What's A Chart?

A chart is a visual representation of transactions. The results of these transactions are depicted by either a line which will look like a map of the Pacific Coast Highway, or by a bar which represents the opening price (the little notch on the left side of the bar), the low for the day (the bottom of the bar), the high for the day (the top of the bar) and the closing price (the little notch on the right of the bar). At the bottom of the graph you'll usually also find volume bars which will tell you how many shares/contracts changed hands that day.

But beyond all this, a chart is a visual representation of buying and selling ***behavior*** on the part of investors, not just a tally, and this behavior creates behavioral patterns. Thus if you approach this from the viewpoint of psychology and sociology rather than cut-and-dried mathematical or geometric models, you'll have a leg up. These behavioral patterns do not exist in nature. They are created by the buying and selling dynamic.

Begin by thinking of the market as a giant bazaar. Lots of buyers and sellers, all excitedly negotiating prices, working to make a deal. If a lot of people are crowded around a particular merchant's stall, he can demand premiums for his goods. If another merchant is getting little or no traffic, he must lower his prices in order to unload his stock. If he's able to manufacture a demand, he can then raise them again. Either that or use whatever demand he creates to unload whatever crap he's selling and move on to something else.

Consider also that all stocks go through accumulation/distribution cycles. These cycles can last for anywhere from a few minutes to several years. Which cycles you focus on will depend on the kind of investor you are and what your time horizon is.

Here's how it works. Somebody's attention is caught by a particular company or its stock. They like it, think the price is reasonable, and begin accumulating it. But they do it gradually and in small lots so they don't attract attention to what they're doing. If they attracted attention, others would start buying the stock as well and the price would be driven up because of the increased demand.

When they've accumulated all that they want, they'll either hold on and wait or they'll "test" the market by offering some of their shares to see what the demand is. If the demand is there, they'll offer more as the price rises (and since there are now fewer shares on the market, there's less to stop the price from rising if the demand is sufficient). If the demand increases and the price rises further (because of buyers willing to pay ever-increasing premiums), they may hold back their shares and let other holders provide the supply for the time being, then sell more of their shares, or all of them, when the price represents their target profit level. Selling into this increased demand is "distribution". It, like accumulation, is quiet. The holder of the shares doesn't want to dump a huge amount of supply onto the market for fear that there may not be enough demand to absorb it, and the last thing he wants to do at this point is drive down the price. When the stock has topped out and the real selling takes place, he's already out of the stock. Thereafter, unless demand increases, the stock falls until it represents "value", to somebody, for some reason. Then the whole process starts all over again.

This is the basic process and cycle. However, it's complicated by the fact that there are many buyers and sellers, each with his own agenda. A seller may distribute all his stock, for example, but demand continues. It may not be enough to drive the price higher, but it may be enough to keep the price from falling. So, you enter a secondary (or whatever) base in which a new accumulation/distribution cycle begins.

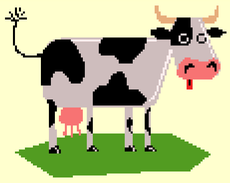
The trick is to figure out whether this new "consolidation" period represents accumulation or distribution, and the only way I know of to be sure is to watch the relationship between price and volume. How does the stock react when a lot of stock is dumped onto the market? Does it tank or does it decline only a trivial amount? Is there follow-through to this action or are the following days business-as-usual? If it's a short, sharp decline with no follow-through, you're probably looking at a "shakeout" (forcing weak hands to sell their shares so the stronger hands can pick them up at a discount) or a spree of short-selling, but the latter is unlikely since it usually takes place over time.

Another help is to draw a line parallel to the bottom of your price-and-volume graph so that only the busiest days show above your line. Note what happens on the busier days. Is the price up or down? What about the slower days? Again, price up or down? If the price rises on heavier volume days (though not enough to break out of the base) and falls on lighter volume days, the stock is most likely being accumulated. Or vice-versa if it's being distributed.

It is important to remember that for a transaction to take place, there must be a buyer and a seller. Huge volume and an increase in price indicates a lot of buying, but it also represents an equal amount of selling. Volume, in other words, reflects only the number of shares traded. Whether the pressure is on the demand side or the supply side is reflected in whatever happens to the price. Unless you put this activity in a context of markets, market psychology, and demand and supply, you stand a good chance of misinterpreting what's happening.

If all of this confuses you even more, or if it fascinates you to the point where you must learn more or else throw yourself into the river, tackle **Demand/Supply**. If you're still standing, study an example of the implementation of all this: **Determining the Trend of the Market.**

Stop when you get tired. And remember that there's no hurry. The market will be there whenever you're ready.



Demand/Supply

Wandering through NetLand recently, I heard the plaintive cries of a fellow traveler, wailing that his indicators had once again betrayed him. "How could the stock have gone up?" he sobbed. "MACD was *negative!* The 12-day ROC said *Sell!* ***The borogroves were mimsy!"*** You hear this stuff a lot. Another investor moans "How can the market be making new highs? We're in a 3C Wave!" It sort of reminds me of those people who try to understand brain function by feeling the bumps on somebody's head. Seems to me that if you want to understand how the brain functions, you study the brain and what makes it twitch and shudder. If you want to understand how the market functions, you study the market, not market indicators.

Technical indicators are the high-tech equivalent of feeling the bumps on the market's head. Since these indicators are often vague and muddy at best, anyone who claims to have any but the most superficial understanding of them can gain great prestige and status. He can cloak himself in a robe embroidered with the Doji Star, the Black Crow and the White Soldier and invoke the Detrended Price Oscillator (shipping and handling extra). But just as tossing the virgin maiden into the volcano had only tangential relevance to the return of spring, the behavior of technical indicators – useful though they may be under certain circumstances – bears only a tangential relationship to the behavior of the market or of an individual stock. To see the relationship, in fact, you have to look out of the corner of one eye.

All technical indicators are based on price and/or volume behavior, usually both. One might surmise, therefore, that to get at the root of all this, one should study the relationship of price and volume in addition to the proper use of technical indicators. Maybe *instead of* technical indicators. But you wouldn't be going far enough. Price and volume behavior are further dependent on the relationship between supply and demand. Therefore, **in order to make consistently profitable trades/investments over the long haul** (perhaps even the short haul), **it is absolutely essential that you understand how the relationship between supply and demand affects what happens to your stock.** Using technical indicators as a shortcut through this landscape is like trying to drive a car without first understanding the functions of the steering wheel, the brake pedal, and the accelerator.

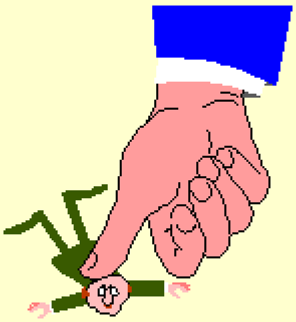
In a nutshell, **when demand is greater than supply, prices go up**. **When supply is greater than demand, prices go down.** Sounds simple, doesn't it? And it is simple when compared to something like gene splicing. But as simple as it may be, it nevertheless confounds many investors who are desperately trying to determine if their stock is going to go up, when it's going to go up, and by how much it's going to go up (if it goes up at all), and whether they should buy more and if so when, or take their profits (if any) and head for the exits. Let's turn on a few lights, then, by going back to the beginning and walking through the process of determining supply and creating demand step by step.

Accumulation

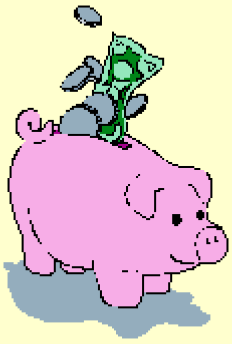
As with the price of red bell peppers in January, **if a lot of people want something and there isn't much of it, it's going to cost more than if there's a lot of it lying around and nobody cares much.** If there are very few shares available for trade and a lot of people want them and are willing to pay through the nose for them, the shares are going to cost more than if there are gazillions of shares to be had and everybody can have as much as they want and then some. Many investors, novice and otherwise, interpret this to mean that they should and must focus on companies with a low "float" (shares issued by the company and not owned by insiders, therefore available for trade) in order to increase the odds that their stock's price will rise.

In a sense, they are right. Given the requisite demand, the fewer the shares, the higher the premium they'll bring. **A low float, however, is not always the key in and of itself to rapid price appreciation and investment success.** Momentum investors, particularly daytraders, can and often do drive the prices of low-float or "illiquid" stocks up rather quickly and dramatically. But as seen during the Internet phenomenon, small floats can turn over several times in a day as a result of daytrader activity, and prices can plummet just as quickly and just as dramatically as they rose, so quickly in fact that one's stop may not be triggered until the price is well below the intended stop level, and those extraordinary gains can evaporate like a Popsicle in July.

Even so, this situation is perceived by many to be a more attractive situation than that in which institutions own a large percentage of the stock, whether the stock originally came from a large float or a small one. The fear is that institutional dumping can drive the price of a stock downward so quickly that one doesn't have time to react. And institutional dumping can drive down prices faster than you can imagine. But if your stock is plummeting, your brokerage account doesn't care whether it's bleeding because of institutional dumping or daytrader dumping. Dumping is dumping. Bleeding is bleeding.



Nonetheless, these cautionary statements do not alter the fact that a small number of shares is preferable to a large number of shares if you want the biggest bang for your buck in the shortest amount of time. A low float, however, can be the result not only of the shares never having been issued in the first place, but also of the process of **accumulation** (call it a *practical* low float, as the end result – reducing the number of shares available for purchase – is the same).



Accumulation is the process whereby a quantity of stock is acquired at the lowest possible price. It is not throwing money at a rocket or even a breakout. It is a subtle, sophisticated, and sly effort to amass a stake that is large enough to not only make the next phase (the "markup" phase) worthwhile, but also possible. The markup phase becomes possible because the number of shares available for trade has been quietly reduced, and when the demand for those shares increases, the prices charged for them can be increased as well. In other words, as with diamonds, there may be a lot of them, but they're released into the marketplace in controlled amounts in order to keep the price artificially inflated (stocks, like diamonds, are worth only what people are willing to pay for them).

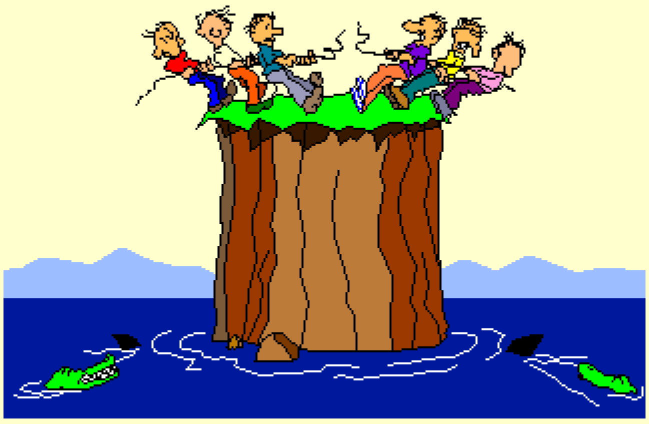
The accumulation process takes place in what is called a "**congestion area**", a sideways movement of the stock in which price shows no inclination to take off either up or down and is accompanied by consistently low volume. The low volume part is important, as **low volume levels are characteristic of indecision** (if people were confident in a decision to buy or sell, they'd do so, and in big lots too; when volume is high, everybody's being decisive – they just don't necessarily agree on whether the stock should be propelled higher or driven lower). Low volume can occur in congestion areas that are part of uptrends or it can occur in congestion areas that are part of downtrends. In either case, **the determining characteristic of the pattern as it relates to accumulation or distribution is the indecision within the pattern itself as to direction, not necessarily the prior direction,** for one can never be really sure in which direction the stock is going to break out except in hindsight.

So how do you know whether the stock (or whatever) is being accumulated or being gradually and surreptitiously dumped? Remember first of all that **when a stock is being accumulated, it is storing up the force of demand that will be the power behind a subsequent upward movement.** This accumulation takes time, and that doesn't mean one or two weeks, much less one or two days (daytrading is a somewhat different ball of wax since the price targets are so much less, but the principle's the same: you want results, you've got to build up the force to get them). And not every horizontal formation, no matter how long it is, represents a zone of accumulation. In addition to a base that is long enough to allow accumulation to take place, you must also satisfy yourself that somebody actually wants this stock, and you know that by the context in which this base or zone or congestion area is placed. Investors who like to think that they are "value" players often miss the boat on this point, believing that since the stock is cheap, it is a "good buy". But **if no one wants the stock, it is not a good buy no matter how cheap it is.**

Determine, then, that this is a stock that interests someone. Where was the stock prior to this base you're studying? Has there *ever* been any interest in this stock at all at any time? Is it resting, is it asleep, or is it dead? What is its strength in relation to its group? In relation to the market? If it is a "famous" stock, it is clearly in demand by someone, but it need not be famous in order for accumulation to take place. Was there increasing volume and higher prices before it reached its current plateau (a well-defined uptrend is always a big plus)? Has the stock ever gone through a sustained advance at any time, even if it was followed by a sustained decline? If so, and particularly if you have reason to believe that a new cycle of demand followed by higher prices is in the cards, **you must then evaluate the character of the base.**

In order to properly evaluate the supply/demand relationship, you need a bar (or candle) chart of prices showing the open, high, low, and close for each day (OHLC), and you need a bar chart of volume which shows how many shares of the stock are traded each day. If you have color-coded volume, get rid of it. This coding shows you what the volume was like on days the stock closed "up" (usually green) and what the volume was like on days the stock closed "down" (usually red). However, it is not at all unusual for price to, for example, close lower than it opened, yet close higher than the close of the previous bar. This makes the volume bar "green" even though the price bar may not be bullish at all within the context of the bars before it. Leave the volume bars black so that you can approach them without bias. If you use candles, their graphic clarity should be enough to give you a general idea of where prices are closing. As for "indicators", you need nothing else, not even moving averages. Just a plain ol' nekkid price and volume chart.

First, volume should be relatively quiet. It should reflect indecision, not an ongoing tug-of-war for dominance between bulls and bears. To the contrary, there should be general agreement between fans and detractors that the stock is pretty much worth whatever it's going for. There should be no massive flows of volume on either up days or down days. In fact, the "up" days and "down" days should be within a fairly narrow range of each other.



Second, even if volume is quiet there should not be a generally wide range between highs and lows each day. If there is a wide range between the highs and lows (indicated by long bars), there is still considerable disagreement intraday and day-to-day as to the value of the stock.

Third, when prices hit the low end of the trading range in the base (the "support" or "demand" line), **volume should remain low.** Coincidentally, when prices reach the upper end of the trading range (the "resistance" or "supply" line), volume should be higher. Color-coded volume, if you just can't live without it, should show generally higher green bars than red bars, though, again, even a high red bar should be analyzed carefully. As mentioned earlier, if the stock falls toward the support line and shows a strong recovery during the day, closing near its high for the day but a hair below the previous day's close, it will show as red. However, you have been sent a message that there is strong support at whatever level the stock reached before rebounding and that there was enough demand on that day to propel it back into the court. Make sure that you're home to receive this message.

Fourth, is the low end of the trading range less than halfway to the support line? For example, if the highest high is 24 and the lowest low is 20, are most of the price bar bottoms at 22 or higher?

Fifth, if the base is several weeks (or months) old, have there been any shakeouts, i.e., short, sharp spikes to the downside generally accompanied by relatively high volume but which last for only a day or so and which have no lasting effect on the day-to-day progress of the stock?

If the answers to the above questions are mostly if not all yes, then your stock is probably under accumulation. But first, a few more words about shakeouts, as they can be very unsettling to those who don't know what they are or how to recognize them.

Shakeouts

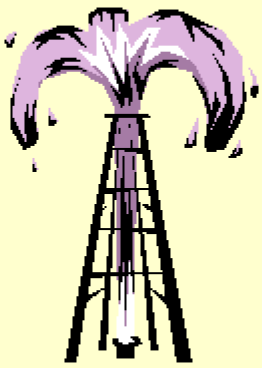
A shakeout is designed to frighten, and it does a pretty damn good job of it. **The general idea is for an elephant who's been accumulating a stock to throw a sizeable portion of it onto the market and temporarily drown demand, thereby temporarily driving the price down.** This rattles the unwary and prods them to sell their shares, making those shares available for purchase by the elephants. Those who have grown weary of waiting for the stock to do something other than drift along in this interminable base may also decide to throw in the towel and let somebody else babysit. And, of course, those who have placed hard stops just below the support line will be stopped out in a flash.

The shakeout is not always easy to spot at the time as one's first reaction is that something has gone horribly wrong and the stock is in deep trouble. But if the stock has been basing for a while, if the base has been relatively contained (it hasn't shot out of the trading range so far), if volume has subsided, and if there has been evidence of accumulation up to that point, one can at least suspect that a shakeout is taking place.

The acid test is the next day or so. If the stock bounces back into its trading range and makes its merry way as if nothing had happened, then you have probably witnessed a shakeout. On the other hand, if volume picks up and efforts to push the stock back up are defeated by too much supply and/or too little demand (except on the sell side), then the stock may actually be in trouble, and if you can't find out what's going on, you may want to get out and watch from the sidelines until the situation becomes clearer.

Markup

Toward the end of the accumulation campaign, we get ready for the second act of our little drama, the "markup" phase. This can get its motor running in several ways, and the road ahead may be rocky and full of potholes, but **the general idea is to propel the stock upwards so that the elephant(s) who went through all this accumulation hassle can make some money.** You'll begin to notice the **lows are gradually millimetering their way higher** and that **volume is increasing** -- perhaps ever so slightly -- along the way (volume need not be terribly heavy, however, as there is now much less supply than there was at the beginning of the base; therefore, it takes less demand to move the price upward). You may notice also that **price ranges from low to high are getting wider,** indicating that those who want the stock are willing to pay higher prices for it and aren't as content to "wait" for their price. The **closes are getting nearer and nearer the daily highs.** And there is **an increasing amount of net upside progress from day to day.** If there are rallies, they may stop short of resistance, but reactions must stop well short of support.



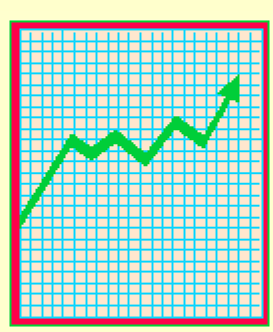
At some point, however, one must inevitably face the supply or resistance line. One can get there gradually as just described, or the stock may "pop" on strong volume and "break out" of the constraining base. **What happens at this point will tell the investor a great deal about the presence of demand and the quality of whatever demand there may be.** If the price breaks through resistance with increased volume, there is likely sufficient demand to sustain an upward move. The larger and swifter the increase in volume, the more likely you're looking at a turning point.

This initial move upward, however, is only the beginning. Does the stock close more than halfway up from the low to the high for the day? Is it breaking through interim resistance or is it making a new high? Is the volume strong, i.e., at least 150% of the ADV (Average Daily Volume)? Is the volume *too* strong?

Too strong? What do you mean "*too* strong"? Well, oddly enough, volume can be too strong on a breakout. Remember that volume is entirely a function of supply. **No matter what the demand, if there's no supply to meet it, the volume is going to remain low.** The price may rise because those who want the stock are willing to pay a premium for it, but the volume will remain low due to the fact that there aren't many shares available for trade.

But so what? All that matters is that the price go up, right? Well, no. Demand will drive up the price in the face of meager supply, but what happens when those few who really want that stock have all that they want or need or can afford? Who's going to take over the reins and continue to move the price? If you happen to have taken the momentum train (either by design or by mistake), perhaps daytraders will begin to churn the stock and turn over whatever shares are available over and over again at higher and higher prices, calculatingly selling to the "greater fool". In this case, **a long volume bar will reflect this churning** (check the float against the number of shares being traded), **not genuine demand for the stock** by people who really want it and want to hold onto it for at least the intermediate-term. If this is what you want and you know what you're doing, great. If it's not what you want and you don't know what you're doing, you better know how to recognize what's going on. Otherwise, the greater fool who winds up holding the bag and an empty wallet will be you.

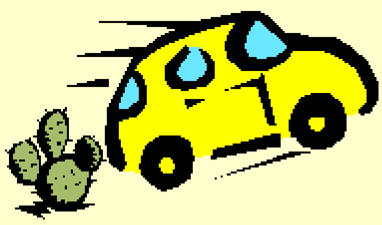
Therefore, **you want to see strong volume on the breakout (or break "through") because it shows strong demand, with enough supply to feed that demand but not so much that it drowns demand.** But you don't want to see it so strong that it becomes more indicative of rapid turnover, even some distribution, ending in a move that collapses back into the base, than it is of a stock that is on its way higher. If the stock breaks out on decent volume which is nothing to write home about, that doesn't mean the breakout is faulty. If everything else is in order, consider buying the breakout anyway. However, if increased volume doesn't kick in within a day or two, you may be in trouble. If supply is being withheld, or the float is thin, you may be being manipulated.



The move upward, if it is healthy and legitimate (not the result of short-covering or daytrader manipulation), will usually take place in several stages, what are sometimes called "two steps forward and one step back" or some variant. The first step may actually be a return to the base, if it hasn't moved too far away from the base in the first place. This is generally the result of "**fading**", or a short-lived short-term bout of profit-taking done by those who played the breakout for only a few points, or even less. Volume should be lower on a fade. If it is, this U-turn represents a "**second chance**" to buy into the stock. It is also usually a much safer spot to enter as the very-short-term players are now mostly out of it.

Stocks don't always return to the base, however, and the "second chance" may not arrive until the stock is considerably higher. If it looks particularly strong, even short-termers may stick with it for the ride. Therefore, no fade. **Your first opportunity to buy, if you hadn't already done so, or to pyramid your position if you *had* done so, will probably be during the first bout of more serious profit-taking.** Here again, volume should be relatively low and the stock shouldn't break its trendline or fall below its last reaction low (much of this will be done by the elephants who were accumulating the stock in the first place and is the first phase of distribution on their part). **The point at which this "reaction" stops will become important, as it is this point which must not be violated after the stock begins its next leg up.** If it is, there may not *be* another leg up.

These drives upward should all be accompanied by good volume – not necessarily great volume, but enough volume to keep the price moving. Consider that once you've got your car moving, you don't need to give it much gas to keep it moving, but you do have to



goose it from a standing position to get it going, or from a cruising status to pass somebody who presents an obstacle to you (a level of resistance?). **Any bouts of profit-taking or near-term shyness about busting through a resistance level should be accompanied by lower volume.** If volume increases, you may have a problem. If it increases dramatically, we're not talking typical profit-taking here. Act accordingly.

The pattern of these moves may resemble arrow-heads--move up a lot, pull back a little, move up a lot, etc. However, they may also look like a series of ascents interrupted by plateaus (like a Mayan pyramid). **These plateaus, or bases, or congestion areas, require just as much attention as the profit-taking pullbacks, for one of these plateaus is likely to be the final resting place before the rocket makes its return trip to earth**, or at least alters its course to an earthward direction. How accurate you are in determining which of those plateaus is going to be the last stop will depend on how well you can spot **distribution.**

Before getting into distribution, however, there is one other stunt which the stock may pull on its way up and which may cause you grief. At some point during the markup phase, the stock will swoop upward in a ski-lift-turned-on-its-end sort of **climax run** in which volume explodes, the price soars skyward, short-sellers scramble to cover, "over-extension" acquires a whole new meaning, and green newbies everywhere are rubbing their hands with glee when they ought to be sweating bullets (this particular phenomenon is linked to all sorts of sexual metaphors that we won't get into here; you can probably guess what they are). If you're ever lucky enough (or unlucky enough, depending on how it all turns out) to be caught up in one of these rocket rides, keep in mind what happens to rockets when they run out of fuel.

It's not pretty.

Remember that volume is a two-edged sword. As stated earlier, you can have too much of a good thing at breakouts. Likewise, **if it seems as though you're getting too much of a good thing after your stock has run for a while, start thinking "top".** Even if your stock doesn't launch itself into a climax run, take the market's temperature. If there seems to be a general consensus that your stock's price can only go higher, locate the exit door even if you're not quite ready to lunge for it.

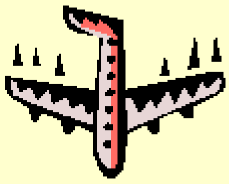
Distribution

At some point, demand will not only diminish, but dry up. As the Street puts it, trees can't grow to the sky. Buyers have run out of greater fools, and no one is willing to pay a higher price for the stock, at least for now. On the other hand, there aren't a great many people who want to sell, either. They like the stock, want to hold onto it, think it's worth what's being asked for it, and are willing to wait for a new wave of demand, spurred perhaps by news or rumor or earnings. Some may want to sell, and there may be buyers who are willing to pay the ask, but there aren't very many, if any, who are willing to pay anything higher.

So there it sits, and if its angle of ascent was 45 degrees or less, it may sit for quite a while. **Your task is to determine whether the stock is just resting, or whether it's sharpening its machete in preparation for cutting you off at the knees**. The angle of ascent, as just mentioned, has a lot to do with danger level (the steeper it is, the more vulnerable the stock becomes to the withdrawal of experienced buyers). So does a careful analysis of the relationship between price and volume. **It is here and on the way up to here that distribution (a process whereby the accumulated store of stock is sold at the highest possible price) takes place, not on the way down,** and unless you enjoy wedgies, learn to recognize the signs.

As an upward move deteriorates, price spreads narrow and less price progress is made from day to day. Determining whether or not this is a result of the stock's meeting supply will help you decide whether an ensuing reaction is profit-taking or a mad dash for the exits. If volume remains strong, the stock is most likely meeting supply (distribution), and whatever shares are offered to the market as a result of profit-taking will be absorbed by this demand (as long as nobody gets spooked) and the stock will resume its advance (but watch that trendline). If, however, volume diminishes as spreads narrow and progress is less and less, or if volume was strong and is now diminishing, it is more likely that demand is diminishing as well, and trouble may be coming 'round the corner PDQ.

It is extremely important at this point to focus on the price-volume relationship, unless you enjoy holding the bag (it is also extremely important at this point that you not take any vacations). Watch where the stock begins to hesitate. Does volume begin to pick up when the stock closes closer to its lows? Is each successive low lower than the one previous? If and when the stock rallies, is volume higher or lower? Are rally attempts stopped (met by further supply) at the same place each time? Does each attempt end lower than the one previous? If volume promptly decreases when the stock begins to roll over, it's unlikely that the market is ready to kick it down the stairs, but **it's important to note the quality and character of rally attempts.** If each one is coincident with stronger volume, but is stopped at or near the same place each time, then a considerable amount of supply needs to be worked through. Again, this is part of the distributive process, and it may be taking place at some older level of resistance, but **distribution is not necessarily a death sentence for a stock.** It simply refers to the process whereby elephants unload sizeable portions of their accumulated store. As long as demand is sufficient, they can exit entirely and the stock will go on its merry way building a Stairway To Paradise.



On the other hand, **if volume picks up on the downside, you've got a problem.** Some investors will hold the stock and wait to see where the reaction stops. If it stops at an important support level, wonderful. If it blows through that support level, they sell. In a volatile and nervous market, this strategy can have its drawbacks, since the stock may not be taking its leisurely time to telegraph all this information. It may, in fact, sink like a stone without giving any warning whatsoever. Which is why **smart money learns how to recognize distribution and to sell at the same time the *rest* of the smart money does.**

On the third hand, there is always the possibility that your worries are for naught, and that the stock is merely basing again. Evaluate this base just as you did the last one when the stock was being accumulated, though this base may be considerably shorter. Ask yourself the same questions and note the same phenomena. If volume declines and continues to fade away during reactions, not much stock is available for sale, even at the lower prices asked at the bottom of these reactions. If the price ranges widen, the closes move higher toward the highs, and volume gradually increases, you should most likely get back on the bus for the next leg up. Beware, however, of the red-spotted **thrust.**

Thrusts

Thrusts are a particularly ugly feature of bases in which distribution is taking place. **They are**

designed to sucker amateurs into thinking that the stock is getting ready to advance again when, in reality, the elephants are merely harvesting the wallets of the unwary so that they (the elephants) can unload whatever they have left before they catch that plane for Barbados.

Thrusts are pretty much the same as shakeouts, only in the opposite direction – a spike in volume, a rapid move upward, perhaps even a close near the high. But, like the shakeout, there's no follow-through. The novice, thinking he's "missing the move", jumps in all innocent and dewy-eyed, at which point the floor collapses beneath him and he drops down the rabbit-hole. The price drops back into the base or below and, before you know it, we're on a sleigh-ride to perdition.

How do you detect a thrust? It's unlikely, though possible, that demand sufficient for a genuine breakout will just appear out of nowhere without any warning whatsoever. Any such move should be viewed with suspicion. If you can't get in within 5% of the buypoint, pass. Even if you can, don't take any magazines into the bathroom. Stay in front of your computer and watch to see that the bottom doesn't fall out of the "advance". If you're using daily charts, you may want to consult an intraday chart (if you're already using intraday charts, check a shorter bar interval). If any of this activity looks the least bit suspicious, start exercising your trigger finger to place that "sell" order if necessary. **Do not hang onto the stock if it closes at or near the low for the day, much less below your purchase price.**

Markdown

At the end of a base or congestion area which has been used for distribution, the price either continues to advance on the wings of new demand, or we enter the markdown phase. The markdown phase is the most depressing and often terrifying part of the entire cycle, unless you specialize in short sales. It is here that hopes are dashed, doubt turns to fear and fear to panic, and Tiny Tim gets trampled in the rush to the exits. The elephants are done, investors who bought in during the just-completed base and have no profit whatsoever will be (if they're smart) the first to get the hell out, and absolutely no one is supporting the price anymore, except perhaps for green newbies and a few truly clueless individuals who seize this "opportunity" to average down. **Supply is thrown onto the market, as evidenced by widening price spreads, increasing volume, and increasing downside deterioration.**

There will be rallies during this phase, just as there are reactions during the markup phase. At certain points, supply will be withdrawn or demand will overpower what's available, perhaps due to elephants trying to shore up prices. For whichever reason, the bleeding will be stanched and the stock (and the investor who's watching his life savings go down the toilet) will be given a break. **As with all rallies and reactions, watch the relationship between price and volume.** Does the volume suddenly disappear during the rally? If and when the first rally attempt fails and the next reaction follows, does it exceed the previous low? If there's another rally attempt, does it exceed the previous rally high or fall short? Is volume stronger on the downsides or the upsides? **If rallies consistently stop short of supply, and up volume is consistently weaker than down volume, don't be shocked when your stock re-accelerates to the downside.**

As with the journey up, the road will not be a smooth one. In fact, it'll be downright nauseating. What makes this particular road tricky is the perennially bullish outlook of the average investor (if he weren't bullish, he wouldn't be in the market in the first place). Whereas fear will generally keep him from jumping into overextended stocks (though an overabundance

of hope may cause him to do just that), hope will induce him to try to buy in at the bottom (buy low, sell high, right?), even to the point of trying "catch a falling knife". When the rally attempt fails and the stock continues to fall, he panics, dumps his shares and adds fuel to the downside slide (this is referred to as "**capitulation**"), assuming he's not one of the truly clueless mentioned earlier who will continue to buy all the way down to what eventually does become the bottom (this is referred to as "ignorance" the first time it happens, "stupidity" thereafter).

Most stocks do not hit the bottom with a thud. **Even if there is a "selling climax" with a precipitous drop on high volume, the true bottom may not be reached until days or even weeks later.** If a bottom (though perhaps not *the* bottom) is reached quickly, there will usually be at least one rally off of it, given the colorful name of "**dead cat bounce**", meaning that it will go nowhere except, eventually, south. This is referred to as a "**technical rally**", as opposed to a legitimate rally attempt, because of the reasons for its occurrence, and it is not to be trusted. This sort of rally occurs not because there's a mad rush of people who are desperate to own this stock and who plan to bequeath it to their children, but because elephants are instituting buy programs to stop the decline, short-sellers are covering their positions, amateurs are attempting to catch the bottom, shareholders are averaging down, and/or daytraders are anticipating (thus helping to create) the rally and want to play whatever points it turns out to be worth. Professionals expect these rallies. They are, after all, helping to create them. And they don't pay much attention to them. They may, in fact, use them as further opportunities to sell, just in case they still have some accumulated stock left over in the fridge. **The volume clues mentioned above will help you to determine if this is what's going on.** If the "rally" does fail, you may find yourself looking at the world-famous double bottom, or W pattern.

Under the right conditions, however, such as those of October '98, stocks will do what's least expected, shatter all fondly-held notions of "how markets (and stocks) behave" and make what is called a **"V" bottom**. In highly volatile markets such as those we've seen this summer and fall (1998, that is), stocks may rebound off these V bottoms without pause, and recover much of their losses before reaching equilibrium and forming the kinds of bases or handles in which at least some accumulation can take place. Conventional wisdom says that **one shouldn't buy if the stock has regained 50% of the loss because it may retrace 50% of the just-achieved gain** (you'll often see this in a W formation in which the low of the second leg doesn't exceed the low of the first). This is why one wants to see a base or handle of at least minimal length to indicate that some agreement has been reached between bulls and bears as to the value of the stock, at least at that time (if the stock bases long enough to reach its trendline, so much the better). Without that, the stock is just as likely to collapse as it is to take off again, taking into consideration all the factors of price and volume, demand and supply, accumulation and distribution that I've delved into here.

There are signs to look for if one is irremediably aggressive and wants to try to buy these bottoms. If you have a cast-iron stomach, a will of iron, and are willing and able to remain glued to your monitor, you may want to try buying these bottoms as well. Otherwise, wait for at least some confirmation of strong demand before writing any checks.

The first, most-rewarding, and far-riskiest opportunity to enter or re-enter a position in a stock that's being marked down is immediately after the selling climax. Making assumptions is never a good idea. Far better to let the chart tell you what's happening rather than some preconception, talking head, or message board post. But in this case, break the rule and **assume that whatever rally ensues will be a technical one leading to a double bottom.** Prepare to use what you've learned about price and volume clues and demand and supply to get out fast if this rally *does* turn out to be technical and *does* collapse just as it's supposed to. If the "technical" rally defies all expectations, turns out to be a legitimate rally after all, and results in a V pattern, you may not be in the clear but you will be able to see light ahead. Never lose sight of the fact, however, that **the many V bottoms that were evident this fall were the result of market activity, not news or anything fundamental pertaining to a particular stock.** Typically, buying V bottoms is a recipe for disaster, is only for the most risk-tolerant, and should never be attempted by those who are new to the markets and to investing.

If the rally does turn out to be technical after all, **watch to see if the ensuing reaction falls below the level of the first reaction or holds above it.** Also carefully watch volume throughout. **If the previous low cannot hold, and particularly if volume picks up,** expect a resumption of the decline as those who bought during the rally or were holding *before* the rally began now throw their shares onto the market. If the amount of this supply is large enough, and whatever demand there may be is not sufficient to absorb it, prices will fall. On the bright side, however, if volume is substantial, there may be less supply to slog through if and when the stock resumes its advance. **If volume subsides and the previous low *does* hold,** you will be given your **second chance to buy,** though it's best to wait until the advance actually resumes. You may also choose to wait for the market's "follow-through day"* if the market as a whole is also going through one of these cycles. **If volume subsides and the previous low does *not* hold,** this will indicate that those who are holding are mostly still holding. They may be waiting for the stock to rally to the midpoint of the W, in which case they'll get the hell out, or they may consider the stock to be a hold and have no intention of selling at all (or they may all be on the same cruise ship). Anticipate the behavior of both.

*(for those who haven't read O'Neil, the follow-through day is characterized by [1] a minimum 2% increase in whatever major market average you're following concurrent with [2] volume which is greater than the volume the day before and which [3] falls within a window of 3 to 10 days after what seems to be the bottom has been reached).

Your third opportunity to buy is the point at which the stock exceeds the high of the first rally attempt, the "midpoint" of the W, though there is always the possibility that a "handle" may form here. This does not necessarily mean that you should wait for one, but be prepared for the possibility that one may form (this midpoint is important resistance as it represents all those suckers who bought the first rally attempt; therefore, getting past it is an important achievement). If a handle does form and you don't want to wait for the breakout, you have the option of moving on to something else. If you choose to stay, monitor price and volume rigorously, as there is always the possibility of a further retest and a triple bottom. Just as the midpoint signifies important resistance, the low of the first leg down represents important support. If it's broken, pay very close attention to volume. Or get out altogether until volume and price show that buyers are clearly in charge once again.

V and W bottoms, however, are not the most common resolutions of the markdown phase. Typically, **volume will subside as selling pressure lets up, spreads will narrow, a line of support will be found, and price will begin to bob up on relatively light volume,** indicating that supply is becoming more scarce, the waters are subsiding, the sun is emerging from behind the clouds, the birds are singing, and a new accumulation phase has begun. It may take a while. There are a lot of burned-out and battle-weary investors out there, many of whom still don't quite understand what just happened. But these are exactly the conditions under which the elephants are most likely to begin buying up all those cheap shares.

And how do you know that your stock is being accumulated? Accumulation takes place in what is called a congestion area . . .

It's the Circle of Life, Simba.

I'm sure it has occurred to at least some readers that if the accumulation-distribution pattern I've described here were dependable in all circumstances under all conditions, then all stocks would have a pattern of up, across, down, across, up, across, ad infinitum. This is clearly not the case. **The markets are not represented by a straight and narrow highway.** A far better metaphor would be a roiling sea of rallies, reactions, markups, markdowns, shakeouts, thrusts, buying and selling climaxes, turning points, all happening all at once in timeframes varying from minutes to years and with all the accompanying eddies, currents, inversions, and undertows. This is the primary reason why I haven't provided graphic examples here of the concepts I've presented. **The point is not to find some stock somewhere that typifies accumulation or a shakeout and use it as a template for all future investigations of manifestations of changes in demand and supply, but to understand at a deeper level how the threads of demand and supply, accumulation and distribution, and the relationship between price and volume all intertwine.** What I've provided here is only the beginning of an exploration, not an exhaustive treatment of the subject.

Each chart you look at, instead of being "typical", will instead be unique. **Each movement of price and volume in a chart has meaning only within the context of what has gone before in that particular chart.** Therefore, solving the puzzle of the dynamics of demand and supply will be a new challenge with each chart. Achieving mastery of this skill will take time, if mastery is ever achieved at all. But applying even the most basic of the principles outlined above will result in an almost immediate payback, if not in money gained, then in money saved.

DbPhoenix

DETERMINING THE TREND OF THE MARKET BY THE DAILY VERTICAL CHART

of the New York Times Average of 50 Stocks

Section 7M, the Richard D. Wyckoff *Method of Trading and Investing in Stocks:*
A Course of Instruction in Stock Market Science and Technique (1931)

(abridged)

The most important thing to know about the market is the trend. Since we aim usually to operate in harmony with this trend, a study of our Daily Trend Chart (daily vertical chart of a composite stock average) should be the starting point of all our deductions.

The accompanying chart [at the end of this practicum] includes the total volume of transactions of all stocks dealt in daily, as indicated by the vertical lines at the bottom of the sheet. These volumes must be considered in conjunction with a study of the price movement. The element of time, as previously explained, is represented by the daily additions to the chart from left to right. The closing figure of each day is indicated by a horizontal line across each of the vertical lines which represent the range from high to low.

A good way to impress upon your mind the principles involved in reading the chart is to cover all but the extreme left side of the chart, exposing only the first few days' plotting. As you read the instructions which follow, gradually slide the paper toward the right, revealing the price movement and volume one day at a time. This will have the same effect as reading the market just as if it were being recorded on the chart today and as if you didn't know what was coming next.

The story told by this chart is as follows: We use the period from December 8th to December l7th as our starting point, and without regard to the market history previously recorded. This interval of nine days marked a sharp acceleration of the previous major decline, culminating in a widening spread of the daily price range and a very marked expansion in the daily volume of trading as the market reached its low point – thus reflecting the panicky selling which takes place under such conditions (see Footnote following).

The volume on the 8th was around 2,000,000. This increases to 5,000,000 on the day of the low point. Tape observers would have noted the fact that a large part of this volume occurred as the market recorded the extreme low and on the rally from the lows. This confirms the fact that the climax of the downward movement (*) has actually been passed, and gives us the starting point for our next forecast.

**The phenomenon of the Selling Climax is caused by the panicky unloading of stocks (supply) by the public and other weak holders which is matched against buying (demand) of (1) experienced operators; (2) the large interests and sponsors of various stocks who now either see an excellent opportunity to replace at low prices the stocks they sold higher up, or wish to prevent further demoralization by giving the market support temporarily; and (3) short covering by the bears who sense a turn.*

Stocks thus become either temporarily or more lastingly lodged in strong hands. An abnormal increase in volume is one of the characteristic symptoms of a selling climax, since supply and demand must both expand sharply under these conditions, but the supply is now of poor, and the demand of good, quality; and since the force of supply now will have been exhausted, a technical rally ensues.

If buying on the break (i.e., during the Selling Climax) was principally for the purpose of supporting prices temporarily and checking a panic, or relieving a panicky situation, this support stock will be thrown back on the market at the first favorable opportunity, usually on the technical rebound which customarily follows a selling climax. This, and other selling on the rebound, may increase supply sufficiently to drive prices through the lows of the climax day and bring about a new decline, that is, a resumption of liquidation.

On the other hand, should a secondary reaction occur after the technical rally above referred to, and prices hold around or above the climax lows while volume at the same time shrinks appreciably, we have an indication that liquidation was completed and support is again coming into the market. Therefore, the market's behavior on these secondary reactions is usually indicative of the next important move.

In this connection, it should be noted that the same principles which apply to the large swings also apply to the smaller moves and to the day-to-day buying and selling waves. Thus, a careful examination of your Trend Charts, Group Charts, and charts of individual stocks over a period of time, will reveal numerous examples of the above phenomena, These will appear on a small as well as a large scale, however, you must allow for variations. That is, do not expect one selling climax to look exactly like another. The same basic characteristics may be observed; but the time and magnitude of price movement and volume, and the extent and sequence of price movements almost invariably will differ.

For example, the abnormal volume may last either one or several days; or the abnormal volume may precede the recording of the extreme low point one or more days. In other words, a selling climax may be completed in one day or be spread over a few days, and volume may reach unusual proportions on the day the low point is made or some days ahead of the final low.

We must now assume, in view of the above, that the trend is tentatively upward; but this is subject to confirmation by the appearance of higher support on the next reaction; that is, if on the next down swing, prices should break through the turning point of 135½ recorded on December 17th, it would be evident that liquidation was not completed and that support which turned the market upward on the l6th has been withdrawn (see previous Footnote). On the other hand, if, as happened to be the case, the buying support comes in around or at a higher level than 135½, we may conclude that demand is beginning to overcome supply (see previous Footnote), and that the next logical development for final confirmation of an important reversal will be the market's ability to rise above the top of the last rally, which was around 150, Dec. 18th.

On January 3rd these averages rise above 152, which gives final confirmation of an upward swing which might develop into a rise of substantial proportions.

In taking a position in the market, which, of course would be a long position, we have had, up to now, three opportunities:

(1) On December 17th when the market gave indications of having completed a selling climax, and at the same time, as shown by the entry on our vertical chart for that day, was able to rally vigorously on increasing volume. This was the first time it had shown ability to rally aggressively and the first time increasing volume had been shown on an advance for some time past. On the basis of these tentatively bullish indications we are justified in establishing long positions if we can get in near enough to the lows so that when we place stop orders on our commitments two or three points under our purchase prices, our stops will be about 1 to 1½ or 2 points under the danger level, that is the lows of the climax day.

(2) Our next buying opportunity is on December 29th when the market completes three days of lower support but the closing prices on each of these days are between 140 and 141, showing that the selling pressure is losing its force, since the net result of these three days' pulling and hauling is to leave the average almost unchanged following a considerable reaction. At the same time, lower volume on the reaction from December 18th's high, compared with the volume of the mid-December decline, confirms the inference that selling pressure is losing its force; buying power is overcoming it, as it now appears that the market has completed a typical secondary reaction (see previous Footnote) which has the effect of broadening the zone of support around the 136-140 level to sustain a proportionately more substantial advance than the first recovery, we either buy on this reaction if we missed our first opportunity, or add to our holdings; with stops on these new positions, as before, under the danger point, that is, the lows of December 17th. The average is now "on the springboard".

(3) On Jan 3rd the average goes into new high ground, overcoming the previous tops of December 18th, l9th, 20th and January 2nd. Volume tends to increase on the rally days, December 30th to January 3rd, an indication that is characteristic of a bullish trend. However, this is the least favorable of our three buying opportunities so far, since we would now be purchasing on an upwave, thereby materially increasing our risk, whereas previous commitments were established on downwaves, close to the danger point.

Having decided that the trend of the market is upward we must thereafter continue to trade on the long side until there are indications of a change in trend, or until the trend is in doubt. We must always be on our guard against any changes; and when the trend is in doubt we must take a neutral position, that is, be out of the market.

For the next several days, until January 9th, the market makes further progress on the bull side, recording 156½ on that day; but observe that the closing figures on the 6th, 7th, 8th, 9th and 10th are all within a range of about one point. That means the market made no upward progress as a net result of four days' activities following the 6th. The daily volume shows a tendency to taper off, which may mean a lessening of demand at the top of the swing to January 8th. This conclusion is partly confirmed by the shortening of the upward thrusts from the 3rd to the 7th, indicating that it was hard work advancing the market from l5O to 155. Buyers now seem reluctant to follow prices upward. On the day when the high of 156½ is recorded, the volume increases abruptly compared with the volume of the preceding sessions at the same time that the price runs up to a new high only to close near the day's low (*) and actually below that of the previous session. All of the foregoing is evidence of the approach of a corrective reaction, but we still hold our long position because, as yet, we have had no indications of important distribution.

** The action of the 9th is an illustration of a typical buying climax, which is the reverse of a selling climax. On this day, a poor quality of demand is being promptly overwhelmed by the superior force of supply of good quality. In order words, the bulls, realizing that they are encountering resistance to the advance, break the stalemate of the 6th to 8th by bidding prices up to attract those buyers who were too timid to come in before the advance to 155, but who now fear that the market may get away from them because it is "making a new high." Thus, there is a concerted rush of public demand which gives the larger and shrewder operators their opportunity to dump part of their lines on a broad and active buying wave, made to order for the purpose.*

Such a reaction begins on the 12th and the low point of it occurs on the 16th. Volume on the reaction diminishes appreciably compared with volume on the rise from the December 29th low, a bullish indication, showing that the selling pressure is light. On the 16th, the closing is nearly at the high point of the day – a bullish indication which is the reverse of the bearish indication on the 9th. This is our first sign that the reaction is nearly over. (*) So here we have a new buying opportunity in expectation that the advance will be resumed. (**) Further confirmation of this comes in higher support on the 17th and in an almost complete drying-up in volume on a dip to the same low level on the 19th. The closing prices on the l5th, 16th, l?th and 19th show support within a narrow zone, mostly around 147-8. We must, therefore, look for the advancing tendency to be resumed.

** Note that there is also an indication of a minor selling climax in the somewhat marked increase of volume on the 15th.*

*** To insure proper limitation of risk on purchases made at this level, our stops should be placed a point or so under the supporting points (lows) of the 16th. The stops on these new, and any previous, long commitments, should be raised to within a point or so of the January 16th to 19th supporting level after the rally of January 20th.*

Then follow four days, in each of which we see higher tops, higher bottoms and higher closing levels, accompanied by gradually increasing volumes – bullish behavior. This brings the market up within a fraction of the high figure of January 9th where, on the 23rd, a volume surge after four days almost perpendicular advance warns us of a buying climax. But here, in any case, we may expect hesitation or reaction, due to the influence of the previous top – January 9th.

Now observe that for the next thirteen sessions following the 23rd the market fluctuates within the range of 156-51, a very narrow range for the average. This is because it is called upon to absorb offerings representing stock purchased by over-anxious bulls who got hooked around the high level of January 9th, and perhaps other quantities bought on the way down in 1930 during the period not shown on this chart – purchases made by people who are now eager to get out even.

Such absorption is evidently completed by February 9th when after closing almost at the top on the previous Saturday, an advance into new high ground, 160 5/8, is recorded. (*) Note how the speed of the advance tends to increase, the average gaining 9 points in two sessions – 9th and 10th. (This is the mark-up forecast by item 3 in the footnote below.) See also how the volume increases to 4,000,000 shares and over on these two days, compared with a previous volume of 1,000,000 or 2,000,000 a day for thirteen days past. The exceptionally large volume of the 10th and 11th, plus the failure to record any material further gain on the high volume of the 11th, as usual, is an indication of some distribution and a setback. On the 11th the average makes a high of only one point above that of the 10th and closes at only a small fractional gain, on large volume – a large supply overcoming demand.

**The probability that this lateral movement, or trading range, between 156-151 is an area of absorption rather than one of distribution may be determined: (1)from the fact that volume remains low on the reaction to January 29th and tapers off promptly on the reaction to February 2nd; (2)from the tendency of the price movement to narrow into a comparatively small range instead of reacting as much as halfway back to the January 19th low, which implies that stocks are not being pressed on the market; and (3)from the fact that after the recession to February 2nd, volume tends to build up consistently at the same time that there is a lifting of the supporting points from February 5th to 7th –- behavior typical of the completion of a period of accumulation or absorption prior to a mark-up.*

After the mark-up of February 9th, we raise the stops on our long commitments to a figure within a point or so of the lows of the Jan. 23-Feb. 7 trading zone, inasmuch as the Feb. 9th rise enables us clearly to define the 151 level as a new and critical line of support.

Now, as we watch the supporting points for the next five sessions (13th to 19th), we find that they are all around the 160-162 mark. Meanwhile, volume decreases promptly on the dip to 160. This says there is another advance coming; the market is not ready to turn downward yet. On the 17th there is an attempt to run the average up to a new high, which fails. The closing is almost on the bottom and volume increases noticeably over that of the three previous sessions. It looks at first as if this might be a buying climax (Footnote, Pg. 3), preceding the end of the rise, so we bring the stops on our long trades up within one point of the February l4th low as a precautionary measure. We have now had a substantial advance, followed by six days lack of progress and comparatively high volume, which means that the market has reached a critical position.

But the average is immediately supported the next day and on the 19th the closing is nearly at the top. It thus shows ability to rally away from a possible danger zone and willingness to try to negotiate the resistance around the tops of the range at 166. The lower volume under these conditions may mean that the supply of stocks has become scarce; so we sit tight. Next day, the 20th, the average advances again into new high ground, absorbing the overhanging offerings on a volume increasing from around 2,500,000 to nearly 4,000,000 shares; on the 21st to a new high and a higher closing, with the volume up to 5,000,000 shares, thus far making progress in proportion with the expansion of volume. (*) On the 24th (holidays intervening) it registers a further gain of 2 7/8 points in price and a little over a point and a half in the closing figure, on a volume of 5,300,000 shares. We now become very suspicious of this advance on such large volume and particularly the failure (apparent on the next day) to hold a quick upthrust to a new high on such heavy turnover (which is characteristic of distribution), suspecting that this volume surge may be climactic. (**) Accordingly, we move our stop orders up within a point or two of the lows of the 24th. (***) Next day, February 25th, we observe a lower top and bottom and a lower closing, as well as a loss of the two previous days' gain, which indicates that

**The actual volume of Feb. 21st was 2,435,000 but in comparison with the volume of recent five-hour, and recent previous Saturday sessions it is clearly evident that this two-hour turnover is relatively large and consistent with the increase of Friday, Feb. 20th. Hence, in order more fairly to reflect the relative magnitude of this particular Saturday's volume -- in comparison with the full five-hour sessions -- we double the actual total and find that we have the equivalent of a 5,000,000 share day.*

***With volume running at the rate of 5,000,000 shares per day for three consecutive sessions, we conclude that the market's advance is attracting an expanding public following. This increased public participation creates an active demand (of poor quality) which facilitates unloading (supply of good quality) by large interests at prices advantageous to themselves.*

****Meanwhile, following the mark-up of February 21st, our stops were brought up under the February l4th low point.*

supply is overcoming demand and confirms the previous indication of a probable reaction. If our stops have not been caught, we now promptly close out all our long stocks; and select from our list of individual issues the best five or ten that are in the weakest technical positions, and sell them short with stops 1 to 3 points above the danger level, i.e., the high points of the advance.

After such a prolonged rise, we may expect a more substantial reaction than any we have had since the December-February bull move started; and perhaps an important decline because there have been evidences of distribution extending as far back as February 10th. On the 26th, the high, low and closing are almost identical with those of the previous day. The market, therefore, is making no further progress upside on heavy volume, but the demand is still enough to hold it within the previous range – 168-173. On the 27th, however, we note a clearly lower top, bottom and closing, and some – but not a very large – shrinkage in volume to about 3,700,000 shares. The significant feature of this day's action is that it marks a pronounced change in the market's behavior. It is the first time since early December that volume has remained so high on a reaction. Heretofore, volume has been shrinking promptly on setbacks.

The fact that prices cannot continue to advance into new high ground, combined with the comparatively high volume, leads us to conclude that the big fellows are unloading. And the relatively large volume on the reaction of the 27th indicates that they are filling up all the buyers on the way down from the highs with what they were able to sell in the range between 168-173.

We must bear in mind that prices have now advanced from 135½ to 173, 37½ points. This is a big rise in the averages, because such a rise indicates that many individual stocks used in making up the averages have advanced nearly double that amount. Also, the angle of the advance, as shown by placing a ruler along the line of bottoms from February 5th to the 18th is such that it is unlikely that this pace of acceleration of rise can be maintained. This is emphasized by an even sharper angle from the 18th to the 24th, when the supporting points were raised considerably away from the previously established diagonal support line. This sudden whooping up of prices, after such an advance, suggests the application of hypodermics which, combined with a high and expanding volume, increases the market's vulnerability to heavy realizing sales and likewise increases the danger of a general withdrawal of experienced operators who refuse to continue to buy at these levels. It is such conditions as these (created, as they are, by large interests who are managing the market) that are detected by floor traders and large outside professionals and recognized as indications of a turning point. The latter now add to the supply by getting out of their long stocks and taking short positions, thereby not only helping to assure a turning point but also placing themselves in a position to profit by that downward swing. (*)

**We should also suspect, when we see such "whooping up" tactics, that informed interests are in a hurry to wind up their campaign of distribution because they see some bad news or adverse conditions in the offing, events not yet apparent to the public, which draws its conclusions from the emphasis placed on all current "good news" and the befuddling atmosphere of bullish excitement in board-rooms.*

In your own experience, you must have observed that "bad news" very frequently comes out say a week or ten days after a decline following just such a violent bidding-up of prices. Financial writers then "explain" the break as being due to the bad news. But the logic of the situation is that large interests have already sold out their long stocks in anticipation of impending bad news, thus creating the supply which starts the market downward before the general public is aware that any bearish developments are imminent. Insiders may, in addition, take short *positions in advance of the unfavorable news so they may have added buying power with which to support the market when a frightened public begins to sell in response to, and simultaneously with, the release of the "news."*

We must act in harmony with these shrewd operators and put out more shorts, (with stop orders placed as before, above the Feb. 24th resistance point) as the action of the 27th gives us a new selling point. On March 2nd, after a little rally, the average declines 6 points from the high of that day and closes nearly at the bottom. If we have ignored all the previous warnings of a gradual weakening of the technical position, we cannot ignore this decisive breaking of the very backbone of the advance. This day's behavior shows definitely the heavy withdrawal of bids underneath the market and the volume (3,300,000) remains high – very high in comparison with the volume on all previous reactions since December 8th – indicating that very substantial lines of stock are still being pressed for sale by large interests. Having accepted some or all of the bearish indications of the foregoing six sessions, we conclude that the upward trend has terminated (at least for the time being), after running the greater part of December, January and February and that a change to a downtrend has begun. That is to say, we are entering a substantial intermediate reaction which may develop into a decline of major proportions.(*) It looks now as if we were correct in our assumption that some distribution was accomplished as early as February 10th, but the main move upward was continued in order to facilitate unloading of stocks which had not topped out at that time.

**Under the conditions now existing, we should liquidate investment as well as long trading positions, for even though it may develop that the major trend will turn upward again later on, by standing aside with our investment funds liquid while the market is working out an important intermediate downward swing, we avoid the danger of carrying some or all of our investment stocks through a bear cycle. Thus, we insure ourselves against serious depreciation of capital and the ever present possibility that Dome of the stocks which we originally held might fail to recover on the next or succeeding advances.*

We shall have ample warming when the market is again stabilizing and preparing for a new bull movement. With buying power intact, investment positions can then be reestablished. And most probably we shall find that certain of the stocks we previously held will not be as desirable or as responsive to the next upward cycle as others which will become new leaders.

By such scientific handling of investment commitments, we may gain more through capital appreciation than we might lose in dividends in consequence of having stayed out of our stocks for as much as a year or more.

At this juncture we should be alert for opportunities to sell short more of such stocks as are shown by their individual charts and Group charts to be in a weak position. These should be sold short only on bulges, and the fact that the averages have declined from the top about ten points (although they may decline further) is indication of a part way rally which normally is likely to fall slightly short of recovering about half the recent decline.

The initial reaction of the downward swing ends on March 4th at around 159, a point at which the market was previously supported on February l4th. Here we have a reverse of the situation which existed on January 23rd. The sharp acceleration of the downward movement on March 2nd, 3rd and 4th creates an oversold position at the same time that the average touches a former support level, a condition that usually is conducive at least to an attempt at a rally due to the buying of traders and others who may believe that stocks are again cheap, and covering (buying in) of shorts on the part of bears who wish to cinch profits and stand aside, waiting to see how the market will meet a test of the former supporting level.

Our expectations of hesitation and a possible rally from this point are fulfilled as demand from the above sources brings a fairly vigorous run-up on comparatively light volume on the 5th. A further rally to a higher top and a higher bottom next day tends to confirm our anticipation of a possible turning point for more recovery; but the sudden increase of volume on the 6th may indicate the climaxing of the rebound, so we wait for clearer indications. Another higher low (marking the fourth day of no material progress on the down side) and a closing near the high on the 7th says that the volume of the previous session was climactic on the down, rather than on the up side. This demonstration of a change from technical weakness to technical strength brings in sufficient new demand to start the part way recovery we have been waiting for. However, we do not expect this recovery to carry much above 165 because large interests would not be willing to help the market far enough into the February distribution area to let the public out even.

Stated another way, our reasoning is that a part way recovery would now be a normal development; but the big fellows would be anxious to run the market back to the February tops only in the event they saw an opportunity of pushing prices far enough above those former highs to realize a profit on the offerings they would have to take from the buyers who are "hung-up" with stocks at these levels. Even should they see such an opportunity, it is more likely that they would prefer first to tire out, or shake out, this overhanging supply. However, we reason further, that in view of the extent of the distribution as indicated by the heavy volume and breadth of the February campaign, the greater probability is that they will manage just enough recovery to discourage amateur shorts from selling and to keep the

February buyers locked in while they, at the same time, distribute more stock on rallies to a lower top.

Meanwhile, we observe that the average, from February 24th to March 4th, recorded a total decline of 14 points from the high of 173. A normal recovery of less than half of this would be five or six points in the averages; or to 164 or 165 (approximately). On March 10th, the average actually recovers 7 points from the low, which is just halfway. Volume on this rally is not measuring up to the standard of the February rise; behavior which (1)marks the rebound as purely technical, and (2)indicates the exhaustion of buying power as a result of filling up all the buyers on the previous distributive movement, thus (3)confirming the probable accuracy of our other deductions.

Around the top of this rally, therefore, we take our additional short positions, selling at prices as close as we can to the danger points on the individual stock charts, so that our risk is limited to a minimum in every case. Further symptoms of progressive weakening of the market's position appear in the dip to March l3th. The volume (*) again remains comparatively high instead of shrinking appreciably as it did during the corrective reactions of December, January and the forepart of February; and on the l3th we find the average down to 158, which is a point lower than the previous supporting point of March 4th. This substantiates the correctness of our general bearish position and suggests further selling on subsequent rallies if we have not sold our full line.

**In judging volume behavior, allowance must be made for the fact that declining markets normally are accompanied by lower volume than advancing markets except, perhaps, at times when active liquidation is taking place. The reason for this is that bull movements attract a much greater public following than bear movements.*

In the following several sessions there is an irregular recovery to 166 with no material or consistent expansion of volume except for a sudden increase on the l9th. But this has the earmarks of a climaxing indication, confirmed by hesitation – or lack of further upward progress – on the next two days. We now also note that the average is faltering about a point below the top of the rally of the 10th, at a level where our previous deductions led us to anticipate just such a probability, we watch carefully for further developments, realizing that the average has reached a critical position. Should new demand fail to come in here, we may anticipate a decline in proportion with the extent of the primary distribution of February, to which there has now been added secondary distribution on this March rally. (Stops on our short positions may now be brought down within 1 or 2 points above the highs of March 10th to 25th.)

There is more lateral movement over the next three sessions, featured by a weak rally on the 24th and 25th (note the relatively small volume), making a total of six sessions during which the average has hesitated just under the lows of the February 20th-28th trading range. The market's inability to overcome the high of March 10th, and its failure even to equal that level is now clearly defined, affording final confirmation of the comparative safety of our short positions; likewise a clear warning of the advisability of liquidation by investors who may not have sold out heretofore, since we now have all of the elements to corroborate the prospect of a substantial decline.

On March 26th, the average starts downward, plunging toward the recent line of 158-160 supports on steadily expanding volume over the next two sessions, which tells us, in advance, that these former lows will not hold. (*) From here on the down trend is unmistakable continuing almost without interruption. A brief rally on the 3lst

**The volume surge of March 28th (4,200,000 shares if we consider this Saturday's volume as doubled) should not be mistaken for a selling climax. The distinguishing difference between this day's relatively large volume increase and previous volume surges is that the latter appeared after an extended or well-developed downward swing, whereas the comparatively high volume of March 28th accompanied the penetration of the March 4th to 27th trading range, 158-166; and therefore indicated a large increase in supply, stimulated by the breaking down of the line of supports around 158-160.*

To clarify this, we may set forth the following principle: A sudden or abnormal increase in volume, appearing after a given price movement has been in progress, usually indicates the end or the approaching end of that particular movement, up or down.

However, if unusual volume appears when the price is breaking through a well defined trading range, or zone of congestion, in that event the abnormal volume more probably indicates a continuation of the price movement in the direction of the break through. Thus, if the price works up to the top of a trading range and breaks out on large volume, the inference is that somebody is willing to absorb all of the offerings overhanging around the previous tops in the expectation of pushing the price to a higher level; and vice versa in the case of a break out on the down side of a trading area. Whether he or they will succeed in extending the movement and accomplishing the purpose intended will depend upon the existing condition of the market.

Therefore, you must not attempt to apply the above principle in a mechanical way, nor as a fixed, or hard and fast rule; but consider it only in conjunction with other contemporary technical manifestations.

and a small two-day rebound from the old January 28th-February 2nd supporting level around 152, on April 4th and 6th, emphasizes the weakness. (Note the immediate shrinkage of volume on these rallies.)

Next follow several days of holding within a narrow range from April 7th to 14th inclusive, as the average approaches the January 15th to 19th supporting points, with no evidence of any selling climax nor convincing rallying power. But as the average levels off and then drifts to a dead center on the 11th, we may reduce the stops on our short positions to a point or so above the level of a halfway recovery from the April 7th low, merely to guard against an unexpected change of trend. But instead of rallying vigorously away from this dead center, after six days' apparent support, the market tells us there is still no buying power by its inability to enlist higher support or materially expanding volume when it tries to follow up the advantage of the April 13th bulge.

On the 15th, a breaking down into new low ground confirms the above indications and affords an opportunity for increasing our short line by pyramiding with more short sales of the same or other stocks which promise to exhibit the greatest weakness. These sales can be protected by stop orders one or two points above the highs of the previous day; and the stops on our other shorts may now also be brought down to the same levels. The persistent increase in volume from April 11th to April 18th accompanied by declining prices is characteristic of a liquidating market, and so long as volume continues at about this level, or higher, there is little danger on the short side, with systematic stop 1oss protection, as above indicated.

There are occasional sharp rallies, evidently made by short covering, such as on April 30th and May 1st. This kind of buying kept the volume up to around the 3 million share level but as will be seen by the performance of May 1st, such advances are quickly lost because when the numerous shorts have covered, no buying power remains to take the place of this demand and the market underneath proves to be hollow. (*)

**The volume surge of April 23rd implies a possible selling climax which suggests that in view of the extent of the decline to date and the fact that the average has now come down into the important December support area, we might expect a corrective rally to appear here.*

A normal rally would be about halfway back to the April 14th high point which, in this instance, would also be up to the small rally top of April 20th, or to about 146. Because of the previous bearish behavior of the averages and the likelihood that we are in a liquidating market, we do not regard this one day's slender evidence (that is, the high volume of the 23rd) nor the possibility of a corrective rebound as threatening to our short positions. However, if we wish, we may reduce our stops to a level one or two points above the part-way rally mark while we watch to see what the market will do next.

When it fails to rally as might be expected but instead sinks back almost immediately to close at the low points with no shrinkage of volume on the 25th, we recognize that it is vulnerable to fresh selling pressure.

The sharp rally of April 30th puts us on guard again, however, for now we observe that the downward thrusts have been shortening since the 28th -- that is, between the 27th and 30th, the bottoms show a tendency to round off or flatten out -- i.e., the rate of decline is diminishing. From the standpoint of the major trend, the breaking of the December lows, plus our other indications, are still bearish. But the slackening of downward progress, on comparatively heavy volume, also warms us to be on the lookout for a possible minor turning point, in other words, a belated technical recovery which may later prove to be the beginning of a more important change depending upon how the market behaves during and after the indicated recovery.

Observe how the rally beginning May 2nd and running to the 4th and 5th is accomplished on markedly decreased volume, showing that whatever demand exists in the expectation of a recovery from the firmer December supporting level, is not willing to follow prices up. Such support is more likely to be due to short covering than the re-entry of substantial buyers. The rally which begins May 7th lasts only three days until the 9th and that day's close is around the low, which shows that the bulls have exhausted their buying power. (*) From the 11th, the downward march of prices is resumed and the volume again increases on the down side, showing a breaking out of fresh liquidation. (Note the complete failure of any tendency toward hesitation or rally as the average touches the critical April lows. Compare this action with December 26th to 30th, and see Footnote Page 1.)

**Additional indications of the weak character of this recovery are given by the following: (1) the volume surge of May 8th which is confirmed as a minor buying climax by the prompt loss of that day's gain over the next two sessions, as (2) the average runs into resistance just under the temporary supports of April 17th to 21st -- resistance created by the offerings of buyers who mistakenly judged those lows to be a bottom and who are now anxious to get out even.*

On the up-wave to May 9th, therefore, we have another selling opportunity in anticipation of a resumption of the major decline on the secondary reaction to the April lows.

A low point is recorded around 113 on June 2nd, with the closing practically at the low. The only warning the average itself gave us of an upturn from this point was the small downward progress made on June 2nd in comparison with the previous day; the closing price on June 1st was 114 ½ and on the 2nd, 113 3/8, notwithstanding heavy dealing -- 3.300,000 shares. This showed resistance -- possible buying by substantial interests. Moreover, the market has now been declining steadily since the high point of February 24th when the average reached 173. The price of 113 is therefore 60 points down, which means that prices have shrunk about one-third from the high.

From our figure charts of the averages and the position of our group charts and of leading stocks on individual charts, and the action of our Wave Chart, we may learn that a danger point to shorts is approaching. But for the purpose of this explanation of the vertical daily Trend Chart, we will assume that this is our only guide. So when the market suddenly reverses its form on June 3rd, recovers 9 points (from the low point) in the average and closes nearly at the top, with the volume of trading equal with that of the two previous days of heavy liquidation, we must, somewhere during the session of June 3rd, cover our shorts if we are still short. In any event, this should be done at the next day's opening. (*)

**Additional reasons for taking such action are that the pace of the decline on May 29th and June 1st became so sharply accelerated as to create an oversold condition which is dangerous to shorts; and the speed with which the market recovers the latter day's loss (on June 3rd) suggests that this last phase of the downward movement is probably in the nature of a shake-out.*

The averages have shown no preparation for a change in trend. This sudden change is like a hypodermic or a heart stimulant, administered to a patient who is dying. He suddenly revives. Of course, we all know that this change reflected the favorable sentiment due to President Hoover's plan of postponing reparation payments. But these things do not always show on the charts at the time they occur and we cannot consider them. We are learning to read the market without the aid of the newspapers. Having operated on the short side for the past three months, we have substantial profits, even though we cover at the high prices of June 3rd or around the opening of the 4th. We await developments in order to ascertain whether this bullish factor is sufficient to turn the tide; that is, turn the bear market into a bull market. With sufficient experience as a foundation for our judgement, we know that such violent changes in trend occurring within a few hours are not a lasting basis for bull operations.

The closing at the top, June 3rd, in itself indicates a further rally. On the 4th, there is a gain of nearly 5 points (over the previous day's high), making about 14 from the low point. The volume is still high, over 3,000,000. That is, we have good progress on high volume. But on the 5th, the gain in the average is only 3 points, and the volume decreases a little, showing that the buying power is less; buyers are reluctant to follow prices upward after such a steep rise. The closing price is below that of the previous day, which indicates that the day's net pressure, or supply of stocks, was greater than the demand. This looks as if the rally is over for the moment. On the 6th, there is a further loss of nearly 8 points, bringing the average down halfway from the top – a normal reaction on reduced volume. On the 8th, after a further small recession, the average runs up and closes at the top, showing that the market met support at the 120 line. It recovers to 126, which is about two-thirds of the reaction. Although the volume is comparatively light, the speed of the rebound and the behavior just described says the balance is in favor of the bull side.

From the 8th to the 15th, a zone is established roughly between 130 and 120. On the basis of what this chart indicates, we are neutral, waiting to see whether, when the market works out of the zone, it will be on the up or down side. As the rallying days proceed, we observe a falling off in the volume which is not a bullish sign; also that on the 11th and 12th, the net gain (in the closing price) for the day on the up side is a point or less. The average seems to be meeting resistance again where the June 5th rally was checked. On the 13th, the range of the average narrows until it is less than 2 points, with a fractional net loss for the day. This is also a bearish sign -- the narrowing into dullness at the top of a 17 point rally, on a volume of only 540,000 shares (or about 1,000,000 if we double this Saturday turnover).

This bearish symptom is confirmed on the 15th by a little wider spread (from high to low), meaning more activity (greater willingness to follow prices down), a closing near the low and an increase in volume, showing slight increase in pressure. The bearish signs are then borne out by the following four sessions, ending on the 19th, with the volume remaining stationary around 1,000,000. However, volume does not increase on the downside; instead it tends to taper off as compared with volume on the rally from June 8th to 12th indicating light pressure; nor does the price break out of the 120 range; in fact it meets support on the 19th at around 122, which is about two points higher than the support on the previous low of the 8th. (*)

**Here we have a variation of the sequence of selling climax, technical rally and secondary reaction referred to in the Footnote, Pg. 3. Considering the action in broad perspective, observe that volume diminishes appreciably on the secondary reaction to June 19th, even more decisively than in the case of the secondary reaction to December 29th and in marked contrast with the increasing volume on the secondary reaction to May 14th which failed to hold. Also, the market on June 19th meets support well above the climax lows of June 1st and 2nd. Likewise compare the greater speed, spread and sustaining power of the June 3rd to 6th rebound with that of April 30th and May 1st.*

All now depends upon what the market does in the next day or two. If we have another downward session on increased volume, particularly if the average price goes below that 120 line of previous support (June 8th), we must conclude that chances favor a lower market (compare with behavior of May 14th and 15th); but if support continues around 122 on such small volume (compare with action of Jan. 15th to 21st), there may be a trading opportunity on the long side with a close stop.

Next day, June 20th, removes all doubts as to the immediate tendency of the average, for the market opens up a point and a half above the previous night's close and on a greatly increased volume (**) makes a rapid advance nearly to 131, putting the average into new high ground above the previous trading zone. The heavy volume emphasizes the importance of this. (See Footnote Pg. 9.) The gain in the average over the previous day's high is more than 7 points and the close is near the top. If we have been watching the tape during the day, or refer to our Wave Chart at the end of the day, we observe this sudden change and we either buy during the session of June 20th with a close stop or we wait until the price breaks through its former highs and buy around the closing price of that day or the opening of the following session, June 22nd, as the market's behavior to here tells us we may expect a quick mark-up. We are not justified in reestablishing investment positions, however, for as explained in Paragraph 1, Page 11, we do not have the basis for a lasting advance.

***The volume is obviously large for the two-hour session and hence should be doubled.*

June 22nd there is a higher opening and a gain of 7 points in the average, most of which is held for the day. The volume runs up to 4,600,000 shares – the price is gaining in proportion with the rise in volume. A reaction on the 23rd shows that most of the gain of the previous day was lost, but the bullish indication therein is a shrinkage in volume to 2,600,000 shares – nearly one-half the activity of the day before. That is our warning to sit tight.

The 24th recovers the loss; the average advances 8 points for the day and 3½ points above the June 22nd high, or to 141, and the volume is the highest thus far, over 5,000,000 shares. We begin to grow wary of the bull side because that volume in comparison with the trading of previous weeks indicates selling by large interests. (That is, a probable buying climax.) We move our stops up within a point or so of the June 23rd low and await developments.

The 25th makes a further gain of 2 points in the average, then the price slumps about 6 points, closing a point from the low, on volume of 4,300,000 shares – large supply overcoming an excited public demand coming in, as usual, on the top of the rise. This is distinctly bearish.(*) We therefore close out our long trading positions and examine our individual charts for stocks which are in a weak technical position so that we can get short on the next bulge.

**Note the shortening of the upthrusts, that is, the tendency of the high points to arch over, from the 24th to the 27th.*

June 26th shows a range of about 5 points – a little narrower. Although the closing is near the top, the volume has fallen off to about 3,100,000 shares and the upthrusts are shortening. In the net, these indications are bearish. The outlines of a new trading zone have been tentatively established between 137 and 143.

On the 27th, the average bulges over a point, narrows its range to 3½ points and closes with a net gain of about 1½ points on a volume of about 3,800,000 (Saturday's volume doubled). This looks like bidding up to a new high in order to catch shorts, and selling on the way down. We therefore put out some shorts, protecting our commitments with stops 1 3/8 to 2 or 3 points above the high of
June 27th.

On the 29th, the opening is lower and the price recedes from 144¾ (the previous day) to 140, closing near the low. We now observe that the average has spent four days moving sidewise, making no further progress after a steep rise from the June 2nd low and, following the 5 million share session of June 24th, there has been a steady decrease in volume. In view of our previous deductions, we interpret this to mean that there is a lessening of demand on the top of the rise. We also note that any further lateral movement or reaction would definitely break the upward stride established on the last phase of the advance from June 19th. Hence, we are ready to sell more stocks short if we can get them off on bulges.

On the 30th, the average declines nearly 3 points to 137 on volume (2,000,000) about the same as the previous day. The market is still in the 137-143 zone but has now definitely dropped out of the sharp upward angle in which it rose from June 19th to the 27th, showing exhaustion of buying power. Low volume on the two-day dip to the bottom of the range 137-143, however, suggests we may anticipate an effort to rally back toward the high at 144¾. The way the market behaves on the expected rally will probably help to confirm, or it may contradict, our position; so we await developments.

July 1st, there is a wider spread in the price, nearly 2 points higher closing, but volume shrinks to 1,700,000: bearish. On the 2nd, the market narrows to a 3 point range for the average and the closing is 1½ points lower on reduced volume – increased dullness, lower close, and less volume indicate less power on the bull side. On the 3rd, there is another attempt to rally and the average reaches the old 143 supply line at the upper edge of the trading zone, closing about 3 points higher but volume is not measuring up to the standard of previous (late June) rally days. Nothing to be afraid of. (We sell more stocks short on this rally which is the bulge we have been waiting for, placing stops, as before, above the danger point, that is, the high of June 27th.)

July 6th, a 2 point range for the average, closing nearly 2 points down on 1,000,000 shares. We read this as an indication that the rally of July 1st to 3rd could not be sustained and that the tendency toward narrow swings, heaviness and dullness is the result of the market's having become saturated with offerings. All bearish. (*)

**The average is now on the hinge and on the "springboard" for an important slump.*

July 7th, a rally at the opening, then a 7½ point break in the average on decisively increasing volume (3,000,000). The market is now out of its former trading zone on the down side and the volume indicates that liquidation is being resumed. Thus the rally from 113 (June 2) to 145 (June 27) has run its course after lifting the average into the lower edges of the old December, 1930 - January, 1931 support area, and we must assume that the next test of the market will be around the levels at which support was rendered (122) on June 19th. If the large interests who bought on June 2nd and 3rd, and who undoubtedly distributed their holdings during the high markets of the last week in June are willing to take them back near or above the previous low levels, it will be an indication of their confidence in the future and a sign that the bear market is over. If there is no such sign, we conclude that the bear market has been resumed and that the June recovery was only an interruption of the main trend. We are on the short side and shall occupy that position until we see some reason for changing it, either to neutral or the bull side.

A 2 point further loss on July 8th, a small rally on a 1,500,000 share volume during the 9th and 10th (as the average hesitates halfway back to the June 19th low), then a dropping off until, on the 15th, the average nearly touches 126 – a 19 point decline from the top. On this day, prices spread over 4 points from high to low and close slightly above the middle of the 4 point range, on a 2,600,000 volume – a minor selling climax. There is no follow through on the down side next day; instead, a quick rally and a high closing. Thus we have two indications which might lead to a rally. But that will be a normal occurrence after a decline of 19 points. It should, in fact, amount to 7 or 8 points from the low if it is to be a real rally. Halfway would be about 9½ points. Such a rally occurs from the 17th to the 21st and amounts to 9 points, thus affording another good selling level if we are not satisfied with the size of our short line. (*)

**So that you may understand better how to handle your investment funds and may recognize the hazards in carrying stocks up and down through intermediate bull and bear trends -- a procedure that causes so many investors heart-breaking losses -- the following general observations are introduced at this point:*

The relatively small volume on which the market is now declining tends to lull the public into a spirit of indifference toward the market. But, contrary to popular impression, the low volume accompanying the steady downward drift is of bearish and not bullish import.

This small volume is explained by the fact that the majority of people are "constitutionally" bullish. They can always be induced to buy stocks <u>after</u> the market has been advancing for some time, or when everybody else seems to be buying. But, as pointed out elsewhere (Footnote, Page 8), they fear to sell short and hence will not participate in a bear market as experienced operators do. Consequently, the volume of daily trading tends to grow smaller during the progressive states of a bear market.

To put it another way, the public which came into the market and bought freely around the tops of the February, 1931 rise and the June recovery, is not loaded up with stocks at the highs. Its buying power, accordingly, is exhausted. These people will not liquidate -- until compelled by necessity -- because on the one hand they fear the market <u>might</u> go up again and on the other they are <u>wishing</u> and <u>hoping</u> that it will. Instead of recognizing the danger and philosophically adapting themselves to the logic of the situation by cleaning house and accepting some losses so that they may have buying power to repurchase profitably and advantageously when the time comes to be bullish again, they merely hang on and thereby magnify their errors. And those whose funds are not so tied up are too frightened to buy and much too timid to sell short.

Consequently, volume shrinks and the market becomes a professional affair, except when outcroppings of new weakness force the tied-up long holders to liquidate from time to time.

Thus we have both an explanation of a little understood market phenomenon and an example of the risks involved in: (1) failing to liquidate promptly on the early warnings of danger to bull positions (which appeared in this case in February); (2) refusing at least to protect long commitments with judiciously placed stop orders; and (3) the folly of yielding to a natural impulse to jump into the market when prices are away up and everybody else is excitedly buying.

Now the rally is over, for, on the 22nd, prices drop off again after approaching the lower edge of the recent 143-137 supply zone a second time (the first was on July 10th) and proceed toward the former low of 126, where we watch to see if any real support appears.

It does not. The average goes to about 122½, recovers slightly, makes a new low August 10th around 120, rallies nearly 10 points after dipping briefly to the June 8th support point, narrows and dies out at the top (August 15th); swings back again to around 120 (August 24), recovers weakly and on small volume (under 1,000,000) from this critical supporting level until August 28th and 29th, when it begins a new downward march at a very sharp angle. The volume rises to around 2,000,000 and stays fairly constant at that figure after a break through 120, showing that the liquidation is again active and heavy. We have no reason to change our short position, but plenty of reason to pyramid every little while. (*)

**Stops on our short positions, meanwhile, have been moved downward as follows: To a level even with our original selling prices after the minor selling climax of July 15th; to a little above the high of July 21st after the decline to July 24th and 25th; to a point or so above the Aug. 15th resistance point after the drop to August 24th and 25th.*

Beginning on September 18th, the volume increases to 3,000,000 shares and on the 19th to nearly 5,000,000. This great increase in volume from less than 1,000,000 shares in late August to the equivalent of 5,000,000 shares on September 19th (Saturday's volume doubled) is our warning to move stops down close to the temporary rally tops of September 15th to 17th and be on the lookout for a sharp rally or turning point. Reason for this: Prices have receded from 145 to 98 without serious interruption. The abrupt extension of the decline, plus the unusually high volume of the 19th suggests that the market has reached an oversold condition. A sharp rebound should not surprise us at any time now and it probably is not far away for there has been no rally of any size since August 29th – about three weeks. Seldom does the market run continuously in one direction for so long without a reversal of some sort.

September 21st, the average loses 4 points more, making a low of 94, but recovers 5 points by closing time and this makes it close above the previous day. The volume is 4,400,000 -- again unusually high and almost equal to the day before. This action, combined with the 8 point spread in prices for the day and the slightly higher closing leads us to cover our shorts with a view to putting them out again on a further rally; or, we may prefer to sit tight and depend on our recently reduced stops to keep our trades alive if the expected rally should fail to develop material proportions.

On the 22nd, the volume drops off to about 2,000,000 shares; the close is slightly lower and the range has narrowed. The net result of these three sessions is to leave the market practically unchanged at the third day's close. Downward progress seems to have been checked and the small volume on the dip back from the high of the 21st, on Sept. 22nd, implies a lifting of selling pressure. After such a great decline within three weeks, this is an indication of more rally. This comes on the 23rd, and gives us an opportunity to sell short again while the market is still strong or when we see the rally is failing. Such an indication is given by the way it rallies on the 23rd. On this day, the average recovers to nearly 107, closing at 105½, but the volume falls off to under 3,000,000 shares and we therefore suspect that it is merely due to shorts who all tried to cover at once. Such a rally is too effervescent. It is not likely to last because it removes buying power which formerly existed, and leaves the market without support between the high point of the rally and the previous low.

The market acts just that way; on the 24th it loses 8½ points from the previous day's close and ends 3 points above the extreme low of the 21st. The constant volume, compared with the previous day, plus the rapidity with which the average yields nearly all of the previous three days' gain, confirms the fleeting character of the rallying power and the lack of important (good quality) demand.

We conclude that the market's inability to enlist worthwhile support and its tendency still to seek the lows will probably induce a fresh outpouring of liquidation should it break the line of support at 95. The situation is still critical on the 26th and 28th when a brief one-day rally (on light volume) and a dip back to 95 bring about a slab-sided, or downward slanting formation, judged by the tops of the 23rd to 28th, which suggests the pressure is downward. Volume decreases to under 1,500,000 on the 26th and 28th, but in view of the market's recent bearish action this looks more like a swing to a dead center preceding new weakness, than diminishing force of supply. Furthermore, the low closing of the 28th leaves the average hanging on the edge of the 95 supporting line. If it cannot rally promptly from here, there will be more decline ahead. Accordingly, should prices break through the low point of September 21st at 94 on increasing volume, we shall again sell more stocks short. We realize that after a big decline we may be taking chances in trying to get what may prove the end of a bear market, but we do not know when the real turn will come so we keep on playing the short side until the market itself tells us we are wrong or that the trend is changing.

New lows are the rule until October 5th when the average touches 79, closing within a point of the low and the volume is more than 3,000,000 shares. On the evidence of this chart alone, we find nothing that causes us to cover on this day, although the decline is again becoming sharply accelerated which warns us to become wary (refer to Footnote, Page 19, commenting on similar behavior May 27th to June 1st).

The low closing suggests lower prices the following session but the market fails to confirm this expectation, thereby giving us additional warning of a change. Instead of sagging, it opens slightly higher on the 6th, then advances steadily all day with only a 1½ point reaction at the close. The recovery in the average is about 11 points on that day, the most aggressive rebound since the long decline from 145 started. Also, there is a heavy increase in volume -- 4,300,000 shares; emphasizing the change. If we were not watching the tape that day (which would have told us to cover), or we had no Wave Chart to show us what the tape revealed, and our other charts (if any) gave us no indication of a reversal, we must cover our shorts after we have had a chance to examine the results of the day's activities.

We realize that the average has now declined from about 312 in September, 1929, to 79 in October, 1931. We cannot expect this bear market to go on indefinitely. We do not immediately jump to the conclusion that a violent recovery is occurring; that a bull market is under way. We wait and study the action of the averages and our other records.

Over the next three sessions, there is a strong rebound from 79 to 99 – 20 points. The rise to October 9th breaks the downward angle of the decline from the August 29th high point as will be seen by placing a ruler across this and the high of September 23rd. On the 10th, the market narrows; volume falls off to 800,000 shares. From what we have learned by our preceding study of this chart, we recognize the indication as a sign of a reaction which comes in the next two days when the average recedes to 88, a point over a normal halfway reaction. Observing on the 14th that the market dips back to the supporting points of Oct. 7th and 8th on comparatively light volume, we decide that if it is able to hold at this level or above the lows of Oct. 1st and 2nd, it will be completing a secondary reaction which would confirm the action of October 5th as a shake-out. Thus the market seems to be forming the outlines of a supporting zone with the low points of September 30th to October 14th (85-88) as its probable base.

Accordingly, we watch for an opportunity to establish long trading commitments with the idea that we may be able to make a play for a further recovery, provided we can secure the proper limitation of risk with stops placed close to the Oct. 5th and 6th, or under the Sept. 30th - Oct. 14th danger points. We do not take an investment position, however, because we should like to see a period of dullness in preparation for a real bull market which, normally, after such a decline, should begin somewhere about this level. To say positively that it <u>will</u> begin would be a pure guess. The market will tell us when it is time to take a long <u>investment</u> position.

On the 15th, after rallying to the previous day's high, the average reacts, but a decrease in volume, higher close and higher low tend to confirm this performance as completion of the secondary reaction from the October 9th rally top, thereby giving the cue to venture trading purchases. Accordingly, we now buy the few stocks we have selected for the purpose of catching the indicated further recovery.

Diminishing volume on the rally of the 17th and 19th, followed by climaxing indications on the next two days as the average reaches the previous resistance point, all tell us to anticipate another setback. We wait to see whether it promises to be brief or whether it may involve another test of the 85-88 support level. In the next three sessions, the market swings to a dead center, coming to an apex on the 24th. Four days' lateral movement, between the 21st and 24th, meanwhile breaks the rather steep angle of the advance from Oct. 5th. Apparently, buying power has been exhausted by the recovery to 100 or buyers are not yet ready nor willing to follow prices upward. Also, there is no increase in volume on the rally efforts of the 23rd and 24th. These indications are all bearish so we either raise our stops close to the lows of Oct. 23rd and 24th, or we get out of our long trades immediately and watch.

If our previous conclusions that a base of support might be forming around the 85-88 level are correct, the market's behavior on the reaction which now seems imminent may give an important confirmation of these deductions or it will contradict them and perhaps indicate a resumption of the bear market. Or, it may do neither. That is, the indications may not prove to be clear, in which case we shall have to maintain a neutral position and expect a professional or trading market; in other words, a series of relatively small swings up and down in a narrow range, say between the recent lows and the recent tops, 79-100, until the market works into a position for its next important intermediate move.

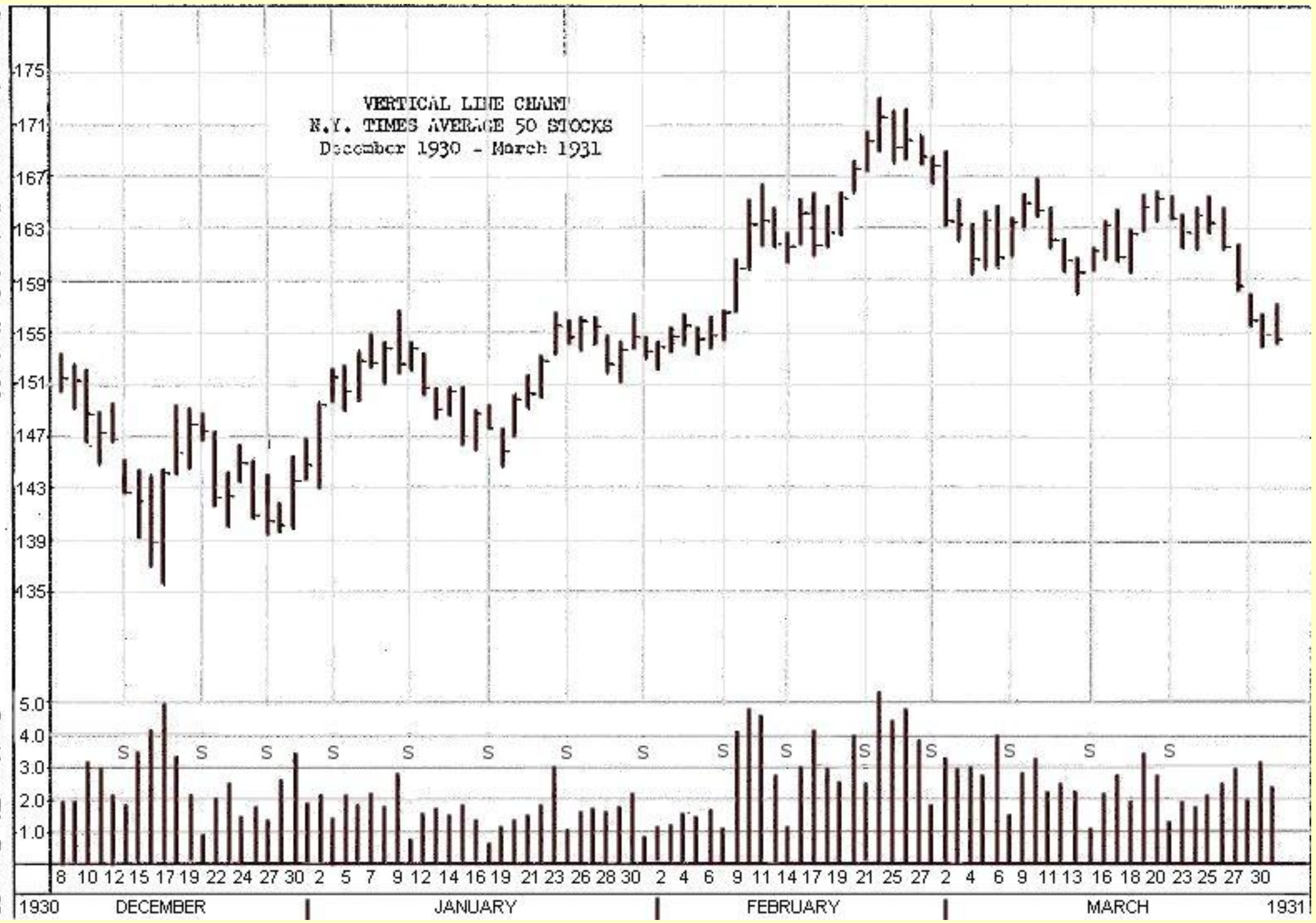
When, on Oct. 28th, the volume gives a minor climaxing indication after the average has settled down to the former supporting line (around 88) with no increase in volume on the way down, Oct. 26th and 27th, we conclude that there is no further liquidation to worry about and that support is again coming in at this level. This is confirmed by decreasing volume and no net change in the closing price, following a small further recession next day, which shows there is no follow-through on the down side.

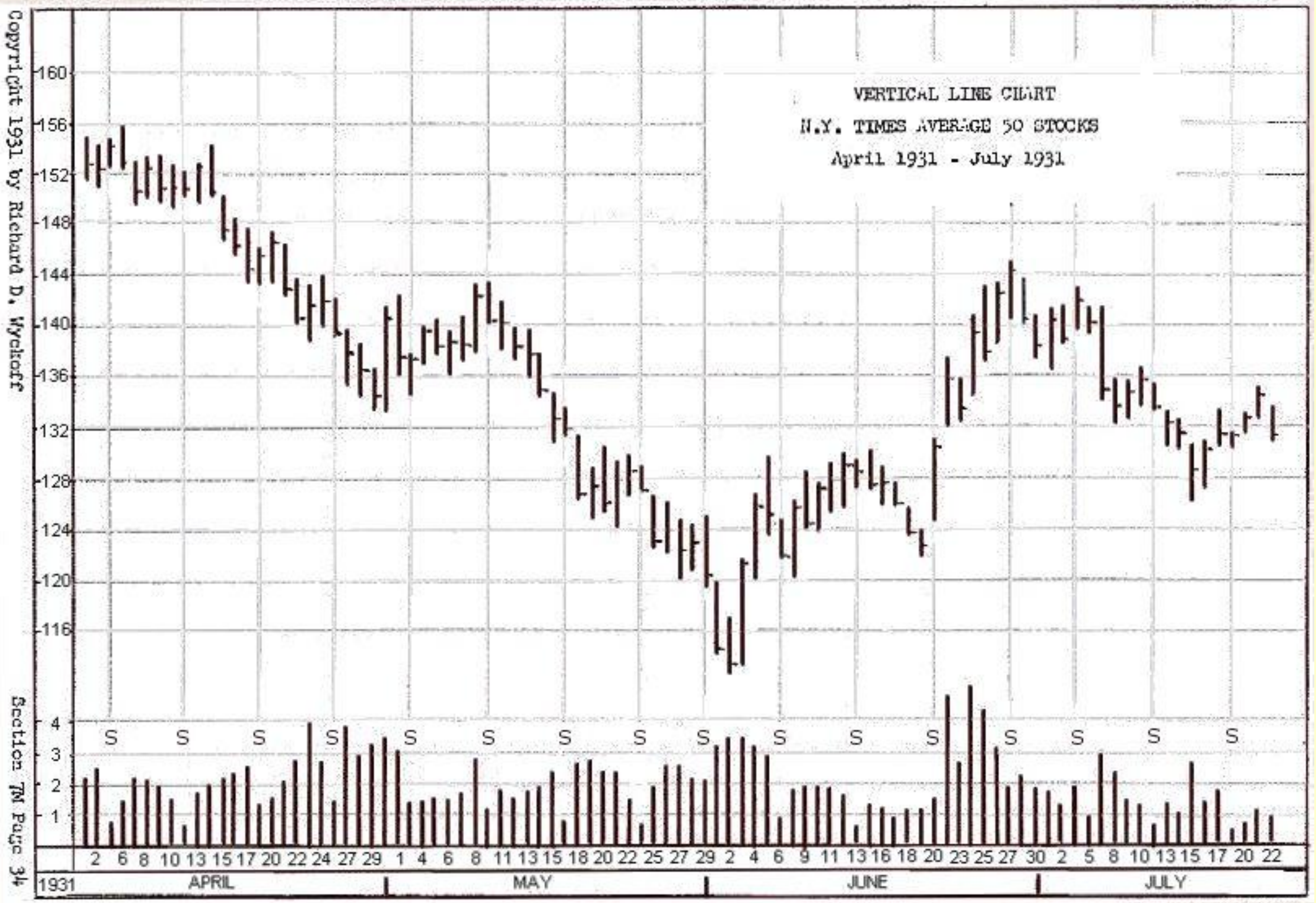
The zone of support has now broadened to provide a foundation for a more substantial recovery (though our other records still do not encourage us to take investment positions) so on the 30th we buy again for trading purposes, this time placing stops a point or so under the Oct. 14th and 29th lows. The average then records a series of rising supports and higher daily tops on moderate volume, until Nov. 9th when the appearance of climactic volume on a small further upthrust to the vicinity of the Sept. 23rd rally top tells us to get out of our long trades and go short; supply is overcoming demand as the average reaches the long bear market supply line running through the successive highs of July, August and September.

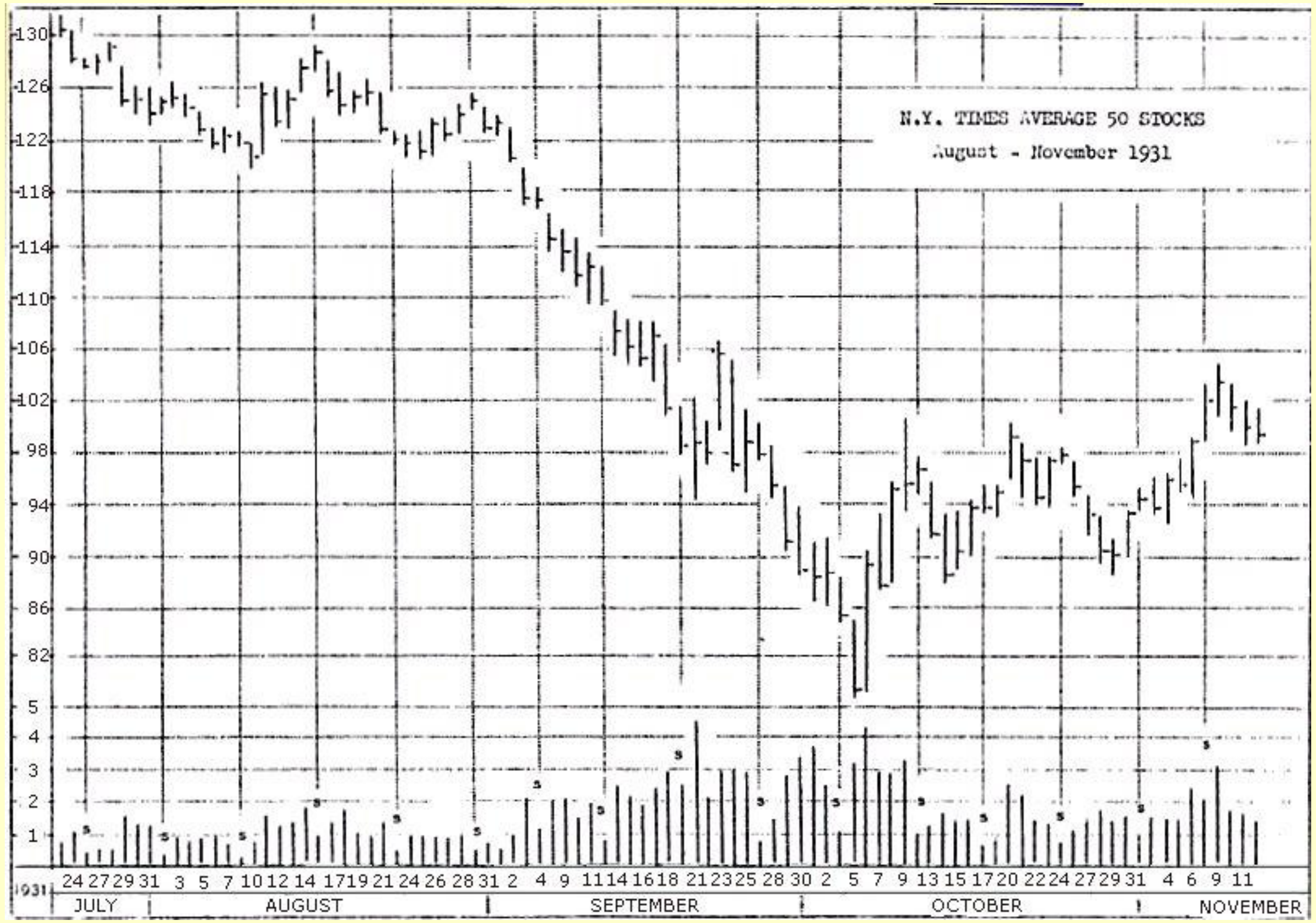
At the point where our chart ends, it appears at first glance that we are getting a reaction on slightly diminishing volume which, if the market has not exhausted the force of the demand stored up around the September-October lows, should encourage another rally effort. No such effort materializes, however. On the contrary, the average gives an indication of renewed weakness by dropping sharply to 95 on November 13th and eventually sinks through the October low with no semblance of rallying power and nothing more than a period of nine days' hesitation in a five point range from the end of November to the 8th of December (none of this is shown on the chart).

Again we have an illustration of the vital importance of employing stop orders to protect investment as well as trading positions at all times. For instance, assume we had mistaken the tentative formation of a base of support in October, 1931, as preparation for a real bull market, and had made investment purchases around the logical buying points of Oct. 28th and 29th. Suppose also that we had let our stops on these commitments remain undisturbed where we originally placed them, just under the 85-88 level. The worst that could happen to us now would be the automatic closing out of our positions at small losses about the middle of November. Thus we would have our capital still intact and liquid, ready to take advantage of the final turning point. But if we had no stops we might have carried these stocks down for seven more months of deflation and loss.

And so we conclude our interpretation of a period of very instructive market movements with one further observation: You may now see why study of the stock market cannot be reduced to rule of thumb procedure; why it is foolish to seek mechanical short cuts and to draw fantastic diagrams on charts.


VERTICAL LINE CHART
N.Y. TIMES AVERAGE 50 STOCKS
December 1930 - March 1931
175
171
167
163
159
155
151
147
143
139
135
5.0
4.0
3.0
2.0
1.0
S
8 10 12 15 17 19 22 24 27 30 2 5 7 9 12 14 16 19 21 23 26 28 30 2 4 6 9 11 14 17 19 21 25 27 2 4 6 9 11 13 16 18 20 23 25 27 30
1930
DECEMBER
JANUARY
FEBRUARY
MARCH
1931


VERTICAL LINE CHART
N.Y. TIMES AVERAGE 50 STOCKS
April 1931 - July 1931
160
156
152
148
144
140
136
132
128
124
120
116
4
3
2
1
S
2 6 8 10 13 15 17 20 22 24 27 29 1 4 6 8 11 13 15 18 20 22 25 27 29 2 4 6 9 11 13 16 18 20 23 25 27 30 2 5 8 10 13 15 17 20 22
1931
APRIL
MAY
JUNE
JULY


N.Y. TIMES AVERAGE 50 STOCKS
August - November 1931
130
126
122
118
114
110
106
102
98
94
90
86
82
5
4
3
2
1
1931
24 27 29 31 3 5 7 10 12 14 17 19 21 24 26 28 31 2 4 9 11 14 16 18 21 23 25 28 30 2 5 7 9 13 15 17 20 22 24 27 29 31 4 6 9 11
JULY
AUGUST
SEPTEMBER
OCTOBER
NOVEMBER

Stages of a Trader

Stage One: The Mystification Stage

This is where the neophyte trader begins. He has little or no understanding of market structure. He has no concept of the interrelationship among markets, much less between markets and the economy. Price charts are a meaningless mish-mash of colored lines and squiggles that look more like a painting from the MOMA than anything that contains information. Anyone who can make even a guess about price direction based on this tangle must be using black magic, or voodoo.

But those ads on TV are so persuasive. Earn $100,000 A Week In Your Spare Time! At Your Kitchen Table! In Your Bathrobe! All one has to do is buy *Hidden Secrets of Market Wizards Revealed!* (plus shipping and handling). Or that software with the red and green arrows (how hard can it be?).

So you open an account, subscribe to Level II, install your charting software, and are absolutely mesmerized by all the flashing lights and colors. DOM? You bet! And all you have to do to participate is . . . click.

Stage Two: The Hot Pot Stage

Before you’ve lost all your money, the thought that you haven’t the least idea what you’re doing may prevent you from blowing your account entirely. You realize now that this is not easy, it’s hard, it’s work, but rather than chuck it, you elect instead to take the subject “seriously”. You locate your library card and/or shop Amazon. You check out – or take much of what you have left and buy – all the “recommended reading”. You take the courses. You attend the seminars (box lunch included). You subscribe to the chatrooms and websites and newsletters. How-To book or notes in hand, you scan the markets every day. After a while (sometimes a good long while), you notice a particular phenomenon which pops up regularly and seems to "work" pretty well. You focus on this pattern. You begin to find more and more instances of it and all of them work! It’s all true! It Works! Your confidence in the pattern grows and you decide to take it the very next time it appears. You take it, and almost immediately your stop is hit, and you're underwater for the total amount of your stoploss.

So you back off and study this pattern further. You go back to the books, back to your notes. And the very next time it appears, it works. And again. And yet again. So you decide to try again. And you take the full hit on your stoploss.

Practically everyone goes through this, but few understand that this is all part of the win-lose cycle. They do not yet understand that loss is an inevitable part of any system/strategy/method/whathaveyou, that is, there is no such thing as a 100% win approach. When they gauge the success of a particular pattern or setup, they get caught up in the win cycle. They don't wait for the "lose" cycle to see how long it lasts or what the win/lose pattern is. Instead, they keep touching the pot and getting burned, never understanding that it's not the pot (pattern/setup) that's the problem, but a failure on their part to understand that it's the heat from the stove (the market) that they're paying no attention to whatsoever. So instead of trying to understand the nature of thermal transfer (the market), they avoid the pot (the pattern), moving on to another pattern/setup without bothering to find out whether or not the stove is on.

Stage Three: The Cynical Skepticism Stage

You've studied so hard and put so much effort into your trading, and this universal failure in the patterns only when **you** take them causes you to feel betrayed by the market and the books and materials and gurus you tried to learn from. Everybody claims their ideas lead to profitability, but every time you take a trade, it's a loser, even though the setups all worked perfectly before you played them. And since one of the most painful experiences is to fail when success looks easy, this embarrassment is transformed into anger: anger at the gurus, anger at the vendors, anger at the writers, the seminars, the courses, the brokers, the market makers, the specialists, the "manipulators". What's the point in trying to analyze and improve your own trading when there are so many dark forces out to get you?

This excuse-driven blaming is a dead-end viewpoint, and explains a lot of what you find on message boards. Those who can't pull themselves out of it will quit.

Stage Four: The Squiggle Trader Stage

If you don't quit, you'll move into the "squiggle trader" phase. Since you failed with patterns and so on, you figure there's some "secret weapon", a "holy grail" that's known to the select few, something that will help you filter out all those bad trades. Once you find this magical key, your profits will explode and you'll achieve every dream you ever had.

You begin an obsessive study of every method and every indicator that is new to you. You buy a whole new series of books, attend new and different courses, sign up for new and different newsletters and advisory services, register for new and different trading websites and chat rooms (you hear this guy really knows his stuff). You buy more elaborate software (100s Of Indicators And Studies!). You buy off-the-shelf systems (Guaranteed Results!). You spend whatever it takes to buy success.

Unfortunately, you stack so much onto your charts that you become paralyzed. With so many inputs, you can't make a decision, particularly as they rarely agree. So you focus on those which agree with the direction of the trade you've taken (or, if you're the fearful sort, you look only for those which will prove to you how much of a loser you think you are).

This is all characteristic of scared money. Without a genuine acceptance of the fact of loss and of the risks involved in trading, you flit around like a butterfly in search of anything or anybody who will tell you that you know what you're doing. This serves two purposes: (1) it transfers to others the responsibility for the trade and (2) it shakes you out of trades as your indicators begin to conflict. The MACD says buy, the sto says sell. The ADX says the market is trending, the OBV says it's overbought. By the end of the day, your brain is jelly.

This process can be useful if the trader learns from it what is popular, i.e., what other traders are doing, and, if he lasts, how to trade traps and panic/euphoria. And even though he may decide that much of it is crap, he will, if he doesn't slip back into the Cynical Skepticism Stage, have a more profound appreciation – achieved through personal experience – of what is sensible and logical and what is nonsense. He might also learn something more about the kind of trader he is, what "style" suits him best, learn to distinguish between what is desirable and what is practical.

But the vast majority of traders never leave this stage. They spend their "careers" searching for the answer, that perfect setting, that ultimate tweak to their backtest, and even though they may eventually achieve piddling profits (if they don't, they will of course eventually no longer be trading), they never become truly successful, and this perpetual not-quite-failure not-quite-success can have debilitating consequences for the psyche.

Stage Five: The Inwardly-Bound Stage

The trader who is able to pry himself out of Stage Four uses his experiences there productively. The trader learns, as stated earlier, what styles, techniques, tactics are popular. But instead of focusing entirely on what's "out there", he begins to ask himself some questions:

What exactly does he want? What is he trying to accomplish?

What sort of trading makes the most sense to him? Long or intermediate-term trading? Short-term trading? Day-trading? Trend-trading? Scalping? Which is most comfortable?

What instrument – futures, stocks, ETFs, bonds, options – provides the range and volatility he requires but is not outside his risk tolerance? Did he learn anything at all about indicators in Stage Four that he might be able to use?

And so he "auditions" all of this in order to determine what suits him, taking all that he has learned so far and experimenting with it.

He begins to incorporate the "scientific method" into his efforts in order to develop a trading plan, including risk management and trade management. He learns the value of curiosity, of detached interest, of persistence and perseverance, of taking bits and pieces from here and there in order to fashion a trading plan and strategy that are uniquely his, one in which he has complete confidence because he has tested it thoroughly and knows from his own simulated trading and real-money experiences that it is consistently profitable. This eventually becomes his “edge”*.

He accepts fully the responsibility for his trades, including the losses, which is to say that he understands that losses are inevitable and unavoidable. Rather than be thrown by them, he accepts them for what they are, a part of the natural course of business. He examines them, of course, in order to determine whether or not some error was made, particularly one that can be corrected, though true trading errors are rare. But, if not, he simply shrugs off the loss and goes on about his business. He understands, after all, that he is in control of his risk in the market.

He doesn't rant about his broker or the specialist or the market-maker or that vast conspiracy of everyone who's trying to cheat him out of his money. He doesn't attempt revenge against the market. He doesn't fret. He doesn't fume. He doesn't succumb to hope, fear, greed. Impulsive, emotional trades are gone. Instead, he just trades.

*the knowledge gained through research and testing that a particular market behavior offers a level of predictability that provides a consistently profitable outcome over time.

Stage Six: Mastery

At this level, the trader achieves an almost Zen-like trading state. Planning, analysis, research are the focus of his time and his effort. When the trading day opens, he's ready for it. He's calm, he's relaxed, he's centered.

Trading becomes effortless. He is thoroughly familiar with his plan. He knows exactly what he will do in any given situation, even if the doing means exiting immediately upon a completely unexpected development. He understands the inevitability of loss and accepts it as a natural part of the business of trading. No one can hurt him because he's protected by his rules and his discipline.

He is sensitive to and in tune with the ebb and flow of market behavior and the natural actions and reactions to it that his research has taught him will optimize his edge*. He is "available". He doesn't have to know what the market will do next because he knows how he will react to anything the market does and is confident in his ability to react correctly.

He understands and practices "active inaction", knowing exactly what it is he wants, exactly what it is he's looking for, and waiting, patiently, for exactly the right opportunity. If and when that opportunity presents itself, he acts decisively and without hesitation, then waits, patiently, again, for the next opportunity.

He does not convince himself that he is right. He watches price movement and draws his conclusions. When market behavior changes, so do his tactics. He acknowledges that market movement is the ultimate truth. He doesn't try to outsmart or outguess it.

He is, in a sense, outside himself, acting as his own coach, asking himself questions and explaining to himself without rationalization what he's waiting for, what he's doing, reminding himself of this or that, keeping himself centered and focused, taking distractions in stride. He doesn't get overexcited about winning trades; he doesn't get depressed about losing trades. He accepts that price does what it does and the market is what it is. His performance has nothing to do with his self-worth.

It is during this stage that the "intuitive" sense begins to manifest itself. As infrequent as it may be, he learns to experiment with it and to build trust in it, understanding that it is essentially a form of subconscious rapid-fire decision-making that stems from all of the work he has done during the previous stages.

And at the end of the day, he reviews his work, makes whatever adjustments are necessary, if any, and begins his preparation for the following day, satisfied with himself for having traded well.

(from Bo Yoder, Vad Graifer, Mark Douglas . . . and me)