# *Wyckoff method of trading stocks part 4*

# Understanding group stock behavior

***by Jack K. Hutson***

The Richard D. Wyckoff method of trading brings the technical analyst a clean, logical way to understand stock market behavior and to anticipate the most opportune trading and investment moments. The Wyckoff analyst begins with charts of a broad composite market average, overlays charts of industry group averages and then, when that information is weighed, compares the trends and critical turning points to the charts of individual stocks within the industry group.

Analyzing group averages is a vital step, because to go after individual stocks willy-nilly, without a plan of action, is to invite disaster or, at the very least, less-than-peak use of investment capital. Group behavior guides a trader to the appropriate section of the market where individual stocks should be selected.

Group averages compared against broad market trends will show you where large-scale traders see something promising and are trading accordingly. By using these signals to make well-timed long or short trades in conjunction with the safety of stop orders, you can make both the up and down sides of the stock market profitable.

In a bull market, the Wyckoff analyst looks for group averages that are "strong" when the composite average hits "weak" spots. A strong group average resists dropping when the composite average hits a downwave. This resistance signifies the group should be the fastest and highest rebounder when the market comes out of its slump. Looking behind the scenes, the resistance says the professional, large-scale operators are buying shares in this group while the market is relatively low because they anticipate significant gains in the future.

In a bear market, the best choice for selling short becomes a group that is "weak" when the market makes a rebound. The weak group is characterized by its feeble response to the composite average's rallies. The weakness indicates the professionals know something to the group's disadvantage and are forcing shares on the market or testing the market to see if it can absorb a large volume of shares. In either case, the group's inability to rally along with the market targets it as a candidate for further declines and a place where short orders seem logical.

The testing in which large operators engage allows them to directly find out whether buying or selling is easiest in the current market. This, of course, involves moving thousands of shares on or off the market. Since few individuals have the resources to run this sort of test, the best option is to look for signs of the operators' presence in the composite and group averages, decide whether they anticipate buying or selling, and follow in their footsteps.

In your composite and group comparisons you want to find the leading groups that will move first, fastest, and farthest. You aim to buy long in groups that resist the pull of bull market downwaves because this is where professionals are buying in anticipation of future upturns. You want to place short orders in groups that resist advancing when a bear market turns upward because the pros either see trouble on the horizon or the chance to buy in later at lower prices.

**Process of Rotation**

This is not to say that just any stock in a favored group will yield the results you want. Just as groups do not rise and fall in harmony, neither do individual stocks. One group or stock may be leading the way up or down while another is still preparing to move. When the leading group or stock meets resistance that stymies its progress, the demand for buying or supply for selling will shift to another group or stock. This is the Process of Rotation that large-scale operators use to their advantage and also explains why dealing in the leaders will still leave time to catch the not-so-aggressive issues.

Wyckoff's Process of Rotation is based on the fact that all stocks do not move together at all times or in agreement with prevailing trend. He observed that bull markets normally advance with high-priced, blue chip stocks as their leaders. These represent the more stable, financially solvent, and widely held stocks. Large operators include well-heeled individuals, insurance companies, corporations, as well as fund managers. These big interests can well afford the effort to examine a great deal of fundamental news information as well as the technical analysis tools and the money to price test the market. As the larger interest operators coax the price of the blue chip market leaders upwards, the smaller, independent operators start to influence other issues that are more in line with their smaller financial ability to underwrite. Eventually, the general public will be attracted by this seemingly across-the-board bullish activity and be interested in lower priced and more speculative issues. This is an example of the Process of Rotation and an explanation of why the blue chip stocks tend to lead such issues as over-the-counter stocks.

**Group averages compared against market trends will show you where large-scale traders see something promising and are trading accordingly.**

The Process of Rotation operates much the same way in bull and bear markets. In a bull market, a group may advance more rapidly than the market, then rest and go through a technical reaction. Demand then shifts to other groups making their advances. This explains why a group that has gone through a prolonged rise will begin a mixed price movement. Large-scale professionals are winding up their campaigns because they feel the group has reached its maximum profitability and are turning their attention to the laggards that still have room for advancement.

Supply moves similarly through groups in a bear market— only faster. This is because profit-taking retards upward movement in a bull market, but in a falling market the many untrained investors that make up the public hang onto their stocks until their last shred of hope is gone and then they rush in to sell their stocks without regard to value.

Let's take a look at how large-scale traders capable of influencing the market can use the Process of Rotation to their advantage. One way rotation aids large operators is by camouflaging their campaigns. When a stock leading the way in a falling market hits a turning point, the Process of Rotation states that selling will move to other groups and issues. Traders may then buy back previously sold out leading stocks, under the guise of rotational weakness, without bidding up prices. This professional buy back occurs as the public gets out in panic or stays out of the market altogether.

  

## Actually measuring the bullish strength or bearish weakness in a group requires attention to points of resistance and support.

Conversely, when a stock leading the way in a rising market comes to a turning point, the rotation of demand enables large traders to unload their other stocks under the cover of this rotational activity without forcing sales on the market and letting the air out of prices.

Professionals with the clout of large volumes also may keep their campaigns alive by invoking the Process of Rotation. They rapidly bid up prices of easily influenced stocks to keep the public in a buoyant, buying mood. You'll know when they've exhausted market demand because stocks respond sluggishly or fall back quickly after a leader has been "whooped up." Similarly, you can recognize when supply in a falling market is losing ground if the leader refuses to move lower as selling rotates to other stocks.

The Process of Rotation also helps explain why certain groups will be more bullish or bearish than their counterparts. But actually measuring the bullish strength or bearish weakness in a group requires attention to points of resistance and support.

To illustrate, a typical group in an advancing market may rise faster and/or higher than the composite average, then hit a normal period of leveling off (a "period of consolidation" or "hesitation"), followed by a reaction that drops the group average toward its previous low point. If the composite also is dropping and the group holds itself above or around the previous low, the group is signaling strength and should be a leader when the composite resumes its upwave.

On the composite average's upwave, the group may reach new highs, but even more informative is the way the group handles itself during successive downwaves. An ascending line of low points is particularly noteworthy of strength. A tendency to react less than the market on a downwave also distinguishes technical corrections from the beginning of a bear trend and could be marking a turning point that other groups will join as the Process of Rotation works through them.

Sooner or later, however, the Process of Rotation catches up with the group and it loses its bullish strength. A frequent signal that a group is switching from strength to weakness is a more extensive drop during a technical reaction than the group has experienced before. When that drop is followed by a sluggish rally and a lower top in the face of a rising composite average, it pretty well confirms the switch.

Although demand in this one group has been played out, other groups can still be advancing or holding steady to offer more investment and trading opportunities. Of course, if the bull market continues long enough, the original, leading group can even rotate back into favor.

How long the rotational process continues depends on how long the market can sustain its trend—and groups will give early warning signals about that, too. If one group's deep reaction and sluggish rally signals it is losing strength, then the sluggish response of all or most groups to the composite average's upwaves is a sign the entire market is turning bearish.

Even facing a bear market, a trader/investor knows the Process of Rotation will continue to operate, although at a faster pace. By simply reversing the technical considerations learned in a bull market, the trader has ample tools to make the best of the short side.

  

Always keep the Process of Rotation in mind while using the comparative power of group and composite charts. Make it a point never to get so caught up in comparing group leaders to the market that you ignore what the lagging groups are trying to tell you. Ignoring how the laggards are meeting their points of support and resistance can not only mean missed trading opportunities, but also missed warning signals about the market trend and the validity of your overall strategy.

### GLOSSARY:

**Composite average—**Composite broad-based average examples are Standard & Poor's (S&P) 500, Value Line, Wilshire 5000.

**Group average—**Includes such entities as the Dow Jones 30 Industrials "30 stocks ' Transportation Index, and Utilities. Group averages are often grouped by industry, such as aerospace, steel, airlines, etc.

**Turning Point—**The time when a rising market (rally) or a declining market (reaction) has *halted* and is about to reverse.

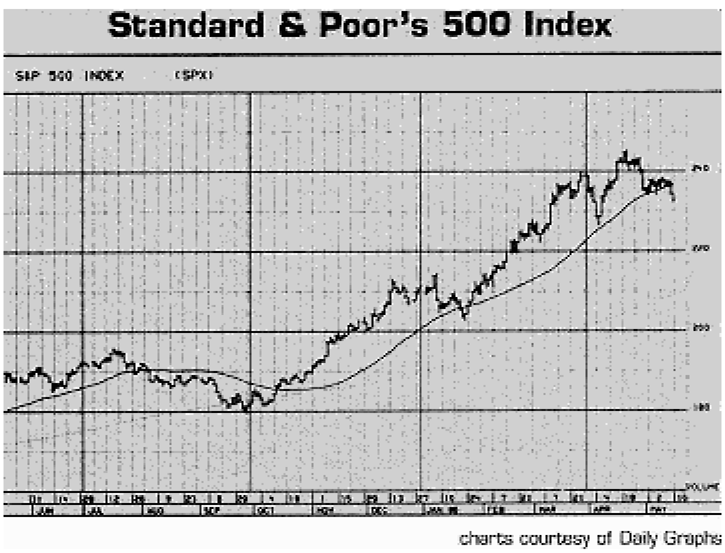


**FIGURE 1:**

  

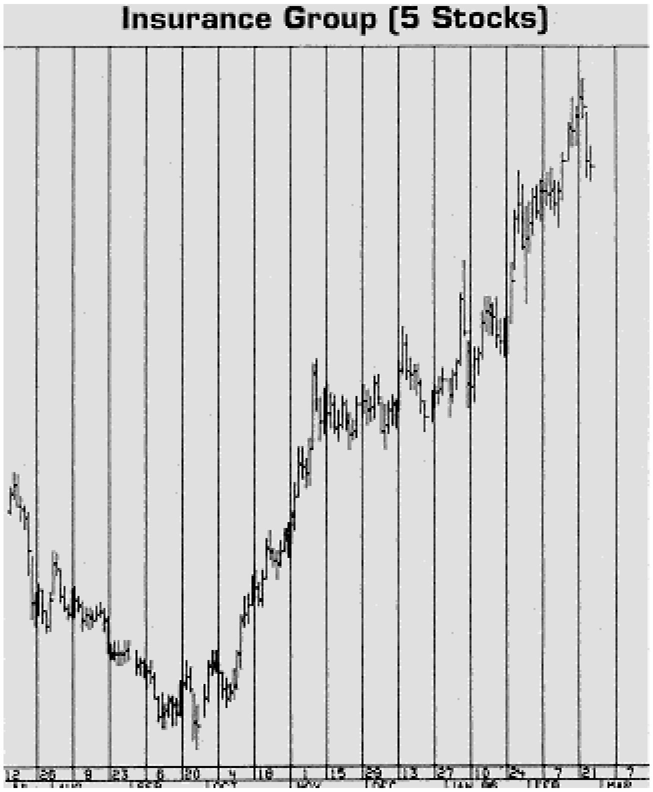


**FIGURE 2:**

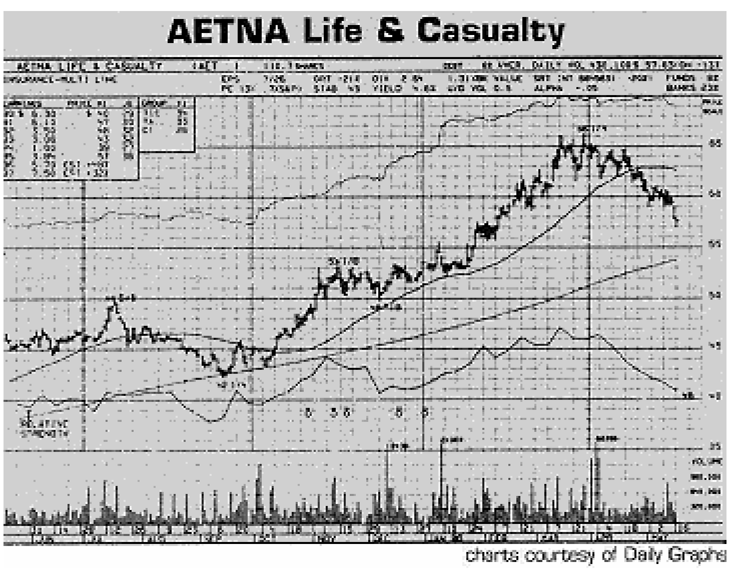


**FIGURE 3:**