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Chapter **1**

Understanding Charting and Where Candlesticks Fit In

The advent of the Internet has leveled the playing field for securities traders. Access to markets once meant placing orders by way of a broker; now it takes little more than a couple of mouse clicks. Commission rates are dramatically lower, and sometimes even free. Additionally, access to market information is free in many cases. Breaking into securities trading is easier than ever, and the result is that a whole generation of investors and traders handles their finances without professional help. Technology allows these people to enjoy many new types of market information, and one of the best tools available is candlestick charting.

Candlestick charting methods have been around for hundreds of years, but candlesticks have caught on over the past couple of decades or so as a charting standard in the United States. *Candlestick charts* allow for an easy way to visualize

market information, which has created a fierce loyalty among traders who use them. We think you'll feel the same way, and this book is the first step on your path to conquering candlesticks.

The material we spell out in this chapter exposes you to many of the facets of candlestick charting that continue to fuel its rise as one of the most popular charting techniques. We begin with the overall role of candlesticks within the context of charting. We cover the advantages of candlestick charting and the basics of candlestick construction. We also take the opportunity at the end of this chapter to discuss how to get started and then give you some insight into the characteristics and habits that successful traders employ in their pursuit of profits. Enjoy, and happy charting!

Considering Charting Methods and the Role of Candlesticks

With advances in technology and the growing availability of trading and investing resources available to traders, many options exist for the charting of securities. Several types of charts and dozens of variations and features can be configured for each type. It's important that you're clear on what other charting options are out there and — perhaps more important — on why candlestick charting is at the top of the heap. We provide answers to both questions.

Getting a feel for your options for charting

When it comes to alternatives to candlestick charting, these are the three main charting contenders:

- » **Line charts:** These charts are simple and helpful for short-term decisions, but they're quite limited when it comes to the amount of data presented.
- » **Bar charts:** These charts, the most common type, are much more useful than line charts, but they're not as versatile as candlestick charts.
- » **Point and figure charts (also known as P&F charts):** These tried-and-true charting methods are helpful for recognizing support and resistance levels, but they're far less dynamic than candlestick charts. These charts, discussed in Chapter 2, have been around since the 19th century as a way of tracking price movements. The Xs and Os were incorporated in the 1930s as a way of standardizing the price movement.

Each one of these charting methods can be used effectively to ratchet up the effectiveness of your trading strategy, but, for several reasons, they pale in comparison with candlestick charts, a few of which we describe in the next section.

Realizing the advantages of candlestick charting

You'd be hard-pressed to find people who are more enthusiastic about candlestick charting than we are. We can go on and on about the benefits that candlesticks afford. If you want to read more of our gushing about the many fantastic features of candlestick charting, turn to Chapter 2, but for now, here are our top three reasons:

- » **Two of the best features of candlestick charting in general are visual appeal and readability.** You can glance at a candlestick chart and quickly gain an understanding of what's going on with the price of a security. You can also tell whether sellers or buyers have dominated a given day and gain a sense of how the price is trending. This isn't easily seen in the other types of charting, such as line charts, bar charts, and point and figure charts.
- » **Even after reading up on the most rudimentary candlestick basics, you can easily spot on a candlestick chart the opening and closing price of a security.** These price levels can be vital areas of support and resistance from day to day, and knowing where they are can be extremely helpful, especially for short-term traders. Support and resistance are, in essence, the floor and ceiling of pricing: The level at which the price naturally doesn't fall below is the *support*; on the other hand, the price level at which the asset doesn't break through, like a glass ceiling, is the *resistance*. Asset prices can, of course, break through either the support or resistance level; they usually don't, however.
- » Candlesticks aren't just pretty faces — candlestick charts also feature specific patterns you can identify and use to determine when it's time to buy, sell, or wait on a trade or an investment. These patterns can be a true boon to your work with securities, and you can combine them with other technical and economic indicators for even more reliable results.



REMEMBER

Differentiating Candlestick Components

You can't trade and invest effectively by using candlestick charts unless you understand candlestick patterns, and you may have difficulty understanding those patterns if you aren't familiar with basic candlestick construction. Candlestick

charting starts with the knowledge of what it takes to make a candlestick and how changes in that basic information affect a candlestick's appearance and what it means. For starters, you need to know what goes into creating a candlestick's *wick* (the thin vertical line) and its *candle* (the thick part in the middle).

The following four pieces of information are combined to create a candlestick:



REMEMBER

» **Price on the open:** The price at which a security opens in a given period is the first piece of information used in creating a candlestick. Depending on whether the security's performance is bullish or bearish, the opening price corresponds to either the bottom edge of a candlestick's candle or its top edge.

Candlesticks that represent *bullish* price action appear white on a chart in this book, but green in many charting packages, and candlesticks that represent *bearish* price action appear black (or red, when color is available).

» **High price:** The highest price a security reaches during a given period corresponds to the top of a candlestick's wick. If a security opens at a certain price and then trades consistently lower than that price throughout the period, no wick appears above the candle.

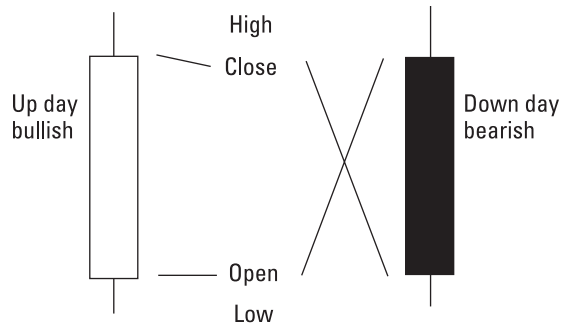
» **Low price:** The lowest price a security reaches during a period corresponds to the bottom of a candlestick's wick. If the price action for that period is extremely bullish and prices trade higher than the open, no wick appears below the candle.

» **Price on the close:** When a security finishes trading during a given period, its closing price is the last piece of information used to create a candlestick. Depending on the security's performance during that period, the closing price can correspond to either the top edge of a candlestick's candle (if the period was bullish) or the bottom edge (if the period was bearish).

As true candlestick devotees, we believe that you can gain far more insight into a period's trading by looking at a candlestick than you can by looking at any other type of charting tool. Want proof? Take a look at Figure 1-1.

You can tell right away that the up day has a white candle and the down day has a black candle. That simple difference alone clearly reveals the nature of the price action that took place during that period. In the case of the candlestick with the black candle, there was more selling pressure than desire to buy. And the candlestick with the white candle indicates that there was more buying pressure than desire to sell.

FIGURE 1-1:
Bullish
and bearish
candlesticks,
side by side.



Why are these details important? Candlestick charts quickly clue you in on the type of buying and selling that has been going on during a given period and where it may occur again. In many cases, the buyers continue to buy and the sellers continue to sell during subsequent periods or when the price reaches a level that spurred them to action in the past. This activity describes momentum or trends, which is a large part of short-term trading.

For more information on candlestick construction, see Chapter 3.

Working with Candlestick Patterns

The components of a candlestick may form the bones of candlestick charting, but candlestick patterns are its heart and soul. Patterns appear on candlestick charts as simple, single-stick occurrences or complex, multistick formations, and many types of patterns can tell you what may be in store for a security you've had your eye on for trading or investing. Knowing what may lie ahead can mean the difference between a profitable trade and a flop.



REMEMBER

Candlestick patterns indicate when prevailing trends reverse or continue. Both types of patterns are quite useful because they tell you when to jump into a trade, when to jump out of a trade, when a trade you're in may make no sense, and even when to hang on to a trade you're already in. Check out Parts 2 and 3 of this book for more info on identifying and trading on a wide variety of candlestick patterns.

Simple patterns

Some candlestick patterns are simple: A single candlestick on a chart can serve as a candlestick pattern. A single candlestick that signifies time to buy or sell is appealing to traders who are just starting to work with candlestick charts because, after you understand the basics of candlestick construction, you can immediately

start identifying simple patterns and using them to make more-informed trading decisions. Turn to Chapters 5 and 6 for several useful examples of how just one candlestick can tell you what a security's price will do in the immediate future.

We also consider double-stick candlestick patterns as simple patterns, and you can explore several varieties in Chapters 7 and 8.

Complex patterns

When a candlestick pattern includes three periods' worth of price action (three candlesticks), we consider it to be a *complex* pattern. Many complex candlestick patterns require specific price activity over the course of three days for the pattern to be considered valid, and we discuss a range of them in Part 3.

Complex candlestick patterns can be frustrating at times because you may watch with anticipation as a pattern develops nicely for the first two days, only to fizzle out on the third. With all trading, patience is the key.



REMEMBER

Complex candlestick patterns are rarer than their simple counterparts, but they can be worth the wait. Because the conditions and criteria for a complex pattern are so specific, it's more likely that the signals they offer will be good ones.

Making Technical Analysis Part of Your Candlestick Charting Strategy

A stunning amount of mathematical ingenuity is applied to security-trading analysis. The options for technical analysis can be as simple as the average of a few days of closing prices and as complex as applying calculus to price action to indicate the momentum of prices. The possibilities are endless, and you shouldn't be shy about including some of them in your trading strategy alongside candlestick charts.



TIP

Take the time to get familiar with an array of technical indicators to make yourself a versatile trader and enrich your work with candlestick charts. It's helpful when you spot a candlestick pattern indicating that it's time to buy while your favorite technical indicator is also flashing a buy signal. Combining trading tools helps build your confidence and can help you determine quickly when a trade won't work out, allowing you to exit with minimal losses.

We explore several types of technical and economic indicators in Chapter 11 and clue you in on a few ways you can combine these indicators with candlestick patterns in Chapters 11–15. Find a few technical indicators that match up with the type of trading you want to pursue, and add them to your candlestick charts. Read up on the choices, and if Chapter 11 doesn't hold enough information, you can always turn to *Technical Analysis For Dummies*, 4th Edition, by Barbara Rockefeller (Wiley). Added understanding of technical and economic indicators can truly aid you in your candlestick charting efforts.

Trading Wisely: What You Must Know Before Working the Markets

Security trading and investing can be a financially rewarding and fulfilling experience, but it's far from a risk- and stress-free undertaking. We want to make clear to you a few key points and concerns before we dive into our candlestick charting discussion so that you're fully aware of what you're up against and what you can do to maximize rewards and minimize risks.

Trading can be an expensive endeavor

There's money to be made on the security markets, but don't be fooled into thinking that earning profits is easy or effortless. Do your homework, and practice wise money management.



TIP

By “do your homework,” we mean look at charts and develop a trading plan. The more you prepare (much as you would for a test), the better your trading results should be. We've seen a direct correlation between the level of trading success we've achieved and how much time we put into preparing for trading situations. As far as wise money management goes, the key is making sure to take a loss when it becomes apparent that a trade won't work. Take the loss and move on. More importantly, take this loss early and quickly before it becomes a much bigger loss. As the old Wall Street saying goes, “Your first loss is often your best loss.”



WARNING

Here's the most important rule for managing your trading and investing funds: Do not risk money you can't afford to lose. The financial markets have many obvious and unforeseen risks. If your lifestyle has changed dramatically because a trade or an investment wiped out your account, you have probably put too much of your personal net worth on the line.

Paper trading costs you nothing but time

Paper trading refers to the practice of tracking trades on paper that haven't been traded in an account. Professional traders tell you that paper trading isn't the same as putting real money at risk on the markets. As professional traders, we totally agree. The emotional roller coaster involved with making and losing money can't be matched in a dry run. But if you're a novice who's just starting to understand the ways of the market, we think that paper trading is a useful idea. The risks are nil, and the educational benefits are outstanding. We still tend to paper-trade new ideas or systems for a while before putting real-life money to work.



TIP

If you try paper trading but lose interest because you have no skin in the game, make just a small trade in a live account. The size of your trade and the risk you're taking to try out a new strategy should be inconsequential relative to your net worth.



TIP

If you're new to trading, test your trading ideas and refine your trading strategy by signing up for a trial account online with an electronic broker. (You can read all about electronic trading resources in Chapter 4.) All you stand to lose is a little time and some pride. But that's better than jumping directly into a live trading scenario and getting taken to the cleaners!

Develop rules, and stick to them

Throughout this book, we stress the importance of setting rules for yourself and sticking to those rules. We just can't stress enough what a good practice that is for any trader. Making and losing money on the market is an *emotional* experience. One main reason that some traders lose big when they should lose (or even win) just a little is that they let their emotions take control of their trading. You can take emotions out of the equation if you develop trading rules and adhere to them no matter what happens.

Create a set of trading rules for yourself and stick to them. Include rules such as these:

- »» When to get into trades
- »» Where to place stops in various trading situations
- »» What amount of money to risk on trades and investments
- »» When to get out of trades, with either a loss or profit



TIP

Write down your rules and keep them handy for a quick review when you're in the midst of a trade and having second thoughts about what action to take. This strategy is imperative because it removes the emotional element from trading.

We've been trading for a long time, and we can say without reservation that creating and adhering to a set of trading rules is the best way to reward yourself, both personally and financially, for the effort you put into the markets. We *always* follow the rules we've set for ourselves, and although it may sound crazy, at this point we're prouder of our rules than we are of our profits. Every trader has to come up with their own set of rules that talk to their trading style and comfort with risk — you should keep that fact in mind and jot down potential rules as you explore the content of this book.

