PART I

THE TRADITIONAL DOW THEORY

CHAPTER 1

By Way of Background

Every day we hear about the Dow rising or falling and may not stop to think who Dow was and what the Dow Averages are all about. In this chapter, I discuss who Charles Dow was and how his theory, which has served so well for over 100 years, can be used to even better advantage in the twenty-first century as a guide to timing the stock market and making money in it.

How It All Started

Charles Henry Dow was born on a farm in Sterling, Connecticut, in November 1851. At the age of 18, he began his career as a reporter with the *Springfield Republican* and in 1875 moved to the *Providence Journal*. After writing a lengthy study about the transportation systems between Providence and New York City, he developed an interest in business subjects. Young Dow also wrote articles from Leadville, Colorado, on the 1878 silver strike. These articles led directly to his move to New York the next year as a financial reporter for *The New York Mail and Express*.

Subsequently, after he became a writer and editor with the Kiernan News Agency, he hired his friend Edward Jones. Jones had been an editor for the *Providence Sunday Dispatch*. Together, Dow and Jones distributed financial news bulletins to New York's business district. In 1882, bankrolled by another partner, they formed Dow Jones & Company and began publishing the handwritten *Customer's Afternoon Letter,* precursor of the *Wall Street Journal*.

The first stock index published by Dow in 1884 was comprised of 11 stocks, 9 of which were railroads. Five years later, the *Wall Street Journal* first appeared with Dow as editor. It was not until May 26, 1896, that the Dow Jones Industrial Average (DJIA) was born with 12 "smokestack" companies. A year later, a separate average was started to keep track of the railroad stocks (DJTA), which were the primary transportation mode of the day.

Origins and Evolution of the Theory

Dow saw the stock market and his idea, yet to be named by others as Dow's theory, as an indicator of business activity. If business was good, the company's stock would do well. When he spoke of a "person watching the tides," that was, of course, an analogy to the great industrial companies' price movements. To confirm that his reading of the "tides" was correct, he checked another part of the "seashore" to see that the ocean tides were the same there. In the stock market, that meant checking the other index he had created: the railroads, which later became the Transportation Index. Dow had used the two indices in tandem because they were all that was available. The Dow Jones Utilities (DJUA) did not come into existence until 1929; the Standard & Poor's 500 Stock Index (S&P 500), not until 1957.

Dow never explained *why* the two indices—the Industrials and the Transports—*must* confirm; instead he observed that they *did* confirm when their signals subsequently proved to be correct. With the ocean, passing ships or other disruptions can interrupt the ebb and flow, or rogue waves can temporarily upset the determination of the tides rising or falling. By looking in two separate locations along the coast (or in the stock market at a separate industry), Dow believed that it was more likely that the reading would be correct. After all, it is the rails (Transports) that deliver the raw materials, and perhaps even the labor, to the mills of industrial corporations. And in the end, it is the Transports that deliver the finished product to the ultimate consumers. Clearly these two groups are interrelated, just as different areas of a coastline have similar and related tides. So the Industrials and Transports were and still are intertwined and need to be in sync for a proper reading of his theory.

The amazing thing is that Dow only had five years' worth of data on the two averages from which to base his theory. Unfortunately, he had

little time to write about and expound on his theory. By 1902, Dow was in failing health and sold the company. He died on December 4 of that year.

Dow never wrote down a complete description of his theory, never dedicated a complete editorial to it, and never gave it a name. A friend, A. J. Nelson, in his *The ABC of Stock Speculation,* named it Dow's theory in 1902. Most of what we know of the theory came from a series of *Wall Street Journal* editorials written by Dow's successor as editor, William Peter Hamilton, between 1902 and 1929. He also wrote about Dow's theory in *The Stock Market Barometer* in 1922.

Rhea's Writings and Hamilton's Quotes

The most organized and thorough description of the Dow Theory as we knew it in the twentieth century came from a book of that name, which was written by Robert Rhea in 1932. My father-in-law had called on Rhea shortly before his death in 1939, and it was through that relationship that I much later developed my interest. Rhea, who was bedridden, had the time and inclination to analyze the 35 years of data available to him to further refine the work of Dow and Hamilton into what I consider the definitive work on the original Dow Theory. The book, which contains both the text by Robert Rhea and selected editorials and quotes by William Peter Hamilton, was reissued in 1993 by Fraser Publishing Company. (Portions are reprinted here with permission.)

Hypotheses

Robert Rhea, after many years of studying the writings of both Dow and Hamilton, set out a "few hypotheses" that he said must be accepted "without reservation whatsoever" if one is to use the theory successfully in order to know when to buy and sell in an effort to make money in the stock market.

1. **Manipulation.** Manipulation is possible in the day-to-day movements of the averages. Secondary reactions are subject to such an influence to a more limited degree, but *the primary trend can never be manipulated.*
2. **Averages discount everything.** The fluctuations of the daily *closing* prices of the Dow-Jones Rail and Industrial averages afford a composite index of all the hopes, disappointments,

and knowledge of everyone who knows anything of financial matters. For that reason, the effects of coming events (excluding acts of God) are always properly anticipated in their movement. The averages quickly appraise such calamities as fires and earthquakes.

3. **The theory is not infallible.** *The Dow Theory is not an infallible system for beating the market.* Its successful use as an aid in speculation requires serious study, and the summing up of evidence must be impartial. The wish must never be allowed to father the thought.

Theorems

The "definite theorems" of the Dow Theory have been rewritten by numerous writers, but I choose to stay with Rhea's book on the Dow Theory, as he actually lived and invested throughout the period that Dow and Hamilton lived. The theorems are altered only to the extent that they are somewhat better organized. After I state the original theorem, I have added notes (identified as "Author's note") in an effort to clarify, expand, and modernize Charles Dow's twentieth-century stock market theory so that it can help investors improve their financial results in the twenty-first century.

Dow's Three Movements

There are three movements of the averages, all of which may be in progress at one and the same time.

1. **The first, and most important, is the primary trend,** which consists of the broad upward or downward movements known as bull or bear markets and may be of several years' duration.
   Primary movements: The *primary movement* is the broad basic trend generally known as a bull or bear market extending over periods that have varied from less than a year to several years. *The most important factor in successful speculation is the correct determination of the direction of this movement. There is no known method of forecasting the extent or duration of a primary movement.*
   Author's note: Once in place, the primary trend is assumed to continue until definitely proven otherwise. This is an offshoot

of Isaac Newton's law of physics, which states a body in motion tends to stay in motion unless compelled to change its state.

Primary bear market. *A primary bear market is the long downward movement interrupted by important rallies.* It is caused by various economic ills and does not terminate until stock prices have thoroughly discounted the worst that is apt to occur. A bear market has three principal phases:

a. Abandonment of the hopes upon which stocks were purchased at inflated prices.
b. Selling due to decreased business and earnings.
c. Distress selling of sound securities, regardless of their value, by those who must find a cash market for at least a portion of their assets.

Author's note: These phases go from complacency, to concern, and finally to capitulation, which is covered in detail in Chapter 6.

Primary bull market. *A primary bull market is a broad upward movement, interrupted by secondary reactions, and averaging longer than two years.* During this time, stock prices advance because of a demand created by both investment and speculative buying caused by improving business conditions and increased speculative activity. There are three phases of a bull period:

a. Reviving confidence in the future of business.
b. Response of stock prices to known improvement in corporation earnings.
c. The period when speculation is rampant and inflation apparent—a period when stocks are advanced on hopes and expectations.

2. **The second, and most deceptive movement, is the secondary reaction,** which is an important decline in a primary bull market or a rally in a primary bear market. These reactions *usually last from three weeks to as many months.*

Secondary reaction. For the purpose of this discussion, *a secondary reaction is considered to be an important decline in a bull market or advance in a bear market,* usually lasting from three weeks to as many months, during which intervals the price movement *generally* retraces from 33 percent to 66 percent of the primary price change since the termination of the last preceding secondary reaction. *These reactions are frequently erroneously*

assumed to represent a change of primary trend, because obviously the first stage of a bull market must always coincide with a movement that might have proved to have been merely a secondary reaction in a bear market, the contra being true after the peak has been attained in a bull market.

Author's note: Many Dow theorists believe the time frame "usually lasting from three weeks to as many months" is cast in stone. Actually, the first reference to the time frame by Dow himself was "from two weeks to a month or more"(December 19, 1900). (Later he wrote: "The secondary movement covers a period ranging from ten days to sixty days" [January 4, 1902]). At various times Hamilton used a time frame for secondary reactions as "extending from 20 days to 60 days [September 17, 1904]," "anywhere from one month to three months [February 26, 1909]," as well as "lasting from a few days to many weeks [February 11, 1922]." It is no wonder that many are confused as to what a secondary reaction is. Actually, these definitions cover a broad area, and the total range of from a few days to three months is correct. My work shows that the minimum time frame can be just days for some signals, but *usually* it is weeks and it can indeed extend for months. The percentage price movement is just a generality and should not be taken as a requirement. After a secondary reaction, the primary trend is *reaffirmed* when *both* the industrials and transports return to extend that trend. In a bull market, such a move to new highs is often described as being "in the clear" and is sometimes labeled as a new buy signal, which is incorrect. The buy signal dates to the original signal. This move merely affirms that signal.

3. **The third, and usually unimportant, movement is the daily fluctuation.** Stocks move up, down, and sideways every day and for the most part those moves are meaningless.

   Daily fluctuations. Inferences drawn from one day's movement of the averages are almost certain to be misleading and are of little value except when "lines" are being formed. The day-to-day movement must be recorded and studied, however, because a series of charted daily movements eventually develops into a pattern that is easily recognized as having a forecasting value.

   Author's note: Lines will be discussed shortly.

Both Averages Must Confirm. The movements of both the Railroad and Industrial stock averages should always be considered together. The movement of *one price average must be confirmed by the other* before reliable inferences may be drawn. Conclusions based on the movement of one average, unconfirmed by the other, are almost certain to prove misleading.

Author's note: A common complaint is that the Railroads (Transports) are of inconsequential import these days, which makes the theory out of date. I would remind the reader that the Transportation Average is actually made up of 20 stocks representing at least *six* industries: airlines, air freight, railroads, rail equipment, marine transport, and trucking. The stocks in the average deliver raw materials and components to industry and then distribute the product to the world. Therefore, their business fortunes are still intertwined.

Determining the Trend. Successive rallies penetrating preceding high points, with ensuing declines terminating above the preceding low points, offer a bullish indication. Conversely, failure of the rallies to penetrate previous high points, with ensuing declines carrying below former low points, is bearish. Such inferences are useful in appraising secondary reactions and are of major importance in forecasting the resumption, continuation, or change of the primary trend. For the purpose of this discussion, *a rally or a decline is one or more daily movements resulting in a net reversal of direction exceeding 3 percent of the price of either average.* Such movements have little authority unless confirmed in direction by both averages, but *confirmation need not occur on the same day.*

Author's note: A modern misconception is that both the Industrials and Transports must make new all-time highs for a bull market to be in force. Some have argued that the 60+ percent gain from the October 2002 lows to the May 2006 high at 11,642.65 was not a bull market because the 2000 all-time high of 11,722.98 was not surpassed. And then in October 2006 it was surpassed, which would imply that those last 80.33 points somehow changed the status to bull market. *A bear market changes to a bull market at the low point,* not *after it gets to a higher point than the last bull market!* Granted, the new bull market is not immediately determinable at that low point, but after a time it can be seen as having been the start. The levels at which a market

attains "official" bull or bear market status are covered in Chapters 5 and 6, and you will see that a 60 percent gain over a nearly four-year time frame would certainly qualify as a bull market.

Lines. A "line" is a price movement extending two to three weeks or longer, during which period the price variation of both averages move within a range of approximately 5 percent. Such a movement indicates either accumulation or distribution. Simultaneous advances above the limits of the line indicate accumulation and predict higher prices; conversely, simultaneous declines below the line imply distribution and lower prices are sure to follow. Conclusions drawn from the movement of one average, not confirmed by the other, generally prove to be incorrect.

Author's note: A line is a period of consolidation, either of accumulation of stocks for an eventual continuation of the bullish trend or of distribution to be followed by a decline. The "break-out" from the range implies further movement in that direction.

Relation of Volume to Price Movements. A market that has been overbought becomes dull on rallies and develops activity on declines; conversely, when a market is oversold, the tendency is to become dull on declines and active on rallies. Bull markets terminate in a period of excessive activity and begin with comparatively light transactions.

Author's note: New York Stock Exchange (NYSE) volume tends to peak ahead of bull market peaks by an average of about six months, as you will see in Chapter 11.

Double Tops and Double Bottoms. "Double tops" and "double bottoms" are of little value in forecasting the price movement and have proved to be deceptive more often than not.

Author's note: This is a surprising theorem as I find the "return move" at tops and bottoms to be part of a requirement for Dow Theory signal formation, as you will see in the next chapter. Even though many stock market bottoms take the form of the letter V, a large number are double bottoms; that is, they take the form of the letter W. Likewise, market tops often make twin or double tops, such as the letter M.

Individual Stocks. All active and well-distributed *stocks of great American corporations generally rally and decline with the averages,* but

any individual stock may reflect conditions not applicable to the average price of any diversified list of stocks.

Author's note: This might also be characterized as a rising tide lifts all ships, and a falling tide can sink them. It also brings to mind the subject of index funds, which, of course, did not exist in Rhea's day. They are ideal vehicles for tracking the Standard & Poor's 500 Index (SPY—Spiders), the Dow Jones Industrial Average (DIA—Diamonds), and the NYSE iShares (NYC—no nickname yet, but how about Apples, as in the "Big Apple") will be covered in Chapter 14.

William Peter Hamilton's Most Famous Editorial

Hamilton, the brilliant successor to Charles Dow at the *Wall Street Journal,* wrote this about the "signal for a bear market" on October 25, 1929. (The article is reprinted here with permission.) Unfortunately, Hamilton died two months later, so he never lived to see the prescience of the "call." It is an example of the Dow Theory in action as interpreted at the time.

A Turn in the Tide

On the late Charles H. Dow's well known method of reading the stock market movement from the Dow-Jones averages, the twenty railroad stocks on Wednesday, October 23 confirmed a bearish indication given by the industrials two days before. Together the averages gave the signal for a bear market in stocks after a major bull market with the unprecedented duration of almost six years. It is noteworthy that Barron's and the Dow-Jones NEWS service on October 21 pointed out the significance of the industrial signal, given subsequent confirmation by the railroad average. The comment was as follows:

"If, however, the market broke again, after a failure to pass the old highs, and the decline carried the price of the industrials below 325.17 and the railroads below 168.26, the bearish indication would be strong, and might well represent something more than a secondary reaction, however severe. It has often been said in these studies of the price movement that the barometer never indicates duration. There was a genuine major bear market in 1923, but it lasted only eight months. One good reason for not taking the present indications too seriously is that they have all been recorded in a most unusually short space of time.

> The severest reaction from the high point of the year had just one month's duration. In view of the nationwide character of the speculation, this seems a dangerously short period to infer anything like complete reversal in public sentiment."
>
> There was a striking consistency about the market movement since the high figure of September 3. There were at least four rallies in the course of the decline in the industrials before the definite new low point was established and each of these was weaker than the last. Dow always considered this a danger signal, but for the past thirty years it has been the custom in discussing the stock market as a barometer of business to require that one average should confirm the other. Failure to agree has been found deceptive.
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> There are people trading in Wall Street, and many all over the country who have never seen a real bear market, as for instance, that which began October, 1919, and lasted for two years, or that from 1912 to 1914 which predicted the Great War if the world had then been able to interpret the signs. What is more material is that the stock market does forecast the general business of the country. The big bull market was confirmed by six years of prosperity and if the stock market takes the other direction there will be contraction in business later, although on present indications only in moderate volume.
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> Some time ago it was said in a *Wall Street Journal* editorial that if the stock market was compelled to deflate, as politicians seemed so earnestly to wish they would shortly after experience a deflation elsewhere which would be much less to their liking.

Not so well known is the editorial from the following day (October 26, 1929), which endorses the Dow Theory signal but also puts a human, and optimistic, face on the situation.

> So far as the barometer of the Dow-Jones is concerned it has been clear since last Wednesday (October 23, 1929) that the major movement of the market has turned downwards. The market will find itself, for Wall Street does its own liquidation and always with a remarkable absence of anything like financial catastrophe. Beyond indicating the trend there is no idea here of prediction. *Conditions do not seem to foreshadow anything more formidable than an arrest of stock activity and business prosperity like that in 1923.*

Suggestions that the wiping out of paper profits will reduce the country's real purchasing power seem rather farfetched.

Author's note: I have added italics to emphasize particular points. The 1923 bear market had dropped 18.6 percent over 7.2 months and the recession lasted 14 months, from May 1923 to July 1924. The 1929 bear market dropped 89.2 percent over 34.2 months and the depression lasted 43 months, from August 1929 to March 1933. These results show the wisdom of the second theorem, which states: "There is no known method of forecasting the extent or duration of a primary movement."

Jack Schannep's Not-So-Famous Editorial

Not so famous but equally timely was my follow-up "editorial," which was written 70 years later and posted in the Subscriber's Area of my web site (www.thedowtheory.com). In this article, I point out the similarities with Hamilton's famous editorial, confirm the then recent Dow Theory sell signal, and point out the uncanny parallels between the two then existing U.S. Presidents. Indeed, 1929 and 1999 did have a lot in common.

A Turn in the Tide—Part II

On October 25th, 1929, William Hamilton, Editor of the *Wall Street Journal*, and the successor to Charles Dow, wrote in his most famous editorial "A Turn in the Tide," that (two days earlier) the Dow Theory "gave the signal for a bear market in stocks." He noted that "There are people trading in Wall Street, and many all over the country, who have never seen a real bear market. . . . What is more material is that the stock market does forecast the general business of the country. The big bull market was confirmed by six years of prosperity and if the stock market takes the other direction there will be a contraction in business later. . . . " Of course he did not expect the stock market to drop 86% from that point and business to enter a great depression, but both happened. The Dow Theory does not predict the duration nor extent of such changes, only that change is coming.

In 1999, when the Dow Jones Industrial Average dropped below 10,466.93, the Dow Theory "gave the signal for a bear market in stocks." Certainly "there are people trading in Wall Street, and many all over the country, who have never seen a

real bear market," in fact we have been in bull markets for 97% of the time over the last 17 years. And the rest of his quote is also correct: 82% of all bear markets in the 20th Century have been followed by "a contraction in business later" whether it be an official recession, or just a "mild" or "growth" one, or "really big one" like the depression. Fortunately, most "real bear markets," which I define as a drop of at least 16% on both the Dow Jones Industrials *and* the Standard & Poor's 500 Index, are not as severe as the 1929–32 experience. They average a not insignificant −34% drop over an 18-month time frame. The "traditional" definition of a 20% drop is widely used but unfortunately excludes several "real" bear markets and their following recessions such as 1923, 1956–57, and 1978–80. Whichever definition you use, a Dow Theory "Sell" signal has been followed by bear markets more times than not.

I won't dwell on the many similarities of the 1929 stock market and that of 1999, such as the record high price to earnings ratio, the price to book value, low dividend yields, etc., etc. But one uncanny parallel you may not be aware of is the almost identical headlines out of Washington, D.C., then and now:

In 1929, from the Chicago Tribune Press Service:

Washington, D.C., June 1—(Special)—Rapid retirement of the public debt will continue to be an administration policy under President Hoover and Secretary of the Treasury Mellon. Despite a program for increased expenditures for public works and a possibility of another tax cut within a year or two, it is estimated that the outstanding public debt can be substantially wiped out within less than 18 years. Retirements through the sinking fund . . . **will pay off the entire debt**, now standing at a little less than $17,000,000,000, **by 1947**. By adding to these debt retirements surplus revenues the debt can be paid off in a somewhat shorter period.

As for 1999, from www.whitehouse.gov came the following on February 17th: "Today, President Clinton will hold an event at the White House to discuss the importance of saving the majority of our future budget surpluses to ensure the long-term solvency of Social Security and Medicare and pay down the national debt, helping reduce the future burden on young people and grow the economy for years to come. . . . By practicing fiscal responsibility, the Administration's proposal will pay down

> nearly $3 trillion ($3,000,000,000,000) of our national debt. . . . President Clinton's proposal would cut the debt held by the public, as a share of the economy, to 7.1 percent in 2014. This would mean that instead of leaving a mountain of debt for our children, we would **completely eliminate the national debt by 2018**." Shortly after the publication of this press release, President Clinton updated the above on September 27th. He said, "*We can do all that and still have an affordable tax cut for the middle class and pay down our debt so that by 2015 we are debt-free for the first time since 1835, when Andrew Jackson was President.*"
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> The more things change, the more they stay the same. I wouldn't expect 1999 to parallel 1929 exactly, only that the tide of the stock market had changed once again. We shall see.
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> *Written and posted September 1999 on the Schannep Timing Indicator & TheDowTheory.com web site*

Author's note: I have added italics and bold to emphasize particular points. There was a bear market from January–March 2000 to September 2001 in which nearly 1 in 10 stocks lost 90 percent in value. The final low after the 2000 highs was 33 months later, in October 2002, for a total loss by the Dow Jones Industrial Average of nearly 38 percent, "somewhat" less than in 1929 to 1932 but almost the exact same 34-month time frame. As for the plans of Presidents Hoover and Clinton for eliminating the national debt, both were swept up in the optimism prevailing at the time. Hoover's plan was done in by the Depression; Clinton's, by 9/11 and the ensuing costs of the war on terrorism.

Now that we have some history and the "rules" firmly in place and have seen how they worked in 1929 and 1999, let's look into the specifics of the signals for their use now and into the future.