top or a bottom is reached.

EXAMINING THIS SIMPLE AND POWERFUL METHOD

Rule 1

This rule tells us to measure and study the time/price relationships. Note that this approach was at the heart of Gann's method, for which an equilibrium between time and price is crucial.[4]

This rule enables us to categorize the movements of the market in terms of time and price. Here is an example: the market has risen *x* points in *y* weeks from a historic bottom to a historic top. During this rise, there have been upward movements for each swing of *p* points and *w* weeks. Within this same movement, corrections and consolidations are each within a range of *d* points for a duration of *e* weeks. We follow the same procedure for the movement from the historic top to the historic bottom. This measuring technique may be applied to any time frame.

The rule tells us that we must not be greedy. It is important that we do not try to obtain the maximum possible gain, as indicated by past movements. We must try to win without becoming greedy. In this way we will avoid the risk of overstaying in the market and seeing our gains disappear.

Unfortunately, this is exactly what happens to most traders. Therefore, choose an exit point that will limit your avarice and that, at the same time, is indicated by the market itself. Here, only practice will bring you knowledge.

By studying the time/price ratios, you will discover things – the market itself will speak to you. Remember that the only master is the market. Remember also that it is necessary to have a practical attitude – a way to knowledge by doing.

I can guarantee that this rule alone will enable you to succeed in the market. The rule has another benefit. It will make you *invulnerable*. No one else will have knowledge of your tactic. It will be your secret.

Rule 2

This rule does not tell us to buy bottoms and sell tops, but to attempt to do it. This is something completely different. Act at the right time. Avoid a temptation to buy when it is already too late. Anxiety and impatience push us toward this kind of behavior. Learn to wait for only the best opportunities.

Rule 3

Increase your position following a rise of 100 bags from a bottom or a decline of 100 bags from a top. This rule indicates a price/volume ratio. For any given price change, there is a corresponding change in volume. Here, the market is inverted because the price was fixed and the volume was variable at the time. A rise of 100 bags means a drop in price. A decline of 100 bags means a rise in price.

This rule tells us to increase our position in the direction of the market (i.e. increase our position only if the market continues to rise; we should not increase our position if the market is down, unless it progressively declines). It also tells us to increase progressively only until our positions have been completed. For example, if we buy 900 shares, we must break up our buying into several purchases. We buy first, say, 300 shares at one price and the next 300 only if the market goes our way. We buy the last 300 shares only if the market continues to go our way.

Do not buy everything at the same time! Exercising patience is a much worthier goal than winning in the market. Thanks to our exercise of patience, we will end up by having a much greater number of winning trades.

Someone may argue, 'But, when there is an opportunity, why not place all our positions in the beginning?' Greed has just made its appearance. A fatal mistake!

Rule 4

In case we are wrong, we must close our positions and stay away from the market for a period of 40 to 50 days. This advice is a nugget of wisdom. It conceals a secret and is a mystery in itself. Even though the meaning of the rule is to refrain from market activity so that we can have a clear mind, the following literal sense of this rule is excellent. Not only will your mind relax and rest, but also your unconscious will have time to integrate and perfect your strategy and tactic, enabling you to see 'clearly.' You will receive insight that only comes as a result of patience and waiting. The secrets of trading will be made clear.[5] Once again, we hear a call for patience and a warning to control greed. Understand whoever can!

Rule 5

Close 70 to 80 % of your positions as soon as you have the minimum expected gain. Wait until the end of the movement to close the others. Here, once again, it is studying the market that will tell us when to close each position. Again, this rule is a call for our patience and a warning to keep greed under control. Many traders want to close their positions as soon as they have a small gain. This leads, as a consequence, to achieving big losses and small gains. We must learn to wait and have the courage to see our position develop according to the precise plan that was prepared in the beginning. One must recognize that a plan that was prepared previously will tell us exactly when to close the first 70 or 80 % of our position and when to close the rest – taking into account the risk/reward ratio known and tested in advance. This rule contains a hidden and powerful secret. It is up to you to discover it!

Up to this point, we have examined the five rules of the subjective part of the method. Their logic is consistent. Further, the five have a common denominator – a *call for patience and to control greed*. This is a mastery of self that has, as a result, the *mastery of time*, because we learn to wait for the right moment, and the *mastery of price*, since we learn to buy at the right price.

There is a rigorous linking of the five rules. The first rule indicates the fundamental principle of the market and its fluctuations in time and price. It tells us to measure them, to measure objectively the natural market movement – its oscillations or swings. Once the extent of this movement is known, the second rule tells us when to take action within these movements. We must wait for the right time. Once we know when to buy and when to sell, we must still learn how much to buy or sell. Rule 3 tells us this. Finally, once we are engaged in a trade, we must know when to exit and close our position with a gain or a loss. Rules 4 and 5 tell us this.

In this way, the Samni No Den, the part of Sokyu Honma's method which consists of the subjective five rules, will have taught us:

1. How to manage time and price.
2. How to manage buying and selling points.
3. How to decide what size of position to take.
4. How to manage losses.
5. How to manage wins.

However, in order to be able to apply the rules of this first part of the method, we need knowledge of market phases and the entire cycle. This comes in the second part of the method, the *five Sakata methods*. It also has five rules.[6]

In the next chapter, we will examine the 'five Sakata methods.'

4
The Five Sakata Methods: The Objective Part of the Method

SAKATA'S FIVE METHODS AND THEIR CORRESPONDING MARKET PHASES

The 'five Sakata methods' belong to the objective part of Sokyu Honma's method and focus on the structures or phases of the market. There are five structures or basic configurations:

1. *San Zan* means *three mountains* and is the *triple top*.
2. *San Sen* means *three rivers* and is the *triple bottom*.
3. *San Ku* means a *triple gap* and refers to the empty intervals between prices.
4. *San Pei* means *three lines* and refers to a continuously ascending trend that is composed of three time/price units.
5. *San Poh* means *three rests* and refers to a corrective movement within a trend that is made up of three time/price units.

Each of these strategies or methods is related to a specific market phase or configuration. These phases are:

(a) 1 and 2: turning points, tops or bottoms;
(b) 3: gaps;
(c) 4: trends;
(d) 5: consolidations, or times when markets rest before continuing their trend.

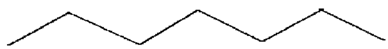
A market can be in only one of these five phases or structures at a time.

For Sokyu Honma, each one of these five market phases has a ternary structure (i.e. one that has three variables). This ternary structure, the foundation of which has a precise meaning in Japanese sacred numerology, is the minimum requirement to define a phase that is valid for trading; i.e. for a trend to be exhausted, we require a minimum of three gaps. For a trend to exist, there must be at least three movements in the same direction. For a consolidation to appear, we require at least three corrective units (i.e. days, weeks, or other periods of specific duration).

Three is an important number. It has a somewhat mystical connotation for traders. Many things involve 'threes.' For example, a trend has a beginning, a middle, and an end. Markets can have more or less than three movements in the same direction, but any trading action taken must account for this triple recurrence. This will prevent mistakes and bad trades. Once again, Sokyu Honma appeals to our patience and to the imperative to control our greed.

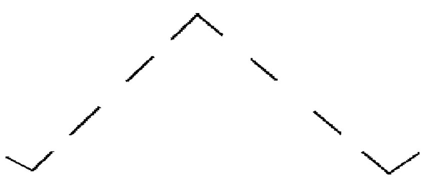
Let us comment on each of these five Sakata structures. We know that Sokyu Honma had no knowledge of Japanese candlesticks. Candlesticks are an add-on after the fact to help interpret the five market phases. Alone and by themselves, these five configurations give us the *key to read the market*:

1. *San Zan*, meaning 'three mountains,' is a triple top as well as a head and shoulders that can be considered to be a variety of triple top.



2. *San Sen*, meaning 'three rivers,' is a triple bottom or an inverted head and shoulders.

3. *San Ku* means 'three gaps.' Gaps occur within a trend. The first gap is evidence of new buying or selling power and the third gap often announces the exhaustion or end of the actual trend.



4. *San Pei* means 'three lines' or time/price units in the same direction. They signal the beginning of a trend. The three lines can be in different time frames and, for example, can very well be three daily consecutive bar charts within a trend, three