A Wyckoff Guide For Investors And Speculators

by Craig F. Schroeder

The Wyckoff method as it is taught today represents the results of more than 100 years of continuous market study. Those years have brought the development of numerous refinements and a variety of applications. The basic building blocks of the approach, however, have remained the same. The ability to stand the test of time in a field where techniques come and go as regularly as the seasons makes a working knowledge of the method a worthwhile undertaking for all serious investors and speculators.

In his course in stock market science and technique, Richard D. Wyckoff stated the basics of his method in five steps. These five building blocks are as follows:

Step 1: Determine the present position and probable future trend of the market. Then decide how yon are going to play the game: long, short or neutral.

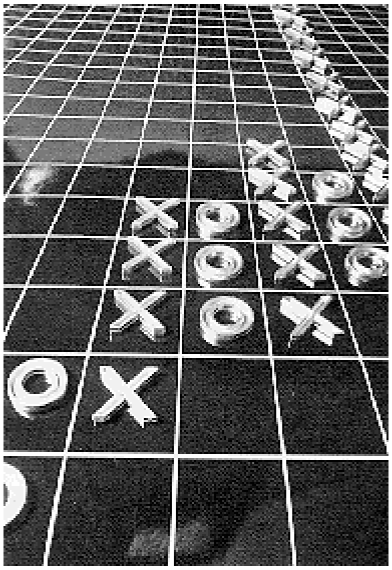
Step 2: Select from those stocks in harmony with the market the ones stronger than the market in a bull market. In a bear market, select those that are weaker than the market.

Step 3: Select those stocks that have built up a cause, a potential count for a move using point & figure charts.

Step 4: Determine each stock's readiness to move. Analyze the vertical and figure charts of the candidates with the help of the buying and selling tests.

Step 5: Time your commitments with a turn in the market in question.

The five steps of the Wyckoff method can be divided into three groups that ask and help answer three important questions. Step 1 stands alone and asks the question *what*. Steps 2 through 4 can be grouped together and ask the question *who*. Step 5 stands alone and asks the question when. Therefore, by employing all five steps, the investor or speculator can determine what type of market operation to undertake, which individual stocks or bonds represent the best candidate(s) and when is the best time to make a commitment. Correct answers to all three questions put the odds of success decisively in favor of the investor. Two correct answers still give the investor good odds for success. Even one correct answer can at least prevent a disaster.



Identifying the trend

Determining the present position of the market requires that a determination as to the present trend of the market be made as well. Wyckoff analysis dictates that the trend of the market is either up, down or neutral (trading range). It also specifies that the market trades in three trends at any given time. There is a short-term trend, an intermediate trend and a long-term trend. There is no set rule as to the amount of time that each trend includes. An intraday trader of futures or options may wish to define a short-term trend as one that begins, unfolds and ends all in the same day. For this trader, an intermediate trend can be completed in several days and along-term trend can be completed in a few weeks. A long-term investor in government bonds would be likely to define the three trends very differently. For this individual, a short-term trend will frequently begin, unfold and end over a period of several weeks. A long-term trend can last a year or more.

Each investor or speculator needs to make an objective decision as to the best trend definition for his or her situation. Many individuals needlessly turn the odds of success against them at this point with out having placed a single buy or sell order. Defining trends that are too short term in nature is the biggest single error. A shorter-term operation results in higher expenses and requires more time. It is also more difficult because the windows of opportunity in which trades need to be executed to be profitable are smaller. Therefore, the individual who lacks the experience, the time or the resources but chooses to follow a short-term path anyway is not likely to succeed.

Wyckoff analysis defines uptrends using a demand line and an overbought line. A downtrend is defined by a supply line and an oversold line. A trading range is defined by a support level and a resistance level. Figure 1 shows an example of a shorter-term downtrend using points 1 and 3 to define the supply line and point 2 to define the oversold line parallel to the supply line. Figure 2 shows an intermediate uptrend defined by lines cc and dd. It also shows an example of a longer-term uptrend defined by lines cc and ff. The mechanics of how these lines are defined and the variations that can be justified is a subject for a separate discussion. For now, all that is needed are examples to illustrate how the position in the current trend influences the probable future trend.

Bucking the trend

SHORTER-TERM DOWNTREND

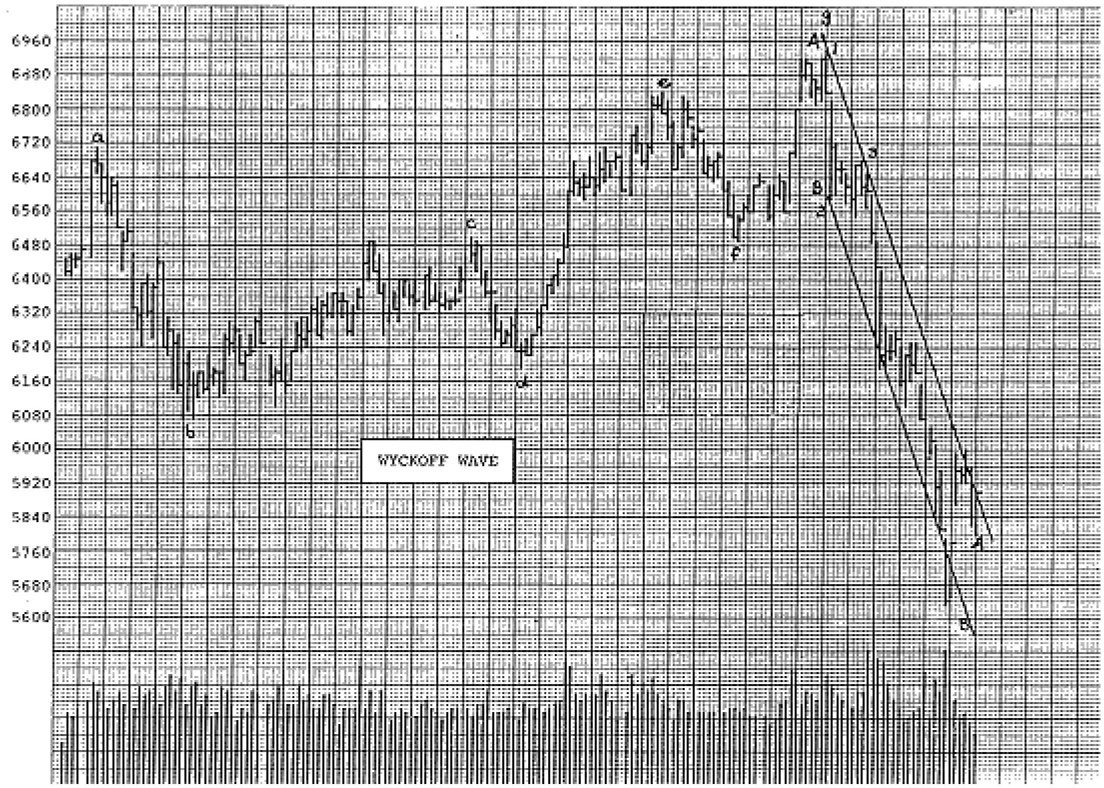


FIGURE 1: *The daily bar chart of the Wyckoff wave has a downtrend channel drawn on it. Line AA defines a supply line, while line BB is labeled as the oversold line. Short positions should be placed near the supply line. The position then offers the greatest amount of distance for downside progress.*

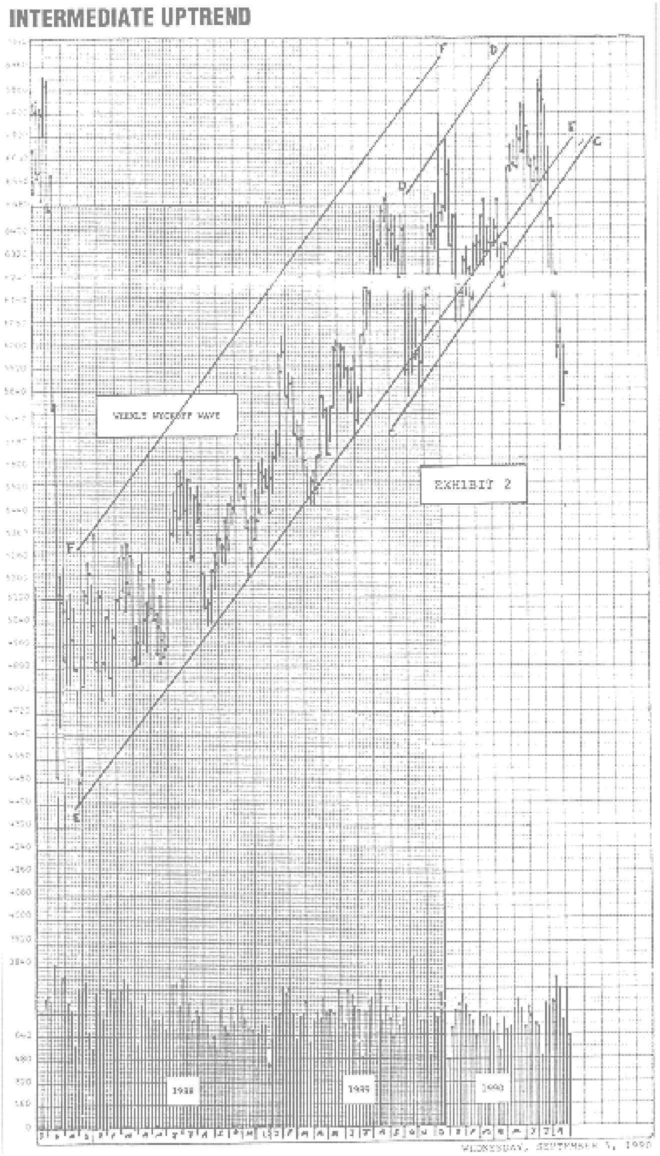


FIGURE 2: *The weekly bar chart of the Wyckoff wave shows two uptrend channels. The long-term uptrend channel is defined by the demand line EE and the overbought line by FF. The intermediate channel is defined by the demand line CC and the overbought line by DD. Purchases should be made when the market is near the demand line.*

Once a trend has been defined, the market will continue to trade within it until supply and demand factors change sufficiently to break the trend. The short-term trend defined in Figure 1 is most likely to continue if the market is positioned near the supply line. Since the line of least resistance has already been defined as being down, a position near the supply line provides the market with the greatest amount of distance in which to make additional downside progress before the support provided by the oversold line is reached. Therefore, if the market is positioned near the supply line and volume factors provide confirmation, it may be concluded that the probable future trend is also likely to be down. Consequently, action on the short side should be considered.

> **Defining trends that are too short term in nature is the biggest single error.**

As the market approaches and reaches the oversold line of the downtrend in Figure 1, the probable future trend becomes more doubtful. This is because the oversold line provides support, which can lead to a rally that may break the trend. If the trend is broken, the future trend may be a new downtrend, a trading range or an uptrend. Therefore, the uncertainty over the direction of the future trend discourages new action. If the market does rally away from the oversold line, it may meet supply again as it approaches the supply line. If so, the probable future trend is likely to be down and new action on the short side may be considered again.

In an uptrend such as the one defined by lines cc and dd in Figure 2, the situation is reversed. The uptrend that is defined by these lines is most likely to be the future trend as well if the market is positioned near the demand line. In this case, the line of least resistance is already pointed in an upward direction. Therefore, a position near the demand line provides the market with the greatest amount of room in which to make additional upside progress. Thus, action on the long side should be considered. As the market rallies in the trend and approaches the overbought line, the resistance provided by that line is increasingly likely to stop upside progress. This results in greater uncertainty about the future trend, which in turn discourages new action on the long side.

If the current trend of the market is not up or down, it is neutral or a trading range. Depending on the market's position in the trading range, it can provide opportunities on both the long and short side of the market. In a trading range, the market as a whole makes little if any additional upside or downside progress. An established high provides resistance to upside progress and an established low provides support to downside progress. A trading range in the general market is caused by relatively rapid rotation among the individual stocks. As a result, some stocks will make substantial advances as the market rallies in a trading range and others will make substantial declines as the market reacts. The process of rotation that occurs while the market is in a trading range results in opportunities on both the long side and the short side.

> **The points of greatest danger represent the points of minimum risk.**

If the trend of the market is neutral, the probability of the future trend also being neutral increases as the market approaches and reaches either the support level or the resistance level, providing volume factors give the necessary confirmation. As the market is stopped by the resistance at the top of the trading range, those stocks, which have been relatively weak to the market during the rally that produces a position at the top of the trading range, are most likely to provide the best participation on the downside as the market moves toward the bottom of the trading range. Therefore, these issues should be considered for positions on the short side. At the bottom of the trading range, those issues that have been relatively strong to the market should provide the best participation to the upside as the market moves back toward the top of the range. Therefore, these issues should be considered for positions on the long side.

Staking out a position

At this point, it should be clear that a position within an established trend that is most likely to benefit from the continuation of the trend represents the best opportunity for the investor or speculator. There are positions within an established trend that suggest the likelihood of a change in the direction of the trend. The Wyckoff method also addresses these. However, these positions are more complex and go beyond the limited scope of the discussion here.

The points I have outlined as the best trading opportunities are all considered danger points. They are points at which price movement in the direction of the trend, or in the opposite direction if the trend is a trading range, must begin or the trend will be violated. On the surface, establishing a position at a danger point might appear to be a crazy idea. However, the points of greatest danger represent the points of minimum risk. This means that the position is established at a point at which the smallest amount of movement possible in the wrong direction will clearly indicate that an error in judgment has been made. If so, the investor or trader can eliminate the position, preserve as much of his or her initial capital as possible and move on to another potential opportunity. Preservation of capital should be a foremost objective. The best way to accomplish this is to cut losses short and let profits run.

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Further reading

Hutson, Jack K. [1986-87] . Wyckoff series, *Technical Analysis of Stocks & Commodities*, Volumes 4-5.

Wyckoff, Richard D. [1931]. *The Richard D. Wyckoff Method of Trading and Investing in Stocks, Wyckoff Associates*,Park Ridge, IL.

THE WYCKOFF WAVE

To determine the current trend, the present position and probable future trend of the market, a means of charting the market's action to reveal the general direction of the trend is necessary. The general trend of the market is created by the interaction of the forces of supply and demand, which are reflected in the selling and buying pressures that cause stock prices to fluctuate. The total price movement is the general trend. The ideal approach to observing and measuring this movement is with a common stock price index. The Wyckoff Wave is such an index.

The Wyckoff Wave is not simply an average of stock prices; it is an index that serves as a miniature version of the entire market. The wave is composed of the intraday movement of eight individual stocks. Currently, these eight issues are:

Bristol Myers (BMY) General Motors (GM)
Dow Chemical (DOW) IBM (IBM)
Exxon (XON) Merrill Lynch (MER)
General Electric (GE) Union Pacific (UNP)

These stocks are all market leaders and are widely held, actively traded and participate in most market moves.

