# ESSENTIAL TECHNICAL ANALYSIS

## Tools and Techniques to Spot Market Trends

LEIGH STEVENS

JOHN WILEY & SONS, INC.

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To my many former colleagues at Cantor Fitzgerald, lost so tragically in September 2001, as well as to the Cantor survivors who are carrying on so ably.

To Mark Weinstein, without whom I would not have the same understanding of how markets work.

This book is also dedicated to Oscar Ichazo, who provided the insights that so enhanced my being, living, and doing.


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# FOREWORD

Financial markets, by their very nature, attract a wealth of high-caliber individuals who are genuinely excited by their chosen profession. Their enthusiasm and their willingness to share their knowledge makes belonging to the community of traders, investors, and analysts a great privilege. It is my experience that an hour spent listening to their stories, or reading their insights, is often the equivalent to months of study in an academic environment.

Most of these individuals are successful because they recognize, in a way that academic analysis still does not, that asset price movements are not just random fluctuations driven by the rational behavior of independent traders. They recognize that human beings are, by nature, gregarious and communicative, and have an inner drive to belong to groups. Not surprisingly, therefore, group psychology provides a controlling influence over individual activity and transforms a large quantity of apparently unrelated decisions into a more certain outcome.

Importantly, this outcome reveals itself in the form of rhythmic, patterned, price movements that bear not only a natural relationship to one another but also are essentially predictable once they are understood. This is why the discipline of technical analysis—hearing the message of the market via price movements—is such an accurate tool for making profitable trading decisions.

Furthermore, since markets essentially attempt to anticipate movements in economic and social fundamentals, the accurate use of technical analysis actually implies an ability to predict those fundamentals. This is why technical analysis is such an important tool for making investment decisions.

Leigh Stevens comes from this community of enthusiastic and knowledgeable individuals. His depth of experience, acquired over very many years, has generated a deep understanding of, and commitment to, the discipline of technical analysis. Moreover, he is one of those rare individuals who have the ability to convey the essence of his ideas, not only in a wonderfully simple and straightforward way, but also charged with appropriate anecdotes and experiences. There are not many people around who can both walk their talk and talk their walk.

—Tony Plummer
Former Director of Hambros Bank Ltd and of Hambros Fund Management PLC
Author of *Forecasting Financial Markets*

# PREFACE

I've been fortunate in many respects in my life in being in the right place at the right time. I took a sabbatical from corporate life to write this book, in time to not be in my office at Cantor Fitzgerald on the 105th floor of One World Trade Center, during the tragic events on September 11, 2001. I'm immensely grateful that I was able to be here to author this book and I suppose you could say that technical analysis saved my life. Thanks also goes to my editor at John Wiley & Sons, Pamela van Giessen, who provided guidance and encouragement in the process of writing this book.

My most fortunate opportunity, in terms of technical analysis, presented itself in 1984 when Mark Weinstein, a world-class trader of stocks and index futures, began mentoring me. Mark demonstrated to me the truth of the words of legendary stock speculator Jesse Livermore, as quoted in *Barron's* in 1921, when he said that "Speculation is a business. It is neither guesswork nor a gamble. It is hard work and plenty of it."

I was at the time an investments vice president at Dean Witter, now Morgan Stanley Dean Witter. A friend, who was an active investor and sometimes speculator in bonds and index futures, came by my office to tell me of this person, Mark Weinstein, whom he had teamed up with to invest money—and that he was his wife's driving instructor. You can be sure that I did not consider that this fellow could know much about the markets, or to have been very successful in them! I then met Mark when he came by to place some orders for his new partner's account—I was his broker. Mark Weinstein turned out to be a very intense person, and the focus of that intensity was the stock and commodities markets, as well as technical analysis, the means that he used to make market decisions. He was temporarily burned out from his life as a professional speculator for the prior 10 years—and was considering buying a driving school, so he was getting a first-hand look at the basics of the business. He often said that he hoped to lead a *normal* life and that maybe some other business would allow him to do that.

Mark, I discovered, knew about all technical chart patterns, indicators and their effective use, how to interpret volume and the stock tape, going against popular market sentiment, interpreting Elliott wave patterns, and a lot more. I knew a little about technical analysis from some self-study and made some use of charts and technical indicators in my business. Mark, however, had been mentored by many top traders and analysts, such as George Lindsay. Mark would literally show up on their doorsteps and ask them if he could learn from them.

What developed over the following two years was that Mark started teaching me what he had learned about the internal dynamics of the markets. He didn't take a position in the market often, but when he did he invested heavily and called in his orders from home. Mark would, for example, take large index options positions at a market low and hold onto them for the first and strongest part of a move. He did this multiple times in this two-year period. I would know when he decided that the market had turned, as he would call me up and tell me shortly after the fact. One morning sticks out in my mind when he called and said the market had bottomed. Nothing was happening in the market either that morning or in prior weeks, as the market was in the doldrums. However, by the end of the day the market was up substantially.

Over time I spent many hours on the phone with Mark listening to him espouse his market knowledge, without arousing much notice in an office full of other brokers talking to their clients. This wasn't great for my business, but I was able to absorb a lot of what he knew. He had time on his hands then, as he was only in the market sporadically. The hundreds of hours he spent discussing his techniques and experiences were of immense value. There are rarely these opportunities to work with such highly successful speculators—these are the market professionals whose sole focus and passion is winning in the market. I sometimes didn't think that this man was real, as his knowledge was so superior to anything I had been exposed to on Wall Street up until then. The only analogy is to compare this to the prowess of a Michael Jordan or a Tiger Woods in the sports world—no doubt if you played with them, they would seem to inhabit another realm. Just as with Jordan and Woods, you won't find the world-class market pros teaching what they know—they also just do what they know. Nor do these top traders write market advice letters or sell *winning* trading systems—in fact, Weinstein often debunked this idea, saying that no one would sell a profitable system, only use it themselves to make money.

In 1986 when I was the stock index and financial futures specialist at PaineWebber, I brought Mark to the attention of Jack Schwager, then senior technical analyst there, as a candidate for his first Market Wizards book. Jack was as amazed as I was that Mark claimed he had almost no losses, in hundreds if not thousands of trades. Jack checked one of his account statements and also relied on me as judge of his trading record. I had known about dozens of Mark's transactions as they were occurring and followed the stock, option, or futures as subsequent market action unfolded. He was the real thing as far as being able to profit from his predictive abilities.

Like all the other top traders Jack Schwager wrote about in his Market Wizards book, Mark Weinstein was also intently focused on avoiding losses. He would exit a position with a small profit or with a small loss (a very rare occurrence), without hesitation, if the market did not move his way. The other very important lesson learned from this enormously successful trader was that the emotional factor makes a difference. Knowledge is important, but someone could have as much, if not more, market knowledge than Weinstein and still lose in the market because of not having the right emotional temperament and discipline it takes to be successful plus, a constant willingness to give up their current notions of market trends when wrong.

It is the emotional element that is the key to winning and losing big in the market. Part of that is waiting for the right price, the right moment, and then having the discipline to stay with your position. And to not overstay or invest too much of your capital. So while technical analysis might be the key to knowing what to buy when, there is this crucial psychological component to capitalizing on this knowledge.

At PaineWebber, I had the opportunity, besides advising the firm's brokers, to devise and run a stock index futures fund. I developed a rule-based system of market entry and exit based on technical criteria and it was these ideas that were sound. However, I found that I was one of the people who had difficulty in handling the emotional pressures of running a speculative fund. I found that I was a better *advisor*—numerous brokers at PaineWebber said they profited from my advice—than trader or fund manager. Having a natural bent toward teaching, I continue in this vein with this book.

After PaineWebber, where I ended up as senior technical analyst, I had the opportunity to combine marketing and technical analysis as the Dow Jones Telerate global product manager for technical analysis in 1993 both in New York and later in London. While still in New York, I organized the establishment and rules governing the Charles H. Dow Award, given annually by the Market Technicians Association (MTA) of which I am a member, for outstanding achievement in technical analysis work. Like the man himself, I stipulated that the Award given in Dow's name by the MTA in conjunction with Dow Jones & Co., be awarded for work that stressed the practical and involved clarity of writing that was superior. This has always been the goal of my own writing.

When I took a position at Cantor Fitzgerald, one of the largest institutional bond and equities brokers in the world, I also had the opportunity to write technical analysis columns for the *Cantor Morning News* and also for CNBC.com. This book is an outgrowth of the attention I got from publishers in 1999–2000 while I was writing these columns. I finally decided to take on the opportunity and challenge of being able to write more than 1,000 words at a time and to expand on the essential principles of technical analysis. Making this effort was very much influenced by the hundreds of e-mail inquiries I received from CNBC.com viewers and their interest in this subject, as well as the appreciation so many of them expressed of my efforts to make technical analysis interesting and useful to them. I hope that this book is the helpful introduction to technical analysis that many of them said they would like to read.

# 1

# INTRODUCTION AND RATIONALE TO THE TECHNICAL APPROACH

## METHOD AND GOALS OF THIS BOOK

The goal of this book is, like my CNBC.com technical analysis columns that came before it, to present technical analysis tools and insights that can help you make more informed, and more profitable decisions relating to trading and investing. I utilize the U.S. stock market for all examples. I also discuss some indicators and aspects that are particular to the stock market.

A major related purpose of the information and stories I present is that a process is begun whereby you start to look at markets in a different way, to see beyond the usual way that market information is presented to you or understood by you. I emphasize again my hope that you will be able to *profit* from this information. A major consideration is to discuss and demonstrate what I consider to be the more useful tools and methods from technical analysis—for example, demonstrating how to locate stocks that offer the best hope of gain at the right time, at lowest risk, and with an effective exit strategy. There are less used technical tools and analysis techniques that could be described but that might be marginal for most people, in terms of improving trading and investment decisions.

A second orientation I have is to discuss some of the pitfalls to improved trading and investing decisions, such as your *attitude* toward the market—is it gambling or is it profitable investing or trading that you can master? How much time will you invest in it and how much perseverance will you maintain? I find that a person's emotional temperament, work habits, discipline, and ability to see ahead (foresight) are as, or sometimes more, important as mastery of some of the more complex areas of technical analysis. Time spent and perseverance in understanding the most basic use of charts and technical indicators are more important to most market participants than exhaustive study of every aspect of this field. And there is a great tendency among people to think that complex ideas and techniques must be the way to approach the markets, which after all, are complex mechanisms. This is wrong, as simple is better in my experience, and I am not the only one saying this—many top advisors and money managers base their decisions on a relatively simple set of criteria.

## USE OF EXAMPLES

### Chart Examples

I use stock and stock averages exclusively for all examples in this book relating to demonstrating technical patterns and indicators. While I also have a background in the futures, fixed income, and foreign exchange markets, I will not provide chart examples from these markets, or discuss aspects of these markets that are unique to them—for example, describing *open interest* and how to use it in futures or the ways of constructing a *continuous contract* price series from the various futures contract–months. I do discuss some custom indicators and methods of analysis that are unique to the stock market, as I believe I have something unique to say about these things. However, again I want to emphasize that all general technical analysis principles, which comprise most of this book, are applicable to all markets.

### All Markets

The popularity of technical analysis owes much to its initial widespread use in the commodities markets, especially in the 1970s, when these markets were very active, drawing in many individual futures traders. Technical analysis is very popular in the biggest single market in the world—the *interbank currency market*, usually just called the foreign exchange or FX market. Having worked in this area in Europe, I can say that I understand a major reason for this—a chart or a technical indicator is the same in any language. This said, I do not draw, for example, on FX charts of dollar–yen or of the eurodollar for my illustrations.

### Further Study

I do, however, point you to other books with a more detailed and specialized orientation toward other markets or specialized fields within technical analysis that you may want to study further if you're interested—for example, on *candlestick charting* or *wave analysis*. Some of what I consider to be the best reference works on technical analysis are provided at the end of the book in a recommended reading list. Some of these books draw on more examples from the futures markets, for example.

## NEED FOR TECHNICAL ANALYSIS

There are plenty, in fact a majority, of successful money managers who say they don't use technical analysis at all. There are also rich investors and speculators who rely mostly on technical analysis. It's not the method; it's the person—just as Jack Schwager found in his wonderful Market Wizard series of books.

You may not have the emotional temperament or time for short-term speculation in the market, which is my situation, but you can still vastly improve your batting average when it comes to longer-term investing, such as in stocks. You can focus on looking at long-term charts and indicators only—however, don't get married to a stock, either. Even very long-term investors decide it's time to exit a stock or stock sector and look for other situations. This group of individuals can benefit from stock market timing to find a more advantageous (cheaper) entry into a stock or mutual fund or to exit when a primary trend reverses.

## WHAT IS TECHNICAL ANALYSIS?

The word *technical* comes from the Greek *technikos*, relating to art or skillful. Webster's goes on to define technical as having special and *practical* knowledge, something I want to reinforce also. *Technical analysis* is the study of any market that uses *price* and *volume* information *only* in order to forecast future price movement and trends. (Consideration of a third factor, that of *open interest*, is part of the technical approach in the futures markets only.)

Technical analysts and technically oriented investors or traders rely on historical and current price and volume information only. Some other, related, statistical information is often considered part of technical analysis. What I refer to here are *sentiment indicators*, such things as surveys of market opinion to determine whether the respondent is *bullish, bearish*, or neutral on the market. These figures are compiled as percentages of those surveyed having each type of opinion, for example, the weekly Investor's Intelligence opinion survey of market professionals or the American Association of Individual Investors (AAII) poll of its members. Studies of *short interest* in stocks or extreme readings in the Arms Index (*TRIN*) are also in this category.

## A THIRD ELEMENT BESIDE PRICE AND VOLUME

The rationale for studying market opinion is the theory of *contrary opinion*. The idea of contrary opinion in market analysis is that there is value at certain times or in general of going against the predominant view of stock valuations or expected market direction. Warren Buffett, considered a master of *value investing*, looks for value in stocks that may not be perceived by the majority of fund managers. Market makers on the New York Stock Exchange (NYSE) buy when others are selling and vice versa and they make money doing it. The most knowledgeable investors and traders comprise a top tier of market participants, in terms of market knowledge. This group often profits handsomely by being contrary to the investing crowd, buying when others are fearful of a further decline and selling when the majority thinks a stock or the market will go up indefinitely.

Market psychology, sentiment, or contrary opinion, could be called a *third element* in technical analysis but is not part of the formal definition of technical analysis. My favorite sentiment *indicator* is actually a ratio of total daily equity call option volume relative to the volume of equity put options. I tend not to rely on survey type information but do place significant emphasis on whether options market participants are speculating or hedging heavily on one side of the market or the other—whether, as a group, they are betting on a rise or fall in the market. Even here I rely on volume information, which is part of technical analysis input.

## TERMS

The terms applied to the use of technical analysis include technical analysis, the *technicals* or *technical factors*—not to be confused with *tech* or technology stocks or technical factors impacting a market, such as a computer failure or blizzard in causing an exchange to close early. *Technical analysis* means a set of principles and analytical tools that are used to make predictions about the market that predominantly involve the use and study of price and volume information only.

## FUNDAMENTAL ANALYSIS

Fundamental analysis, rather than concentrating solely on the study of market action itself, relies on examination of the laws of supply and demand relating to a market or to individual stocks. The aim is the same, to determine where stock prices may be heading. Much of fundamental analysis revolves around one basic area—*earnings*. What is a company likely to earn in its business during the current time frame and going forward? Or what is the earnings potential of an entire group of stocks, such as the S&P 500? Relative to earnings, what *multiple* is the market likely to assign to the value of the stock or market index? Will, or should, the price of the stock trade at a value that represents 10, 15, or 50 times past and future (projected) earnings in dollar terms? Price/earnings ratios or P/E considerations form the core of fundamental analysis of stocks.

Relative to P/Es, the broad area of investor sentiment provides an area where fundamental and technical analysis overlap. Whether a stock should or will trade at a price/earnings ratio of 10, 15, or 50 is more than a matter of economic and company growth expectations, it is also a matter of investors' bullish or bearish sentiment. Market participants may decide that they will no longer reward growth stocks with a P/E ratio that is far above the average simply based on having seen a recent collapse of such ratios. Or their views of a company's or industry's growth prospects may be good, but a more cautious attitude takes hold, forcing a downward adjustment to stock prices, when even the fast growing companies with rapidly expanding earnings no longer command hefty premiums to the average stock.

## TECHNICAL ANALYSIS RATIONALE

Why would someone rely on just studying charts that plot past and current price and volume information, as well as perhaps technical indicators or formulas that use the same information?

The reasons are found in observations of the stock market, as first noted by Charles Dow in this country and can be described in three ways.

1. ***Efficient Market.*** *Over time, market prices reflect everything that can be known about a stock and its future prospects.* The market as a mechanism is very efficient at discounting whatever can affect prices. Even unforeseen events, such as new competition, legal or financial problems, a company takeover, the death of a founder, and so on are quickly priced into the stock. Even unknown (not yet publicized) fundamental factors, such as a sharp earnings drop, are seldom unknown or unanticipated by everyone; those who know often act on the information, and selling volume starts to pick up on rallies. Here I am not talking necessarily about facts known only by company insiders. There are traders, investors, and analysts outside a company or an industry who see changes coming, through astute observation and sharp analysis.
2. ***Trends.*** The information about a company's stock and its future earnings prospects that are reflected in the stock price will also be reflected in a price *trend* or tendency to go up or down. Trends are not only up or down, but sideways as well or what is sometimes called a *trendless* pattern—I consider a sideways movement to be the third trend possibility, for example, a stock moves between 40 and 50 multiple times. A trend is the action of a body in motion staying in motion until an equal countervailing force occurs.
3. ***Reoccurrence.*** *Price trends occur and reoccur in patterns that are largely predictable.* The idea of trends reoccurring is that history repeats itself. If there was abundant stock for sale (supply) previously for sale at 50 and that selling caused a retreat in prices, it may well be the case again when the stock approaches this level again. If it doesn't, that tells you something also, as demand was this time strong enough to overcome selling.

The basic technical analysis rationale can be remembered by the ETR acronym (as in Estimated Time of Arrival). Well, you can estimate arrivals with technical analysis!

## TECHNICAL *VERSUS* FUNDAMENTAL ANALYSIS

If you are reading this book, I assume you have an open mind as to the possible validity of technical analysis. I see no contradiction between these forms of analysis. I often use technical analysis as an adjunct to fundamental analysis—I may like a market sector or individual stock for fundamental reasons, for example, computer use is on a path of explosive growth. I might then use technical analysis for or because of

- Market timing—when to get in, for example, a pullback to a *trendline*
- Risk control—judging where to place protective stop (liquidating) orders, for example, on a break of a major trendline
- An end to a trend—applying criteria for when a trend may have reversed, for example, a decisive downside penetration of a stock's 200-day moving average

There are other reasons to use charts, of course, even if you don't use technical analysis techniques, such as for seeing price and price *volatility* history.

Not only do I not see the two means of analysis to be complementary, but I also consider technical analysis to be a shortcut or an efficient way to do stock market fundamental analysis! I may not be able to or want to study everything about the ongoing progress of a company whose stock I own. However, there are always an interested body of people who trade the stock and make informed investment decisions because they know the company or business quite well. I can ascertain what the informed opinion is on a stock by seeing what is going on with the price and volume patterns on the chart. I assume that the market judgment on a stock is right until proven otherwise.

## CRITICISMS OF TECHNICAL ANALYSIS

- *There is no proof that technical analysis works.* Actually, there has been some relevant work done by Dr. Andrew Lo at MIT, who has answered the question of the predictive power of some technical analysis concepts. He studied a chart pattern recognized as having a predictive outcome, that of the "head and shoulders" top formation. Dr. Lo sought to determine if a subsequent price decline was in evidence after this pattern developed—compared to outcomes present without this condition. Once the pattern was defined mathematically and tested over the long-term price history of 350 stocks, it was compared to "random walk" simulations. The results confirmed that the pattern studied was in fact predictive in nature for a *subsequent* price decline.

- *Technical analysis works only because traders believe it works* and act accordingly, causing the action predicted, for example, traders sell when a stock falls below its 200-day moving average. While this is sometimes true, most active stocks have too much trading activity to cause me to believe in the idea of a self-fulfilling prophecy. If there was a temporary price decline due to the technical selling related to such a break, the stock would rebound if the value became too low relative to its fundamentals. Moreover, the influence of technical analysis is not that great. If you follow the market related channels like CNBC, you'll see a drumbeat of fundamental news all day long. Focus on fundamentals is the mainstream approach and the numbers of investors or traders influenced by technical analysis is small in comparison.
- *Price changes are random and can't be predicted*. This criticism is related to the "random walk" theory, as the idea that price history is not a reliable indicator of future price direction. Adherents of this view take a different view of the market being *efficient*. I used this term previously to mean that the market is an effective mechanism *over time*, to reflect everything that can be known about a stock and its prospects. The efficient market *theory* holds that prices fluctuate randomly around an intrinsic value. This point is actually similar to the one technical analysts make that a market price reflects everything that can be known about that item. The difference is that one school (random walk) holds that current relevant factors affecting price are discounted immediately, and the other (technical analysis) is that this *discounting* ebbs and flows, taking place over time intervals that are predictable. Random walk adherents suggest that a buy and hold strategy will offer superior returns, as it is impossible to *time* the market. More on the possibility that attempting entry and exit on intermediate price swings could increase returns, relative to a buy and hold strategy, is found in Chapter 2.

## STOCK MARKET DECISION CRITERIA

Even if your primary criteria for making investment or trading decisions are fundamental ones—for example, you like a company's business, the way that company is doing that business and their growth prospects—there may be much to be learned by using a historical chart of the price and volume trends of the stock and by applying some simple rules of thumb related to technical analysis for *timing* considerations.

For example, is there some likelihood that the stock might drop back to a lower level as it's near a prior high, and previously sellers pushed it lower when it was in this price area? You could couple this information with a technical *indicator* that suggests that this stock is *overbought*. If the stock goes above its prior high, you can make a purchase at a bit higher level but with some greater degree of assurance that the stock has willing new buyers coming in.

Or you could wait until a price comes back to the old high that was exceeded, as it often does, one more time. If a stock does retreat from its first advance and you buy in a natural *support* area, you've improved your purchase price. Better entry prices over years of investing add up. Exiting soon after a major trend reversal, such as was seen in the Nasdaq in March and July–August 2000, because you had exit rules based on technical analysis criteria, could have been a major financial advantage.

## BROADER APPLICATIONS FOR TECHNICAL ANALYSIS

Technical analysis can be applied to any market or any stock. Also to any market sector index by your studying the chart of that market segment, for example, the semiconductor and oil stock indexes. Or if you are ready to purchase a mutual fund, it's possible to obtain and analyze historical data on the daily closing fund values for major mutual funds. You may also evaluate the stock market as a whole in the way that Charles Dow analyzed it. Is the Dow Transportation average lagging the Dow-Jones Industrial average, suggesting a slowdown, not in manufacturing, but in shipments, a business area that experiences an economic downturn the fastest? Perhaps this observation would cause you to wait and see if the famous Dow theory barometer confirmed a continuation of a market trend, thereby avoiding a big risk by reducing your equity holdings or by waiting to put more money into stocks.

## WHOM THIS BOOK IS FOR

Some of these categories of individuals overlap and one person cannot always be so easily defined, but the following are market *orientations* that are common.

- Investors in stocks and mutual funds, including those who have a buy and hold philosophy but who are open to learning the entry and exit decisions that technical analysis helps provide. Mutual funds can be charted like stocks also, and there are sources of closing prices you can download every day if you use a computer. You can chart these prices daily on graph paper also by using the financial press.
- Traders, including day traders and those who trade in and out of stocks over time as opportunities present themselves. Chart patterns and indicators work basically the same way whether seen on a 15-minute, hourly, daily, weekly, or monthly chart. Traders are going to tend to rely more on computers and Internet information.
- The average investor, who combines a bit of both investing time frames and may combine elements of fundamental and technical or chart analysis. And, by the way, it's been shown that the average holding period for stocks is now down to around 10 months.
- Someone who has no prior knowledge of technical analysis. I assume at most that you have some familiarity with stocks, the market, and have bought and sold stocks. You may not have shorted stocks previously.
- People willing to put some time into studying the market and keeping track of their stocks and mutual funds, relative to the market and its sectors. "Never stop evaluating" tends to be the motto of top money managers and traders.
- Pragmatists. Certain core technical analysis principles and precepts show useful information about market trends, but cannot always be demonstrated, proven, or even explained. The fact that they do work can be seen over and over, however. Those less interested in the theory and more interested in what works and its practical use will find technical analysis helpful.

## WHOM THIS BOOK IS NOT FOR

- Someone with the expectation of averaging 10–15 percent a month, instead of annually, in stocks, may learn some things from this book, but they're also not likely to be prudent in the risks they take, which is one of my messages.

- A person who expects any system of market analysis to have all the answers all the time. You won't find that in technical analysis or elsewhere that I know of. The best traders and fund managers in the world always stand ready to admit that they are wrong, and they are the top people in making money in the market.
- Someone who will not put some minimum time into studying the market and the charts. You can only expect results from effort put into something. A few hours a week would be sufficient if you are an active market participant, less if you are not.

## HOW THIS BOOK IS ORGANIZED

The chapters that follow are summarized.

### Chapter 2

**How we invest or trade.** Investing versus trading time horizons or orientation: Choose one or both, at different times, but don't confuse the two; risk attitudes, risk control, and a trading strategy—your attitude toward risk is all-important to winning in the stock market.

### Chapter 3

**Charles Dow and the underlying principles of market behavior.** Understanding that the internal dynamics of the market have much to do with investor attitudes or psychology. How Dow's concepts form a foundation for technical analysis and predicting future trends.

### Chapter 4

**Types of charts and scaling.** The different ways that price and volume information are displayed.

### Chapter 5

**Concepts of trends, trendlines, and trading.** Entering the basics of technical analysis; the trend is your friend and trendlines your best friend.

### Chapter 6

**Pattern analysis and recognition: price and volume.** Price movement is the president or commander-in-chief; volume is the vice-president; identifying the beginning of major trends; identifying market reversals.

### Chapter 7

**Technical indicators.** Did you need them always? The times they preserve profits or your skin; moving averages; overbought/oversold indicators; advance/decline figures and other stock market specific indicators.

### Chapter 8

**Confirmation and divergences.** Charles Dow said it best in the West; volume divergences; not all divergences are tops but tops often have divergences.

### Chapter 9

**Specialized forms of analysis and trading, people, and systems.** The easy Elliott wave primer; Gann principles and techniques; developing trading systems and back-testing; optimization; indicator and pattern screening techniques.

### Chapter 10

**Putting it all together.** Developing your checklist; some fun stuff.

## MORE PERSONAL HISTORY

I came to technical analysis, like many other things in my life, by the process of trial and error leading to discovery and by the fortuitous circumstances of having someone around who could help me discover how markets work. This almost always was a process of uncovering something about the inner workings of the market as a dynamic process of individuals interacting with each other and with outside forces. In the early stages of my learning about technical analysis, it was usually not about the *obvious*. I think Joe Granville said that "if it's obvious, it's obviously wrong." Various events and experiences I had taught me that there was something beyond the obvious.

## THE 1970S—MY FIRST *BUBBLE* AND PIGS IN A POKE

In the 1970s there was a speculative *bubble* in the commodities markets, especially in the gold and silver markets. You may be of an age to remember people melting down their heirloom silverware to sell it when prices went from $3 to $30 an ounce and higher. There is no precise definition for a bubble, but generally it's a rise so steep in the market that it's a very rare event. This was a decade of inflation, and tangible assets like real estate and commodities were seen as safe havens, whose price appreciation would stay ahead of rising prices.

I fled to it myself and decided to become a commodity futures broker at Merrill Lynch where they had offices specializing in this type of brokerage. One of my early clients, someone who knew the commodities markets firsthand as the president of Continental Grain Company, was an active trader of the live hogs contract. This contract called for future delivery of the porkers in the pens, before they got cut up into bacon (pork bellies). Merrill Lynch's livestock analyst at the time was an old pro. Growing up in Michigan, I happened to have heard this analyst at times on a farmer-oriented radio show hosted by a neighbor. This expert had a calm voice of authority and his manner gave no doubt that he knew this market and what was going on.

Many years later in the late 1970s in the Merrill Lynch commodities office on Fifth Avenue where I worked, it happened that this same expert was our livestock analyst. He would attempt to predict where prices were likely to be headed in the coming season based on all the known factors of supply and demand. I emphasize *known* here, as another study of the obvious. Based on his own and my firm's experienced market analyst, my client bought a sizable number of hog futures contracts—maybe 50 contracts, which is a lot—a dime change in the price per pound for hogs was worth $15,000. Then prices started falling. My firm's expert was saying, "Don't worry; it's a temporary downturn and not justified by the fundamentals."

You can guess the rest of the story. As prices sank so did my spirits. My client was a very knowledgeable man in the commodities markets and I had the advice of the best fundamental analyst out there, but we were stumped by what was happening. I remember my client ended up selling most, if not all, of his position at a substantial loss. It was a shock to me, as

I didn't know what else to rely on but the kind of analysis related to supply and demand projections I was getting. I don't remember what reason came out finally to explain the substantial price drop. I became very interested in how I could be forewarned about price reversals in the future.

An old friend and a commodities broker himself, Jeff Elliott, told me about using something called an *oscillator* and that this indicator could give me an idea when a market was *overbought*. This was a term in technical analysis suggesting a price rise that was so steep as to be unsustainable—and a situation that would most likely be relieved by prices dropping back to a level where supply and demand equilibrium would be more in balance. The suggestion was that I should not rely just on fundamental analysis and our expert's interpretation of the price influencing factors. I could also rely on price action itself to see if a market might be vulnerable to a substantial price trend reversal.

## I THOUGHT I KNEW SOMETHING UNTIL I HEARD GEORGE LINDSAY

In early 1982, with inflation under control and a prospective investing shift to financial assets, I was in the process of becoming a registered stockbroker. In February 1982, George Lindsay, a technical analyst with the institutional and specialist firm Ernest & Company, appeared on the PBS television program *Wall Street Week*. Interestingly, through subsequent years I met many people that also saw that broadcast and remembered it quite well. George Lindsay, by then in the late stages of his career and an unimposing figure, spoke softly and often referred to a small piece of paper. At this time, stocks had been underperforming every other asset class for many years and stockbrokers were becoming real estate brokers. Lindsay stated flatly on the program, that in August, some six months away, a stock market rally of monster proportions would begin. In the prior 20 years the S&P Index had gained only 55 percent.

Figure 1.1 tells the story for the market after August 1982, using the S&P 500 Index, which comprises the stocks forming the core mutual fund holdings in the United States. From mid-February, around the time of Lindsay's public prediction, the market declined approximately 8 percent from the mid-February peak into mid-August. In August a broad advance got underway and in the next 18 years, the S&P gained nearly 1,400% as measured to the weekly closing high in March 2000—using the March 2001 close, the gain is more than 1,000%.