

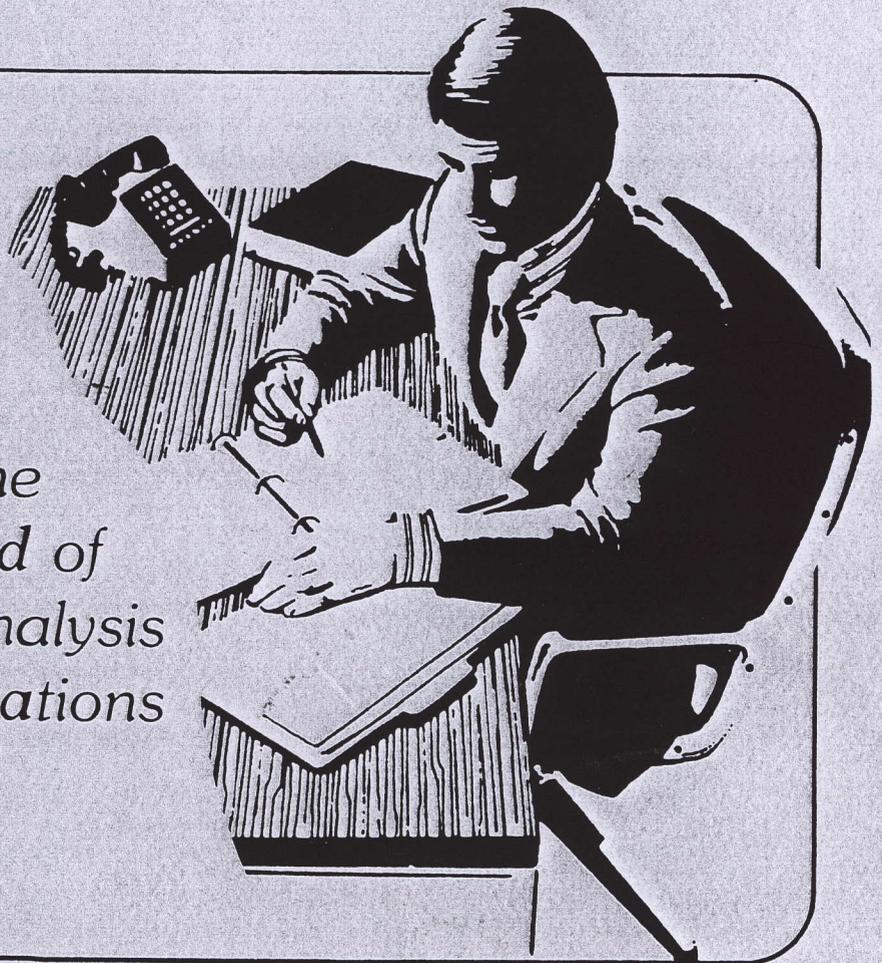
STOCK MARKET INSTITUTE

Founded in 1931

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Introduction to the Wyckoff Method of Stock Market Analysis



*Introduction to the
Wyckoff Method of
Stock Market Analysis
—Exhibits and Illustrations*

Table of Contents

	Page
Lesson One—Philosophy	
Introduction	1
Technical vs. Fundamental Analysis	1
Mechanical Technical Analysis	2
Judgmental Technical Analysis	3
The Law of Supply & Demand	4
The Law of Cause & Effect	4
The Law of Effort vs. Result	5
How the Market Moves	6
A Typical Analysis of Market Action	8
The Wyckoff Method	10
Types of Charts	15
Lesson Two—Principles and Procedure	
Introduction	19
Defining Trends	19
Trading Positions in an Uptrend	26
Trading Positions in a Downtrend	28
Culmination of an Uptrend	31
Culmination of a Downtrend	32
Trading Positions in a Trading Range	33
Figure Chart Counts & Counting (Advances)	45
Figure Chart Counts & Counting (Declines)	50
The Nine Buying Tests	53
The Nine Selling Tests	56
Analyzing the General Market	58
The Wyckoff Wave & O.P. Index	58
Divergences	59
The Trend Barometer	61
The Market's Readiness to Move	63
Stock Selection	65
Protecting Capital	68
Lesson Three—Performance	
Introduction	73
Resources and Goals	73
Practice Trading Exercises	75

Introduction

On behalf of Stock Market Institute, welcome to lesson one of this introduction to the Wyckoff method of stock market analysis. Your desire to participate in this exercise indicates a genuine interest in the stock market. More importantly, it suggests a willingness to make a commitment to learn a technique of doing successfully what millions of people before you have failed to do; that is, profit from the action of the stock market.

Failures in the stock market are based on one thing, a lack of knowledge. Without having first arrived at an understanding of how the market moves, why it moves and what the various types of moves justify as anticipation for the future, the chances of truly meaningful profits are greatly reduced. It is true that an infinitesimal minority of the uninformed do find success in the market and sometimes reap incredible profits. These results, however, are not based on any particular knowledge or understanding, but on pure luck. As such, they come to only a very few.

Those who are not blessed with unlimited good luck have to take the time to gather the knowledge and develop the understanding. Although this learning process seldom produces the lightning quick results that come with a spurt of good luck, the effects are generally more lasting and over all more gratifying. Throughout these three lessons we will be seeking to implant the basics of a successful approach to the market into your thoughts and actions. Hopefully, you will complete the three lessons on the road to a true or better understanding of how the market works and how to get it to yield profits on a consistent basis.

Technical vs. Fundamental Analysis

No doubt you are aware that there are two approaches to studying the stock market. They are fundamental analysis and technical analysis. The subject here will be technical analysis. In our opinion, the average investor, or trader, is in a position where he is more likely to realize greater profits from the use of this type of analysis than from trying to unravel all of the intricacies of fundamental thinking.

Those investors who attempt to use fundamental analysis place their reliance on a method that emphasizes business conditions, economic events and news. They do this by utilizing balance sheets, profit and loss statements, cash flow figures and other statistics as well as such vehicles as the Wall Street Journal, Barrons and the evening news. The object is to arrive at an estimate of a particular company's present worth and prospects for future growth. Many, and in fact most investors, continue to cling to this method of operation. It can be used satisfactorily. One type of investing where this is especially likely to be true is that which is intended to be very long term in nature. By that, we mean as much as five years and perhaps even more. There is certainly nothing wrong with retaining a stock market position for such a long period of time. The problem is that as our economy becomes increasingly more uncertain, more and more of the investors who once were willing to wait for years to realize their profits are now seeking a shorter term return. As there is nothing wrong with a willingness to wait for a return, so also there is nothing unacceptable about desiring a more timely windfall. However, there are serious questions as to whether fundamental analysis is applicable to this type of expectation.

The types of information mentioned as being the tools of the fundamentally oriented market student are, at best, one step removed from the price of a stock. It cannot be denied that an unusually dismal or prosperous period in an industry, or a recession or recovery in the general economy, or the threat of a world war or the promise of eternal peace will have a relatively short term effect on the price of a stock. The problem lies in the fact that by the time the information becomes available, or can be absorbed and sorted out by the individual investor the price of the stock has generally made whatever short or intermediate adjustment it is going to make to the news. This leaves most investors in a position of hoping that there will be a significant longer term effect from the information. Sometimes there is, but just as many times there is not.

This leads to a conclusion concerning the single most devastating defect in fundamental analysis. It is an absence of timing. The professional traders and insiders have more immediate access to important facts and figures. What's more, they have a better developed understanding of what is really important. Therefore, there is no need to waste a great deal of time in absorbing what is, for the most part, useless information. They see, they act, and the price of the stock responds accordingly. By the time the general public has figured out what is going on, the best time to act has long since past. This is why so many people who rely on fundamental information seem to find themselves investing in so called "good" stocks year after year realizing only small profits. If their stock pays a good dividend, this is likely to be the bulk of their return, instead of the

substantial appreciation that they expect. If not, they have virtually nothing and because of the ever taxing effects of inflation, they actually have less than when they started.

It's a rather depressing picture, isn't it? Everybody likes a good hard fought game. It's exciting and when you win it's exhilarating. But, when the rules start to favor the other guy to the point that the agony of defeat becomes a constant companion, what's the sense of playing the game? Hopefully, your experiences have not created such a state of frustration that you are now only a spectator. Technical analysis can be the force that will resurrect any downtrodden spirits that now exist and help restore the value of your portfolio as well.

In technical analysis, there is nothing between the investor and the price of the stock. There is no slick annual report to figure out and no news article to interpret. If somebody tells you that somebody else said something that will have a direct effect on your well being, you may believe him. However, if the person who is reported to have made the statement tells it to you directly, there is much less chance of a misunderstanding. This is very much the way in which technical analysis works. By evaluating a stock, or the market, based on its own action, in a logical and orderly manner, it is possible to arrive at an understanding of what the market or the individual stock is doing and, equally important, how it is doing it. In addition, technical students of the market have equal access with the professional of having that understanding updated on a day to day basis. The advantage of the insider is removed. From this knowledge and through the use of a logical set of principles and an orderly set of procedures, it is possible to arrive at a conclusion as to the prospects for the future. This can all come from carefully evaluating the stock's own action.

[Mechanical Technical Analysis]

[There are two approaches that can be made to technical analysis. One is mechanical and it is by far the easier of the two to understand and utilize. Unfortunately, it is also far less reliable than the second approach. The generally accepted grandfather of this approach was a man by the name of Schabacher who did his writing back in the 1920's. He studied the pictures produced by the charted action of thousands of individual case studies. He was looking for patterns of action that all led to the same result. From his work the world of technical analysis had added to it such terms as head and shoulders top, double tops, triple tops, gaps, pennants and a whole host of others too numerous to mention.]

Schabacher's work has been widely copied. Most of this, no doubt, was done in an effort to improve upon the basics that he laid down and in an effort by someone to make an easy buck. [The problem is that (none) of these people, nor the grandfather of the method itself, could remove from it one basic and potentially disastrous flaw.]

[Remember how his work was described? It was a search for patterns from among thousands of examples. The question to consider here is what constitutes a pattern. If a certain result develops out of a particular action fifty percent of the time, is that enough to establish a pattern? Or, is it possible to establish a pattern with a forty percent result? Perhaps it takes as much as sixty percent. [The problem with any of these figures is that they all leave an incredible number of situations that do not fall under the pattern. How can this unsettling fact for the trader be reconciled? Do we simply say tough luck? That is hardly an acceptable response, but it is the only one that is available.]

[Let's consider two of these mechanical gimmicks in somewhat greater detail. The two that are perhaps the most widely known and used and the ones that investors try to sneak into their analysis most frequently are the ideas of the head and shoulders top and the gap. Of these, the head and shoulders top is probably the most classic.

If you will turn to exhibit one for this lesson, you will find on the top half of the page a simple depiction of what a head and shoulders top is. The stock begins by making an impressive move up from point "A" to point "B". About this time, the upward progress begins to fade and the action becomes predominantly horizontal. This produces the first "shoulder".

After the shoulder broadens out for a while, the stock begins to resume its upward progress to about point "C". Upon reaching this lofty peak, the price may hold here for a while before dropping back to point "D", which is generally at about the same level as point "B". This action creates the "head".

Now, the action of the stock again goes through a substantially horizontal period to perhaps point "E". For the student of this method watching the development of the picture, this is taken as being the creation of the second shoulder. It means that a first class short selling opportunity is approaching. Then the stock begins to round down to point "F" and the trader gets excited enough about what he is seeing to take a short position. Obviously, the hope is that the stock will eventually retreat to point "G", and the investor will make a tremendous profit. }

{ Look at the drawing at the bottom of the page. Here is the idea of a gap. A stock is apparently wandering aimlessly in a narrow range. In the process, it moves through points "A", "B", "C", "D", "E", and "F". All of a sudden, after leaving point "F", the price explodes upward leaving a big "gap" of empty space. How can this happen? It certainly does not fit the pattern of the past action. Therefore, it must not be for real. The gap will be filled. }

The upward explosion takes the stock to point "G" where it stops and reacts back to point "H". This is of no surprise since it is known that the whole up move is not going to last. From "H" there is another rally attempt to point "I", which fails to make a new high. The mechanical technical student is ecstatic! He knows that the stock is going back from whence it came and now he has the proof. Consequently, he sells short in anticipation of a major pay day when the stock returns to point "J". }

Both of these examples show how the technically oriented investor using a mechanical approach might prepare for a short side profit. We can just as easily, however, stand our little man, at the top of the page, on his head or flip the gap upside down and see long side opportunities. (The important question, though, is) are these drawings good for anything other than conversation? In other words, do they work? }

(They do work, or at least they do sometimes.) No one dreamed them up one night, and decided to put together a system of technical market analysis. How often do they work, however? That is where the problem arises. At best, these drawings depict what is suppose to happen most of the time. The rest of the time, something else happens. Unfortunately, there is no way to tell for sure as the investor watches one of these formations take shape in the real world whether or not that particular case will progress to the desired conclusion. If the flow of events gets off the track somewhere, the best the mechanical technician can do is get out before things get too bad. }

{ Now, turn over to exhibit two. At the top of the page, there is a reasonably good example of a head and shoulders top that produced the desired results. On the chart, it can be noted that the approximate positions of the various important points on the drawing are identified. The bottom half of the page is devoted to an example of a gap. In both of these cases, the mechanical approach works quite nicely. } In fact, in an effort to be totally honest, it must be admitted that both stocks produce a very profitable move. Is there reason for excitement? Anyone who happens to have made either of these trades certainly should be excited. It is always exciting to turn a profit. Don't lose control, however. Now, please turn to the third exhibit.

(In these two examples, we again have instances of a head and shoulders top and a gap formation. The major difference is that both situations are only developed to the critical point where a commitment may be made. What happens? If exhibit four is examined, it can be seen that both of the stocks go against what the mechanical approach suggests will happen. Even worse is that there is really no graceful way to get out of one of these situations. If the investor remains committed to the reliability of the formation, chances are he will be locked into the position with nothing more than the hope of eventually getting even. }

(The real problem with this approach is not so much the formation, but) rather that it does not really stand for anything. (There is no underlying principle that is being judged. These two words, principle and) judged, or judgment, form the foundation of the second approach to technical analysis) and the one that will be considered for the balance of these lessons.

[Judgmental Technical Analysis]

(The mechanical approach relies totally on observation. The judgment approach also depends heavily on developing a keen power of observation. The difference comes in what is being observed. In the mechanical approach, the investor is observing formations. He is provided with a set of models and then told to seek out as many carbon copies as he can find. The judgmental approach begins with a set of principles. The observation that is done is aimed at finding these principles at work in the market or a particular stock. When an investor finds one or more, he responds in a prescribable manner.

[At this point, there might be the inclination to say, "what's the difference"? There is a very basic difference. A formation is a constant. If a stock does not fit one of the molds stamped out by the types of drawing in exhibit one, it is eliminated.] It may produce an absolutely tremendous move, but in failing to produce one of the desired formations, it is branding itself as an outcast. [And yet, there is still the ever present reality, that even in fitting one of the molds perfectly there is no guarantee of the desired result.]

[A principle, on the other hand, is more than a constant. It is an absolute. In the case of the market, it is a statement of condition that is unequivocally true. Given a certain condition, or set of conditions, the result will always be the same. These conditions may not, and usually do not, produce carbon copy formations. It is true that there are quite often similarities, but these are usually only general in nature and not a primary concern. What is of utmost concern is adhering to the principle. Quite frankly, this is more difficult than looking for formations. It takes more time and requires more skill.] Proficiency does not come overnight.

[Is the effort worth it, one might ask? In answer to this, be reminded that what is being dealt with are principles that are absolute. This means that their result is absolute as well. Most traders and investors, for a galaxy of reasons, may never reach the point where their power of observation is so well developed that an error in judgment is never made.] Few people ever reach this point. [However, there is only one way to reach whatever the pinnacle of one's individual abilities is, and that is to try. The more effort that is put into the study and practice of the principles, the higher will be the degree of proficiency. With each step up to a higher level, the results will be larger and more frequent profits.]

[The Law of Supply and Demand]

Now, forget about formations, [it is time to get down to principles. The first one is the law of supply and demand.] There was a time when many would ask what does the law of supply and demand say. Fortunately, this is less likely to occur nowadays than in the past. The roller coaster path of the American economy over the past years has been a marvelous force in bringing an education to the general public on just how the system works. Everyone now seems to understand that [when there is too much of something in the economy its value is reduced in an effort to create a demand that will take up the supply. On the other hand, if there is not enough of something to meet the demand, its value has to be raised in an effort to create a supply that will meet the demand.]

Anyone who knows anything about the workings of the stock market knows that for every buyer there must be a seller and every seller is matched by a buyer. Since this is true, it must be that the law of supply and demand does not apply in the stock market. A conclusion such as this can be arrived at quite easily. However, it is based on misconceptions and is, therefore, unsound. The stock market does not operate on bodies. It deals in shares and dollars. The fact that there is always a body attached to the hand holding the shares and one attached to the hand holding the dollars does not reduce the validity of the law of supply and demand.

If an investor wants to exchange his dollars for someone else's shares, but can only get those shares by offering more dollars than did the previous buyer and if he is, in fact, willing to offer the increased number of dollars, the price of the stock increases to absorb the extra dollars. In this case, it is said that the demand is greater than the supply. On the other hand, if an investor wants to exchange his shares for dollars and will accept fewer dollars than the seller before him to accomplish his objective, the price of the stock will be reduced. In this case, it is said that supply is greater than demand. Theoretically, demand can exceed supply forever. An excess of supply over demand is limited only by the zero point. In between the excess of supply over demand, or demand over supply, is a state in which the two are in equilibrium. In this case, there is an equal exchange of a number of shares for a quantity of dollars. [This is the only way in which fluctuations in the stock market, or a particular stock, can occur. Every principle that will develop from this point is in some way a postulate of this basic truth.]

[The Law of Cause and Effect]

[A second basic principle underlying all analytical efforts is the law of cause and effect. The idea here is that in order for there to be an effect that shows up as a change in the price of a stock, there must first be a cause. In its most basic state, this law seems very much the same as the law of supply and demand.] In the cases of the individual trades mentioned, the cause is the buyer's desire to hold the shares, or the seller's desire to have dollars. In one case the cause is expressed in terms of demand and in the other in terms of supply. Therefore, [although there is a definite relationship to the law of supply and demand, there is a basic difference which sets the law of cause and effect apart.]

A cause can be stated in terms of the reason behind an individual trade. In the making of important profits in the stock market, however, the significance of each individual trade is greatly reduced. Here the idea of a cause must be taken more broadly. [The effect realized by a cause will be in direct proportion to that cause. Consequently, to get an important move, or effect, there must be an important cause. These are not built from one trade, but rather take time, sometimes a long time, to develop. Generally these causes are built during an important shift in who is holding the stock. The flow of shares that is of greatest significance is the one that occurs as shares leave the strong hands of the professional traders and go to the weaker hands of the general public.] To see how this can work, an example is in order.

{ It begins by assuming that the market is going up since most investors feel most comfortable with an advancing market. Every market advance begins only after the professional traders have all, or just about all, the shares they desire. Once the move begins, it will be carried forward primarily by the increasing and emotional buying of the public. The emotion at work here, by the way, is greed. The knowledgeable trader will go with the upward trend of the advance as long as prices continue to move up easily. At some point, prices will begin to encounter resistance. They may continue to advance for a while, but eventually the rise will be halted. The chart that appears in exhibit five shows how this action might look for a particular stock. }

{ During the area around "A", the emotionalism runs wild. People want the stock so badly that the price they have to pay becomes a secondary concern. Needless to say, the price responds to this open door with a sharp move upward. At "B", the advance continues, but is somewhat tempered. At this point, it is quite possible that some resistance has already started, but not to an extent that matters to most. At point "C", however, the price of the stock hits a brick wall of resistance and almost all upward progress ceases. The price is at a level where the public can no longer be excited into buying. Buying is still going on, otherwise the price would immediately fall, but the professional sees the signs of resistance and is using this buying as an opportunity to liquidate his holdings. In so doing, he is creating the supply that will eventually be the cause for the next downward move. [How much selling is done here will determine the size of the cause and the extent of the decline.] }

[The Law of Effort vs. Result]

There is one more basic underlying rule behind the movement of the market. It is the law of effort versus result. [Throughout these lessons, it will become apparent that price is not the only important factor at work in the stock market. The importance of price is of consequence to most investors because it is price movement that determines whether a trade produces a profit or a loss. [Although an investor might not realize it, an equally important factor and, perhaps an even more important factor, is the character of the volume.]

[In terms of the law of effort versus result, the result is what happens to the price. It is the volume that produces the effort that achieves the result. Without effort there can be no result. When the amount of effort and the extent of the result are not in harmony, something is wrong. Any positions held when this situation exists are potentially in danger. They may not be liquidated, but they should be protected.]

{ To get a better idea of how the concept of effort versus result works and how it can help protect against disaster, consider yet another hypothetical situation. It begins with a stock that explodes upward by six points. The volume is ten thousand shares. The next day, there is an additional advance of four points and trading expands to twenty thousand shares. At this point, many people are making a lot of money. This is also the type of situation that brings out an incredible amount of greed. On the third day, the stock takes on an additional two points while the volume soars to forty-thousand shares. Then day number four comes and this time the "wonder stock" only advances half a point. The volume, however, tops the hundred thousand share level. }

{ Is it clear what is happening in this case? Obviously, the price is moving up and the volume is expanding. That should be a good sign and in many cases it is a good indication for the future. In this case, though, it creates a problem. As the stock advances, the amount of each successive advance decreases. The volume on the other hand increases steadily throughout the four days. This results in a clear case of an effort without a corresponding result. It produces a warning of potential trouble. Anyone not already in this stock is well advised not to get in, at least not at this dangerous time. Those already holding positions should protect themselves as best they can, or just get out. Until it can be determined why the result is lagging behind the effort or until the situation corrects itself, there is the potential for disaster. The chart at the bottom of exhibit five shows how this concept of effort without result might look in actual practice. }

EXHIBIT 1

