Building a Solid Foundation

The purpose of this site is to break down what I consider to be the basic foundation of chart technical analysis. It's intended for traders of all experience levels, though it's going to be the most beneficial to those with not a lot of experience or traders that need to add some basic structure to their chart reading methods. Located in the left sidebar is a list of all of the topics, and though each one was written so it could be read independently, I recommend starting from the top and reading them all. Think of this as a free course to learn what I consider to be some of the most fundamental aspects of chart technical analysis and trading.

Once you've read, absorbed, and implemented the principles I go over, you should be able to look at any chart and almost immediately have a good idea of what the overall picture is telling you, and whether or not you want to trade it. This site won't be your last stop for learning chart technical analysis, but I believe it does a better job than most sources I've read of outlining some basic fundamentals that often get skipped or overlooked in favor of fancy indicators and complex strategies. The great thing about the material I go over is that it doesn't prevent you from pursuing more technical methods; it can actually work with them and improve their results. The MACD, RSI, STO, or whatever indicator you're using may be giving you a buy signal, but should you be taking it? If the stock is in a downtrend and is approaching resistance, I don't care what the indicators are telling me, I don't want to buy there. On the other hand, if the stock is in an uptrend and the price is sitting on support or breaking through resistance, then maybe I do want to take that buy signal. Basically, the point of these articles is to get you to where you know when you should be looking to buy, when you should be looking to sell (or short), and when you should be doing neither. I hope you enjoy the site as well as find it helpful and informative. If you do, I kindly ask you to tell anyone else about it that you think may find it useful.

Now get to work, you have a lot of reading to do.

Do Charts Work?

This question is the subject of many debates but it really shouldn't be so disputed. The answer is yes, charts absolutely work and do exactly what they're supposed to do, but the reason so many people argue this fact is because their idea of what they're supposed to do is skewed. Charts don't tell you the future, when to buy, when to sell, etc. What they do is reflect everything that has happened and everything that is known about the security (stock, stock option, future, bond, fund, or any other financial asset) being charted, and it is the job of the trader to take any clues they may see in that chart to make educated guesses, then translate those guesses into trades. If one hundred traders all looked at the same chart and all of them decided to go long (buy) and none of them decided to go short (sell), you may assume that the chart is predicting a move up. Then, if the stock happens to crash, would you say that the chart was wrong? Nope. The traders were wrong; the chart did exactly what it was supposed to do, reflect the action. As soon as your expectations of what charts are supposed to do become realistic, then you can start to take advantage of them. I can't tell you how many times I've heard people say things like "Charts are meaningless on this stock because it's a news play" or some other excuse. Then you have chartists who add more confusion to the situation by saying things like "This stock is moving because of the chart". Again, a chart is never meaningless because it will always reflect exactly what is happening, and stocks don't move because of charts, but they may give you clues as to when they're going to move.

Being a successful trader is all about playing the odds, and though a chart will never give you a definitive, guaranteed to work buy or sell signal, when used properly they can help you identify trades where the odds are in your favor. That's all it comes down to, if you can identify the setups where the odds are better than 50% in your favor, over time you will be profitable if you only take those trades. That's also assuming that you practice proper money and risk management, but that's beyond the scope of this article. Here's an example of how I may use a chart to identify a possible trade with limited risk and where the odds are better than 50% in my favor: Say the stock GOOG (Google) has been hit with some heavy selling and the price has been severely beaten down for a few days. Based on the chart, I identify an area of potentially strong support at 350, and the price is starting to fall to that range. In this article I won't get into what to look for to identify support and resistance, but what they represent is areas where in the past have been met with heavy buying or selling, and therefore it's reasonable to assume it may happen again. Eventually the price makes it's way down to the 350 range and now I start to see an increase in volume, as well as the price start to level off, even going up a little. How do I know this? Well the volume is easy to see on the chart and so is the rising price. So here's what I know: GOOG had been declining in value at a rapid pace, there is potential support around 350, the volume has picked up since the price got to the 350 range, and the price has even slightly rebounded from it's lowest point. Those are all facts and they are all reflected in the chart, now it's my job to take those facts and decide whether or not I see a potential trade, and what that trade should be. Based on all that is reflected in the chart, I decide that the stock is currently oversold, at least temporarily, and that the market is starting to find buyers in this 350 range, so there's a good chance that the sellers are exhausted and therefore GOOG could see a nice bounce soon. Should this bounce materialize, it's not the chart that was right, it was my prediction based on what I saw in the chart. So I end up buying GOOG at 352, but then a new wave of sellers come in and quickly drop the price to 340. My prediction was wrong, the sellers weren't exhausted and the buyers that came in at the 350 support

were only enough to slow the free fall temporarily. Again, the chart wasn't wrong, just my prediction. The good news is that charts can also help you limit your risk on a trade too. Since I identified the support range at 350, I knew to bail when I saw the sellers bring the price below it, and I was stopped out at 345, for roughly a 2% loss.

I think so many people are skeptical of charts and the possible benefits they offer because they have unrealistic expectations from them, they aren't willing to put in the time it takes to learn to read them and then properly use them, and they've heard from so many other people that they're useless. I forget where I read this, but I remember an article that supposedly debunked the use of chart technical analysis and its effectiveness, and it did so by implementing and testing some sort of simplistic method based on moving average crossovers. If you're not familiar with what that is, it's basically one of the simplest buy or sell signals that I know of. Though it can be useful in the right context, without other indicators or confirming criteria, it's a method that is destined for failure. People are often looking for the Holy Grail when it comes to charts and buy/sell signals. Just like the person who supposedly debunked the effectiveness of charts, they want some sort of simple to follow signal that makes them money every time or nearly every time. If it were that simple, everyone would know about it and everyone would be rich.

So do charts work? If by 'work' you mean provide you with easy to read buy and sell signals that will instantly make you a great trader, then no they don't work. If by 'work' you mean reflect everything that is known by the market about that security, then yes, they work every single time. Are there people out there that use the clues from charts to develop sound trading strategies and an in depth perspective into how a security trades? Absolutely, and that's a fact.

What Can Charts Tell You?

In my last article I stated that charts completely reflect everything that is known about a particular security, but what exactly can you learn from them and how can you use it to your advantage? Charts may not be able to predict the future like Ms. Cleo, but certain information they reveal can definitely help you make better educated guesses as to what is going to happen. I think possibly the most important bit of information a chart can very easily tell you is whether the trend is up, down, or flat. There are always multiple trends at work, depending on what time frame you look at. A stock may be in a short term uptrend, meaning it's been going up recently, but if you pull back to a longer term time frame, it may be in a downtrend. **If I was looking to invest in a company, I would want that stock to be in a long term uptrend, but the short term trend isn't nearly as important, in fact I may want to be a buyer when the short term trend is down.** If I'm looking to make a quick trade, say maybe a couple of days, the longer term trend isn't too much of a concern, just the short term trend (since I'm trying to profit from a short term move) and possibly the midterm trend. Being able to identify what direction the trends are will almost instantly make you a better trader and can even help out your long term investments. Once you become more comfortable with identifying the different trends, you can start to base your trades off of multiple time frames. The longer term time frames hold more weight than the shorter term trends, but doesn't it make sense to combine them so multiple time frames are working with your trade? You can break the different time frames down into three basic categories, short term, mid term, and long term. There is no one way to do this, but here is an example of one stock viewed through three different time frames.

The first is the short term time frame, and for this one I'll use a daily, three month chart. Every candle here represents one day and the entire chart goes back three months.

Here is the same chart, only now the time frame is a bit longer term, so it goes back a full year. Each candle still only represents one day.

Finally, here is the same chart, but viewed through a longer term time frame. This one not only goes back three years, but each candle now represents a week's worth of trading.

It's important to understand that time frames are completely relative. For a daytrader who's trades last minutes on average, a long term time frame may be a sixty minute chart (each candle represents an hour) that goes back five days and a short term chart may be a one minute chart that goes back five hours. The examples I gave you above would probably be for a swing trader that held anywhere from overnight to a few months, depending on which of the three time frames they're using. For a long term investor, a short term chart may be the swing trader's long term chart. It's critical that the time frames you trade off of suite your style and time frame for trading. If you're trying to daytrade off of a swing trader's time frame, even the short term, you're going to have major problems.

Other than the different trends at work, charts can tell you other important things. The price action on a chart can give you a lot of insight as to what the market considers a fair value. If you heard that a stock finished the day up 5%, you'd probably assume that it had a good day and overall it was bullish. What if at one point in the day the stock was up 35%, but it only could manage to hold a 5% gain on the day? To me, that shows that the market felt that the price was overvalued when it was up 35%, and the fact that it closed so much lower tells me that the higher prices were essentially rejected. Price tug of wars like this are very obvious when you look at them through a candlestick chart, which I'll be going over more in depth in the future.

In addition to the different trends at work and the price action, the last thing I want to mention is support and resistance. Support is basically a price range on a chart where historically there have been enough buyers to keep the price above a certain point, and resistance is the opposite, a price range where sellers have prevented the price from moving above a certain point. Once support has been successfully broken, that old support is now new resistance. The same goes for when resistance is broken, it then becomes support. Don't look at support and resistance as specific prices, but as general ranges. If I said there is support at 375 for GOOG, that doesn't mean the second it hits

374.99 that support has been broken. The price could dip well below the support range, but if it quickly recovers and establishes it's self back above it, that is a successful hold for support. Support and resistance, just like most aspects of chart analysis are not exact sciences. I actually would consider chart reading in general more of an art form than a science, though it has it's scientific elements too.

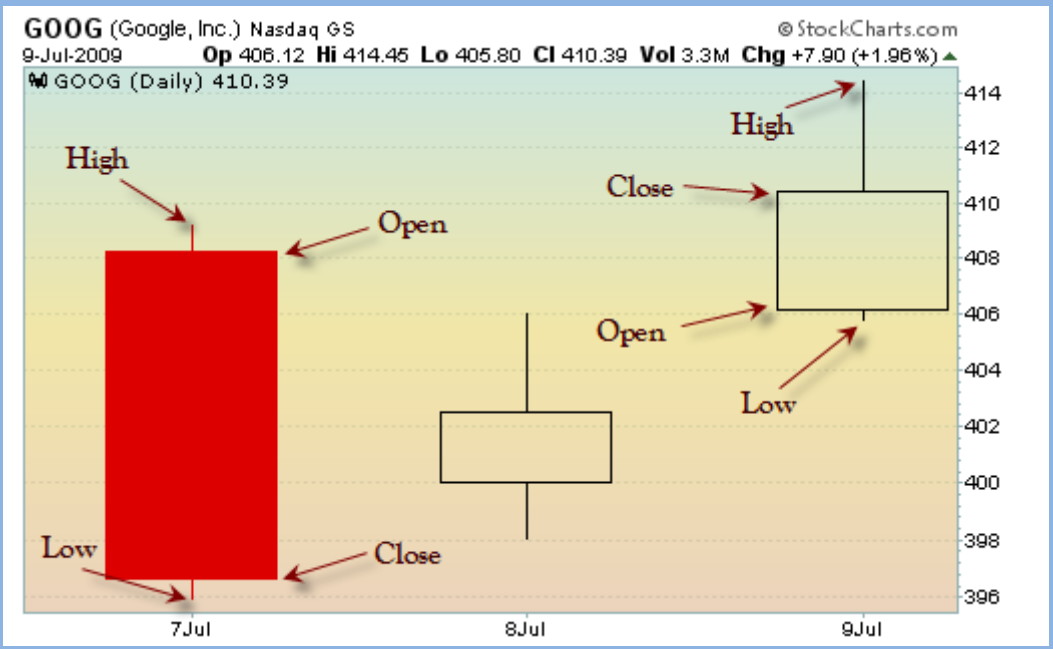
The point of this article wasn't to go into detail about how to identify support and resistance, the current trends, or how to analyze price action. I just wanted to point out the key things I look for in a chart, and probably the most revealing. **If you know what the trends are, how to spot price rejection and acceptance, and where the major support and resistance lies at, you're in a position to make an informed and educated guess about how to execute your trade.** This is true from the daytrading scalpers up to the long term buy and holders. Will this guarantee that every trade is a profitable one? Absolutely not, but it not only swings the odds into your favor but it will limit your risk on each trade. This is the difference between someone who is able to consistently make profits and someone who is trading on whims, which to me is essentially gambling, and a professional trader is not a gambler.

The Very Basics of Candlestick Charts

There are a number of different chart types, and the difference between them is how they display the data. All charts plot the data by individual periods, and each period can represent as much or as little time as you want. One chart may have each period set to five minute intervals and another may be set to weekly intervals. The three most popular types of charts that are used are probably the line chart, bar chart, and the candlestick chart. On a line chart, the only thing that is plotted is the closing price of each period. Regardless of what the period is, whatever the last price of that period happens to be, that's what you'll see. Basically you're drawing a dot for each period's closing price, and then connecting them to form a line. Here's an example of what one looks like.

A line chart is better than no chart, but the information it reveals is extremely limited. You have no idea what the security opened at, or what the high and low were for that period. A bar chart, otherwise known as an OHLC chart (Open, High, Low, Close), gives you that information. On a bar chart, each period is represented by a vertical line with a horizontal line sticking out from each side. The line sticking out on the left side is where the price opened at for that period, the top of the vertical line is the high of that period, the bottom of the vertical line is the low, and the line sticking out of the right side is the closing price for that period. Here's an example of a bar chart.

Clearly, the bar chart is much more revealing and helpful to traders, but the problem with them is you really have to zoom in to see each period's action. If you look at a daily chart with a year's worth of bars, you're basically just going to see a bunch of vertical lines, and if you squint hard enough you may be able to notice that there are lines sticking out of the side. It's still not easily recognizable whether each period finished even, positive, or negative. This is where candlestick charts really shine. Technically, they reveal the exact same information as a bar chart (open, high, low, and closing prices), but they do this in a way that is much easier to quickly identify. All candles will fall into one of these three categories; candles that open and close at the same price, candles that close higher than they opened at, and candles that close lower than they opened at. Here is a chart that breaks down a couple of candles, one that represents a negative day (left, red candle) and one that represents a positive day (right, white candle).



This chart was zoomed in to show only three candles for simplicity, but even on a chart with hundreds of candles, it's still pretty obvious what each one is saying. First off, they're color coded. Without the different colors, you wouldn't be able to tell where it opened or closed at. Most charts will have a red candle to represent down days and either a white or green candle for up days. Some charting platforms will have a different color (usually black) for candles that closed lower than they opened, but still higher than the previous candle, or closed higher than they opened, but still lower than the previous candle. Each candle is made up of two basic parts, the body and the wicks. The body encompasses the opening and closing points and everything in between. If the open and close are identical or close to it, you'll have basically a horizontal line for a body. The wicks represent the trading that took place outside of the range of the open to close. If you see a candle with a very long upper wick, you know that at one point the price was much higher than it finished. If you have a real time charting platform, you can watch as each candle will change depending on the price action.

Thanks to the color coding and the contrast between the wicks and the body, it's easy to get a good idea of what took place during that period, even with just a glance. A long white candle means the price went up from the start to finish, a long red candle means

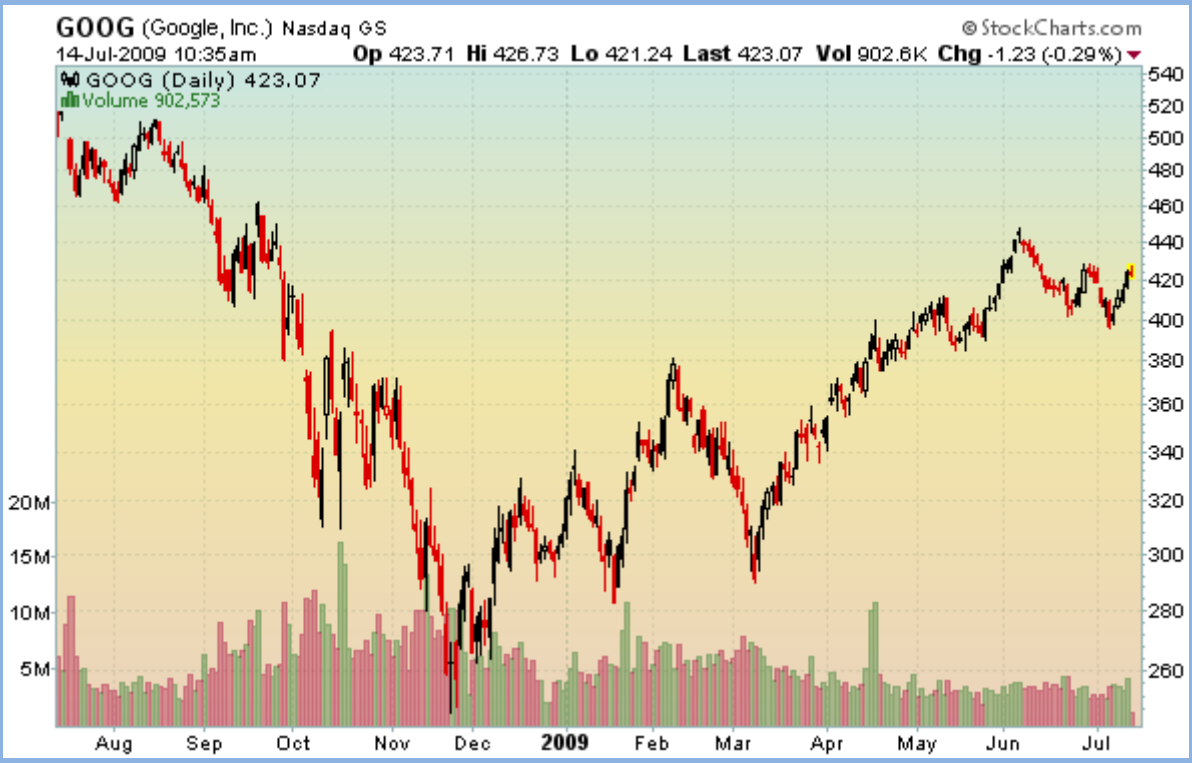
the price went down from the start to finish, and any long wicks will inform you that there was a struggle between the buyers and sellers. This isn't to say that each candle will tell you exactly what happened during each period. If you had a long white candle that formed on a daily chart, you may assume that the price had risen all day, when in reality it may have been flat all day up until the last five minutes when it went crazy. So it may not tell you exactly how it played out, but it gives you a very good idea, and to see more detail you can always break the candles down to a shorter time frame. On a daily chart, each candle represents one day. Like I said, you don't know exactly how that candle got to where it's at, but if you break your chart down from a daily chart to an intraday chart (like an hourly chart), then you can see the price action from that day more in depth. So in my example where the stock was flat all day but ended up running in the final minutes, an intraday chart would be able to tell you that.

This is just the tip of the iceberg for using candlesticks. Besides telling you the basic info about a trading period, there are much more advanced methods to using them. Candlestick patterns are at minimum an incredible compliment to most trading strategies, and for some traders they are the backbone of their methodologies. I'll identify and break down some of the more popular and commonly seen patterns in a future article, but for now you need to be able to fully absorb the basic information that each candle is telling you. If you don't already use candlestick charts, I highly recommend you start now. If you feel like you're trading in the dark, candlesticks will certainly help add some light for your path.

Identifying Trends

If someone says to you that the market is in an uptrend, do you know what they mean by that? Obviously they mean the market is going up, but specifically what are they referring to? It's been going up for a day? A week? A year? Uptrend and downtrend are two terms that are thrown around a lot, but often people don't really have a clear cut definition of what that exactly means. **Many people define an uptrend by saying it's where the chart makes higher lows and higher highs.** The problem with this is which lows and highs do you look at? Maybe for the past week it's made higher lows and higher highs, but if you go back and look at the last three months the highs have gotten lower. Then go back and look at the last year and it may be different as well.

Look at this chart and tell me if the trend is up, down, or flat.



You could have said any one of the three and been correct because there are many trends at work here. In the last month or so the highs and lows have gotten lower, so one person might say it's in a downtrend. Another might say it's clearly in an uptrend since the highs and lows have gotten higher since the December low, and they'd be correct as well. Then the longer term trader comes in and points out that ever since the August 08 high, we've failed to even come close to making a higher high, so it's undoubtedly in a downtrend. Since the first and third person both would agree that it's in a downtrend, you'd think they were on the same page, but they're talking about two very different time frames. Finally, you may have someone that says the stock is uptrending because all they are thinking about is the last couple of weeks where price has gone from 400 to 425, not even looking at the highs or lows. Confusing, isn't it? So you've heard the cliché before that the trend is your friend and that you should trade with it, not against it, but how do we do that if we're not even sure how to figure out what the trend is? Unfortunately, there is no official explanation to determine what the trends are, and

that's why there's so much ambiguity when people speak of them. The method of looking at the lows and highs is better than nothing, but as I pointed out it can be very subjective.

Before I show you the method that I use to determine the trends on a chart, I want to give complete credit to the trader who I learned it from. Dr. Barry Burns is a market veteran who has a great set of instructional videos, I'd highly recommend that you at least check out his blog. I have a lot of respect for him as a trader, not only because he has some good methods, but because he preaches about aspects that a lot of teachers seem to ignore, like the psychology of trading, money management, risk management, etc. As far as his trend identifying method, it's extremely simple, but I've found that a lot of traders like to make things more complicated than they need to. What's good for me isn't necessarily going to be good for you, but in my experience taking a simple approach has often been the most effective.

To start, the one indicator that you'll need for this trend identifying method is the moving average. The moving average is a line that represents the average price of a security for any set amount of time at any specific point. If I said the 50 day moving average for GOOG is currently at 412, that means over the past 50 days the average price has been 412. Since the price is always changing, the moving averages will always move as well, and if the price has been increasing, the moving averages will move up as well. The shorter the moving average time period is, the quicker it will react. A 5 period moving average will quickly react to any price movement, whereas the 200 MA will hardly blink at short term moves. Here is the GOOG chart again, only this time I added the 50 period moving average.

The basis for this method is simple; use a short term moving average to determine the short term trend, midterm moving average for the midterm trend, and long term moving average for the long term trend. This isn't a science, so there is no right or wrong one to

use, but I use what Dr. Burns suggests because they make sense to me. He recommends using the 15 EMA (exponential moving average, puts more weight on the most recent periods so it's quicker to react) for the short term, 50 MA for the mid term, and the 200 MA for the long term trend indicator. I tend to focus on the mid term trend indicator, the 50 MA. I really like using this one because it's not too short or too long of a time period, it's right in between and really it's relevant to both the short and long term trends. **The thing to look for is the angle of the line, if the angle is up the trend is up, a flat line is a flat trend, and a descending line is a down trend**. It's also good to note where the price is in relation to the line. If the 50 MA is angling down but the price is trading above it, that may be an indication that the mid term trend is trying to turn around. Right at the beginning of 09, the price started to trade above the 50 MA, even though the 50 MA was angling down very sharply. It didn't happen right away, but that was the start of the trend reversing. The longer the trend, the longer it takes to reverse. The run that GOOG went on from the end of January to the beginning of March was impressive, and by the middle of it the 50 MA had started to angle up. From mid February to mid March GOOG corrected and went straight down, and obviously the short term moving average would have been angling down with it (confirming the short term down trend), but the 50 MA was still up. For those who recognized that the mid term trend was up, they may have been buying into that dip, and they would have been able to ride the wave up in what turned out to be a very impressive rally. Now let's look at GOOG with all three moving averages applied to it.

It should be clear as day that the long term trend (200 MA, red line) has been down for pretty much the entire chart, though now it's started to level off since the price has been trading above it. See how long it takes for that line to react to the price movement? The short term trend has done what we'd expect it to do, pretty much follow the general price movement pretty closely. GOOG wouldn't have gone from 300 to 440 in such a short period of time without the short term trend being up the majority of the way. Ever since the peak in June though, you can see the 15 EMA (green line) has either been flat

or down, so that would indicate that the short term trend has at least stalled, if not started to reverse. The mid term trend (blue line) is still up at the moment, though the weakness in the short term trend may be a precursor to the mid term trend turning around. I don't want to do any speculating, just make observations as to what the current trends are.

Like I said, this isn't the official way to determine what the trends are because there isn't one. This is just a simple to use method to quickly sum up a chart and give you a better perspective on the current market conditions. If I'm looking to play a chart setup, I better know if the trend is working with me or against me. If I'm looking to buy into the market's pullback, which many people like to do, I'd really like to know if I'm buying into an uptrend or downtrend, and what time frame those trends are on. Trend identifying alone isn't enough to turn you into a profitable trader, but it's about as solid of a foundation as I can think of to start from.

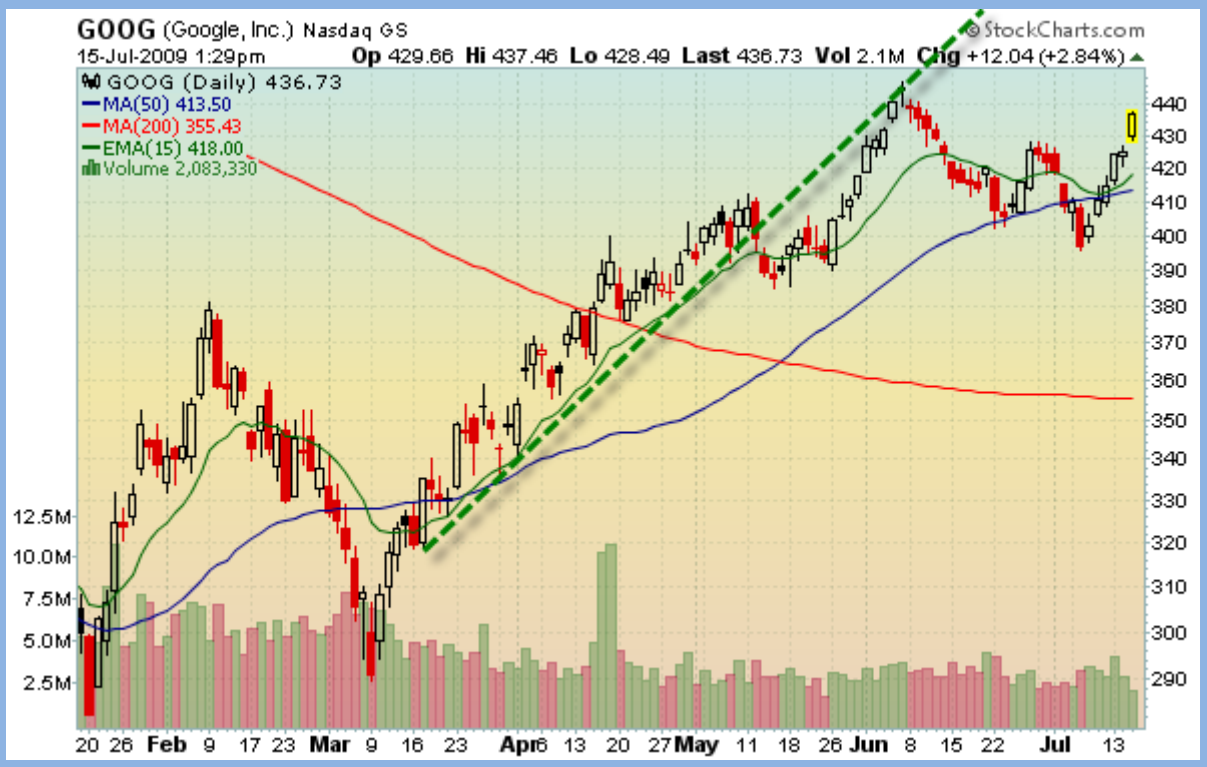
Identifying Support and Resistance

Before I tell you how I identify support and resistance, I'll briefly explain what they are. Support is generally thought of as a price range or level where the security (stock, future, etc.) has historically had difficulty falling below, and resistance is the same principle except it's a price range where the security has had trouble getting above. If a security's price is going down and reaches a certain point that brings in enough buyers to make the price bounce, that general range would be an area of support. As long as the price stayed above that point, you can consider that area support, but once a support range is broken, it becomes resistance (and vice versa). It's important to remember a couple of things about support and resistance. One, they're not specific price points, but general ranges. If someone says that support is at $100 and the price hits $99.99, that doesn't mean that support has been broken. Even if the price temporarily breaks well below it but quickly recovers to get back above it, that would still be considered a successful test of support. The second thing to remember is that no matter how strong you think support or resistance may be, they can always be broken. If someone says that support is at $100 and it falls through that range, that doesn't necessarily mean that they were wrong about it being support, it just means that the selling was strong enough to wipe out the buyers at that support range.

The main types of support and resistance are horizontal price levels and diagonal trendlines, but there are others too, such as moving averages and fibonacci retracement and extension levels. This article is going to focus on how to spot trendlines and horizontal lines. At first, these may be difficult to spot, but after you've looked at so many charts they start to jump out at you. In essence, every high and low on a chart is a horizontal support or resistance level, but if you drew a horizontal line for every one of those your chart would be a mess and it would only hurt your trading. The key is to find the price levels that correspond with multiple pivot highs or lows, the more the better. Here's a 6 month chart of GOOG with one obvious area of support that I see. The red arrows point to where the level acted as resistance and the green arrows point to where it acted as support.

Identifying support and resistance is not an exact science; it's more of a rough estimation. A helpful tip I've heard is to pretend you're drawing your support and resistance lines with a **big crayon**, that way you're not pinpointing one specific price line but more of a zone. Notice on that horizontal line I drew that the price doesn't always hit precisely on the line, but it comes close enough. I could've even drawn the line a little higher or made it wider to include a larger range. I'd actually say that the whole 390 – 400 area is the support or resistance zone (depending on if the price is above or below it). One question that comes up a lot is whether the lines should be drawn at the tops/bottoms of the wicks or the actual candle bodies. Again, this isn't a science so the answer could be either one, but the candle bodies hold more weight than the wicks so I like to focus on those. I actually like it when wicks are formed under a support line or over a resistance line because that shows that the market is rejecting the attempt to break through and further confirms the support or resistance. Spotting horizontal support/resistance lines will become second nature to you after you start to look for them in every chart.

Diagonal trendlines are similar to horizontal support/resistance lines in that they connect pivot highs and lows, but they are either ascending or descending to show the direction as well as the speed of the price movement. They generally connect a series of higher lows (uptrend) or lower highs (downtrend). Some may be very obvious on the chart and some may not be as noticeable. **I've found that trendlines tend to be more subjective** (depending on the trader drawing them) **than horizontal support/resistance lines**. Here is an example of a trendline on GOOG's chart.



Back from March through May, GOOG was riding this steep trendline for the entire rally. Any time prior to May that the price came back down to that trendline would have been a good time to pick up some shares. A trendline that steep isn't going to be able to sustain itself for too long, and in May it finally ended up breaking below it. That wasn't the end of the party though as the price still pushed its way considerably higher after that. The trendline still existed though, but at this point it was acting as resistance since the price was below it. In early June the price ran right into that trendline and that marked the top of that particular move.

There are going to be many trendline and horizontal support/resistance lines on a chart, your job is to identify the ones that look the most obvious or stand out the most. **The more times the line has been tested, the more it confirms it as a critical area of support or resistance.** You could also say the more it's been tested the stronger it is, *but* when you start to see a line get tested multiple times in a short period of time, that's very often a clue it's going to be broken soon. The best way to become proficient at identifying support and resistance lines is to look for them on every chart, draw them where you think you see them, and then follow the action to see if the lines you drew get a reaction from the price. If you've correctly identified strong support or resistance, most of the time the price will have some sort of reaction to it, either by completely bouncing or at minimum stalling and consolidating (trading in a tight range). **Consolidation right near support or resistance is also often a sign that the price is getting ready to break through, but it needs to rest first**. Just like being able to identify trends, spotting support/resistance alone won't make you a successful trader, but it is one of the most important pieces to the puzzle. Once you can properly identify the trends and support/resistance, you then have a solid foundation to build your methods off of. When you start to apply these things to aspects of your everyday life, like "My love life is in a downtrend" or "My bank account just broke it's support", you'll know you're on the right path.

Trading Support and Resistance

My last article went over how to spot support and resistance, but how exactly do you work that into your trades? This article will go over the basic methods of incorporating support and resistance into your trading. The first and most obvious method is to buy at support or short at resistance. For those that aren't familiar with shorting or short selling, it's where you sell shares/contracts that you don't own (your broker lends them to you), then buy them back later (also known as covering), ideally at a lower price than you sold them for. With shorting you are profiting when the security goes down in price.

Here's a chart of GOOG, and I've identified the most obvious support and resistance lines I see.

So the plan here is simple, if the price comes into the resistance zone, you go short. If the price comes down to support, you go long (buy). What's nice about trading support and resistance is that it generally offers a good reward to risk ratio. If you short at resistance and the price breaks right through it to the upside, you exit the trade for a small or moderate loss. If it bounces off of resistance and comes back down, you should have a nice profit on the trade. The tricky part can be figuring out where exactly your stop loss should be at in relation to support or resistance. You have to give the trade a buffer to move around, you can't set your stops one tick above resistance or one tick below support. The price can penetrate through support/resistance, hit your stop price, then turn right back around and go in the direction you thought it would, leaving you behind to watch. So your stops should be far enough away to account for normal market fluctuations and volatility, but not so far that you're going to eat too large of a loss should it get hit. **One other thing you can do is wait to enter the trade until the price has actually pierced support or resistance a little**, in anticipation that it's going to

bounce back still. Using the above chart as an example, the resistance looks to be a little above 440, we'll say 442. A lot of traders may look to go short at 442 on the nose, then maybe they'll set their stops at 444. Let's say that the market is extra volatile and it busts through the 442 resistance and ends up hitting 445, triggering your stop at 444, but then it comes back down and ends up crashing. Had you waited until the resistance was pierced a little and entered the trade at 444, you wouldn't have been stopped out. Another advantage to this method is that you can keep a tighter stop because you're entering on the far edge of support or resistance. There is a drawback to this though, and that is you'll end up missing out on some trades since they don't all hit the far end of support or resistance. For very conservative traders who don't mind missing out on some trades, it's a good fit.

Buying support and selling resistance is the most obvious way to play them, but it's not the only way. Playing breakouts is a great trading method, and the basic concept of this strategy is waiting until resistance has been broken then going long (buy), or wait until support has been broken and going short. In the previous paragraph I mentioned that a conservative way to buy support or short resistance was to wait for the price to start to pierce through the respective zone, but that's exactly the opposite of what the principle is behind trading a breakout. In a breakout, you want to be a buyer when resistance is broken and a seller when support is broken, so how do you tell when you should be buying support/ shorting resistance or playing them as breakouts? There is no perfect answer to this, a huge part of trading is just making educated guesses and going with it, and if your guess was wrong get out of the trade. Here are some things to look at and consider when making your decisions.

The first thing I'd look at is the recent price action. How has the price arrived at this support or resistance area? Has it slowly and methodically made it's way into position or did it arrive there by making a sharp, violent move? If a stock is testing resistance right after it's already made a huge run, I would not initially be looking to play it as a breakout because I know that there are a lot of people who are looking to sell after making good profits in such a short amount of time. Another thing to look for is consolidation, which is basically where the price starts to trade in a narrow range for a while. **If a stock has moved up to an area of resistance (or moved down to support) and starts to consolidate, that can often be a precursor to a breakout.** Think of it as the price is resting and forming a base to take off from. Once the price starts to breakout and trade on the other side of support or resistance, normally you'd like for the volume to start to increase to show that others are seeing and trading the same thing you are. Without volume to confirm the breakout, you may be buying into a bull trap or shorting into a bear trap.

There is an alternate way to play a break of support or resistance, and this method is not only more conservative but in my experience it has a greater chance of success. The key is to wait for the price to clearly break through the support or resistance, then wait and watch for it to come back and test that area again. Old resistance will be new support and old support will be new resistance. The longer a trendline or horizontal line has been acting as support or resistance, the more likely it is to be tested. When you buy or short the test, it offers you an incredible reward to risk ratio. The drawback here is that the breakout points don't always get tested, so you will miss out on some trades by going this route. Here's an example of a breakout and then a test of support.

Looking at the chart above, you can see that in February the price made a pivot high then came down. That previous peak is going to act as resistance, and when the price bounced straight back up to the range of that peak's price level, the resistance was also further reinforced by the fact that the 200 day moving average was right there as well. I mentioned in a previous article that moving averages can also act as support and resistance. Considering the price went almost straight up from 290 to that resistance zone around 380, my initial thought would be to go short when the price tested it. Had I done that, I would have been stopped out as soon as I saw the price start to blast through resistance, and not only that **but the volume had an incredible surge** which should tip you off as well. So I get stopped out for a small loss, but now I'm looking to go long if I see an opportunity. As luck would have it, the price does end up coming back down and tests the old resistance for new support. Remember, not only is that horizontal line support, but you also have the 200 MA acting as support as well. This is the perfect time to take a chance and go long, buying anywhere in that general support zone and your stop loss would be somewhere below it.

The methods I've gone over have all been in terms of entries, but you can easily use them as exit strategies as well. If you are in a long position and looking to sell, you would just use the short selling strategies since shorting is really just selling. If you're in a short position and looking to close it (cover/buy), you would just use the long (buying) strategies since covering a short is essentially just buying. Since I've now gone over the concept behind identifying trends and support/resistance, you can now combine the two for hopefully better odds of success. **If the midterm trend is down on the time frame you're trading and the short term trend is up, it may be a good idea to look for strong resistance to short into. Likewise, if the midterm trend is up but the short term trend is down, you might want to identify some solid support to but into. If I'm looking to play a breakout to the upside, I almost always want the midterm trend to be up.** At this point you have more than a solid foundation to work with, you actually have enough to put together a legitimate method. There are still ways

to add to and refine your strategy, but this should be the meat and potatoes of it, everything else will just be gravy. Just remember not to overdo it on the gravy, otherwise you'll ruin a perfectly good meal.

Using Candlestick Patterns

There are a ton of candlestick patterns out there, and some of them have very specific rules and real funny names. While it doesn't hurt to know all of them, I don't think it's necessary (at least not right away), to spend countless hours learning every last one as well as all of the very specific rules that apply to them. There are some basic principles to learn that I think are more important than any specific rule or pattern. Candles help you quickly identify where a security opened and closed at, as well as the high and low for that period. To oversimplify what these candles are essentially telling us is, if the it closes near it's high, that's bullish, near it's low is bearish, and in the middle is a sign of indecisiveness. Without learning one specific candle pattern, I think one of the most revealing things to look for is long wicks. When a candle forms a long upper wick, that means that the price finished well off of it's high point. If the bulls were in command, they would have been able to finish the period closer to the high point, but the fact that it didn't shows that the bears started to gain control late in the period. The opposite is true for candle's with long lower wicks. That shows you that the bears were able to knock the price down initially, but then the bulls came in and started to buy up the lower prices and they successfully closed the period well off of it's low point. Here is a weekly chart with the majority of the long wicks identified.

First off, each long wick doesn't have to imply that a major reversal is coming. It may be the precursor for a major reversal, a small reversal, a stall in direction, or it could mean none of the above. On this chart, almost every single long wick came before either some sort of reversal or stall in price. The only real obvious time it failed was in September of 08 when the price formed back to back long lower wicks around 420. The price ended up breaking below that point, but a failed setup can often be a buy or sell signal in itself because as you can see the drop after the price failed to react to the long lower wicks was very sharp. Another thing to keep in mind that many traders overlook

is the context of where the candles are being formed. If the price is chopping around in tight channel, a long wicks are just probably indicating a struggle between the bears and bulls and it's hard to take much meaning from it other than that. On the other hand, if the price has made an extended move in one direction and is clearly becoming overbought or oversold, long wicks can have very strong implications that the move is coming to an end. Try and remember that the candle itself means a lot less when the context around it doesn't make it clear what's going on. Also, a long wick doesn't have to mean the end of a move, but at minimum it means the opposing team is starting to put up a fight.

Now I'm going to break down some of the specific patterns to look for. They won't be in any particular order as I don't necessarily have one favorite or any that work that much better than the rest. Like I said, it comes down to the context. The more the context is telling me to look for a reversal, the more I like that particular reversal pattern that is forming, no matter what pattern it happens to be.

The first pattern I am going to go over is the **hammer or hanging man**. They look identical, but the key is a hammer is formed after a downtrend and a hanging man is formed after an uptrend. These are formed when the price moves significantly lower than the opening price, but by the end of the period is has gotten back up to the range of the opening price, forming a long lower wick. Technically speaking, a hammer/ hanging man shouldn't have an upper wick to it, but that's being too picky in my opinion. If there is a slight upper wick, it may not be classified as a hammer, but it's still just about as valid. This is where the rules for some of these candle patterns become unnecessarily complicated. The important thing to note is the rejection of the lows for a hammer, and for the hanging man the rejection of the lows isn't the key, the fact that it traded below it's opening price all day is. Here is an example of a hanging man that was formed after an incredibly sharp uptrend.

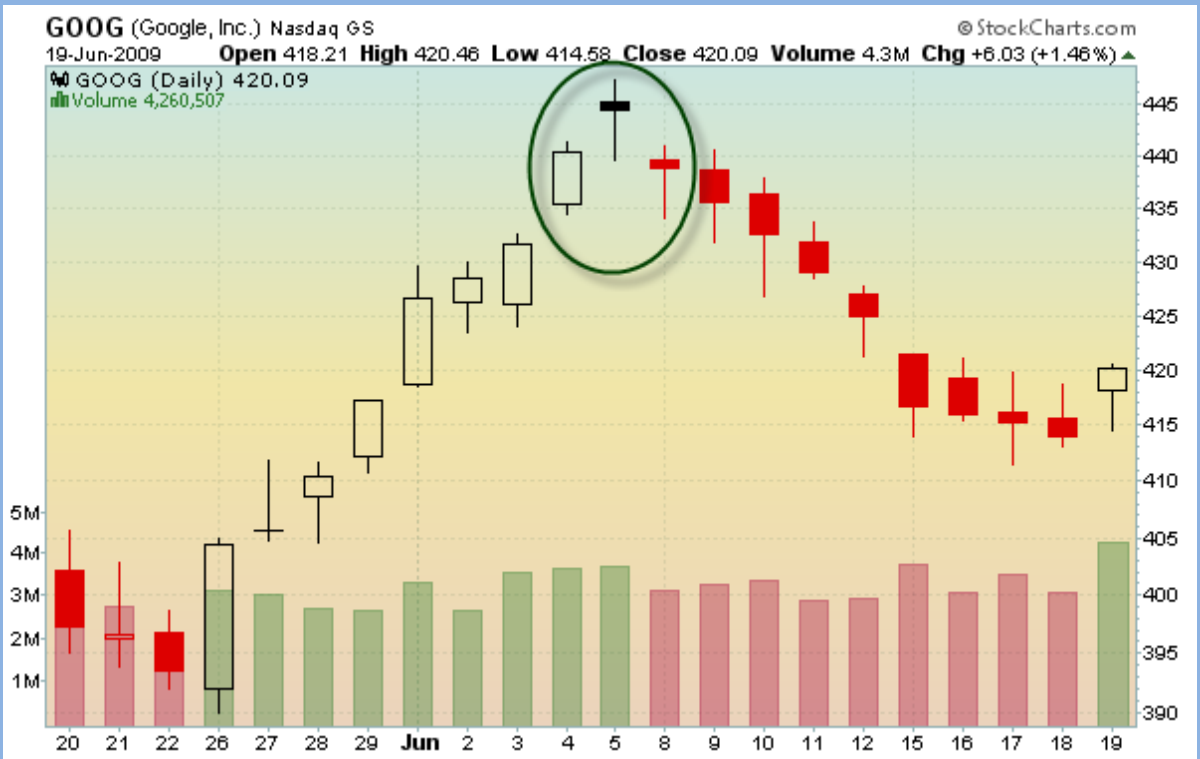
Next up on the list is the doji. **Dojis** can have many different appearances, such as long upper or lower wicks, short upper or lower wicks, and any combination of these. The main attributes that make them dojis are: The open and close have to be the same or very close (close enough that the body looks like a horizontal line) and there needs to be some sort of lower or upper wick, or both. Most dojis have both the upper and lower wicks, but a doji that closes at the low of the period (which would mean it also opened there) is a gravestone doji and a dragonfly doji is where it closes at the high of the period. The main thing to take from a doji is the indecision it's conveying. Again, if this is formed in a channel or anywhere without a major move to reverse/ correct, than it's not nearly as helpful as one that forms after an extended move that is overbought or oversold. Here is an example of one that is formed after a nice downtrend.

Regarding the above chart, there are some other things to note. First off, you can see that the price doesn't immediately respond to the reversal candle. The next candle was a down day that even tested the lows of the doji again. You can't expect the price to immediately react all of the time. In this case, the market was still testing out what it wanted to do, and the candle following the doji ended up forming a long lower wick as well. Back to back long wicks are a pattern in themselves, known as tweezers (either tops of bottoms). Basically, the second one is just confirming the first, making it more of a reliable signal. You may even end up getting more than two long wicks, that just shows a major battle but the wicks continue to imply that the price continues to be rejected when it enters that range.

Another reversal pattern to be aware of is **bullish and bearish engulfings**. Whether or not it's formed after an uptrend or downtrend determines whether it's bullish or bearish. The characteristics to look for is one large candle that completely engulfs at least the previous day's candle, if not more. The chart I posted above that has the hanging man is actually an example of a bearish engulfing as well (look at the candle after the hanging man), though a truly ideal engulfing pattern completely engulfs the entire previous

candle, not just the body of it like in that example. Here is an example of a bullish engulfing that formed after a downtrend. The price may not have instantly reversed after it was formed, but it did end up marking the bottom.

The last pattern I'm going to cover is a three candle setup that I've found to be reliable as well, but once again the key is that it needs to be formed after an extended move to be truly significant. This pattern is called either an **evening star or morning star**, depending on where it's formed at. An evening star is formed after an uptrend and is bearish, a morning star forms after a downtrend and is bullish. The characteristics of an evening star pattern is a long white candle that continues the uptrend, followed by a small candle that gaps up but finishes lower (than it opened), then the last candle gaps down and finishes down. Basically the middle candle needs to be isolated from the surrounding two. A morning star is the exact opposite, a long red candle followed by a small candle that forms after a gap down, followed by a candle that gaps up and closes up. Just like the middle candle on an evening star should close down a little, the middle candle on a morning star pattern should close up a little. If the middle candle is a doji, then the pattern is still essentially the same but it's now called an **abandoned baby pattern**. Depending on whether you consider this middle candle a doji or not, here is an example of either an abandoned baby or an evening star reversal pattern. Whatever you want to call it, **the key thing to note is the isolated, indecisive candle that forms in the middle**.



All of the candle patterns I went over today are considered reversal patterns. There are setups that are known as continuation patterns, but I haven't found them to be nearly as useful as reversals. If I'm buying into support on a pullback or selling into resistance during a rally, I'm looking for reversal candles/ patterns. If I'm selling on a break below support or buying on a break above resistance, I'm not looking for reversal patterns (since I'm not looking for a reversal), but I don't really look for specific continuation patterns either. It's basically a matter of making sure there is consolidation in the range of the support or resistance, then waiting for one of the candles to close either below support or above resistance. Since buying can mean covering a short position and selling can mean short selling, that pretty much covers all of the possibilities, and none of those possibilities really require the use of continuation patterns. Others may disagree with me, but the good thing about how I've presented the material in my articles is that by implementing what I've gone over, you won't be painting yourself into a corner so to speak. I believe that the things I've covered are pretty much universal, and they leave open the possibility to add whatever touch of TA you'd like use in addition. If you want to add continuation patterns, that's no problem. If you want to add RSI, MACD, Stochastics, or any other indicator for additional and conformational buy or sell signals, awesome. Everything I've gone over so far is just the framework for my method of chart analysis. Though it may be just the foundation, it probably is more than three quarters of what I actually use in my trading.

Candles alone are limited in what they can do, but when you use them to time your trades based on the trend and support and resistance, you have a very powerful, yet still simple, method for trading.

Putting It All Together

Now it's time to combine the basic concepts I've already gone over in my previous articles and give you an example of how to use them together. You should have a good idea of how to determine the trend on a chart, spot support and resistance, and identify candle patterns that are hinting at a possible reversal. If you're still uncertain about these concepts, go back and reread the articles. Let me start off by giving you the chart I'm looking to trade as well as the time frame. This is a weekly chart for GOOG, and I'm approaching it as a longer term swing trader. I plan on using the 50 week moving average to identify the midterm trend on this time frame, and if all goes well a trade on this time period should take at bare minimum a few weeks, but should end up taking much longer. The only exception would be if the trade went against me and I got stopped out prematurely. Here is the chart.

Right off the bat, you should notice that the stock has had a serious fall in price since it's peak. Hopefully you also noticed that the last two candles are reversal candles, specifically spinning tops, but even without knowing that (since I didn't specifically go over spinning tops), the long wicks should have tipped you off. Two long lower wicks side by side are their own reversal pattern in themselves, called a tweezers bottom (which I did go over). I don't want to base my trade on the candles alone though, so I'm going to apply the 50 MA to this chart and get a feel for what the midterm trend is.

Looking at the chart now with the 50 MA applied, you can see that for the first three quarters of it, the stock was in an uptrend and the price was trading above the 50. The 50 MA can act like a magnet, and if the price gets too far away from it, expect it to correct itself (or at least trade sideways to let the 50 MA catch up). You can see that when the price peaked, it was the furthest it had been from the 50 in a long time. Now the 50 MA is leveling off and the price is trading well below it. Based on this, I'd say that the midterm trend on this has now flattened and even looks to be starting a downtrend, but like I just mentioned, the price has strayed very far away from the 50 MA and it looks like it's going to revert to the mean sometime soon. While I would be expecting a bounce here in the near future, the fact that the midterm trend is flattening after a long uptrend indicates that this won't be a trade where I ride a trend for a while. I'm mainly looking at playing the correction from this sharp drop in price. So I know what the trend is, and though it's not totally in my favor, there is an opportunity for a shorter term trade. I already pointed out the two reversal candles that have formed a reversal pattern, the last thing to do is spot support and resistance. Normally, you'd probably identify support and resistance first, and then wait for the reversal candles to form. It just depends where the price is at when you start following the stock. Now here's a chart with what I see as the major areas of support and resistance. Remember, you can draw a ton of lines on the chart, but you really want to limit it to the ones with the most touches and reactions from the price.

First off, the ascending trendline which held up for over two years is very critical considering how long it was in play. In early 08, the price ended up breaking below it, then it tried to bounce off of the support line around 500. It was support back then, now that the price is below it, its resistance. You can see where the price had a reaction to it, I circled it in red. It broke below it, then climbed back above to form a hammer, which is a reversal candle. There was a mild bounce, but when that area was broken below for the second time, that was a failed bounce attempt and the bulls knew to give up and the bears were then clearly in control. Fast forward a couple more months and now we have the two spinning tops/ tweezers bottom forming, and you can see that there is definitely support in that general area. The first attempt to bounce at 500 was a failure, so that makes the current conditions even move oversold and a sharp bounce even more likely. Like I said in the previous paragraph, since the mid term trend is flat to down, I don't plan on buying this here for a long term hold, but the conditions are perfect for a sharp, shorter term bounce. I am going to look at those previous areas of support turned resistance for possible profit targets. First up will be the horizontal line at 500. Considering the magnitude of the drop, I think that target is fairly conservative, and next up after that would be the 50 MA. Remember, the major moving averages (50 MA, 200 MA, etc.) can often act as support and resistance, and since the price is below the 50, that would make it resistance at the moment. Finally, that trendline which held the price up for so long is going to be major resistance. The stronger something acted previously as support, the stronger it will act as resistance. The opposite is obviously true as well for resistance turned support. Should the price make its way back up to that trendline, the chances of it knocking down the price are incredibly high. Even if the price eventually gets back over it, the initial contact with it will almost certainly get a very large reaction. Let me fast forward a few months to show you how this played out.

You can see that the stock did end up rallying very hard after it tipped its hand with those reversal candles. Remember, the stock didn't move because of the chart, the chart just reflected what was going on. You can see that the rally took the price right through the resistance lines and through the 50 MA, but once it hit it's head on that trendline, that was it. The price tried to consolidate and regroup for an attempt to break back above it, but when it broke below that consolidation range, the bears quickly stepped in and took over.

This was just one example of how to possibly use these three aspects (trends, support/resistance, and price action/candles) of chart technical analysis. Not every trade has to have all three working perfectly in your favor; in fact this example didn't even have the trend on our side. If you really wanted to have everything working for you, you'd wait for a fresh uptrend (50 MA angling up after it's flattened), wait for the price to break over the 50 MA and make it's initial move, wait for the first major pullback, identify support, then time your entry. An example of that would be the first test of the trendline I drew on the chart, right around March 06. You wouldn't have known that was the start of the trendline since it was the first test, but you would have known that the 50 MA had just started to angle up and the price was pulling back to test it for support. If you look closely, you can see that there was also a nice reversal candle right at that point, giving you a perfect entry. Imagine if you'd have bought in then and rode the wave all the way up. Remember, this all applies to shorting as well, but instead you'd want a fresh downtrend (50 MA to start to angle down after it had flattened), wait for the first major move below the 50, wait for the first correction after that, identify resistance, then time your entry. That is just an example of the typical, ideal setup where everything is working in your favor, but there are many possibilities.

This example I gave you today was on a weekly chart, which is much longer term than most traders I know use. This method applies to any chart time frame you want, hourly, daily, weekly, monthly, etc. I could trade exclusively using just setups like the one I

posted, but this may only be the beginning for you. The longer you watch charts in action and are actually aware of the trends at play, support and resistance, and candles that form and where, you'll start to develop a sense for how stocks move. There is only so much I can actually tell you, eventually it becomes up to you to absorb these things first hand. So get out there, be aware of the trends at work, where support and resistance are at, and what the candles are hinting at. Once you can start to spot these things without much effort, the puzzle will really start to come together and the rest of the pieces will just fall right into place.

Proper Position Sizing

How large or how small should your position be in any given trade? Before I get into the answer to that, there is one prerequisite that supersedes everything, the liquidity of what you're looking to trade. You need to keep your position size to as small of a percentage as the average daily money volume. You can estimate the average money volume by taking the price and multiplying it by the average amount of shares traded daily. If a stock that is trading at $1 averages in between 10,000 and 30,000 shares, the average money volume is probably in the ballpark of $20,000. How much of the average money volume do you want to be? The less the better, but there is no official threshold to stay under. I'd say staying under 2% is pretty safe, but if you know what you're doing you can push that somewhat. This really only applies to penny stocks and other thinly traded stocks, but I figured I should cover that base just to be sure. If you're trading highly liquid securities like blue chip stocks, commodity futures, forex, etc. then this won't be an issue.

As long as you have the liquidity issue covered, here is how I determine my position size. To start with, I need to know a few things to figure out what my position size should be. Those are; how much I'm willing to lose on this trade, where my entry is, and where my stop loss is at. For example, say I'm watching a stock that is an uptrend, but it's currently falling back to support at $10. Since the longer term trend is up, I'm looking to buy into the support at $10, but if that support fails to hold, I'm going to bail. The most I want to risk losing on the trade is $200. That doesn't mean my position size will be $200 worth of shares, that means that should my stop loss get triggered I only want to lose $200. So my entry is at $10, and my stop loss will be enough below that to allow for normal market fluctuations, we'll say at $9.50. So now I know all the factors to determine my position size. My maximum risk is going to be $200, the entry is at $10, and the stop loss is at $9.50. Based on that, my position size would be 400 shares. 400 shares multiplied by $10 is $4000, and 5% of that (which is what my stop loss is set at) is $200. An easy way to figure this out is by dividing your maximum risk amount by the percentage of the stop loss. In this case, it would be $200/ 5%, which would give the $4,000 figure. You then just need to factor how many shares you can buy with that amount.

If you always risked the same amount on every trade and kept an arbitrary percentage for your stop losses, your position size would always be the same (in dollars). My problem with this is that an arbitrary percentage doesn't make sense to me since all stocks and charts are different. The stock (or whatever you're trading) and the chart should dictate your stop loss. A 5% stop may work great on one stock, but on another much more volatile one may get triggered way too easily. If you feel that on a certain trade you need a 10% – 20% stop loss because of either the volatility, where the closest, most relevant support/resistance is at, or both, then use that wider stop, but adjust your position size accordingly. That way, you're still allowing the proper amount of buffer room for price fluctuations, but you're still risking the same amount if your stop gets hit.