Dow Theory Trend Endings

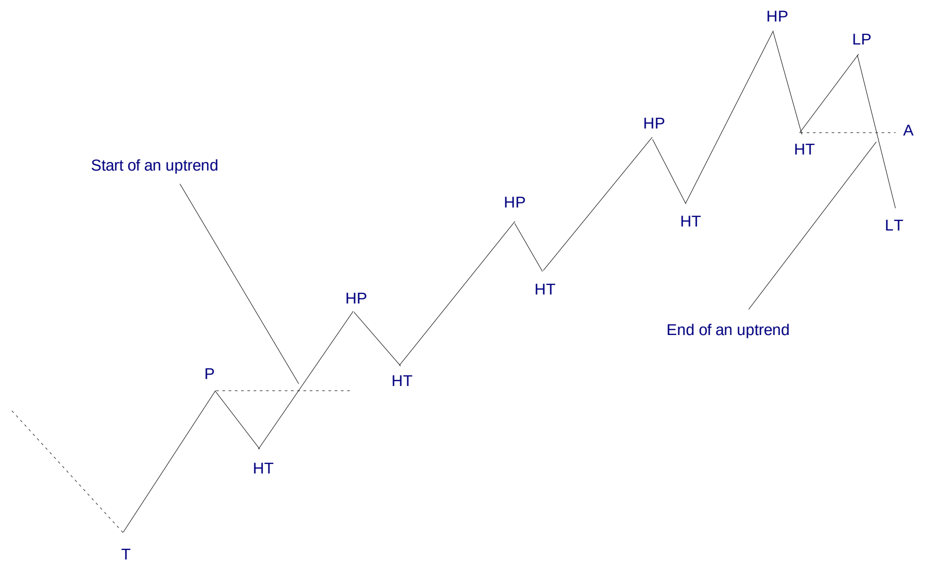
Investors can learn a lot from active traders and even very short-term traders, because traders must be very disciplined in their approach. They need this discipline to survive in short-term trades where the profit objective is often smaller than for an investor and particularly where leverage is used, or derivative securities are traded, such that financial risk is much higher than is typical for an investor. Investors tend to be less disciplined and this often impacts on their results, sometimes without them even being aware of it.

The objective for every investor or trader is to try to keep losses small and allow profits to build up in successful trades. This is the exact opposite to what most private investors and traders do. Instead they tend to grab profits while they can and let losing positions run in the hope they will come good. This is always the main reason why private investors tend to do less well than professional money managers.

In this article we will explore ways of using technical analysis as a basis for changing behaviour in this critical area of the investment process. It is all about knowing the failure point for your investment.

Recently the Australian Technical Analysts Association played host to Dan Gramza, a professional trader from Chicago. In the course of his address, Dan made the statement that he "never entered a trade without knowing the failure point for it." The failure point is where he was wrong about his trade.

All successful technical trading is based on exploiting a trend. Whenever a technical trader takes a trade it is on the basis that the situation he sees on the price chart is one where he believes that the probabilities favour either the continuation of an existing trend or the beginning of a new trend.

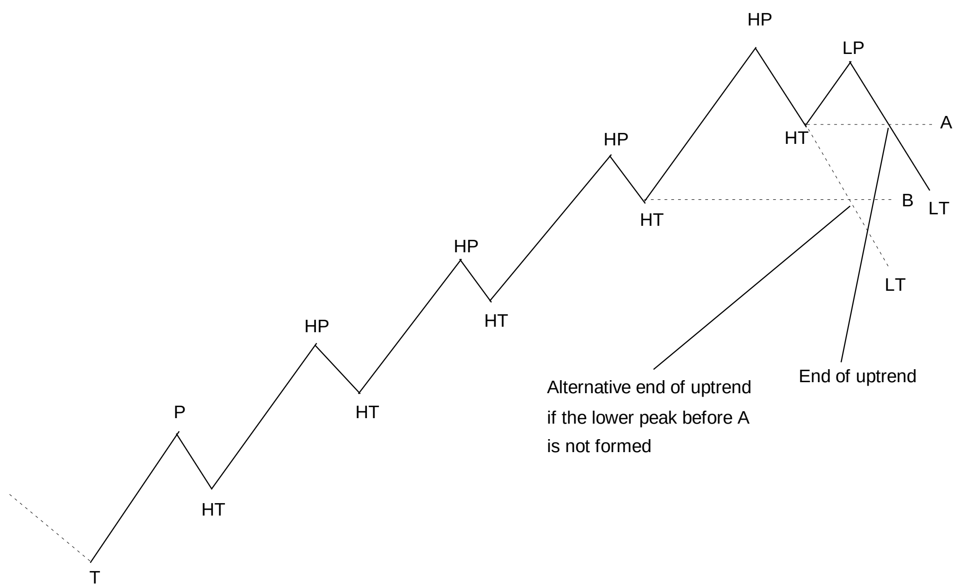


A trend is present on a price chart when each time price rallies, it carries to a higher peak than it did previously and each time it corrects, it turns around and begins to rise again from a higher price than it did previously. Thus, the theoretical model for an uptrend is that shown in the diagram above.

This model extends the basic definition of a trend by also defining where an uptrend begins and when it ends. An uptrend begins as soon as we have a higher trough on a chart and price then rises above the last peak, guaranteeing that wherever the rally ends, it will make a higher peak. This is the first time a trend is evident on a chart – once we have both a higher trough (HT) and a higher peak (HP).

In a similar way, we can define when an up trend ends, when a rally fails to rise above the last peak and then price falls below the previous trough, guaranteeing that wherever that decline ends, it will form a lower trough. This is when the uptrend ends – once we have both a lower peak (LP) and a lower trough (LT).

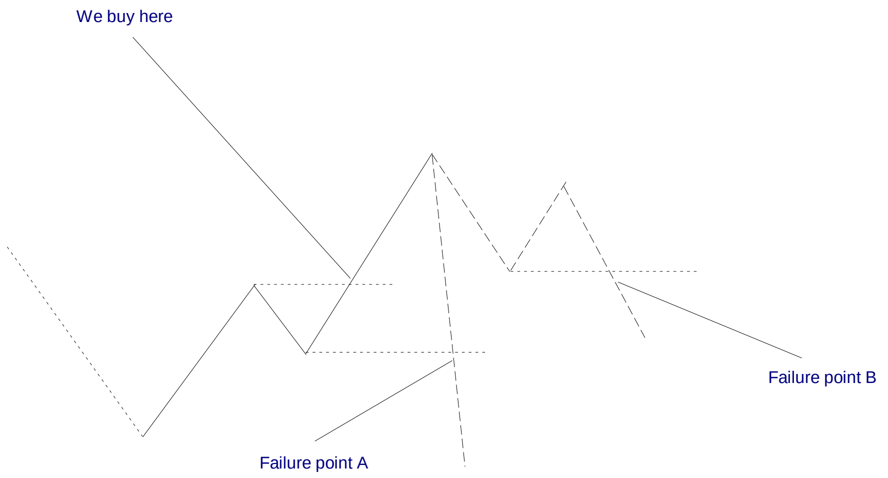
However, there is a complication, in that we have to consider the situation where, in an uptrend, price just falls relentlessly, without a rally to form a lower peak. This is easily dealt with when we remember that an uptrend is defined as a series of higher peaks and higher troughs. The trend may be ended by formation of a lower peak and then a lower trough. However, a trend is also logically ended if a decline makes a lower trough, because the series of higher peaks AND higher troughs has been broken. Thus, there are two possible ways in which an uptrend can end, depending upon which occurs first, as shown in the next diagram.



The uptrend is ended when either a lower peak is formed and then price falls below trough A on its way to a lower trough, or when it simply plunges below the last higher trough in an uptrend, at B in our diagram.

These two ending points of an uptrend are the failure points for us if we join an existing trend, or if we have assumed that a trend is likely to develop from our entry point. They are also the failure points for us if we have a profitable investment – where we should take our profits.

The bigger problem for most private investors is their failure to take losses, so let us explore the unsuccessful investments. These are the ones that hurt our portfolio the most and determined effort must be made to get out of them before the loss becomes too great. Let us consider that prices have been falling for some time and we believe that the shares have become very cheap. We look for the shares to rally, as they will do many times in a downtrend, and then decline less far than they did on the previous decline. As they begin to rally again, we wait for them to rise above the previous rally, so that an uptrend has started. We decide to invest. Before we do so, however, we must know our failure point. From the earlier discussion, there are two possible failure points.



In the above diagram, there are three possibilities. Firstly, the trend develops normally (not shown), forming higher peaks and higher troughs, as in our first diagram. Secondly, it fails immediately, when the next decline falls below the previous trough. This is marked as failure point A in the above diagram. Thirdly, it forms a higher trough after we invest, but the next rally is a weak one and does not make a higher peak. It then falls through the higher trough. This is marked as failure point B in the above diagram.

Clearly, at either failure point A or failure point B, the up trend we expected and which was the basis of our decision to invest, has failed to develop. At this point most private investors freeze and start to hope that the trend will somehow reassert itself and they will not make a loss. However, there is an old saying among professionals on Wall Street that "the first loss is always the smallest loss". Professional investors tend to appreciate immediately the devastating logic that the basic assumption for their investment decision has been proven to be invalid. They immediately take the small loss and look for a better opportunity. Unfortunately, most private investors put the decision off and rationalise it in all sorts of ways. The result is inevitably the same, the loss gets larger and larger and they become psychologically locked into a losing investment, perhaps for years. The loss becomes simply too big for them to consider taking. Only a few of these failures to act quickly on losses can devastate the return from their portfolio for a long time.

The lesson is a simple one: before making an investment, know its failure point and take the loss while it is small. There are always other better opportunities to invest in winners, rather than hoping a loser will come good.