CHAPTER 1

THE TECH SAVVY RESPONSIBLE TRADER

Based on my experience with trading forums and trading groups, I usually encounter the following scenarios:

A new trader who is just starting out would usually ask two questions the first is:

1. "Ano pong stock ang maganding bilhin ngayon?"
   (What is the best stock to buy now?)

Many well-meaning people would readily give answers based on their personal experiences, preferences, time frames, etc.

The new trader then by elimination usually picks the stock that has been recommended most thinking that since it is the choice of the majority it is also the best for him. Based on these inputs he buys the stock and if he is lucky enough the stock goes up a few days later. This being so, the new trader starts thinking that stock trading is easy.

It is good if this is always the case. Sometimes the opposite happens which leads the newbie to ask the next question.

2. "Anyare?"
   (What happened?)

The newbie being clueless about the stock he bought is now very much worried wondering why the stock's price suddenly went down and is at a loss what to do next.

I know many of you are smiling at this point and could easily relate to these scenarios.

In this Chapter we are going to study Technical Analysis to enable us to understand price action so that we will be able to answer

these two frequently asked questions ourselves without the need to depend on others.

Just like me when I was starting out, I am sure a lot of you are very eager to immediately apply what you are going to learn from this book. Most of us have taken Basic Accounting courses so we will tackle Technical Analysis first and Fundamental Analysis later. This way, you will immediately have the knowledge to guard yourself against becoming a Victim of Hype or Bash and take action necessary for your best self-interest. This early, I would like to point out that no matter what people say, in trading or investing you are the only person in this world who has your best interest in mind.

As I stated earlier, Responsible Trading is Evidence-Based Trading. It is the application of critical thinking to secure an edge by identifying Low-Risk, High Probability trades. In Responsible Trading we encourage independent thinking never blind following. This early, I would like you to develop this kind of attitude. This book is written with one of these purposes in mind.

Throughout the pages in this Chapter, we will be discussing the evidences that will prove to us the existence of Low-Risk, High Probability trades. These are the same evidences we are referring to when we talk about Positives and Negatives in our Stock Charts and Analysis. When there is Preponderance of Evidence that proves the existence of a Low-Risk, High Probability trade that is the only time that we take the trade.

This Chapter is divided into Nine Sections. Some of these Sections are organized in the same way as my TRT-POV on the course Masters Certificate in Technical Analysis in our YouTube Channel. The videos are intended to give a brief introduction to the concepts. Some of the materials needed in order to be able to trade effectively are expounded more in this book, while some materials not relevant have been totally eliminated to give more space to the more important ones.

These Nine Sections cover the essential things you need to know for effective evidence gathering. The Sections build upon each other so please be sure to read them in sequence.

Section 1 – Technical Analysis and the Dow Theory

Section 2 – Charting Basics

Section 3 – Trend Concepts

Section 4 – Reversal and Continuation Patterns

Section 5 – Volume, Divergences and Gaps

Section 6 – Moving Averages

Section 7 – Technical Indicators

Section 8 – Further Charting

Section 9 – Elliott Waves and Fibonacci

For easy reference, the images in this book are divided into:

1. Figures – these are screenshots of drawings of the concepts that I explain. These are numbered consecutively starting with Figure 1.

2. Charts – these are screenshots of charts of the stocks traded mostly in the Philippines starting with Chart 1. Unless otherwise specified, the Charts are taken from actual stocks traded in the Philippine stock market using Amibroker Charting Software.

3. Tables – these are screenshots or presentation of Data or concepts presented in tabular form starting with Table 1.

4. Photos – these are photos or pictures of persons relevant to the topic being discussed starting with Photo 1.

Section 1 – Technical Analysis and the Dow Theory

Demand and Supply

Although this Section is about Technical Analysis and the Dow Theory, let us forget about the Dow Theory for the meantime. Many readers when they see technical terms like "Theory" are immediately turned off and start thinking that the material is "nosebleed" (a local term for something that is highly technical and difficult to comprehend and understand). I promised to make your learning fun and enjoyable, remember.

So let us start first with something you already know. I am sure you are all familiar with the Law of Supply and Demand that we learned in Economics 101 which states:

"Law of Supply and Demand:
Prices are determined by the interaction of supply and demand. An increase in supply will lower prices if not accompanied by increased demand. Conversely, an increase in demand will raise prices unless accompanied by increased supply."

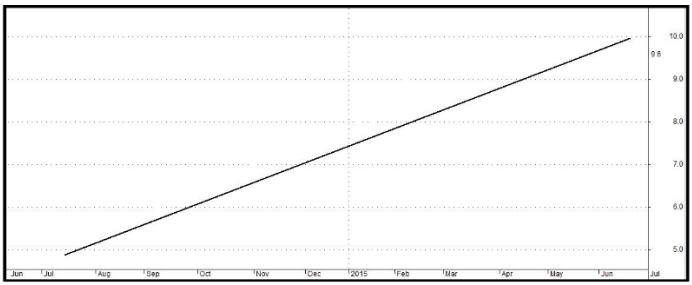

Figure 1 - Demand Line

From what we learned, the Demand Line is a line moving or sloping upward and it looks like this as shown in Figure 1.

I am sure you have seen some of the Stock Charts we have shared in our website. Let us take a look at Chart 1 of DNL. Do you see anything similar to Figure 1?

Chart 1 - DNL Uptrendline

Correct. The Demand Line looks the same as the Uptrendline. An Uptrendline is a sloping line that is drawn between two or more prominent points on a chart as you can see on the Chart of DNL here.

From what we learned, the Supply line is a line moving or sloping downward and it looks like this as shown in Figure 2.

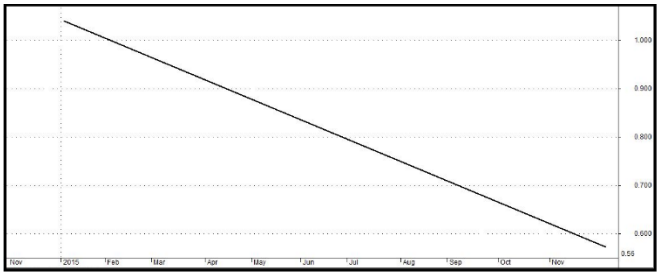

Figure 2 - Supply Line

Now let us take a look at the Chart 2 of CPG. Same question: Do you see anything similar to Figure 2?

Chart 2 - CPG Downtrendline

Correct again. The Supply Line looks the same as the Downtrendline.

Based on these, what are our conclusions?

1. The Law of Supply and Demand applies to all markets and the stock market is no exception.

2. The Demand line is the same as the Uptrendline and the Supply Line is the same as the Downtrendline.

3. The Demand Line or the Uptrendline is identified with the Buyers and the Supply Line or the Downtrendline is identified with the Sellers.

4. The Uptrendline is the result of more Buyers willing to buy at higher prices and the Downtrendline is the result of more Sellers willing to sell at lower prices.

Peaks and Troughs

Now that we understand Uptrendlines and Downtrendlines, let us talk about Peaks and Troughs.

Whether Uptrendlines or Downtrendlines prices do not move in Straight Lines as we see in Charts 1 and 2.

I am sure that at some point in your life you have climbed hills if not mountains. The highest point you reach when you climb is called the Peak and the lowest point you reach when you go down is called the Trough (Just pronounce it like rough and add a "T" in the beginning. A lot of people I know pronounce it as "throw.")

A Peak is the highest point reached after a certain move and a Trough is the lowest point after a certain move. As I previously stated, prices do not move in a straight line. They move in zigzag manner and go down after reaching their peaks and move up after reaching their troughs. This is illustrated in Figure 3.

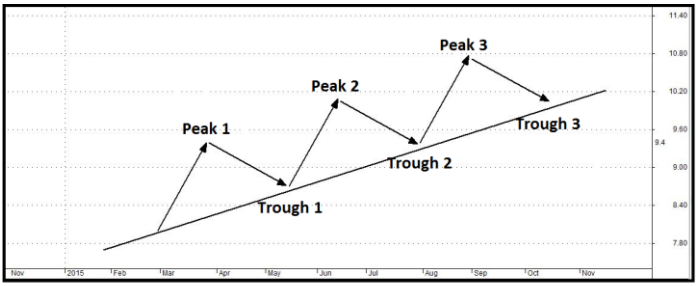

Figure 3 - Peaks and Troughs

If we replace the term Peak with the Letter "H" meaning High and the term Trough with the letter "L" meaning Low we get Figure 4 and the Definition of an Uptrend and the corresponding Uptrendline.

Uptrend is a series of Higher Highs and Higher Lows. As long as H2 is Higher than H1, L2 is Higher than L1 and H3 is higher than H2, and L3 is Higher than L2, we can say that the stock is on an Uptrend.

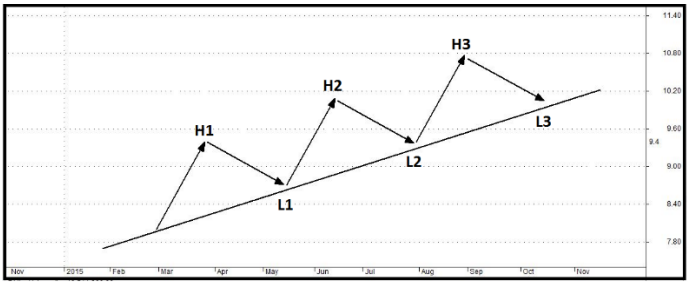

Figure 4 - Uptrend defined as Higher Highs and Higher Lows

An Uptrend is characterized by higher Highs and higher Lows which translates into price moving upwards.

Uptrendline is a line that connects all the Lows. By connecting L1, L2 and L3 through a straight line, we have an Uptrendline. It is a diagonal line connecting all the Lows with a slope going up.

Using the same concept and this time connecting the Highs, we get Figure 5 and the definition of a Downtrend and the corresponding Downtrendline.

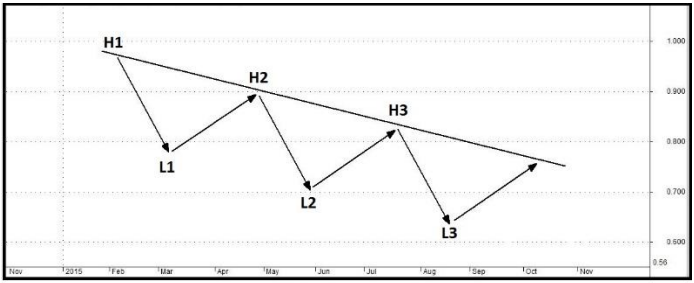

Figure 5 - Downtrend defined as Lower Highs and Lower Lows

Downtrend is a series of Lower Highs and Lower Lows. As long as H2 is Lower than H1, L2 is Lower than L1 and H3 is Lower than H2, and L3 is Lower than L2, we can say that the stock is on a Downtrend.

Downtrendline is a line that connects all the Highs. By connecting H1, H2 and H3 through a straight line, we have a

Downtrendline. It is a diagonal line connecting all the Highs with a slope going down.

I am sure the next question that comes to your mind is: What happens when the stock does not make a Higher High nor a Higher Low and remains flat all throughout?

Then we have Figure 6 – A Sideways Trend and its Definition.

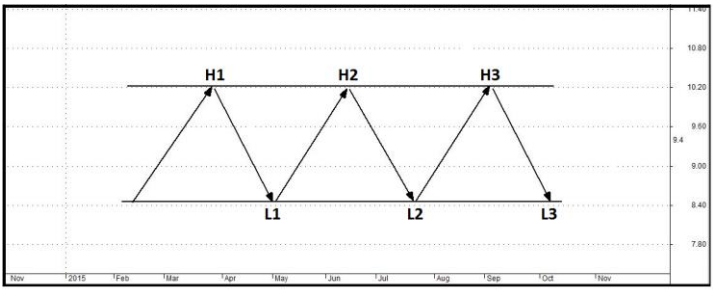

Figure 6 - Sideways Trend defined as No Higher Highs and No Lower Lows

Sideways Trend is a series of Highs and Lows on the Same Level. This is also known as a Flat Trend or Consolidation.

In all three it is the price action that determines the type of Trend.

Price action is defined as the individual movement of price from Peaks to Troughs and vice versa. The movements are always forward because they are making the movements in time.

Congratulations! Without you even realizing it, you have just learned Peak and Trough Analysis. Peak and Trough Analysis is the most basic way used by Technical Analysts in identifying and analyzing trends. This is also our source of evidence on what type of Trend the stock is in.

Let us apply Peak and Trough Analysis to PSEi, our Index. From Chart 3, we can see that our Index failed to make a Higher High as early as May 2015. This evidence is sufficient to give trading guidance. It does not take rocket science to realize that the

Index trend strength is weakening so we should take appropriate action by holding our buying decision or reducing our position if we have already taken one.

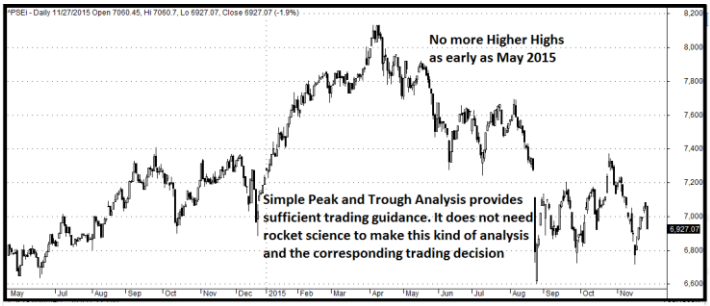

Chart 3 - PSEi - Peak and Trough Analysis

With this knowledge you should now be able to answer the two questions newbies ask: "What is the best stock to buy now?" The answer is of course, buy the stocks that are making Uptrends and continue holding them until they have shown evidence that they are changing their direction. Just observing this simple guideline would have saved me a lot of money and trouble when I was a newbie. I am sure it applies in your case too.

For the second question "What happened?" The answer is stocks do not move in a straight line but rather in zigzag movements. We will discuss more about this in Section 3 – Trend Concepts.

Phases of Major Trends

By putting all the Trends we have studied together we have the Three Phases of a Major Trend as illustrated in Figure 7.

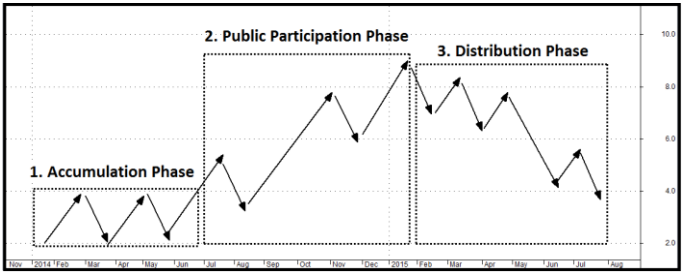

Figure 7 - Three Phases of a Major Trend

"Phase 1 is the Accumulation Phase and this is reflected as a Sideways Trend. The accumulation phase represents informed buying by the most astute investors or traders. If the previous trend was down, then at this point these astute investors or traders recognize that the market has assimilated all the so-called "bad" news.

Phase 2 is the Public Participation Phase and this is reflected as the Uptrend. The public participation phase is where most technical trend-followers begin to participate and it occurs when prices begin to advance rapidly and business news improves.

Phase 3 is the Distribution Phase and this is reflected as the Downtrend. The distribution phase takes place when newspapers begin to print increasingly bullish stories; when economic news is better than ever; and when speculative volume and public participation increase. During this last phase the same informed investors or traders who began to "accumulate" near the market bottom (when no one else wanted to buy) begin to "distribute" before anyone else starts selling."

Source: Murphy, John. Technical Analysis of the Financial Markets. P26 . Copyright 1999, New York Institute of Finance.

Technical Analysis and the Dow Theory

Armed with the basic knowledge you just gained, I believe you are now ready to tackle the main subject of this section – Technical Analysis and The Dow Theory.

My research on the origins of technical analysis always lead me to the Dow Theory. This theory is the foundation of much of what we know today as Technical Analysis.

Definition of Technical Analysis

Technical analysis is:

1. A method of evaluating securities by analyzing statistics generated by market activity, such as past prices and volume. Technical analysts do not attempt to measure a security's intrinsic value, but instead use charts and other tools to identify patterns that can suggest future activity.

Source: http://www.investopedia.com/terms/t/technicalanalysis.asp#ixzz3iOHBiDbc

2. Technical analysis is the study of market action, primarily through the use of charts, for the purpose of forecasting future price trends.

Source: Murphy, John. Technical Analysis of the Financial Markets. P. 1. Copyright 1999, New York Institute of Finance.

I like the definition of John Murphy better. The ultimate purpose of technical analysis is to enable us to forecast future price trends. As investors or traders this information is most valuable to us for decision making purposes.

Photo 1 - Charles Dow

Technical analysis started with the work of Charles H. Dow, who teamed with Edward Jones, and both are still remembered today in the name of the leading stock market index, the Dow Jones Industrial Average (DJIA).

Dow published his ideas in a series of editorials he wrote for the Wall Street Journal. Most technicians and students of the markets concur that what we call technical analysis today has its origins in theories first proposed by Dow. The Dow Theory still forms the cornerstone of the study of technical analysis, even in the face of today's sophisticated computer technology.

Six Basic Tenets of the Dow Theory

All traders using technical analysis should get to know the Six Basic tenets of the Dow theory.

1. The Averages Discount Everything
2. The market Has Three Trends
3. Major Trends Have Three Phases
4. The Averages Must Confirm Each Other
5. Volume Must Confirm the Trend
6. A Trend Is Assumed to Be in Effect Until It Gives Definite Signals That It Has Reversed

“**1. The Averages Discount Everything**

According to Dow, the markets reflect every possible knowable factor that affects overall supply and demand. This is one of the basic premises of technical theory. The theory applies to market averages, as well as it does to individual markets, and even makes allowances for "acts of God." While the markets cannot anticipate events such as earthquakes and various other natural calamities, they quickly discount such occurrences, and almost instantaneously assimilate their effects into the price action.

2. The Market Has Three Trends.

Dow defined an uptrend as a situation in which each successive rally closes higher than the previous rally high, and each successive rally low also closes higher than the previous rally low. In other words, an uptrend has a pattern of rising peaks and troughs. The opposite situation, with successively lower peaks and troughs, defines a downtrend. Dow's definition has withstood the test of time and still forms the cornerstone of trend analysis.

3. Major Trends Have Three Phases.

Dow focused his attention on primary or major trends, which he felt usually take place in three distinct phases: an accumulation phase, a public participation phase, and a distribution phase. The accumulation phase represents informed buying by the most astute investors. If the previous trend was down, then at this point these astute investors recognize that the market has assimilated all the so-called "bad" news. The public participation phase, where most technical trend-followers begin to participate, occurs when prices begin to advance rapidly and business news improves. The distribution phase takes place when newspapers begin to print increasingly bullish stories; when economic news is

better than ever; and when speculative volume and public participation increase. During this last phase the same informed investors who began to "accumulate" near the bear market bottom (when no one else wanted to buy) begin to "distribute" before anyone else starts selling.

4. The Averages Must Confirm Each Other.

Dow, in referring to the Industrial and Rail Averages, meant that no important bull or bear market signal could take place unless both averages gave the same signal, thus confirming each other. He felt that both averages must exceed a previous secondary peak to confirm the inception or continuation of a bull market. He did not believe that the signals had to occur simultaneously, but recognized that a shorter length of time between the two signals provided stronger confirmation. When the two averages diverged from one another, Dow assumed that the prior trend was still maintained.

5. Volume Must Confirm the Trend.

Dow recognized volume as a secondary but important factor in confirming price signals. Simply stated, volume should expand or increase in the direction of the major trend. In a major uptrend, volume would then increase as prices move higher, and diminish as prices fall. In a downtrend, volume should increase as prices drop and diminish as they rally. Dow considered volume a secondary indicator. He based his actual buy and sell signals entirely on closing prices.

6. A Trend Is Assumed to Be in Effect Until It Gives Definite Signals That It Has Reversed.

This tenet forms much of the foundation of modern trend-following approaches. It relates a physical law to market movement, which states that an object in motion (in this case a trend) tends to continue in motion until some external force causes it to change direction. A number of technical tools are available to traders to assist in the difficult task of spotting reversal signals, including the study of support and resistance levels, price patterns, trendlines, and moving averages. Some indicators can provide even earlier warning signals of loss of momentum. All of that notwithstanding, the odds usually favor that the existing trend will continue."

Source: Murphy, John. Technical Analysis of the Financial Markets. Pp 24 - 28. Copyright 1999, New York Institute of Finance.

The Six Basic Tenets as Guiding Principles

These six Basic Tenets form part of the Guiding Principles of Responsible Trading. Please take note of these six tenets because we will encounter them in application from time to time as we go through the lessons in this book. Trendlines, Support and Resistance, Price Patterns and Moving Averages are some of the important evidences we look at and examine closely to assist us in identifying Low Risk, High Probability trade set-ups.