

Wyckoff: Identifying Opportunities

by Craig F. Schroeder



Completing the first two steps of the Wyckoff method provides the investor or speculator with information that is essential for success. At this point, he or she knows whether to consider establishing long positions for an anticipated advance or short positions for a projected decline. In addition, he has a group of candidates from which to select the issues in which positions will be established. The next two steps of the Wyckoff method provide the basis for identifying the best opportunities from among the group of potential candidates.

CAUSE AND SELECT

Step 3 of the Wyckoff method involves selecting those stocks that have built up a cause in keeping with your goals. Many aspects of the Wyckoff approach employ the concept of cause and effect. In this step, the concept is applied using a point & figure chart. A cause on a point & figure chart is identified as a horizontal buildup of postings that develops at one particular level or over a relatively narrow range while the stock or the market as a whole is in a trading range. The cause is measured by the number of divisions that it covers on the point & figure chart. Figure 1, which is a point & figure chart of Bristol-Myers, shows a cause at the 52 level.

The chart of Bristol-Myers begins on January 1, 1990. It shows that a trading range developed in January and lasted until April. During this period, the stock traded in a range from a low of approximately 51 to a high of approximately 55. The 52 level is selected as the level at which to measure the potential because it represents the bottom of the last reaction before the stock broke out of the trading range to the upside. Measuring from right to left, the trading range occupies 17 divisions on the chart. Therefore, the stock is said to have a count of 17 points at the 52 level, which represents its cause or potential. The 17-point

BRISTOL-MYERS
Point & Figure Chart

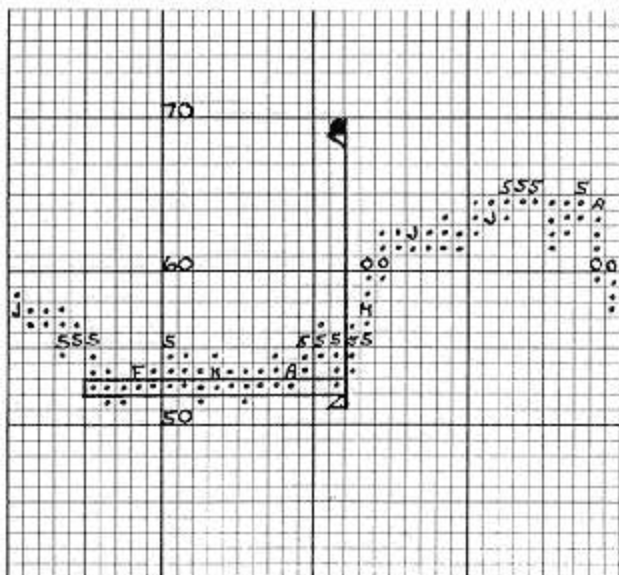


FIGURE 1: *The 52 level is selected as the level at which to measure the potential move because it represents the bottom of the last reaction.*

horizontal cause indicates the likelihood of a 17-point vertical effect. In this case, the 17-point potential cause is added to the level at which it is measured and to the low point of the trading range, resulting in an objective range of 68 to 69. The stock's own action is indicating the possibility of a move to the 68 or 69 level, which is equal to about 33% of the value at the count level.

Why should there be a relationship between the length of time that a stock takes to move sideways and the possibility of an upside or downside price target if the stock moves out of the trading range? The theory is that as a stock moves in a sideways fashion, traders and investors build up a certain passiveness or apathy toward the stock. Typically, in such a situation, the current "fundamentals" relating to the stock value may be widely known; in effect, the stock may simply be lacking a following of sorts. Over the course of time, however, many factors can change, directly or indirectly affecting the value of the stock. The strength of the economy, the management of the company involved, or any number of events could suddenly change investors' attitudes. If a stock has been trading sideways for a long time there may have been a buildup of ownership by "strong hands" able to detect some very positive developments afoot in the company, which could change investors' attitudes toward the stock. While the stock was moving sideways the "strong hands" may have been able to accumulate large holdings, and once a rally is underway, the savvy investors would not be willing to sell their shares until prices were much higher. By observing the length of time that the stock takes to move sideways, a trader can deduce the a potential move.

Each stock that is a potential candidate for a position should have its count or potential measured and its objective range determined. Those stocks with the biggest counts have the greatest potential and should represent the best candidates in which to establish positions. How much potential is enough is up to the investor. If a substantial number of stocks are still being considered at the completion of step 2, it is best to insist that a stock have a count that indicates a substantial potential. Using a potential of at least 50%, for example, will help reduce the number of candidates.

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When determining which stocks have the greatest potential, be sure to measure each stock in question from the current level to the objective. If Bristol-Myers is at 52 when the potential is measured, a 30% advance is indicated. However, if it is already at 60, the potential remaining from the count at the 52 level is only 13%. Those stocks that are the strongest or the weakest are least likely to be in trading ranges, and they are the most likely to have left their count levels far behind. As a result, their remaining potential may not measure up to the requirement determined by the investor. Sometimes, the best candidates determined by steps 1 and 2 of the Wyckoff method will be the worst candidates indicated by step 3. The investor should therefore limit his further consideration to those that meet his minimum potential requirement, thus weeding out the possibles even further.

A student of the Wyckoff method should never forget that point & figure charts provide indications only. Holding to an objective indicated by figure charts even when the price and volume action suggests that the objective is not going to be reached invites disaster. As a result of changing supply and demand factors that develop after the potential has been put in place, but before it has been worked out, some

stocks will overrun their indicated objectives while others will fall short. Those that fall short are most likely to produce problems for the investor.

JUDGING CHARACTER

Fortunately, certain aspects of the Wyckoff approach help an investor judge the character of the action. They can help determine whether a stock in which a position is held will or will not reach the objective; if not, the position can be closed out before paper profits are given back. For the investor who has not yet learned these finer points of the approach, or for the individual who chooses not to learn them, step 3 of the Wyckoff method provides the information required to utilize a simple risk-management device to help avoid a disaster. A student of the Wyckoff method always uses a stop order to limit loss or to protect a profit. The Wyckoff approach teaches the placement of stops using a profit risk ratio. Assume that BMX in Figure 1 is at the 52 level and that all considerations indicate that a position may be established at that level. The potential profit is to the 68 level, or 16 points. Sixteen points represents the profit side of the profit risk ratio. Wyckoff theory states that the minimum acceptable profit risk ratio is 3 to 1. Therefore, if the anticipated profit is 16 points, the risk may be as much as 5 1/4 points without breaking the 3 to 1 guideline. The risk may be less, which will result in a higher profit/risk ratio, which in turn is better than a lower ratio. The stop, however, should always be placed below a previously defined support level.

Note that the low figure change during the trading range was 51, indicating that the stock traded at least as low as 51 but did not trade any lower than 50 1/8. Therefore, the initial stop order may be placed as high as 49 7/8 and still be below previously defined support. If the entry point is 52, then the risk is 2 1/8 points. This risk, when combined with the potential profit of 16 points, results in a profit/risk ratio of 16 to 2.1, which is better than 7 points of potential profit for each profit risk, an excellent profit/risk ratio. Assuming that this stock ranked highly from a relative strength standpoint, its substantial potential and excellent profit/risk ratio make it a good candidate of a position.

FINAL CONSIDERATIONS

Upon completion of step 3 of the Wyckoff method, the investor knows most of what he needs to know to make an informed decision as to which stocks represent the best candidates of a position. At this point, he knows which stocks are outperforming the market and how much farther they are likely to move and how much may be risked to realize the anticipated profit. The investor is close to making a decision about taking a position. The final considerations determine each stock's readiness to move and the proximity of the general market to a turning point. These considerations are addressed in steps 4 and 5 of the Wyckoff method.

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