Forex Trading Classic Chart Patterns - A ringing phone; the first indication that something was wrong. Very wrong.Especially when the person on the other end was Mary. “I own Cisco Systems,”she gloated, and instantly I knew I was in trouble. I also owned the stock, and I knew that whatever Mary bought went down as sure as the sun sets in the west.Mary is new to the world of stock market investing. She believes in fundamental analysis, but does not have the time or inclination to do it properly.Technical analysis? Forget it. If she looks at a stock chart at all, it only shows closing prices—like watching television using only a quarter of the screen. To her, the small stake in a self-directed IRA—where she trades—is play money as her other, professionally managed retirement accounts hold the bulk of her savings. Make no mistake; she is a very talented, well-respected, senior vice president making big bucks at a growing company. She is not an early adopter—one who buys the latest cell phone because it is smaller than the dozens she already owns—but one who is willing to pay up for the good life: the in-ground swimming pool, the vacation time-share, dance and piano lessons for the kids, the BMW, the SUV, the frequent vacations to exotic locales. In other words, she lives well. I am jealous.THE NOVICE EXPERIENCE Enough about Mary. Let us turn to the trade she made in Cisco Systems, shown in Figure I.1. When she called, I asked her why she bought 85 shares of the stock at 65. Her answer was as you would expect from a believer of fundamental analysis. She said Cisco was a good company with good earnings and market momentum.

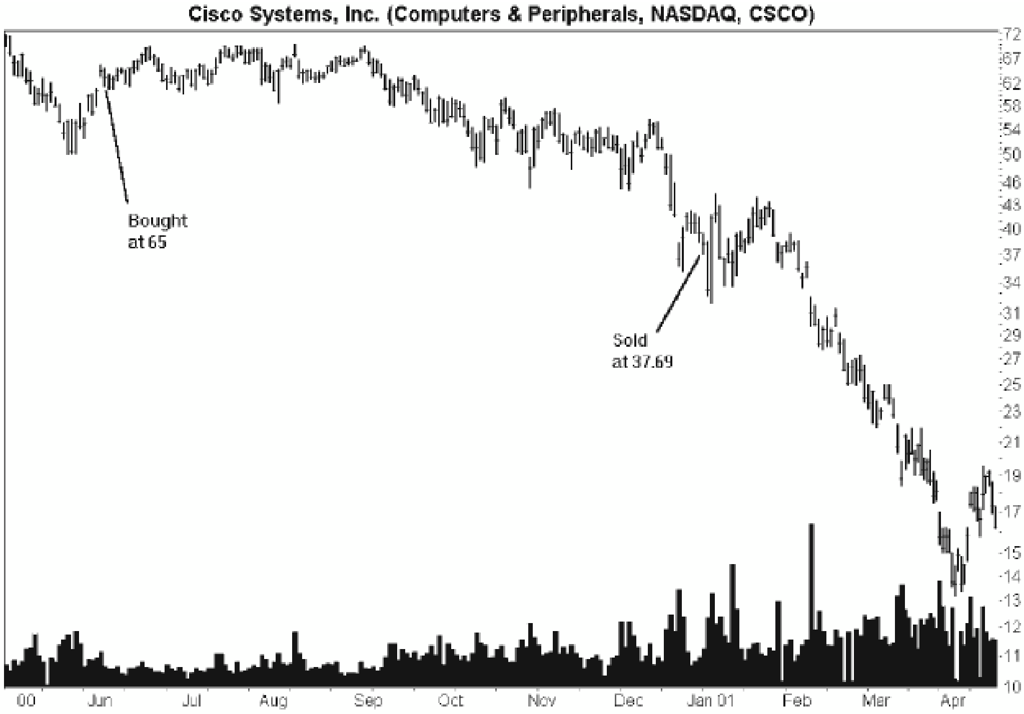

Figure I.1 Mary made a bullish bet on this trade, but failed to cut her losses. How could technical analysis have helped?

For about 2 weeks, it looked as if she was right. Prices climbed from 65 to a high of 69.56, then bounced between 58 and 70 until September. After that,prices started sliding, slowly at first, but the new trend was clearly down. As Cisco dropped, it followed the Standard & Poor’s 500 Index lower, almost in lockstep. Like a drain, the declining market acted as a siphon sucking Cisco lower. The Nasdaq Composite meanwhile, formed a double top—peaks in July and September—with prices confirming the chart pattern in early October. A bearish signal; it was time to pull the trigger.Mary knew none of this; all she cared about was the falling stock price.Why not sell? Good question. Listening to Mary discuss her trades, you can imagine the mental trading blocks building like ants reconstructing a mound after a rain storm. Phrases such as, “As soon as I sell, prices will rise,” and “It has been dropping for so long that it must be near bottom,” and “As soon as I break even, I will sell,” and, my personal favorite, “I have decided to hold it for the long term,” became part of the lexicon, the justification for holding onto a losing position. On December 29, Mary sold the stock. Her reason? “I was sick of taking losses.” She received a fill at 37.69, for a tidy 42% loss. The good news, if you can call it that, is that she got out when she did. She could have ridden the stock to its low of 13.19, a massive 80% decline. Still, a 42% loss is not what most would call “cutting your losses short.” What about my trade? Those who know me understand that I like chart patterns and trade them often. For me, they make it easy to time the market—something the experts claim is impossible to do profitably for any length of time. You should get used to it, though, because every time you trade, you are timing the market whether you want to admit it or not.During bear markets, bullish chart patterns are like budding flowers in winter: a rare sight. As soon as the market turns, it is as if spring arrives and the head-and-shoulders bottoms, the double bottoms, and other bullish patterns sprout forth and start blooming. The trick is that some of the patterns are weeds and some are orchids; distinguishing them is the subject of this book. I get to that later. In the meantime, let us return to the Cisco situation. Figure I.2 shows what I saw when I looked at the same chart Mary did (but the time scale is shifted somewhat—the

June to December periods overlap). The precise name for this chart pattern is a broadening formation, right-angled and descending. It sports a flat top, a down-sloping trend along the minor lows, and a volume pattern that can best be described as irregular. This pattern is as rare as finding water in a desert.

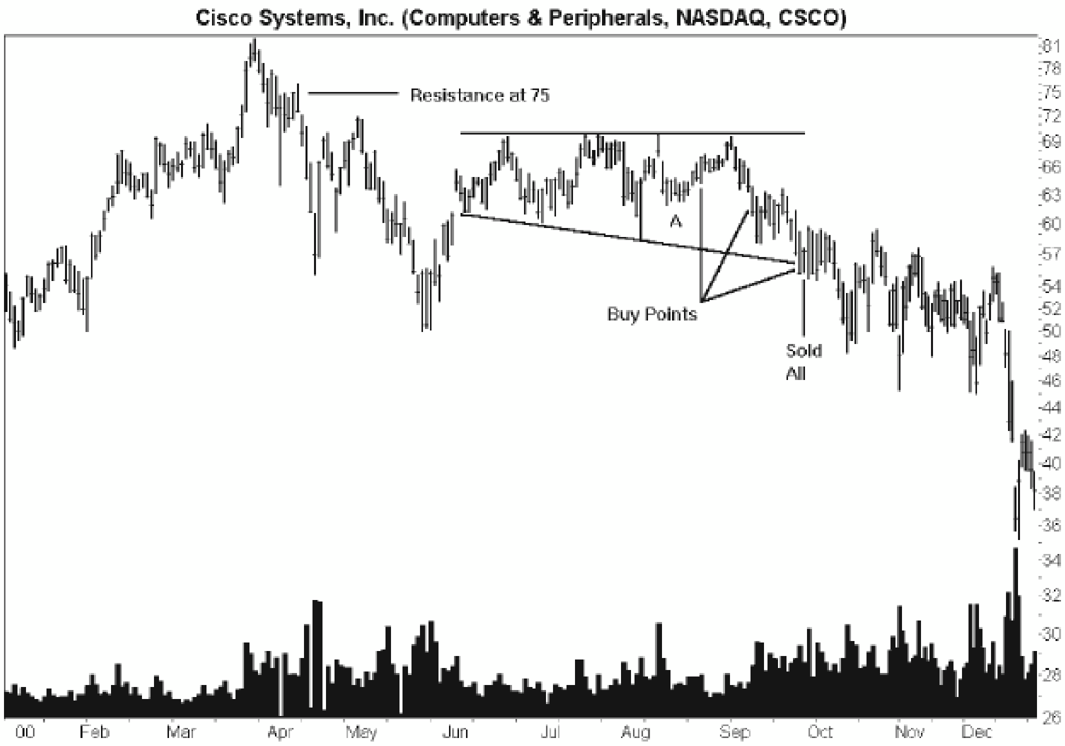

Figure I.2 A right-angled, descending, broadening formation with a partial decline (point A). Prices failed to break out upward, as predicted, dooming the trade.

A computerized notebook chronicles my trading experience, so I can watch for bad habits forming and learn from past mistakes. Here is what I wrote for the first purchase: “8/23/00. I bought 300 shares at the market and received a fill at 65.97. I expect the last hour rush to push this up even more [I was right. The stock closed at 67.19, which was 6 cents below the daily high].Why buy? Partial decline in a broadening formation, right-angled and descending. The stock will pause briefly at 70 then zoom up to 75 and on to 80. I expect help from the Nasdaq Composite that broke out downward from an ascending broadening wedge, pulled back, and should continue higher. Downside is 61.88, where I must sell."The key is the mention of a partial decline, and it appears at point A in Figure I.2. Prices touch the top trendline then head lower—but do not touch the lower trendline—curl around, and, usually stage an immediate, upward breakout. If things worked out as expected, the stock would have climbed to the resistance area at 75, burned its way through, then paused near the old high of 82. My guess is that it would stop at the round number 80, a common resistance point, then retrace some of its gains, curve around, and form a second top (for a double-top pattern). The trick would be to sell near the top.None of that happened. After tagging the top trendline, prices moved lower in a stair-step decline. Here is the next notebook entry: "Saturday 9/9/00. Trend channels suggest the stock should drop to about 62 (from the current 64) then rise. Prices touch an up trendline drawn from the June 30 low to the present, ignoring the two down spikes on August 2–3, suggesting a rebound Monday. Stop is still 61.88. The Nasdaq Composite looks as if it double topped, pierced an up trendline, and now appears to be heading down. With September here and October to follow, this might not be a good time to buy. For this stock, the best days to buy are Tuesday and Wednesday [based on linking price changes to days of the week], so I'm going to delay buying."The general market was now declining—never a good sign when you own a stock. As with many trades, the technical evidence was mixed, but there were warning signs of trouble ahead. Instead: "9/11/00. I bought 200 at 61.25,shooting from the hip. I think that the stock will stop here, and it is a good buyin price. Tomorrow will tell if I am right. Downside is 56–57, upside is 70,pause at 75 then upward to 80." Whenever I write the words "shooting from the hip," it means the trade is about to go bad. These are the trades that feel good, feel right, but never are.Having recently reviewed my 20 years' worth of trades, I recognize this trading flaw, and now I know better (which is a good reason to keep a trading notebook: It gives you the ability to recognize a mistake when you make it again!). Notice how the stop-loss price magically changed from 61.88 to 56–57. A lowered stop is another warning of a trade gone bad."9/26/00. I bought 300 at the market open and received a fill at 58.16. Indicators were almost uniformly negative. Outside day [a chart pattern] with the close near the lower end implies a lower low today. Right-angled broadening formation meant that I couldn't tell the breakout direction. Measured move down chart pattern from 69.63 to 58 then 63.63 to . . . 52. But did I listen?No. I bought anyway and the stock moved below the formation with bid/ask of 54.75–54.88, well below the stop price of 56." Averaging down in a falling market is never a good idea, but it is a common mistake for novice investors and turkeys like me—ones who know better. After I bought, the stock closed outside the chart pattern, signaling a downward breakout. Even though I made a host of mistakes in this trade, at least I got one thing right: "9/27/00. I sold all 800 shares this morning as the stock had breached the lower trendline boundary of a descending right-angled broadening formation. Lessons on this trade: If an upside breakout from a partial decline does not appear immediately, sell. Do not buy more as the stock moves to the other side of the formation. I received a fill at 56.13, about a point higher than yesterday's close." **To read more,Please download the book.**

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