PART I

An Overview

CHAPTER 1

A Primer on Chart Setups

This is a book about chart setups and how they can make you a more profitable trader. I have been involved in trading for a quarter-century, and during almost that entire time, I have used charts and technical analysis as the basis of my investing decisions. This book endeavors to show you meaningful, clear examples of the most powerful chart patterns so that you can commit them, and their importance, to memory.

Technical analysis is the study of past price movement for the purpose of predicting future price movement, which, if done correctly, can lead to substantial trading profits. The prices studied are typically those of financial instruments such as stocks, commodities, and foreign currencies. But no matter what market is being studied, the underlying principles are the same. Specifically:

- A price chart is the most perfect representation of the balance of buyers and sellers for any given entity.
- Prices tend to move in trends and patterns which, based on historical analysis, can lead to statistically meaningful probabilities of future price movement.
- The skilled examination of a price chart can guide a trader as to how long he should remain in a trade and when he should exit.

No matter what you trade, technical analysis can make you a better and more profitable trader. Price charts will consistently provide the most truthful picture that can be had of a tradable object, because everything that can be publicly known or speculated is already built into the graph. You will never get the same pure representation of a stock (or anything else) from a broker, a newsletter writer, or an analyst. A chart is as good as

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it gets. How much good that chart can do for *you* depends on your own skill and objective analysis.

THE BULLS VERSUS THE BEARS

Before we get into price charts—and there will be hundreds of them in this book—let's examine the basics about what forms a price chart in the first place: sellers (the supply) and buyers (the demand). It should also be noted at the outset that almost all the examples in this book will be of stocks, but the same rules and methods are appropriate for any form of financial instrument.

When buyers are more powerful than sellers, prices move up. When sellers are more powerful than buyers, prices move down. This tug-of-war, in these simple terms, is behind the trillions of dollars that get traded every week of the year. Buying power represents an excess of demand which will, because of simple market dynamics, inflate price levels.

What many people tend to forget is that every time a trade is placed, each side believes that they are right and the other side of the transaction is wrong. When person A buys stock from person B, person A believes the stock is going to go up in price (meaning B is selling too cheap) and person B believes he would rather have the cash than the stock (meaning A is buying an overvalued, or at least fully valued, stock).

As a group, the individuals who believe a given instrument is going to move higher in price are the bulls, whereas the opposing camp, believing prices for the same instrument will drop, are the bears. And the war between the bulls and the bears, fought over many thousands of different stocks, options, and commodities every day, is what creates price movement. Analyzing that movement with skill is what will give you a substantial edge in the markets you trade.

This book seeks not so much to interpret what those wiggles of movement mean. Instead, it seeks to illustrate for you, with example after real-life example, how these patterns as a whole have played out in actual trading. History tends to repeat itself, and recognizing the meaning of a well-formed pattern will be a great ally in your trading career.

WHY IS A PREDICTION VALUABLE?

The astonishing thing about technical analysis is not only how far out its predictive power goes, but also how, even with a future full of unknowns, it still seems able to see its way clear to make a meaningful prediction. A staggering number of great forces can wreak havoc with financial markets—scandals, war, governmental chaos, interest rates, terrorist attacks, earnings surprises, the social climate, financial meltdowns, and so forth.

Through it all, the knowledgeable chartist can see what others cannot see and know what seems unknowable.

Let's take a real-life example with a very long timespan: the Dow Jones Industrial Average over a period of more than a century. Figure 1.1 has two Fibonacci fans drawn on it (don't worry if you are not familiar with that term; it is explained later in this book). These fans are drawn from an extreme low to an extreme high. The first is drawn from the low in 1903 (called the Rich Man's Panic) to the peak of the Roaring Twenties bull market in 1929. The second is drawn from the depths of the depression in 1932 to the peak of the Internet bubble in January 2000.

FIGURE 1.1 The Dow Jones Industrial Average from 1900 to 2005, enhanced with two Fibonacci fans.

There is a variety of astounding things to note in this chart:

- The point where the two major lines intersect in 1974 predicted the precise bottom of the massive 1973–1974 bear market.
- The steady climb from 1990 to 1995 was perfectly bounded by two of the fan lines.
- Most impressive of all, the ultimate market top in 2000 was established by the first fan (which, remember, began 97 years before).

Figure 1.2 is a close-up view of late 1999 and early 2000; as you can see, the almost century-old fan line creates impressive resistance to these prices moving higher on four different occasions. If we owned stocks at that time, this would be a vital warning signal that the top was established.

FIGURE 1.2 Highlighted here are four instances when the Dow bounced off the fan line established over a century earlier.

This is an extreme example, but the point is that being able to gain insight into the most likely future of a particular price is a vehicle for real trading profits. It is an edge that those not using charts lack.

A WORD ON SHORTING

There are many places in this book where we refer to *shorting* a particular stock or *being short* a stock. It is valuable to understand this terminology, in case you do not already. I also have a personal fondness for shorting stocks, so there will be more examples of short setups in this book than you might expect.

Most people participating in a market are *long* the market; that is, they own the security with the hope that the price will go up. So if a person owns 1,000 shares of Apple Computer (AAPL) which he bought at $250 per share, and later sells it for $290 per share, he has made $40,000 based on the long position (a $40 per share gain times 1,000 shares).

A person who is short a security has done things backwards: He first sells a security he does not own for a certain price with the hope that the price will go *down*. The reason people are able to sell stock they do not own (essentially giving them a negative number of shares) is that their broker has so much of the stock already that it is available to sell with the promise that, at some point, it will be repurchased to replace the shares that were sold.

Taking the example of Apple again, an individual might sell short 1,000 shares of Apple at $290 per share. If the stock fell to $250 and the trader *covered* the position (that is, bought 1,000 shares of the stock, thus making the broker whole), he would have made $40,000 just as the other trader did, only he would have done it in the other direction.

The advantages and disadvantages of shorting markets will be discussed in a special section later in this book, but the principal benefit of shorting is that you can take advantage of a *falling* market as well as a *rising* one. If you are at the beginning of a bear market, and you can only buy stocks, it will be very difficult to make money (inverse ETFs and put options notwithstanding). If you are able to short stocks at high prices and then buy them back later at low prices, you can make money in either an up or down market.

The key disadvantage to shorting stocks is that all the big money is made by going *long*. The most you can ever make with a short position is 100 percent (that is, if the stock goes to $0.00, which almost never happens), whereas the most you can make with a long position is unlimited. You can definitely make profits shorting markets, but unless you are a brilliant options trader, you will never get rich being a bear (that is, a person betting on a market going down).

SUPPORT AND RESISTANCE

The world of technical analysis can seem overwhelming to many. There are hundreds of complex mathematical indicators, studies, patterns, and rules. But there is absolutely no reason good charting has to be complicated. A trader can set aside all of the complexity and focus on some solid basics, starting with the ideas of support and resistance.

You will find the themes of support and resistance to be the backbones (almost literally) of every single setup in this volume.

To illustrate this, think back to the classic playground-based children's game Red Rover. In case you don't remember it, kids split up into two groups, and each group forms a line by holding hands, so that there are two parallel lines of children facing each other across a field. Then one team calls out, "Red Rover, Red Rover, send Skylar (or some other kid's name) right over!" and the named child rushes headlong into the other line, trying to break through. If she busts through the line, she gets to choose a person to join her team.

This image of *breaking through* is exactly what support and resistance are all about, because in the grown-up world of trading, buyers of securities tend to mass at certain price levels. And those owners will hold the line at those prices if the security tries to go above (in the case of resistance) or below (in the case of support).

Let's take a simple, hypothetical example. Suppose a given stock traded at between \$4.95 and \$5.05 for many months. Day after day, week after week, it stayed in this range, accumulating owners of the stock at around the \$5 level. Let's go on to assume the company has some good news, and the stock goes up to \$6, but subsequent profit-taking pushes the stock back down again.

Given this circumstance, you can rest assured that it's unlikely the stock is going to drop beneath the \$5 level. The reason is that there's a huge number of owners at that level, and they are simply *not* going to sell. Fear and greed are the primary drivers of any market, and in this case, greed is going to come first (meaning the owners are telling the market "I refuse to sell my stock at this price for a breakeven trade; I want a profit"). If something remarkable happens and it shoves the stock down to, say, \$4.50, the fear starts to take hold ("I am worried my losses will get even worse, so I'm going to sell now while I still have the chance"), which means the selling will feed on itself.

Expressed in economic terms, the stock price found equilibrium at the \$5 level, thus amassing a large number of owners. If the stock price challenges that level again, equilibrium will once more take hold, stabilizing the price. The people owning stock at this level constitute resistance—the Red Rover line will hold fast, unless a very powerful force punches through it.

Support, therefore, is a price level at which prices are prone to stay above. Resistance is a price level at which prices are prone to stay below. So these are reliable levels at which we can count on a pause in price movement, unless the levels are violated, which is where the real action is.

WHAT HAPPENS WHEN PRICES PUNCH THROUGH?

One time when outsized profits can be made is when prices push through either support or resistance and break out. The longer a price has been trying to push through a certain price level, the more momentum it will have if it finally does make it through (imagine our Red Rover game again, and picture a particularly eager youngster who has tried ten times to get through the line and is more determined than ever to do so on this turn).

Figure 1.3 is an example of how potent this is. The first half of the stock chart for ALVR shows prices bouncing between about \$2.00 and \$2.50. For month after month the stock was completely stagnant, and buyers were accumulating at these levels.

There were several attempts to push through resistance (represented by the horizontal line), but they failed . . . until the midpoint of the graph, in April.

FIGURE 1.3 After breaking out of a saucer pattern, ALVR blasted ahead on much bigger volume to a 500 percent gain in about a year.

At that point, three important things happened: (1) buyers overcame sellers, pushing prices above resistance; (2) volume increased as excitement began to build around the stock; and (3) when some profit-taking took place, prices eased back, *but they did not go beneath the former line of resistance*. From that point, the stock moved up about 500 percent in the course of a year.

The concept of how resistance can change into support (and vice versa) is critical to your understanding when reading a chart. Any sort of line—be it a trendline, a channel, or a horizontal line—has two faces to it: support and resistance. Once prices cross a line, the nature of that line changes.

Let's take another look at resistance to see how valuable it is to have an awareness of price behavior at certain levels. Figure 1.4 shows the chart for Chesapeake Energy (symbol CHK) over a period of about half a year. Early on, the price was blasting skyward to a new high, then it slumped down through August. It then regained its footing and mounted a new assault on higher prices, but it was repelled again at about the same level. A couple of months later, in November, a third attempt was made to push past the $34 barrier, but it failed a third time. You can imagine the exasperation of the owners of this stock as they watched their stock being shoved away from higher prices again and again.

FIGURE 1.4 This is known as a triple top, where a new high happens three times, but the price can't get above it. Once the attempts at overcoming this resistance failed, the stock collapsed.

What the market was telling the owners of this stock was: "The price is probably not going to go any higher." The supply of stock (those selling it) represented what is known as overhead resistance. Perhaps some people who bought earlier at $34 promised themselves that the moment the stock recovered to a breakeven level, they would get out. Perhaps most people felt the stock was fully valued at $34. The reasons really don't matter; the fact is that over a six-month period, there was an invisible line drawn on the stock chart through which prices simply could not pass.

What happened afterward is very interesting: Far from pushing above the $34 price, the stock instead started collapsing. As Figure 1.5 shows, CHK withered away from $34 per share to about 50 cents, almost a 99 percent decline. Clearly the stock had worse problems than a triple top, but the important point here is that the market was *telling* the owners of the stock something, and the triple top was a warning that this was a stock to sell, not keep.

FIGURE 1.5 After its triple top, CHK went on to a nearly 99 percent decline in price.

HISTORY REPEATS ITSELF

Another tenet of technical analysis is that human behavior doesn't change, and therefore price behavior doesn't change. If a certain pattern is predictable now, it will be just as predictable 10 years from now.

An excellent illustration of this on a single chart is Figure 1.6. The stock shown here is Red Hat (symbol RHAT) over a four-year period. For all of 2002 and most of 2003, RHAT was forming a rather large *cup with handle* pattern, indicated by the horizontal line. When it broke above this pattern, the stock just about tripled in price.

After it peaked, RHAT sank for about a year before establishing another pattern. This time, the pattern was quite similar, only smaller. And once again, after it broke above the pattern, the stock soared (this time to "only" double its breakout price, which is typical of a smaller pattern).

As you can see, once you train your eyes to find patterns and understand what the important price points are, you can take advantage of what are relatively predictable price movements.

There are a variety of factors that dictate the power of a breakout from a particular pattern. One is the pattern itself, because some patterns are simply more potent and reliable than others. Another is the volume accompanying the price movement; a stock

FIGURE 1.6 Patterns can—and often do—repeat themselves in the same chart.

moving higher on stronger and stronger volume is far more attractive than a stock moving the same direction on anemic volume. Yet another factor is the length of the pattern. A breakout from a three-year-old saucer is going to have a lot more fireworks than a breakout from a tiny two-week saucer.

Figure 1.7 provides an illustration of both (a) repetition and (b) pattern size equaling potency. The chart is the Russell 2000. The symbol is $RUT. This chart actually shows several patterns within a larger pattern. The broad pattern, shown by the two almost parallel lines, is an ascending channel. This index makes a series of higher highs (bumping up against the upper line) and higher lows (bouncing off the lower line). So the index is in a general uptrend.

Within this pattern, though, are three smaller patterns, all of which are progressively smaller versions of the first. If you look at the shape of the prices beneath the horizontal line, you can see that this price movement is virtually identical in all three instances, although the second pattern is smaller than the first, and the third pattern is smaller still.

What's interesting, of course, is what happens after the prices break above each horizontal line—the stock moves higher. But not only can we see the stock moving higher, we can also observe that the amount it goes up is a little less each time. This is an example of how the *oomph* of the push upward is closely related to how sizeable the pattern is in the first place.

FIGURE 1.7 An ascending channel and, within that pattern, three nearly identical patterns indicated by the horizontal lines.

WHEN PATTERNS WORK TOGETHER

A pattern on its own can be a good indicator of future price direction, but when two patterns work in concert, pointing to the same direction, it can add even more credence to the prediction.

The patterns need not be similar, although they can be. For example, the right shoulder of a head and shoulders pattern might itself be a smaller head and shoulder pattern. Or you might find two bullish patterns (or bearish patterns) appearing on the same chart in approximately the same time frame.

Figure 1.8 is an example of this. The stock is the Utility HOLDRS Trust (symbol UTH). There are two bearish situations shown here: The first is that UTH broke beneath an extremely long ascending trendline, which indicates a possible change in direction from bullish to bearish. As the price meandered along during the last few months of 2005 and the first few months of 2006, it formed a very well-defined head and shoulders pattern whose neckline it pierced. Since these two patterns were both bearish and happened roughly in the same period, it made a doubly bearish argument for UTH's direction.

FIGURE 1.8 This chart shows two patterns in action—an ascending trendline, which was violated, and a head and shoulders pattern.

HOW TO USE THIS BOOK

This book has three principal purposes.

First, it is intended as a solid introduction to the principals and philosophy of technical analysis. This chapter was a big step in that direction, and throughout the book you will find a lot of background about the *why* behind the patterns shown.

Second, it is organized to be a teaching tool, presenting all the important patterns of technical analysis so that you can identify, interpret, and discuss with some familiarity any of the important graph types contained herein. The order in which you read these sections isn't important, because each one stands on its own as an overview of the given pattern.

And third, it is meant to be an ongoing reference for you, long after you've completed reading it. If you think you spot a certain pattern on a chart, grab this book and refer to the appropriate section. Look at past examples and discern the similarities and differences to the pattern you are considering. Having reviewed this history, you can then decide if it still makes sense to take action.

I've enjoyed charting and trading for many, many years. I hope that this book helps enrich your own trading life and provides you with added profits for years to come.