Chapter 1

Introduction to Chart Patterns

An investor I'll call Gina e-mailed me her story. She had saved $100,000 in her IRA. Then she bought this book and used its teachings to grow her account. She bought exchange-traded funds that tracked the metals. A year later, her account was worth $1.1 million. She made a million in one year. Wow.

I had a hard time believing her story so I talked to my brother. "She's an outlier." She's the exception to the rule, the one person in the world that makes it to the very top. She was in the right place at the right time and did everything right to make a bundle.

If Gina can do it, why not you?

What Are Chart Patterns?

Have you ever strolled into the woods and found footprints in the soil? If it's muddy, you may see bird tracks. You may also find larger tracks from cats, dogs, and even deer. You don't see the actual animal, just their tracks. If you follow the tracks, perhaps you can discover a beautiful creature.

When people trade a stock, they leave behind a footprint. Volume increases. The price bar printed on the chart may also change. String enough of those price bars together and they form patterns, which we call chart patterns.

chart patterns
chart patterns are recurring formations that appear on price charts. They reflect the trading behavior of professional traders, companies, and individuals.

I used to think that *chart patterns* were the footprints of the smart money. I think the dumb money steers the feet, too. What does that mean?

Imagine that you sell office supplies to a retailer called BOSS (Best Office SupplieS, a fictional company), which, in turn, sells them to the public. Your business is prospering because BOSS is buying lots of your products. With that knowledge, you purchase their stock.

Six months later, you notice that the rate of their purchases has slowed. Uh-oh. It could be a seasonal fluctuation. Fewer people need office supplies when they are on vacation during the summer. But the slowdown persists. You decide to sell the stock.

Imagine another scenario when you meet your good friend Barry, the CEO of BOSS. He is looking glum, as if someone spit into his cereal. He shakes his head and remarks, "We're being sued. If they win, we're sunk. If we win, we still take a big hit from legal fees."

"Your stock is going to take a pounding."

"No kidding," he says.

The next day you dump your holdings in BOSS.

Enter the Retail Investor

It's not only the smart money leaving footprints on the stock charts. What about people without inside information, the so-called retail investors?

Anyone can drive by BOSS and see vacant parking lots. If people inside the store are pushing around empty carts with no one waiting in line at the cashier, then that can't be good for business.

That scenario happens with apparel retailers all the time. Last year's fad has faded, and the chain is left with too many lemon-yellow polka dot sweaters. In summer!

Facebook is a good example of the public's excitement (fear and greed) for a stock. Facebook is an Internet company that went public in mid-2012 (**Figure 1.1**). It seemed as if the entire world was in love with the company. Two days before the initial public offering (IPO), the company said it would increase the number of shares offered by 25% due to demand.

One analyst said the stock could reach as high as $60 on the first day.

The underwriters priced the IPO at $38, and the stock opened at just over $42. It reached a high of 45 but closed just pennies above the offering price.

Then look what happened. The stock didn't hit 60; rather, it went the other way. It plummeted like a climber slipping off the Balcony on Mount

FIGURE 1.1 Facebook has an initial offering price of $38, shown at the horizontal line on the daily scale.

Everest, bouncing down until it reached base camp at 17.55 in early September, less than half the offering price.

Could retail investors have predicted such a move by looking at the charts of other IPOs? LinkedIn Corporation's stock opened at 83 but within six months, the stock hit a low of 60.14.

Of course, Facebook could have been the exception. Google, for example, opened at 100, and six months later, it was trading at almost 200.

These are just examples of the footprints left by the smart and dumb money. Our job as investors and traders is to recognize those footprints, decide which are valuable, and profit from them.

- Use prior price action to help determine future price movement.

Advantages of Chart Patterns

What advantages do chart patterns offer when trading a stock? The first two that come to mind are that chart patterns give buy and sell signals.

1. Chart patterns issue clear buy signals.
2. Chart patterns issue clear sell signals.

When price closes above the trendline boundary of a chart pattern, that's a buy signal. A trading signal can also occur when price closes above the top or below the bottom of a chart pattern.

For example, Figure 1.1 shows a double bottom at AB. When price closes above the high between the two bottoms (C), it confirms the pattern as a valid one and signals a buy.

The sell side is similar. Sell signals occur when price closes outside a trendline boundary or below the bottom of a chart pattern.

There's no guessing about where the signal might be. The rules are known.

A third advantage is that signals are timely. If you have day-traded a stock using a moving average, you may know about this. Imagine a stock gap significantly higher at the day's open (opening gaps are common).

A 20-period moving average, for example, needs 20 samples to fill the pipeline and give a result. If you're on the one-minute scale, it will be 20 minutes before you see a simple moving average not influenced by the gap.

If you use two days of price data, then the moving average will be influenced by the gap up. One trader I know didn't recognize these effects and lost money because of it.

Indicators lag price. Using our simple moving average as an example, what happened at the gap up to 20 minutes ago influences the current value of the moving average.

Chart patterns don't suffer this type of delay.

- Chart patterns do not lag price.

One of the things many traders find useful is that chart patterns give an estimate of where price might go (called the *measure rule*, which is based on the height of the pattern). Often the estimate serves as a minimum price move, not a maximum.

- The height of the chart patterns helps set a price target.

Disadvantages of Chart Patterns

Chart patterns have their flaws, too. You have to find the darn things! If you don't see a chart pattern until *after* the breakout, you may have sacrificed some profit when price zipped away from you. How many times have you pointed to a chart and said, "I should have bought right there."

- You have to find chart patterns to use them.
- If you are late finding a chart pattern, its usefulness declines.

You have to be patient with chart patterns. Yes, you can buy a stock at any time and get lucky when the stock cooperates and moves higher, breaking out upward from a chart pattern. But the stock could drop, too. Waiting for the breakout is often the smartest option, but it requires patience. Patience is an ingredient of many successful traders and investors. Do you have what it takes?

- Patience is required to wait for a buy signal.

A person I know puts the gas pedal to the floor whenever the stop light turns green. It's a metaphor for his impatience. He keeps asking if anyone can make money in the markets. Of course, anyone can, but he doesn't have the temperament for trading stocks. Do you?

Another drawback to chart patterns is that stop placement can be tricky. How so? Often price will breakout upward and then return (throwback) to the pattern. The breakout is still valid providing the stock doesn't close below the bottom of the pattern. If you sell when that happens, then you could suffer a substantial loss. That problem is easily rectified by using a closer stop, of course. Correct stop placement is an art that people must master for any trading technique. It's not specific to chart patterns.

- As with all trading techniques, stop placement can be tricky.

Imagine an unusually tall chart pattern, one that extends from the bottom of the screen to nearly the top. By the time you receive a buy signal, a substantial rise may already have occurred. That means you could be closer to the end of the uptrend than the beginning, limiting the upside potential. That's a problem easily fixed by looking for another pattern.

- Tall chart patterns may mean you are closer to the end of the trend than the beginning.

Finally, like other indicators in the stock market, chart patterns can fail. They issue a buy signal, but then price reverses and shoots off in the opposite direction.

- Chart patterns can fail.

What Does It Mean?

You may have noticed that the number of disadvantages outnumber the advantages. Don't let that worry you. The advantages say that you can make money trading chart patterns or use them to improve your trading with other methods. The disadvantages say that trading chart patterns isn't easy. In fact, it can be downright hard to make money consistently. But you can say that about any method.

You can't become a skilled brain surgeon overnight. Nor can you become an expert at trading chart patterns quickly. Both take experience and a dedication to the craft.

In the coming pages, we'll learn how to find chart patterns, what they mean, and how to profit from them.

- Don't expect to become rich overnight in the markets.

What We Learned

Here is a list of the major lessons discussed in this chapter.

- Chart patterns are recurring formations that appear on price charts. See "What Are Chart Patterns?"
- Use prior price action to help determine future price movement. See "Enter the Retail Investor."
- Chart patterns issue clear buy signals. See "Advantages of Chart Patterns."
- Chart patterns issue clear sell signals. See "Advantages of Chart Patterns."
- Chart patterns do not lag price. See "Advantages of Chart Patterns."
- The height of the chart patterns helps set a price target. See "Advantages of Chart Patterns."
- You have to find chart patterns to use them. See "Disadvantages of Chart Patterns."
- If you are late finding a chart pattern, its usefulness declines. See "Disadvantages of Chart Patterns."
- Patience is required to wait for a buy signal. See "Disadvantages of Chart Patterns."
- As with all trading techniques, stop placement can be tricky. See "Disadvantages of Chart Patterns."
- Tall chart patterns may mean you are closer to the end of the trend than the beginning. See "Disadvantages of Chart Patterns."
- Chart patterns can fail. See "Disadvantages of Chart Patterns."
- Don't expect to become rich overnight in the markets. See "What Does It Mean?"