Jim is struggling.

He is the owner of JCB Superstores and his competitor across town is beating him up; there is blood all over Jim’s ledger. He decides it is time to take off the gloves: JCB goes public. He uses the money from the initial public offering to buy his competitor and add a few more stores around town.

With a growing sales base, Jim’s clout allows him to negotiate lower prices for the office supplies he is retailing. He passes on part of the savings to his customers, while watching his margins widen, and plows the profits back into building more stores.

Jim calls his friend, Tom, and tells him of his plans to expand the operation statewide. They chat for a while and exchange business tactics on how best to manage the expansion. When Tom gets off the phone, he decides to conduct his own research on JCB. He visits several stores and sees the same thing: packed parking lots, people bustling around with full shopping carts, and lines at the checkout counters. He questions a few customers to get a sense of the demographics. At a few stores, he even chats with suppliers as they unload their wares. Back at the office, he does a thorough analysis of the financials and looks at the competition. Everything checks out so he orders his trading partners to buy the stock at no higher than 10.

When news of the expansion plan hits the wires, the Street panics. It is, after all, a soft economy and expanding willy-nilly when a recession looms is daft, maybe even criminal, according to the pundits. The stock drops below 10 and Tom’s crew makes its move. They buy as much as they can without raising suspicion. The stock rises anyway. It goes back up to 11, then 12, and rounds over at 13 before heading back down.
Several months go by and the economic outlook is as bleak as ever. The stock eases down to 9. After Tom checks in with Jim for the latest public news, Tom’s team buys more. It is an easy score because investors are willing to dump the stock, especially as year-end tax selling approaches.

Six weeks later the company releases the sales numbers for JCB; they are better than expected. The stock rises 15% in minutes and closes at 10.75. And that is just for starters. Six months later, it’s clear the economy was never in danger of entering a recession and everyone sees boom times ahead. The stock hits 20.

Years go by, the stock splits a few times, and the holiday season looms. Tom interviews a handful of customers leaving JCB Superstores and discovers that they are all complaining about the same thing: The advertised goods are not on the shelves. Tom investigates further and discovers a massive distribution problem, right at the height of the selling season. JCB has overextended itself; the infrastructure is simply not there to support the addition of one new store each week.

Tom realizes it is time to sell. He tells his trading department to dump the stock immediately but for no less than 28.25. They liquidate about a third of their large holdings before driving the stock down below the minimum.

Since it is the holidays, everyone seems to be in a buying mood. Novice investors jump in at what they consider a bargain price. The major brokerage houses climb aboard and tout the stock, but Tom knows better. When the stock recovers to its old high, his trading partners sell the remainder of their holdings. The stock tops out and rounds over. During the next month and a half, the stock drifts down, slowly, casually. There does not appear to be a rush for the exits—just a slow trickle as the smart money quietly folds up shop.

Then news of poor holiday sales leaks out. There is a rumor about distribution problems, merchandising mistakes, and cash flow problems. Brokerage firms that only weeks before were touting the stock now advise their clients to sell. The stock plummets 39% overnight.

One or two analysts say the stock is oversold; it is a bargain and investors should add to their positions. Many bottom fishers follow their brokers’ recommendation and buy the stock. Big mistake. The buying enthusiasm pushes the price up briefly before a new round of selling takes hold. Each day the stock drops a bit lower, nibbling away like waves washing against a castle of sand. In 2 months’ time, the stock is down another 30%.

The following quarter JCB Superstores announces that earnings will likely come in well below consensus estimates. The stock drops another 15%. The company is trying to correct the distribution problem, but it is not something easily fixed. It decides to stop expanding and to concentrate on the profitability of its existing store base.

Two years later, Tom pulls up the stock chart. The dog has been flat for so long it looks as if its heartbeat has stopped. He calls Jim and chats about the outlook for JCB Superstores. Jim gushes enthusiastically about a new retailing concept called the Internet. He is excited about the opportunity to sell office
supplies online without the need for bricks and mortar. There is some risk because the online community is in its infancy, but Jim predicts it will expand quickly. Tom is impressed, so he starts doing his homework and is soon buying the stock again.

**Investment Footprints**

If you picture in your mind the price action of JCB Superstores, you may recognize three chart patterns: a double bottom, a double top, and a dead-cat bounce. To knowledgeable investors, chart patterns are not squiggles on a price chart; they are the footprints of the smart money. The footprints are all they need to follow as they line their pockets with greater and greater riches. To others, such as Tom, it takes hard work and pavement pounding before they dare take a position in a stock. They are the ones making the footprints. They are the smart money that is setting the rules of the game—a game anyone can play. It is called investing.

Whether you choose to use technical analysis or fundamental analysis in your trading decisions, it pays to know what the market is thinking. It pays to look for the footprints. Those footprints may well steer you away from a cliff and get you out of a stock just in time. The feet that make those footprints are the same ones that will kick you in the pants, waking you up to a promising investment opportunity.

Let me tell you how I followed one trail of footprints. I sold my holdings in Alaska Air because I thought the stock was going down. Here is my notebook entry: “9/6/2001. I put a stop at 31.50 this morning and it hit. The stock has breeched a support level and with weakness in the economy and September/October upon us, it’s time to leave with a small loss [2.5%]. I should have bought at the breakout price [of an Eve & Adam double bottom]. The relative strength index peaked twice and now is headed down, suggesting a sale, and the commodity channel index says sell, too.”

I sold the airline two trading days before the terrorist attacks of 9/11. Four days after trading resumed, the stock bottomed at 17.70, nearly half the price at what I sold. The footprints did not lie; they led away from a cliff.

This book gives you the tools to spot the footprints, where they predict the stock is heading, how far it will travel, and how reliable the trail you are following really is. The tools will not make you rich; tools rarely do. But they are instruments to greater wealth. Use them wisely.

**The Database**

For this book, I used several databases in which to search for chart patterns. The main database consists of 500 stocks, each with durations of 5 years beginning
from mid-1991. I included the 30 Dow Jones industrials and familiar names with varying market capitalizations. Stocks included in the database needed a heartbeat (that is, they were not unduly flat over the 5-year period) and did not have consistently large intraday price swings (too thinly traded or volatile).

I usually removed stocks that went below $1.00, assuming bankruptcy was right around the corner. Most of the names in the database are popular American companies that trade on the NYSE, AMEX, or Nasdaq. The numerous illustrations accompanying each chapter give a representative sample of the stocks involved.

To capture the bear market of 2000–2002 and expand on the bull market since 1996, I included two additional databases. The first uses about 200 stocks that I follow daily. The other contains about 300 stocks that I no longer follow but that have historical data of limited duration (some issues no longer trade).

For rare chart patterns, I use all three databases and search from 1991 to the most recent date available. For plentiful patterns, I use already found patterns and add those appearing during the bear market. Thus, the number of stocks I use to find patterns and the amount of historical price quotes varies.

In the first edition of this book, I used a combination of computerized algorithms and manual searching to find chart patterns. The current edition includes the 15,000 patterns from the first edition and others found manually since then, for a total of more than 38,500 patterns.

**Stock Performance from 1991 to 2004**

Before reading about the various chart patterns in this book, it is wise to review the performance of the stock market during the period. Figure I.1 shows a monthly price chart of the Standard & Poor’s 500 stock index. Beginning in mid-1991, you can see that the market moved up at a leisurely pace, pausing during much of 1994, and then resuming the climb at a steeper angle in 1995. The index stumbled in August 1998 and made lower lows for 2 more months before continuing upward, peaking in March 2000, and signaling an end to the bull market. The move capped a rise of 418% from the start of the period. After that, the downhill bear run began, reaching a low in October 2002, for a decline measuring 51%. The index bounced once but made a higher low in March 2003, signaling a trend change. Thus, the October low marked the end of the bear market.

What does all this mean? The bear market measures from March 24, 2000, to October 10, 2002—about 2.5 years long. For data collection purposes, the bull market is everything else, about 11 years long. That covers the period I used to search for chart patterns in this edition.
Investing Using Chart Formations

I could give a dentist’s drill to any person walking by, but that doesn’t mean I would let that person near my teeth. This book is just like that. It gives you the tools to invest successfully. It suggests which chart patterns work best and which ones to avoid. Whether you can make money using them is entirely up to you.

I call this book an encyclopedia because that is how I use it. Whenever I see a chart pattern forming in a stock I own, or am thinking of buying, I read the applicable chapter. The information refreshes my memory about identification quirks, performance, and any tips on how I can get in sooner or more profitably. Then I search for similar patterns in the same stock (using different time scales), and if that does not work, I search for similar patterns in stocks in the same industry. I look at them closely to determine if their secrets are applicable to the current situation. I try to learn from their mistakes.

Developing an Investment Style

The question I am asked most often is, how do I develop an investment style? It is usually not asked like that. Most take a more direct approach: How do I make money trading stocks? When first asked this question, I stumbled over the answer. I think it is like showing four people the color blue and asking them to
describe it. One person is color blind so you automatically throw out whatever he says. One says it is solid blue. Another says it is not blue at all but green, while the third says it looks like a combination: blue-green. To each individual, blue looks like blue—just do not try to compare answers.

Developing a trading style is a lot like that. It is an individual endeavor that has a lot in common with experience. I cannot give you experience; I can only suggest ways to acquire your own.

If you read a chapter on a bullish chart pattern and buy the first stock showing the pattern in a bull market, you will probably be successful. The first trade nearly always works for the novice, maybe even the second or third one, too. Eventually, though, someone is going to pull the rug out from under you (who knows, maybe it occurs on the first trade). You will make an investment in a chart pattern and the trade will go bad. Maybe you will stumble across a herd of bad trades and get flattened. You might question your sanity, you might question God, but one thing is for certain: Your trading style is not working.

Most people buy stocks like they buy fruit. They look at it, perhaps sniff it, and plunk down their money. We are not talking about $1.59 here. We are talking about thousands of dollars for part ownership in a company.

If you have ever been a board member, you know what I am talking about. You have a fiduciary responsibility to the people who elected or appointed you to that position. Not only should you study the material handed to you by the staff, but you have to get out in the field and kick the tires. Do not assume that what the staff says is always correct or represents the best solution. Question everything but learn in the process and try to be helpful without being a pest (I always seem to fall into the pest category). As a shareholder—an owner of the company—should it be any different?

Once, I considered buying a position in a company showing an upward breakout from a symmetrical triangle. My computer program told me the company is a member of the machinery industry and further research revealed that it makes refractory products. I continued doing research on the company until the problem gnawing at me finally sank in. I did not have the slightest idea what a refractory product was. Despite my search for an answer, I was not getting the sort of warm fuzzies I usually get when researching a possible investment. So, I passed it over. I am trading it on paper, sure, but not in real life. Call it the Peter Lynch Syndrome: Do not invest in anything you cannot understand or explain in a paragraph. Good advice.

Of course, if you blindly invest in chart squiggles and it works for you, who am I to tell you you are doing it wrong? The fact is, you are not. If you consistently make money at it, then you have developed an investment style that fits your personality. Good for you!

My investment style, as you might have guessed, combines fundamental analysis, technical analysis, emotional analysis, and money management. Just because I rely on technical analysis does not mean I do not look at the price-to-earnings, price-to-sales, and other more esoteric ratios. Then there is the
emotional element. After going for months without making a single trade, suddenly a profitable opportunity appears and I will take advantage of it. Three days later, I will want to trade again. Why? Am I trading just because it feels good to be finally back in the thick of things? Am I trading just because the single woman living nearby does not know I exist, and I am acting out my frustrations or trying to impress her with the size of my wallet? That is where paper trading comes in handy. I can experiment on new techniques without getting burned. If I do the simulation accurately enough, my subconscious will not know the difference, and I will learn a lot in the process.

Once I come to terms with any emotional issues, I look at money management. How much can I realistically expect to make, and how much can I lose? What is the proper lot size to take? When should I add to my position? How long will it take for the stock to reach my target and should I invest in a less promising but quicker candidate?

Investing using chart formations is an exercise in probability. If you play the numbers long enough, you will win out. Sure, some of your investments will fail, and you must learn to cut your losses before they get out of hand. But the winners should serve you well, providing you let them ride. Just do not make the mistake of watching a stock double or triple only to reverse course and drop back to where it started. Or worse.

**Day Traders, Position Traders, Buy-and-Hold Investors**

As I was writing this book, I kept asking myself *what is the time horizon for chart patterns?* Are they best for day traders, position traders, or buy-and-hold investors? The answer I kept coming up with is: Yes! Chart formations can be profitable for day traders—those people who are in and out of a trade during a single day. Many day traders have trading styles that depend on chart formations, support, and resistance. They concentrate on reliable formations that quickly fulfill their measure rule predictions.

For position traders, those who hold the trade longer than a day but not forever, chart patterns offer convenient entry and exit signals. I put myself in this category. If the trade goes bad, I am out quickly. If it is profitable, I see no need to cut my profits short. When the gains plateau, or if the stock has moved about all it is going to, I consider moving on. Like the day trader, I try to keep cash employed by buying formations that promise reliable returns and reach the ultimate high quickly.

For the long-term investor, chart patterns also signal good entry and exit points. I remember buying an oil services company knowing that the investment would not make a significant return for 2 or 3 years. (I was wrong; it doubled in 3 weeks) I believe that in 3 years’ time, the stock will be in the 30s, a sixfold increase from its low. It probably will not qualify as a ten-bagger, but it is not small change either. In the short term, the road is going to be rocky, and
I have added to my position as the stock has come down. Since I am in it for the long term, I have an outstanding order to buy more shares. If this stock goes nowhere, then my analysis of the market trend was wrong, and I will have learned a valuable lesson.

The Sample Trade

Most of the sample trades included in the chapters of this book are fictitious. Each sample trade uses techniques I wanted to illustrate, incorporating fictitious people in sometimes unusual circumstances. Call it poetic license, but I hope they give you some ideas on how to increase your profits or to minimize your losses.

Statistics: “I Don’t Believe the Numbers”

A high, tight flag has an average rise of 69% in a bull market. Question: If you trade this pattern often enough in a bull market, will you make an average of 69%? Answer: No. Why not? Well, you may be like a friend of mine who has traded stocks a dozen times but made money only once (a few hundred bucks). But here is another reason: The 69% average rise represents 253 perfect trades. A perfect trade is one in which you buy at the breakout price and sell at the ultimate high—the highest high before prices decline by at least 20%. Not only are the trades perfect, but also commissions are not included. Your return may be lower . . . or higher. However, I used the same spreadsheet formulas from pattern to pattern, so you can compare performance in most cases (the exceptions: flags, measured moves, and pennants) without worrying about whether you believe the numbers.

“If I reproduce your tests, will I get similar results?” Yes. A person in India I know is pulling 30%, 40%, and more out of the market on a consistent basis. He would claim my statistics are too conservative! A hedge fund manager reports that my numbers for the dead-cat bounce are dead solid perfect. Another says that while she was able to reproduce my dead-cat bounce numbers, she was having trouble reproducing others. If you do not follow the methods I used, your results will vary. Guaranteed. So, this edition includes a Glossary and Methodology chapter to explain how I measured each result.

The method I used opened a door to a new world. In this world, you will find that a month after a breakout in a bear market, price often shows strength. You will discover that when pullbacks occur, performance suffers. You will find that failure rates start low but increase rapidly. Volume shapes, price gaps, pattern size, and a dozen other performance clues help some patterns but not others. Findings like these are what make this book unique. The numbers tell a story of fact that I share with you within the following pages.