

CHAPTER 1

The Most Popular Chart Patterns

Why Chart Patterns Are So Important

In this chapter I am showing chart examples without the OVI indicator. This is deliberate. You'll see some of the same charts with the OVI displayed in Chapter 2.

The study of charts is known as technical analysis. This comes in two forms:

1. Chart patterns—seen directly by looking at the charts.
2. Indicators—typically these are mathematical algorithms derived from price and volume.

For the purpose of this book we're going to focus on chart patterns, and as we progress through the chapter I'll explain why. Principally it's because they're the purest interpretation of price action, and as traders we want our main focus to be on price!

Chart patterns are vitally important to traders, and frankly should be just as important to longer-term investors as well. Traditionally long-term investors focus more on the financial reports of a company. The problem with that approach is that a share's stock market performance is not correlated perfectly to the past quarter's results. It's also based on future estimates, the market's view of management, and the quirks of the market itself.

Charts give us a visual representation of how the markets are interpreting a company's financial performance, its management capabilities, and its future prospects.

Over many decades, technical analysis has proved that familiar patterns will form repeatedly and that some patterns may give rise to the increased possibility of a particular future event occurring. So, for example, one pattern may often lead to a stock rising, and another pattern may often lead to a stock falling.

The idea, of course, is that chart patterns increase our odds of success. But that's not the whole story. The real secret is that the most useful chart patterns are the ones around which you can implement a simple and safe trading plan.

Not all chart patterns are conducive to this, so in this chapter I'm only going to focus on the ones that have proven to be the most reliable to recognize.

Understanding chart patterns will not guarantee you success. But align a reliable chart pattern with a robust trading plan *and* the OVI—well, now you have a great chance of achieving great results!

So this chapter is an overview of the patterns I consider the most useful for us moving forward.

PRICE BARS

When I look at charts I typically view them as candlestick charts. It's just a personal preference, and just in case you're not familiar with them, here's a quick summary of how to view price bars in a chart.

Typically we view a price chart from left to right, with time on the horizontal axis and price on the vertical axis. (In Figure 1.1 you'll also see volume bars underneath the price chart. Each bar corresponds with the price bar above it.)

Individual Price Bars

Each price bar shows the price activity over a certain period of time. Price bars can literally be for a "tick," or a minute, or for a 5-minute, 30-minute, 60-minute, daily, weekly, monthly, or yearly period, depending on the length of time you're looking at.

Obviously the shorter time frame you trade, the shorter the time period of the chart you'll want to look at. In this book we're focused on the daily bars, meaning each bar represents one day.

Price bars can be represented in different ways. The simplest way to depict the price range for a particular period of time is by way of a simple vertical bar that displays the high and low points for that bar.



FIGURE 1.1 Basic Chart

Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

The most common way to view price bars is a simple vertical bar that displays the high and low, and a left horizontal tag for the opening price and a right horizontal tag for the closing price (as shown in Figure 1.2).

As you can see, the extremes of the bar represent the high (h) and the low (l). The left tag represents the price the stock *opened* at for the day (o), and the right tag represents the price the stock *closed* at for the day (c).

So each bar contains the following information for its period of time:

- **OPEN:** the price at which the stock opened on that day.
- **HIGH:** the highest price the stock reached that day.
- **LOW:** the lowest price the stock reached that day.
- **CLOSE:** the price at which the stock closed that day.

In the example in Figure 1.2, the stock closed lower than the open, we can see that quite clearly. You can also see it moved higher than the open at some point during the day. It also moved lower than the final close at some point during the day.



FIGURE 1.2 Simple Price Bar



FIGURE 1.3 Candlestick Up

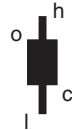


FIGURE 1.4 Candlestick Up

Now let's look at the same bar but using a Japanese candlestick (see Figures 1.3 and 1.4).

With the candlestick, we still have the low and the high as vertical lines (shadows), but what we have instead of the left and right tags is the top and bottom of the body of the rectangle.

When we have a hollow body as in Figure 1.3, it means that the price closed higher than it opened.

When we have a filled body as in Figure 1.4, it means the price closed lower than it opened.

When you view price charts you'll notice that the bars on the chart will often be in color. Typically, if the close is higher than the previous day's close, then the bar will be green. If the close is lower than the previous day's close, then the bar will be red.

You can get a scenario where the stock close is higher than the open on the specific day, but the close is still lower than the close of the previous day. In such a case the bar will be *hollow* and *red*. Table 1.1 is a summary.

TABLE 1.1 Reading Japanese Candlesticks

Close vs. Open	Close vs. Previous Day's Close	Candlestick Appearance
Close > Open	Close > Previous Close	Green + Hollow
Close < Open	Close > Previous Close	Green + Filled
Close > Open	Close < Previous Close	Red + Hollow
Close < Open	Close < Previous Close	Red + Filled

> means "higher than."
 < means "lower than."

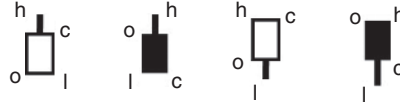


FIGURE 1.5 Extreme Candlesticks



FIGURE 1.6 Doji Bar Candlesticks

Specific Candlesticks One advantage of using candlesticks is that the individual candlestick bars have their own patterns. I'm not a candlestick guru, but there are a couple that are worth knowing about and that are obvious when they appear.

We already know that the candlestick is comprised of a body and shadows. The body contains the information about open and close prices. The top of the upper shadow is the high of the bar, and the bottom of the shadow is the low of the bar.

If the extreme (high or low) of the day was exactly at the open or the close, then there may not be shadow for a particular candlestick (see Figure 1.5).

Sometimes we'll encounter a price bar where the open and the close are at similar levels within the same bar. These are known as Doji bars (see Figure 1.6).

A Doji is thought to represent uncertainty in the market, which could herald a significant change in market direction. Dojis come in all sorts of shapes and sizes, as outlined above, and can have varying degrees of proximity between the open and the close of the bar, and also the relative position of the open and close.

As my personal rule of thumb, if the distance between the open and the close is within 20 percent of the range of the bar then I'll consider it a Doji. So, if the range of the bar is, say, \$2.00, then provided the open and close are within \$0.40 of each other I'll view it as a potential Doji. Of course it's more powerful if the open and close are really close together; the nearer they are to each other (particularly in the case of a wide-ranging price bar with long shadows), the greater the perceived uncertainty of the market.

A variant of the Doji and another candlestick bar that often signifies a reversal is a Hammer bar (see Figure 1.7). The Hammer is characterized by the open and close being relatively close together and being positioned at one end of the candlestick. Candlestick theory talks about different types of Hammer bars, a few of which are depicted in Figure 1.7.



FIGURE 1.7 Hammer Bar Candlesticks

In the context of an extreme in price being formed, a Hammer bar can signify a reversal. The same applies to a break of support or resistance. If it occurs with a Hammer bar, the break of support or resistance may turn out to be short-lived.

Let's not get too hung up on individual price bars though.

Price bars tend to make more sense when they're viewed in the context of other price bars. The collection of bars can then start to resemble recognizable chart patterns.

Chart patterns come in two forms: continuation patterns and reversal patterns. Our main focus for trading will be continuation patterns. This is because the fastest way to make money in the markets is by hitching a ride on a trend.

Before we discuss how to define a trend, let's define one of the basic tenets of chart reading: support and resistance.

SUPPORT AND RESISTANCE

Support and resistance are bread-and-butter terms for both novice and seasoned traders.

- Support means a “floor”—typically created by the achievement of a previous high or low. If a price breaches support, this can be interpreted as weakness with further falls likely to follow.
- Resistance means a “ceiling”—typically created by the achievement of a previous high or low. If a price breaches resistance, this can be interpreted as strength with further rises likely to follow.

Where clear lines of support and resistance have already been established, the psychology of these levels comes into play. Around a resistance level some traders may become nervous and sell their existing long positions in case of a bounce down off the resistance level. Other traders may look on a break of the resistance level as a sound reason to buy in the hope that the stock will continue on its upward trend.

Similarly, where a stock drops to a support level, those who are already shorting the stock may look to cover their shorts by buying back the stock in case of a bounce up off support. Other traders may look at a break of the

support as an opportunity to go short in the hope that the stock continues its downward trend for some time.

The biggest challenge with trading is that we don't have hindsight. Sounds obvious, doesn't it!? We don't know in advance whether the stock is going to break or bounce off these support and resistance levels, so we must use a trading plan that not only keeps us safe but also enables us to play for windfall profits. More about that later; for now it's crucial to understand two things:

1. Do not fall into the trap of trying to forecast the markets.
2. Do appreciate the role that a well-defined chart pattern plays in forming a well-defined trading plan.

When support and resistance lines are broken, they may form the opposite of what they were before: Former support can become new resistance, and former resistance can become new support.

Here's an example of Apple (AAPL), which formed a resistance level around \$320, which subsequently became a support level (see Figure 1.8). The resistance (R) was first hit in November 2010. The stock then bounces off it and becomes a bit sticky around that level in December 2010. Several months later the stock tests the level twice—in April (S) and June (S)—but does not close below the \$320 level.



FIGURE 1.8 AAPL Chart: Resistance and Support

Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

At this point it's tempting to believe that if the stock does close below \$320 it will continue to slide. What happens next, then, is quite surprising.

AAPL breaks the \$320 support level the very next day, and closes below it too. However, it does so with a gap down¹ and with a Hammer candlestick bar.

In the context of an extreme in price being formed, a Hammer bar can signify a reversal. The same applies to a break of support or resistance. If it occurs with a Hammer bar, the break of support or resistance may turn out to be short-lived (see Figure 1.9).

In this case, AAPL has broken support and formed a new price extreme low but the Hammer bar is making the break ambiguous. We therefore need to ensure that if you were in the trade already, and if the stock does reverse back above \$320, you'd be closing it with a very small loss.

As it happens, here the Hammer bar did signify a reversal, and the stock roared back within a day and didn't look back. If you had already gone short, the key would be to close your trade by buying back the stock as soon as it got back into the trading range above \$320 (see Figure 1.10).

As you'll discover later, our trading plan involves placing stop-limit orders. These orders prevent us from being "gapped into" a trade. In this



FIGURE 1.9 AAPL Chart: Hammer Bar

Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

¹Our particular trading plan ensures that we do not trade gaps by placing our trades as stop limit orders.



FIGURE 1.10 AAPL Chart: Hammer Reversal

Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

case, we might have wanted to short AAPL if the stock had traded through \$319.59—meaning the stock price touched that price during trading hours. However, we would not have wanted to have our trade entered at anything below this.

So the order would have been a sell (to open) stop-limit order at \$319.59. This means that the broker could not execute our trade at any price lower than \$319.59, or any price higher than \$319.59. This gives us more control and a more restful night's sleep in the case of gapping stocks!

Most traditional and online brokers will have the facility for stop-limit orders without any problem. Some types of brokers (like spread-betting companies in the UK) do not have this facility yet, in which case you would place your orders during trading hours right after the open.

As a trader you should not be obsessed with trying to nail the high and the low, or the precise turning point of a stock price. In fact, that's a road to ruin. What you want is to jump onto a trend when it's breaking through support or resistance areas.

As you've just seen, support and resistance lines can be very easy to spot when they're formed from previous highs or lows. Note also that they don't need to be horizontal lines. Support can be formed by joining the lows of an up-trending stock. Resistance can be formed by joining the highs of a down-trending stock.

A Brief Rant about Fibonacci, Elliott Wave, and Gann

Support and resistance points can also be formed by other mathematically derived levels, such as pivot points (used primarily in Forex trading) and more exotic techniques like Fibonacci, Elliott Wave, and Gann.

These techniques do have their fan bases, and can have their relative merits. However, having studied Fibonacci, Elliott Wave, and Gann comprehensively over many years, I eventually concluded that *for me* only the most elementary use of Fibonacci was worth considering without going completely insane or running around in circles. We'll cover the simple and effective way of using Fibonacci when we apply our trading plan in Chapter 4.

As a quick summary, the techniques of Fibonacci, Elliott Wave, and Gann rely on the natural order of number sequences and various ratios that are derived from them.

The problem with these techniques is that they presume the markets are preordained by some force of nature or divine energy. If this is the case, no one has yet cracked the code without using hindsight—which means no one's really cracked the code at all!

Don't get me wrong. These theories do have some validity in the markets as the same numbers and ratios do keep cropping up as key support and resistance levels time and time again. The numbers also have validity in terms of counting time periods.

However, it is pretty much impossible to know in advance which numbers will occur at a particular time. And this makes these theories very difficult, and in some cases dangerous, to trade.

The problem is exacerbated by scholarly types who analyze ad nauseam which ratio is going to happen at a particular time—and once in the bluest of blue moons they'll get it right! But as I keep saying, even a broken clock is right twice a day . . . and for the rest of the day it's hopeless.

Elliott Wave analysts can never even agree among themselves which "wave of a wave of a wave" we're in, so what chance do the rest of us have?!

Gann specialists can't agree on what his favorite number was and which paper is his genuine transcript!

And Fibonacci experts can't agree on time, price, ratios, or numbers.

This gets us to the nub of the problem: By getting obsessed with a particular number or ratio for a particular stock to reach before you enter or exit, you're indulging in magical thinking and forgetting what trading is all about.

- Trading *is* about making money from the opportunities that the market brings with wonderful regularity.

- Trading is *not* about being right all the time. That would be a virtually impossible aim.
- Trading *is* about maximizing the reward when you're right.
- And trading *is* about minimizing the damage when you're wrong, and embracing the fact that being wrong is part of the game.
- In this way trading is a probability game of numbers. You have to play in order to be paid.
- In my trading plan, which you'll learn in Chapter 4, you can sometimes be wrong and not even lose a dime! Now that kind of approach starts to put the probabilities in your favor.

So, a quick summary on Fibonacci, Elliott Wave, and Gann.

Fibonacci In the case of Fibonacci, each number in the sequence is the sum of the two previous numbers. Starting with zero, the sequence runs like this:

0, 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, ...

As the sequence develops, each number will divide into its successor by 1.618 times, and into its predecessor 0.618 times. 0.618 is the reciprocal of 1.618 and is known as the Golden Ratio. From here, new numbers can be discovered by squaring, square-rooting, subtracting from 1 to arrive at 0.382, et cetera.

The permutations and combinations are mind-boggling, and the seriously obsessed can then start to veer into Lucas numbers and even planetary and lunar ratios.

The principle idea behind using Fibonacci in trading is to identify a natural point of support or resistance where a stock may reach. This can be in terms of identifying a retracement point where the stock has been trending, and then retracing to a target price. Or it can be in terms of identifying a target point where the stock may reach during its trend.

Here's the problem in practical terms: Because the method embraces the idea that the markets are divinely operated, Fibonacci enthusiasts become obsessed with being right.

Remember, trading is a deeply psychological game. And your trading plan must take this into account. The psychology is to make money over the medium term. You don't have to be right all the time in order to achieve this.

Let's take an example of how I've seen this played out more times than I care to imagine!

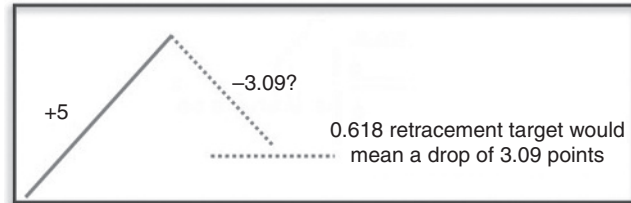


FIGURE 1.11 Fibonacci Retracement

Fibonacci Retracement Example Stock ABC rises by 5 points. Fibonacci analysis says the stock is dead certain to retrace by a ratio of 0.618, meaning the stock should fall by 3.09 points.

The immediate problem here is that the target presupposes that that high has been reached and that the retracement target will be reached before a new high is made (see Figure 1.11).

So, what if the 0.618 target that they were convinced of isn't reached? Well, they start to convince themselves that it will be. They have to be right. And then when they're not right, they make excuses and then wait until they are proved right. And this starts to mess with their trading plan. In fact, there is no plan.

Because instead of trading what they're seeing, they're making decisions based on what they want to see. They're making decisions based on the need to be right. And that is not what trading is all about.

Fibonacci Expansion Example This is the other common use of Fibonacci. Where is the stock price going to reach during its trend? Bearing in mind that many automated trading systems may be set to buy or sell at different Fibonacci target levels, this target-setting strategy does have some merit (see Figure 1.12).

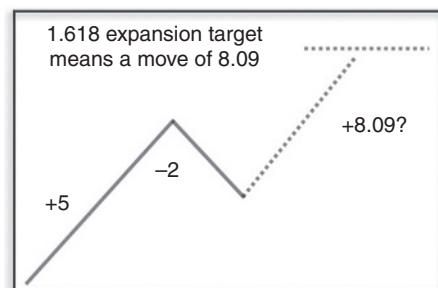


FIGURE 1.12 Fibonacci Expansion

However, the problem occurs when you ask the questions of which level (there are so many of them!) and what happens if the stock doesn't reach that level? Again, for many Fib enthusiasts, the priority is being right, and that priority will deplete their accounts.

In Chapter 4 you'll discover we do have a use for this target-setting strategy. If used correctly, you have a trading plan that is based on sensible principles that will keep you safe when you're wrong and allow you to make a windfall if you get it right.

In terms of using Fib to set our profit targets, I'm not wedded to the precise ratios either. I just want a sensible place at which to take partial profits and a simple method of grabbing a windfall if the market is generous enough to keep trending for me.

Elliott Wave I'm going to deliberately keep this short!

The Elliott Wave Principle is tied in with Fibonacci numbers and ratios. The theory is that prices undulate in waves. These waves are sequenced in the basic Fibonacci ratios.

The basic structure is that you have a five-wave impulse followed by a three-wave, A-B-C retracement. In a complete Elliott Wave sequence there are 34 waves as follows:

5 3 5 3 5 3 5 5

Add the numbers together to see the corresponding cumulative wave count below (Fib numbers in bold)

5 **8** **13** 16 **21** 24 29 **34**

Now, here's where it can start to get bewildering. . . .

Within one wave can exist another smaller set of waves, and within that smaller set of waves can exist an even smaller set of waves, and within that even smaller set of waves can exist a yet tinier set of waves. . . .

And to exacerbate the conundrum, Elliott Wave experts rarely agree on whether they're looking at a five-wave impulse or an A-B-C retracement. And this is before we even get to the rules of how to trade the darn thing!

Here's where I sit on all of this: If the so-called experts can't even agree what wave we're in, then the method has to be a dud as far as making money from it is concerned.

Trading is all about keeping it simple. Elliott is so confusing and mind-boggling that if you get into it, you'll be trapped in a never-ending cycle of fascinating confusion—and, more worryingly, you won't make any money from it!

Furthermore, it's worth mentioning that Elliott experts have been predicting the end of the world as we know it for donkey's years, and, as far as I can see, the markets are still here and the world is still here. One day they'll be right, but remember the broken clock! In the meantime, let's keep it simple and learn how to make money from the markets. I wasted three years on all this stuff. It was interesting, but it got me nowhere.

Gann I'm going to deliberately keep this one short, too!

W. D. Gann was a renowned trader who started his career at the turn of the twentieth century.

Believing that highs and lows were all related by certain ratios, Gann was an early advocate of using Fibonacci numbers to make price target projections. In fact, Gann numbers are either the same or only fractions away from the Fibonacci numbers, and he was among the first proponents of linking price with time.

During my adventures I did have success with Gann, but the successes can cause problems later on. How so? Because once you start to believe in the numbers, it can seriously affect your capacity for objectivity in future trades. These numbers can work once in a while, or even as if by magic during a sequence of trades.

But sooner or later they stop working! At that point you're left like the Wile E. Coyote cartoon character, running off the edge off the cliff and suspended in mid-air until the inevitable drop. "How come it doesn't work anymore? This was perfect. There must be something wrong with the markets!"

For what it's worth, here are the major Gann levels. But that's not where it ends. In fact, it's only the start, because Gann also used percentages and angles, combining price with time. And guess what? They sometimes work like magic! But more often than not they don't, and that leaves you in the trading wilderness.

The Major Gann Levels Gann calculated four levels that appeared to have significance to stock prices. He also calculated many other levels. In fact, my mischievous side considers that between Gann, Elliott, Fibonacci, and Lucas numbers, just about every number in the universe is covered!

$$G1 \text{ Level} \quad \frac{\text{All Time High Price}}{2}$$

G1 is the most important Gann level, representing a key support level. If price breaks below G1, then it is likely to drop further to G3. G1 then becomes resistance.

$$G2 \text{ Level } \frac{(\text{All Time High Price} + \text{All Time Low Price})}{2}$$

$$G3 \text{ Level } \frac{\text{All Time High Price}}{4} \quad \text{or} \quad \frac{G1}{2}$$

G3 is the second most important Gann level. G3 acts as support when G1 has been breached. If G3 support is breached, it then becomes resistance.

$$G4 \text{ Level } \frac{(\text{All Time High Price} - \text{All Time Low Price})}{4} + \text{All Time Low Price}$$

So, if you feel you want to pursue a scholarly approach, by all means read up on more of this. My own feeling is that it will have you fascinated but ultimately running around in ever-decreasing circles—and then you'll return to the method I teach you in this book!

Whatever you choose to do, keep things simple. You're not here to become a scholar. You're here to make money from the opportunities that the markets conveniently offer you.

To do this effectively you need a trading plan that is simple to understand, is easily repeatable, and keeps you sane.

After years of seriously detailed Gann and Fib analysis, I could see that the techniques weren't for me, other than the very simple "first-profit-target" method I detail in Chapter 4.

Support and Resistance Summary

Support and resistance levels can be formed by a number of methods, ranging from simple horizontal lines extended from previous lows and highs, to complex algorithms based on obscure concepts.

The important thing to remember is that support and resistance are psychologically sensitive areas for traders. Given that trading is a psychological game, it's vital to keep your trading plan as simple as possible. We'll see examples of breakouts from support and resistance in Chapter 3.

The art of trading is not to be right. It's to win over the medium term. Some traders become obsessed about being right and use methods that are unworkable without hindsight. Don't fall into that trap.

In order to win, you do not have to achieve perfection. In fact, striving for perfection in trading is seriously misguided.

When it comes to support and resistance the simplest and most effective support and resistance is formed from previous highs, previous lows, and simple trend lines.

TRENDS

Trading in the direction of the trend will yield you the biggest profits you'll ever make in the markets. The challenge is how to jump on one and ride it for as long as possible.

What Is a Trend?

Prices move up, down, and sideways. There are two types of trends: an uptrend and a downtrend (see Table 1.2).

The easiest way to identify a trend is to eyeball it. Some traders define trends by using moving averages or moving average crossovers. I think this is flawed, because slower-moving averages can allow for massive retracements that can hurt you.

The main things to identify when defining a trend are what timescale you are measuring and what timescale you are trading. For example, a stock that has been trending up in the last two months could have been trending down for the previous six months, and vice versa.

Let's take a look at a few charts of the same stock where you can easily see if there's a trend or not.

Clearly in Figure 1.13 we can see AAPL is trending up from February 2009 until October 2011. Within that longish-term trend, we can see that it made three significant retracements, taking the stock to within touching distance of the rising trend line.

If we zoomed into the chart and took a snapshot during these retracements we might not consider the stock was in an uptrend.

In Figure 1.14 we're taking the same stock, AAPL, during the period from April to August 2010. We know in the longer-term context that AAPL was in an uptrend. But the chart shows it to be going sideways.

TABLE 1.2 Defining a Trend

Uptrend	An uptrend can be described as a sequence of higher lows in conjunction with higher highs.
Downtrend	A downtrend can be described as a sequence of lower highs in conjunction with lower lows.



FIGURE 1.13 Up-trending Chart
Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.



FIGURE 1.14 Sideways Chart
Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.



FIGURE 1.15 Down-trending Chart

Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

In Figure 1.15 we see the same stock again, from June to September 2010. Although it's not steep or severe, the stock looks like it's trending downward. Again, it's a simple matter of eyeballing the chart.

So in the previous three figures we can see that within AAPL's uptrend, it had periods of going sideways and even down.

The important question is: What time frame should you be observing for the purposes of trading a trend?

Well, when I look at charts, my default setting is to be able to view about nine months of daily bars. This gives me the relevant context without overwhelming me with information. I also need to be aware of any relevant longer-term support and resistance areas that may have been formed in the past. That can be achieved in a couple of seconds by quickly referencing a weekly bar chart, where each bar represents a week.

Figure 1.16 shows AAPL for most of 2011, and the immediate thing I notice is that the stock looks more volatile from August to October. This reflected the entire market's performance, which also exhibited increased volatility in the wider indexes like the S&P 500. You can easily observe increasing volatility by noticing wider-ranging price bars, increased gapping, and an overall sense of a chart becoming "messier."

Trend Lines

Apart from eyeballing the chart, the easiest way to identify a trend is by creating a trend line. Trendlines are far more reliable and simpler to use than moving averages.

**FIGURE 1.16** Nine-month Chart

Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

With an uptrend, we draw the trend line below the lows, as per Figure 1.13.

With a downtrend, we draw the trend line above the highs, as in Figure 1.15.

Sometimes a stock will be in a trend, make a retracement without hitting the trend line, or will just touch the trend line. This type of reaction shows the trend line has some significance for other traders.

Sometimes a trend line will be breached before the price suddenly bounces back and resumes its trend. This will shake out the traders who have stops near the trend line. If this happens to you, you may need to consider how to jump back on the trend safely. (I'll get into this during Chapter 4.)

A break of the trend line, particularly with rising volume, may signify the end of that trend.

FLAG PATTERNS AND CONSOLIDATIONS

Flag patterns are among the most powerful chart patterns in the stock-trading world. Not only do they provide a good signal but, more importantly, they give us the ability to construct a simple and effective trading plan. This combination makes them so powerful.

Flags can be further distinguished into pennants, triangles, and wedges. For our purposes let's call them all flags or tight consolidations. The idea is that we trade them only when they break out of their tight consolidation in the direction of the dominant trend.

A flag pattern is made up of two parts:

1. A thrusting surge or step (the flagpole).
2. The flag (the consolidation).

The thrust or step can occur in either an upward (bullish) or downward (bearish) direction. This is the direction of the dominant trend, and that's the direction in which we're going to trade. An analogy would be fighting the tide.

The flag part temporarily interrupts the trend before it resumes. Our job is to jump onto the trend as the flag breaks in the direction of the dominant trend.

The flag part consists of the price pattern rebounding off two short-term lines of support and resistance—sometimes as little as three consolidating bars—before the breakout happens or fails. If the breakout never materializes, our trading plan ensures we don't lose because our entry stop-limit order only executes if the breakout occurs (without a gap).

Bull Flags

A bull flag occurs when the dominant trend is up. We're therefore hoping for the stock to rise and break the flag's short-term resistance. However, our trade is only activated when the stock has traded upward past the resistance level. I'll cover flags with real examples in Chapter 4 but for now I'll give a summary, referencing Figure 1.17.

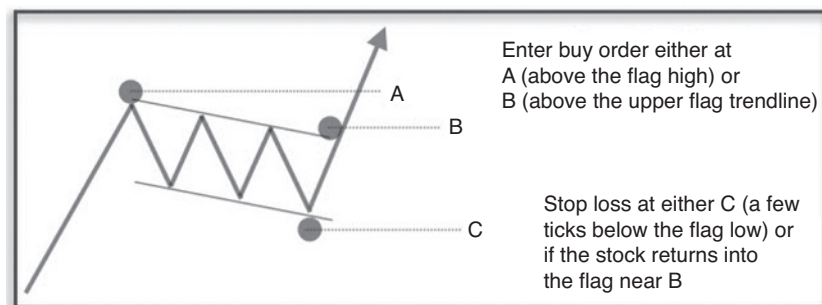


FIGURE 1.17 Bull Flag

The short-term resistance can either be the very top of the pattern or the higher trendline if the bull flag consolidation forms with lower highs.

- You enter your buy order at either point A or B.

Point A is just above the highest point of the flag. This is the most conservative entry point, because it requires the highest point of the flag to be broken. If this occurs with increasing volume, then so much the better, because increasing volume indicates buying conviction behind the rising price, which makes it more likely to keep going.

Point B is just above where the price would break out above the higher trend line of the flag pattern. This is more aggressive than Point A and the danger is of a double top² forming at the top of the entire pattern at Point A. Again, if volume is increasing as the break happens, then so much the better.

- If the entry is activated then you need a sell stop loss. You can have this set at either Point C, or below Point B, inside the flag, if you want a tighter stop loss.

This is your basic trading plan for a bull flag, within the context of an upward trend.

The short-term resistance can either be the very top of the pattern or the upper trendline if the flag consolidation forms with lower highs (see Figure 1.17).

Notice how I've drawn the bull flag consolidation moving slightly downward against the direction of the main upward trend. It's preferable that the bull flag consolidation moves either sideways or slightly downward against the direction of the dominant trend.

This helps our trading plan with particular reference to entering our buy order when a resistance level is being breached at either Point A or B. If the flag consolidation occurs in the same direction as the main trend, we wouldn't be able to identify a Point A or B, and our trading plan would become muddled.

²A double top occurs when the price approaches a previous high (which is forming resistance) and then reverses.

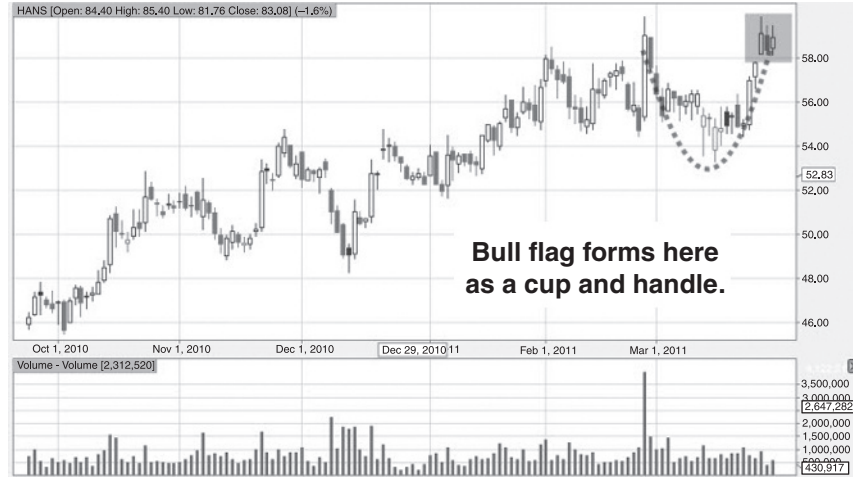


FIGURE 1.18 Bull Flag Chart
 Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

In Figure 1.18 you can see the bull flag forming in the shaded square. The thing to note in this chart is that the bull flag forms at the end of a bowl type of pattern. The bowl is in itself a bullish pattern, and therefore the combination of the bowl and the bull flag is one of the most sought-after patterns in the markets, because we’re combining two bullish patterns into one. This is known as a cup and handle.

Cup and Handle Cup and handles vary in terms of the steepness of the cup and the position of the handle (flag) relative to the first lip of the cup (see Figure 1.19). Typically we play them as standard flags, but do bear in mind that the first lip of the cup (on the left side of the diagram) does in itself form a resistance level.

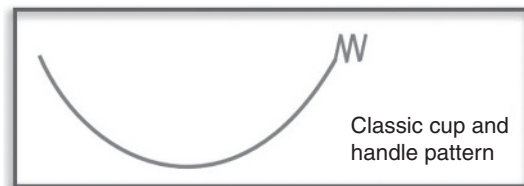


FIGURE 1.19 Cup and Handle

Bear Flags

A bear flag occurs when the dominant trend is down. We're therefore hoping for the stock to decline and break the flag's short-term support. However, our trade is only activated when the stock has traded downward below the support level. We'll go through examples of this in Chapter 4, but here's the summary, referencing Figure 1.20.

The short-term support can either be the very bottom of the pattern or the lower trendline if the bear flag consolidation forms with higher lows.

- You enter your sell short order at either point A or B.

Point A is just below the lowest point of the flag. This is the most conservative entry point, because an entry requires the lowest point of the flag to be broken. If this occurs with increasing volume then so much the better, because increasing volume indicates selling conviction behind the falling price, which makes it more likely to keep going.

Point B is just below where the price would break out below the lower trend line of the flag pattern. This is more aggressive than Point A, and the danger is of a double bottom³ forming at the bottom of the entire pattern at Point A. Again, if volume is increasing as the break happens then so much the better.

- If the entry is activated then you need a buy stop loss to cover your short. You can have this set at either Point C, just above the upper flag trend line, or above Point B, inside the flag, if you want a tighter stop loss.

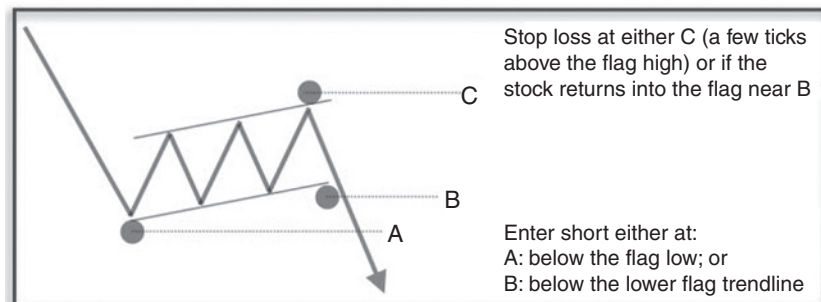


FIGURE 1.20 Bear Flag

³A double bottom occurs when the price approaches a previous low (which is forming support) and then reverses.

This is your basic trading plan for a bear flag, within the context of a downward trend (see Figure 1.20).

Notice how I've drawn the bear flag consolidation moving slightly upward against the direction of the main downward trend. It's preferable that the bear flag consolidation moves either sideways or slightly upward against the direction of the dominant trend.

This helps our trading plan with particular reference to entering our short order when a support level is being breached at either Point A or B. If the flag consolidation occurs in the same direction as the main trend, we wouldn't be able to identify a Point A or B, and our trading plan would become muddled.

In Figure 1.21 you can see the bear flag forming in the shaded square at the bottom-right of the price chart.

Similar to the bull flag example, in Figure 1.21 the bear flag forms at the end of an upside-down bowl. The upside-down bowl is in itself a bearish pattern, and the combination of the reverse bowl and the bear flag is known as a reverse cup and handle. Again this is highly sought after, as it is the combination of two bearish patterns in one.

Reverse Cup and Handle As with the standard cup and handle, the reverse equivalent can also vary in terms of the steepness of the upside-down cup and the position of the handle (flag) relative to the first lip of the

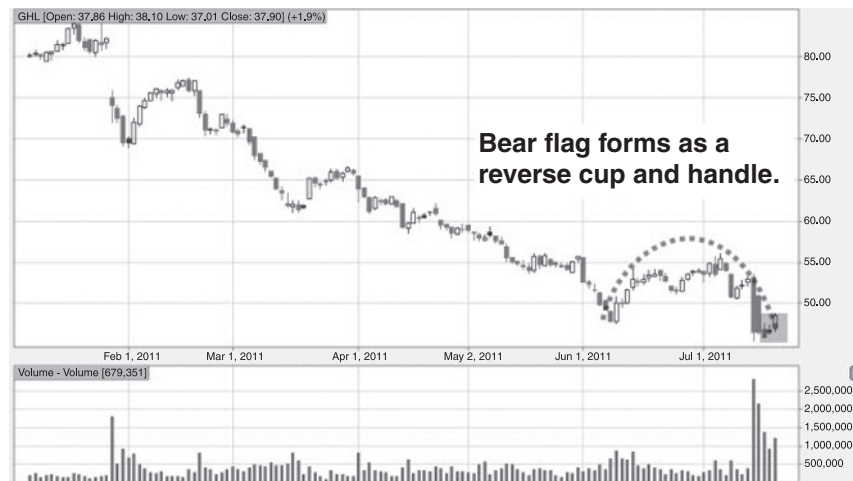


FIGURE 1.21 Bear Flag Chart

Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.



FIGURE 1.22 Reverse Cup and Handle

cup (see Figure 1.22). Typically we play them as standard flags, but do bear in mind that the first lip of the cup (on the left side of the diagram) does in itself form a support level.

Rounded Tops, Rounded Bottoms, and Flag Failures

There are three possible outcomes to a flag pattern formation:

- (i) The flag breaks out in the direction of the dominant trend and keeps going. In such a case our trade is triggered by the breakout and we're going to make good profits.
- (ii) The flag breaks out in the direction of the dominant trend and reverses. In such a case our trade is triggered by the breakout, and if our first profit target is not reached, the reversal may cause us a potential small loss. If our first profit target is reached then we'll make a small profit despite the reversal. (More about the trading plan in Chapters 3 and 4.)
- (iii) The flag doesn't break out at all. In the case of a failed bull flag, this is known as a rounded top. In the case of a failed bear flag this is known as a rounded bottom.

One of the great merits of our trading plan is that if there is no breakout, then our trade is not executed, and therefore we cannot make a loss. Given that trading is all about putting the odds in our favor, how good is it to have a trade "fail" and yet we don't lose a penny?!



FIGURE 1.23 Rounded Top
 Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

Let’s look at an example of a rounded top and then a rounded bottom.

In Figure 1.23 we can see a promising bull flag forming. If it breaks upward and above the top of the flag our buy stop limit order would be executed.

However, the breakout never materializes. We were “wrong,” but our trading plan ensured we weren’t punished for it (see Figure 1.24).



FIGURE 1.24 Rounded Top
 Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

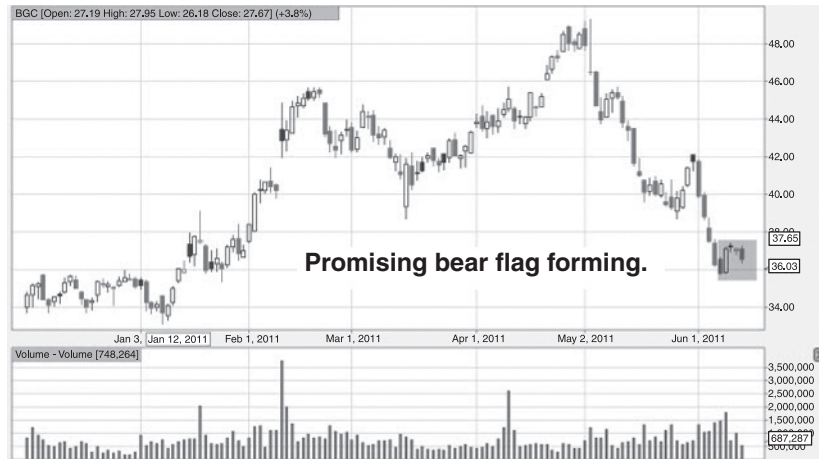


FIGURE 1.25 Rounded Bottom
 Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

Figure 1.25 shows a similar story, except we have a promising bear flag forming. If it breaks downward and below the bottom of the flag, our sell stop-limit order would be executed.

Again, here the breakout never materializes. We were “wrong,” but our trading plan ensured we weren’t punished for it, as shown in Figure 1.26.



FIGURE 1.26 Rounded Bottom
 Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

The Megaphone Pattern

The megaphone pattern is the anti-flag pattern! It's like the opposite of a consolidation, where instead of the price bars getting tighter as with a flag consolidation, the bars actually get wider.

The pattern exhibits increasing volatility and is often found near the culmination of a rising trend. When you see this occurring it can often spell the end for that uptrend.

In April 2010, I spotted such an example as it was happening and warned my members rather fortuitously on the high of the market on April 26 (see Figure 1.27).

The resulting decline was stupendous and was dubbed the "flash crash" (see Figure 1.28).

Be aware of this pattern, as it's a fantastic precursor to further volatility and often a down move.

Another bearish pattern is the head and shoulders pattern.

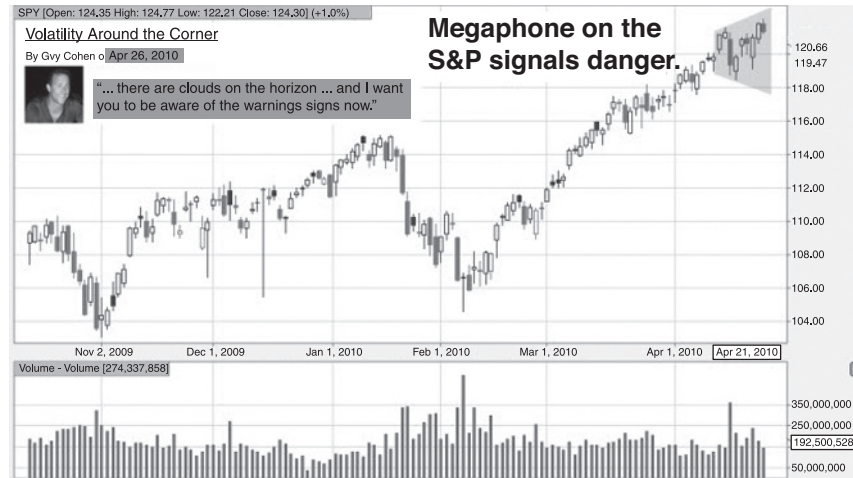


FIGURE 1.27 Megaphone Pattern
 Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

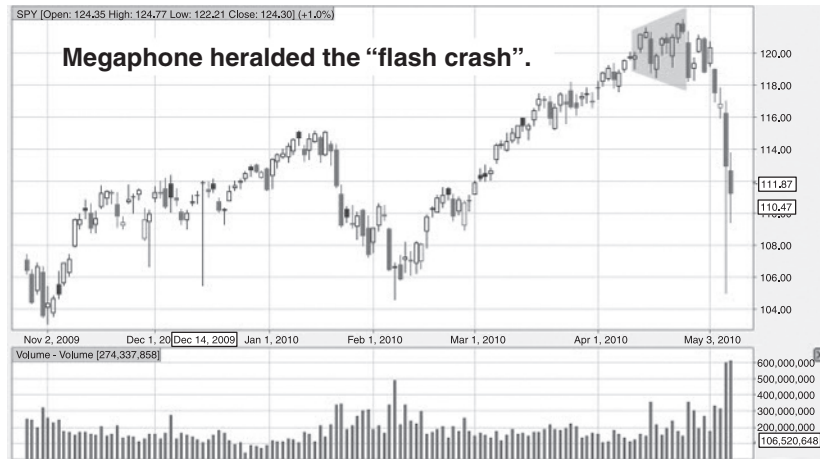


FIGURE 1.28 Megaphone Pattern
 Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

HEAD AND SHOULDERS

Head and shoulders patterns can take two forms: standard and reverse.

Standard Head and Shoulders

A head and shoulders pattern occurs when a high is made, followed by a higher high, which in turn is followed by a lower high (see Figure 1.29). Effectively the middle high (the head) is sandwiched between two lower peaks (the two shoulders).

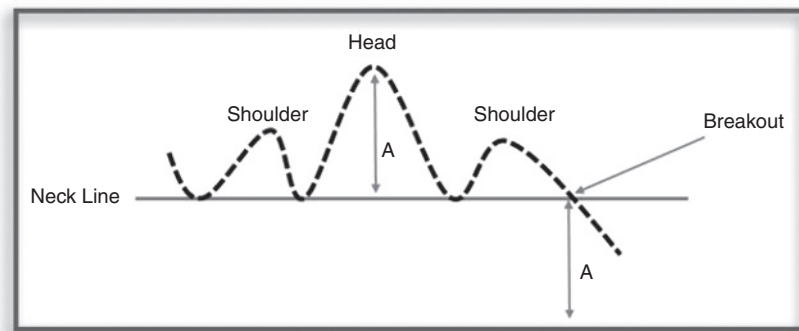


FIGURE 1.29 Head and Shoulders



FIGURE 1.30 GS Head and Shoulders Setup

Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

The chart is telling us that the price didn't have the strength to rise past the highest high. This can be interpreted as weakness.

The anticipated decline in the price can be estimated as the amount of distance (A) between the neckline and the "head" high.

At any point after the second shoulder we may see bear flag patterns develop as the stock trends downward. In such cases we need to be aware of the wider context of these bear flags being within a bearish head and shoulders pattern, and take advantage of the situation by shorting on the breakdown of the bear flag.

In the chart of Goldman Sachs (GS), we can see a prolonged bear flag forming with support at \$150 (see Figure 1.30). This was one of the easiest trades you'll ever spot. The bear flag was forming in the context of a broader head and shoulders, which in this instance had two shoulders on each side. Notice also how the neckline is sloping downward in this case (another bearish sign).

The setup is about as good as it gets and was one that I highlighted to my students well in advance of the breakout, which yielded an easy \$15 within two weeks (see Figure 1.31). You really don't need that many of these kinds of easy trades to make trading like this a very enjoyable hobby.

Reverse Head and Shoulders

A reverse head and shoulders is what it sounds like: an upside-down head and shoulders. The implications are also reversed in that this is a bullish setup.



FIGURE 1.31 GS Head and Shoulders Breakout
 Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

A reverse head and shoulders occurs when a low is made, followed by a lower low, which in turn is followed by a higher low. Effectively the middle low (the reverse head) is sandwiched between two higher lows (the two reverse shoulders).

The chart is telling us that the price didn't have enough momentum to fall below the lowest low. This can be interpreted as imminent strength to come.

The anticipated rise in the price can be estimated as the amount of distance (A) between the neckline and the reverse head low, as shown in Figure 1.32.

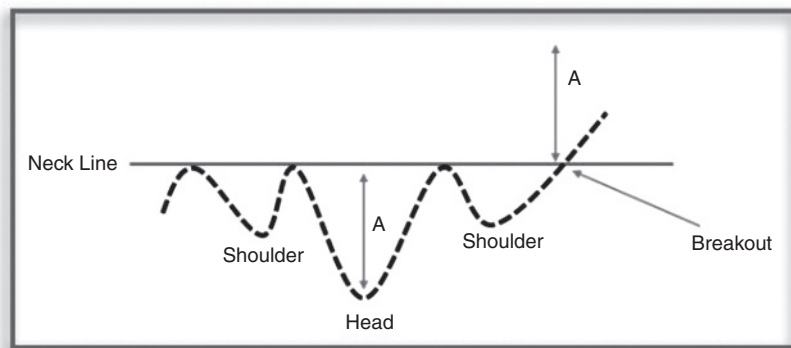


FIGURE 1.32 Reverse Head and Shoulders

At any point after the second shoulder we may see bull flag patterns develop as the stock trends upward. In such cases we need to be aware of the wider context of these bull flags being within a bullish reverse head and shoulders pattern, and take advantage of the situation by buying on the breakout of the bull flag.

In the following charts of Google (GOOG), you'll see how we identified a reverse head and shoulders and two bull flags that were wonderfully tradable and which I alerted my students to in advance.

Figure 1.33 shows the first bull flag forming just below \$485 in the context of a reverse head and shoulders. If the flag breaks out to the upside, we'll be in the trade.

As you can see, the setup is obvious. When you see the corresponding OVI in Chapter 2 you'll be even more enthused.

In Figure 1.34 you can see the explosive breakout from this bull flag with the result that the stock rests just below \$520 and forms a second bull flag just above the reverse head and shoulders neckline.

So we're now sitting on a \$20 profit per share—pretty good for just a few days—and we have a second bull flag setting up, the difference being that this time the new bull flag is forming above the reverse head and shoulders neckline. This, too, was one of the easiest trades you could ever spot (see Figure 1.35).



FIGURE 1.33 GOOG Reverse Head and Shoulders Setup 1

Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

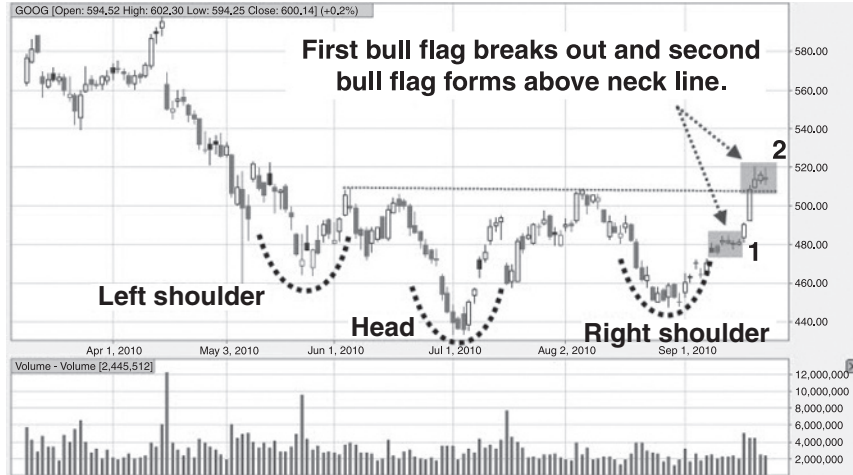


FIGURE 1.34 GOOG Reverse Head and Shoulders Setup 2
 Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

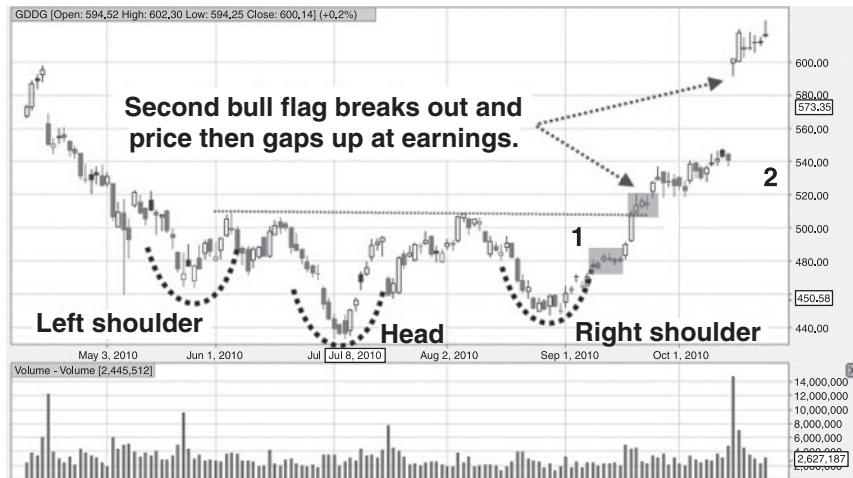


FIGURE 1.35 GOOG Reverse Head and Shoulders Breakout
 Source: OVI Charts. Courtesy of FlagTrader.com. Go to www.theinsideredge.com for more information.

From the first flag breakout to earnings was a \$60 move up. At earnings Google (GOOG) gapped up a further \$60! Now, earnings is a sensitive area, and in reality you would not be sitting on \$120 worth of points-profits. This is because you would already have taken partial profits on the first flag breakout, added to your position as the second flag broke out, taken partial profits again pre-earnings, and would therefore be in a virtually bulletproof position as at earnings, having taken plenty of profits off the table.

For a number of reasons GOOG looked like a fantastic opportunity at this time and this was borne out. However, you would not bet on earnings (a) without sitting on very healthy profits and (b) without having taken a decent portion of those profits off the table.

INDICATORS

Technical analysis comes in two forms:

1. Chart patterns
2. Indicators

As you've seen, chart price patterns are visible patterns of what is happening to the price of the security.

Indicators are mathematical algorithms that convert price action and volume into all kinds of ratios and analysis from which it is hoped that future price movement may be interpreted.

I don't want to denigrate indicators, because ultimately your success will come down to the quality of your trading plan and your ability to stick to it. But the problem with traditional indicators is that they are so subjective.

For example, which moving average, MACD or stochastic settings should you use? Also, because most of these indicators are created from averages of past prices, most of them are *lagging* in nature.

That's not to say that you can't formulate a decent trading plan using them, but again, which settings should you use? And, surely one setting won't fit all the stocks that you want to trade.

With my OVI indicator there are no such dilemmas and the indicator is *leading*, not lagging.

So, what about the leading indicators that I ranted about earlier such as Fibonacci, Elliott Wave, and Gann? Well my rant was mainly about the

fact that these methods can seriously affect your trading psychology and trading plan because of their propensity to encourage magical thinking on behalf of the trader.

The notion that the markets are preordained isn't necessarily magical thinking in itself, depending on your beliefs. But the notion that you can tap into this force and foretell the markets' precise turning points would most definitely be magical thinking! The fact that fans of these methods can never agree on the numbers, combined with my own misadventures with them, is enough for me to largely discard those methods (just in case you hadn't noticed from my rant earlier!).

Moving Averages, MACD, Stochastics

There is so much information available for these lagging indicators that it would only be worth detailing them here if we were going to construct a trading plan from them, or if I felt the need to make a nuclear-style warning about them!

Instead I'll just summarize what they're all about.

Moving Averages Moving averages are the most widely recognized and simplest of technical indicators. A moving average is simply a line that depicts the average closing price of a sequence of bars on a price chart. For example, on a daily chart, a 200-period moving average is the average of the last 200 days' closing prices.

The important moving averages are considered to constitute important levels of support and resistance. In this regard the 200-day and 50-day moving averages would be the most important to consider.

In terms of their constitution, as we look at today's chart before the close, today's moving average figure includes what happened yesterday but not today. Similarly, before tomorrow's close, tomorrow's moving average figure will include what happened today but not tomorrow.

Moving averages are considered useful for the way in which they smooth price action and eliminate outlier price bars, more commonly known as "noise."

Another popular use of moving averages is to deploy two different moving average lines on a chart and use their crossovers as trading signals. The idea is that when the shorter (50-day) moving average crosses through the longer (200-day) moving average, this produces a signal. Where the faster line crosses up through the slower line is considered bullish; where the faster (50-day) line crosses down through the slower (200-day) line is considered bearish.

One major weakness with moving averages is that they only really work with prices that are trending up or down. Where a stock is oscillating sideways for months, you'll find arbitrary crossovers that make no sense. Also, where a stock trends in a parabolic fashion, the moving averages cannot get near the stock and could leave you with a dangerously distant stop placement.

I tend to have a 200-day moving average on my charts and that's about it.

MACD Moving average convergence-divergence (MACD) is a moving average of the difference between two moving averages. As such, it is a measure of momentum in the price movement.⁴ As the moving averages move further apart, this is a sign of increasing momentum. Since MACD depicts the relationship of two moving averages, it can be used as either a trend indicator or a measure of whether the price is overbought/oversold.

MACD can be drawn as lines or as a histogram under a price chart, and can be interpreted in several ways.

The conundrum with MACD is which settings to use. However, there are decent trading plans that can include MACD parameters. For our purposes in this book we don't need to go through them, as we don't use MACD in our trading plan.

Stochastics A stochastic is an oscillator that is used to determine whether a market is overbought or oversold. As with most technical indicators, it works best in conjunction with other indicators and chart patterns.

Stochastics measure the relationship of a sequence of closing prices with their highs and lows. It consists of two lines, %K and %D, and ranges between 0 percent and 100 percent. A reading of 0 percent shows that the close was the lowest price that it has traded during the preceding specified time periods. A reading of 100 percent shows that the close was the highest price that the security has traded during the preceding specified periods.

Aside from determining which settings to use and how to use the lines, the main problem with stochastics is that often an overbought/oversold stochastic reading may have you exiting a trend that still has a long way to run. When stocks trend for a while, the stochastics will have the appearance of being overbought or oversold, depending on the direction of the trend.

Again, for our purposes in this book we don't need to go through stochastics in detail, as we don't use them in our trading plan.

⁴Gerald Appel, *The Moving Average Convergence-Divergence Method*. (Signalart, 1979).

Relative Strength Index (RSI) The relative strength index (RSI)⁵ is a measure for overbought/oversold analysis. Using a horizontal 50 percent midline most followers of RSI take a buy signal above the midline and a sell signal below the midline.

The RSI measures the internal strength of a single security and does not compare the relative strength of two securities.⁶ It is a price-following oscillator that ranges between 0 and 100. A popular method of analyzing the RSI is to look for a divergence where the security itself is making a new high, but the RSI is failing to exceed its own previous high, and vice versa. A divergence is interpreted as an indication of a likely reversal.

It is thought that the RSI forms chart patterns in itself that may not actually be visible on the price chart. Such patterns would include support, resistance, head and shoulders, and flags.

My main use for RSI has been to determine if a stock is trending over specific time periods.

The weakness with RSI is that, because it has a minimum and maximum, extreme levels imply the imminent end of a trend that may, in fact, have much longer to run. For example, when the RSI reading is 10, the indicator only has only 10 more points to fall, whereas the market may have a lot further to fall in relative terms. The same applies for a strong uptrend where the RSI is in the 90s (suggesting an imminent end of the move) but the uptrend keeps going.

LEARNING POINTS

For me the best indicator for price action is price itself. Therefore I focus predominantly on price patterns and the key support and resistance levels.

Volume is also important, as it demonstrates the appetite of investors for a price breakout. As the price starts to move decisively either up or down, increasing volume suggests conviction from investors being behind the move, and therefore a sustained move is more likely. In the context of breakouts we'll discuss volume in Chapter 3.

⁵See J. Welles Wilder Jr., *New Concepts in Technical Trading Systems* (Trend Research 1978).

⁶The comparison analysis tool is called the Comparative Relative Strength (or Comparative Strength), which measures one security's performance against another's. The Comparative Strength is used to compare how a stock is performing compared with its sector, an index, or another security within the same industry or sector. Comparative Strength is calculated by dividing one security's price by another's (the comparison security).

For now you have a good understanding of the patterns that will form our bread and butter, and therefore the ones we're going to focus on:

- Support and resistance
- Flags and consolidations

The idea is that we trade breakouts from these patterns. If there's no breakout, we can't lose money because our trades are only triggered upon the breakout occurring.

In Chapter 2 we're going to add a touch of magic to all this in the form of the OVI. In the context of breakout trading, the OVI can be seen to be a *leading* indicator, as well as an uncanny indicator of potential informed trading activity.