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ZB H3	112 18/32	26/32	0.72%

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Ten New Tips for Trading Chart Patterns

by: *Thomas N. Bulkowski*

Chart patterns are little more than warning signs flashing a buy or sell signal. Here are ten tips to make those signals more successful.

Each day I stare at 250 stock and commodity charts. Depending on my mood, the review can take from 15 minutes (when I'm not interested in trading or finding chart patterns) to hours (when I'm searching for opportunities and finding some). Traders who do this long enough develop an innate feel for the markets and the stocks they follow. Someone who eats chocolate each day can tell when a batch is better or worse than the usual lot; it is the same with the markets.

An investor who actively trades five stocks each day will know when they are cheap and when they are dear. They may not realize that they are buying near the yearly low or selling near the yearly high, but that may be the case. If a stock drops substantially due to bad news, they may not view it as the start of a dead-cat bounce, but as an intermediate-term buying opportunity. I have traded dead-cat bounces like that several times with a stock I have held for the long-term.

Having a feel for the markets is difficult to explain. That is where research comes in. I statistically studied tens of thousands of chart patterns for my books (the latest edition uses more than 38,500). Along the way, what I found surprised me. Here are ten facts that I uncovered about trading stocks and trading chart patterns.

#1 – Patterns Get Smaller as They Occur in a Rising Price Trend

Figure 1 shows an example using ascending scallops in an upward price trend. Ascending scallops look like the letter J. The right side of the pattern is higher than the left, with a rounding turn between the two peaks. Sometimes the turn is not as smooth



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as one would like, but nothing is perfect in every chart pattern. A buy signal occurs when a price closes above the highest high in the pattern.

The July scallop is a wide, rounding turn lasting 112 days. The October scallop is narrower, coming in at 91 days, followed by 43 and 25 days wide for the remaining scallops. These patterns get narrower as they climb higher in the trend. Is this always the case? No. However, in the 736 ascending scallops I looked at in a bull market, the average width was 56, 49 and 46 days for two, three and four scallops in a series, respectively, in a rising price trend. The patterns tended to get shorter, too, but Figure 1 does not show that behavior.

Thus, a narrow scallop high in a price trend may be a caution sign warning of an approaching trend change. Be ready to tighten (raise) those stops.



click image for larger view

#2 – Trade with the Market Trend

I separated chart patterns into bull and bear markets, up and down breakouts. The best performers came from chart patterns with upward breakouts in a bull market, and downward breakouts worked best in a bear market.

For example, symmetrical triangles are patterns that have lower highs and higher lows (Figure 2 shows two examples). Two converging trendlines bound the narrowing price series. The breakout can be in any direction, including horizontal, as price oozes out of the triangle apex. I looked at nearly 1,350 symmetrical triangles in both bull and bear markets. In a bull market, triangles with upward breakouts had rises averaging 31 percent compared to a 26-percent rise for triangles in a bear market. (The statistics in this article assume all patterns were traded perfectly, without commissions.) Downward

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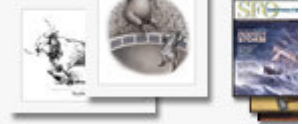
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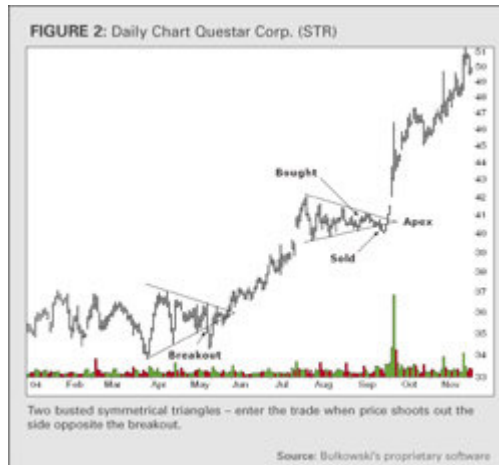
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breakouts in a bear market had average declines of 19 percent versus a 17-percent decline in a bull market.

What does all of this mean? Avoid countertrend trades. In a bull market, trade patterns with upward breakouts. In a bear market, stick to chart patterns with downward breakouts.



click image for larger view

#3 – Trade with the Industry

The securities I follow come from 34 different industries with at least five stocks in each industry. Each day, I compare the performance (average price change over time) of those industries against each other. This relative strength shows me which industries are hot. My best trades usually come from the top ten industries showing the best price performance over the last six months.

For example, in October 2004 the integrated petroleum industry was the best performer with an average rise of almost 28 percent over the previous six months. Semiconductors had the worst performance, losing 34 percent over the same period. A trader might have been tempted to buy semiconductor stocks and sell the oils, but at that point it would have been a mistake. Those near the top of the list (the best performers) tend to remain there for months. The same goes for the bottom fishers. The order changes surprisingly little from week to week.

#4 – View Stocks Grouped by Industry

For a long time, I reviewed my portfolio of stocks in alphabetical order. As I viewed each one, I pondered what others in the same industry were doing. Then I changed my proprietary program to show each stock grouped by industry. Thus, I look at the airlines first, followed by apparel stocks then building materials,

and so on. As I scan each industry, I get a feel for how each industry is doing. If I see three airline stocks taking off, I can check the others, find one that is still at the gate and climb on board the rising price trend.

#5 – Expect Weakness a Month after the Breakout

In a bear market (or patterns with downward breakouts), prices seem to firm up a month after the breakout. For example, if a trader shorts a stock and prices begin moving up between three and five weeks after the breakout, consider closing out the position. I only found this behavior in bearish chart patterns, not bullish ones.

#6 – Trade Busted Chart Patterns.

I define a busted chart pattern as one that moves less than five percent from the breakout before reversing and shooting off in the new direction.

Figure 2 shows examples of this. The April symmetrical triangle has a downward breakout when price closes outside the lower trendline. In three days, price pokes back inside the triangle. A week or two later, prices are rising above the triangle. The figure shows prices moving from 36 to 42 (17 percent) in less than two months.

The August triangle also seen in Figure 2 burned me. I jumped the gun and bought before the expected upward breakout. When price closed below the triangle trendline, I changed my stop order into a market order and sold. I lost \$314, or less than two percent of the \$16,000 I had on the line. The stock turned around and shot out the top of the triangle. I could have bought back in, but I did not want to tangle with the wash sale rule. The wash sale rule disallows a loss if a trader buys substantially identical securities 30 days before or after the date of the sale.

#7 – Trade Partial Rises and Declines for Early Entry

This is not for the novice, as broadening patterns can be difficult to trade. However, look at Figure 3. It shows two examples of broadening patterns. The left one shows a partial rise, and the right one shows a partial decline.



click image for larger view

A partial rise occurs after the pattern is established, meaning that price must touch each trendline at least twice. Then look for price to climb from the lower trendline, move up but not touch or come close to the top trendline. A downward breakout from a broadening bottom in a bull market follows 67 percent of the time. A partial decline is similar. Look for at least two touches of each trendline before searching for a partial decline. A partial decline occurs when prices leave the top trendline and curl downward but do not touch or come close to the bottom trendline. An upward breakout in a broadening bottom follows 80 percent of the time in a bull market.

#8 – Trade Necklines for Early Entry.

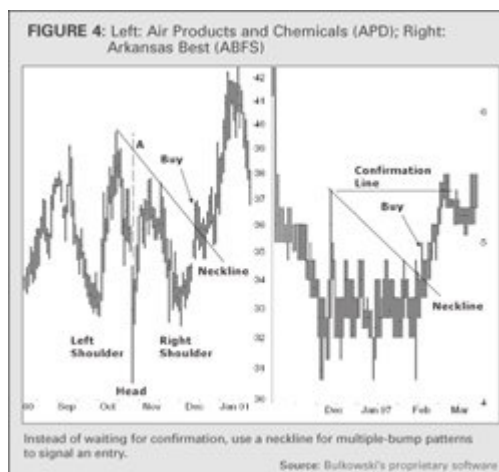
Figure 4 shows the traditional neckline as it applies to a head-and-shoulders bottom pattern (the left side of the figure). The neckline is really an “armpit” line, as it joins the two peaks between the head and shoulders. Buy when price closes above this line. For head-and-shoulders tops, imagine the image flipped upside down. The neckline would join the two valleys between the shoulders.

A trader can apply the neckline to other chart patterns, such as triple bottoms. The right side of Figure 4 shows an example. The neckline joins the two peaks between the three bottoms. In this example, the neckline slopes downward. When price closes above the neckline, buy. A down-sloping neckline will signal a trade earlier than waiting for price to close above the confirmation line, which is a horizontal line drawn across the highest high in the pattern.

#9 – Use the Measure Rule to Predict a Target Price

The measure rule for most chart patterns is the height of the pattern applied to the breakout price. In other words, subtract the lowest low from the highest high in the pattern to get the height. For upward breakouts, add the height to the breakout price; for downward breakouts, subtract the height. The result is the target price. If a trader waits long enough, chances are price will hit the target, but a trader also can eat a tennis ball if he tries hard enough. By that I mean the measure rule works about 70 percent of the time. Using half the height in the computation increases the hit rate to better than 90 percent.

With some patterns, like a head-and-shoulders bottom (Figure 4), measure the height from the lowest low at the head vertically to the neckline (point A). Do not use the highest high in the pattern.



click image for larger view

#10 – The Largest Gains Happen in the First Week

I found this when working on my second book. For the most popular chart patterns, I looked at returns over time and found that the largest moves usually occur in the first week. I know from my own trading that I am often late getting into a trade. Instead of placing a buy order at the breakout price, I wait for price to close outside the trendline, and then I buy. This delay is often costly. That is why I tried to anticipate the breakout direction in Questar (Figure 2) – to my detriment. Because I use stops to limit losses on every trade, the downside is limited. If price breaks out upward, I am in a better position to profit even if price moves up less than I expect.

Closing Position

An old joke goes, "Experience is a quality that allows a trader to recognize a mistake when they make it

again." Learning from mistakes and profiting from the advice of others is a key ingredient to success in the markets. By studying the tools a trader uses, one can find inventive ways to reduce losses and increase profits. This continual exploration helps make money, and that is what trading is all about.



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