Dow Theory – The Basic Ideas

In 1934, Benjamin Graham wrote the book *Security Analysis*, editions of which are still being reprinted today. Graham's work was so influential, that he has become the undisputed *father* of modern fundamental analysis. Over thirty years earlier, Charles Dow outlined ideas that are the basis of modern technical analysis. Dow's theory is still taught today and his ideas, in one form or another, run through most of mainstream technical analysis. Yet his ideas were not written in a learned book, like Graham's, but in newspaper editorials.

Dow Theory is the name given to the ideas that derive from Charles H Dow, who was one of the founders of *The Wall Street Journal*, which he edited up to his death in 1902. What we know now as Dow Theory is the cumulative work of Charles Dow, William Hamilton, who followed Dow as editor of the *The Wall Street Journal*, and Robert Rhea, who researched and codified the ideas of Dow and Hamilton.

In the last years of his editorship, Dow wrote a number of editorials that set out his ideas on analysis of markets. The term *Dow Theory* was coined by S.A. Nelson after Dow's death in his book *The ABC of Stock Speculation* in 1902. Nelson reprinted Dow's editorials and was the first to try to explain their practical use. William P Hamilton followed Dow as editor of the *The Wall Street Journal* and continued popularising Dow's ideas in editorial forecasts. These features were very popular and the observations based on them surprisingly accurate. They continued until Hamilton's death in 1929. Because of the success of Dow-based observations and the interest they generated in the ideas, Hamilton set the Dow Theory out in his book *The Stock Market Barometer* in 1922.

In 1932, Robert Rhea published his book *The Dow Theory*. He reviewed the 252 editorials written by Dow and Hamilton and tried to set out a clear exposition of the Dow Theory. Rhea's contribution is that he made a coherent theory out of the work of Dow and Hamilton. This is generally regarded as the authoritative reference today to Dow Theory, although the books mentioned by Nelson and Hamilton are, along with Rhea's, still in print today.

The Market Average

In 1897, Dow invented the Dow Jones Average, calculating it backwards for many years. This was the first mathematical indicator used in what is now known as technical analysis. Dow devised the stock market average because he saw that most stocks moved together in the general up and down movements of the markets. By taking a basket of stocks and averaging their prices, he was able to plot the general rise and fall of the stock market as a single value.

Later commentators suggest that Dow's main motivation in studying the stock market was as a way of anticipating changes in the real economy, shaping what is known as the business cycle. He observed that by the time news of improved business conditions made its way into the Wall Street Journal, the stock market had been moving up for some time. He also observed the reverse, that when bad news began to appear, the stock market had already been falling. Dow concluded that the stock market anticipated changes in general business conditions and is what is called a *leading indicator*. This is just economists' jargon for saying that stock markets change direction ahead of the real economy. They do this because investors do not wait for the official statistics to tell them what has happened, but anticipate changes. In short, markets act, not on hard information, but on expectations. While individual traders may be astray in their expectations, the overall verdict of the market is remarkably prescient, except when totally unexpected shocks occur.

The first of the tenets of Dow Theory is that the averages discount everything. This is an enormously important idea and was revolutionary in its time. Dow realised that stock prices represent not only known information, but also information that was not generally available. In those days all markets were manipulated and there was a great deal of insider trading, with no laws against it.

However, that was not all. Dow also sensed that stock prices reflected expectations about business conditions. Market participants will act on a combination of information and expectations and the strength of their buying or selling will reflect their level of conviction. Thus on balance, many people acting on different stock prices, will influence the market average, causing it to reflect their overall judgement about the market. In this sense, the average discounts the balance of all their views.

In modern technical analysis, this basic idea of Dow's is often expressed as: all information and expectations are reflected in the price. Thus, the technical analyst studies price as a way of gaining an insight into the balance of supply and demand in the market.

Dow Theory Basic Principles

The basic principles of Dow Theory may be summarised under a series of headings as follows:

The Averages Discount Everything

This has been explained above.

The Market has Three Movements

The three movements are:

The Primary Trend

There are two of them:

1. the broad upward movement known as a bull market, or up trend and
2. the broad downward movement known as a bear market, or down trend.

The Secondary Reaction

The primary trends do not move in one direction continuously. The primary trends are interrupted by reactions. We call these *corrections* in a bull market or up trend and *rallies* in a bear market or down trend.

Daily Fluctuations

These tend to be quite random and are usually unimportant except to very short-term traders.

The Primary Trends have Three Phases

The three phases of a bull market are:

- Reviving Confidence
- Increasing Earnings
- Rampant Speculation

The three phases of a bear market are:

- Abandonment of Hopes

- Decreasing Earnings
- Distress Selling

Determining the Trend

Dow defined a bull market as a period during which every time the market average rose it moved higher than previously and each time the market average fell, it did not fall as far as it had previously. In other words, a series of rising peaks and troughs form on the chart.

Dow defined a bear market as a period during which every time the market average fell it moved lower than previously and each time the market average rose, it did not rise as far as it had previously. In other words, a series of falling peaks and troughs form on the chart.

Both Averages Must Confirm

The idea here is that the Industrials average and the transport average must both have turned before the overall market trend can be confirmed to have turned. Structural changes in the economy since Dow's time have reduced the logical basis for this principle. Also, it is no longer possible to apply it in Australia after June 2002, when the Australian Securities Exchange and Standard & Poors discontinued the broad ASX All Industrials and Transport sector indexes.

Volume Provides Additional Evidence

The idea here is that the volume (the total number of shares traded, or the total value of shares traded) will confirm the health of the primary trend. This is important corroborative evidence, but is minor in importance compared with the price trend.

Other Aspects

The other aspects of Dow Theory are minor, or no longer particularly relevant:

- The Theory is Not Infallible. Today we would say that it describes strong tendencies or its ideas are based on probabilities.
- Manipulation, which was rife in Dow's days, does not distort the primary trends.
- Double Tops are Unreliable. This is simply an extension of the idea that the theory is not infallible, but was expressed separately, because Dow indicated in his editorials that double tops were reliable for individual stocks. Hamilton and Rhea concluded that this was not so for the market average.
- Individual Stocks tend to move with the market average, but any one of them may move counter to it if driven by conditions not applicable to the overall market.

These are the basic ideas in Dow Theory. They remain powerful today and underlie most of what we know as charting or technical analysis.

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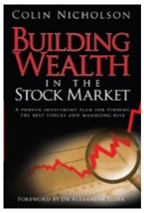

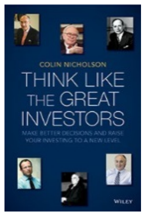

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