



Powerful Chart Patterns that Consistently Make Money

A 20-year veteran of trading, Ed Downs is the developer of the OmniTrader software, which was released in 1994. Now in its fifth version, OmniTrader is recognized around the world as one of the leaders in trading system automation.

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](http://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



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?

<u>Publication:</u>	The Economist, August 19, 2000
<u>Article:</u>	“Head & Shoulders, Broadening Bottoms”
<u>Authors:</u>	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...

More Art than Science (continued...)

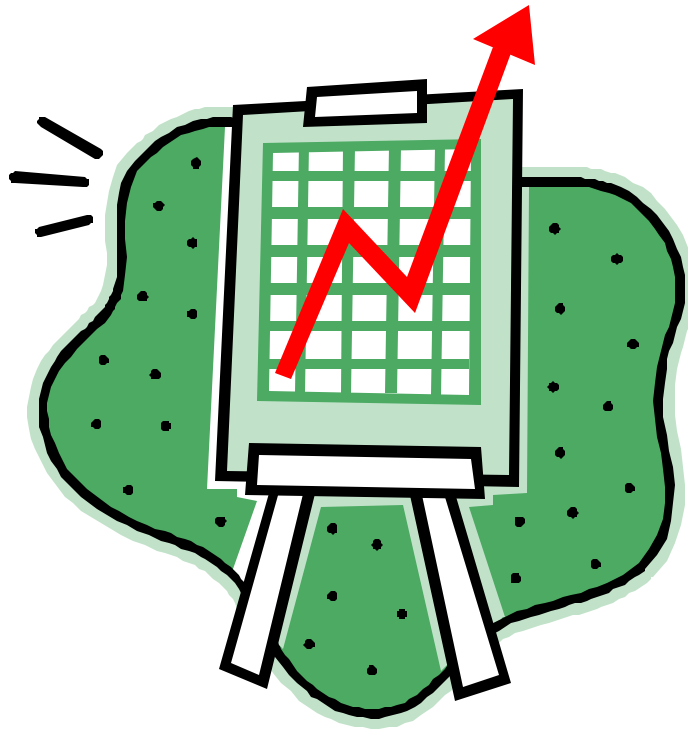
- **Edwards & Magee** – “An [exhaustion gap] should not be read as a sign of *Major* reversal, nor even, of reversal at all. It calls ‘stop’, but the halt is ordinarily followed by some sort of area pattern, which may lead to reversal...”
- **Martin Pring** – “It should not be concluded that every gap 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 . . .

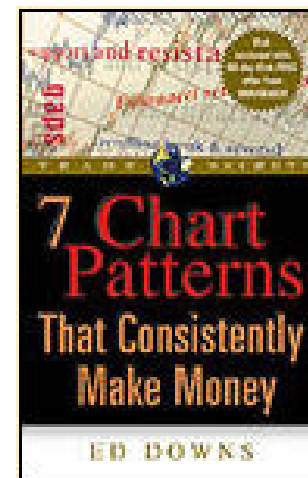
- Chart Patterns are Predictive.
- However, identifying Chart Patterns that “work” 100% of the time is difficult (or impossible).
- Rules are needed to assess and trade the opportunities.

Chart Pattern Overview



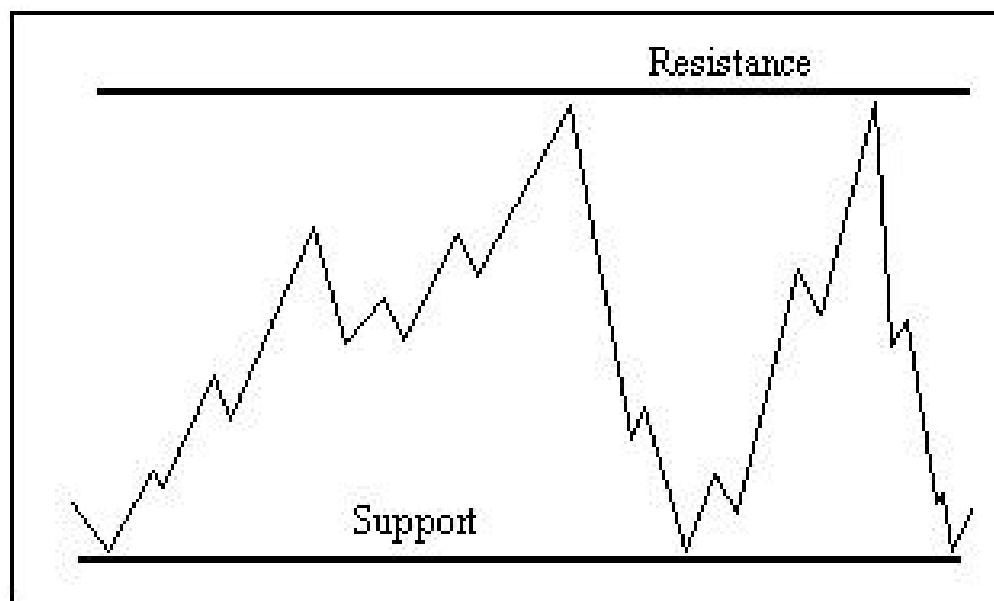
There are 7 Key Patterns

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



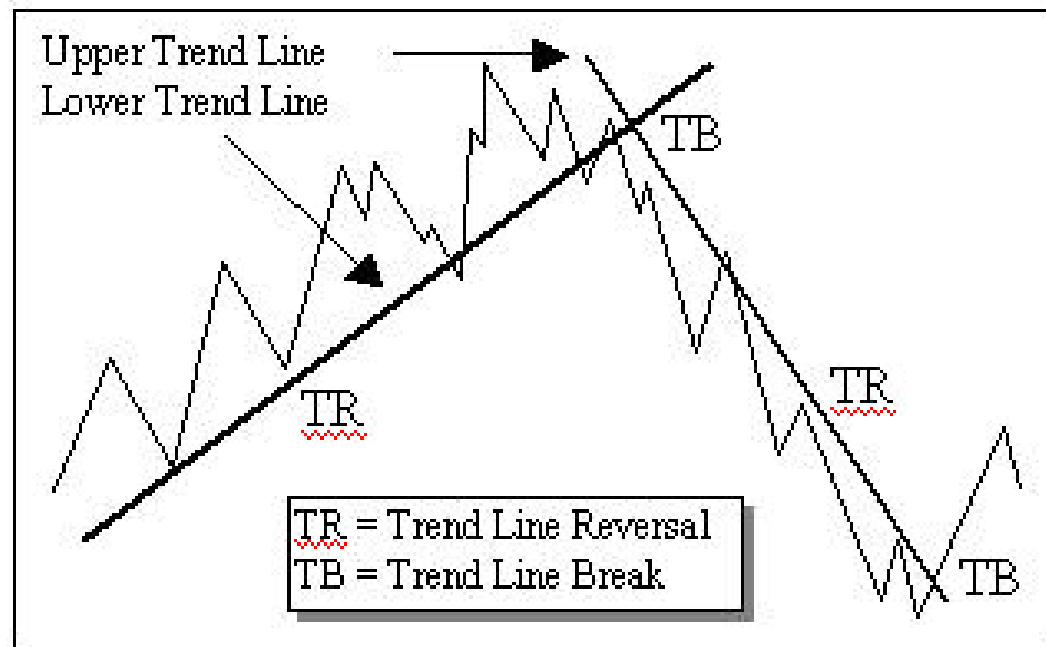
Let's discuss the Psychology of each one...

1. Support / Resistance



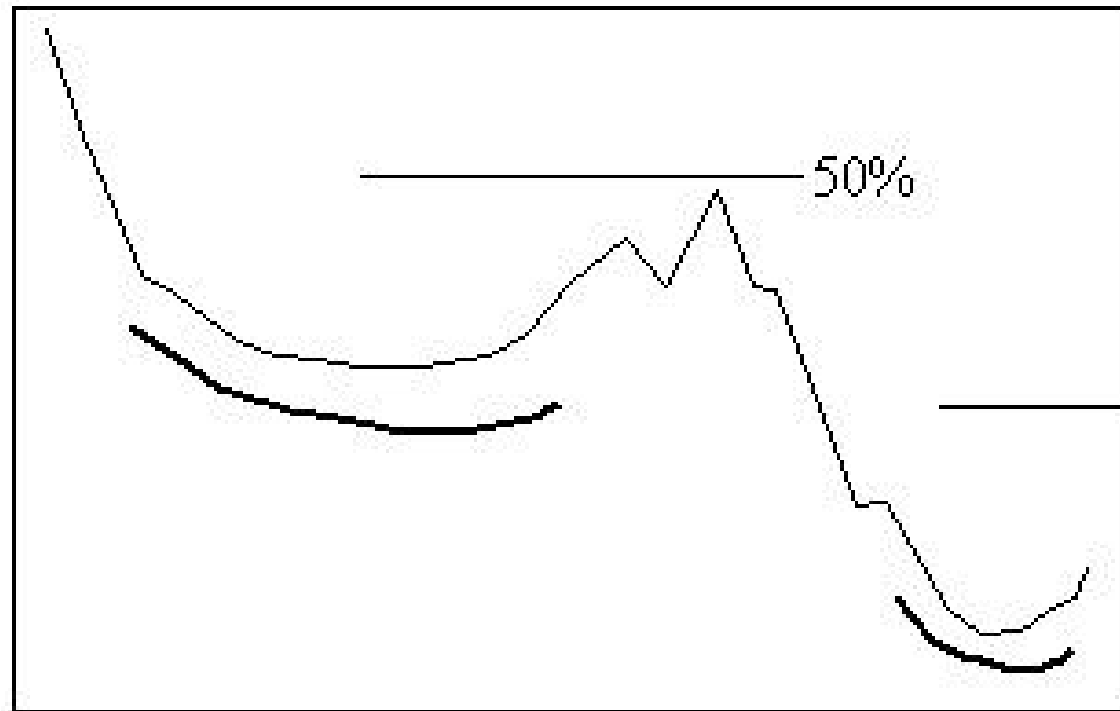
“As market approaches support, and especially as it reverses, the market participates – adding more fuel to the fire. **Support breaks can create PANIC.**”

2. Trend Lines



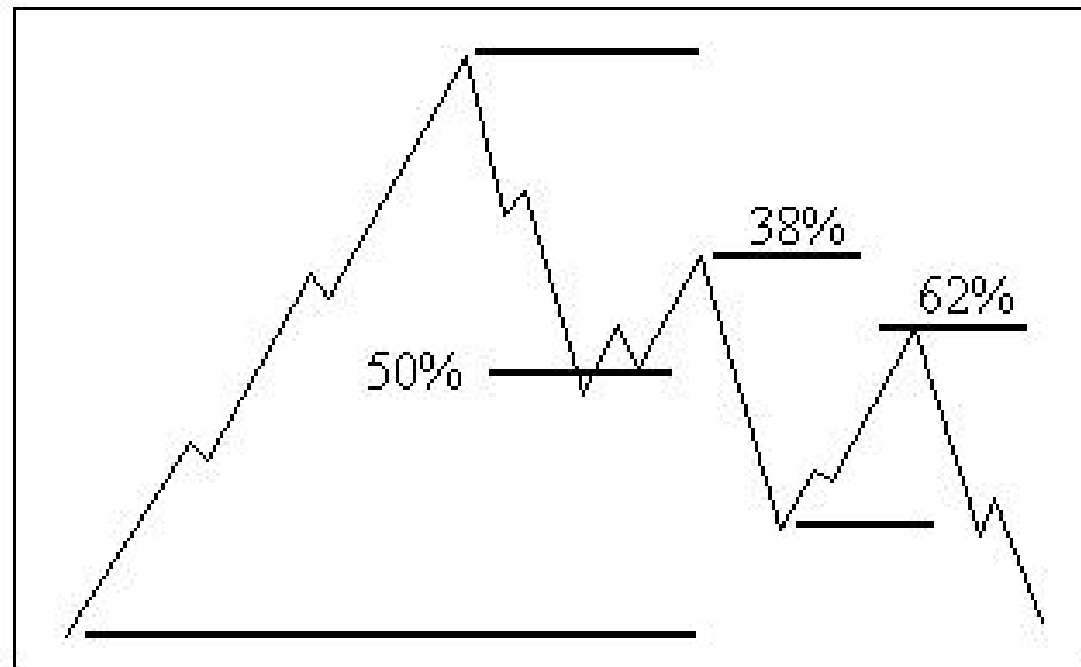
“An invisible line forms as price reacts to it. This creates a similar psychology as Support and Resistance lines do. **Breaks can create panic.**”

3. Saucer Formations



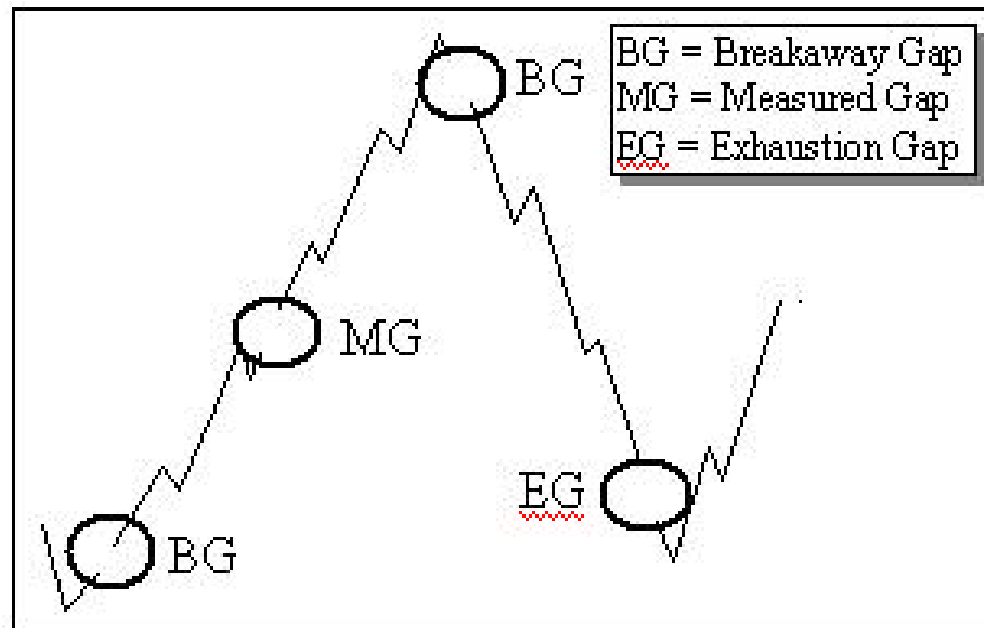
“Saucers usually occur at support (resistance, occasionally). Smooth transitions in price are noticed, causing buyers (sellers) to enter.”

4. Fibonacci Retracements



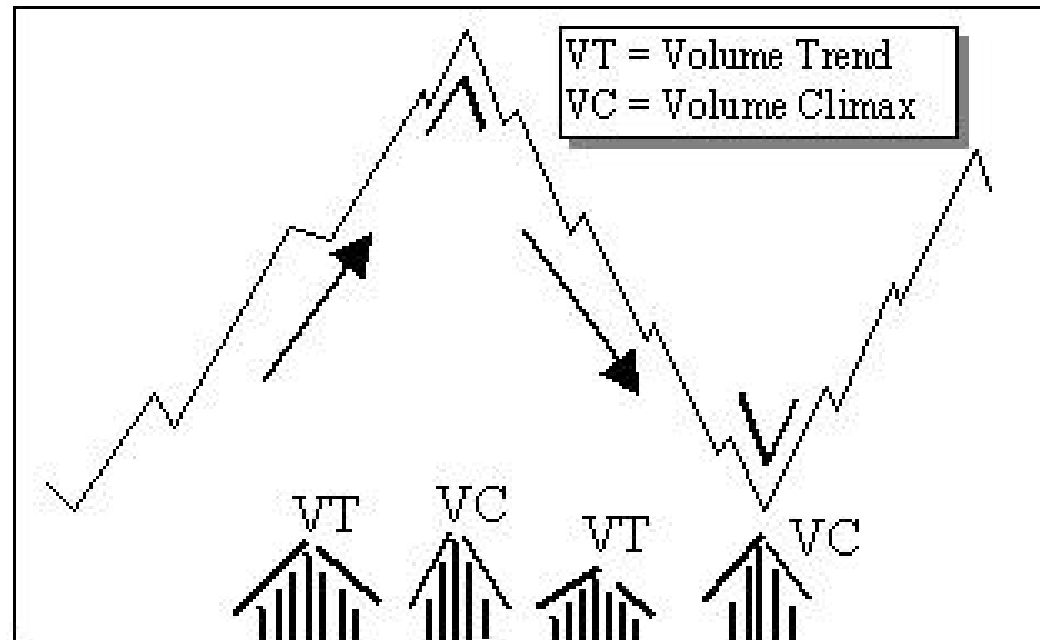
“Markets typically reverse on eighths, especially $3/8$, $4/8$, and $5/8$ – which is 38%, 50%, and 62%. This is an observed truth of market psychology.”

5. Price Gaps



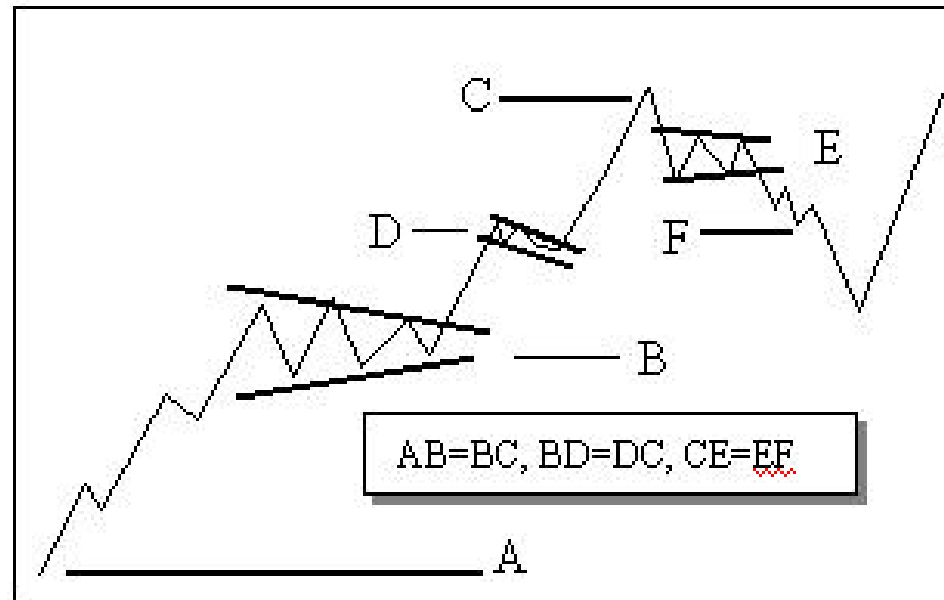
“Breakaway Gaps mark the beginnings of moves, Measured Gaps mark the centers of moves, and Exhaustion Gaps occur at the ends of moves.”

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

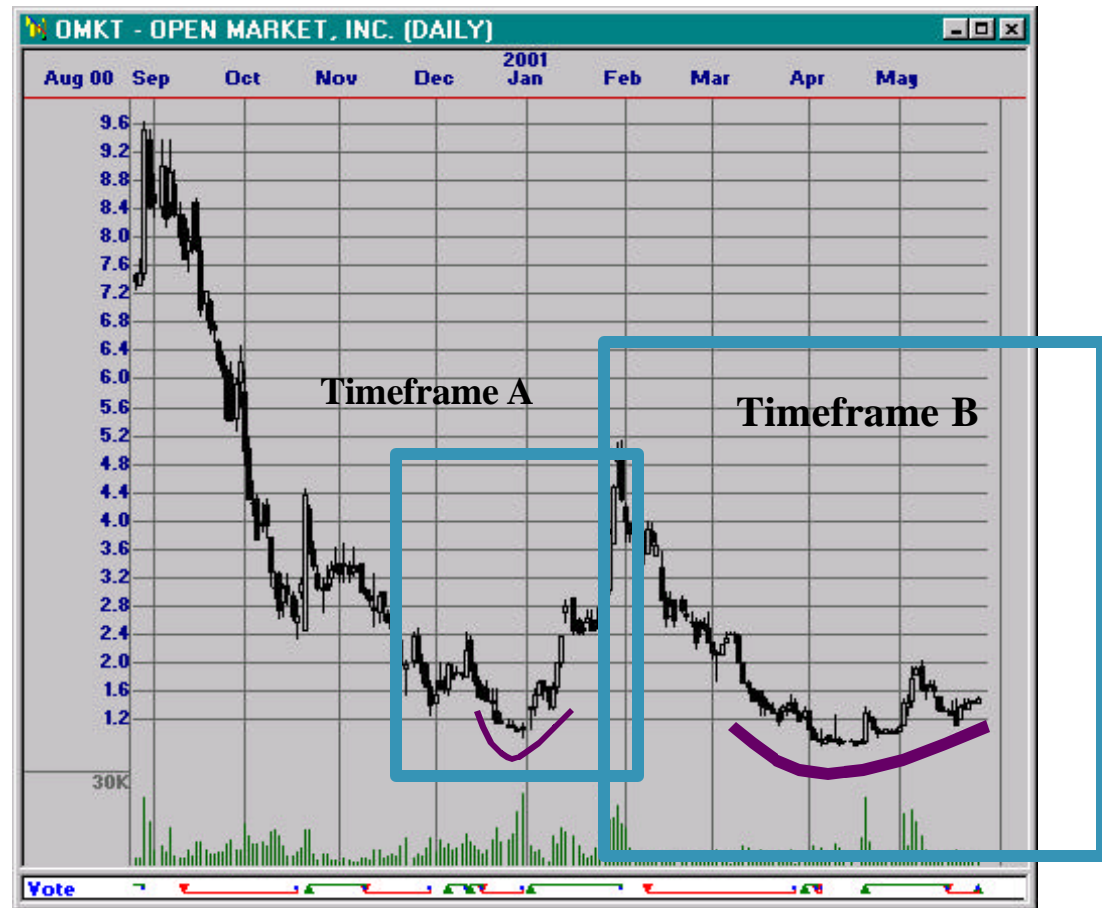


- 1) Establish a Timeframe
- 2) Determine a Reference
- 3) The Rule of Eighths
- 4) Avoid Volatility
- 5) Watch for Opposites
- 6) Apply Reward:Risk

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.

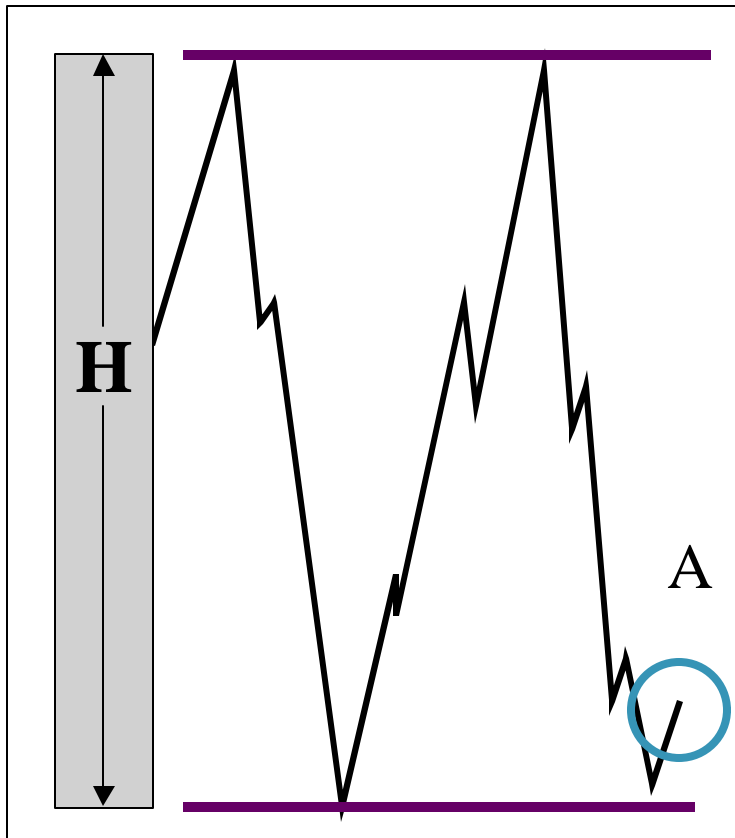


Example: saucer

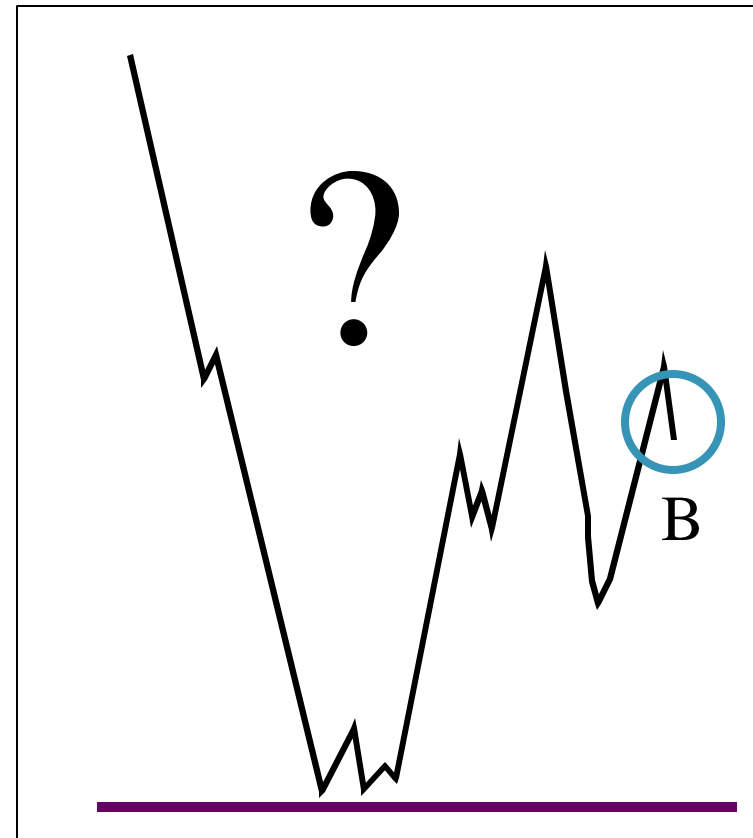
Small saucer

Large saucer

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

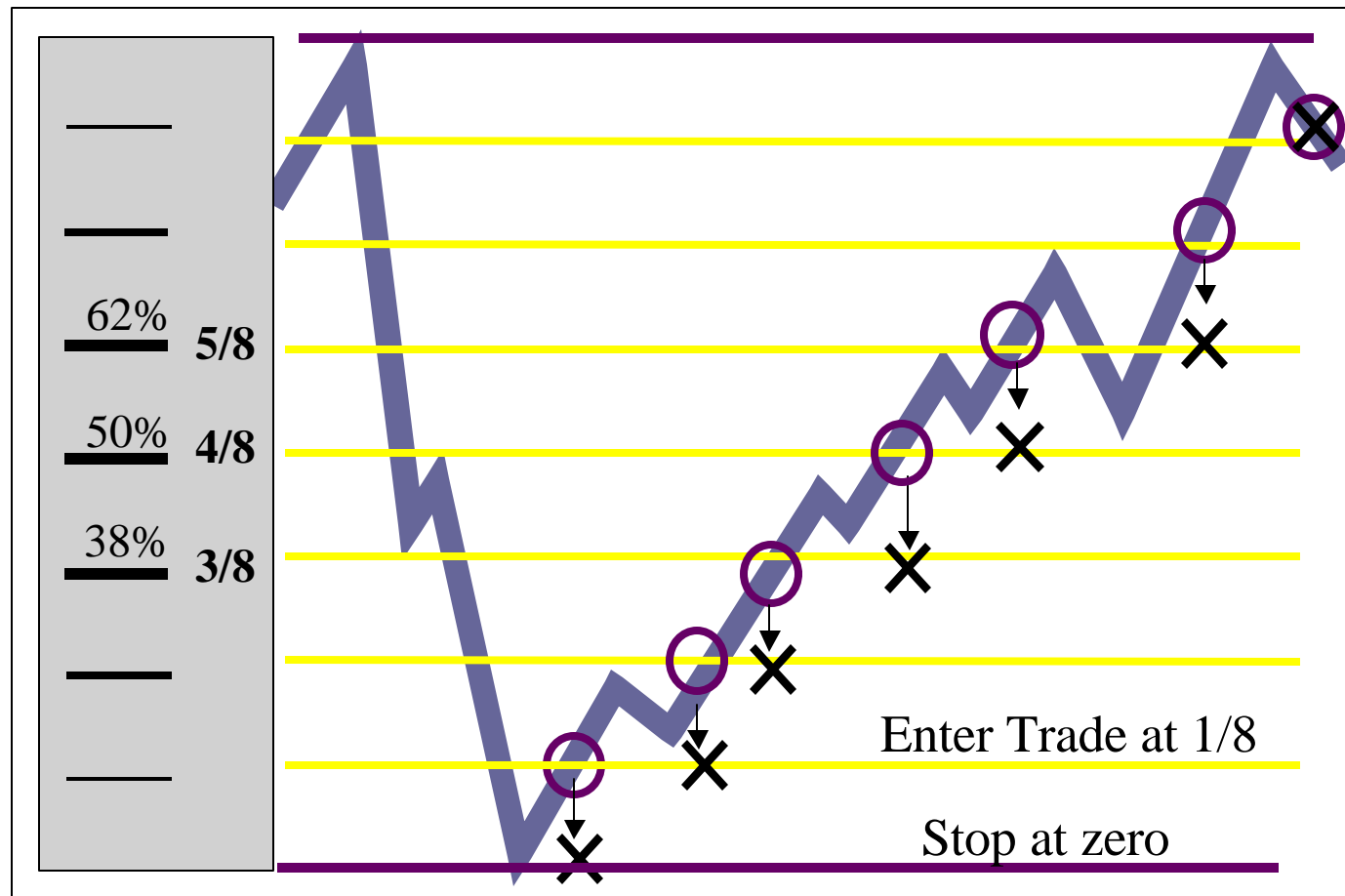


At “A” we can use H.

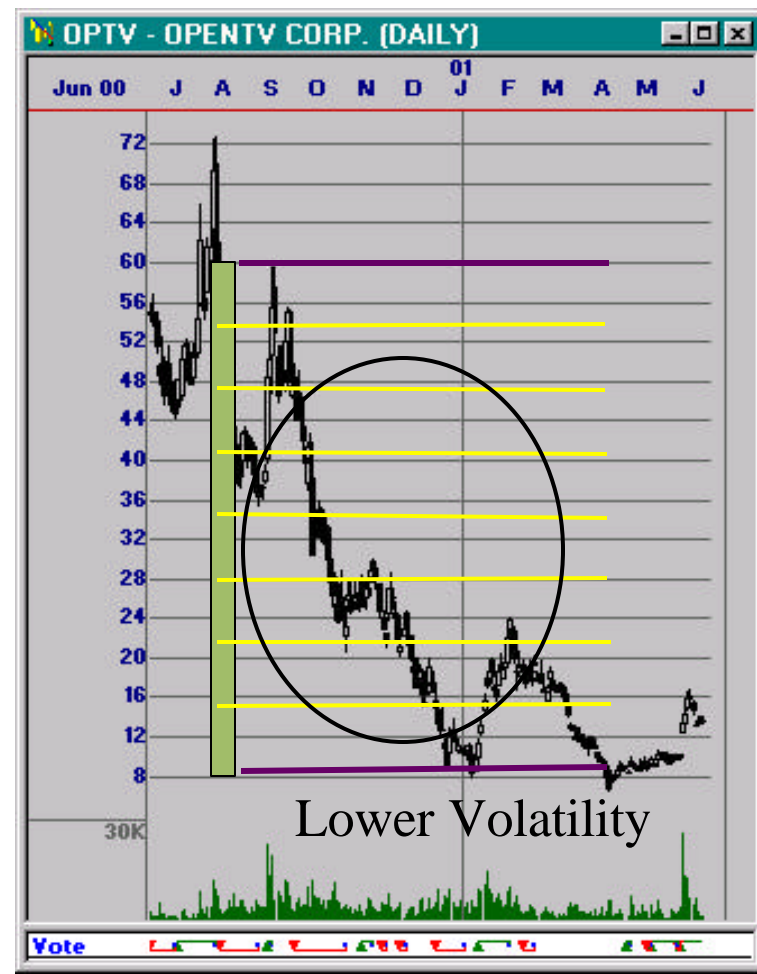
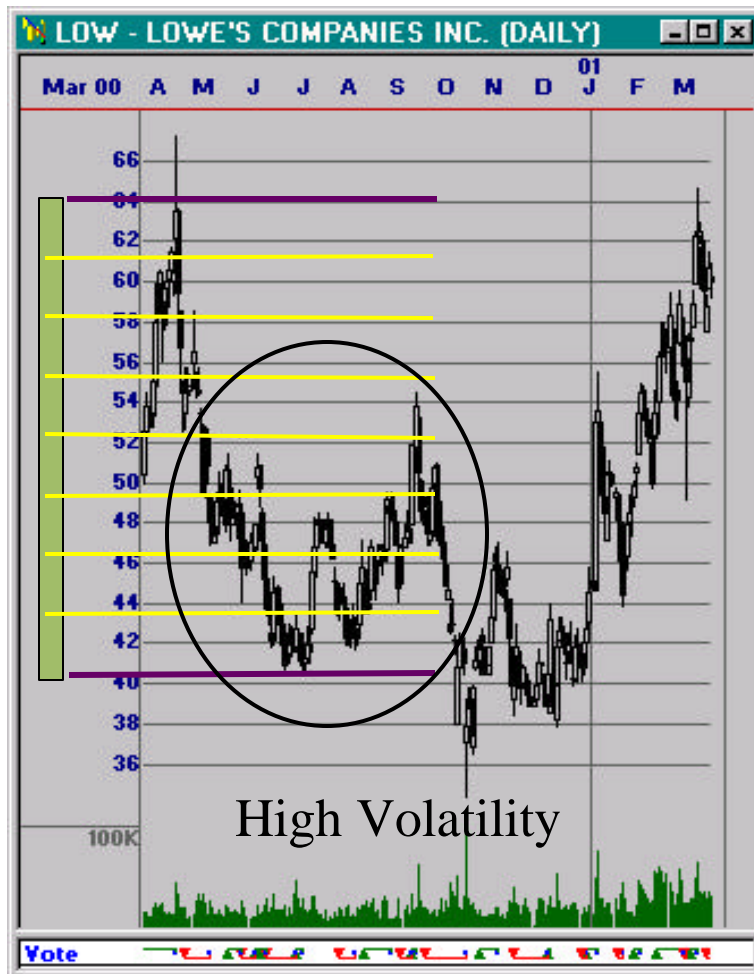


“B” is more ambiguous.

3) Rule of Eighths: Use eighths within the reference to set trailing stops



4) Avoid trading issues which reverse across 2+ lines within 5 bars (volatile).

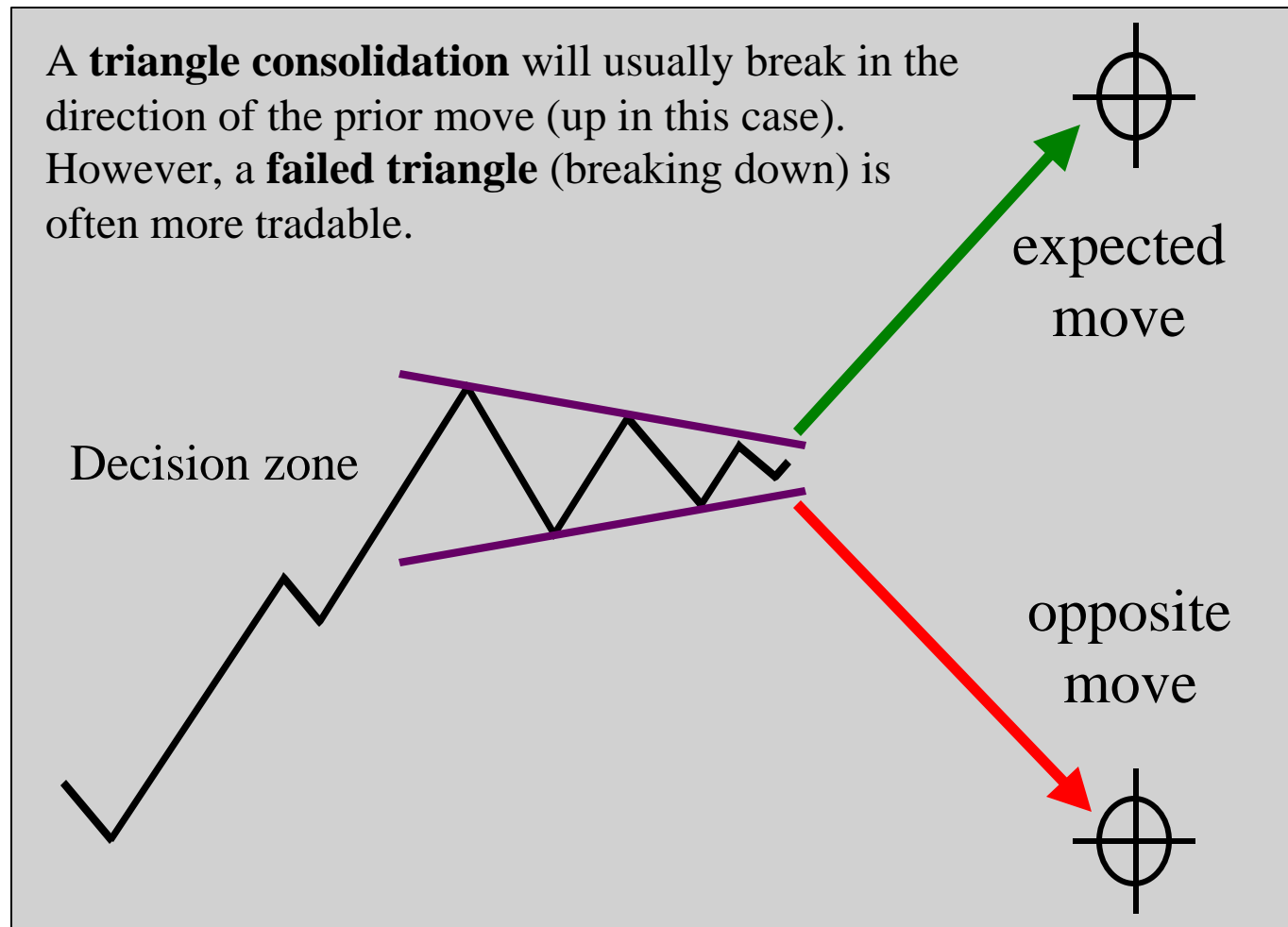


5) Patterns can indicate a Continuation OR a Reversal of Trend.

Pattern Type	Reverse Trend	Continue Trend
Support / Resist.	Reversal	Break
Trend Line	Reversal	Break
Saucer	Reversal	Break
Fibonacci	Reversal	Break
Gap	Exhaustion	Break, Measured
Volume	Climax	Trend
Consolidation	Failure	Continuation

Be prepared to trade both sides.

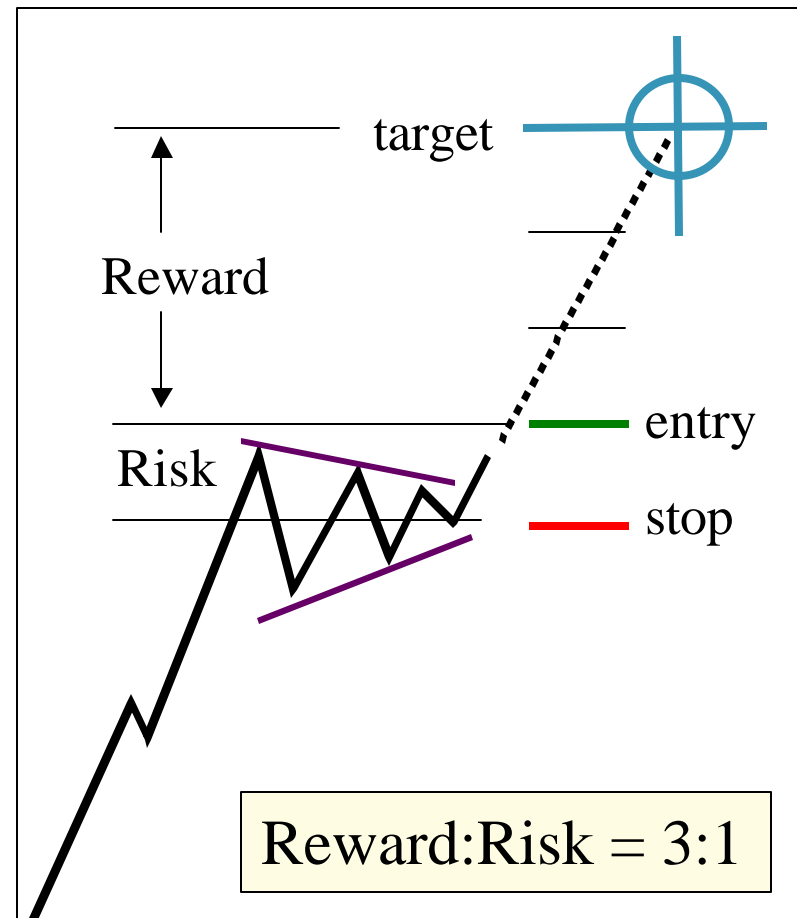
Example: Consolidations usually break in the direction of prior trend but can also reverse in the opposite direction. Such “failed” consolidations can prove highly profitable.



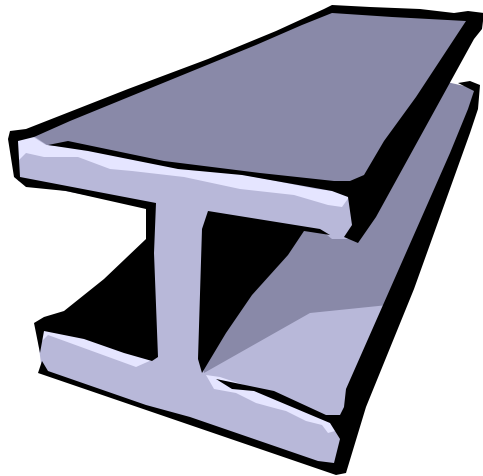
6) The most important factor is trading opportunities with high Reward:Risk

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.

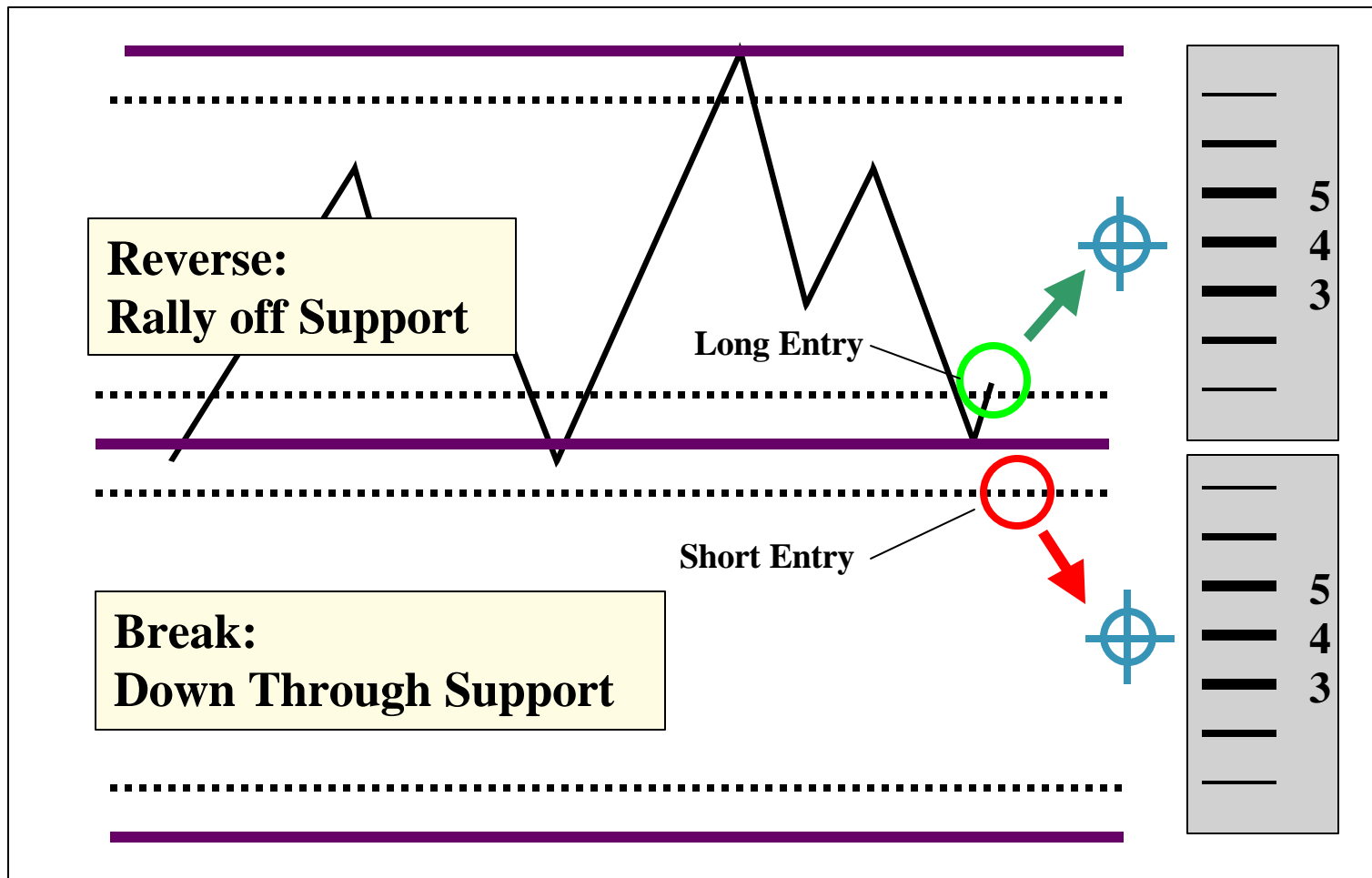


Pattern Structures



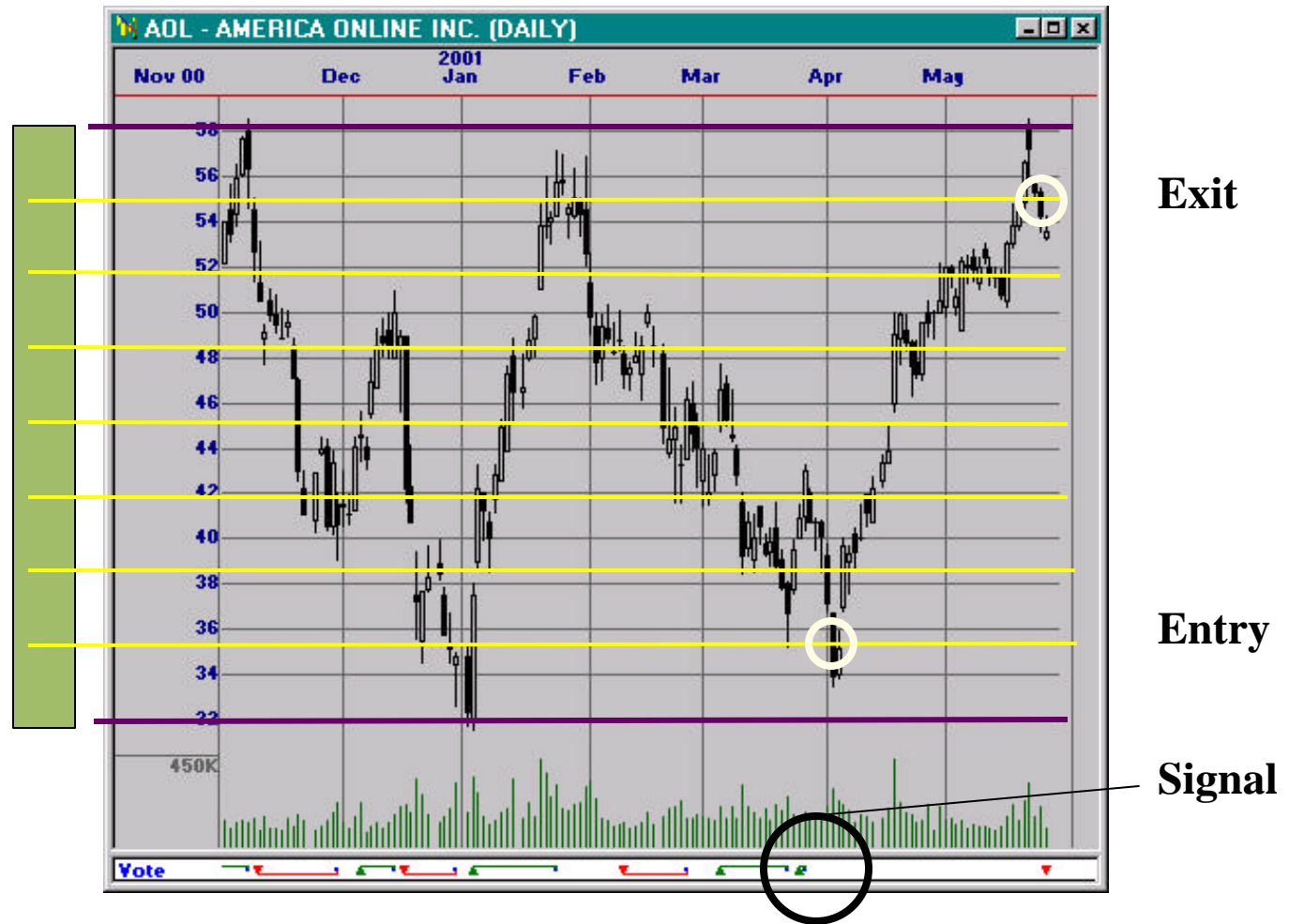
- ✓ Pattern Dimensions
- ✓ When to Get In.
- ✓ Where to Place Stops.
- ✓ When to Get Out.

Support (& Resistance)



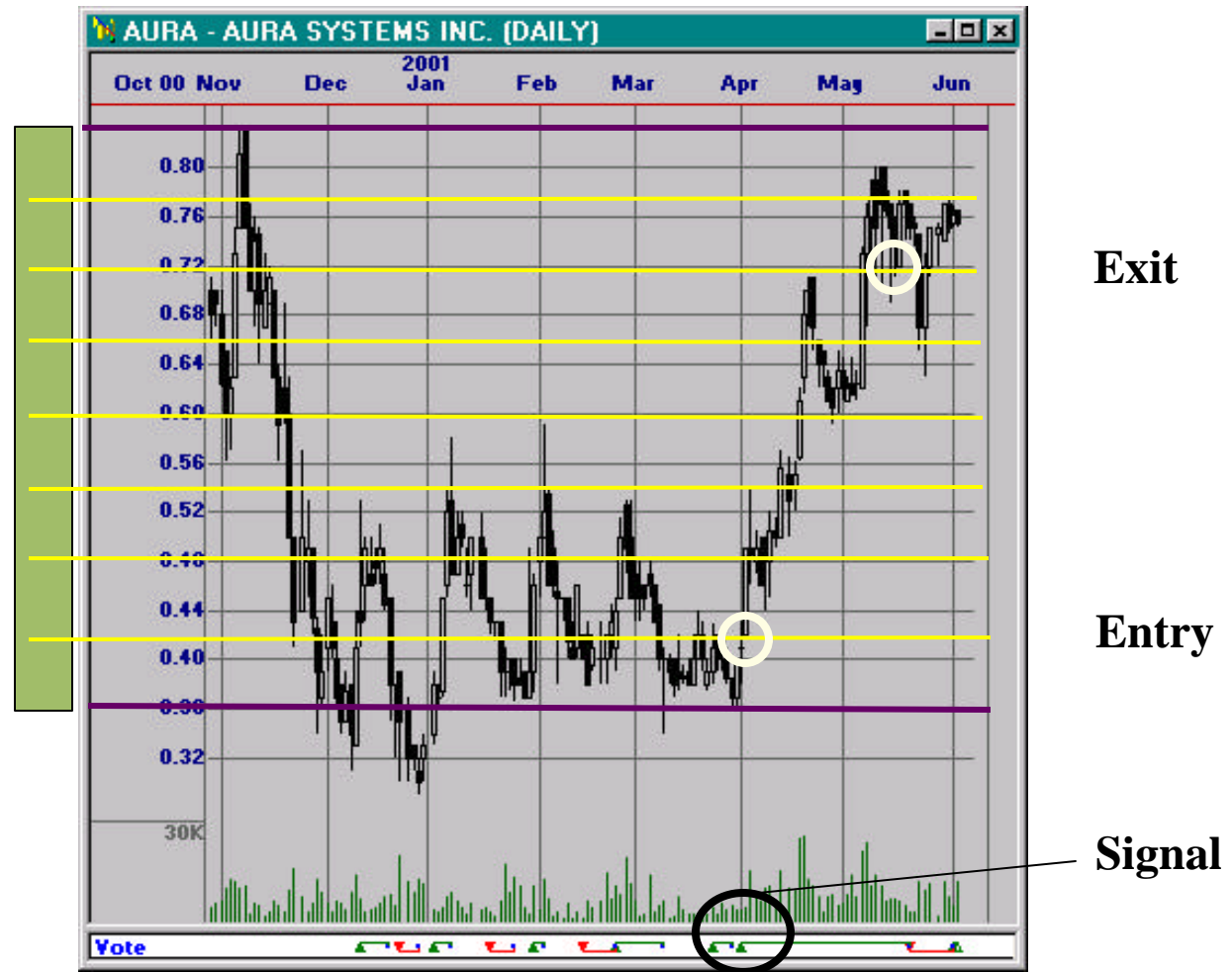
Support & Resistance

America Online, Inc.

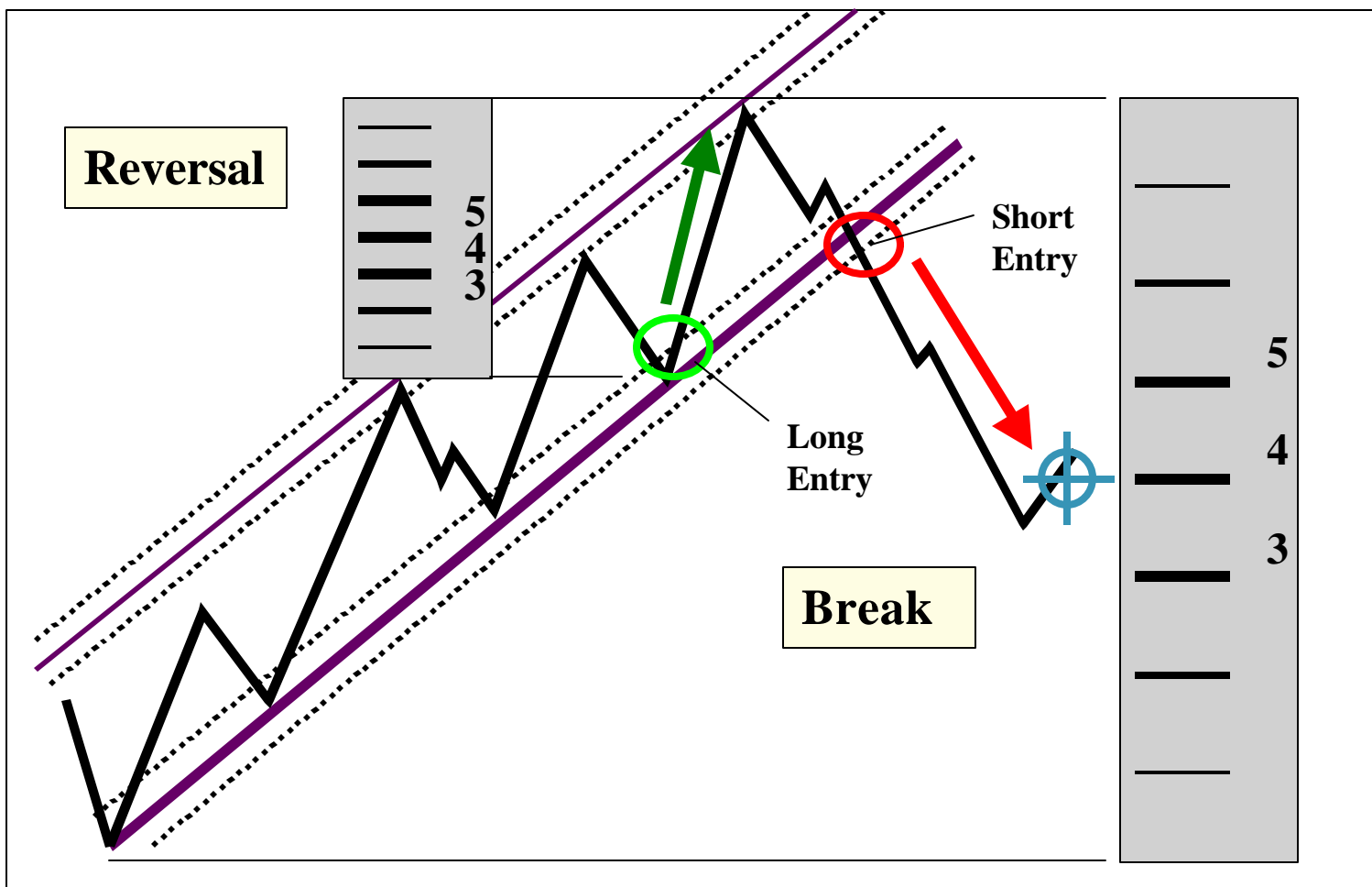


Support & Resistance

Aura Systems, Inc.

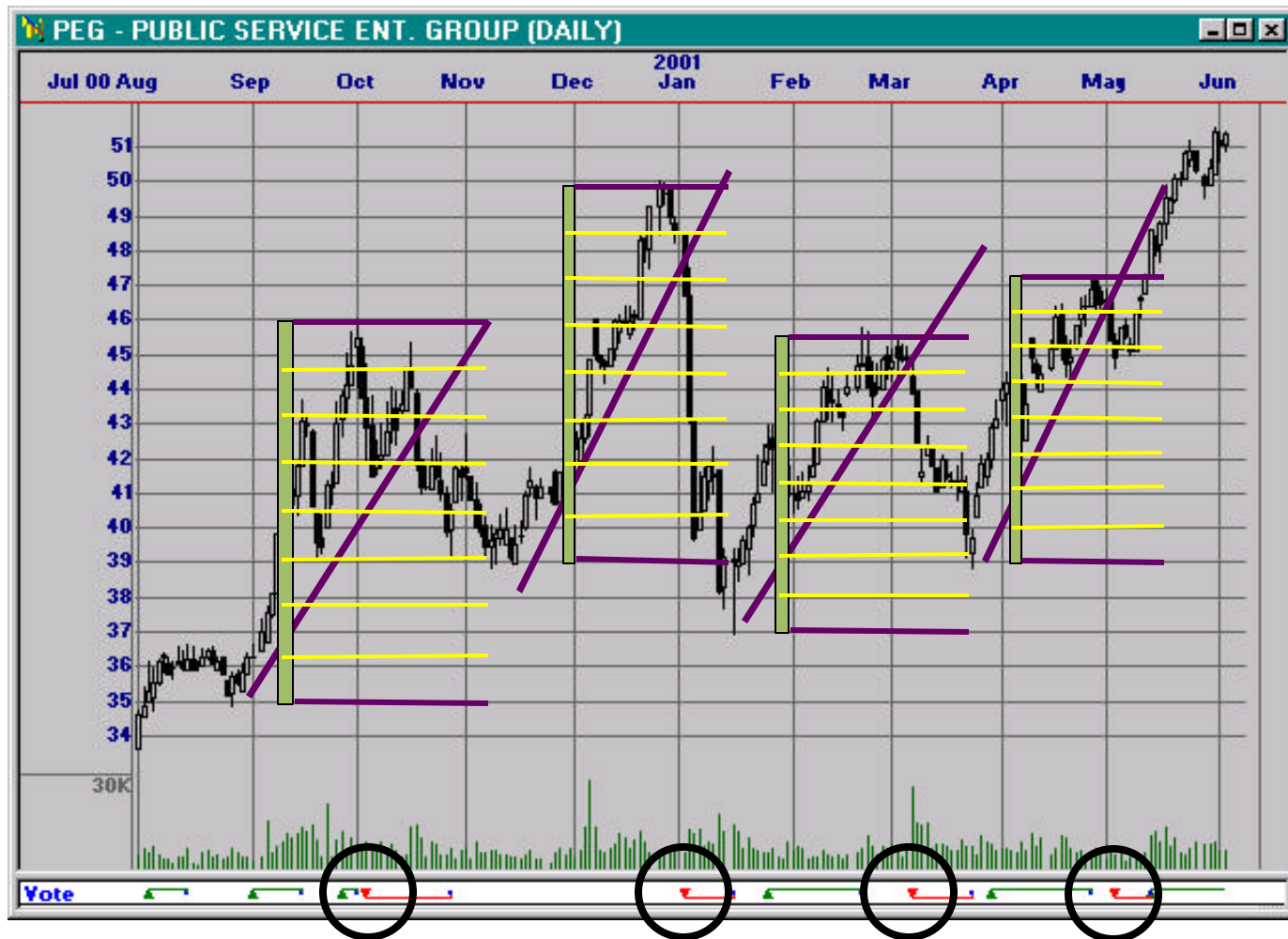


Trend Reversals (Breaks)



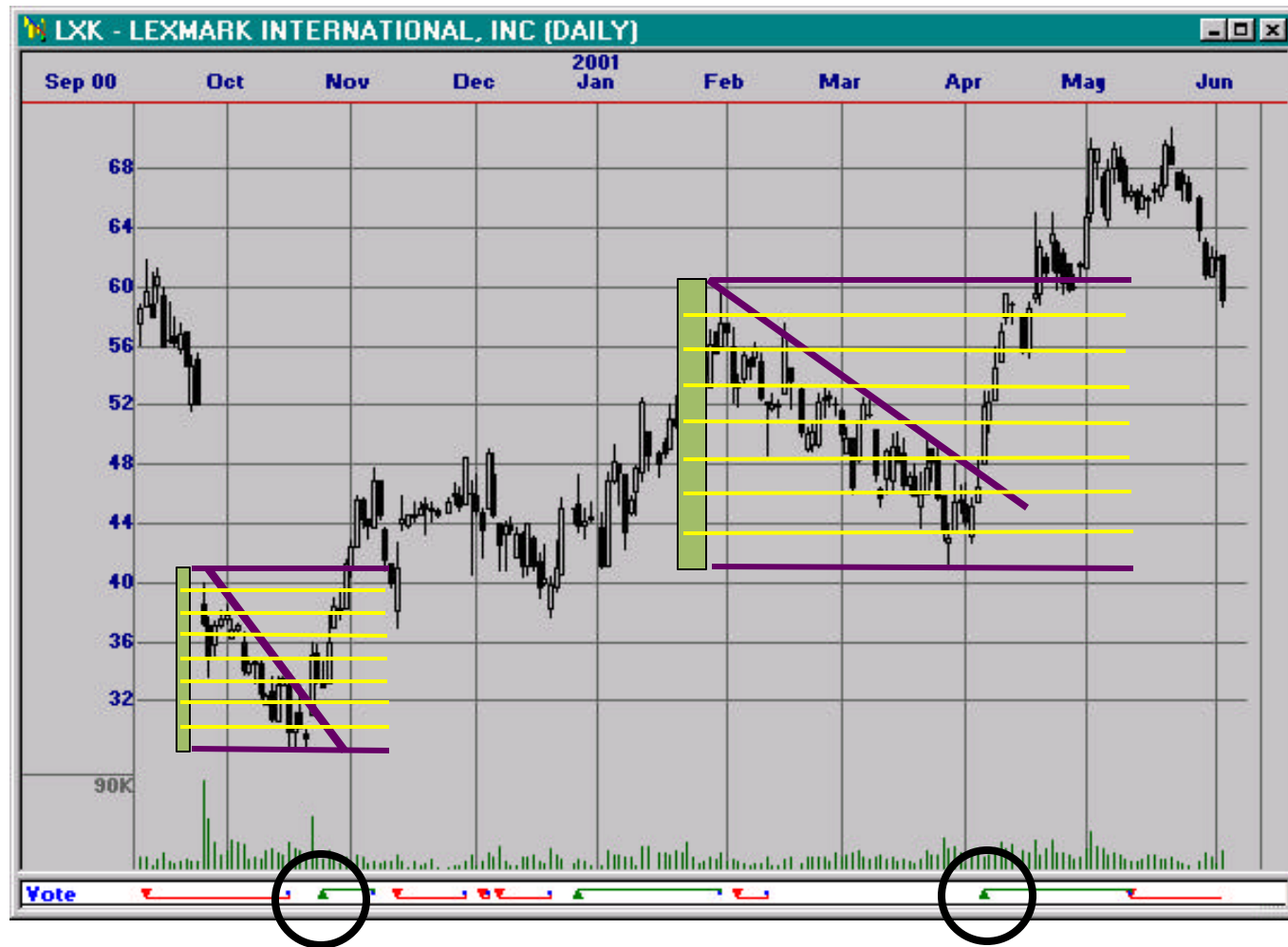
Trend Line Breaks

Public Service Ent. Group



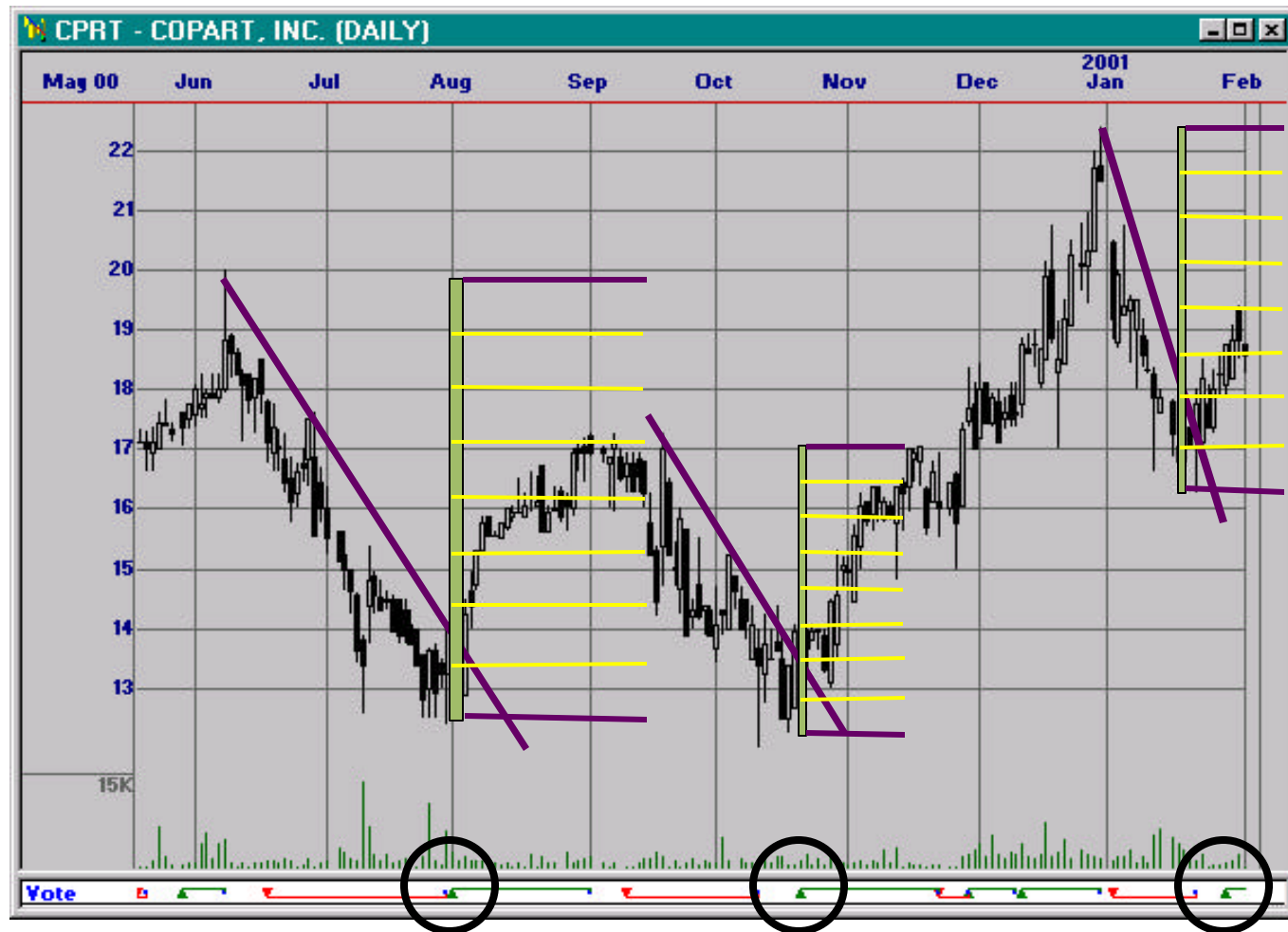
Trend Line Breaks

Lexmark International, Inc.

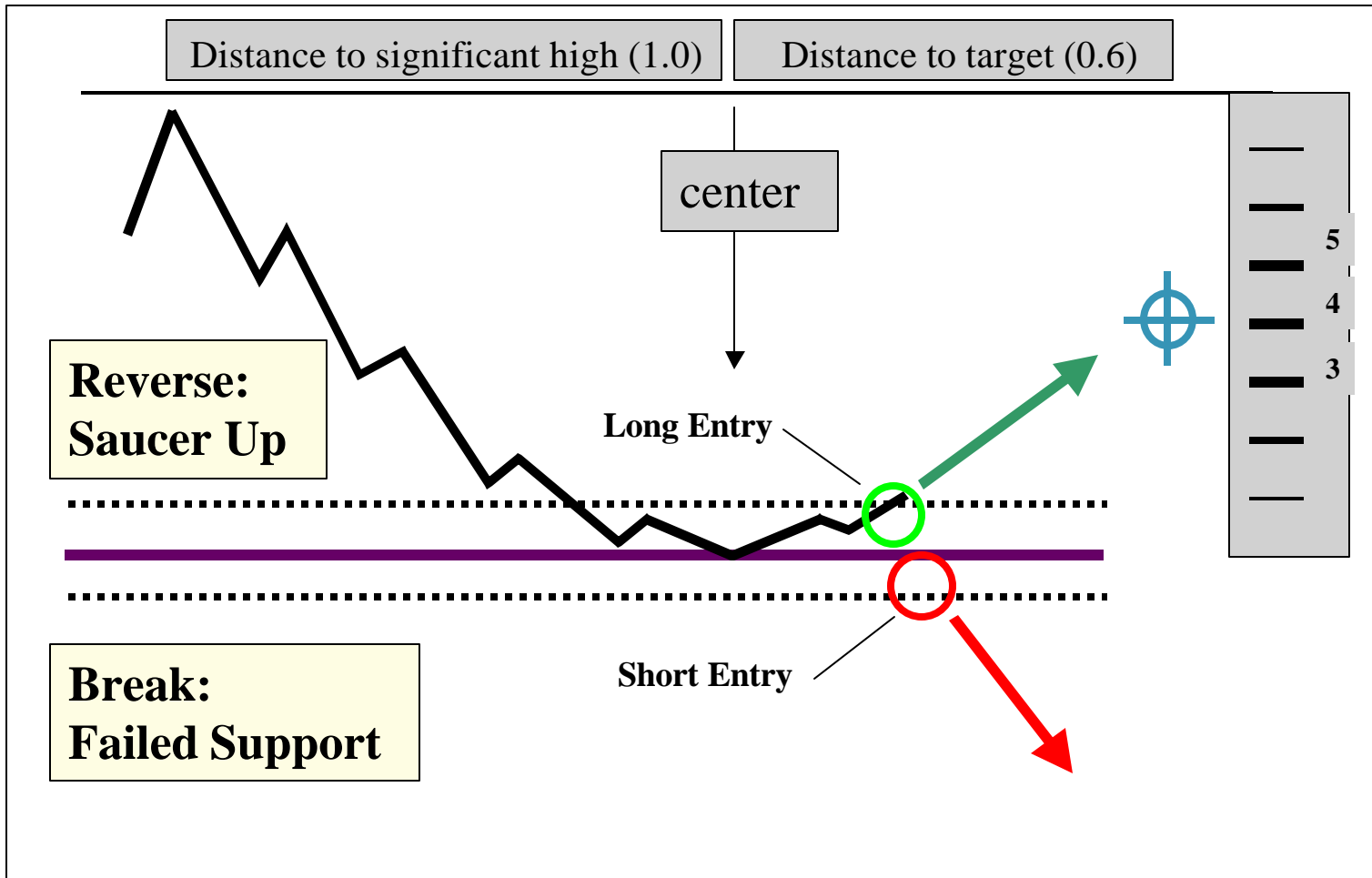


Trend Line Breaks

CoPart, Inc.

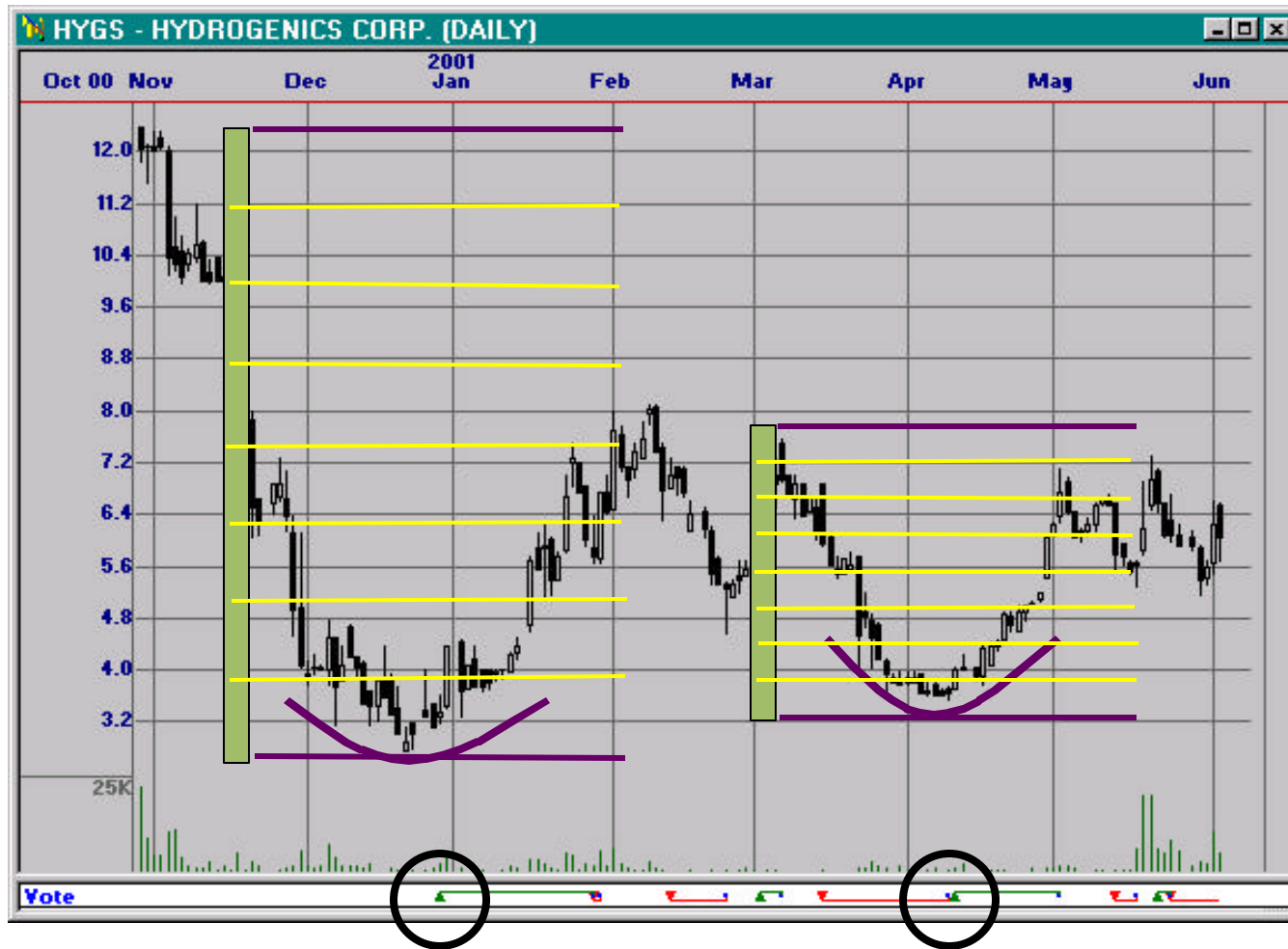


Saucer Patterns



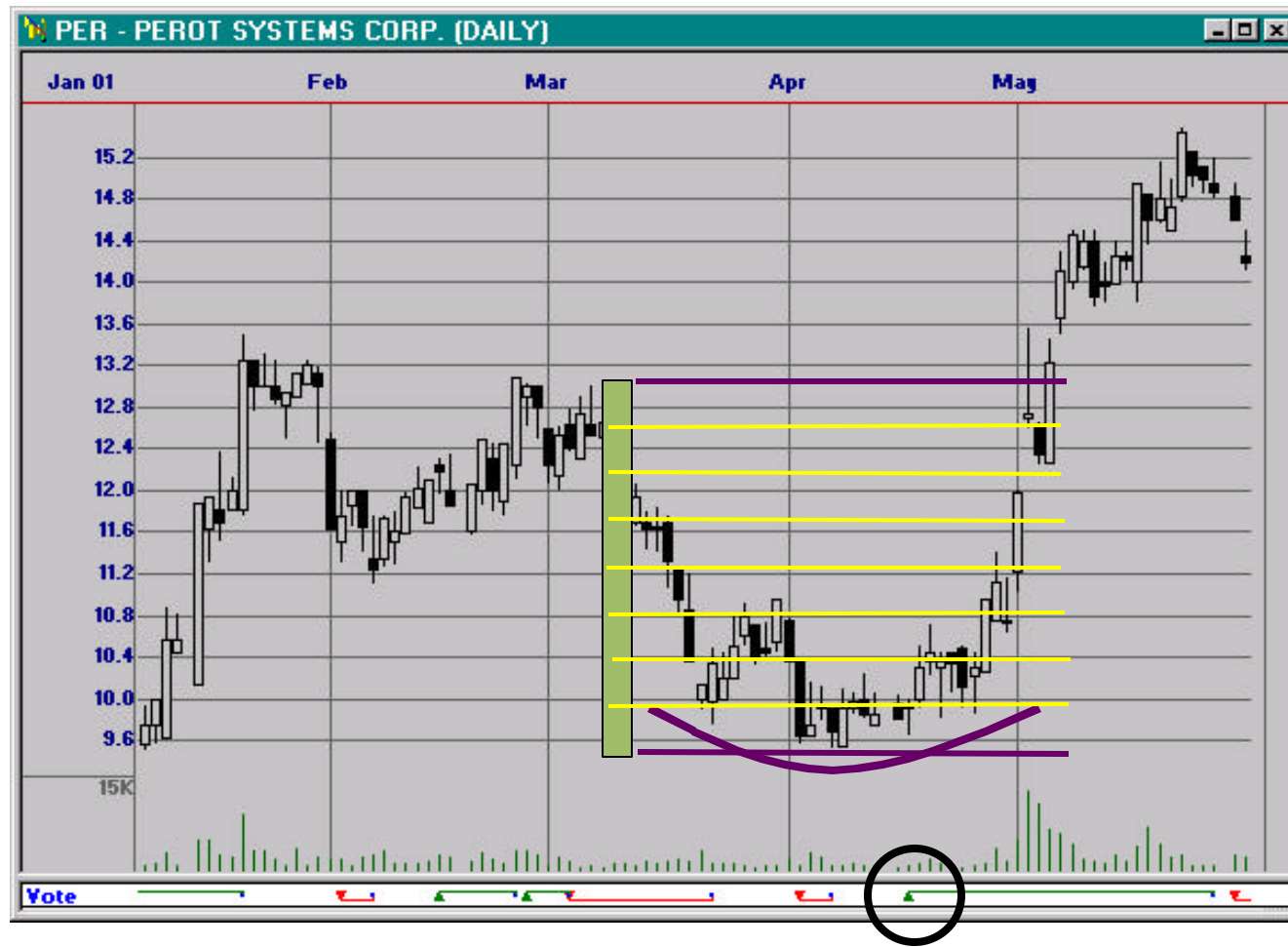
Saucer Patterns

Hydrogenics

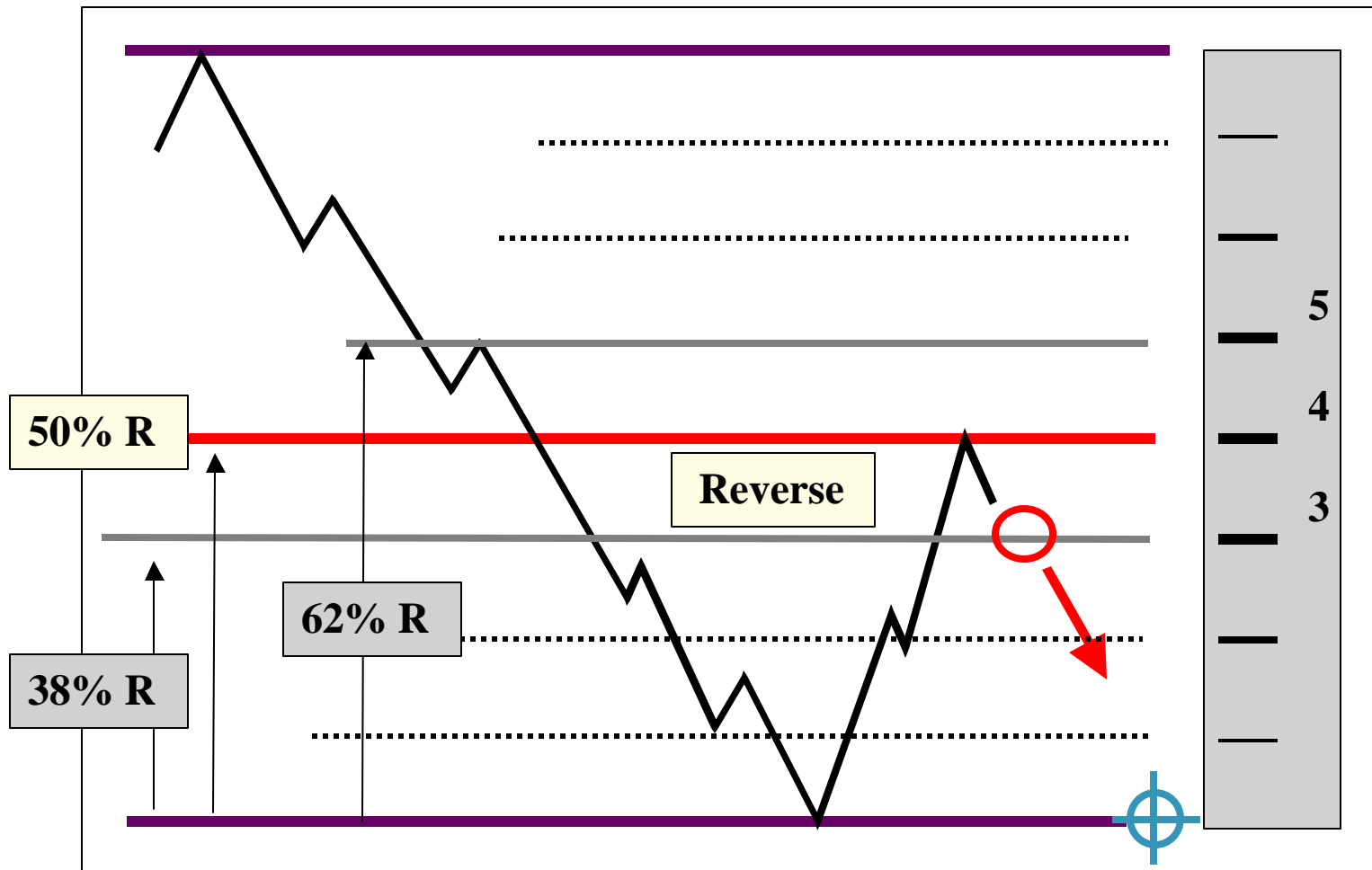


Saucer Pattern

Perot Systems

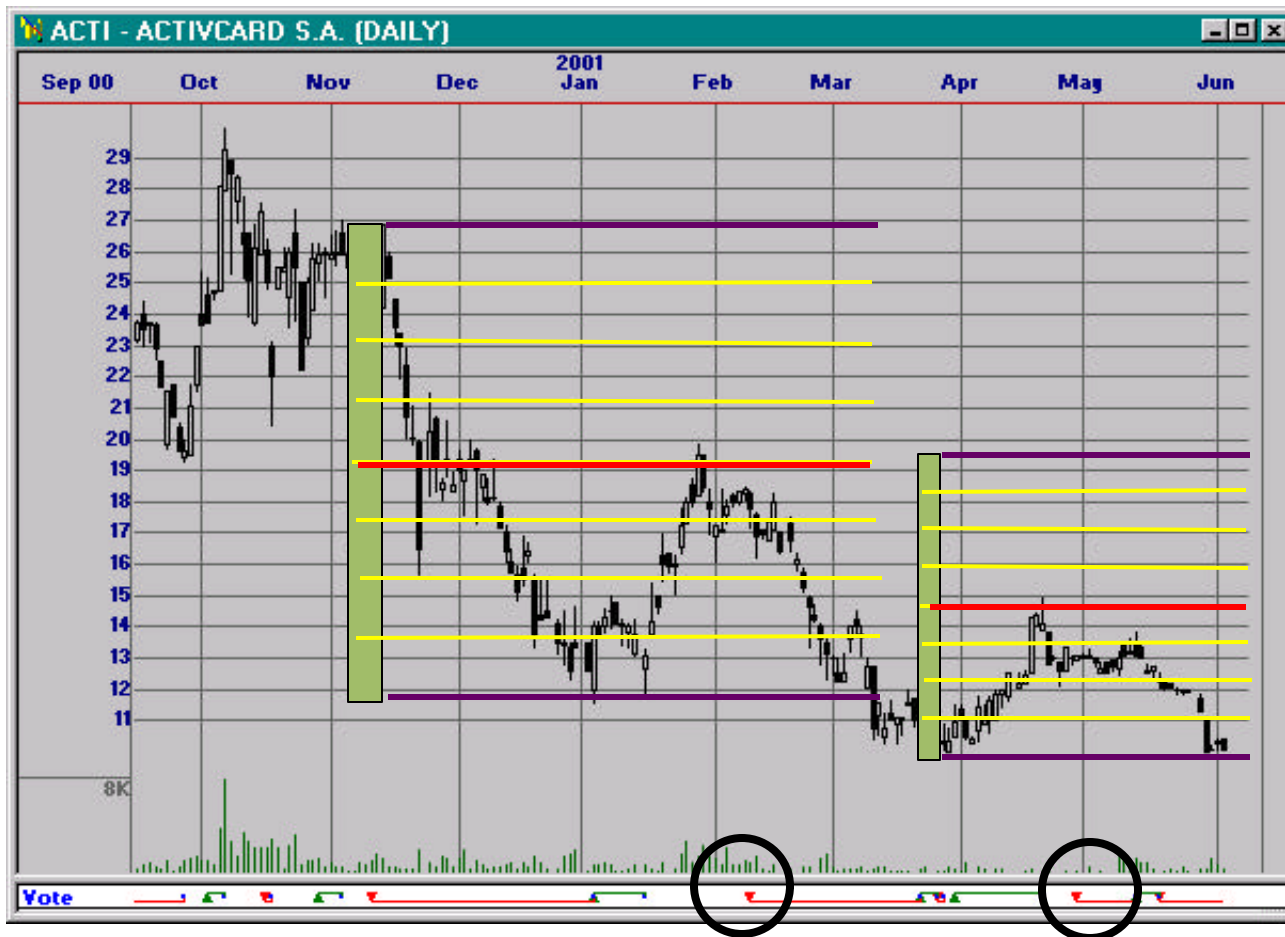


Fibonacci Retracements

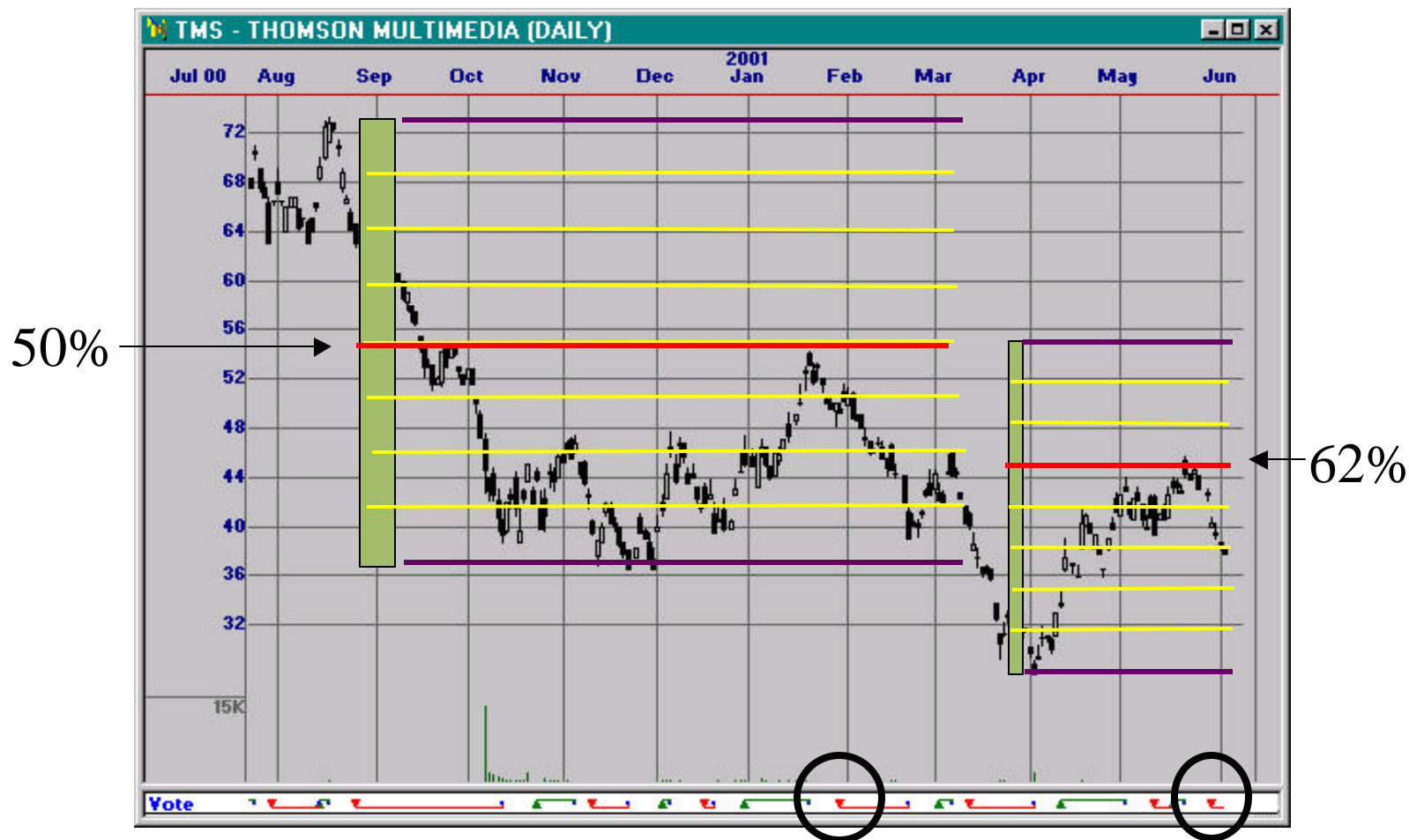


50% Retracements

Activcard

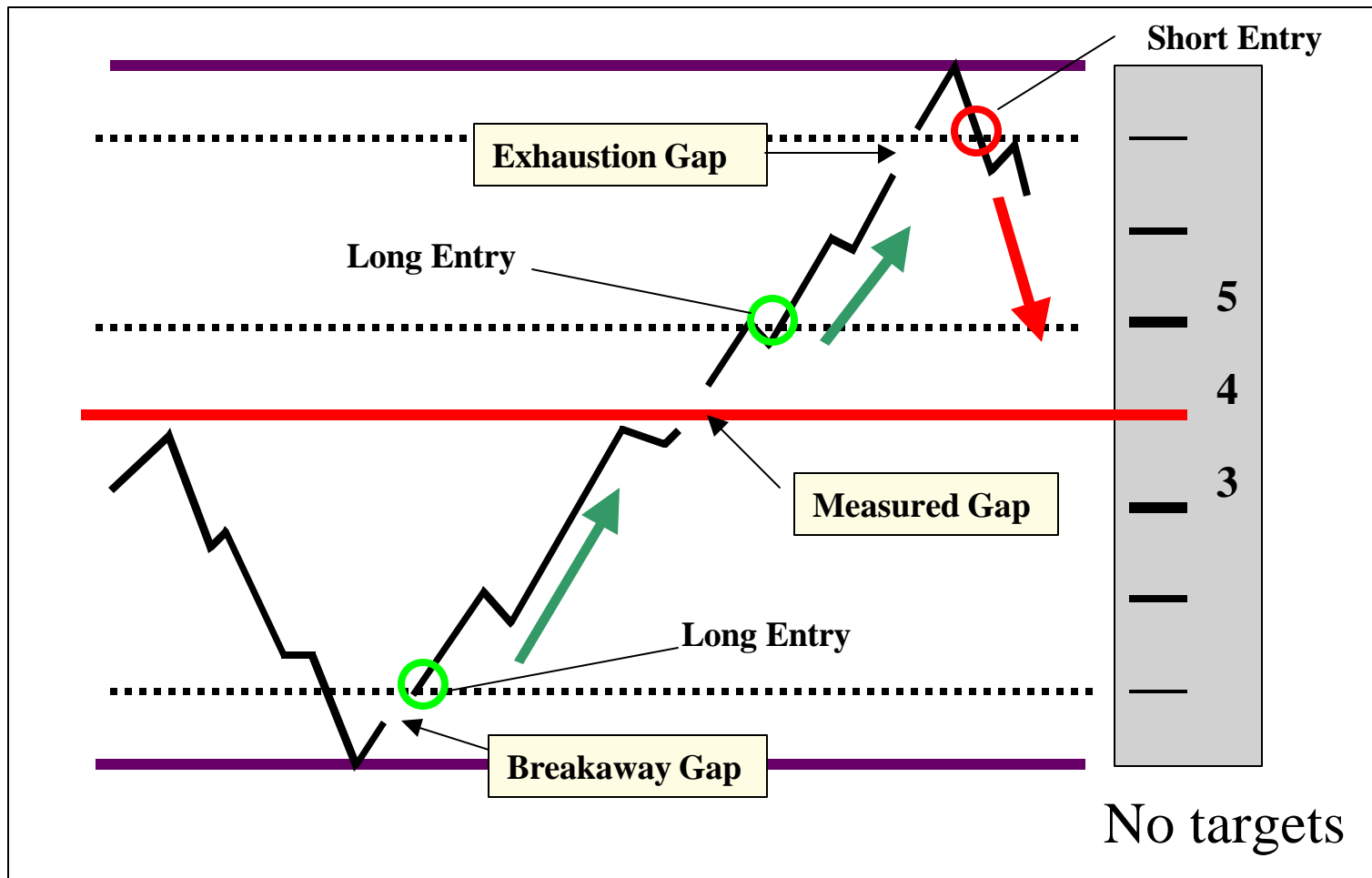


50%, 62% Retracements Thomson Multimedia



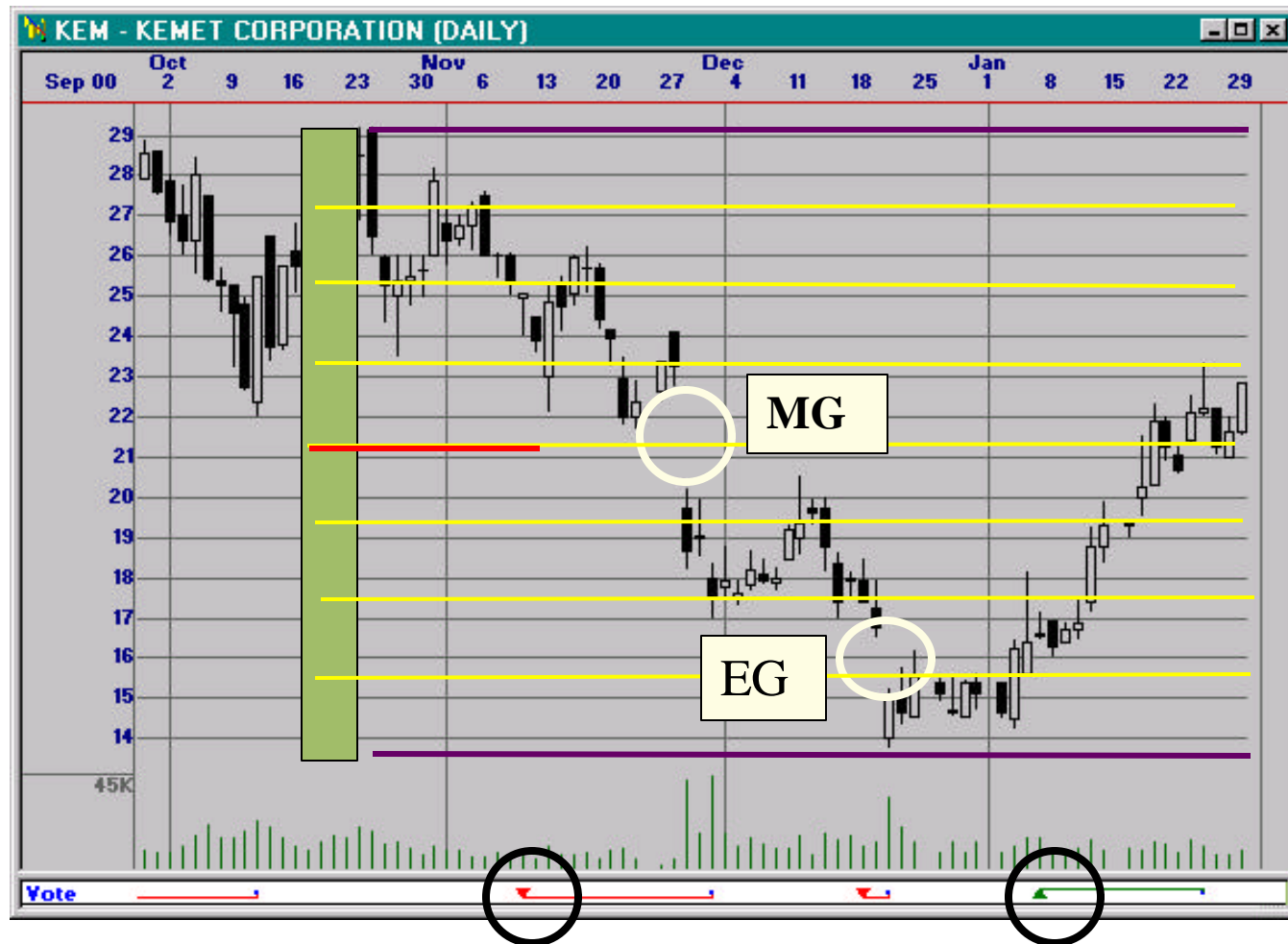
Price Gaps

Breakaway, Measured & Exhaustion

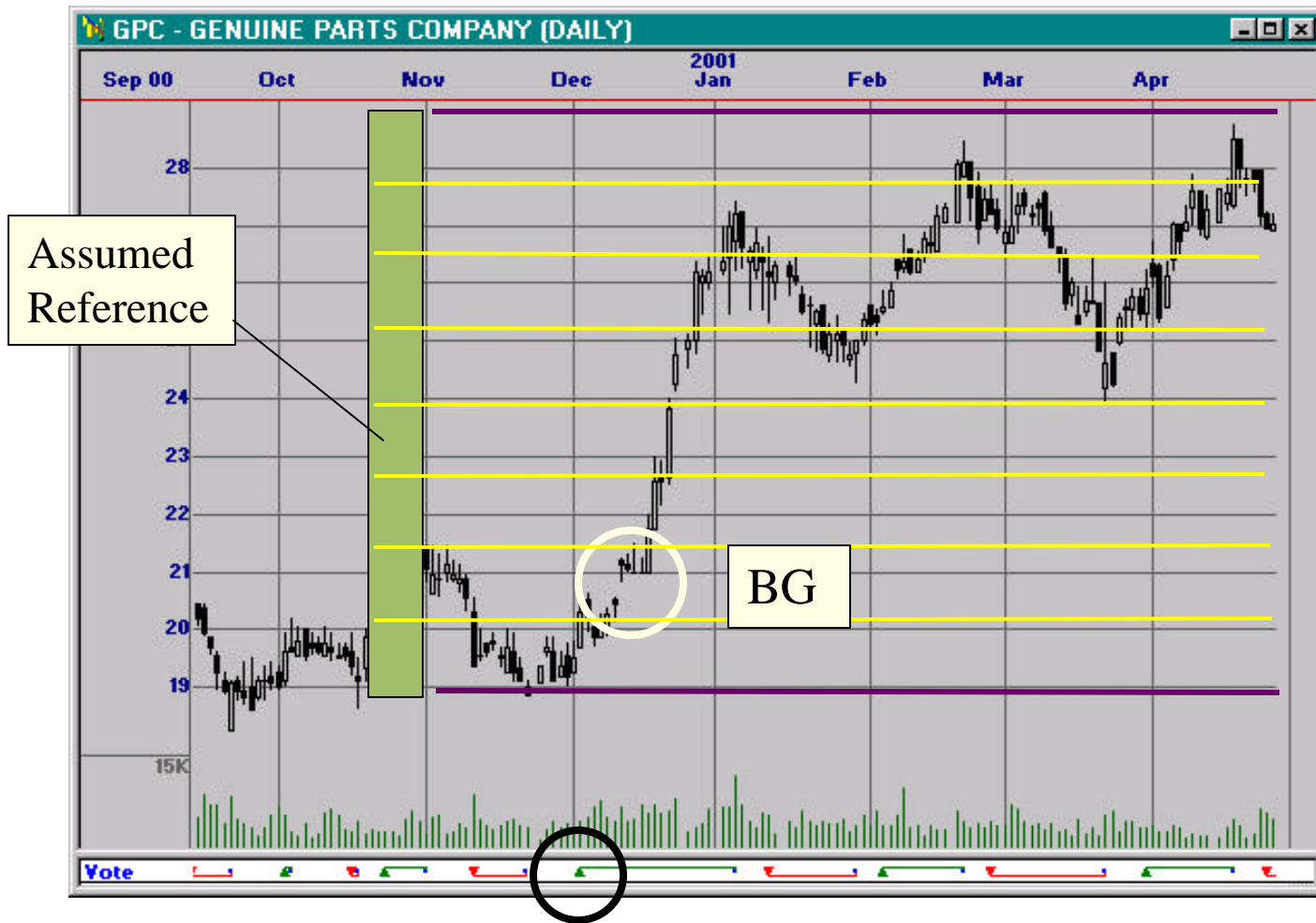


Measured & Exhaustion Gaps

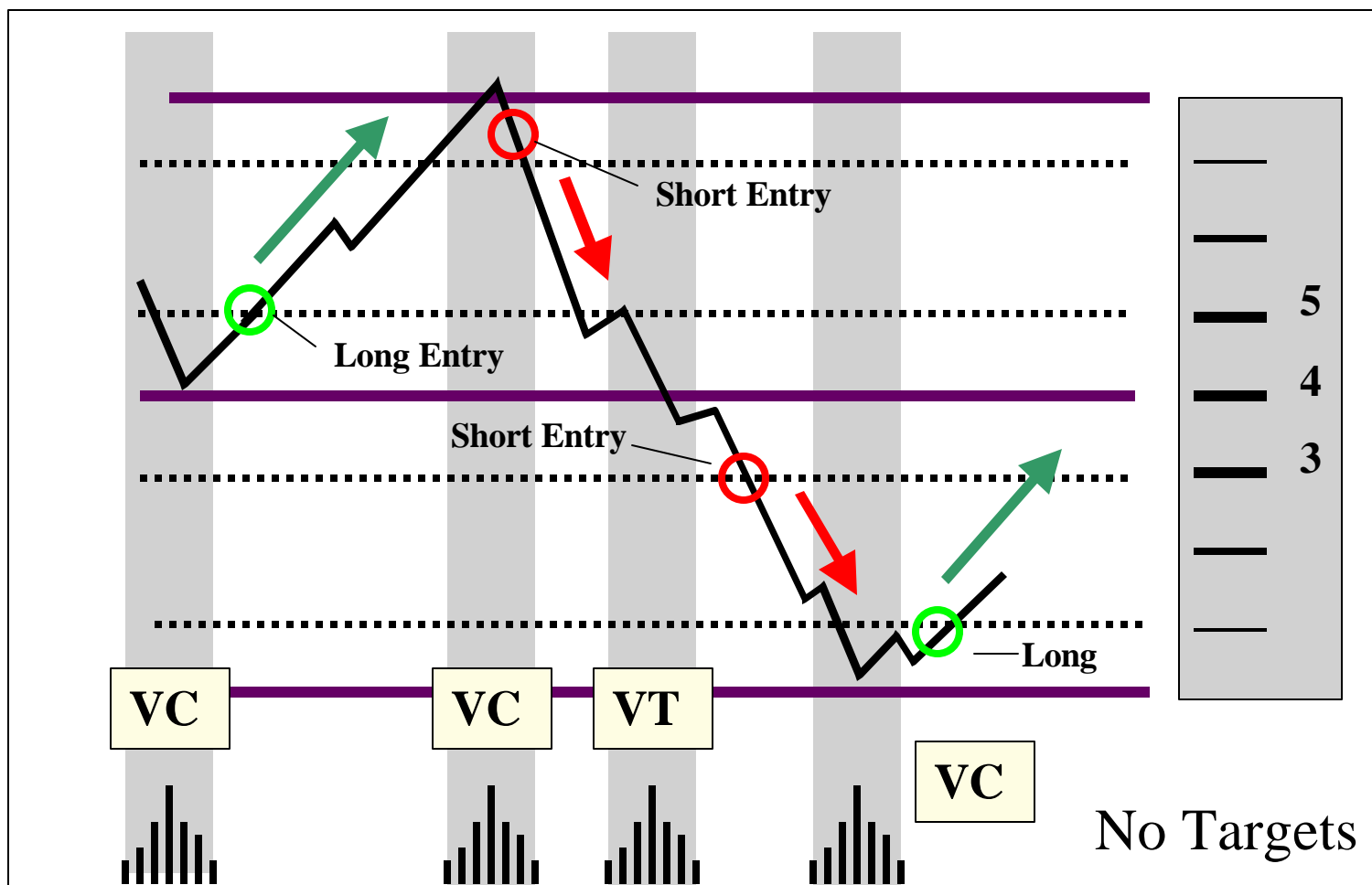
Kemet Corp.



Breakaway Gap Genuine Parts Co.

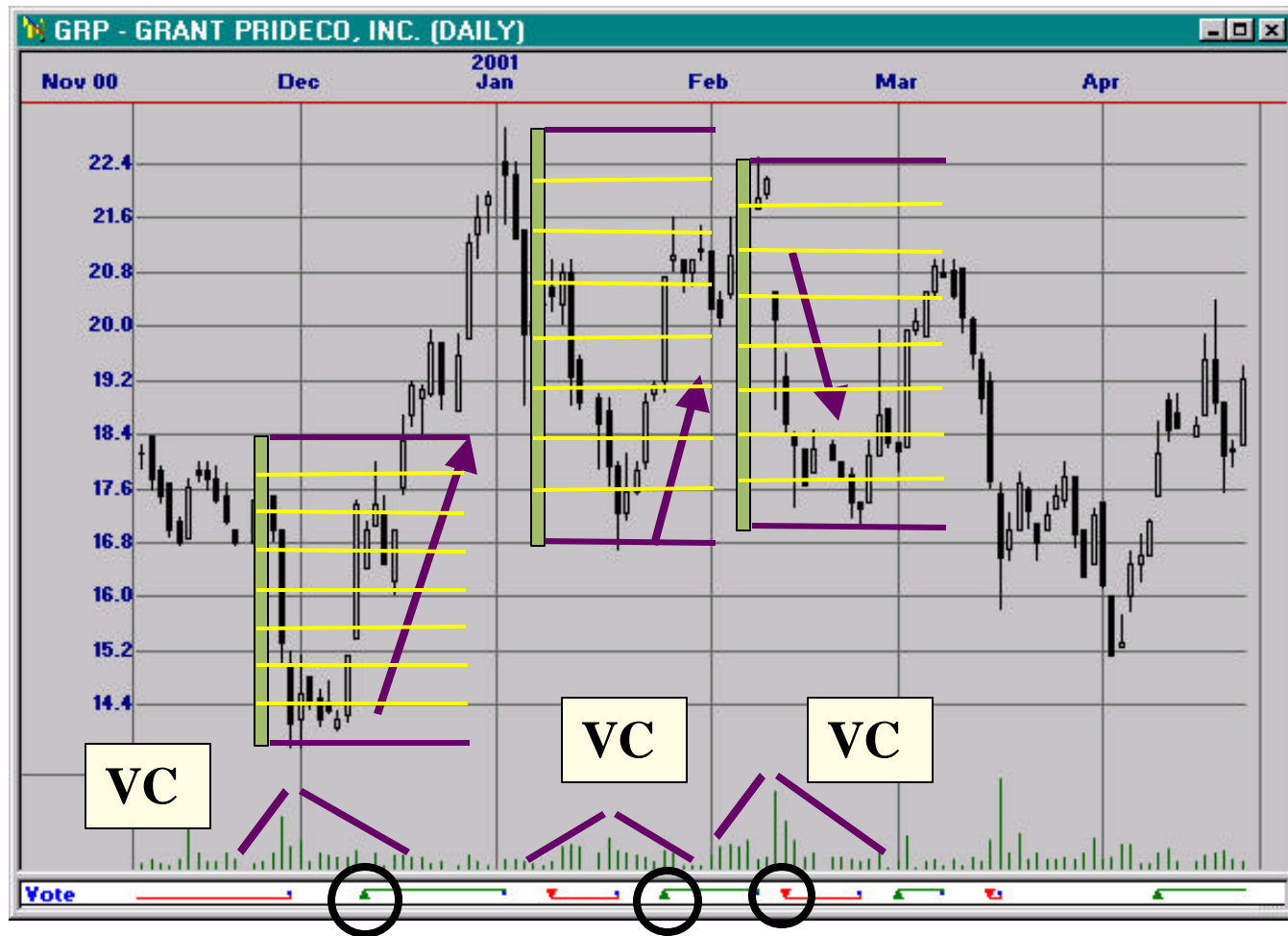


Volume Climax (Trend)



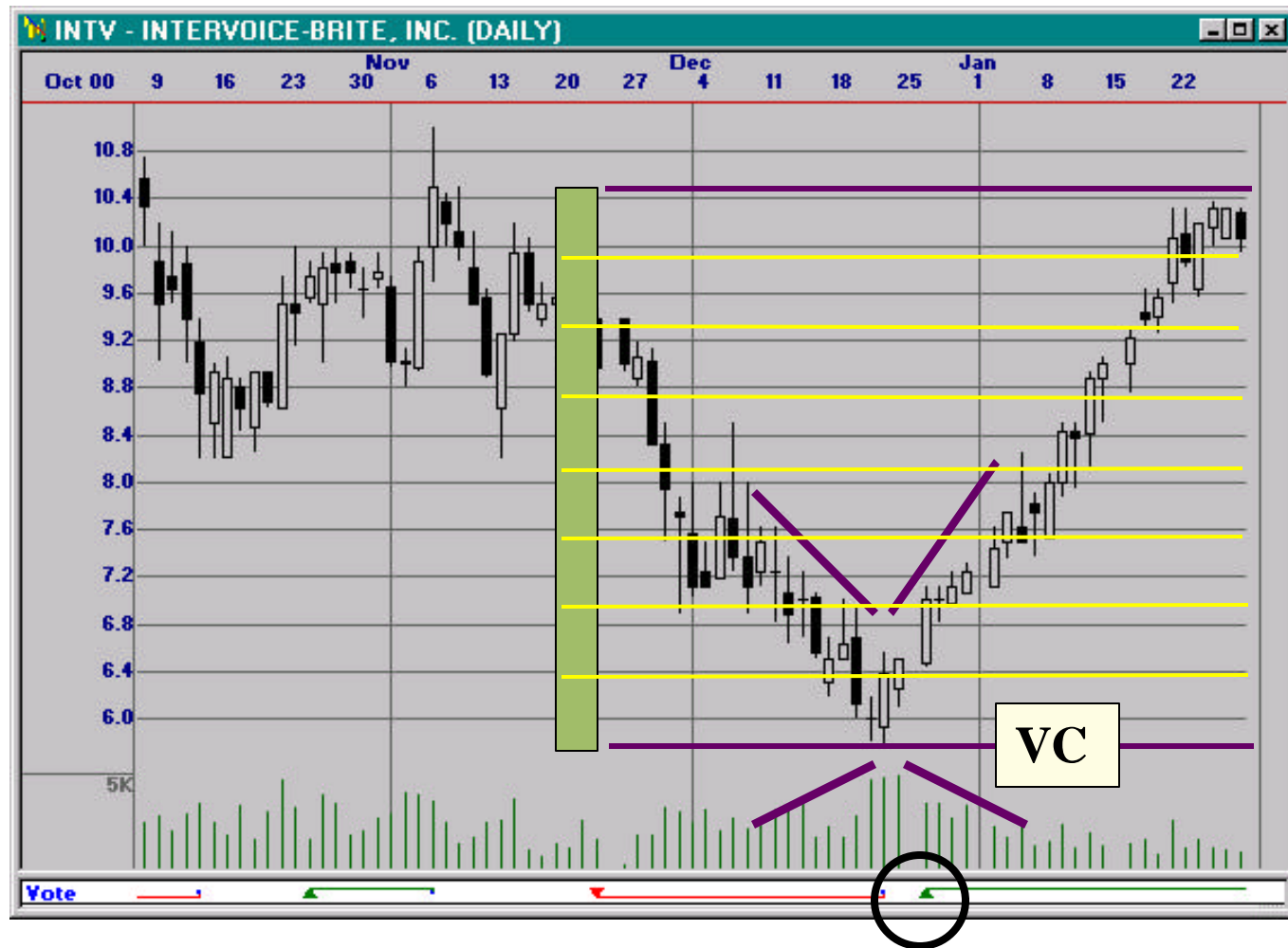
Volume Climaxes

Grant Prideco, Inc.



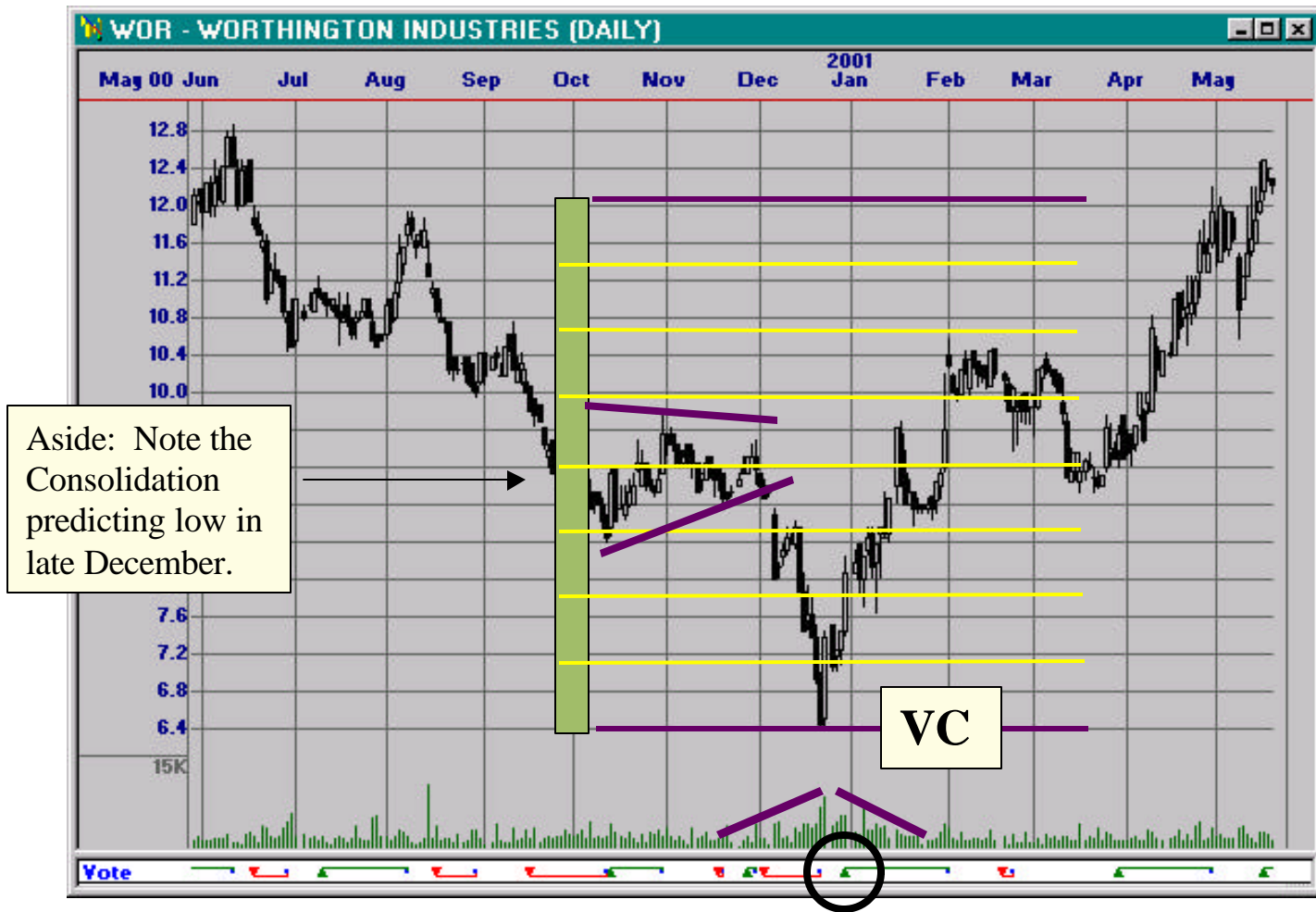
Volume Climax

Intervoice-Brite Inc.



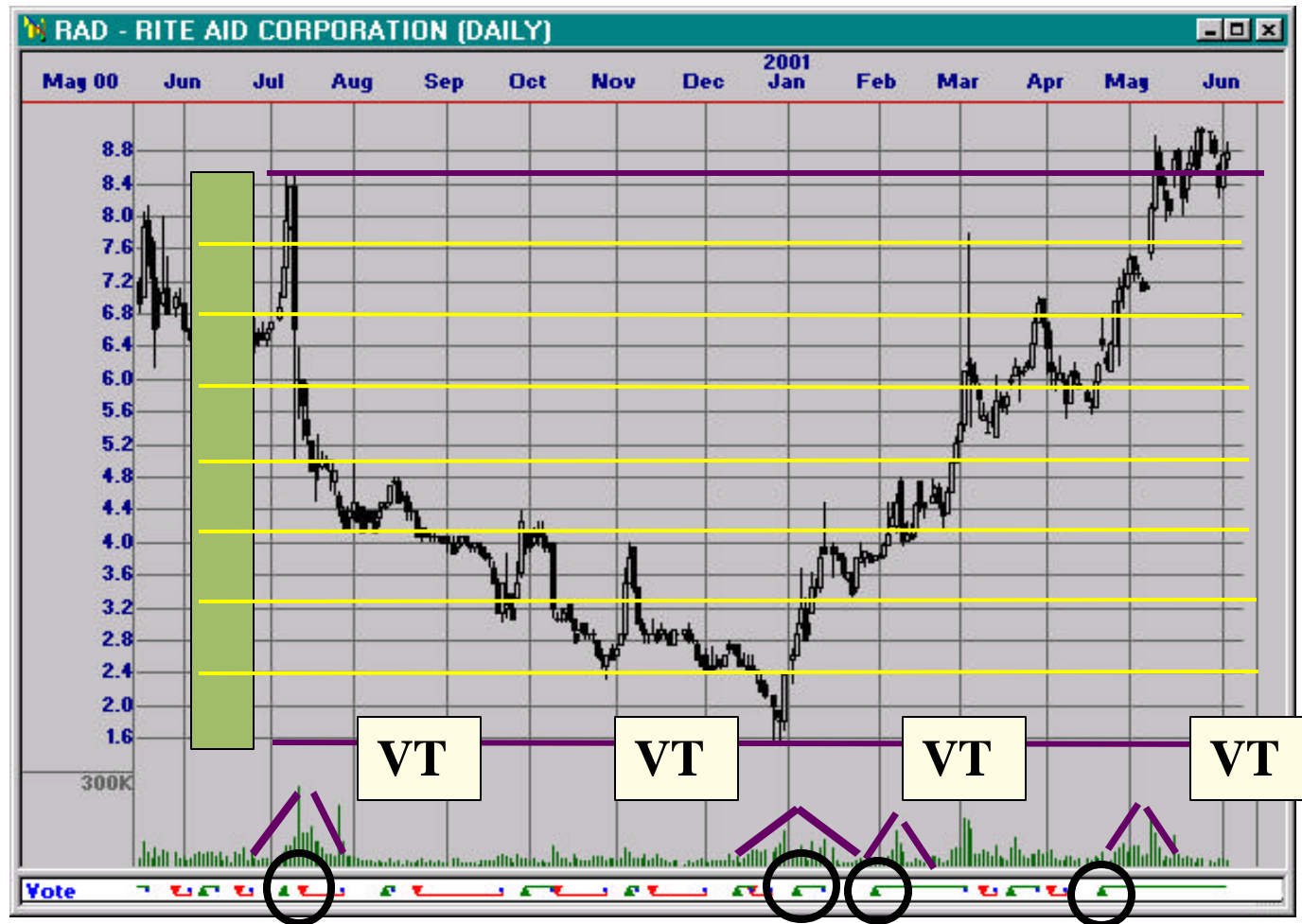
Volume Climax

Worthington Industries



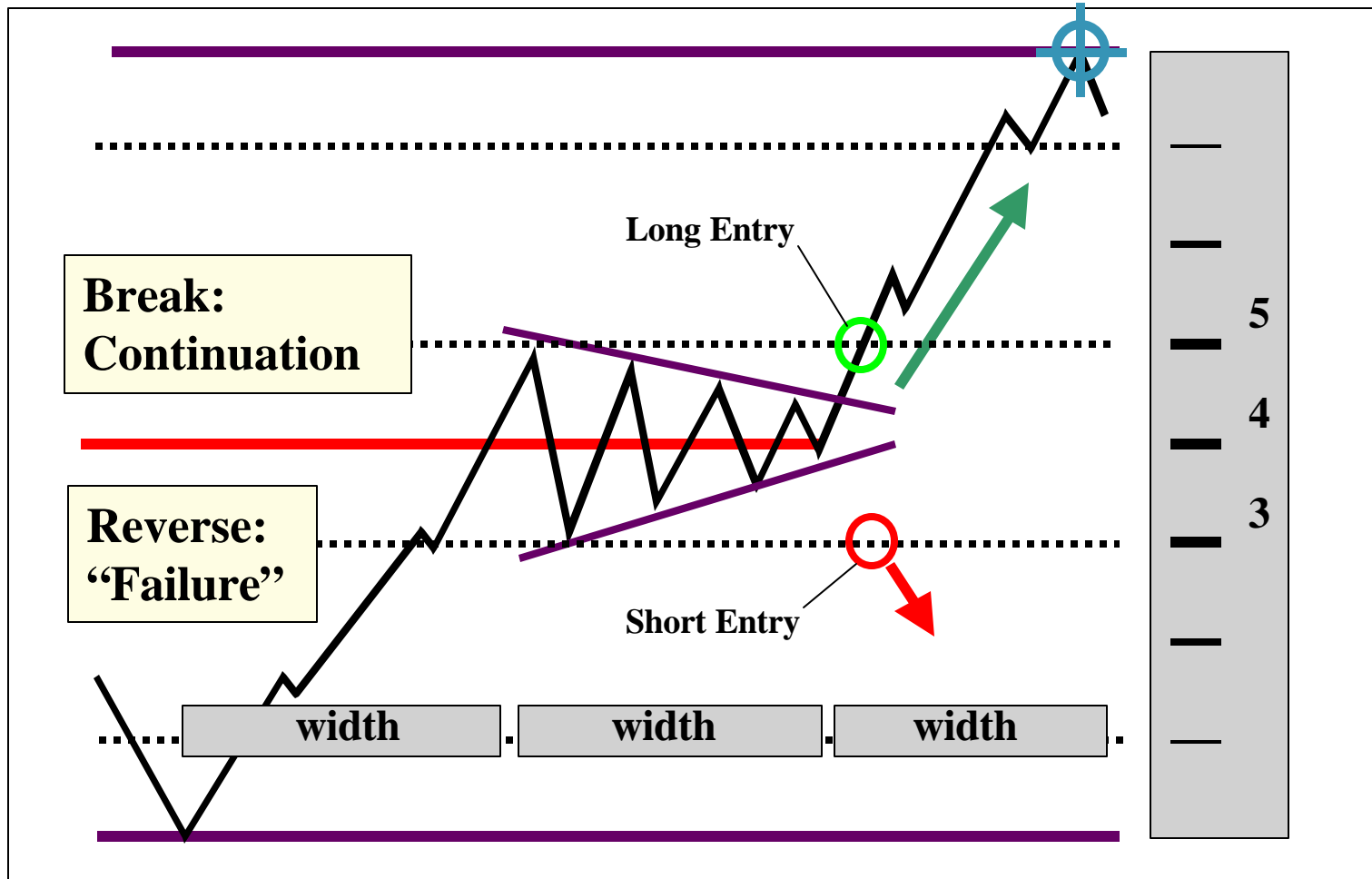
Volume Trends

Rite Aid Corporation



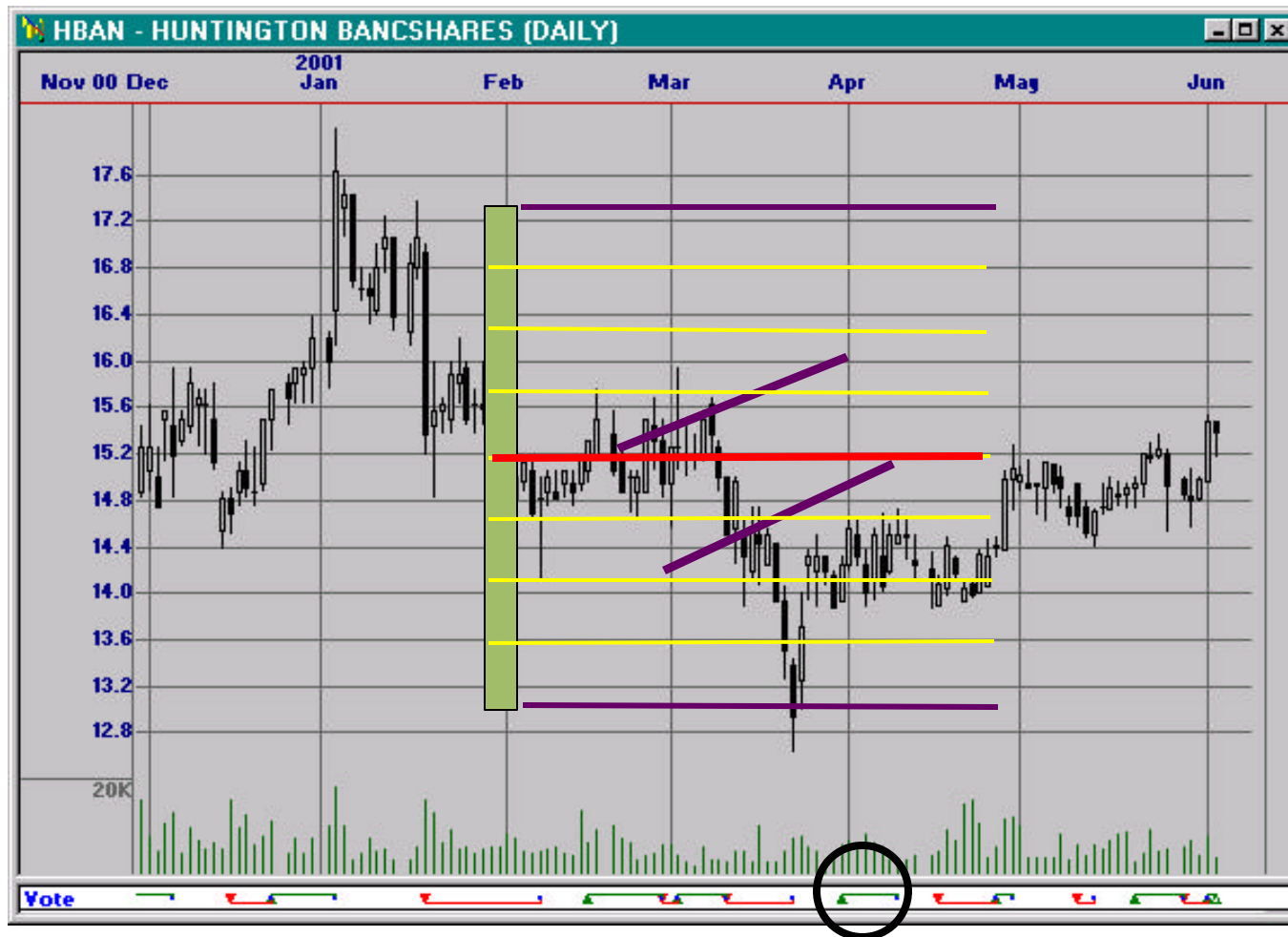
Consolidations

(Symmetrical Triangle shown)



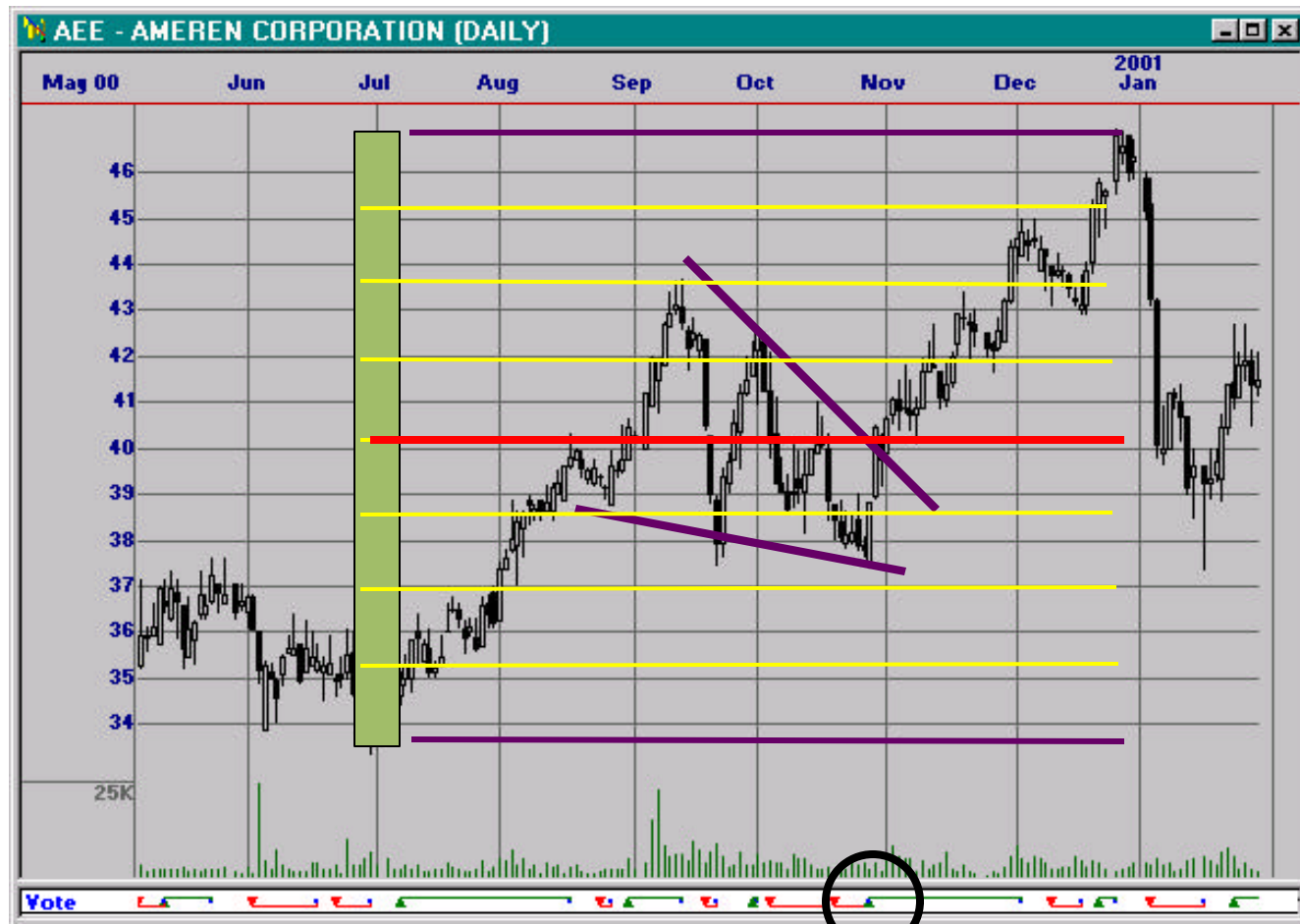
Consolidation

Huntington Bancshares



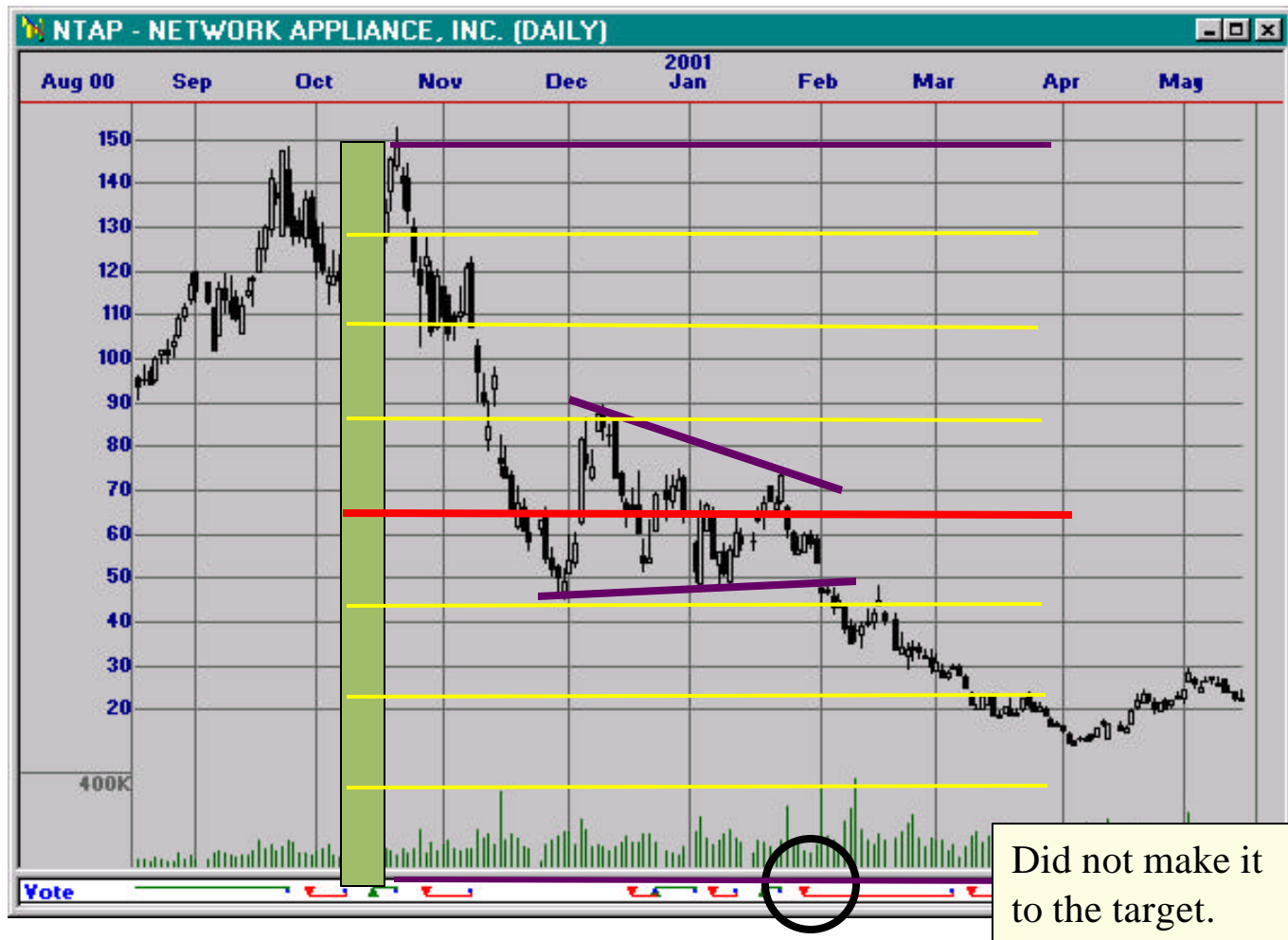
Consolidation

Ameren Corp.



Consolidation

Network Appliance



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.

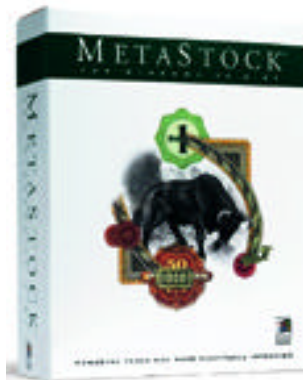


Web Sites

These web sites scan the market for technical factors and or signals which can be compared against charts for technical patterns.

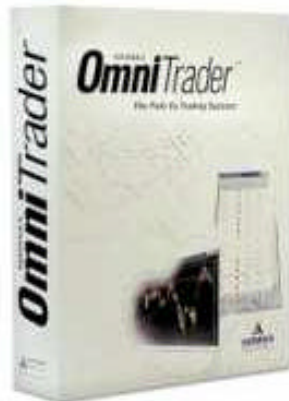


Technical Analysis Software



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

www.equis.com



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

www.omnitrader.com

** 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 eighths.
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

end

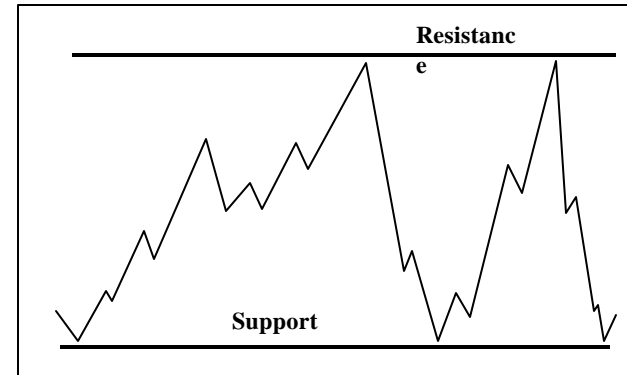
The 7 Chart Patterns that Consistently Make Money

Workbook

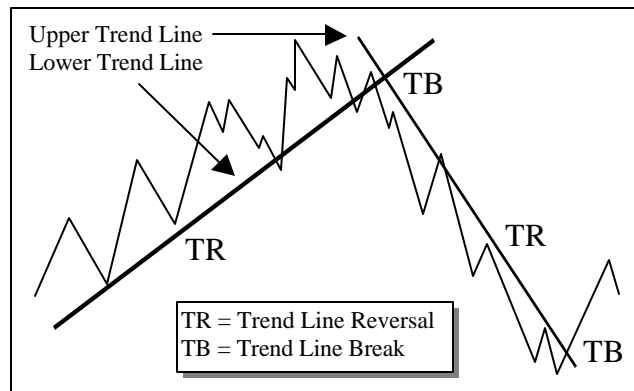
Pattern Guide for “The 7 Chart Patterns that Consistently Make Money”

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

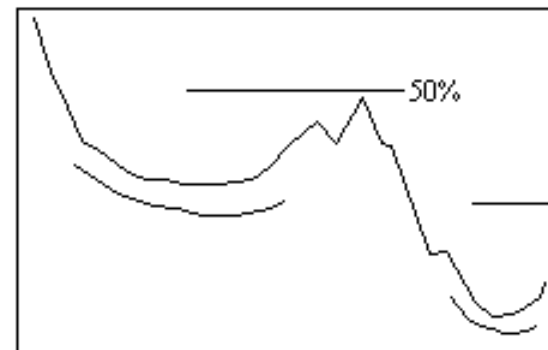
Support and Resistance



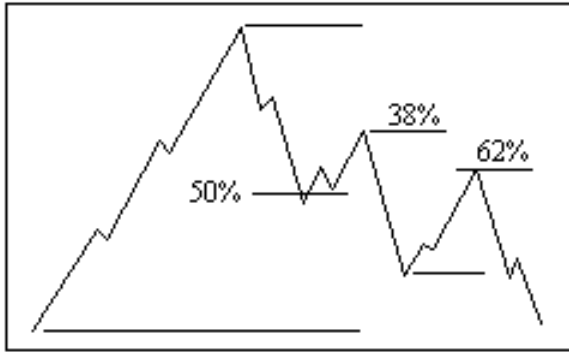
Trend Line Break & Reversal



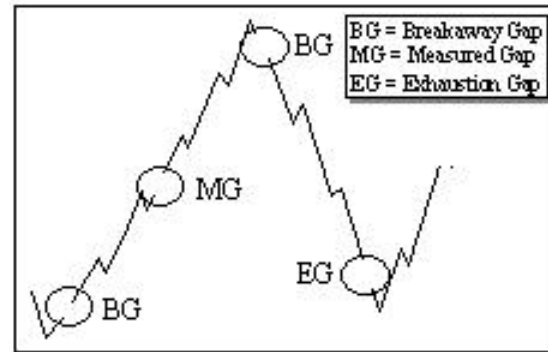
Saucer Formations



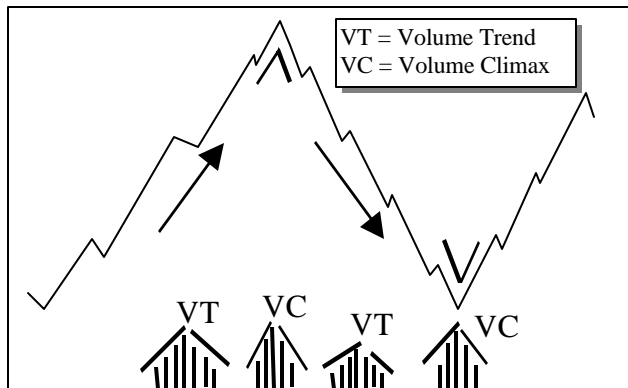
Fibonacci Retracements



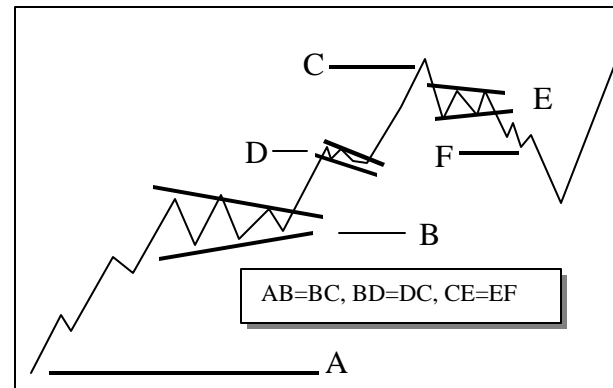
Price Gaps



Volume Climax & Trend

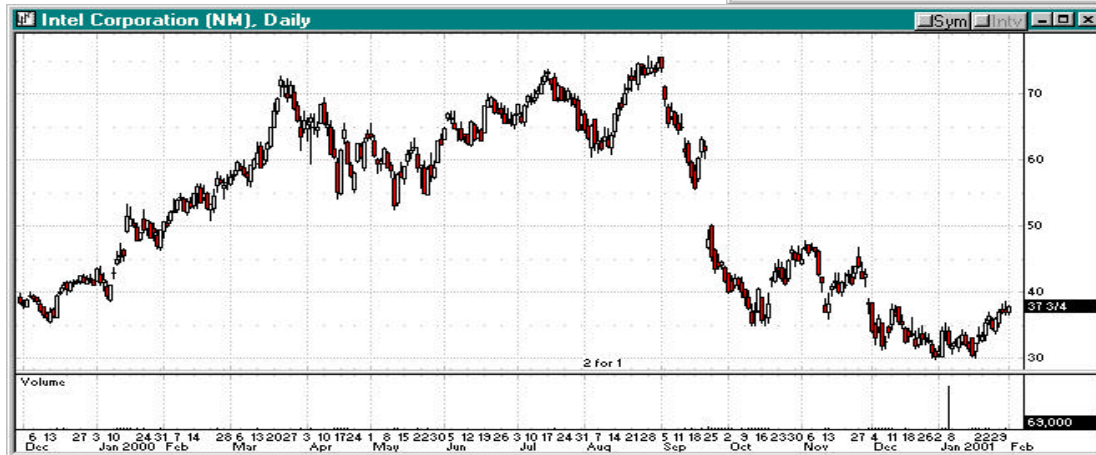


Consolidations



2) Price Gaps.

Mark and trade all gaps.
Mark "BG" for Breakout,
"MG" for Measured, and
"EG" for Exhaustion



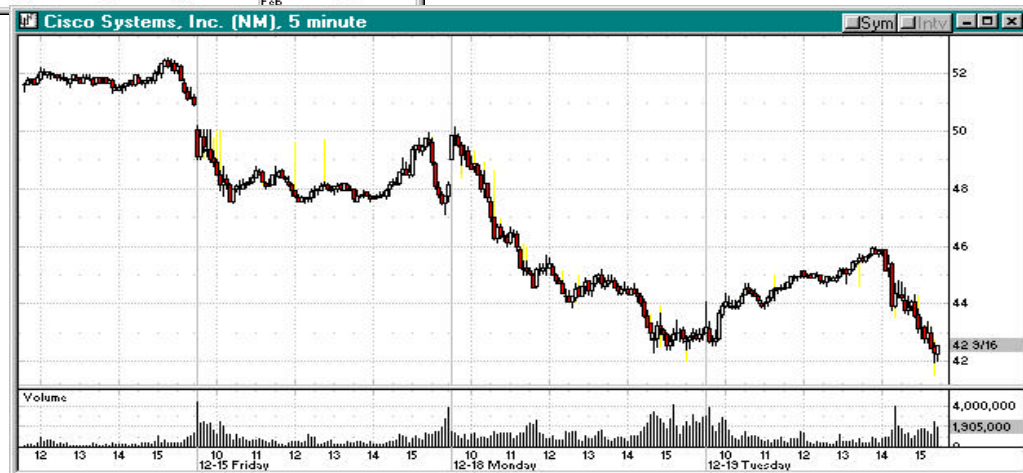
3) Trend Lines

Mark and Trade all Trend Lines greater than 2 weeks in size.



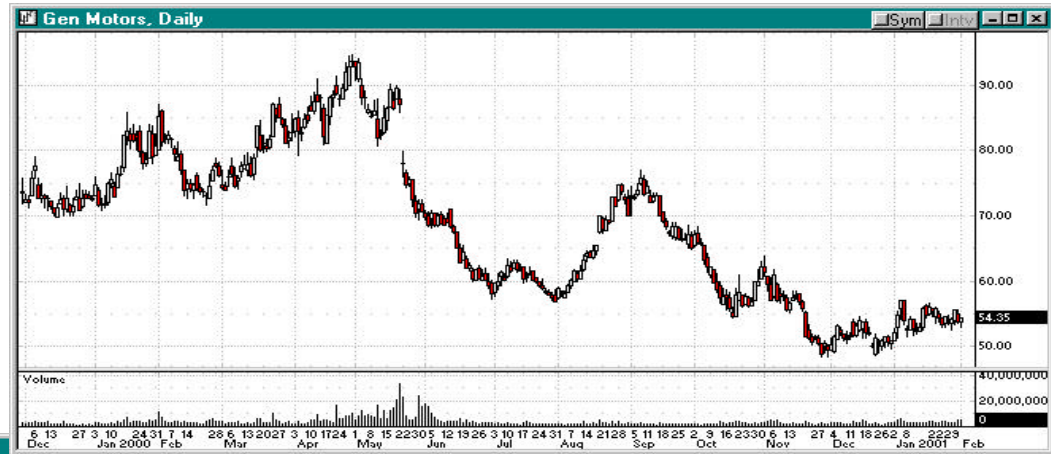
4) Volume Climax and Volume Trend

Mark and Trade all Volume
Climax “VC” and Volume Trend
“VT” patterns



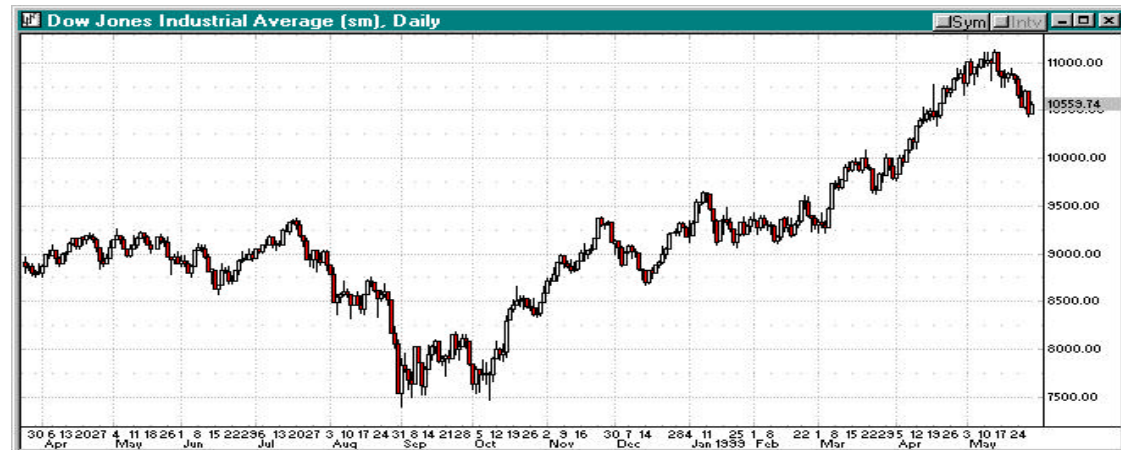
5) Fibonacci Retracements

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.