CHAPTER 1

The History and Theory of Classical Charting Principles

Speculators have used charts to make trading decisions for centuries. It is generally believed that candlestick charts in their earliest form were developed in the 18th century by a legendary Japanese rice trader named Homma Munehisa. Munehisa realized that there was a link between the price of rice and its supply-and-demand factors, but that market price was also driven by the emotions of market participants. The principles behind candlestick charts provided Munehisa a method to graphically view the prices over a period of time and gain an edge over his trading competitors. An edge is all that a speculator can ever expect.

In the United States, Charles Dow began charting stock market prices around 1900. The first exhaustive work on charting was published by Richard W. Schabacker (then the editor of *Fortune* magazine) in 1933. Under the title *Technical Analysis and Stock Market Profits*, Schabacker provided an organized and systematic framework for analyzing and understanding a field now known as "classical charting principles."

Schabacker believed that the stock market was highly manipulated by large operators who tended to act in concert. He observed that the activities of these large players could be detected on price charts showing the opening, high, low, and closing price for each trading session.

He further observed that prices, when plotted on a graph, were either in periods of consolidation (representing accumulation or distribution by the large operators) or sustained trends. These trends were known as periods of price "markup" or "markdown." Finally, Schabacker noted that periods of consolidation (as well as some trending periods) tended to display certain geometric formations—and that, depending on the geometry, the direction and magnitude of a future price trend could be predicted.

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Schabacker then identified the form and nature of a number of these geometric patterns. These included such traditional patterns as:

- Head and shoulders (H&S) tops and bottoms
- Trend lines
- Channels
- Rounding patterns
- Double bottoms and tops
- Horns
- Symmetrical triangles
- Broadening triangles
- Right-angled triangles
- Diamonds
- Rectangles

The pioneering work of Schabacker was picked up in 1943 by Robert Edwards and John Magee in the book *Technical Analysis of Stock Trends*, commonly referred to as the bible of charting.

Edwards and Magee took Schabacker's understanding to the next level by specifying a number of trading rules and guidelines connected with the various chart patterns. Edwards and Magee made the attempt to systematize charting into trading protocols. *Technical Analysis of Stock Trends* has remained the standard reference book for more than three generations of market speculators who use charts in some manner for their trading decisions.

My Perspective of the Principles

As a trader, classical charting principles represent my primary means for making decisions. I maintained all of my charts by hand in the days before sophisticated computer programs and trading platforms. Now there are numerous computerized and online charting packages and trading platforms.

I continue to rely solely on high/low/close bar charts in daily, weekly, and monthly form. I pay no attention to the myriad of numerous indicators have been developed in the past 20 years, such as stochastics, moving averages, relative strength indicators (RSIs), Bollinger bands, and the like (although I do use the average directional movement index [ADX] to a very limited degree).

It is not that these methods of statistical manipulation are not useful for trading. But the various indicators are just that—statistical manipulations and derivatives of price. My attitude is that I trade price, so why not study price directly? I can't trade the RSI or moving average of soybeans. I can only trade soybeans.

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I am not a critic of those who have successfully incorporated price derivatives into their trading algorithms. I am not a critic of anyone who can consistently outsmart the markets. But for me, price is what I trade, so price is what I study.

Three Limitations of the Principles

Three important limitations of classical charting should be understood by market operators who use charts or are considering the use of charts.

First, it is very easy to look at a chart and call the markets in hindsight. I have seen unending examples in books and promotional materials of charts marked up retroactively to make magnificent trends look like "easy money." Unfortunately, in order to emphasize some charting principles, this book may commit this very sin.

It is the dominant and gargantuan task of a chart trader to actually trade a market in real time in a manner even closely resembling how a market would have been traded in look-back mode. Significant and clear chart patterns that produce profitable trends are most often comprised of many small patterns that failed to materialize. Charts are organic entities that evolve over time, fooling traders repeatedly before yielding their real fruit.

Second, charts are trading tools and not useful for price forecasting. Over the years, I have been extremely amused by "chart book economists" who are constantly reinterpreting the fundamentals based on the latest twists and turns of chart patterns.

There is a huge difference between being short a market because of a chart pattern and being "bearish" on the fundamentals of a market because of the same chart pattern. Charts represent a trading tool—period. Any other use of charts will only lead to disappointment and often net trading losses. The idea that chart patterns are reliably predictive of future price behavior is foolhardy at best. Charts are a trading tool, not a forecasting tool.

As a trader who has used charts for market operations for 30 years, I believe I am permitted to make this statement. I am an advocate for charting—not a critic. But I am a critic of using charts in the wrong way. In my opinion, it is wrong-headed to use charts for making price forecasts, and especially for making economic predictions.

You may know trading advisory services that use charts to make predictions on the economy. They let you know when they are right. They make excuses or become silent when they are wrong. I think it is a much more honest position to just admit that I never know where any given market is going, whether or not the chart seems to be telling a story.

The third limitation is that emotions cannot be removed from the trading equation. It is impossible to study and interpret price charts separate from the emotional pull of fear, price, hope, and greed. So it is foolish to pretend that charts provide an unbiased means to understand price behavior. The bias of a trader is built into his chart analysis.

Summary

Classical charting principles provide a filter to understand market behavior and a framework for building an entire approach to market speculation. In the chapters to follow, I will display the construction of a comprehensive approach to market speculation using these charting principles—an approach I call the Factor Trading Plan. I will then proceed to apply the Factor Trading Plan, using classical charting principles as the foundation, to actual commodity and forex speculation for a period of about 21 weeks.