CHAPTER 1

The OWL Ethos

Determining If the Methodology Is for You

One of the most fundamental axioms of trading and investing is that one should select and stick with a methodology that melds well with one's personal psychological makeup. A simple example might be that someone who has trouble sleeping at night when they are invested in stocks should not use an aggressive system that employs leverage or invests in securities that display a great deal of price volatility. From our perspective as O'Neil-style traders and investors, we find that our psychology and attitudinal approach to investing, our investing *ethos* as we called it, is best represented by what we now like to refer to as the *OWL ethos*. Why OWL, you ask? Because it represents the surname initials of three of the greatest traders of the last 100 years—William O'Neil, Richard Wyckoff, and Jesse Livermore. All three shared the same investing ethos, and their trading strategies and ideologies overlapped to a great degree. We discussed this close relationship between the investment methods and philosophy of all three of these gentlemen in Chapter 1, "The Evolution of Excellence," in our first book.

Success with OWL-based methodologies lies in the degree to which one's psychological makeup and concomitant approach to stock market investing can exist in fluid harmony and synergy with the OWL approach. Thus investors interested in learning our general methodology need to ask themselves whether the OWL is really for them. "Know thyself" is one of the central tenets of investing as we see it, and the following quiz and chart exercises will help reveal where your instinctive sensibilities lie.

QUICK QUIZ

Answer the following questions as quickly as possible.

1. **The O'Neil methodology is most consistently derived and/or similar to the investment philosophies and writings of:**
   a. Benjamin Graham
   b. Jim Cramer
   c. Richard D. Wyckoff
   d. Joseph Kennedy, Sr.
   e. Jesse Livermore
   f. Milton Friedman
   g. Bernard Baruch
   h. A and F
   i. B and C
   j. C and E
   k. C, E, and G
2. **Nicholas Darvas implemented the original use of a technical guidepost, which he used to determine whether any stock he owned or was considering for purchase was acting "correctly." This technical guidepost embodied a concept that correlates to today's technical concept of a chart base or consolidation. Darvas referred to these guideposts as:**
   a. Windows
   b. Chutes
   c. Rivers
   d. Boxes
   e. Ladders
   f. Stair-steps
   g. A and D
   h. D and F
3. **When a stock is purchased, and then begins to decline in price, the market is telling you:**
   a. To buy more.
   b. Your original reasons and decision for buying the stock may be incorrect.
   c. That your stock must now become a long-term hold since the price will inevitably come back to and above your original purchase price.
   d. That it may be necessary to sell the stock and cut your loss short.

- **e.** To go away, leave things alone, and stop watching your stock decline because it will simply "scare" you out of the position.
- **f.** A and C.
- **i.** B and D.

4. Investment success can best be achieved by:

- **a.** Making stock market investing your primary hobby.
- **b.** Buying stocks with low P/E ratios.
- **c.** Having a sound plan and methodology that eliminate the emotions of investing.
- **d.** Following news developments and how they might affect individual stocks and the general market.
- **e.** Devoting sufficient time for proper study and preparation in order to develop the necessary expertise for understanding stock market movements.
- **f.** C and E.
- **g.** B and F.

5. Investors should approach the task of buying stocks for the purpose of capital appreciation as:

- **a.** A shopping expedition, seeking to buy stocks when they are the cheapest.
- **b.** A hobby, whereby one dabbles in the markets and thus avoids the stress of getting overly involved.
- **c.** A business that is purchasing raw materials at cost and developing those materials into high-demand products that can be sold at a price much greater than the cost, resulting in a profit to the business.
- **d.** A long-term proposition for which one must buy stocks and exercise patience before profits can be properly realized by maintaining a fixed portfolio of stocks over many years.
- **e.** A way to become popular with the opposite sex.

6. Investment success depends on being right:

- **a.** All of the time.
- **b.** Roughly 50 percent of the time.
- **c.** As often as possible.
- **d.** Two out of three times or better.
- **e.** None of the above.

7. Jesse Livermore always abided by a strict stop-loss rule of:

- **a.** 12 percent
- **b.** 7–8 percent
- **c.** 10 percent

8. William J. O'Neil recommends cutting losses by:

a. Selling when your stock is down 12 percent from your purchase price.

b. Selling when your stock is down 7–8 percent from your purchase price.

c. Selling when your stock is down 10 percent from your purchase price.

d. Selling down to the sleeping point.

9. When it comes to taking profits and losses, it is best to:

a. Take your profits, not your losses.

b. Take your profits and wait for your losses to turn to profits.

c. Cut losses quickly and let profits run.

d. Keep profits to a minimum in order to avoid paying taxes.

e. Operate according to a general philosophy of keeping your losses as small as possible.

e. A and B

f. C and E

10. The OWL methodology is primarily:

a. A day-trading system.

b. A trend-following system.

c. A long-term strategic investment system.

d. A value-oriented investment system.

e. A fully invested strategy that does not attempt to time the market.

11. The OWL methodology is:

a. A symmetric strategy.

b. An asymmetric strategy.

12. Jesse Livermore said that the "uncommon man" is one who can:

a. Be right trade after trade after trade.

b. Sit through huge drawdowns.

c. Sit tight and be right.

d. Read the meaning behind every twist and turn of the market tape.

13. The difference between a pivot point and a pivotal point is:

a. Two letters, "a" and "l."

b. One is viewed in real time, the other in postanalysis.

c. One is limited to an upside breakout, the other to a significant price/volume signal that indicates a potential strong price movement in one direction or another.

14. In Livermore's day, the early 1900s, he understood that "pools" of large investors working in concert were a primary driving force in the markets.

Choose any or all of the following that could be considered today's counterparts to the "pools" of Livermore's time:

a. Pension funds

b. Investment clubs

c. Ponzi schemes

d. Mutual funds

e. Hedge funds

f. Company insiders

g. Banks

h. Trusts

i Insurance companies

j. Financial cable TV

15. Concentrating in fewer stocks rather than being spread out among a large number of securities, but determining the exact position you should use, should be based upon:

a. Your personal risk tolerance levels, keeping in mind that holding too many positions (e.g., average position size is less than 10 percent) may be a hedge for ignorance and thus result in inferior returns.

b. The strength of the stock and the general market.

c. How far your sell stop is from the buy point.

d. All of the above.

16. Institutional sponsorship is an important factor for any stock because:

a. It represents where all investors are putting their money.

b. Institutions will support their stock when it falls to a certain price, which is how chart bases and consolidations are created.

c. Such a consistent and large flow of funds into a stock can make it move up severalfold in price over time.

d. A and C

e. B and C

17. Listening to tips and headline news can result in losses because:

a. The tip sounds good yet in reality it may be outside your particular trading discipline and strategy and hence outside of your trading psychology.

b. The tip sounds good but is just a false rumor.

c. Tips usually turn out to be false, but if you take one tip thinking it is true and you end up making money on it, you may be more likely to take tips given to you in the future.

- **d.** Headline news usually has a tendency to exaggerate the pros or cons of a particular event, and such sensationalism can either prematurely scare you out of the market or a stock or prematurely goad you into the market or a particular stock.
- **e.** Headline news and stock tips can take your focus off your trading strategy.
- **f.** All of the above.

18. Overtrading can be prevented by:

- **a.** Taking your eye off the markets.
- **b.** Putting your focus and attention elsewhere.
- **c.** Exercising patience and waiting for the right setups, either short or long, while ignoring and choosing not to participate when the setups are merely just good enough.

19. Even though trying to predict where the market is going to go is tempting, it is a losing strategy because:

- **a.** While there is satisfaction in "out-thinking" the market, there are many variables that can change between now and the future that can throw off your prediction.
- **b.** While there is false comfort in thinking you know where the market is headed, there is danger in becoming wedded to your prediction. This results in rigidity and causes you to overlook or have a bias against objective, real-time market information that may be contradicting your original prediction.
- **c.** For a trader, the future does not exist, only the present, so it is best to focus on what the market is telling you now, today, and position your size accordingly, rather than think you can tell the market where it is going to go in the future.
- **d.** All of the above.

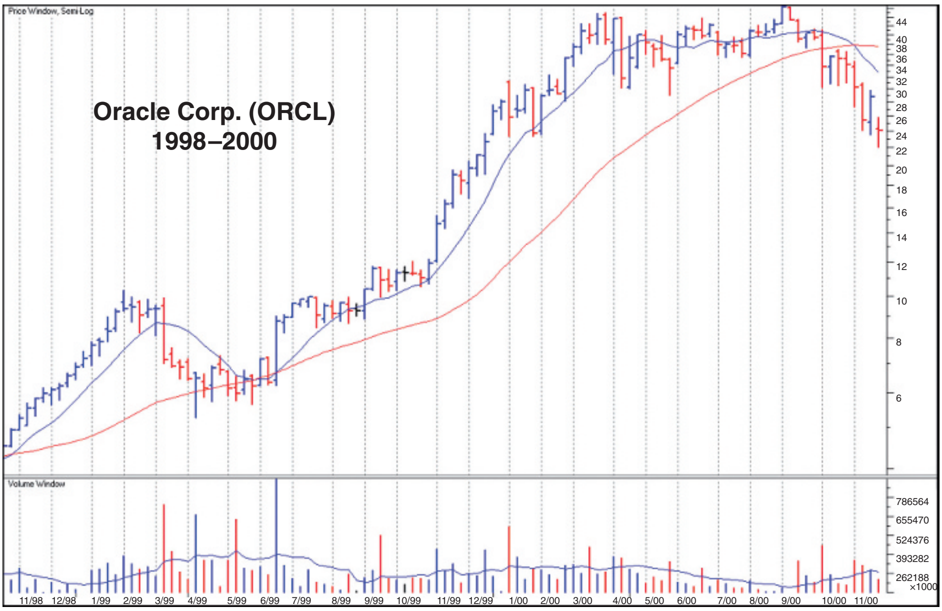
20. The "big stock theory" has to do with:

- **a.** The idea that one should seek to invest in those stocks that are on the cutting edge of economic developments in any given market cycle.
- **b.** The idea that one should seek to invest only in the largest capitalization stocks.
- **c.** The idea that one should seek to invest in those stocks that are "must own" situations for large institutional investors.
- **d.** The idea that one should seek to invest in "the leading issues of the day."
- **e.** The idea that one should seek to avoid investing in smaller, more innovative companies.
- **f.** A, B, and E
- **g.** A, C, and D
- **h.** B, D, and E
- **i.** All of the above.

CHART EXERCISES

Identifying Bases

In the following charts, circle the areas that you think represent Darvas boxes and the areas that you think represent O'Neil-style bases. Draw a square or rectangle around those that you think represent both.



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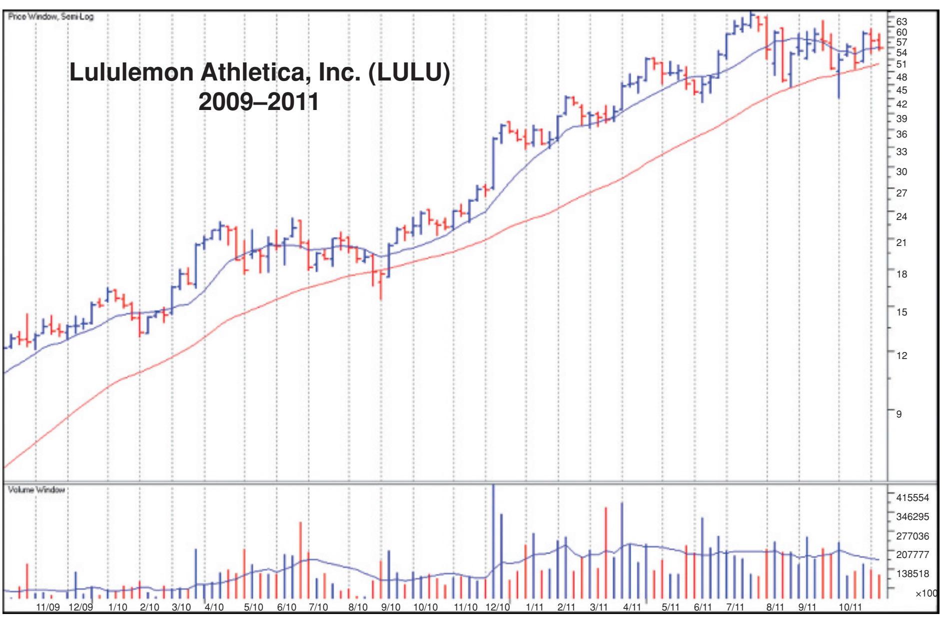

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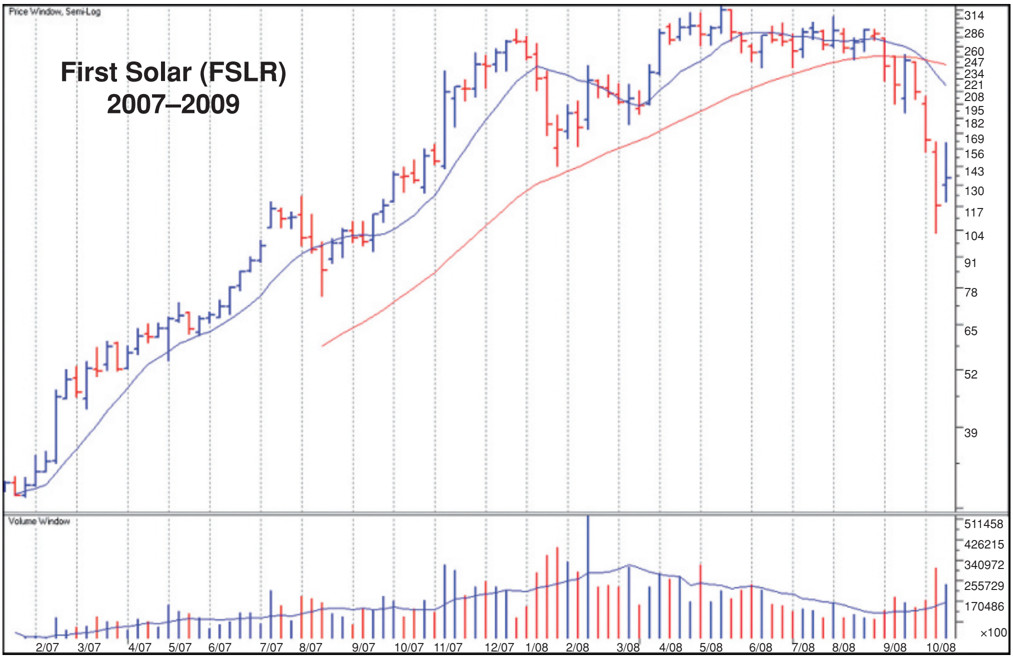

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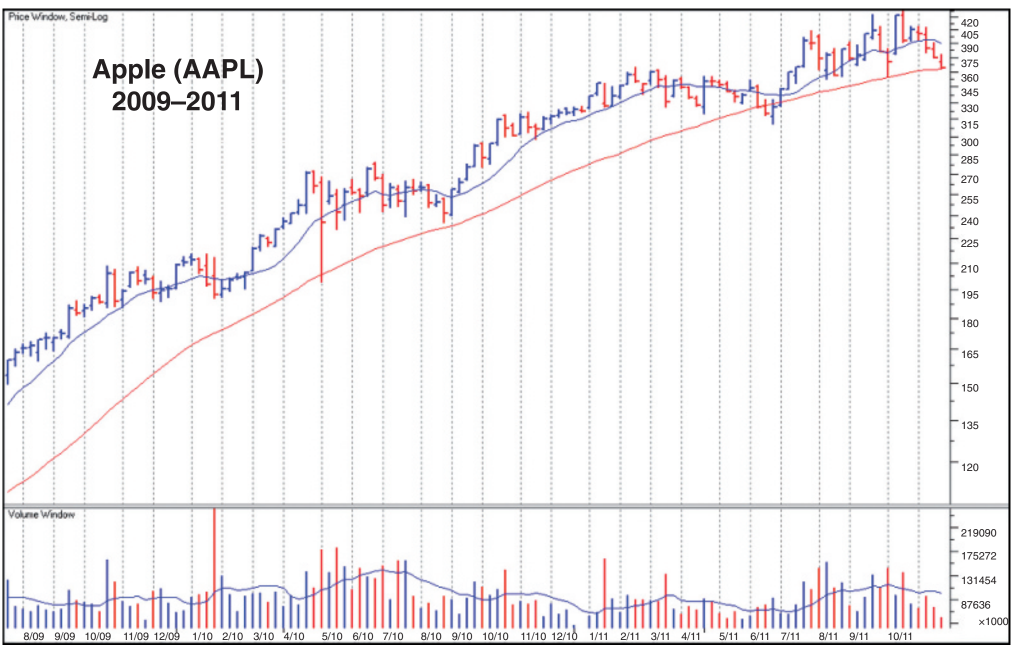

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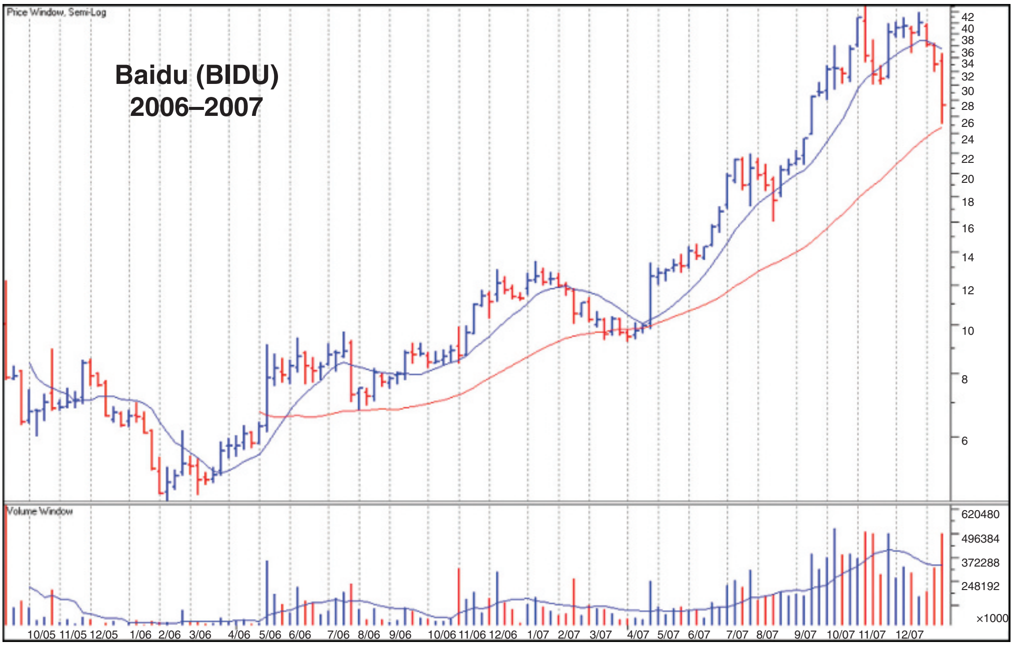

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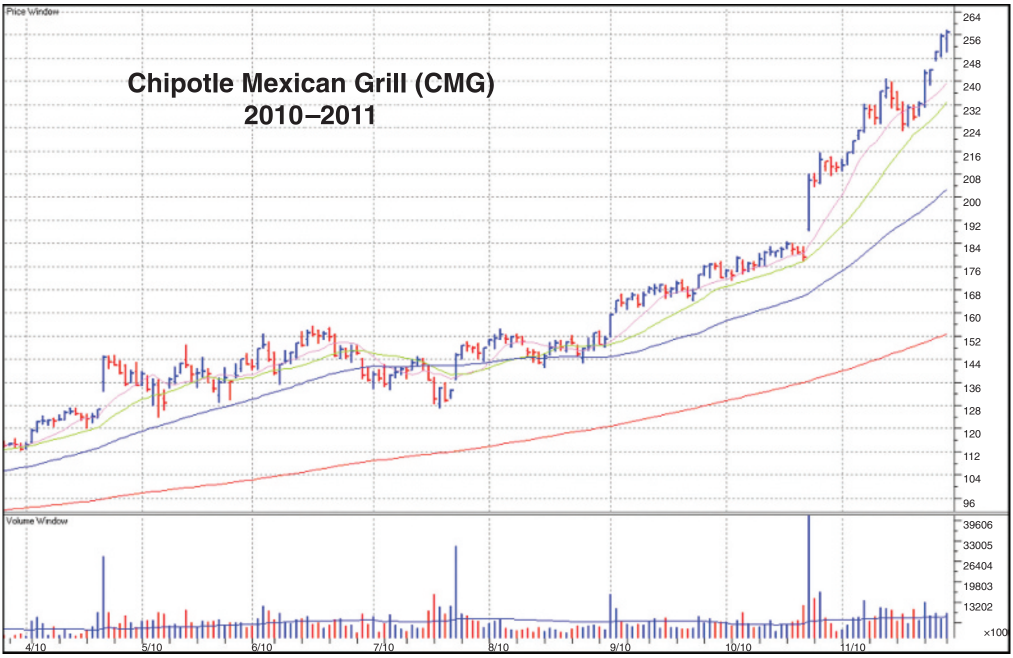
The Line of Least Resistance

An important aspect of O'Neil- and Livermore-style investing is to capitalize on impending rapid price moves. Jesse Livermore referred to the point at which a major and very sharp upside or downside price move in an individual stock occurred as the line of least resistance. Once a stock had pierced such a line, it was considered to have achieved a pivotal point. The ethos of the OWL focuses on locating and getting positioned for such movements in stocks, and its emphasis on the biggest winning stocks in any market cycle helps to keep one's focus on those stock that have the best potential for rapid upside price action. In the following charts, draw where you think the lines of least resistance are located in relation to the price action and trends seen on the charts.



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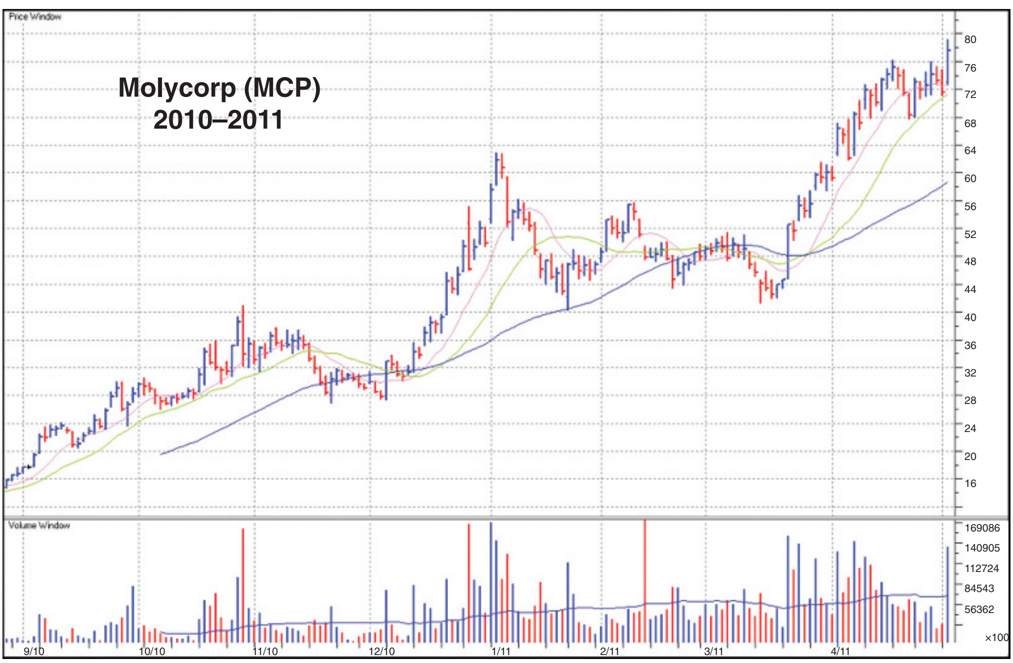

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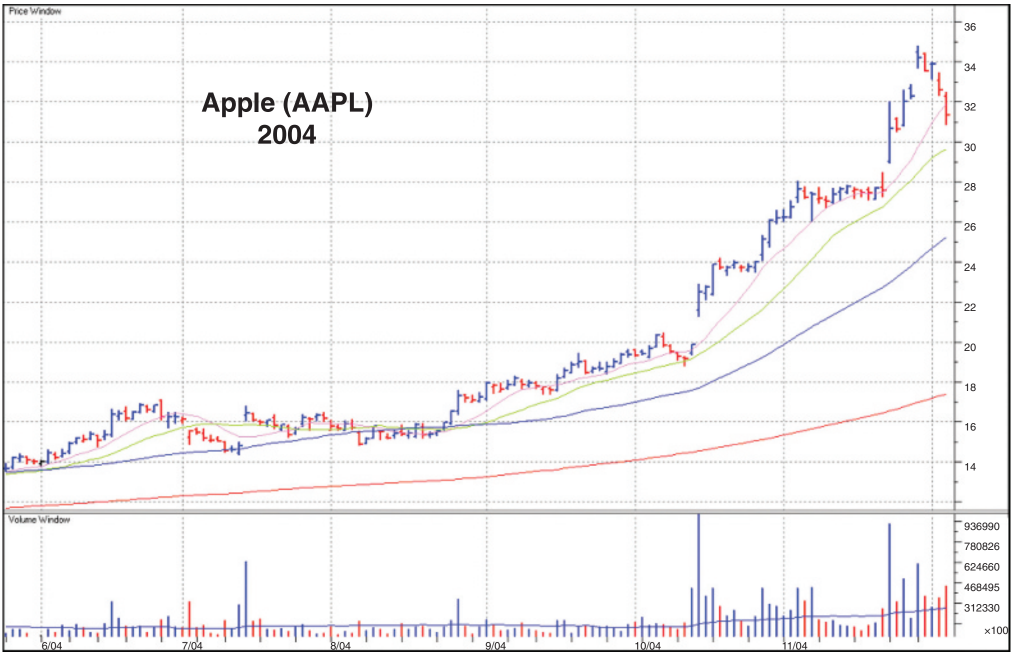

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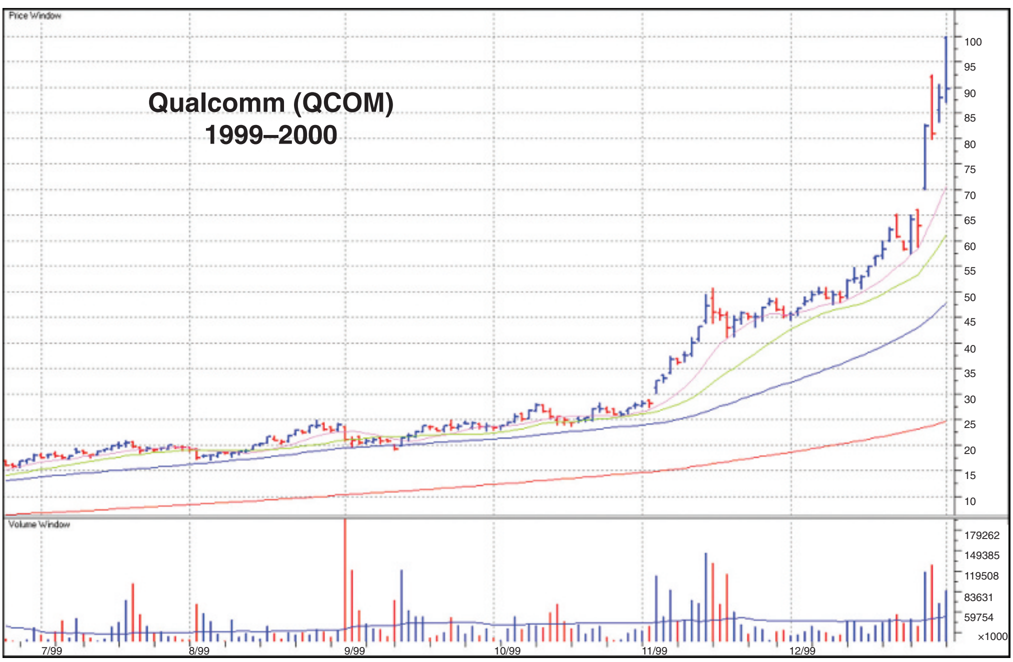

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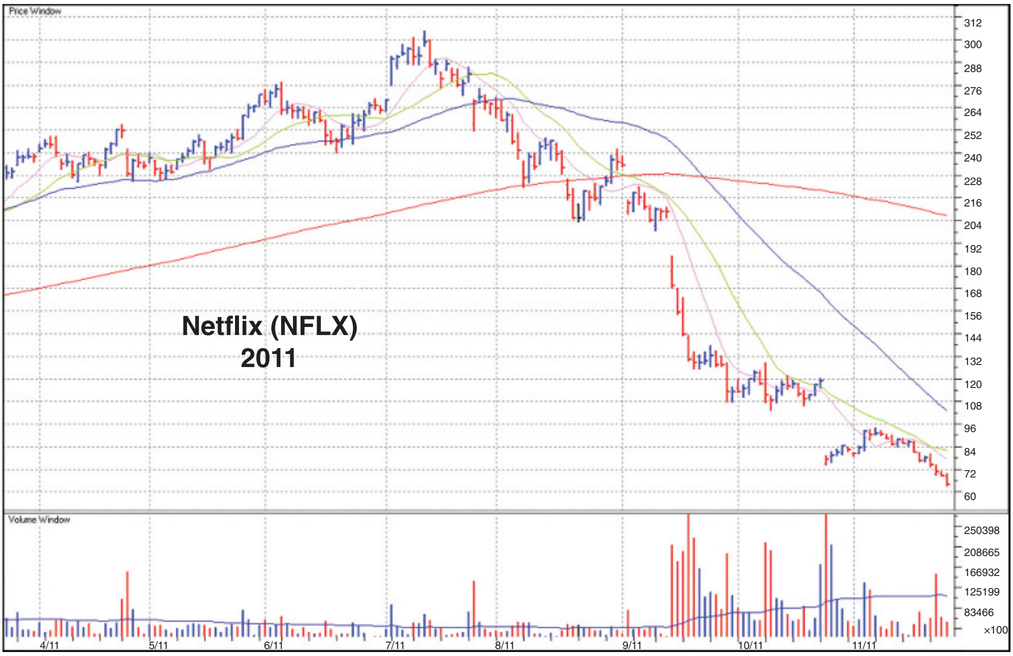

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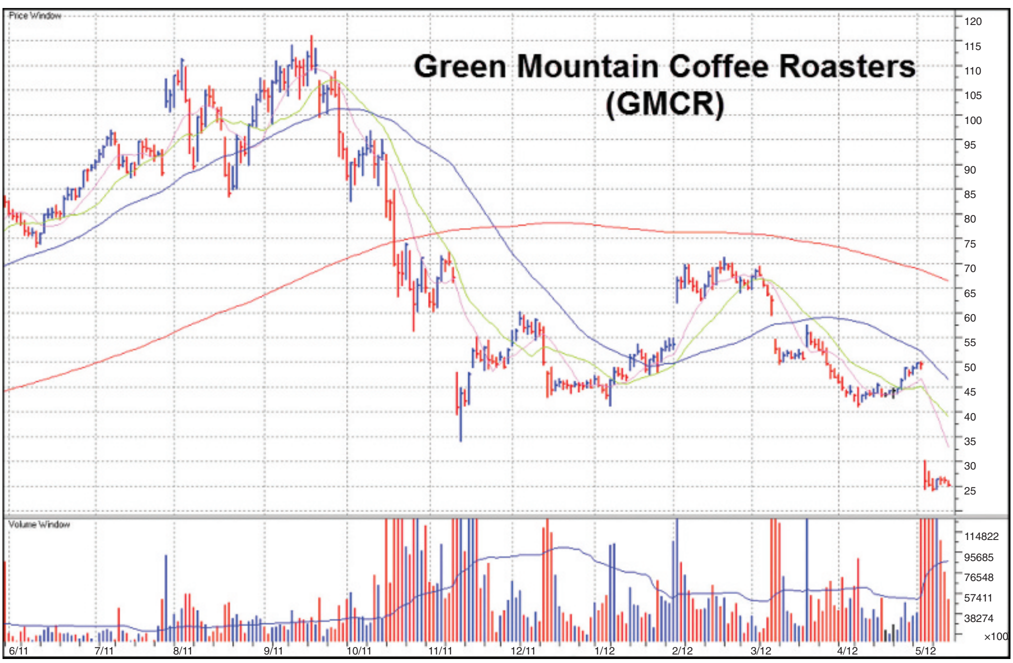

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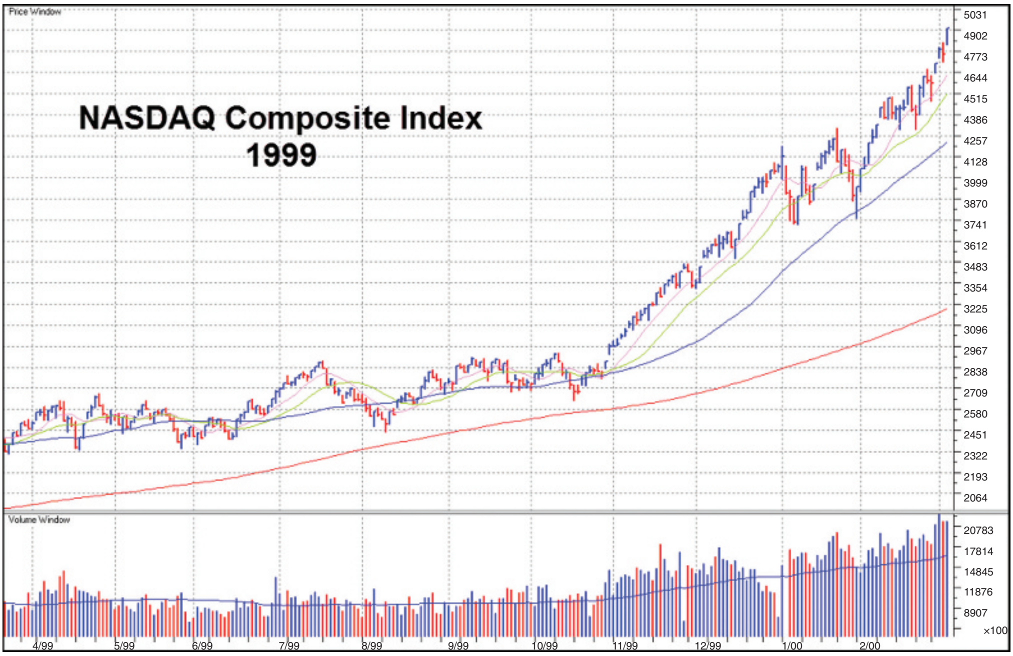

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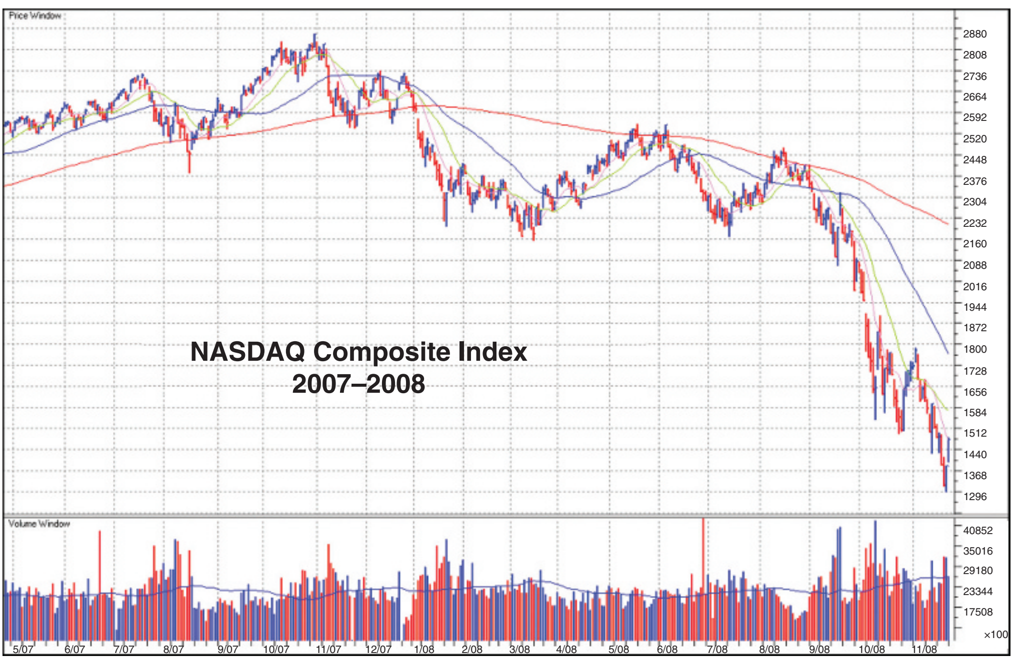

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ANSWERS TO QUICK QUIZ

1. Answer: (j) C and E. The O'Neil methodology is most consistently derived from and/or similar to the investment philosophies and writings of Richard D. Wyckoff and Jesse Livermore. As we wrote in the original *Trade Like an O'Neil Disciple*, it is our view that much of O'Neil's work, based on the written record as well as our own tenures working side-by-side with the man while managing money for his firm, derives from the general, often commonsense philosophies, strategies, trading rules, and discipline of Jesse Livermore.

Livermore's trading ethos as well as his trading career were first chronicled and documented by one of the market's first technically oriented chartists, Richard D. Wyckoff, publisher of the original *Magazine of Wall Street*. Underlying the writings and discussions of all three is a common thread with respect to their basic psychological approach to the market, hence the acronym OWL (**O**'Neil-**W**yckoff-**L**ivermore.) Much of the OWL ethos is rooted in ideas that are, quite simply, in contradiction to many widely held myths and false notions about how the stock market really works. Even today, many of these myths and notions are promulgated and reinforced by the financial media and academia. The essence of OWL is that the quest to understand the market based on the facts on the ground, to use a military phrase, is paramount, and that the market provides a ready feedback mechanism for accessing these facts in real time. Our own market methods and research build upon the commonsense principles and observations of these three market wizards: O'Neil, Wyckoff, and Livermore.

2. Answer: (d) Boxes. Nicholas Darvas implemented the original use of a technical guidepost, which he used to determine whether any stock he owned or was considering for purchase was acting "correctly." This technical guidepost embodied a concept that correlates to today's technical concept of a chart base or consolidation. Darvas referred to these guideposts as boxes. While Darvas found boxes useful for his purposes, in practice they are far too rudimentary. O'Neil discovered that there is much more to the market than simple boxes. From ascending bases to cups-with-handles, O'Neil identified far more patterns that served as constructive consolidations from which stocks often launched on mind-blowing upside price runs.

3. Answer: (g) B and D. When a stock is purchased, and then begins to decline in price, the market is telling you that your original reasons for buying the stock may be incorrect, and that it may be necessary to sell the stock and cut your losses. Remember that the OWL ethos seeks to understand and utilize the market as an informational feedback system. The best indicator of whether your decision to purchase shares of a particular stock was a correct one is quite simply whether it goes up from your purchase price or down from your purchase price, end of story. If you cannot heed that kind of obvious market feedback, then you cannot understand how to use OWL methodologies.

4. Answer: (g) B and F. Investment success can best be achieved by having a sound methodology that eliminates the emotions of investing and devotes sufficient time for proper study in order to develop the necessary expertise for understanding stock market movements. If you aren't willing to roll up your sleeves and get a little dirty, seeking instead a simple or easy way to make money in stocks, then failure is your most likely outcome. In fact, investing in the stock market without doing the requisite preparation and having a sound game plan is a one-way road to disaster.

5. Answer: (c). Investors should approach the task of buying stocks for the purpose of capital appreciation like a business that is purchasing raw materials at cost and developing those materials into high-demand products that will be sold at a price much greater than the cost. Investing is not a shopping spree. A stock that is lower in price is not the same as a new BMW that has been marked down $10,000. A stock only derives its utility from its ability to move higher in price, while a product like a BMW derives its utility from its function as a very stylish and performance-oriented mode of transportation, regardless of the price. Stocks are not cars, houses, clothing, watches, or other consumer items. A stock represents your "raw good" that as an investor you purchase for a specified price with the idea of eventually selling that stock at a higher price, in the same way that a clothing manufacturer takes the raw good of spun cloth that it purchases at one price and then turns it into apparel that it can sell at a higher price, that is, at a profit.

6. Answer: (e) None of the above. While it may surprise you how often you are right, your so-called *hit ratio* is simply not a factor in investment success. In 1995 Gil Morales was down over 30 percent after being wrong several times in a row. It was not until he finally found C-Cube Microsystems (CUBE) that he was able to make huge profits in excess of 500 percent, despite a hit ratio that was probably around 1 or 2 out of 10. One correct purchase in a winning stock that is then handled properly is often all that is needed to make big money, and those who follow the OWL methodologies generally understand this.

7. Answer: (c) 10 percent. Jesse Livermore always abided by a strict stop-loss rule of 10 percent. Richard Wyckoff also proposed such a rule. Why 10 percent? Our guess is that it represents nothing more or less than a convenient round number that serves as an "uncle" point where Livermore was not willing to tolerate any further pain of loss, period. It does, however, force you to listen to the market's message and cut the loss at a prescribed point once the market starts telling you that you are wrong and the stock begins trading down from your initial purchase price. It is not possible to survive in the stock market by taking an all-or-nothing approach whereby you never buy a stock with any idea where you will sell it if it starts going down. One must always operate with a clearly defined exit point, no matter what that is precisely.

8. Answer: (b). William J. O'Neil recommends cutting losses by selling when your stock is down 7–8 percent from your purchase price. Unlike Livermore's 10 percent rule, O'Neil's rule is derived from the fact that he advocates buying base breakouts, and he claims that his studies show that a future winning stock will rarely fall more than 7–8 percent below the buy point on the base breakout. The devil here, however, is in the details, since one can, according to O'Neil's rules, buy a pivot point up to 5 percent past the actual pivot point buy price. Thus, in practice, one could buy such a pivot point 5 percent higher and could be required to sit through as much as 13 percent of downside, if in fact O'Neil's studies are correct in that, statistically, winning stocks rarely pull back more than 7–8 percent from their *precise buy point*. This is why position sizing is another strong component of risk management that we like to employ. It is also why we like to use pocket pivot buy points within bases to sometimes gain an early start on a stock before it stages a typical O'Neil-style new-high base-breakout pivot point.

9. Answer: (g) C and E. When it comes to taking profits and losses, it is best to cut losses quickly and let profits run while operating in accordance with a general philosophy of keeping your losses as small as possible. This is the most basic principle of investing, but we are often amazed at how less-sound approaches are advocated by many considered in the know. For example, we recently heard a financial cable TV host admonish investors that they should "take your profits, not your losses." Translation: Take your small profits and let your losses run you into the ground! This does not strike us as a smart way to invest. The only way to make big money in the markets is to cut your losses quickly and let your profits run as long as they want to.

10. Answer: (b) A trend-following system. O'Neil, Wyckoff, and Livermore were all about playing the major bull and bear trends in the market and individual stocks. Going long in a bull market and short in a bear market when a strong trend exists is the way OWL investors make big money. Trendless markets are their bane, however, as stocks will often whipsaw back and forth in such a neutralized environment. The OWL's only defense in such an environment is to exercise patience and wait for the window of opportunity to open wide, while in the meantime avoiding getting sucked into the market's whipsaw movements.

11. Answer: (b). The OWL methodology is an asymmetric strategy. An asymmetric strategy is one that does not follow the market, hence is not symmetrical to the ups and downs of the general market over time. It seeks to make money whenever a trend can be identified and capitalized on. Thus in a bull market, an asymmetric strategy will seek to be long, while in a bear market it will seek to be short in order to make money while the market is going down—an asymmetric strategy that does not intend to go down with the ship when the market tanks.

12. Answer: (c). Jesse Livermore said that the uncommon man is one who can "sit tight and be right." No doubt that someone who can be right time after time after time might be uncommon, but as we know, it is not necessary to be right all the time in order to achieve success in the stock market. The OWL methodology is a trend-following methodology, and one must have the ability to ride the trend for as long as it continues—the essence of being right and sitting tight.

13. Answer: (c). The difference between a pivot point and a pivotal point is that one is limited to an upside breakout, the other to a significant price/volume signal that indicates a potential strong price movement in one direction or another. O'Neil has his pivot point, the breakout point near the peak of a stock's chart base where the stock either makes a new high or is very close to doing so, but Livermore was much broader in his interpretation of buy points, often referring to them as pivotal points. In our work we have merged the two to come up with other types of buy points, the pocket pivot buy point and the buyable gap move. In our view these have much in common with Livermore's concept of a pivotal point as a meaningful price/volume signal that provides a favorable and timely entry point, yet when used in conjunction with O'Neil-style pivot points or new-high breakouts, they become very potent arrows in the quiver of any stock trader.

14. Answer: (a), (d), (e), (g), (h), and (i). In Livermore's day he understood that pools of large investors working in concert were a primary driving force in the markets. In the modern investing world, these represent large sources of investable funds that are often mandated to be invested in stocks at all times. Thus they are often the big backstops behind stocks that at some point create the bottom of a base as well as the main source of money flows into a stock that drive its price ever higher. We would consider mutual funds and hedge funds to be the more active among the institutional investors listed here, while insurance companies, banks, pension funds, and trusts are often much slower animals in the institutional investment herd.

15. Answer: (d) All of the above. One should always be comfortable with one's position size. This comfort level is determined by risk tolerance levels, that is, the amount of drawdown that you can tolerate before emotions start to interfere in your trading, which can cause you to sell too soon or hold a position too long. Of course, you should know that if you prefer to hold many positions (> 20), then this style of investing may not be suitable to your style.

Answer (b) is also correct because the relative strength of a stock along with the general market are the greatest predictors of continued price success in a stock since strength tends to lead to more strength. The majority of stocks follow the direction of the general market. Of course, if a stock is having a climax top, one should plan an exit strategy.

Answer (c) is also correct since if your maximum loss, for example, on entering a position is 7–8%, and the stock is trading 10 percent above your exit point, you should either not buy the stock, or trade a smaller sized position.

16. Answer: (e) B and C. Sponsorship is an important factor for any stock because it represents where the largest investors, the institutional sponsors, are putting their money. We don't need to worry about all investors, just the biggest ones, and those are the institutional investors. Institutions will often support stocks they own when they fall to a certain price level, and it is their actions that create the bottoms of bases. Since most institutional investors tend to hold a good stock for three to five years, they represent a consistent, large flow of funds into a stock that can make it move up severalfold in price over time.

17. Answer: (f) All of the above. Let's consider each of these separately:

a. Even if a tip is right and the stock hits projected price levels, if the stock is outside your risk tolerance levels, you may end up not being able to hold the stock long enough to realize profits either because the stock is too volatile or because you take profits too soon.

b. Most tips are false rumors, so you may get a one-day surge in the price of a stock, only to see the stock fall back in price, causing you to sell at a loss.

c. If a tip works, you may become conditioned to think that tips work, but in reality, the odds of tips working are against an investor, so over time, you will probably net a loss.

d. March 2009 is the perfect example. Headline news was reporting the sky was falling, and since things looked about as bad as they had since the 1930s, many including your authors ran to either cash or the short side. It was a great learning experience that even in the worst of circumstances, you should follow your rules and, if you have one, follow your model.

e. The investment of a lifetime often comes around more often than you think, but the window of opportunity to capitalize on it may be just a day or two or less. If your attention is swallowed by headline news or market tips, you may miss the opportunity.

18. Answer: (c). Exercising patience and waiting for the right setups, either short or long, while ignoring and choosing not to participate when the setups are merely just good enough, is the best way to prevent overtrading. This, of course, requires experience to understand what makes a great investment or trade versus merely a good investment or trade; in other words, when the window of opportunity is wide open. Going through the exercises in this book should help you fine-tune your judgment in this regard. Ignoring the market is never a good idea, and while it may prevent overtrading, it may also prevent proper trading. This is because new opportunities and trends often present themselves when least expected, so always keep an eye on the markets even if you're in cash or have become disgusted with the market environment.

19. Answer: (d) All of the above. Even though trying to predict where the market is going to go is tempting, it is a losing strategy because:

a. Many traders have big egos. With big egos comes intellectual satisfaction in being able to predict where the market is headed. Don't fall into this trap. Big egos have been the downfall of many successful traders.

b. We are human beings and subject to emotional bias that supports our viewpoints. If you get too attached to your prediction and unwittingly become selectively biased toward your prediction, it will cost you money, since evasion of reality tends to be expensive.

c. What matters is today, now, the present. The market will tell you all you need to know to make wise market exposure and position-sizing decisions.

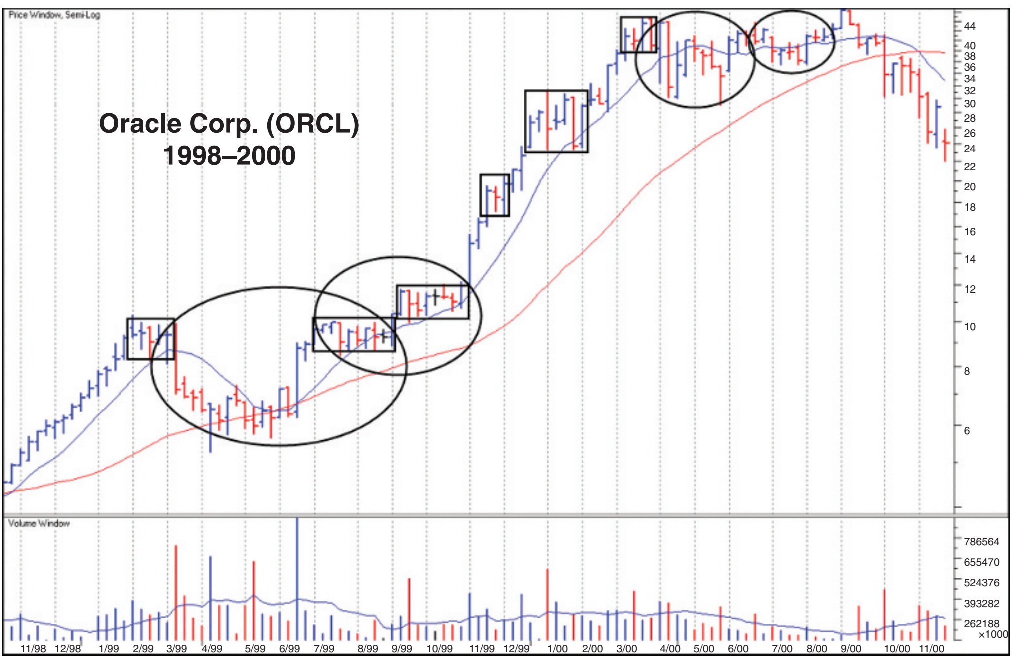
20. Answer: (e) A, C, and D. The "big stock theory" is a basic principle whereby one seeks to invest in those stocks that are on the cutting edge of economic developments in any given market cycle. Examples are Apple, Inc. (AAPL) since 2004, Walmart, Inc. in the 1980s, Cisco Systems, Inc. in the 1990s, and so on. Big stocks are not necessarily high-capitalization stocks, but because of their unique roles and positions as cutting-edge companies with the best products and management in any given economic and market cycle, they are "must own" situations for large institutional investors. Thus they become what Jesse Livermore and Richard Wyckoff would refer to as "the leading issues of the day" as institutional money steadily streams into them, driving their stock prices ever higher. They often start out as smaller, more innovative companies, so this is usually a fertile area in which to seek such future big stocks. Stocks like Crocs, Inc. (CROX) in 2007, Green Mountain Coffee (GMCR) in 2009–2011, and America Online (AOL) in

1998 began as small situations but had huge price runs as they gained a strong following among growth-oriented institutional investors.

ANSWERS TO CHART EXERCISES

Identifying Bases

Oracle Corp. (ORCL), 1998–2000. Moving from left to right we see a clear box, and then a big cup-with-handle formation where the handle is also another box. The stock forms another box on top of that handle box to form a base-on-base formation. The stock then moves up and forms another three-week box followed by two more boxes on the way up. This is followed by a circle double-bottom base and then a circled cup-with-handle. ORCL fails on this breakout in late 2000 and rolls over.



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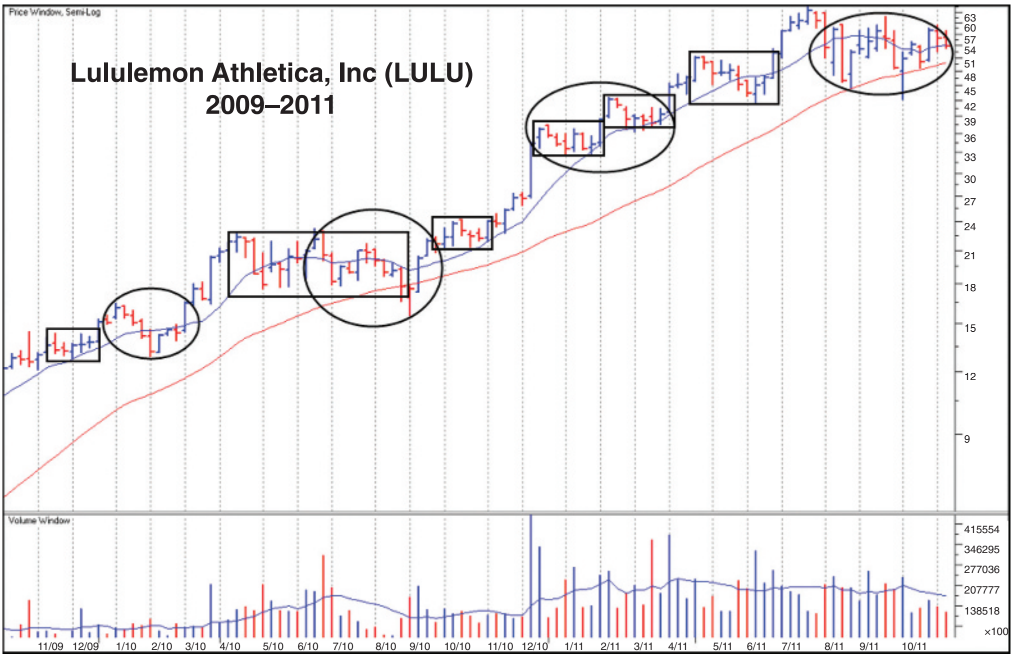
Lululemon Athletica, Inc. (LULU), 2009–2011. Moving from left to right we see one box, then circle an eight-week cup-with-handle formation with a one-week handle. The stock then moves in a large Darvas box, and the second half of this box is an O'Neil-style double-bottom base from which the stock breaks out. This is followed by another box, then two more boxes stacked on top of each other in stair-step fashion, but we also circle these two boxes since they constitute an O'Neil-style base-on-base formation. Another box, and then we circle a big double-bottom formation that the stock begins to roll over from.



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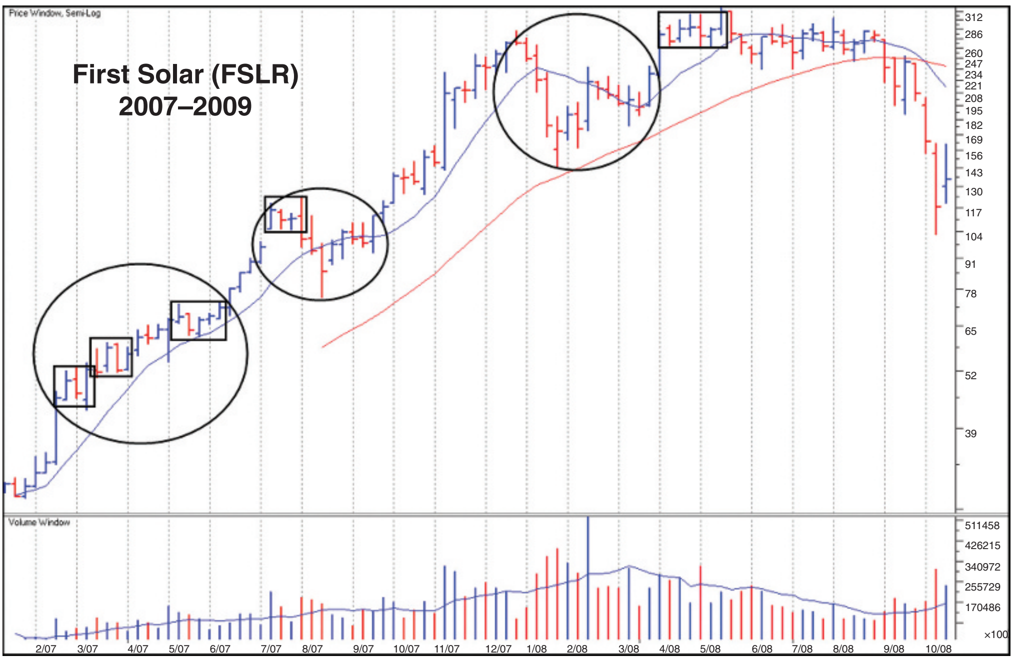
First Solar, Inc. (FSLR), 2007–2009. The first big circle on the left also encompasses three boxes in what is an O'Neil-style ascending base formation. The stock moves up and out of this ascending base and forms a little box before correcting and forming a circled cup-with-handle formation. The stock breaks out from there and continues higher, forming a defective cup-with-handle where the handle forms mostly in the lower half of the pattern. One final box is formed at the top, and FSLR tops.



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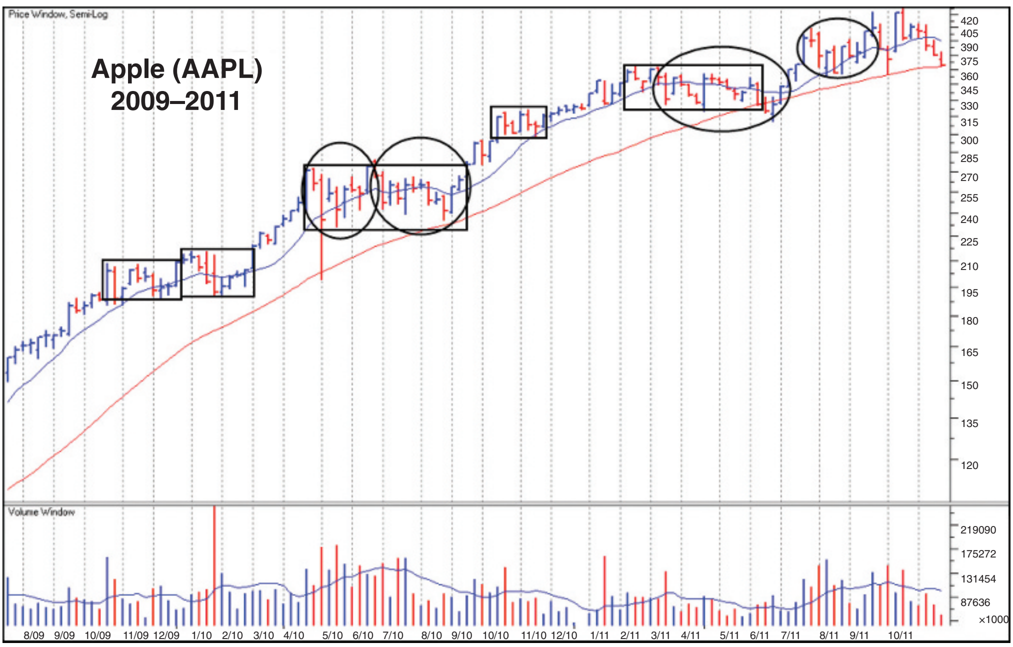
Apple, Inc. (AAPL) 2009–2011. The first decade of the new millennium was clearly the Apple decade, with the stock starting a big price run in 2004 that carried well into 2012. Apple's move off the market lows of March 2009 carried into October 2009, where we first pick it up in this chart. From here the stock formed two boxes before moving higher and forming a large rectangular box that had two O'Neil-style bases within it, the first a bizarre-looking cup-with-handle with the flash crash lows in the first week of May 2010, and the second a double-bottom formation from which the stock breaks out and moves higher before forming a short box. Now moving up to the 350 level, Apple forms a long rectangular box, the latter part of which also forms a big double-bottom type of formation from which the stock breaks out, forming one more cup-with-handle formation, and then starting to roll back down below the $400 price level.



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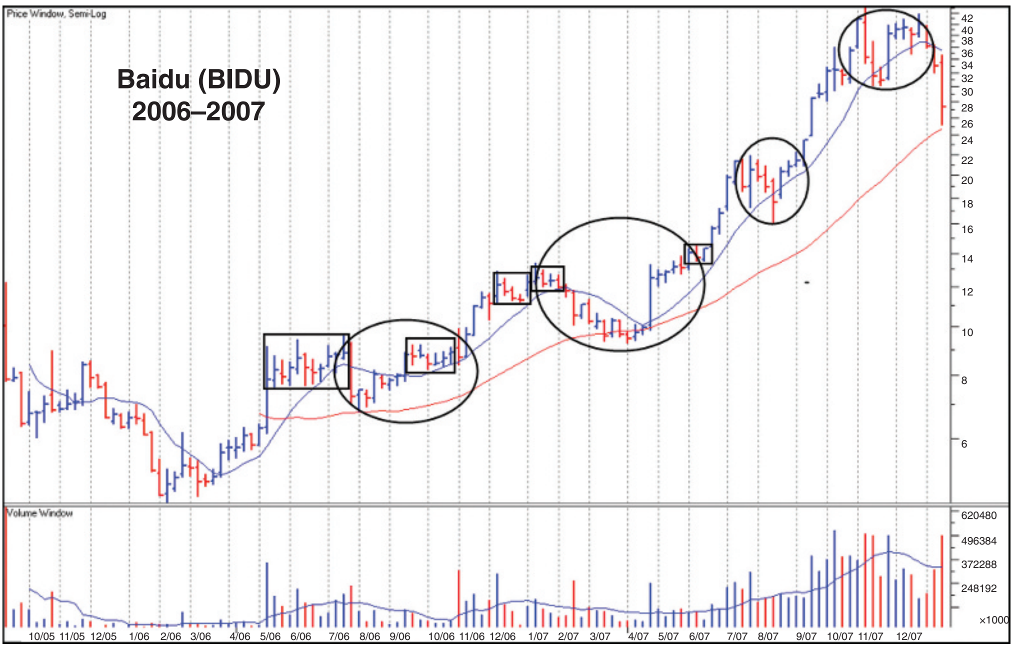
Baidu, Inc. (BIDU) 2006–2007. Despite being a red-hot IPO in the summer of 2005, BIDU took a long time to set up before it finally had a big price move in 2007. Once the stock bottoms in early 2006, it comes up and forms a box, then falls out of the bottom of the box before rallying to form another box, which is also the handle in a cup-with-handle formation that is circled. Two small boxes form before the stock pulls back again, forming a big cup-with-handle where the handle is high and only one-week in duration. The high handle is also a little box. The third circle from the left is a cup-with-handle formation where the handle only showed up on the daily chart but was five days in duration. The stock actually had a very sharp upside price move from this strange base. At the top, BIDU formed a very narrow, late-stage cup-with-handle before it rolled over.



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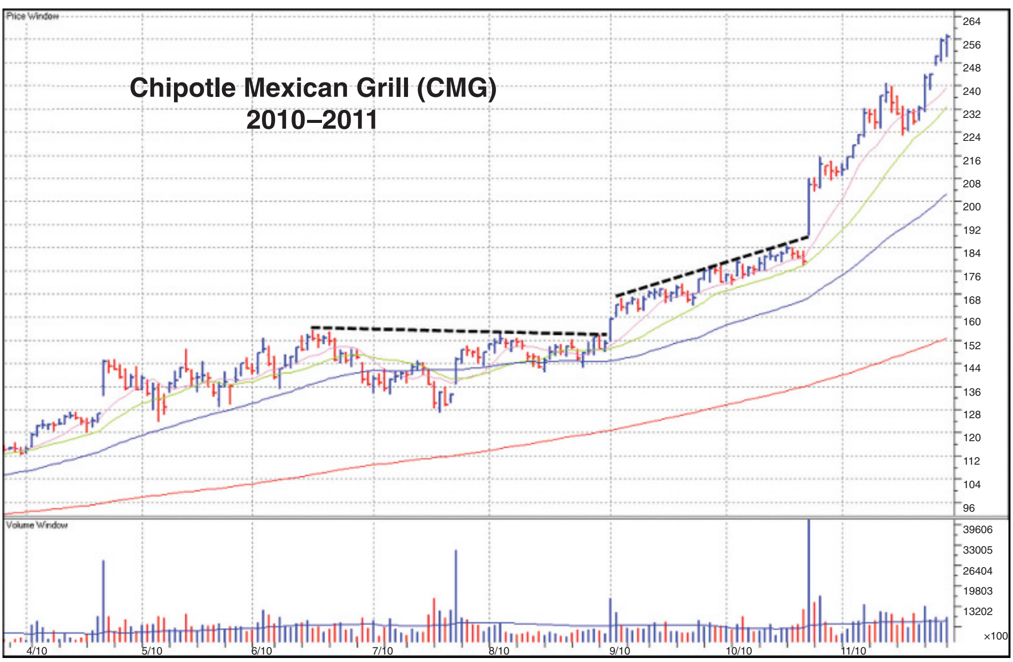
How well did the rectangles and circles you drew on the charts match up with the answers? Did you see more bases than those shown in the answers, or fewer? By doing this exercise you likely gained an appreciation for the interpretive aspects of understanding consolidations, which includes these animals known as bases and boxes. Also, when we try to label these bases and boxes we find that while we can apply a uniform label to, say, a cup-with-handle, these cups-with-handles don't always appear uniform when we begin to compare one to another. The BIDU example alone shows four different types of cups-with-handles in the price move that extended from mid-2006 well into the end of 2007.

What we have found is that it is not necessary to label bases in an attempt to make uniform that which in practice is not uniform. Rather than seeking to identify bases in order to determine "proper" breakouts from these bases, we prefer to use pocket pivot buy points and buyable gaps as critical tools that will get us into stocks even when the bases don't exactly lend themselves to uniform interpretation or labeling. It is not until you sit down and mark up charts, identifying all the bases, that you begin to make sense of the nonuniform flow of a stock as it moves up and consolidates, moves up and consolidates several times during a major price move.

The Line of Least Resistance

A big part of the OWL ethos is the idea of seeking to buy a stock not at the lowest price but at the right price. And the right price is the point from which a major price advance ensues. Buying a stock because it seems cheap does not guarantee that it will produce any upside performance for the investor, but buying a stock right, that is, at that point at which a major price advance is just beginning, does.

Chipotle Mexican Grill, Inc. (CMG), 2010–2011. The first line of resistance is broken when the stock emerges from a long cup-with-handle type of formation and then embarks on a long, slow upside move that remains contained within a well-defined trend channel as it plods higher. In the process, the top of the trend channel forms another line of least resistance that is broken decisively when the stock gaps up through the top of the channel, and its upside price move begins to accelerate dramatically. The move through the first line of least resistance was presaged by several pocket pivot buy points, and the move through the second line of least resistance was a buyable gap-up move that resulted in sharp upside gains over the next four to five weeks.



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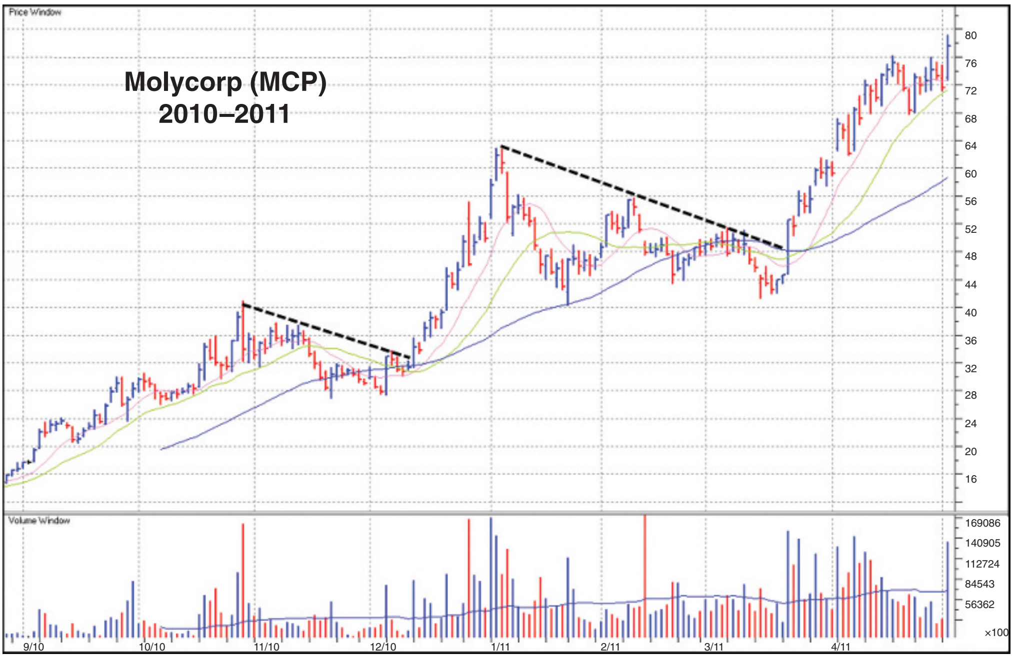
Molycorp, Inc. (MCP), 2010–2011. MCP has two breakouts through descending tops trend lines that each pierce the line of least resistance and initiate sharp upside price moves. The first trend line breakout was preceded by a pocket pivot buy point five days earlier, and the second trend line breakout was itself a pocket pivot buy point. In both cases, pocket pivots were present at or before the trend line breakouts that penetrated the line of least resistance and resulted in sharp, profitable upside price moves.



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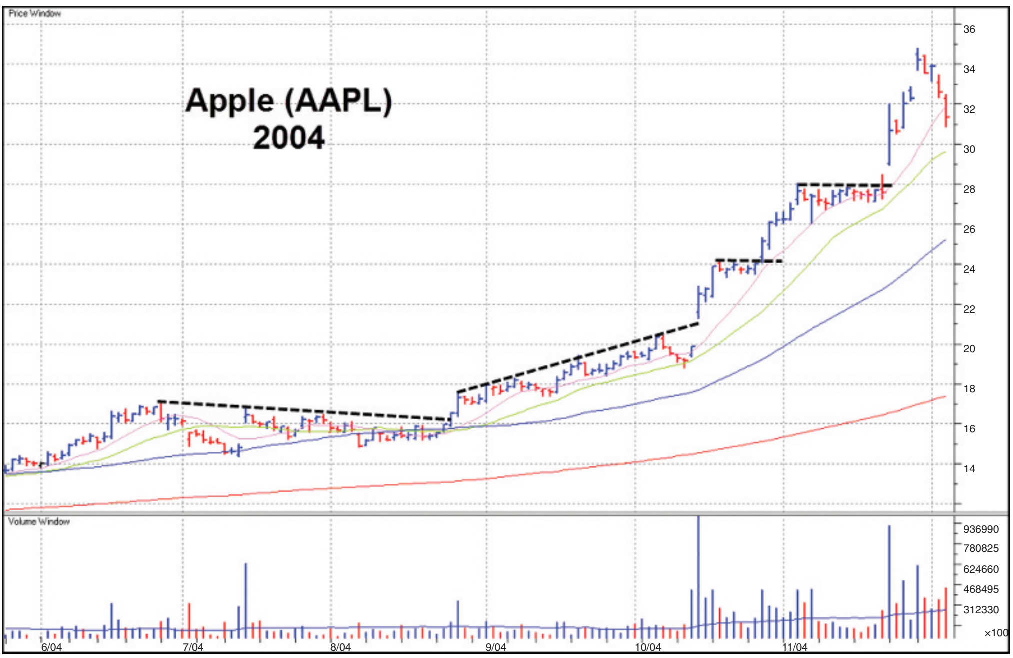
Apple, Inc. (AAPL) 2004. The first two penetrations of the line of least resistance in AAPL's pattern during 2004 are very similar to Chipotle Mexican Grill (CMG) in the first example, above, that was taken from 2010. Like CMG in 2010, AAPL broke out through the top of a cup-with-handle formation that constituted the first line of least resistance, and this breakout was followed by a slow ascension that formed an upside trend channel. AAPL gapped-up through the top of this trend channel and embarked on a very sharp upside price move for the remainder of 2004. This move was in fact a buyable gap-up, so using our rules for handling such buy signals would have allowed one to jump on the train early enough to catch the parabolic move into the end of 2004. Two further breakouts from short price consolidations constituted lesser moves through lines of least resistance, but conceptually they worked similarly in that each led to sharp upside gains..



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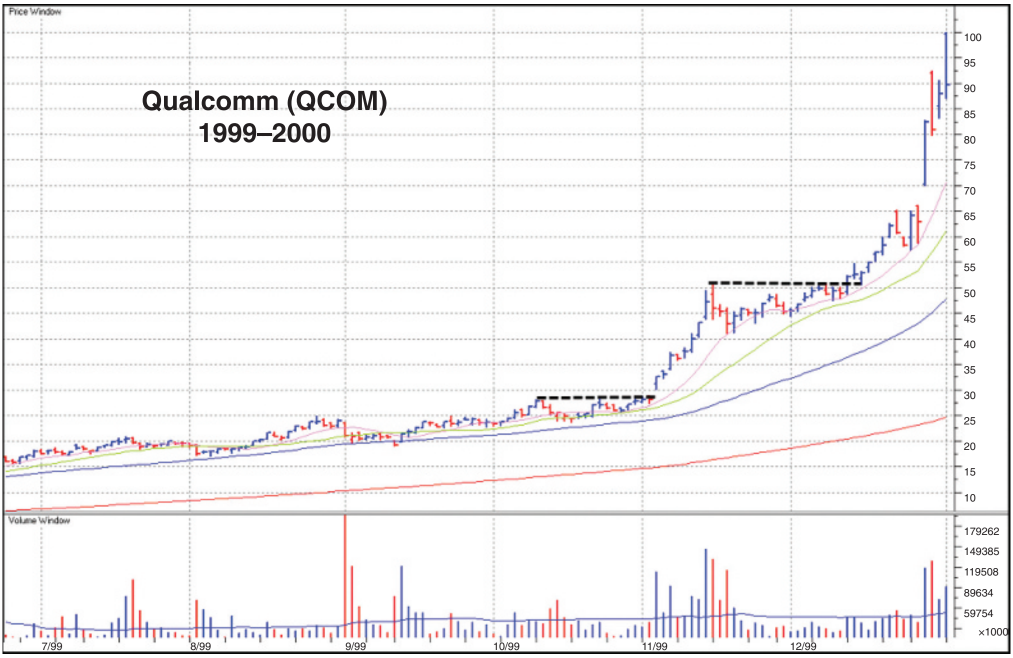
Qualcomm, Inc. (QCOM) 1999–2000. QCOM had two clear lines of least resistance in 1999, and penetrations of each led to sharp upside price moves. Both had pocket pivot buy points in and around the breaks through the line of least resistance.



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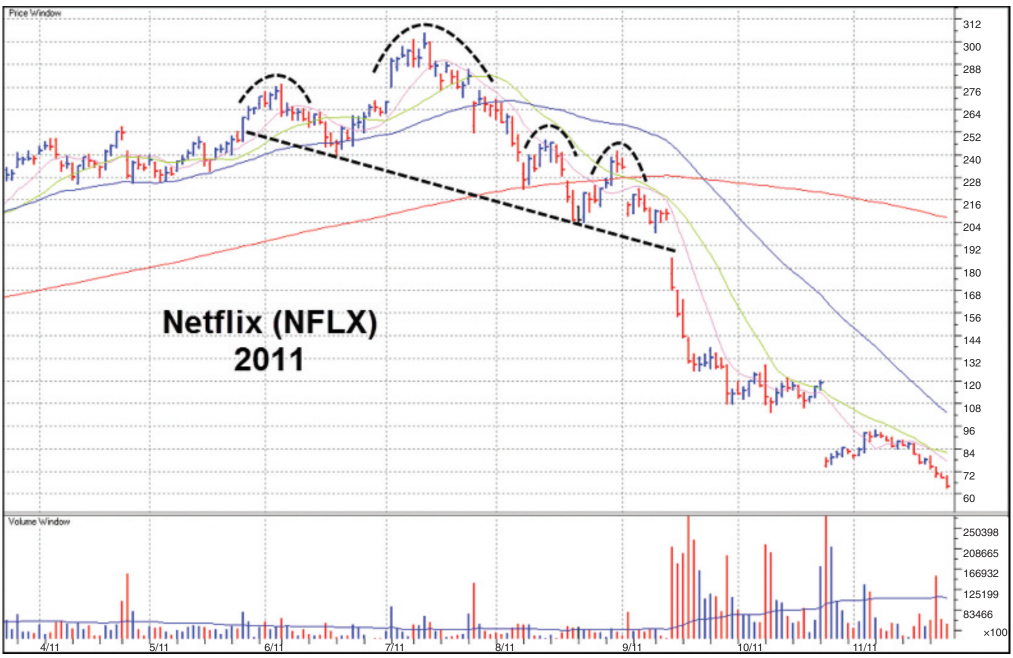
Netflix, Inc. (NFLX) 2011. The line of least resistance does not always have to exist as a barrier to upside price movement. Lines of least resistance can also be penetrated to the downside, and when they occur as they did in NFLX during the middle of 2011, the alert investor moves quickly to sell the stock short. NFLX had already formed a head and shoulders topping formation, and the line of least resistance became the neckline in the head and shoulders. Once NFLX gapped down through the "neckline of least resistance," the stock plummeted to the downside, making for a very profitable short-sale operation for those who recognized when the line of least resistance had been decisively pierced. Another shorter line of least resistance was broken later on a massive-volume price gap-down in late October 2011, but the price movement to the downside was more gradual following the gap-down.



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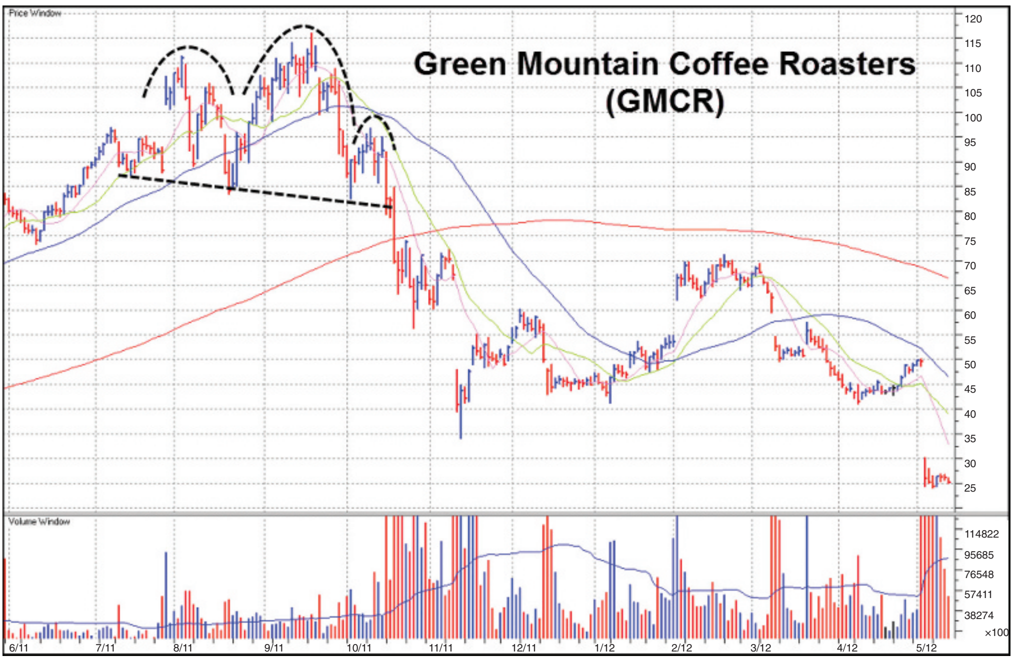
Green Mountain Coffee Roasters, Inc. (GMCR), 2011. During most of its upside move from 2009 into 2011, GMCR was very popular with short-sellers, and short interest in the stock remained relatively high throughout its upside move. Of course, those who kept trying to short GMCR as it was in an uptrend lacked any concept of the line of least resistance. Had they been paying attention, GMCR was breaking lines of least resistance all the way up. Of course, there is a right time to short a stock, and that is when the line of least resistance is finally broken to the downside. In October 2011 GMCR busted through the neckline of a head and shoulders top formation and plummeted over 50 percent before another month had passed.



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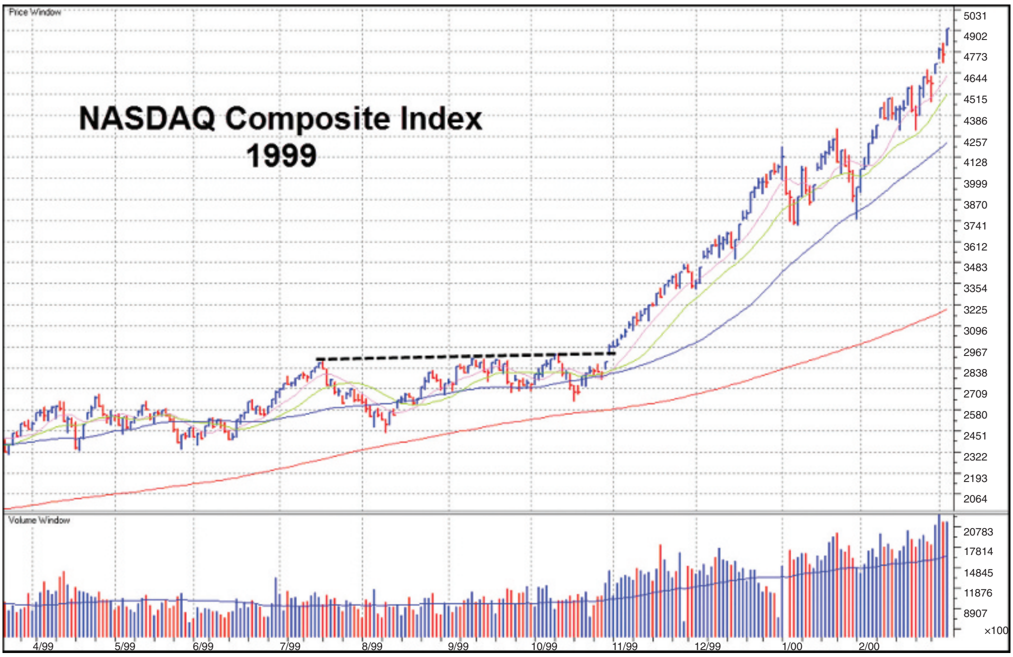
NASDAQ Composite Index, 1999. The market itself is also capable of breaking through the line of least resistance, and we see in Chart 1.25 that the NASDAQ Composite Index had just such a move in late October 1999, sparking the great dot-com bull market run into March of 2000. Many geniuses were born of this bull market, but you can see that once the line of least resistance was penetrated, the market was on now on the up escalator, and it only remained for smart investors to jump on and sit tight for the ride as the market did all the heavy lifting for them.



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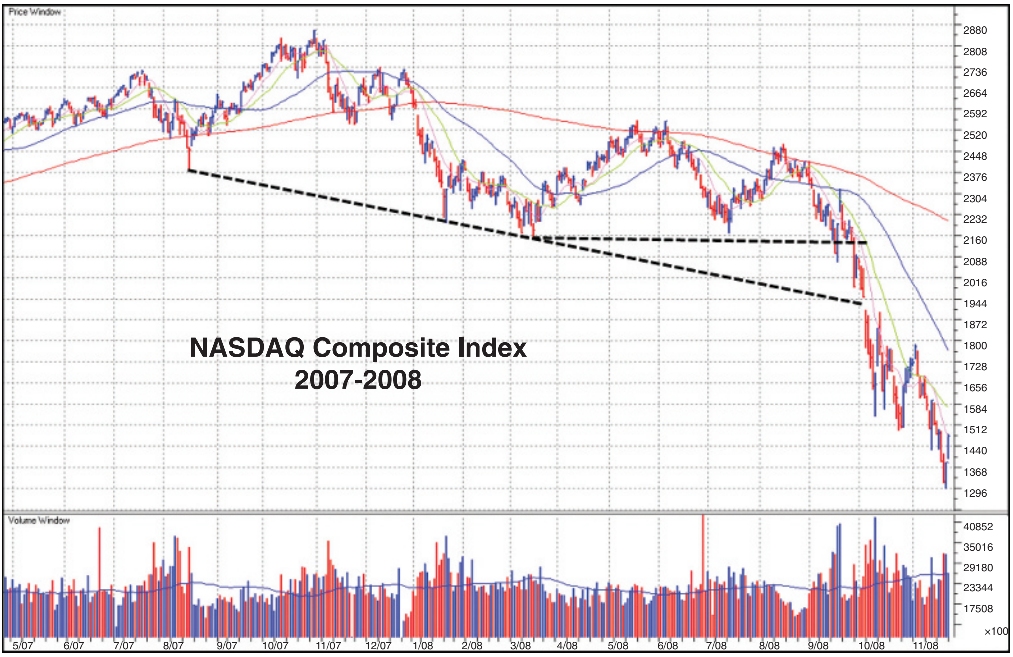
NASDAQ Composite Index, 2007–2008. In September 2008 we can see how the market penetrated the line of least resistance to the downside, and there was plenty of money to be made on the short side when this occurred. It is possible to see a couple of lines of least resistance here, as we've drawn it, and either turns out to be valid in practice.



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SUMMARY

Capitalizing on big and relatively rapid price moves is a basic tenet of the OWL ethos. One must deeply internalize the basic market law of physics that strength begets strength, for example, a body in motion remains a body in motion, and once the line of least resistance is penetrated the physics of a sharp price move are set in motion. Being able to recognize where these lines may lie, as well as when they have been decisively penetrated, is critical. Such moves provide a very strong signal to act and make the trade, whether long or short, depending on the direction in which the line of least resistance is broken.

Most investors, when seeing a stock move decisively in one direction, tend to fall into a reversion-to-the-mean mentality in that they think the movement is excessive and that the stock must surely pull back. But if they have no impetus to act, they can just as often be left behind. We find that pocket pivot buy points and buyable gap-ups are often associated with penetrations of the line of least resistance, and therefore provide ready tools with which to approach the task of capitalizing on such tasks.

The predisposition we bring to the market has a great influence on how we perceive the price/volume action we are looking at in real time. A break through the line of least resistance on the upside can look to some like a stock that has gone too far, too fast, while to us the potential for the stock to begin a serious, accelerated move to the upside is evident once it is in the clear. It is truly a matter of being able to see things a certain way and to react to the information at hand in real time, in a manner that conforms to the OWL ethos. In order to see what is there to be seen, however, and gain a clear picture, one must get through the various mind games and mazes, which brings us to the next chapter.