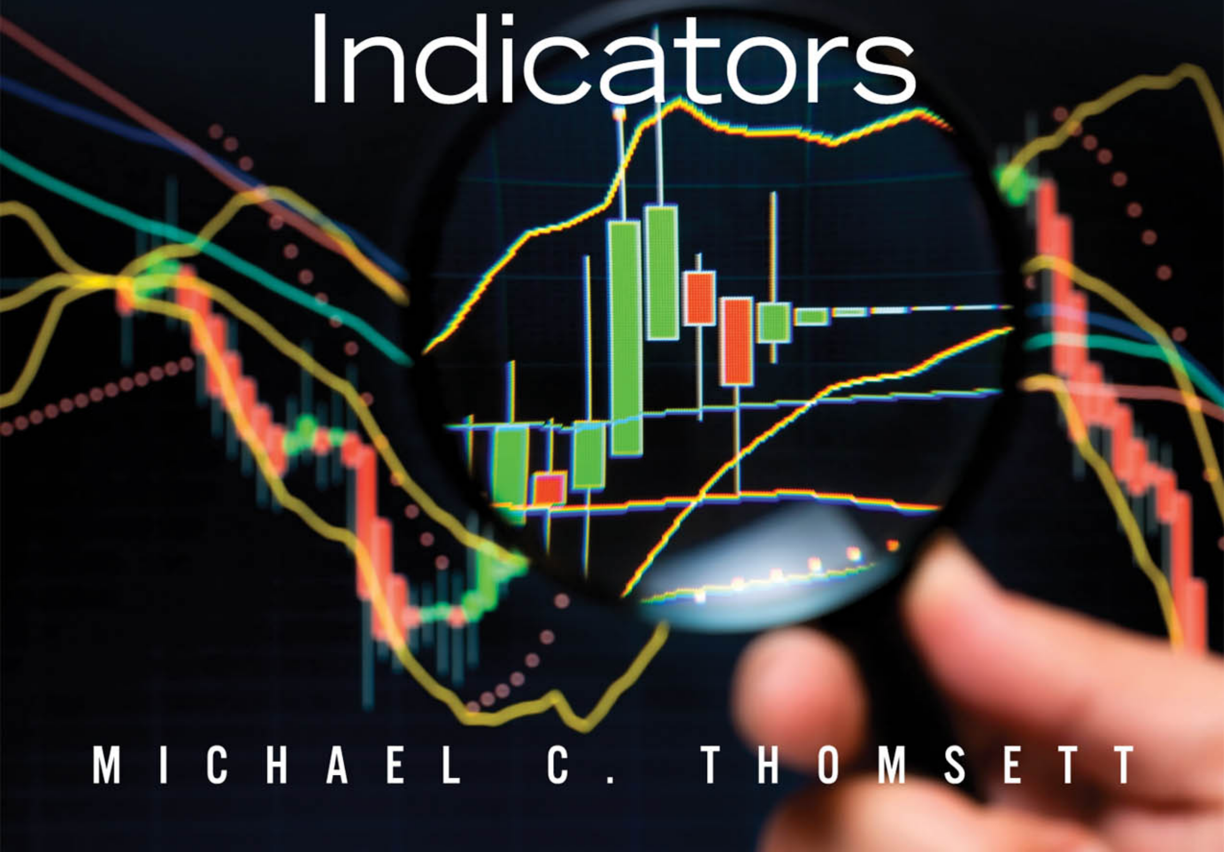
POWERFUL METHODS FOR ACCURATELY TIMING TRADES

PROFITING *from* Technical Analysis *and* Candlestick Indicators



MICHAEL C. THOMSETT

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Powerful Methods for Accurately Timing Trades

Michael C. Thomsett

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About the Author

Michael C. Thomsett is the author of more than 80 books, including many FT Press projects (*Stock Profits: Getting to the Core*, *Put Option Strategies*, *The Options Trading Body of Knowledge*, *Options Trading for the Conservative Investor*, *Options Trading for the Institutional Investor*, and *Trading with Candlesticks*). He also has written several other books on the topics of technical analysis, candlesticks, and options trading. Thomsett is the cofounder of the education site ThomsettOptions.com, where he manages a virtual portfolio emphasizing technical analysis and candlestick charting as required trading skills; there, he has executed trades using the system explained in *Profiting from Technical Analysis and Candlestick Indicators*. He is a frequent speaker at investment and trading conventions and trade shows, and he teaches several classes for Moody's and the New York Institute of Finance. Thomsett lives in Nashville, Tennessee.

Introduction

The Self-Fulfilling Prophecy

Traders relying on candlestick charts have a problem. Whether experienced retail investors or managers of institutional portfolios, one of their greatest challenges in chart analysis is creating and maintaining objectivity.

The tendency is to seek reversal and confirmation that agree with the initial belief. So once you spot an initial signal (such as momentum moving into the overbought range), the next step is to seek bearish confirmation. Upon finding a signal, or two or three signals that confirm the bearish reversal, traders take action—closing long positions or opening short positions based on the discovered bearish signals.

This is where the problem lies.

In seeking *only* bearish signals, do you ignore contradictory bullish signals at the same time? A bullish pattern may be ignored, for example, with the latter session used as the first of a new bearish signal. But which signal is correct?

Are traders at risk for seeking only those signals confirming what they initially see on the price pattern? If so, chances for a poorly timed trade increase. With the purpose of signal identification and confirmation to accurately identify reversal and time trades, it is essential that an objective and open process is created for two contradictory purposes. First, traders seek confirmation for the initial reversal signal spotted because the entire exercise of chart analysis is designed to spot reversal before it occurs. By doing so, you are able to enter your trade before the greater market sees the same thing. Second, however, you will vastly improve your timing of trades if you also seek contradictory signals and then attempt to interpret them accurately. What initially seems like a clear reversal signal could become a false signal to be followed by a different set of indicators forecasting continuation of the current trend.

Traders as a group tend to seek what they expect to find on the chart; this creates a large blind spot and vulnerability. Even those who consider themselves entirely objective are at risk for this type of error, seeking a set of signals that become a *self-fulfilling prophecy*.

This book proposes that a candlestick indicator by itself is not reliable for timing of trades. You need confirmation through distinct and separate signals forecasting the same reversal (or continuation), but you also need more. In the process of seeking confirmation, the candlestick only becomes a valuable forecaster of future price direction under one premise: The chances of confirmation or contradiction are given equal weight. In other words, a series of very specific methods need to be brought to bear to ensure that all possible signals are recognized and analyzed. In the desire to spot reversal and confirmation, the tendency to ignore any signals contradicting that idea reduces the reliability of chart analysis.

Several supporting principles are brought into this revised analysis. It is based on statistical principles as well as the scientific method, under which an indicator is subjected to objective analysis, which may have either a positive or a negative outcome. In this application of the principle, a positive outcome is confirmation of likely reversal or trend continuation. A negative outcome is a contradictory indicator, which draws into question whether the initial signal is correct or a false lead. Either of these outcomes is valuable, leading either to trade execution or caution and a delay in action.

Augmenting the concept that candlesticks are useful only when applied within an objective search for confirmation or contradiction are a few additional principles. Every chartist will benefit from being aware of these.

First, reversal signals vary in their strength based on *proximity* to resistance or support. When a reversal occurs close to these borders of the current trading range, it is much stronger than the identical signal found at midrange.

Second, when reversal occurs at the point that price trends above resistance or below support, it is the strongest possible proximity, meaning reversal is more likely than anywhere else—assuming the first signal can be strongly confirmed by other price, volume, or momentum signals. The move above resistance or below support lends to even greater likely reversal when price gaps accompany that breakout. At this point, a candlestick reversal signal is quite strong, as long as it is confirmed.

By the same series of arguments, breakouts may be accompanied by candlestick continuation signals. These are particularly strong following a resistance/support or support/resistance flip (in which the prior border becomes a new, opposite one). This tends to add great strength. For example, if price moves above resistance and is accompanied by a candlestick continuation signal, and the new assumed level of support is at the same price location as prior resistance, this is one form of strong confirmation, making it likely that the new range will not reverse.

These concepts contain many variables, but can be demonstrated with a detailed analysis of chart patterns; with the study of candlesticks in the context of their interaction with traditional Western technical analysis of prices; and with a range of moving average, volume, and momentum signals acting as confirmation.

One aspect of this analysis used throughout this book is recognition that among the dozens of candlestick indicators, many are reliable only about half of the time. Even those candlesticks leading to expected price movement between 50% and 70% of the time serve little use in predicting price movement. These weaker signals may be useful if and when confirmed independently, or when they confirm other signals. However, it makes sense to limit an analysis of candlestick patterns in a logical manner. For this reason, the arguments for strong and objective analysis of trends and prediction of reversal are limited to only ten of the strongest candlestick indicators. These are explained in detail in Chapter 3, "Candlestick Patterns—Recognizing Evolving Strength or Weakness."

Why use only the strongest candlestick signals? The belief that objective analysis has to begin with solid and reliable information leads to a conclusion that exceptionally strong candlestick indicators form a solid basis and a starting point in the analysis. This is based on a statistical rule for sampling. In a population sample, the statistician needs to ensure that the sample is representative of the larger group. Thus, a survey of "likely voters" should include only those who have voted in recent elections, and not those who *might* vote or might not. A survey of shoppers in a product survey should include the family member likely to do the majority of shopping, and not the occasional shopper seeking a fast in-and-out of the store, regardless of price, product nutrition, or brand loyalty.

The same idea should apply to candlestick analysis. Some studies of candlesticks focus on the attributes of the indicator itself and its location within the price chart. However, even those examples that include explanations of false signals often do not focus on the narrowing down of likely outcomes. By limiting the discussion to ten of the strongest candlestick signals, this book presents the best case for utilizing candlesticks in a context of accuracy and reliability.

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