Wyckoff: Buying And Selling Tests

by Craig F. Schroeder

In the Richard D. Wyckoff method on stock market science and techniques, the fourth step of his approach is explained thus: Determine each stock's readiness to move, then analyze the vertical line chart and figure chart of the candidates previously selected by the use of buying and selling tests.

The first three steps of the Wyckoff method are simple and easy to apply. Step four can also be simply stated. Hidden behind the simplicity in this case, however, is a wide range of considerations to be addressed, most of which require the use of an element that is much less of a factor when applying any of the first three steps: good judgment, which must be developed through practice and cannot be learned from a book. What *can* be learned are tools that can aid in the development of good judgment. These are the focus of step four of the Wyckoff method.

READY OR NOT

Whether a stock is ready to move is determined by its current position compared with the previous action and the kind of action that has brought it there. With few exceptions, positions that appear ready to move occur at or near the completion of reactions or rallies. A stock will indicate a readiness to rise as it completes a reaction and it will indicate a readiness to drop as it completes a rally.

The necessarily brief nature of this article does not allow an explanation of all the finer points that must be considered in the fourth step of the Wyckoff method. But several points can be presented and put to work immediately with steps one through three: position and nature of action.

The nature of the action, which is determined by relating price and volume action, is a good indicator of when direction is likely to change. Being able to read the character of the action will help in taking a position closer to the completion of a rally or reaction than would otherwise be possible.

When a stock is rallying, demand is in control; good quality or increasing demand will tend to keep the rally going. If applying the first three steps of the Wyckoff method have revealed the stock to be a potential short candidate, the object at this point is to determine when demand will lose control on a rally. The loss of control will coincide with the completion of the rally and the best time and place to take action on the short side.

During a rally, the presence and quality of demand are indicated by wider daily price spreads from the low to the high, increasing volume from day to day resulting in strong closes and increasing amounts of net upside progress from day to day (Figure 1). As long as these factors continue, the stock is said to be controlled by good quality and increasing demand. As a result, the rally should continue and there is no indication that it is near completion. Thus, action on the short side should be postponed, even if the stock appears to be an especially good short candidate.

No matter how strong a rally is, the demand that fuels it cannot be unlimited. At some point, the factors mentioned above will deteriorate, and as this occurs, the rally's completion draws closer. Instead of wider price spreads and increasing net upside progress from day to day, price spreads narrow and less progress is made. At this point, one of two things is happening: The stock is either meeting supply, which is trying to assume control, or the stock's demand is diminishing.

Knowing which process is underway is important. A determination can be made from the volume; increasing volume combined with narrower price spreads and less net upside progress as a rally progresses indicates that demand is being met by supply (Figure 2). Decreasing volume combined with narrower spreads and less progress, on the other hand, signals that demand is diminishing (Figure 3). Both provide warnings that the rally is nearly completed. Therefore, action on the short side may be considered. As a rule, ample supply should be considered to be a more negative indication than diminishing demand. If a rally is being stopped by supply being met, that means that supply is actually taking control of the stock away from demand, which is likely to result in a bigger decline after the rally has been completed. If a rally is being stopped by a withdrawal of demand, however, then supply is not automatically in control; the buyers in question are simply saying that at progressively higher prices they are progressively less willing to participate at this time. The buyers may return to the market when prices are somewhat lower, or their willingness to pay the current price may increase if the stock holds its gains following a withdrawal of demand.

THE IMPORTANCE OF JUDGMENT

Unfortunately, no single set of price spread, net progress and volume can be used to indicate a rally's completion . Judgment becomes very important at this point. For example, if two stocks have both been identified as potential short candidates and both appear to be equally weak to the market with the same proportion of downside potential, good judgment dictates the selection of the one that is meeting supply at the top of a rally rather than the one that is completing its rally because demand is diminishing. In this example, judgment is relatively limited due to all factors but one being the same. In the real world, opportunities are less likely to develop in such a clear-cut manner.

Among the stocks that are meeting supply, some may be stopped immediately, while others continue to

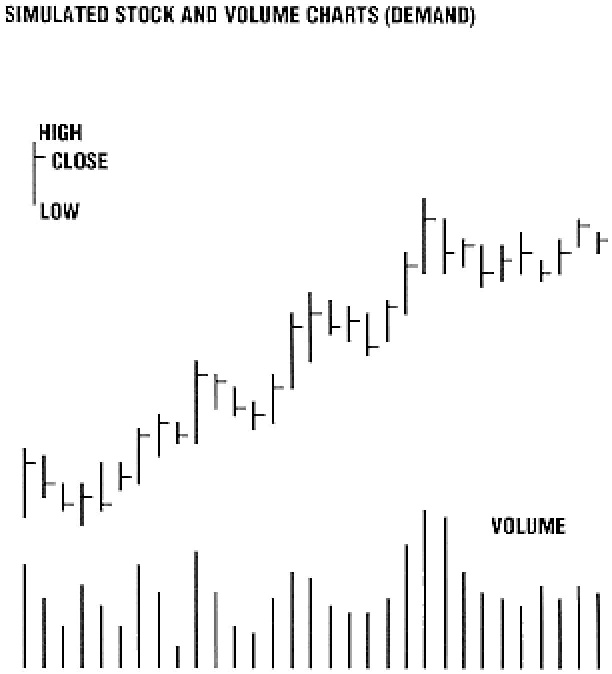

FIGURE 1: *During an advance, good quality or increasing demand will tend to keep the rally going. The price range for the day will be large and the close will be the high for the day. The volume is greater on up days than the days where the market traded down.*

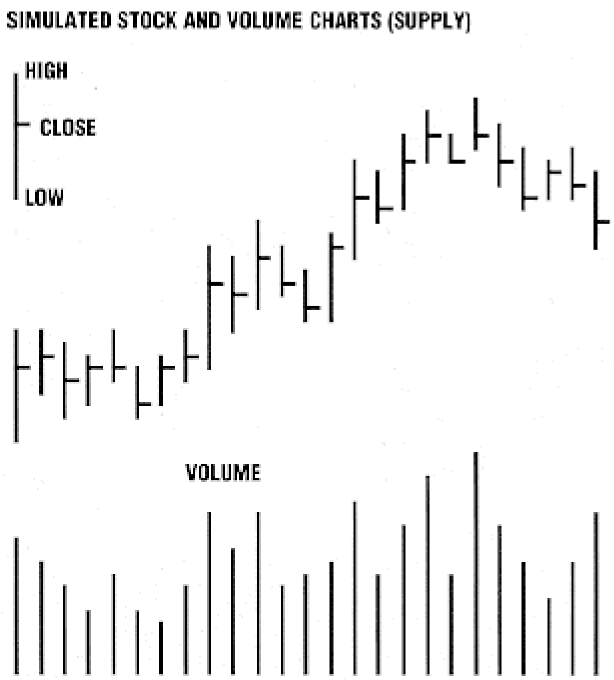

FIGURE 2: *Witnessing the daily trading ranges becoming smaller with increasing volume during an advance indicates that demand is being met by supply. Signs of increasing supply is a negative indication.*

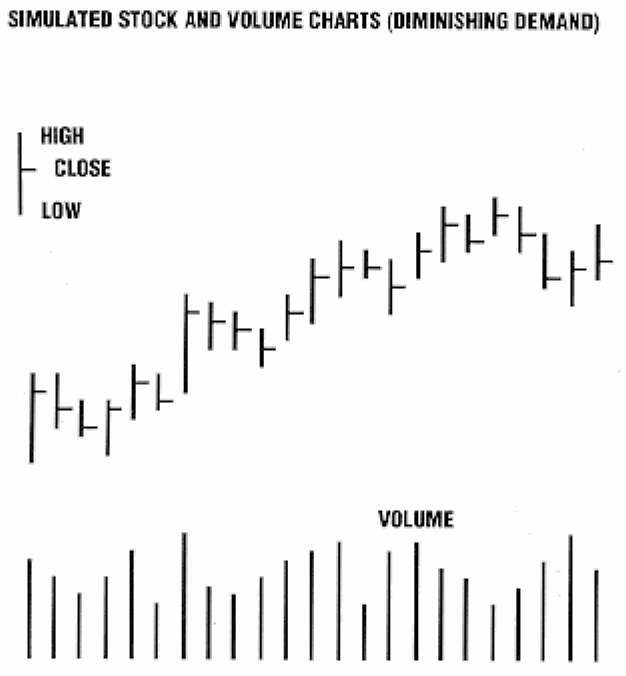

FIGURE 3: *A sign of diminishing demand is decreasing volume and narrowing daily price ranges during an advance.*

rally for several days until supply finally overwhelms demand. Judging each stock's relative weakness and downside potential may result in selecting an issue for a short position that continues to rally for several days after the position is established. The rally's continuation does not necessarily indicate poor judgment as long as the potential is sufficient to allow the proper placing of a stop order, allowing some continued upside progress.

Just as the action on a rally can indicate its completion and an opportunity on the short side, it can also signal the completion of a reaction. Supply controls a reaction. Increasing supply is reflected by widening price spread to the downside, increasing amounts of net downside progress and increasing volume. Like demand, supply is not unlimited; at some point, that supply will be withdrawn (Figure 4), or demand will overwhelm it. When the daily action indicates that one of these two processes is underway, it is time to seriously consider action on the long side.

Not every change of character in the action should be viewed as a potential trading opportunity, however. This is where the current position in relation to previous action becomes important. For example, consider a stock that is in a previously defined uptrend. The stock is relatively strong to the market and has a high enough objective to still be considered a candidate for a long position. The fact that the stock is in a well-defined uptrend indicates a readiness to move. However, this is not the readiness to move that is addressed in step four of the Wyckoff method.

> **The student of the Wyckoff method who chooses to limit him- or herself to stocks that are ready to move and that are already in defined up- or downtrends will do very well over time.**

As a stock advances in an uptrend, it is normal for it to correct each small phase of the advance as it goes. At some point, it is normal to see the entire advance corrected. For the trader, the correction of each small phase of the advance is an opportunity on the long side. Wyckoff states that it is normal for a stock to correct to the vicinity of the halfway point of the move being corrected; this can be anywhere from a third to a two-thirds correction. When this zone is reached, begin watching the price and volume action more closely. Look for signs of demand being met or supply being withdrawn. Such action here calls for the consideration of new action on the long side.

STUDYING THE HALFWAY POINT

The longer-term investor can also use this concept of establishing positions near the halfway point. In this case, however, a broader perspective is necessary. Instead of trying to enter a position on the corrections of a minor phase of an extended advance, the investor should look for the correction of the entire advance to that point. When the correction is near the halfway point, it is time to start monitoring the price and volume action more closely. Again, the object is to identify either supply being met or demand being withdrawn. Note that this process is now being viewed on a broader scale; here it is likely that the indication given will not come from just two or three days' worth of action and more likely to be spread over a week or longer. Deciding whether to act comes from judging the character of the action as a whole near the halfway point. This example refers only to the long side; similar but opposing considerations must be addressed for the short side.

The student of the Wyckoff method who chooses to limit him- or herself to stocks that are ready to move

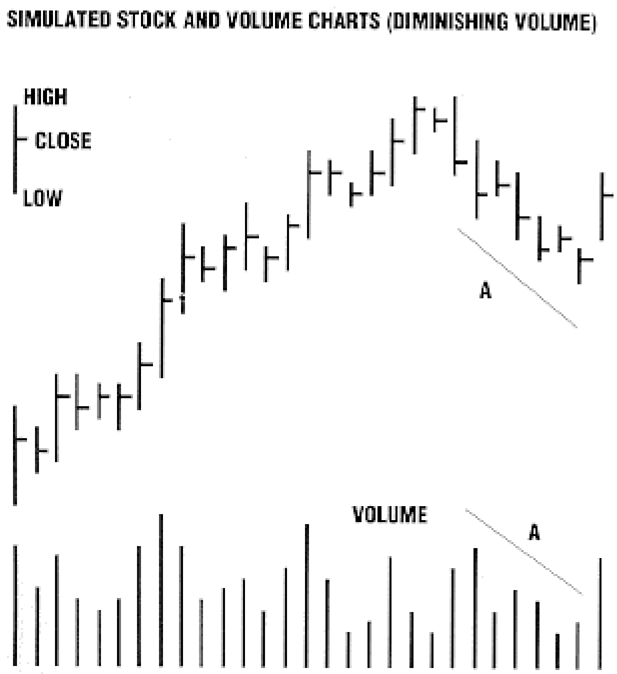

FIGURE 4: *The declining prices along with diminishing volume indicates that supply is being withdrawn. A rally typically follows this situation.*

and that are already in defined up- or downtrends will do very well over time. However, this individual will need more than a little patience. Normally, stock action will spend more time in trading ranges than in either uptrends or downtrends. Thus, waiting for the completion of normal trend corrections is going to result in extended periods between trading opportunities. There is nothing wrong with waiting; however, for those who wish to expand their profit potential and increase the number of trading opportunities, there is the trading range action. Readiness to move with respect to trading range action can be divided into two categories: There is action that indicates a readiness to move from the bottom of a trading range to the top or from the top to the bottom, and there is also action that indicates a readiness to leave the trading range altogether and begin trending.

EXTENDED TRADING RANGE ACTION

For many investors and speculators, extended trading range action is the most frustrating of all. The common error is to view every rally as a likely breakout to the upside and every reaction as a breakout to the downside. From a profit standpoint, the result is a constant give-and-take, with the market doing both the giving and the taking. Frequently, the investor ends up with very little profit, or in worst cases less capital than when the started. Two preliminary steps can help avoid this: One is to avoid initiating any new action in the middle of a trading range, and the second is to approach every rally or reaction within a trading range with the idea that is going to be confined by the limits of the trading range.

The wisdom of avoiding new positions in the middle of a trading range should be obvious, but many fall victim to this error in their desire to remain active in the market. A trading range is a limited amount of vertical space; therefore, taking a position in the middle of the range automatically cuts the potential profit in half unless the selected reaction or rally is the one that leads to the breakout. This particular rule on avoiding the middle of the trading range becomes easier to apply if the area to avoid is specifically outlined. One way to do so is to divide the trading range vertically into thirds, with the middle third the one to avoid. Another approach is to divide the range into quarters and avoid the middle two. This approach will result in fewer trading opportunities, but those that do develop should have greater profit potential.

Consider next the stock that is in a trading range exactly six points wide. The point and a half just above the bottom of the trading range is the area in which to consider long positions. The one and a half points of the top of the trading range is the area in which to consider short positions. It is reasonable to expect the stock to rally from the lower quarter to the upper quarter of the range and to react from the upper quarter to the lower quarter. Therefore, a move of four and a half points may be anticipated. The use of a 3-to-1 profit/risk ratio in this case calls for a stop order placed one and a half points above or below the entry price. If the stock is in the upper or lower quarter of the range when the position is established, the stop will be outside the limits of the range, making it less vulnerable to being triggered except where the stock is actually leaving the range. In such cases, being stopped out should be welcome, especially if the investor has been able to ride the stock up and down several times within the range.

Trading range action is such that many stocks will at some point penetrate the support or resistance level of a trading range without achieving a breakout. For the range trader, these instances can be especially frustrating, since the likelihood of being stopped out is good just before a move in the anticipated direction begins. Frequently, these penetrations of support and resistance that do not lead to immediate breakouts are followed by price movement in the opposite direction. Wyckoff refers to these as spring and upthrust actions.

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Some stocks move independently of the general market. Most, however, move with it. This is what makes a fifth and final step to the Wyckoff method necessary. The investor who chooses to act only on the basis of the first four steps takes a greater risk than is necessary; he risks trading against the market, which usually results in a loss. In addition, the risk of being premature is greater, frequently resulting in being stopped out just before the anticipated move gets underway. The fifth step, which I will consider next, tells the investor to time positions in individual stocks to anticipated turns in the general market.

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