Part 5: Wyckoff method of trading stocks

Prelude to individual charting reading

by Jack K. Hutson

Averages—both market and group averages—are essential to stock market analysis and your investment or trading strategy with the Richard D. Wyckoff Method. But the true test of analysis begins when we move from market and group averages into the third stage of chart interpretation—the charts of individual stocks.

This is where a trader/investor absolutely must learn the fine points of market operation and technical indicators. There's no more "averaging" here, no margin for sloppy interpretation. Your money and, yes, your reputation are now on the line.

Unlike averages, stocks have personalities that can be unique. One stock may be a large investor's personal favorite, another may be the object of competition, and then there's always the forgotten waif waiting for the chance to show its stuff. But the beauty of the Wyckoff Method is that it discerns these personalities and shows an investor/trader how to anticipate individual moods and reactions.

It does this because the charts of individual stocks are like the graphic waves on an oscilloscope screen. Both are windows into events we can't actually see as they're taking place. An oscilloscope doesn't show us individual electrons bouncing through a circuit, and a vertical chart doesn't peer into the offices of influential traders and investors. But if we know how to read them, both will show us where and how the influence— either electrical or monetary—is headed.

It's critical, therefore, that you completely understand how operators with large amounts of capital work the market. They have the time to investigate individual stocks and the capital to make things happen. What you're aiming to do is ride piggyback on their moves and share in the profits they intend to make for themselves.

When a large operator decides there's worthwhile profitability in a stock, you can pretty well divide the campaign into four phases that take place through both advancing and declining markets.

First there's "accumulation," the period of manipulation where an operator will bid low, gradually buy and sell, and buy again to acquire a line of stock at the lowest possible prices. The "marking up" phase follows when the operator ceases manipulations that kept prices low and allows the price to rise or gives it a push with well-placed bids. The operator acts as the issue's buying underwriter.

Once the public is aware of the "hot," rising stock, it's time for "distribution," or selling the line of stock. As prices peak the operator may start "marking down" in preparation for a decline in the stock's price and the chance to make profits using short sales.

You can look at this manipulative process as a kind of investment "physics." The investment forces are supply and demand, and they can be pent up and released just like physical forces.

During the accumulation phase, a stock stores up the force of demand—supply grows scarce, demand builds, and this gives price the power to rise during the marking up period and the momentum to keep rising before distribution sets in.

Distribution reverses the forces of supply and demand. As the operator puts the line of accumulated stock on the market, demand is assuaged and the power balance shifts in favor of marking down. In marking down, price falls until selling out momentum is exhausted or a fresh force of demand overcomes it.

Interpreting and understanding these phases as they unfold on a chart can only be accomplished when price and volume are considered together.

Price vs. volume studies

Price, alone, tells the analyst what the stock's present technical position is and where the trend is probably headed. Volume determines the trend with more accuracy, and detects turning points when to open or close trades, and when to change stop orders. Together, they form a complete picture.

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Price and volume are linked much like a car and gasoline. Volume is to price what gasoline is to a car. The more gas you feed a car, the greater its momentum. Put in the clutch and the car coasts on its accumulated power. Give the accelerator just a tap, and the car doesn't roll as far.

Likewise, volume that expands consistently, growing larger and larger with public participation, gives price a momentum that's not readily reversed. Even when large operators stop their manipulations, the momentum of public participation carries on the price trend. But a temporary volume increase, like a tap on an accelerator, gives price a little boost that dies out quickly.

Price-volume relationships are not fixed; there are too many exceptions in the stock market. A Wyckoff analyst knows there are no unshakable rules, no absolutely reproducible results. The Wyckoff analyst develops a "feel" for price-volume relationships the same way you develop a "feel" for your car's handling, and learns how to interpret present signals from the behaviors of the past.

When a Wyckoff analyst looks at the current price of a stock, he or she immediately compares it to previous prices where buyers supported a declining price or resisted paying more for an advancing stock. Whether or not a stock price can breach these support or resistance points is an essential clue to its future performance, and the support or resistance prices, themselves, are the "danger points" that dictate where the stop orders should be placed.

Another essential test is how far a price drops during a reaction (the temporary decline after a bull market advance) or how far a price rises during a rally (the temporary advance after a bear market decline). This movement determines a stock's technical strength or weakness and, thus, its ability to continue its trend.

A "normal" reaction is half the distance of an advance. For example, after a 10-point advance, a normal reaction would be five points. Less than five points says the stock is in strong hands and likely to continue its climb. More than five points says the stock is in weak hands and the trend may be fading.

Conversely, after a 10-point decline, a less-than-5-point rally indicates technical weakness and a greater-than-5-point rally shows technical strength.

The analyst reading the vertical chart also is gauging the rate of price acceleration or deceleration, and is looking for sudden, sharp up or down movements (called thrusts and shakeouts) or a price that stops oscillating and comes to "dead center."

This dead center or "hinge" price tells the analyst the stock may very well be "on the springboard," which is the best time of all to buy into a stock. When a stock is on the springboard it's ready for sharp and immediate action. Entry into the market here makes most efficient use of your capital. The stock is no longer dilly-dallying around. It's ready to take off.

Springboards occur at the bottom of a range of accumulation or in the upper levels of a range of distribution.

Charts of individual stocks are like the graphic waves on an oscilloscope screen.

On the bull side, this means a springboard will show up after the price has stayed in a trading range—either because a previous advance is being "consolidated" or "digested" or a new mark-up is under way. Usually, a springboard occurs at the bottom of a decline during the consolidation period because this is where operators are more likely to want to accumulate the stock for a bull campaign.

On the bear side, a stock is said to be on the springboard after preparations for distribution. A springboard will become evident after the price has declined and then stayed in a range. The springboard comes at the top of an advance during this preparation, a precursor of further distribution and plunging prices.

When a rising price tends to flatten out or "arch over ' demand is dying or encountering a greater force of supply. When a declining price levels off or "rounds upward" it's telling the analyst supply is petering out.

Of course, volume studies will confirm or deny these price clues and volume also is judged against its past behavior. The sheer magnitude of a stock on the market is not what draws an analyst's attention, but rather if the current volume magnitude is significantly different from preceding volumes.

A gradual volume buildup says the public is coming into an advancing market or leaving a declining one. Gradual volume growth is like a steadily pressed accelerator and gives price its momentum to continue advancing or declining.

An abnormally large and swift volume expansion during an advance or decline marks a turning point that's either temporary or lasting, depending on the stock's technical position.

A small volume, on the other hand, is like the end of a chapter in a book: a new chapter will begin sooner or later. Where the small volume occurs is the clue to the next phase.

A small volume at the bottom of a decline of any size says selling is drying up and taking pressure off the decline. For example, when volume narrows and continues to fade away during a reaction, it says not much of the stock is for sale even at lower prices and the price should resume its advance.

Light volume at the top of a rally or a rise in price is often bearish because it says demand has been filled and without active demand, price goes lower.

But again, these are generalities. A stock's behavior has to be judged against its history, its unique

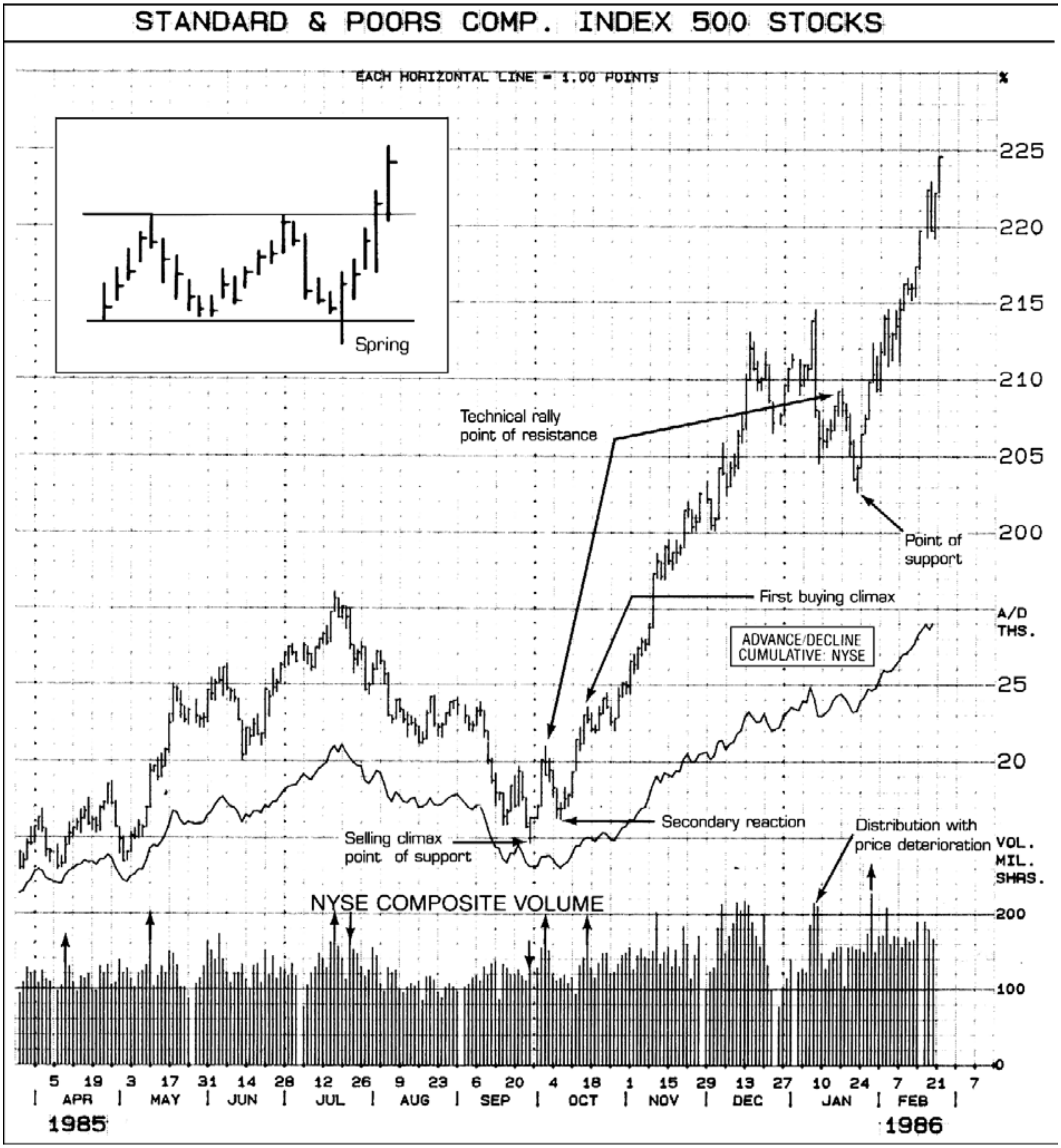

FIGURE 1. Typical bear market intermediate trend cycle followed by a strong bull market intermediate trend cycle. Each of these major (bull or bear) is separated by a short corrective phase.

Chart by Commodity Research Bureau, 75 Montgomery St., Jersey City, NJ 07302 personality. Isolating incidents on a chart and applying "rules" to them invariably leads to disappointing results. The best teacher is charting the market, its groups and individual stocks without actually trading or investing (paper-trading). The nuances of price-volume relationships will unfold as your charts take shape and the experience will clearly register the concepts in your mind.

You shouldn't feel as though you must instantly recognize a campaign. Accumulation doesn't occur overnight. It takes considerable preparation to buy thousands or hundreds of thousands of shares without alerting every trader on the floor to what's going on and sending prices sky high.

The campaign

Usually, a large operator who finds reason to accumulate a stock tries to make that issue look unattractive by bidding low, buying a portion, offering part of that for sale, and finally buying more shares back. Accumulation comes across on vertical charts as a "congestion area" where prices stay in a certain range, moving "sideways" across the chart and showing no tendency to take off in either direction, accompanied by consistently low volume.

The prolonged process may even include some drastic downturns to shake stocks out of tight-fisted owners' hands and into the operators' portfolio. The intentionally cloudy signals may not come into sharp focus until weeks or months have passed.

When the operator has all of the targeted stock in hand, the stage is set to "mark up" the price. This may be done gradually or swiftly, timed to coincide with favorable news from the corporation issuing the stock or let loose as the market takes off. Essentially, in marking up, the operator ceases the buying and selling gambit that kept prices depressed and lets outside demand begin to take over. On a vertical chart, marking up is a series of fast price upthrusts alternating with momentary plateaus or "resting spells, ' and accompanied by rising volume.

The initial demand almost always comes from professional traders and investors because they are closest to the market. But to really reach a profit objective, an operator has to attract public attention and public buying. So distributing, or selling the accumulated line of stock, calls for manipulation, too.

Here, the operator uses the same kind of tactics—buying and selling from the accumulated line to give the stock an appearance of strength that induces public buyers into the market. The price can be marked up more than once and a return of the characteristic "congestion area" on the vertical chart is evidence of important distributive selling. At the climax of distribution, a congestion area can signal that the move is ending and the operator is going short.

When an operator has unloaded the accumulated line, the stock is said to be "technically weak" or "overbought." Saying it's in "weak" hands means it's held mainly by public buyers who got in during or at the top of rising prices and can't or won't hang onto the stock when the price doesn't surge again. An overbought condition is especially prevalent when the price rises too rapidly and without corrective reactions or resting spells. In this condition, the price becomes sensitive to sales and the withdrawal of experienced buyers.

As we said before, when distribution is over, the operator again makes the price swing back and forth in a certain range or congestion area, to fool the public into thinking the stock is waiting to take off again, while the operator takes a short position. Seeing that it's advantageous to "mark down" the price, the operator ceases the supporting manipulations, the professionals raid the stock and the operator covers the short sales.

Once accomplished, the stock is said to be "technically strong" or "oversold." All those who could be induced to sell have done so, and the stock is in hands of experienced operators.

Glossary:

Supply and demand– Prices rise when buyer demand exceeds seller supply, and *vice versa*–when supply and demand are balanced, price fluctuates in a range.

Technical position– Refers to the ability of stock owners to hold onto their purchases. A stock is technically weak when it's mainly held by the public who can't or won't hold onto it. A stock is technically strong when held mainly by large-scale trader/investors who have the ability to ride out cyclical behavior.

Oversold position– In effect, when liquidation is temporarily or permanently finished. Usually occurs at the end of a big decline or the last stages of a decline–all those who could be induced to sell have done so, stocks are in the hands of experienced operators; sellers weak, buyers strong and able to carry what they have bought through any further declines; amateur shorts still hanging in at the end of decline are a bullish factor because they have to buy back (cover) what they sold short.

Oversold– Doesn't have corrective rallies or resting spells during a down swing, too rapid reaction or declineÑprice becomes highly sensitive to short covering and withdrawal of experienced sellers.

Overbought– Too rapid acceleration of rally or advance, lack of corrective reactions or resting spells during an advance-price sensitive to sales and withdrawal of experienced buyers.

Reaction normally half a rise– Not a must, just a reference point for technical strength or weakness (less than half is strong, more than half is weak).

Springboard– Best time of all to get long or short into the stock, when it is ready for a plunge or a rise. On the bull side, this follows period of preparation, usually at the bottom of a declineÑthe greater the decline, the more likely operators will accumulate it for a bull campaignÑor can be after price in trading range after consolidation of previous advance in preparation for a new mark-upÑon the bear side, follows preparation for distribution; occurs at the top of an advance and after price has been in a range after a decline in which further distribution will take place before a new plunge.

The beginning of a springboard is at bottom of range of accumulation or in upper level of range of distribution (not when it breaks old line of resistance or support).


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