Wyckoff: Timing Your Commitments

by Craig F. Schroeder

The Wyckoff method ends where it begins — with the general market. Step 5 of the Wyckoff method, the final step and the topic of this month's discussion of the Wyckoff method, instructs the Wyckoff student to time positions in individual issues to anticipated turns in the general market.

The logic of this is easy to understand. If the first four steps of the Wyckoff method have been correctly applied, the results will be enhanced by a market that is moving with a particular position. While it is true that all markets will have issues that make substantial moves counter to the prevailing trend, most individual stocks will go with the trend following the line of least resistance. The odds of achieving success are improved by selecting positions from the majority rather than by trying to identify the minority.

In his course in stock market science and technique, Richard D. Wyckoff stated the basics of his method in five steps:

Step 1: Determine the present position and probable future trend of the market. Then decide how you 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 in keeping with your goals.

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

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

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 *which*. 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 the best time is to make a commitment.

GAUGING THE TREND

Step 5 tells us the best time to make a commitment in individual issues is the point at which we can anticipate a turn in the general market. Anticipating a turn in the general market requires the use of a general market index. Indices come in a variety of shapes and sizes. Some are very broadly defined, using the action of most of the individual issues. Others, like the Wyckoff wave, are very narrowly defined by the action of just a few key issues (see sidebar entitled "The Wyckoff wave"). Though no one index is perfect, all the indices in their own way reflect market action. Therefore, the individual investor need not agonize over the selection of an index. However, once the selection is made, it is best to remain faithful to that index; hopping from index to index can be dangerous because it allows the investor to seek out the index that most closely confirms a preconceived conclusion rather than using the index to arrive at the conclusion.

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Learning to anticipate a turn in the general market requires an understanding of all three of the basic laws of the Wyckoff method: supply and demand, cause and effect, and effort vs. result. Supply and demand are represented in the action of a general market index just as they are represented in individual stocks. A general market turn occurs when demand or supply is sufficiently met to overwhelm the other, or when either demand or supply is sufficiently withdrawn to leave the other in control. As outlined in step 4 of the Wyckoff method, the meeting or withdrawal of supply or demand can be seen in a vertical line chart of the index's action.

As a review of this extremely important concept, consider the chart of the weekly Wyckoff wave in Figure 1. The move from point A to point B illustrates some aspects of supply and demand. Note that during the six weeks from A to B, the weekly price spreads remained wide except during the final week. Volume increased through week 4 (point X). It then contracted somewhat on week 5 and contracted substantially on week 6. From A to X, the advance was very healthy; increasing volume was producing consistently wide price spreads and good net progress, indicating increasing demand.

Week 5, which immediately follows point X, shows a change of character. Price spread is again relatively wide, but volume is reduced. Something has changed. One possible explanation is that demand is being withdrawn due to the higher prices. This reduces the buyers' control and gives supply more control. Another possible explanation is that during the week, supply came in and overwhelmed demand, accounting for the poorest close to that point. Either way, the change of character tells the investor looking for an opportunity on the short side to pay closer attention.

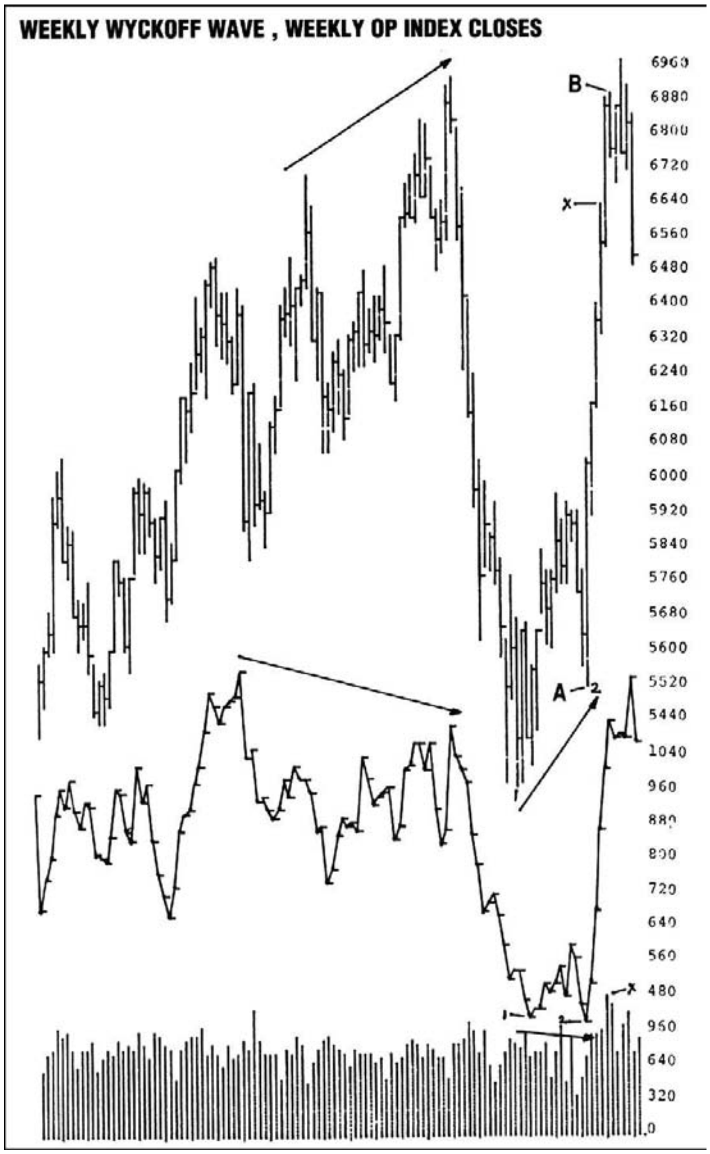

FIGURE 1a: *The optimism/pessimism index moved to a new low(point 2) while the Wyckoff wave did not. The new low by the optimism/pessimism index indicated heavy volume (a measure of effort). The Wykoff wave held above the previous low (a measure of result). Effort versus result were not in harmony. This divergence indicated a change in the market. During the weeks from point A to B, the price spread remained wide, indicating strong demand.*

During week 6 (point B), the market attempts to extend its advance. The sharp drop in volume indicates a decisive withdrawal of demand, and a turn in the general market may be anticipated. The investor may now reexamine the stocks he previously identified in steps 1 through 4 of the Wyckoff method as being good short candidates and may consider establishing a short position if the criteria required by the first four steps are still being met. It is not necessary that the general market immediately turn down to qualify as a market turn. Since the anticipation of a turn is justified, and taking into account that some stocks or stock groups fall in and out of favor, those stocks that steps 1 through 4 revealed to be good short candidates should be some of the first to turn down.

The law of cause and effect is also important in anticipating a turn. Examining the supply and demand factors in Figure 1 revealed a problem with the character of the advance, suggesting the possibility of a turn. However, a cause as indicated by a figure chart is required to convert that possibility to a reality. Consider the 10-point modified figure chart of the Wyckoff wave in Figure 2 as it appeared at the close of week 6 (point B). The horizontal build-up of postings between the 6750 level and the 6900 level represents potential, or a cause.

Since a turn is anticipated, we measure the cause as a downside potential, or count. The result is the anticipated downside objective following the anticipated turn. The count is measured at the top of the areas that represent the cause to keep the indicated objective as conservative as possible. This particular potential has two phases. Phase A is the more conservative. It indicates a potential decline of 160 points from the count level to 6740. The mechanics of this projection are as follows: the distance from the right side of phase A to the left side includes 16 horizontal divisions on the figure chart. Since this is a 10-point modified figure chart where each vertical division represents a 10-point move, the 16 horizontal divisions are multiplied by the number of points represented by each vertical division. The result is 160 points.

Phase B represents a more aggressive downside potential. It is measured from the point where phase A ends to the left side of the potential. This area covers an additional 16 horizontal divisions, indicating an additional 160 points of potential. The potential indicated by phase B is added to that indicated by phase A. The result is 320 points for an objective of 6580, which represents a move of approximately 4.5%. A 4.5% move may not seem worthwhile, but it should be remembered that a 4.5% potential move does not mean that every stock is going to decline 4.5%. Some will not decline at all. Some will continue to move higher, and some will outperform the market to the downside. Some should be already represented in the group of short candidates previously identified by steps 1 through 4. As a general rule, never establish a position in a stock that has less potential than the general market.

EFFORT VS. RESULT

The law of effort vs. result is a third important factor in anticipating a turn in the general market. Effort and result should move in harmony. When they do not, a turn in the market is suggested. Result is measured by price movement, which is reflected in the Wyckoff wave. Effort is measured by the flow of volume, which is reflected in the optimism/pessimism (OP) index (see the sidebar entitled "The optimism/pessimism index"). Each trading day is made up of buying waves and selling waves. The trading volume during buying waves is added to the OP index. Trading volume during selling waves is subtracted from the index. The net effect is posted as a continuous line. On the weekly chart of the Wyckoff wave, the OP index is posted between the volume and the wave (Figure 1).

PRICE AND VOLUME			
For the period from A to B (Jnuary 14 through February 22)			
Week 1 (A) Price spread	527.5 points	Volume	916,260,000 shares
Week 2	264.0		901,460,000
Week 3	238.875		973,060,000
Week 4 (X)	296.75		1,299,590,000
Week 5	347.25		1,195,590,000
Week 6 (B)	152.375		776,930,000
Average for weeks 1 through 5		Price spread	334.875 points
		Volume	1.057,192 shares

FIGURE 1b:

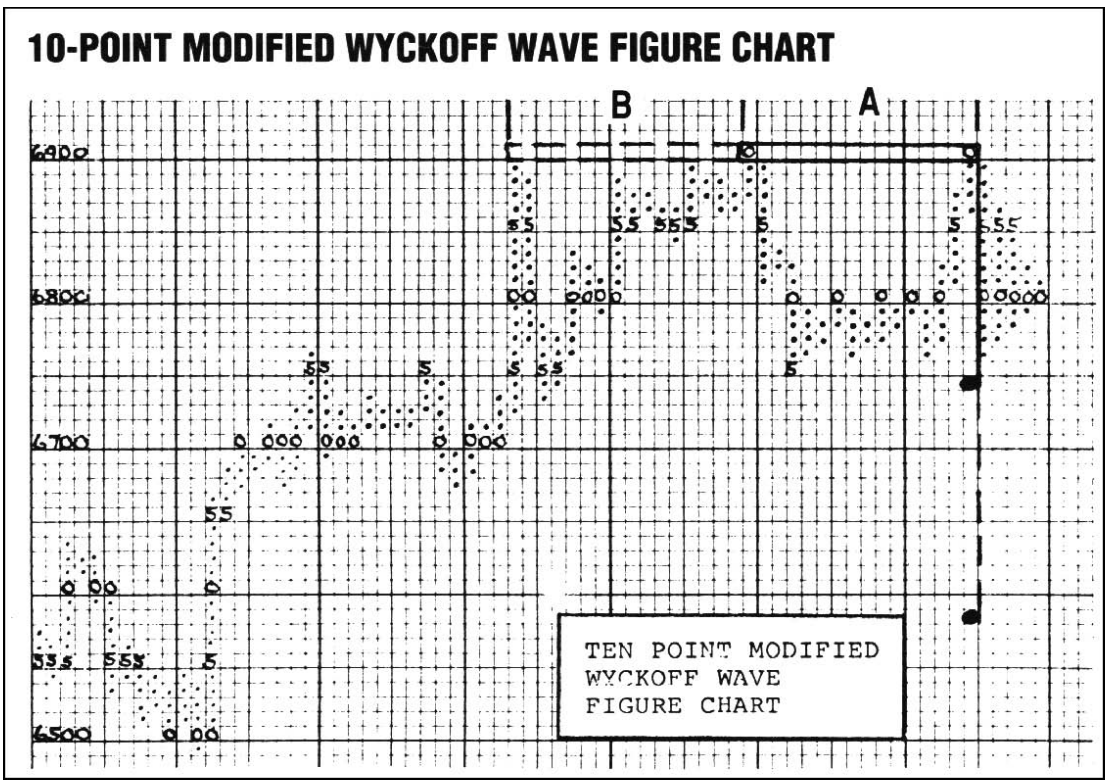

FIGURE 2: *Price objectives are determined by measuring the horizontal count on the figure chart and projecting down from the upper boundary.*

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Compare points 1 and 2 as marked on the Wyckoff wave to similar points marked on the OP index. Note that while point 2 on the OP index is lower than point 1, point 2 on the Wyckoff wave is higher than point 1. Effort and result are not in harmony. From point 1 to point 2, there was too much downside effort for the result, indicating the likelihood of a change in direction for the Wyckoff wave. The investor seeking to identify potential long candidates should use this anticipated turn as justification for considering long positions.

PRACTICE, PRACTICE

Discussion of step 5 completes our summary of the Wyckoff method of stock selection. Remember, the Wyckoff method is not magic or even mechanical. It is a logical, systematic way of interpreting the action of markets and individual issues. It requires good judgment, which takes time to develop. Wyckoff students are encouraged to reinforce their understanding of these principles periodically. Restudy all five steps of the Wyckoff method and then move on to the important second step: practice. Through practice, we increase our understanding of the principles and of ourselves, which should lead to improved results.

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FURTHER READING

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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.

THE OPTIMISM/PESSIMISM INDEX

The Wyckoff method divides each trading session into intraday buying and selling waves. The optimism/pessimism (OP) index reflects the flow of volume during those waves. The trading volume during the upwaves is added to the previous reading. The trading volume during downwaves is subtracted. A volume of 1 million shares is assigned a value of 1.00. Therefore, if the OP index began the day at 1000.00 and the first intraday wave was a buying wave during which 10 million shares were traded, the value of the OP index at the end of that wave would be 1010.00.

