Powerful Chart Patterns that Consistently Make Money

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Downs is also the editor of the *SignalWatch* daily market column, where he evaluates the overall market, provides trading lessons, and selects charts that are exhibiting proven technical analysis patterns. The column can be viewed at www.signalwatch.com.

Downs is also the author of the best selling book: *7 Chart Patterns That Consistently Make Money*.

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The 7 Chart Patterns that Consistently Make Money

Ed Downs
What is a “Pattern?”

• Patterns indicate the psychology of a market.

• Patterns also determine the behavior of a market.
Example: Buying at Support

Price had been here.

24 was established by 2 touches as the “value” point.

Confirmed
Goals of Chart Pattern Analysis

1. Identify the most predictable patterns.

2. Define rules for trading patterns which result in winning trades.

3. We should have more winners than losers, and the losses should be smaller than the gains.
Do Chart Patterns Work?

Publication: The Economist, August 19, 2000
Article: “Head & Shoulders, Broadening Bottoms”
Authors: Craig MacKinlay, Wharton School and Andrew Lo, Massachusetts Institute of Technology

“Using American share prices during 1962-96, MacKinley and Lo focused on technical indicators that were especially controversial among economists such as “head and shoulders” and “triangle tops and bottoms”.”
Yes, they do.

“The results showed that the various technical patterns mostly occurred far more frequently than they would have done if they were truly random events. In general, the charts contained useful information about future share prices.”
Nasdaq is better for patterns.

“(However), there was a significant difference between the results for different markets. For shares listed on the New York Stock Exchange and American Stock Exchange, seven of the ten technical patterns had enough predictive power to be statistically significant. For Nasdaq shares, all ten of the patterns tested did.”
More Art than a Science

“The traditional patterns used in technical analysis were, of necessity, fairly crude, determined by what was readily visible to the eye. As a result, technical analysis has always been more of an art than a science.”

In fact, text books on Technical Analysis are very quick to point this out…
• **Edwards & Magee** – “An [exhaustion gap] should not be read as a sign of Major reversal, nor even, of reversal at all. It calls ‘stop’, but the halt is *ordinarily* followed by some sort of area pattern, which *may* lead to reversal…”

• **Martin Pring** – “It should **not** be concluded that *every* gap breakout that takes place is a valid one, because there is no such thing as a ‘sure thing’ in technical analysis.”

• **William Jiler** – “A [breakaway gap] **generally** occurs after an important chart pattern has been completed, and it **often** marks the beginning of a major move.”

Ambiguity in Chart Pattern Recognition is universal!
We Conclude That . . .

• Chart Patterns are Predictive.

• **However**, identifying Chart Patterns that “work” 100% of the time is difficult (or impossible).

• Rules are needed to assess and trade the opportunities.
Chart Pattern Overview
There are 7 Key Patterns

1. Support & Resistance
2. Trend Line Reversal & Break
3. Saucer Formations
4. Fibonacci Retracements
5. Price Gaps
6. Volume Climax & Trend
7. Consolidations

Let’s discuss the Psychology of each one…
1. Support / Resistance

“As market approaches support, and especially as it reverses, the market participates – adding more fuel to the fire. Support breaks can create PANIC.”
2. Trend Lines

“An invisible line forms as price reacts to it. This creates a similar psychology as Support and Resistance lines do. **Breaks can create panic.**
3. Saucer Formations

“Saucers usually occur at support (resistance, occasionally). Smooth transitions in price are noticed, causing buyers (sellers) to enter.”
4. Fibonacci Retracements

“Markets typically reverse on eighths, especially 3/8, 4/8, and 5/8 – which is 38%, 50%, and 62%. This is an observed truth of market psychology.”
5. Price Gaps

“Breakaway Gaps mark the beginnings of moves, Measured Gaps mark the centers of moves, and Exhaustion Gaps occur at the ends of moves.”
6. Volume Climax, Trend

“Climaxes form powerful patterns, indicating an exhaustion of supply or demand. If the market does not reverse, it becomes a trend indication.”
7. Consolidations

“Consolidations are the most powerful pattern. Each consolidation will typically imply a move of equal distance from the last significant low or high.”
Rules & Tools

1) Establish a Timeframe
2) Determine a Reference
3) The Rule of Eighths
4) Avoid Volatility
5) Watch for Opposites
6) Apply Reward:Risk
1) Establish a timeframe based on the size of the pattern

Timeframes are dictated by the size and the timeframe of the pattern.

Once you decide to trade a timeframe, don’t change your mind.

Example: saucer
2) Only trade those Patterns which have a clear size reference in the timeframe.

At “A” we can use H.

“B” is more ambiguous.
3) Rule of Eighths: Use eighths within the reference to set trailing stops

- Enter Trade at 1/8
- Stop at zero

62%
50%
38%
4) Avoid trading issues which reverse across 2+ lines within 5 bars (volatile).
5) Patterns can indicate a Continuation OR a Reversal of Trend.

<table>
<thead>
<tr>
<th>Pattern Type</th>
<th>Reverse Trend</th>
<th>Continue Trend</th>
</tr>
</thead>
<tbody>
<tr>
<td>Support / Resist.</td>
<td>Reversal</td>
<td>Break</td>
</tr>
<tr>
<td>Trend Line</td>
<td>Reversal</td>
<td>Break</td>
</tr>
<tr>
<td>Saucer</td>
<td>Reversal</td>
<td>Break</td>
</tr>
<tr>
<td>Fibonacci</td>
<td>Exhaustion</td>
<td>Break, Measured</td>
</tr>
<tr>
<td>Volume</td>
<td>Climax</td>
<td>Trend</td>
</tr>
<tr>
<td>Consolidation</td>
<td>Failure</td>
<td>Continuation</td>
</tr>
</tbody>
</table>

Be prepared to trade both sides.
**Example:** Consolidations usually break in the direction of prior trend but can also reverse in the opposite direction. Such “failed” consolidations can prove highly profitable.

A **triangle consolidation** will usually break in the direction of the prior move (up in this case). However, a **failed triangle** (breaking down) is often more tradable.
6) The most important factor is trading opportunities with high Reward:Risk

On any opportunity...

- Assess the Target and initial Stop values.
- Trade those patterns with a Reward:Risk Ratio of at least 2:1 and preferably 3:1.
Pattern Structures

✓ Pattern Dimensions
✓ When to Get In.
✓ Where to Place Stops.
✓ When to Get Out.
Support (& Resistance)

Long Entry

Short Entry

Reverse:
Rally off Support

Break:
Down Through Support
Support & Resistance
Aura Systems, Inc.

Entry
Exit
Signal
Trend Reversals (Breaks)
Trend Line Breaks
Public Service Ent. Group
Trend Line Breaks
Lexmark International, Inc.
Trend Line Breaks
CoPart, Inc.
Saucer Patterns

Distance to significant high (1.0)  Distance to target (0.6)

Reverse:
Saucer Up

Break:
Failed Support

Long Entry

Short Entry
Saucer Patterns
Hydrogenics
Saucer Pattern
Perot Systems
Fibonacci Retracements

50% R

38% R

62% R

Reverse
50% Retracements
Activcard
50%, 62% Retracements
Thomson Multimedia
Price Gaps

Breakaway, Measured & Exhaustion

Long Entry

Exhaustion Gap

Measured Gap

Breakaway Gap

Short Entry

No targets
Measured & Exhaustion Gaps
Kemet Corp.
Breakaway Gap
Genuine Parts Co.
Volume Climax (Trend)

Long Entry

Short Entry

No Targets
Volume Climaxes
Grant Prideco, Inc.
Volume Climax
Intervoice-Brite Inc.
Volume Climax
Worthington Industries

Aside: Note the Consolidation predicting low in late December.
Volume Trends
Rite Aid Corporation
Consolidations
(Symmetrical Triangle shown)

Break: Continuation

Reverse: “Failure”

Long Entry

Short Entry

width width width
Consolidation
Huntington Bancshares
Consolidation
Ameren Corp.
Consolidation
Network Appliance

Did not make it to the target.
Finding the Patterns

- Technical Scans
- Web Sites
- Software
Using Moving Average Convergence / Divergence (MACD)

MACD plots the difference between the 12 and 26 period moving averages. A separate “trigger” average identifies the swings.

MACD signals can be examined as reversal pattern entry candidates.
Web Sites

These websites scan the market for technical factors and signals which can be compared against charts for technical patterns.
Technical Analysis Software

MetaStock has a wide array of technical indicators, and an Explorer feature making it easy to run indicator scans across directories of data.

OmniTrader ** is designed to scan for opportunities using systems related to patterns, such as the Trend Line Break System and the Gap System.

** All Signals in this presentation were generated by OmniTrader.
A Summary of The 7-Pattern Method

1. **Start with an Opportunity List.**
   We use OmniTrader, but any rational approach that finds viable candidates is fine.

2. Look for one of the 7 Patterns to confirm.

3. Establish a Reference Scale. Move trailing stops behind the position on the eightths.

4. If stopped out, **re-enter on an eighth**, provided the Reward:Risk ratio remains 2:1 or better.
Conclusion …

Identifying and using Chart Patterns at any trading opportunity can substantially improve your odds.

Remember – 1% a day is all you need!
The 7 Chart Patterns that Consistently Make Money
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Workbook
Pattern Guide for “The 7 Chart Patterns that Consistently Make Money”

Each pattern reflects a psychology. Each pattern creates a psychology.

Trend Line Break & Reversal

TR = Trend Line Reversal
TB = Trend Line Break

Support and Resistance

Saucer Formations

TR = Trend Line Reversal
TB = Trend Line Break
**Fibonacci Retracements**

- VT = Volume Trend
- VC = Volume Climax

- 50%
- 38%
- 62%

**Price Gaps**

- BG = Breakaway Gap
- MG = Measured Gap
- EG = Exhaustion Gap

**Volume Climax & Trend**

- VT = Volume Trend
- VC = Volume Climax

- AB = BC, BD = DC, CE = EF

**Consolidations**

- AB = BC, BD = DC, CE = EF
Instructions:

For each pattern, draw the Reference Grid. Then, follow each Entry Signal to the most likely Close. If you are stopped out and a re-entry was warranted, mark that on the chart as well with the symbol ®.
2) Price Gaps.
Mark and trade all gaps.
Mark “BG” for Breakout,
“MG” for Measured, and
“EG” for Exhaustion
3) Trend Lines
Mark and Trade all Trend Lines greater than 2 weeks in size.
4) Volume Climax and Volume Trend
Mark and Trade all Volume Climax “VC” and Volume Trend “VT” patterns
5) Fibonacci Retracements
Mark and Trade all Retracements, using 38R (38%), 50R (50%), 62R (62%).
6) Consolidations
Mark and Trade all Consolidations Patterns, identifying the Start (SC), Center (CC), and End (EC) of each consolidation you identify.
Pattern Recognition
Mark and Trade ALL Patterns of Significance.

What is DELL likely to do here? Why?

Mark patterns on chart.

Extra Credit: Mark all additional patterns on the charts in the exercise, for example – mark all the Gaps (use BG, MG, EG) and other patterns you see, on each chart in the workbook.