Chapter 1

Understanding Charting and Where Candlesticks Fit In

In This Chapter

- Taking a look at options for charting and why candlesticks are superior
- Making sense of candlestick construction
- Exploring the wide variety of candlestick patterns
- Using technical analysis alongside your candlestick charts
- Understanding a few trading and investing basics

The advent of the Internet has leveled the playing field for securities traders. Access to markets once meant placing orders through a broker, and now it's little more than a couple of mouse clicks away. Commission rates are dramatically lower, and access to market information is now in many cases free. Getting into securities trading is now easier than it ever has been, and the result is a whole generation of investors and traders that handle their finances without professional help. Technology allows these people to enjoy many new types of market information, and one of the best tools available is candlestick charting.

Candlestick charting methods have been around for hundreds of years, but candlesticks have caught on over the past decade or so as a charting standard in the United States. I've been working with candlestick charts for quite a few years, and I've seen many traders — novice to professional — develop a fierce loyalty to candlesticks after taking the time to understand their uses and potential. I think you'll feel the same way, and this book is the first step on the path to conquering candlesticks.

The material contained in this chapter exposes you to many of the facets of candlestick charting that continue to fuel its rise as one of the most popular charting techniques. I begin with the overall role of candlesticks within the context of charting. I cover the advantages of candlestick charting, and the basics of candlestick construction. I also take the opportunity at the end of this chapter to discuss how to get started as well as give some insight into the characteristics and habits that successful traders employ in their pursuit of profits. Enjoy, and happy charting!

Considering Charting Methods and the Role of Candlesticks

With advancements in technology and the growing availability of trading and investing resources available to traders, many options exist for the charting of securities. There are several different types of charts and dozens of variations and features to be configured on each type. It's important that you're clear on the options and, perhaps more importantly, why candlestick charting is at the top of the heap. This section explains.

Getting a feel for your options for charting

When it comes to alternatives to candlestick charting, the three main charting contenders are as follows:

- **Line charts:** These charts are simple and helpful for short-term decisions, but they're quite limited in the amount of data presented.
- **Bar charts:** These are much more useful than line charts and are the most common, but they're not as versatile as candlestick charts.
- **Point and figure charts:** These are tried-and-true charting methods, and they're great for recognizing support and resistance levels, but they're far less dynamic than candlestick charts.

Each one of these charting methods can be used effectively to ratchet up the effectiveness of your trading strategy, but they pale in comparison to candlestick charts for a number of reasons, a few of which I describe in the next section.

Realizing the advantages of candlestick charting

You'd be hard pressed to find someone who's more enthusiastic about candlestick charting than yours truly. I can go on and on about the advantages that candlesticks afford. If you want to read more of my gushing about the many great advantages of candlestick charting, turn to Chapter 2, but here are my top reasons:

- One of the best features of candlestick charting in general is the visual appeal and readability. You can glance at a candlestick chart and quickly gain an understanding of what's going on with the price of a security. You can also tell whether sellers or buyers have dominated a given day, and get a sense of how the price is trending.
- Also, even after reading up on the most rudimentary of candlestick basics, you can easily spot the opening and closing price for a security on a candlestick chart. These price levels can be very important areas of support and resistance from day to day, and knowing where they are can be extremely helpful, especially for short-term traders.
- Candlesticks aren't just a pretty face. Candlestick charts also feature specific patterns that you can identify and use to decide when it's time to buy, sell, or wait on a trade or investment. These patterns can be a real boon to your work with securities, and you can combine them with other technical indicators for even more reliable results.

Understanding Candlestick Components

You can't trade and invest effectively by using candlestick charts unless you understand candlestick patterns, and you may have a very hard time understanding those patterns if you aren't familiar with basic candlestick construction. Candlestick charting starts with the knowledge of what it takes to make a candlestick and how changes in that basic information impact a candlestick's appearance and what it means. For starters, you need to know what goes into creating a candlestick's wick (the thin vertical line) and its candle (the thick part in the middle).

The following four pieces of information are combined to create a candlestick:

- **Price on the open:** The price at which a security opens on a given period is the first piece of information used in creating a candlestick. Depending on whether the security's performance is bullish or bearish, the opening price corresponds to either the bottom edge of a candlestick's candle or the top edge.

  REMEMBER

  Candlesticks that represent *bullish* price action appear *white* on a chart, and candlesticks that represent *bearish* price action appear *black*.
- **High price:** The highest price that a security reaches during a given period corresponds to the top of a candlestick's wick. If a security opens at a certain price and then trades consistently lower than that price throughout the period, there won't be any wick at all above the candle.
- **Low price:** The lowest price that a security reaches during a period corresponds to the bottom of a candlestick's wick. If the price action for that period is extremely bullish and prices trade higher than the open, there won't be any wick below the candle.

- **Price on the close:** After a security finishes trading during a given period, its closing price is the last piece of information used to create a candlestick. Depending on the security's performance during that period, the closing price can correspond to either the top edge of a candlestick's candle (if the period was bullish) or the bottom edge (if the period was bearish).

As a true candlestick devotee, I believe that you can gain far more insight into a period's trading by looking at a candlestick than you can by looking at another type of charting tool. Want proof? Take a look at Figure 1-1.

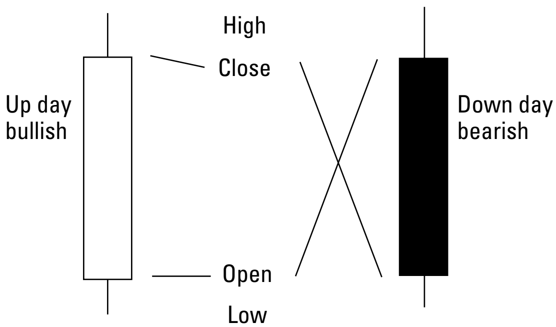

Figure 1-1: Bullish and bearish candlesticks side by side.

You can tell right away that the up day has a white candle and the down day has a black candle. That simple difference alone clearly reveals the nature of the price action that took place during that period. In the case of the candlestick with the black candle, there was more selling pressure than desire to buy. And the candlestick with the white candle indicates that there was more buying pressure than desire to sell.

Why is this so important? Candlestick charts quickly clue you in on the type of buying and selling that's been going on during a given period and where it may occur again. In many cases, the buyers continue to buy and the sellers continue to sell during subsequent periods or if the price reaches a level that has spurred them to action in the past.

For more information on candlestick construction, refer to Chapter 3.

Working with Candlestick Patterns

The components of a candlestick may be the bones of candlestick charting, but candlestick patterns are the heart and soul. Patterns appear on candlestick charts as simple, single-stick occurrences or complex, multi-stick formations, and many different types of patterns can tell you what may be in store for a security that you've had your eye on for trading or investing. And knowing what may lie ahead can be the difference between a profitable trade and a flop.

REMEMBER

Candlestick patterns indicate when prevailing trends reverse or when they continue. Both types of patterns are very useful because they tell you when to get into a trade, when to get out of a trade, when a trade you're in may make no sense, and even when to hang onto a trade you're already in. Check out Chapters 5 through 10 for more info on identifying and trading on a wide variety of candlestick patterns.

Simple patterns

Some candlestick patterns are very simple: A single candlestick on a chart can serve as a candlestick pattern. A single candlestick that signifies time to buy or sell is very appealing to traders who are just starting to work with candlestick charts because after you understand the basics of candlestick construction, you can immediately start identifying simple patterns and using them to make more informed trading decisions. Flip to Chapters 5 and 6 for several great examples of how just one candlestick can tell you what a security's price is going to do in the immediate future.

I also consider double-stick candlestick patterns as simple patterns, and you can explore several varieties in Chapters 7 and 8.

Complex patterns

When a candlestick pattern includes three periods' worth of price action (three candlesticks), I consider it a complex pattern. Many complex candlestick patterns require specific price activity over the course of three days for the pattern to be considered valid, and I discuss a range of them in Chapters 9 and 10.

Complex candlestick patterns can be frustrating at times because you may watch with anticipation as a pattern develops nicely for the first two days only to fizzle out on the third.

REMEMBER

Complex candlestick patterns are more rare than their simple counterparts, but they can be worth the wait. Because the conditions and criteria for a complex pattern are so specific, it's more likely that the signals they offer will be good ones.

Making Technical Analysis Part of Your Candlestick Charting Strategy

A stunning amount of mathematical ingenuity is applied to security trading analysis. The options for technical analysis can be as simple as the average of a few days of closing prices and as complex as applying calculus to price action to indicate the momentum of prices. The possibilities are endless, and you shouldn't be shy about including some of them in your trading strategy alongside candlestick charts.

Take the time to get familiar with an array of technical indicators to make you a more versatile trader and enrich your work with candlestick charts. For example, it's great when you spot a candlestick pattern indicating that it's time to buy, and at the same time, your favorite technical indicator is also flashing a buy signal. Combining trading tools helps build your confidence and can help you quickly determine when a trade isn't going to work out, allowing you to exit with minimal losses.

I explore several different types of technical indicators in Chapter 11 and clue you in on a few ways that you can combine these indicators with candlestick patterns in Part IV (Chapters 11 through 15). Find a few technical indicators that match up to the type of trading you want to pursue and add them to your candlestick charts. Read up on the choices, and if Chapter 11 isn't enough, you can always turn to *Technical Analysis For Dummies* (Wiley) by Barbara Rockefeller. The added understanding of technical indicators can really aid you in your candlestick charting efforts.

Trading Wisely: What You Must Understand Before Working the Markets

Security trading and investing can be a financially rewarding and fulfilling experience, but it's far from a risk- and stress-free undertaking. I want to make clear to you a few key points and concerns before diving into my candlestick charting discussion, so that you're fully aware of what you're up against and what you can do to maximize rewards and minimize risks.

Trading can be an expensive endeavor

There's money to be made on the security markets, but don't be fooled into thinking that earning profits is easy or effortless. Many smart people have taken on trading as a hobby or profession and been quickly humbled by poor trades and losses. Do your homework and practice wise money management, or you could end up joining their ranks!

By doing homework, I mean look at charts and develop a trading plan. The more you prepare, much like for a test, the better your trading results should be. I've seen a direct correlation between the level of trading success I've achieved and how much time I've put into preparing for trading situations. As far as wise money management, the key here is making sure to take a loss when it becomes apparent a trade isn't going to work. Take the loss and move on. Take this loss early and quickly before it becomes a much bigger loss.

The most important rule for managing your trading and investing funds is to not risk money that you can't afford to lose. There are many obvious and unforeseen risks in the financial markets. If your lifestyle changed dramatically because a trade or investment wiped out your account, then you're probably putting too much of your personal net worth on the line.

Paper trading costs you nothing but time

Paper trading refers to the practice of tracking trades on paper that haven't been traded in an account. Professional traders tell you that paper trading isn't the same as putting real money at risk on the markets. As a professional trader, I totally agree. The emotional rollercoaster involved with making and losing money can't be matched in a dry run. But if you're a novice who's just starting to understand the ways of the market, I think paper trading is a great idea. The risks are nil, and the educational benefits are outstanding. Even after 15 years of trading experience, I still tend to paper trade new ideas or systems for a while before putting real money to work.

If you're new to trading, test out your trading ideas and refine your trading strategy by signing up for a trial account online with an electronic broker. (You can read all about electronic trading resources in Chapter 4.) All you stand to lose is a little time and some pride. But that's better than jumping right into a live trading scenario and getting taken to the cleaners!

Developing rules and sticking to them

Throughout this book, I stress the importance of setting rules for yourself and sticking to those rules. I just can't stress enough what a good practice that is for any trader. Making and losing money on the market is a very emotional experience, and one of the main reasons some traders lose big when they should lose just a little (or even win) is that they let their emotions take control of their trading. You can help take emotions out of the equation if you develop trading rules and adhere to them no matter what happens.

Create a set of trading rules for yourself, and stick to those rules. Include rules such as the following:

- When to get into trades
- Where to place stops in various trading situations
- What amount of money to risk on trades and investments
- When to get out of trades, either with a loss or profit

TIP

Write down your rules and keep them handy for a quick review when you're in the midst of a trade, and you're having second thoughts about what action to take.

I've been trading for a long time, and I can say without reservation that creating and adhering to a set of trading rules is the best way to reward yourself both personally and financially for the effort you put into the markets. I always follow the rules that I've set for myself, and although it may sound crazy, at this point I'm more proud of my rules than I am of my profits. All traders have to come up with their own sets of rules that talk to their trading style and comfort with risk, and you should keep that in mind and jot down potential rules as you explore the contents of this book.