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Getting Started with Technical Analysis
Learn the assumptions that guide technical analysis, and get to know the basics of trend trading.

Understanding Indicators in Technical Analysis
Identify the various types of technical indicators, including trend, momentum, volume, volatility, and support and resistance.

Identifying Chart Patterns with Technical Analysis
Use charts and learn chart patterns through specific examples of important patterns in bar and candlestick charts.

Managing Risk with Technical Analysis
Manage your trading risk with a range of confirmation methods.
About Our Coauthor

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He is a Chartered Market Technician, a past member of the board of directors of the Market Technicians Association, past editor of the Journal of Technical Analysis, past board member and vice president of the CMT Association Educational Foundation and a member of the American Association of Professional Technicians (AAPTA). He coauthored Technical Analysis: The Complete Source for Financial Market Technicians, the primary textbook for the CMT program and for university graduate courses on technical analysis, authored Beat the Market and, most recently, Time the Markets: Using Technical Analysis to Interpret Economic Data.

He is a graduate of Phillips Exeter Academy, Harvard College (AB), and the Wharton School (MBA) and lives with his wife in Maine.
Agenda

Techniques for Trading Patterns

Understanding Patterns and Their Limits

Construction of Common Chart Patterns
Understanding Patterns and Their Limits
Defining Patterns

• A pattern is bounded by at least two trend lines (straight or curved)
• All patterns have a combination of entry and exit points
• Patterns can be continuation patterns or reversal patterns
• Patterns are fractal, meaning that they can be seen in any charting period (weekly, daily, minute, etc.)
• A pattern is not complete or activated until an actual breakout occurs
The Limits of Patterns

Keep in Mind

Some of our human tendencies can be dangerous for investors.

- See patterns where there aren’t any
- Believe “market lore,” technical and fundamental, without evidence
- Look backwards rather than forward
- Stick with original price targets of patterns after conditions have changed
Techniques for Trading Patterns
Techniques for Trading Patterns

- Breakouts
- Entry Stops
- Protective Stops
- Retracements
Breakouts

Violation of Trend Line, Support or Resistance, or previous reversal point

It signifies that a change in buyer and seller behavior and signals the beginning or end of a trend.
Confirmation Filters

Apply a confirmation filter to determine whether a breakout has taken place.

Types of Filters

- Intrabar
- Multiple closes
- Time
- Percentage or point
- Money
Entry Stops

Buy stop orders are used to enter trades once the price breaks out.
False and Failed Breakouts

False Breakout

Price breaks out but almost immediately returns back through its breakout price.

Failed Breakout (Trap)

False breakout occurs and the price then breaks out in the opposite direction.
Protective Stops

Protects Capital

Determines the amount of capital risk before entry

Types of placement

- Filters, such as percent, points, or money
- Trend line, support or resistance level with filter
Trading False Breakouts Using Protective Stops

Example

• Enter on breakout

• Place protective stop outside breakout bar opposite from breakout direction

• Place entry stop at same level (called a “stop and reverse” order)

• If price continues in direction of breakout, profit from breakout entry

• If breakout is false, profit from stop and reverse
Retracements

Counter Trend Correction

Types
• Pullback (on breakout down)
• Throwback (on breakout up)

Waiting for
• Don’t always occur
• Performance can suffer when they do
Construction of Common Chart Patterns
Horizontal Congestion: Double Top

Characteristics:

- Two successive peaks separated by an opposite reversal point
- Either rounded or pointed peaks that are usually at roughly the same price (resistance level)
- Price must break out of middle reversal point

Calculate target price:
Taking the height from the highest peak to the trough and then subtracting the amount from the breakout price to the downside.

Horizontal Congestion: Double Bottom

Characteristics:

• Two successive troughs separated by a peak

• Either rounded or pointed troughs that are usually at roughly the same price (support level)

• Price must break out of middle peak

Calculate target price:
Taking the distance from the troughs to the peak and then adding that amount from the breakout price to the upside.

Horizontal Congestion: Triple Top

Characteristics:

- Three distinct peaks at roughly the same price level separated by two intermittent troughs
- Breakout occurs when price exceeds the extreme of the intermittent trough or a trend line connecting those points

Calculate target price:

Take the height from the highest peak to the lowest trough in the pattern. Then subtract that amount from the lowest trough in the pattern to generate a price target.

Horizontal Congestion: Triple Bottom

Characteristics:

• Three distinct troughs at roughly the same price level separated by two intermittent peaks at any level

• Breakout occurs when price exceeds the extreme of the intermittent peaks or a trend line connecting those points

• Best performance may be after a sustained decline*

• An average performance, but watch for failures*

Calculate target price:

Take the height from the highest peak to the lowest trough in the pattern. Then add that amount to the highest peak in the pattern to generate a price target.

Horizontal Congestion: Rectangles

Characteristics:

• Trading range with support and resistance levels bounding price action

• Slight tilt, similar to horizontal channel

• Often has many false breakouts*

• Things to consider:
  - Confirm a breakout
  - “Shortfall” often indicator of eventual breakout direction

• Best occurrence may be bottom breaking upward*

Calculate target price:

Take the height from the resistance line to the support line. Then either add that amount to the resistance line to generate a price target for an upside breakout, OR subtract that amount from the support line to generate a price target for a downside breakout.

Triangle: Symmetrical

Characteristics:

• Bounded by a downward sloping upper trend line and an upward sloping lower trend line. Each bound is a straight trend line

• Prices must touch each bound at least twice. Many false breakouts. Moderately successful in performance

• Things to consider:
  - Confirm a breakout

• Best occurrence may be upward breaking out – above average for all patterns*

Calculate target price:

Take the height from the highest peak in the pattern to the lowest trough in the pattern. Then either add it (for upward breakouts) to the breakout price or subtract it (for downward breakouts) from the breakout price to generate a price target.

Triangle: Ascending

Characteristics:

- Bounded by a horizontal upper trend line and an upward sloping lower trend line. Each bound is a straight trend line.
- Prices can break in either direction, but more commonly upward.*
- Breakout usually occurs in pattern. About average failure rates but many small false breakouts.*
- Post breakout performance average on upside but above average on downside.*


**Calculate target price:**
Take the height from the highest peak in the pattern to the lowest trough in the pattern. Then either add it (for upward breakouts) to the breakout price or subtract it (for downward breakouts) from the breakout price to generate a price target.
Triangle: Descending

Characteristics:

- Bounded by two trend lines; the lower is horizontal and the upper slopes downward
- Prices can break in either direction but most commonly downward*
- Above-average performance on upside break; retracements occur often*

**Calculate target price:**

Take the height from the highest peak in the pattern to the lowest trough in the pattern. Then either add it (for upward breakouts) to the breakout price or subtract it (for downward breakouts) from the breakout price to generate a price target.

Triangle: Wedge

Characteristics:

• Bounded by two trend lines, each headed in the same direction; Price must touch a trend line at least five times (3 times on one and 2 times on the other) before a breakout.

• Often occur following a panic (declining wedge) or bubble (rising wedge).

• Performance in both types is below average, and retracements are very common.*

Calculate target price:

For downward breakout, the lowest trough in the pattern is the price target. For upward breakouts, take the height from the highest peak in the pattern to the lowest trough in the pattern and add that amount to the breakout price for a price target.

Head and Shoulders: Top

Characteristics:

• Three peaks with center peak higher than the other two

• Shoulders should be at approximately the same level and the head higher

• Line connecting the two throughs between the peaks is called the “neckline”

• Pattern is only complete on breaking the neckline

• Target is the distance from the head to the neckline projected from the neckline

• This is a standard pattern for tops and has one of the lowest failure rates

Head and Shoulders: Bottom (Inverse)

Characteristics:

- Inverted but otherwise identical to a top pattern except not as profitable*

Cup and Handle (also “Saucer”)  

Characteristics:

• Pattern consists of a rounded bottom (not a “V” bottom), two “lips” at each end, and a “handle” (similar to a flag pattern) from the handle.

• Pattern is complete with breakout above both lips.

• Often have a throwback.

• The pattern’s performance ranks about average for bottom patterns.*

Calculate target price:

Take the height of the right cup lip to the bottom of the cup, then add that amount to the breakout price.

Trading with Patterns

- **Rectangle**
- **Triangle**
- **Wedge**

= Buy
= Stop
= Exit

Best Multi-Bar Patterns

Upward Signals
• Descending Triangle
• Rectangle
• Pipe Bottom

Downward Signals
• Flag
• Head and Shoulders top
• Island Reversal
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