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# The Most Accurate Chart Patterns and How to Use Them

by Ed Downs





# Forward

Everyone who buys a stock thinks it's going up. And everyone who sells to those buyers thinks it's going down. But it is the imbalance between Buyers and Sellers that causes price to change. The larger the imbalance the bigger the change.

Price change is seen by the market and creates more price change, which creates patterns of human behavior that we call Chart Patterns. Because human Buy & Sell decisions around money are fairly consistent, these patterns can be predictive of what the market will do next.

If sudden buying causes a "gap", the odds of an additional price rise are high because more buyers will react to the gap and start buying. If price approaches a "support level", buying will increase on the *anticipation* of a price rise, *because of the mere existence of the support level*.

In this course, we will become familiar with all the important Patterns, learn which ones to pay special attention to, and how to profit from this knowledge.



## "Greed and Fear"

From: [jrotman.wordpress.com](http://jrotman.wordpress.com)

Ed Downs





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# Part I

## Chart Patterns Defined

**101: The Most Accurate Chart Patterns  
and How to Use Them by Ed Downs**



# Part I – Chart Patterns Defined

## 1. The Psychology of Patterns

## 2. Pattern Structure

## 3. The 7 Base Patterns

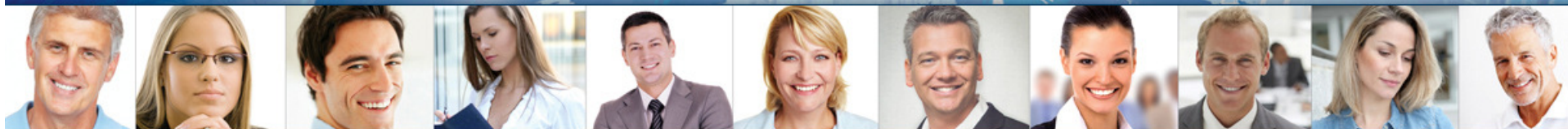
- Support & Resistance
- Trend Line
- Saucer
- Fibonacci Retracement
- Gap
- Volume Climax
- Consolidation

## 4. Combinations of Patterns

- Channels
- Cup & Handle
- Head and Shoulders
- Tops & Bottoms
- Ranges







# Part I

## Section 1: The Psychology of Patterns





# What is a Chart Pattern?

- Patterns reflect the psychology of a market.
- Patterns can also determine the behavior of a market.



Patterns work because investors, traders, and fund managers **react the same emotional way to them.**



# Why Patterns Work

- Chart Patterns work because participants **react** similarly based on what happens in the chart. Each of the following patterns causes an emotional Buy or Sell reaction.





# Trader Psychology & Patterns

**Measured Gap** indicates more downside movement in store.

**Resistance Bounce** signals a new sell-off.

**Volume Trend** at the Bottom indicates buying pressure.

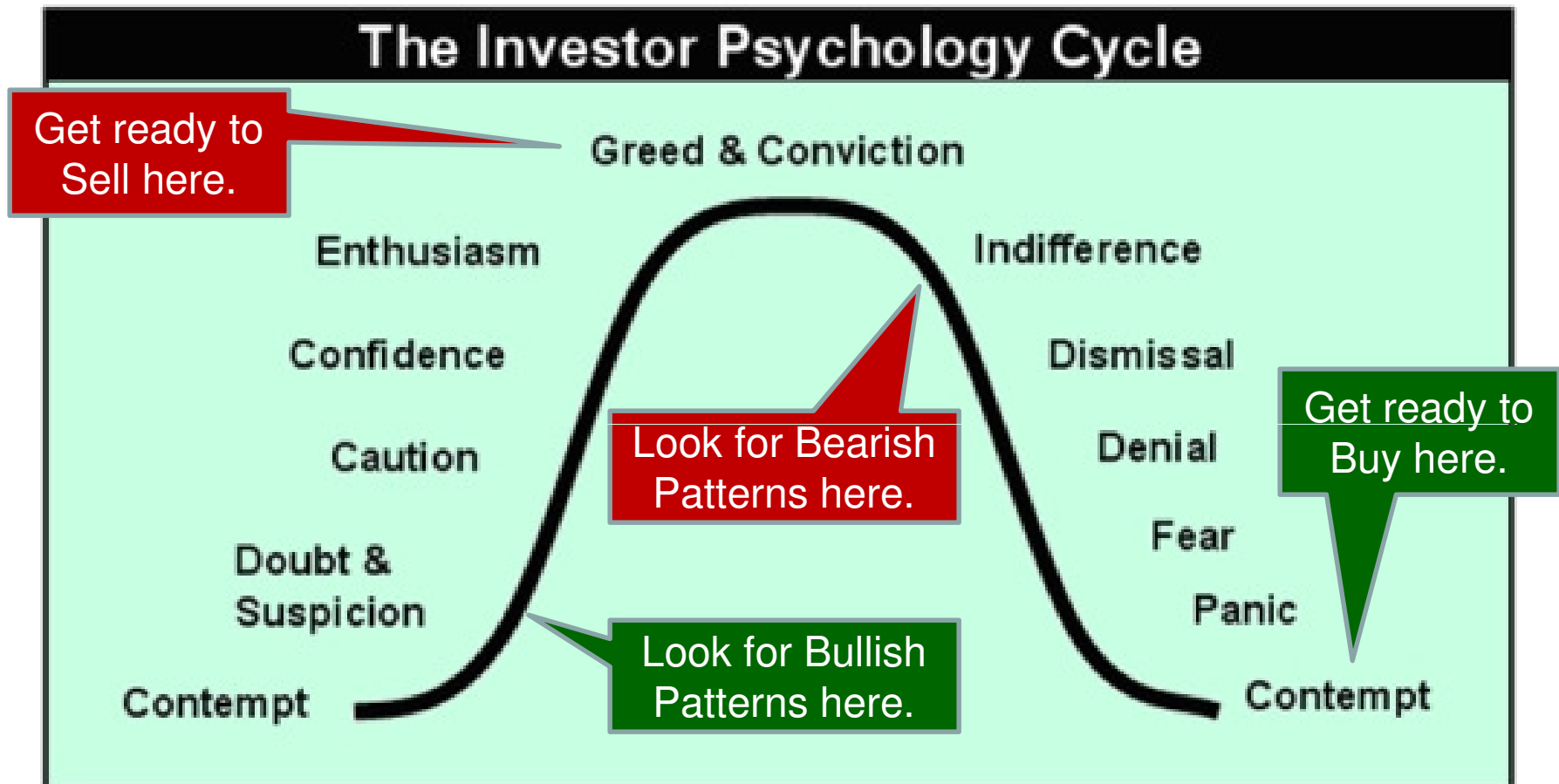
Higher Lows confirm a new rally. A **Trend Line Bounce** indicates buying pressure.

A **Head and Shoulders** pattern indicates new weakness in the market.





# The Fear/Greed Investor Cycle

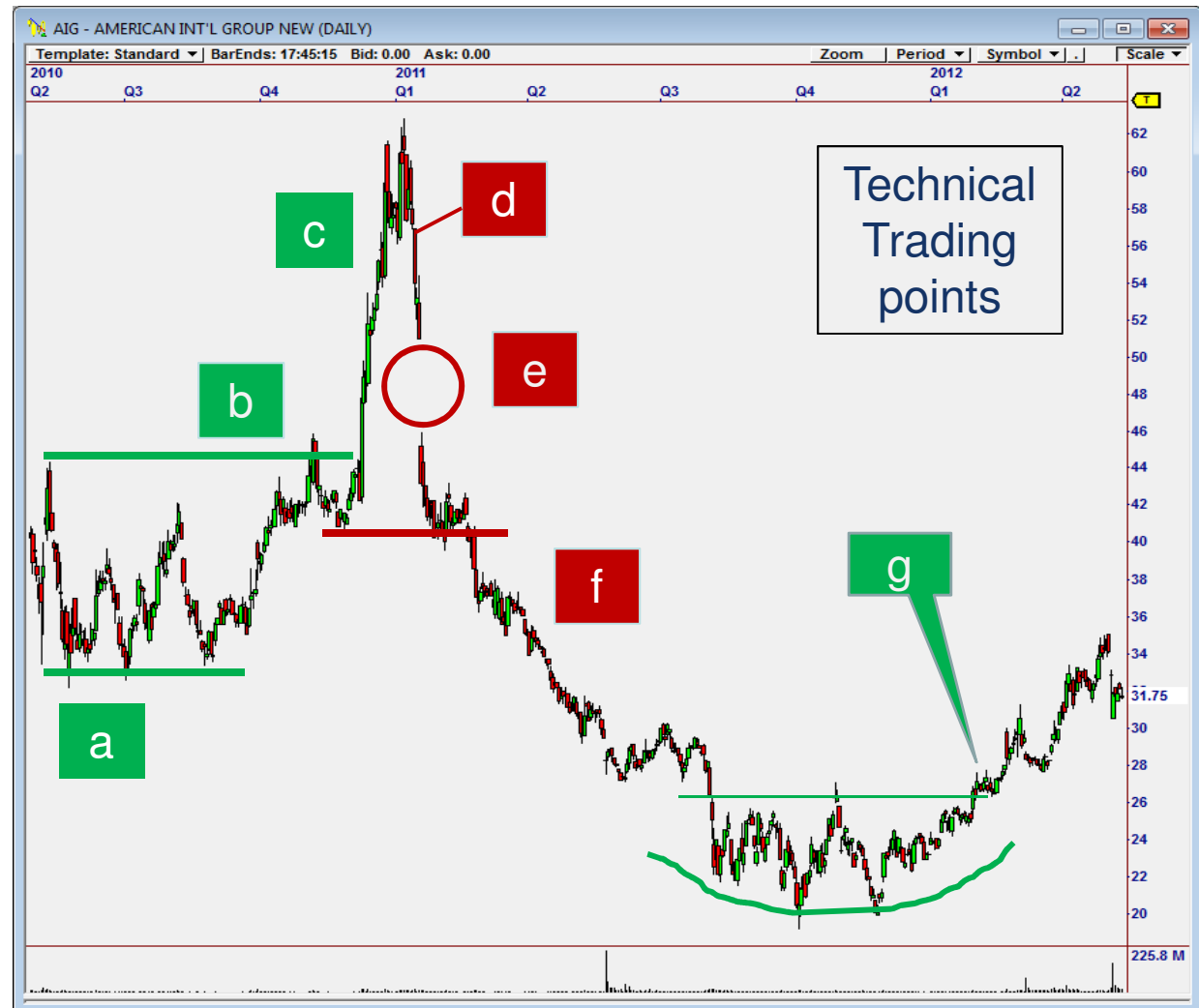


Investor psychology constantly moves Fear to Greed and back in cycles. We can profit from this if we recognize extreme Greed and Fear.



# Transition from Greed to Fear, and Back

- a) **Market Uncertain**  
(support bounce)
- b) **Out-Performing**  
(breaking resistance)
- c) **Late Arrivals**  
(dramatic price increase)
- d) **Disappointment**  
(breakaway gap)
- e) **Confirmation**  
(measured gap)
- f) **Weakness**  
(Head & Shoulders breaking down)
- g) **Early Optimism**  
(saucer pattern)

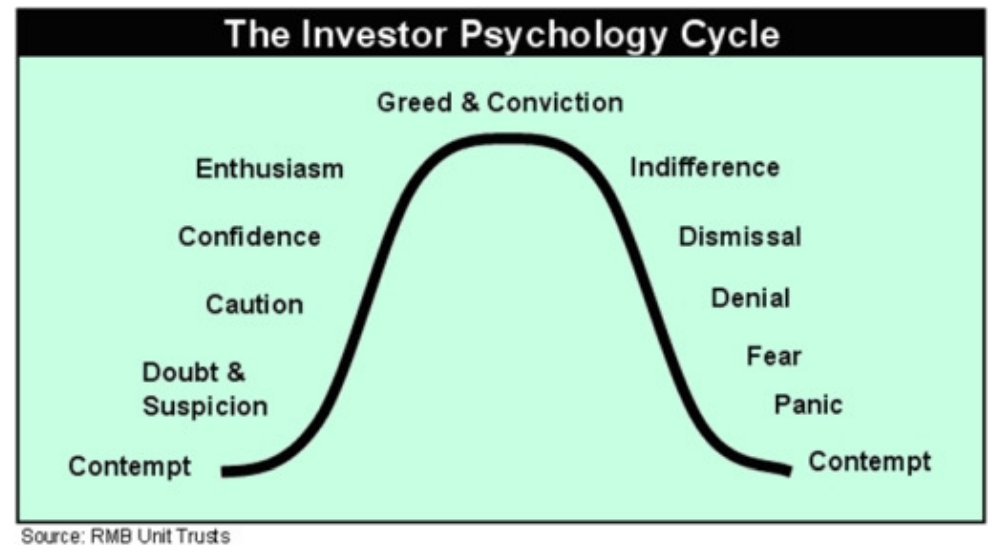




# Summary

Markets Cycle between the emotions of Greed and Fear

- Chart Patterns REFLECT these emotions.
- Chart Patterns also CAUSE these emotions to occur.



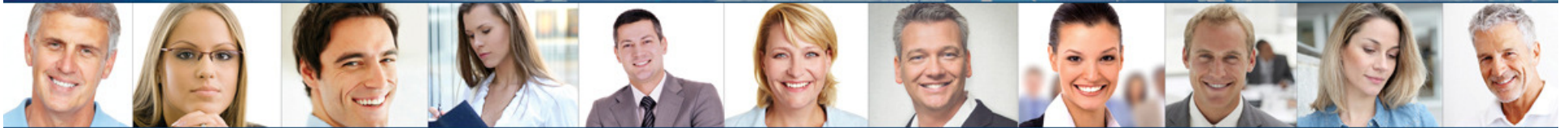
By learning to read Chart Patterns effectively, we can stay ahead of most investors.

- Buy on Bullish Patterns at the end of a FEAR cycle.
- Sell on Bearish Patterns at the end of a GREED cycle.





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## Part I

### Section 2: Pattern Structure





# Pattern Identification Structure

All Chart Patterns have a defined structure that enables us to identify the Pattern.

This example shows a Channel, which we identify at the lower swing pivot, because of the parallel line drawn above (this is covered in the section on Channels)





# Trade Management (Eighths Tool)

The Eighths Tool can be used for Trade Management.

We are introducing it here because we are going to use it in all our pattern examples.





# Trade Management (Eighths Tool)

We will study the Eighths Tool in depth in **Part II, Section 2 – Trade Management**, but let's briefly look at how it works before we review the patterns.

As price advances, we move the Stop up to rungs of the tool as the Stock Closes above a higher rung. \_\_\_\_\_





# The Target Rule



If the Stock closes above its Target, we can move the Stop up to that level. This can result in an immediate exit but often price will run past it.

(The 8ths Rule will be covered in Part II).



# Summary

All Chart Patterns have a defined Structure we will explore in the next section.

In each case, we will show:

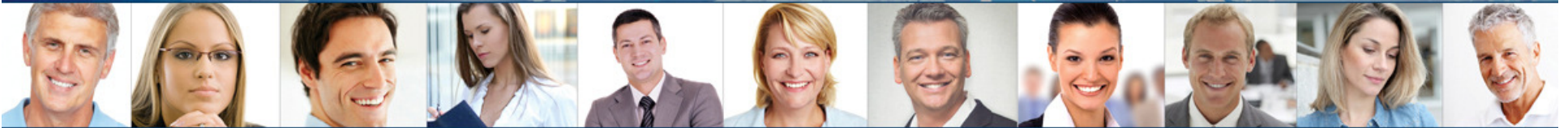
- How the Pattern is identified.
- A basic Eighths Scale for Trade Management
- Entry and Exit using the Eighths Scale.







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## Part I

### Section 3: The 7 Base Patterns



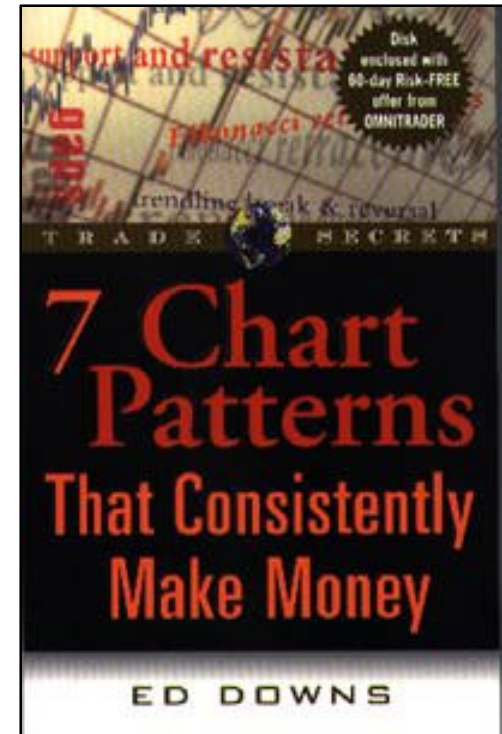


# Base Patterns

The 7 Base Patterns:

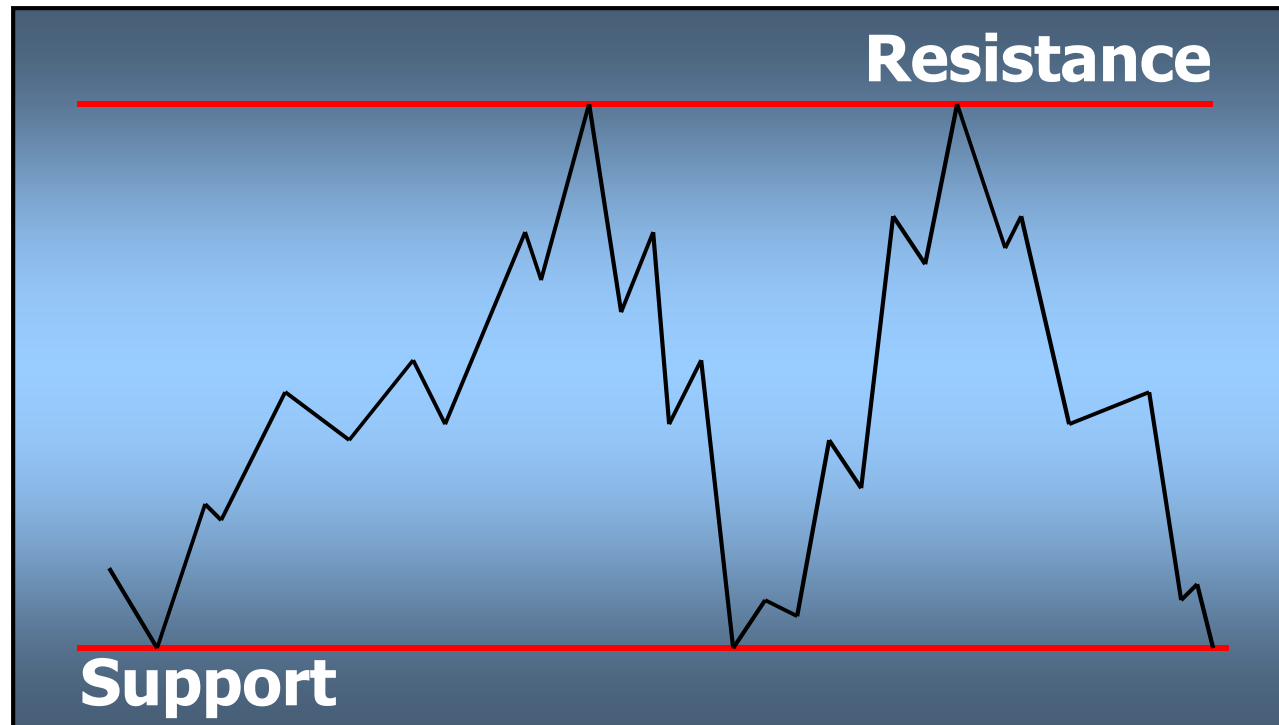
1. Support & Resistance
2. Trend Line Reversal & Break
3. Saucer Formations
4. Fibonacci Retracements
5. Price Gaps
6. Volume Climax & Trend
7. Consolidations

Virtually all Chart Patterns are some variation of these basic constructs.





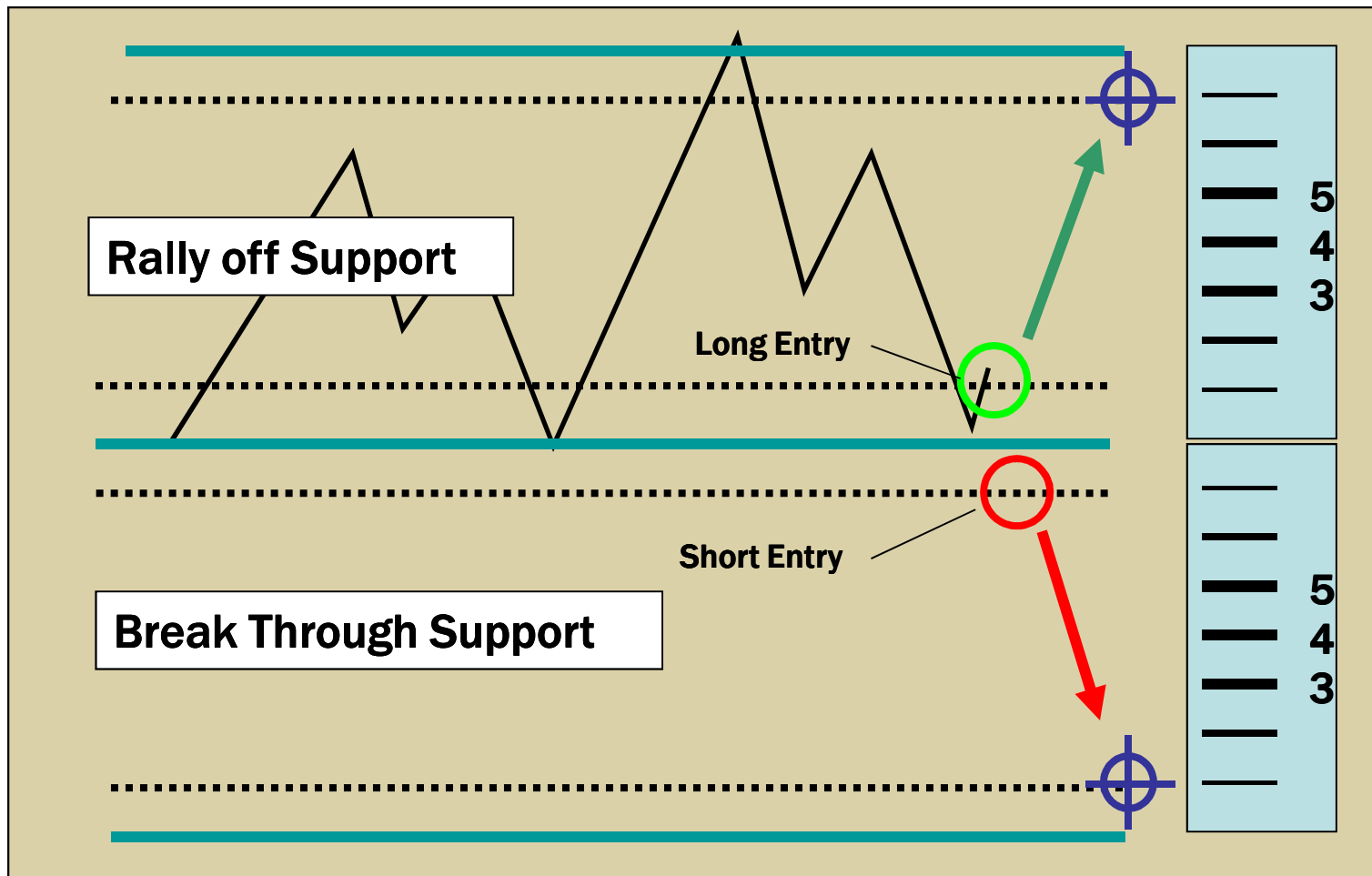
# 1. Support / Resistance



“As market approaches support, and especially as it reverses, the market participates – adding more fuel to the fire. **Support breaks can create PANIC.**”



# Support / Resistance Structure





# Support & Resistance

## Retail Holders Trust



The 1st trade exited on a traversal using the 8ths tool.

The 2nd trade actually hit its target, so we used the Target Rule to Exit



# Support & Resistance

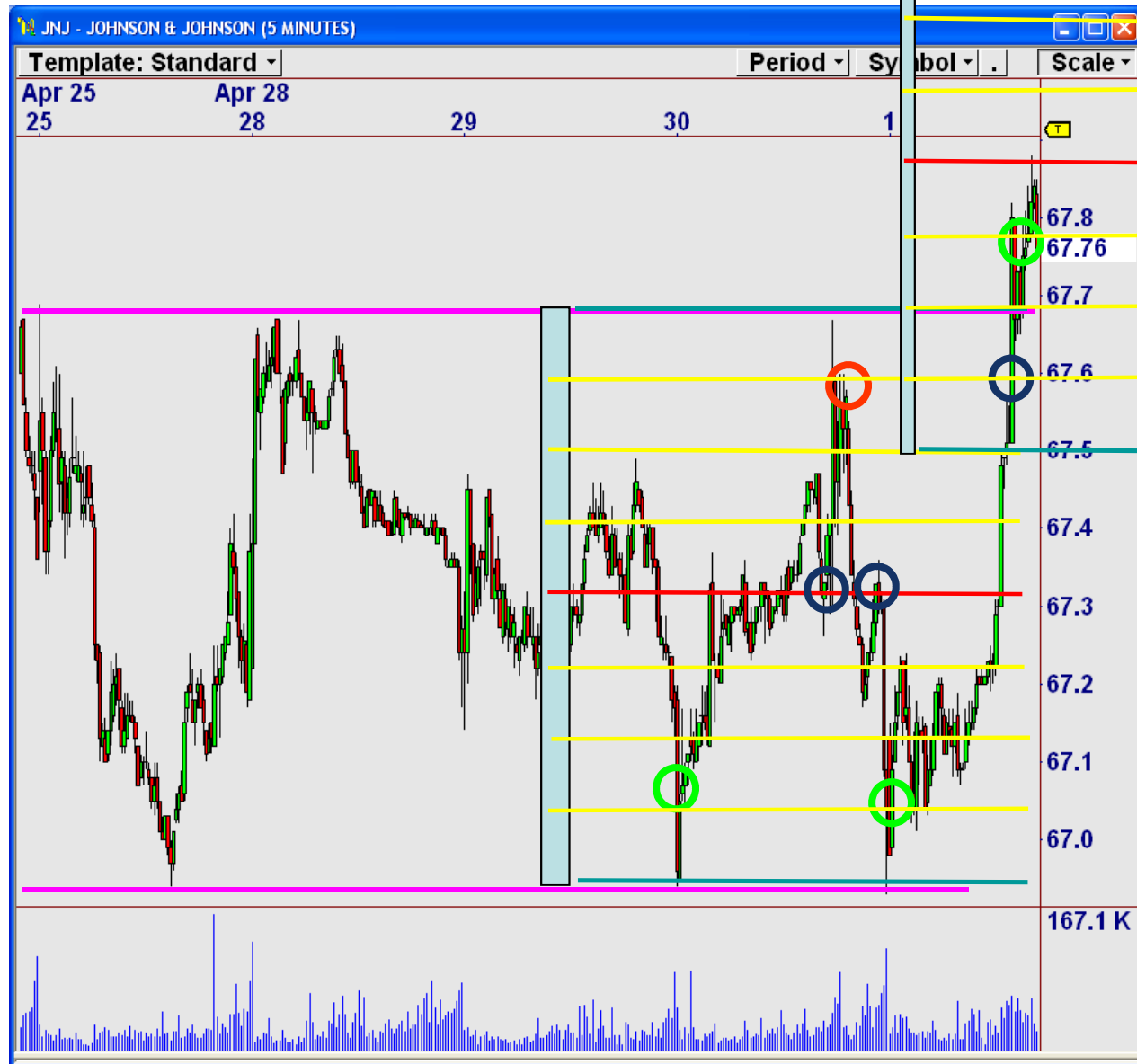
## Nexen, Inc.





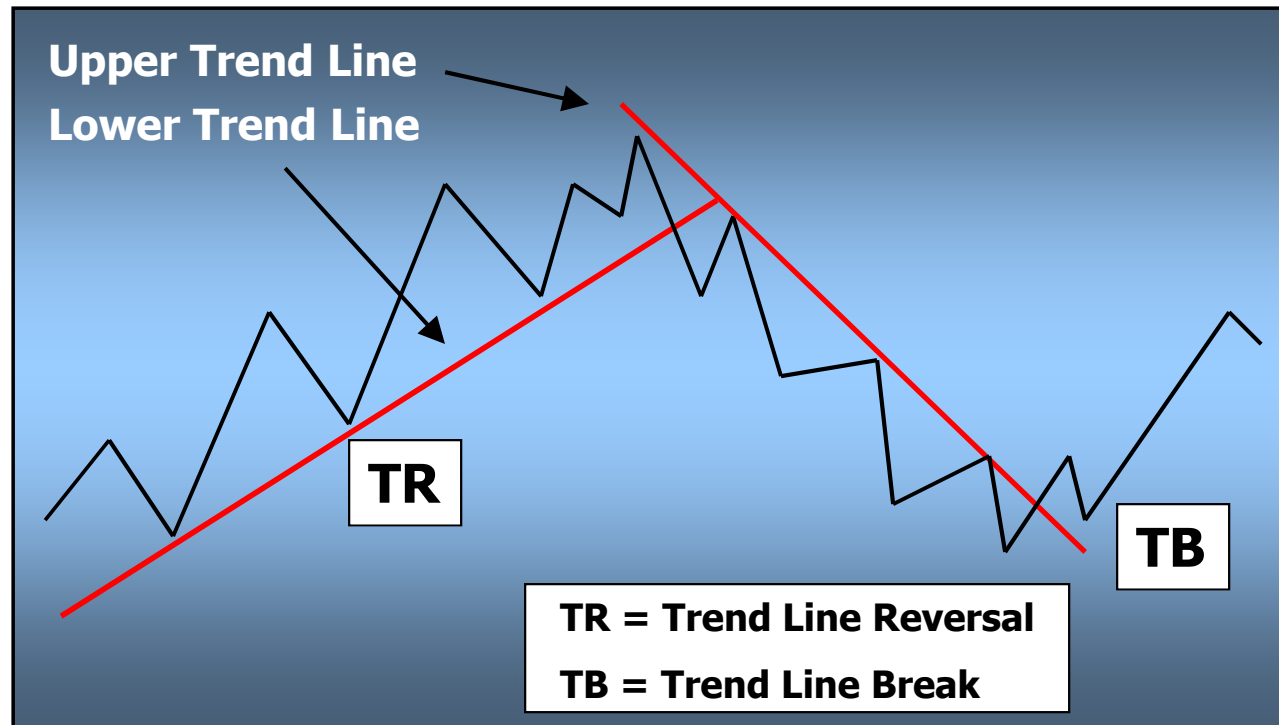
# Support & Resistance

## Johnson & Johnson





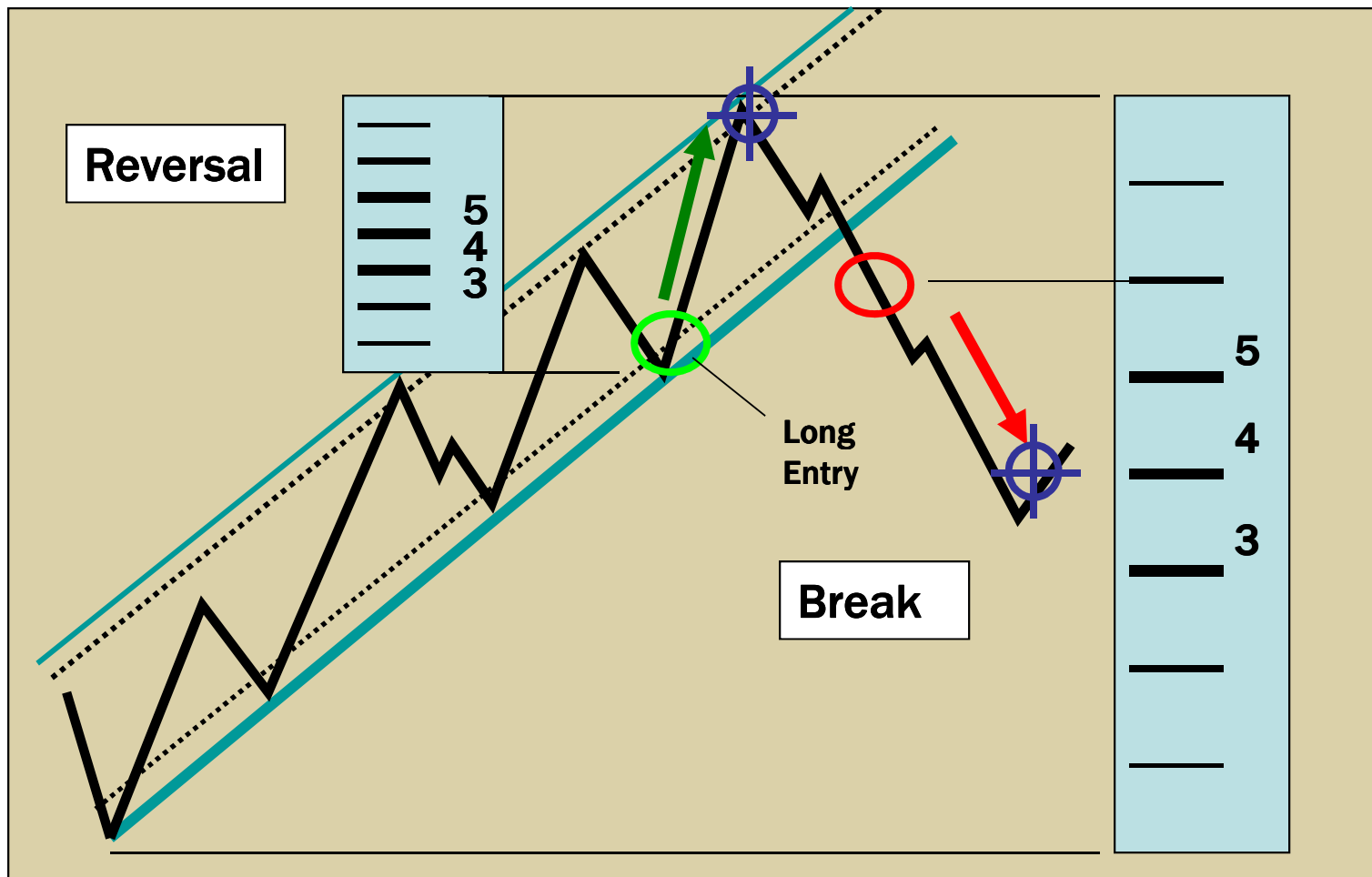
## 2. Trend Line Break (& Reversal)



“An invisible line forms as price reacts to it. This creates a similar psychology as Support and Resistance lines do. **Breaks can create panic.**”



# Trend Line Structures





# Trend Line Break

## UNS - Unisource Energy Corp.



Target  
Exit



# Trend Line Break

## ODFL - Old Dominion Freight Line



Target  
Exit



# Trend Line Break

## PEP - PepsiCo, Inc.





# Trend Line Break

## UYG - Proshares Ultra Financials



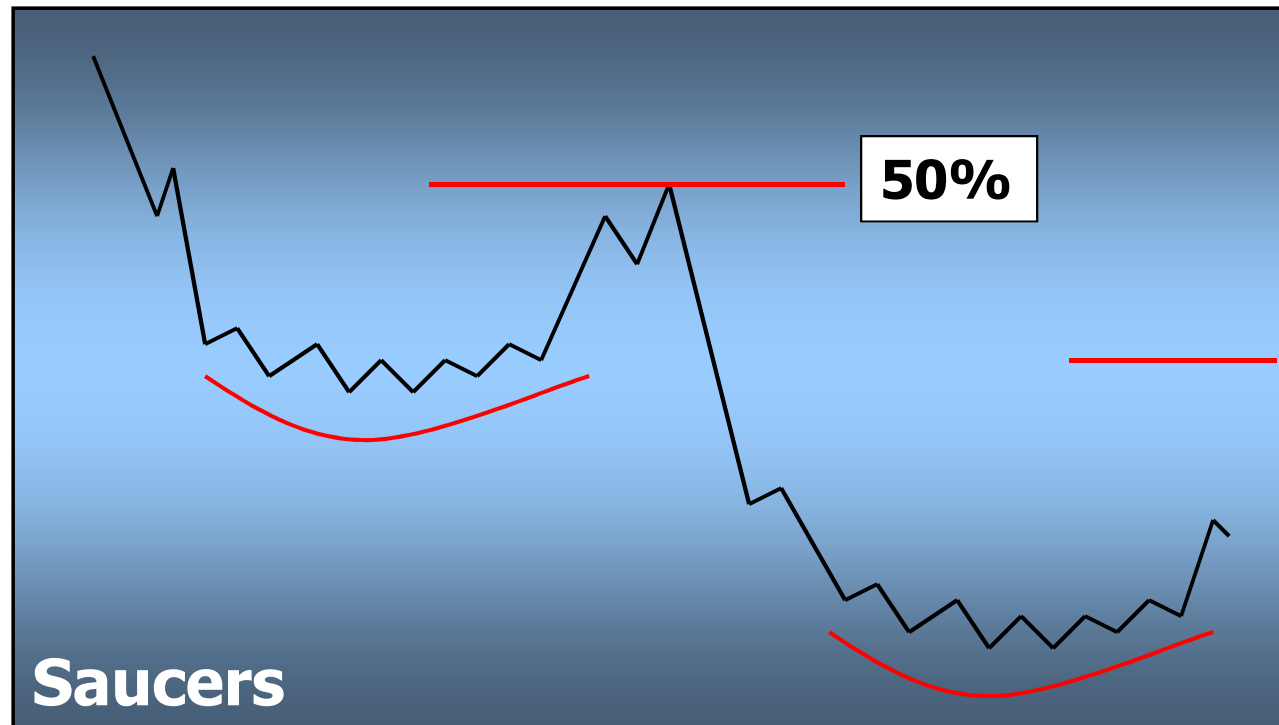
**Target**

8ths  
Exit

**Entry**



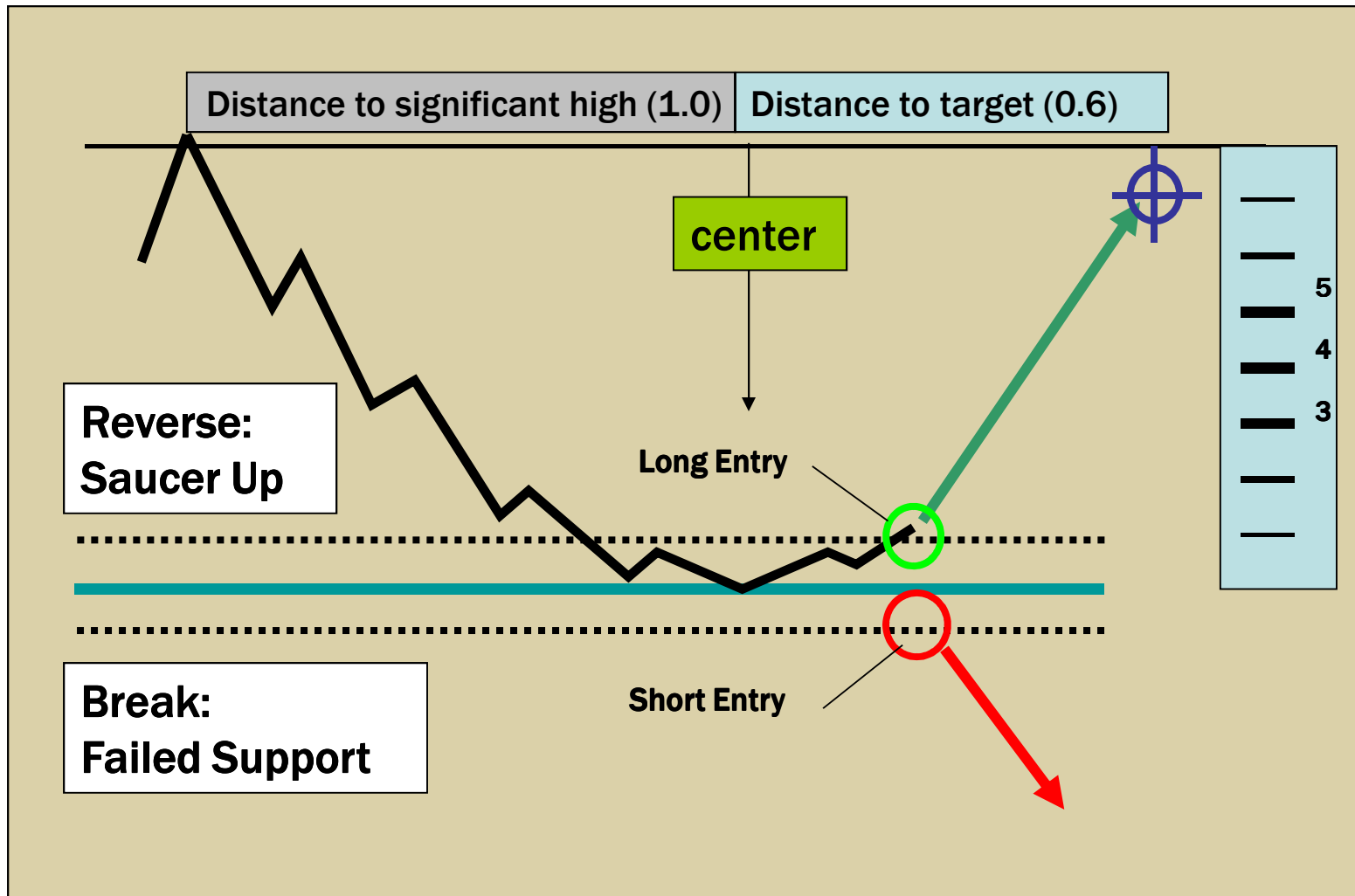
### 3. Saucer Patterns



**“Saucers usually occur at support (resistance, occasionally). Smooth transitions in price are noticed, causing buyers (sellers) to enter.”**



# Saucer Pattern Structure





# Saucer Pattern

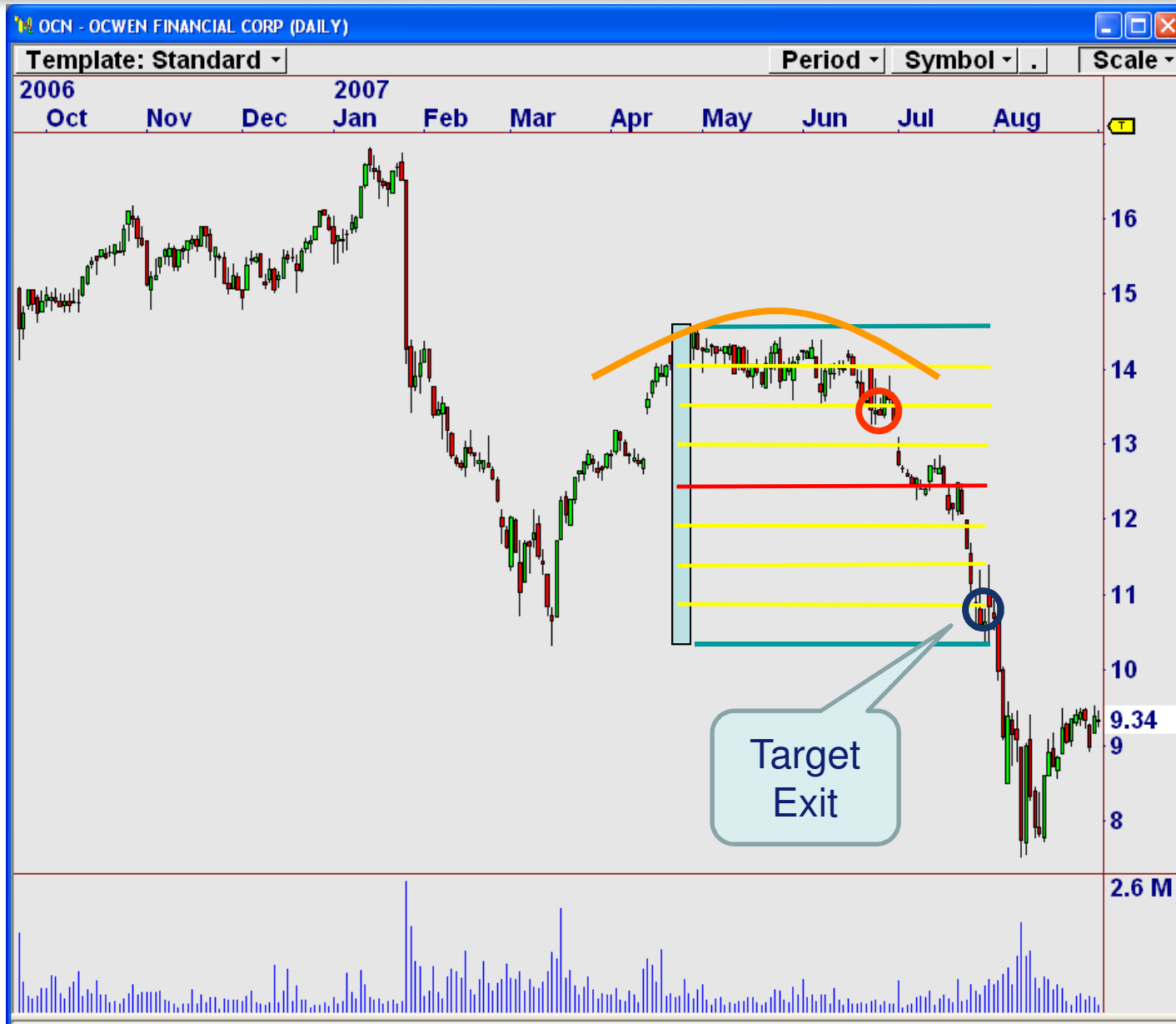
## WIRE - Encore Wire Corp.





# Saucer Pattern

## OCN - Ocwen Financial Corp..





# Saucer Pattern

## ICO - Internat Coal Group, Inc.





# Saucer Pattern

## GM - General Motors Corp.



Current Stop



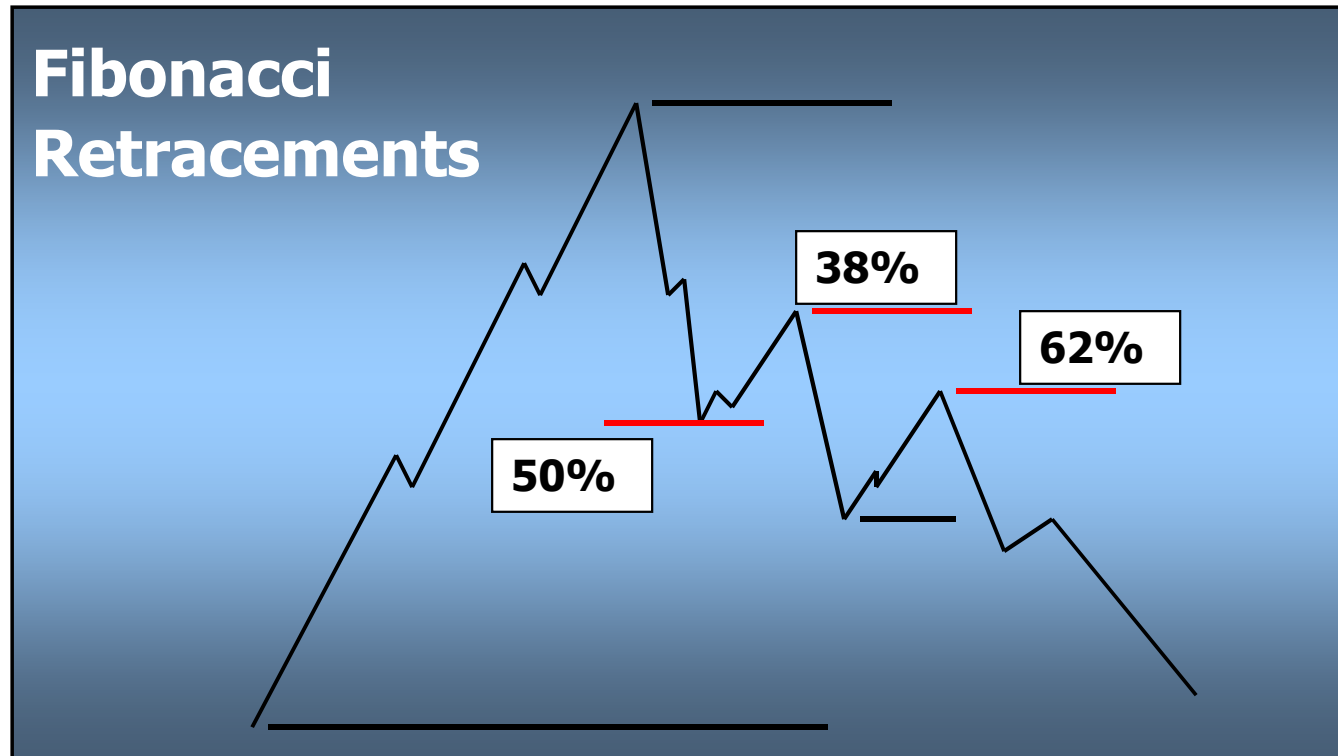
# Saucer Pattern

## RGLD - Royal Gold, Inc.





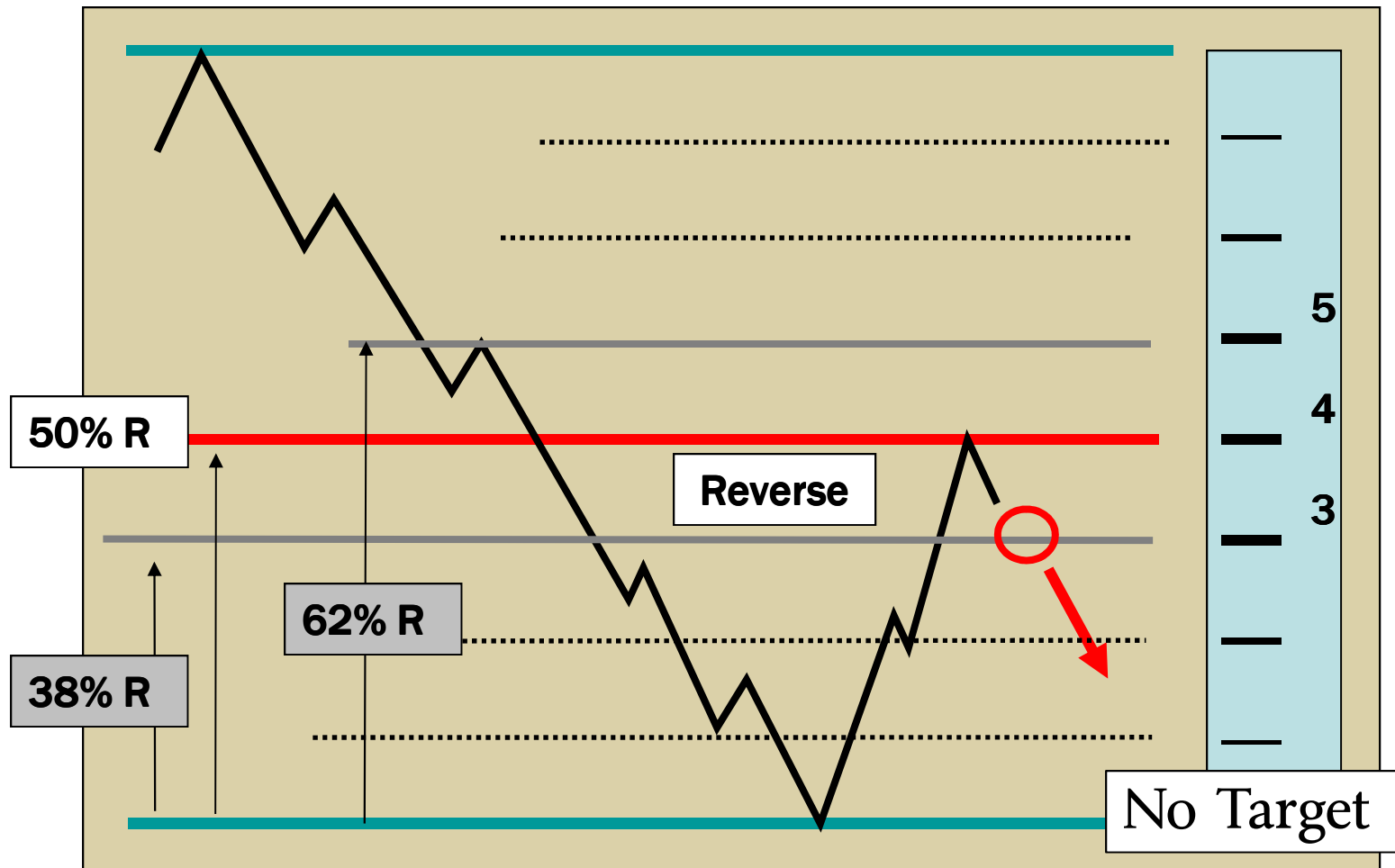
## 4. Fibonacci Retracements



**“Markets typically reverse on eighths, especially  $3/8$ ,  $4/8$ , and  $5/8$  – which is 38%, 50%, and 62%. This is an observed truth of market psychology.”**



# Fibonacci Retracement Structure





# 38% Retracement

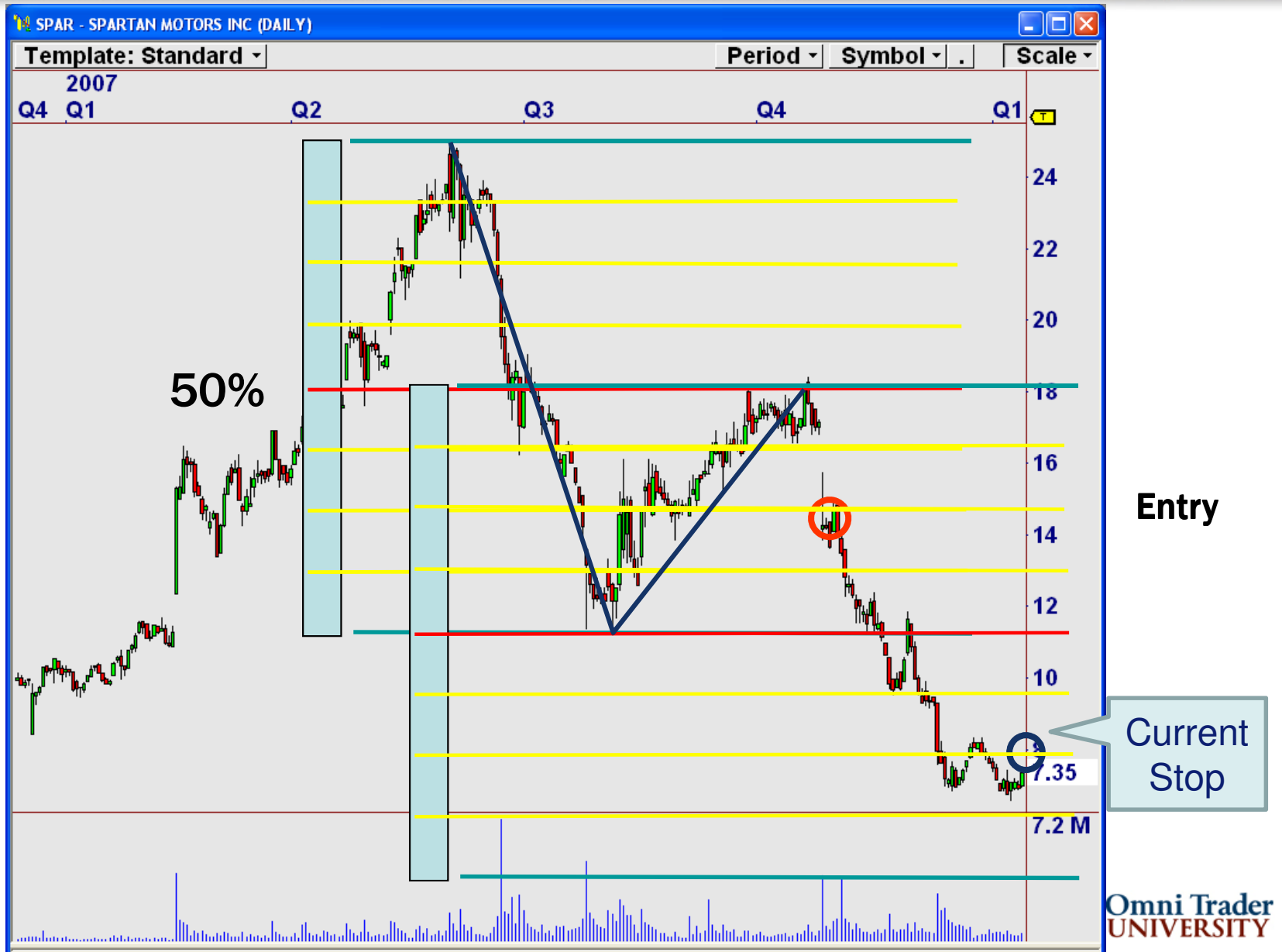
## UNT - Unit Corp.





# 50% Retracement

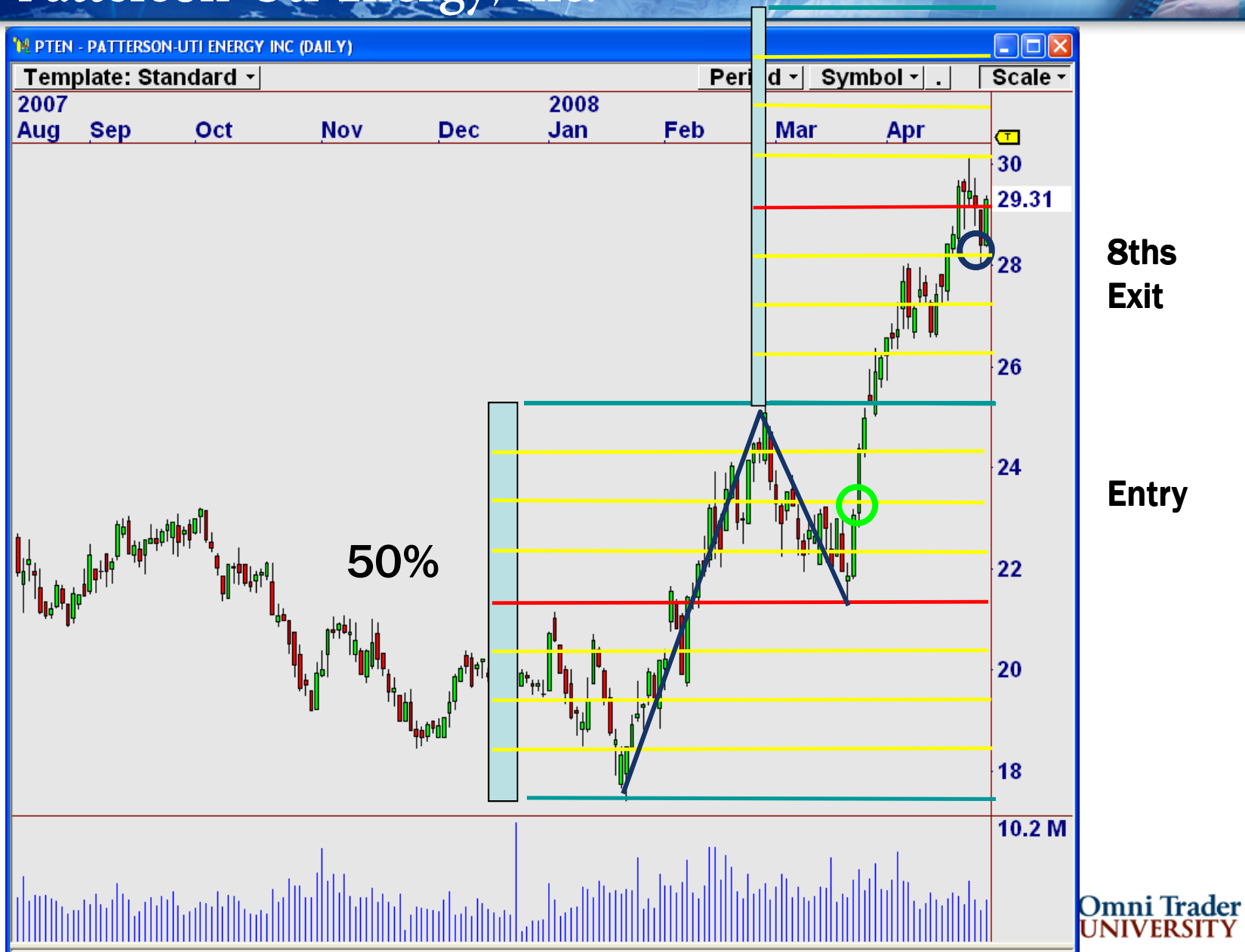
## SPAR - Spartan Motors, Inc.





# 50% Retracement

## PTIN - Patterson-Uti Energy, Inc.





# 38% Retracement

## FO - Fortune Brands, Inc.



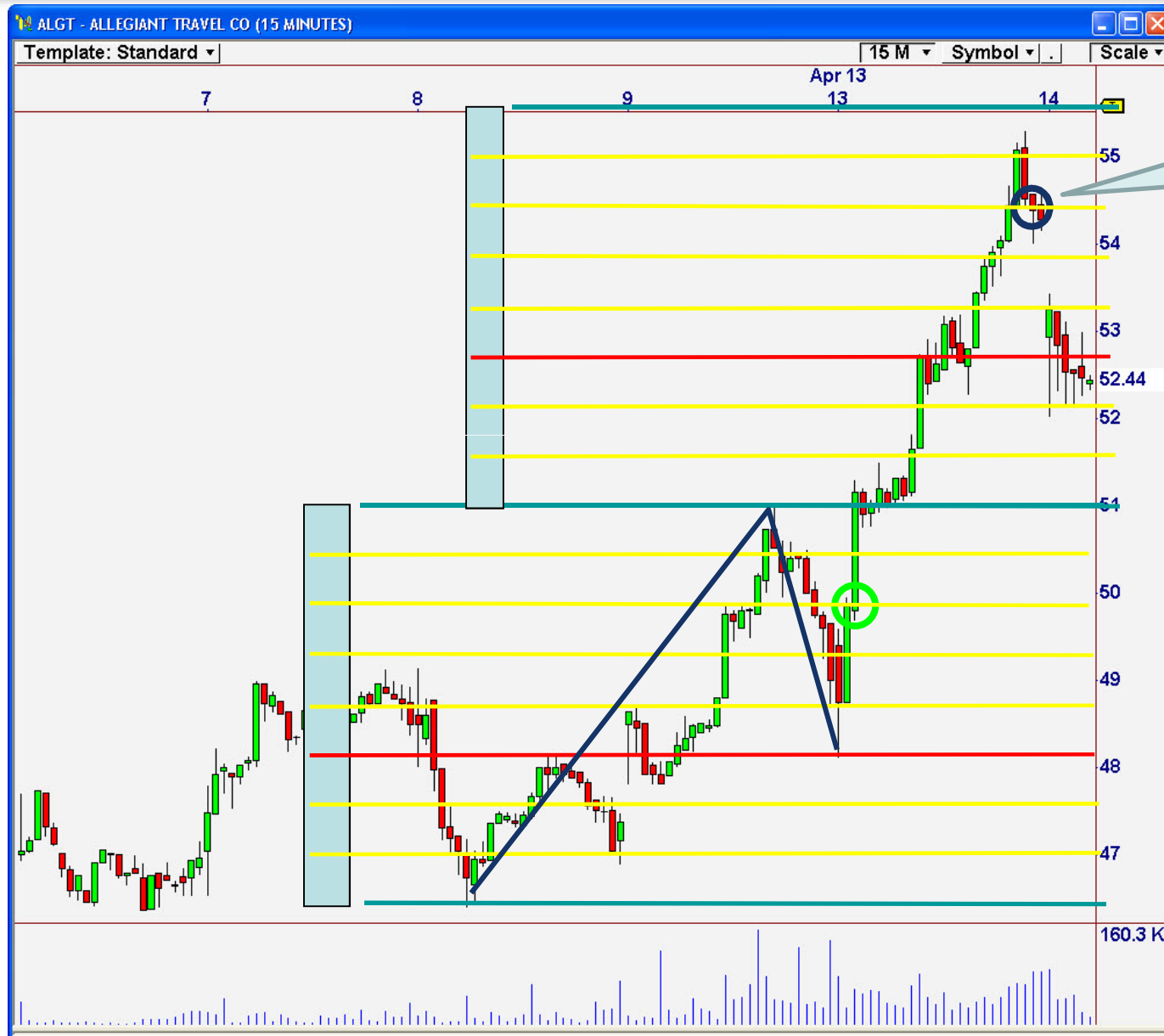
**38%  
Entry**

**8ths  
Exit**



# 62% Retracement

## ALGT - Alegiant Travel Co.



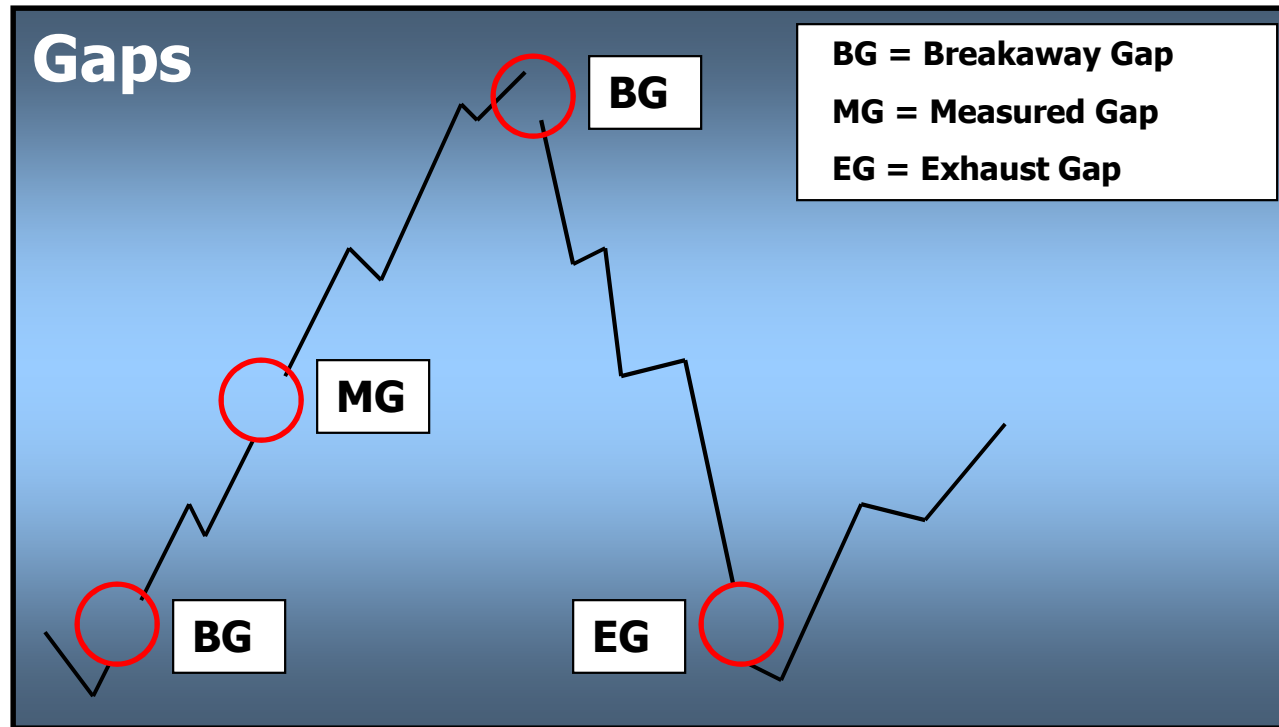
8ths  
Exit

Entry

62%



## 5. Price Gaps

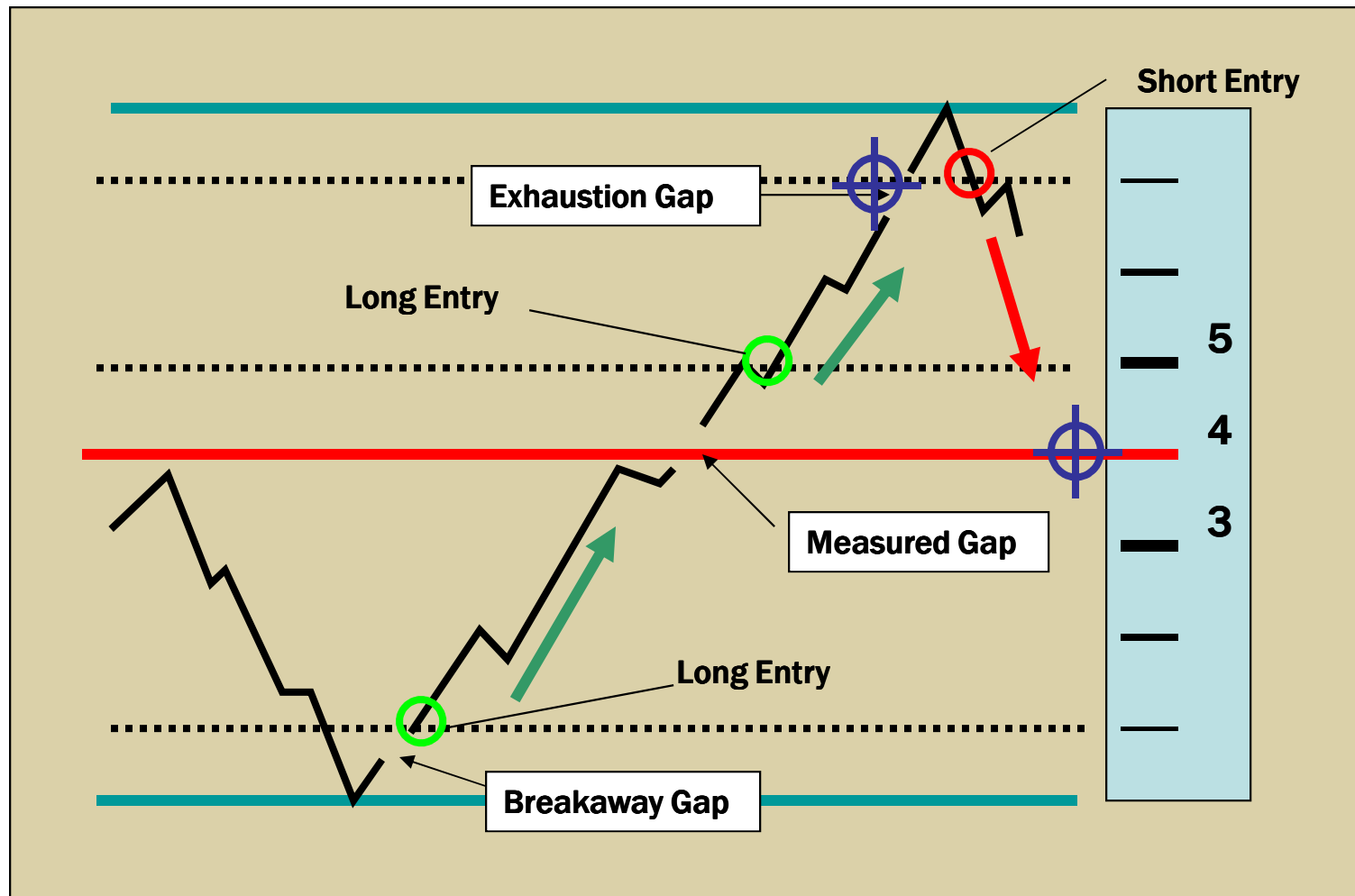


“Breakaway Gaps mark the beginnings of moves, Measured Gaps mark the centers of moves, and Exhaustion Gaps occur at the ends of moves.”



# Price Gap Structure

## Breakaway, Measured & Exhaustion





# Exhaustion and Measured Gaps

## NFP - National Financial Partners





# Breakaway Gap

RFS - RPC, Inc.

Would you trade this  
Breakaway Gap?  
Why or why not?





# Breakaway Gap

RFS - RPC, Inc.

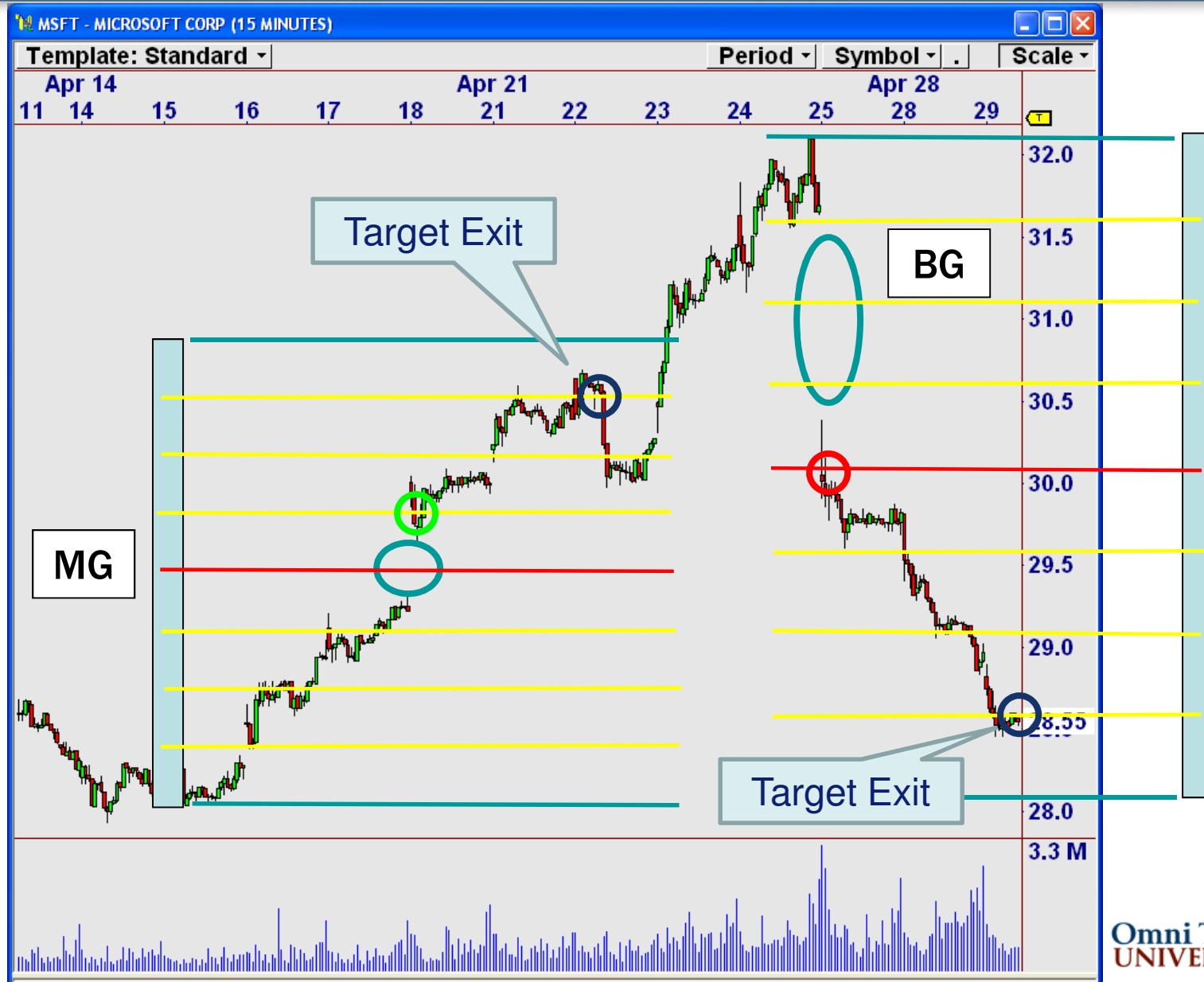
No. Entering on the bar after the gap, the move is close to our target.





# Breakaway and Measured Gaps

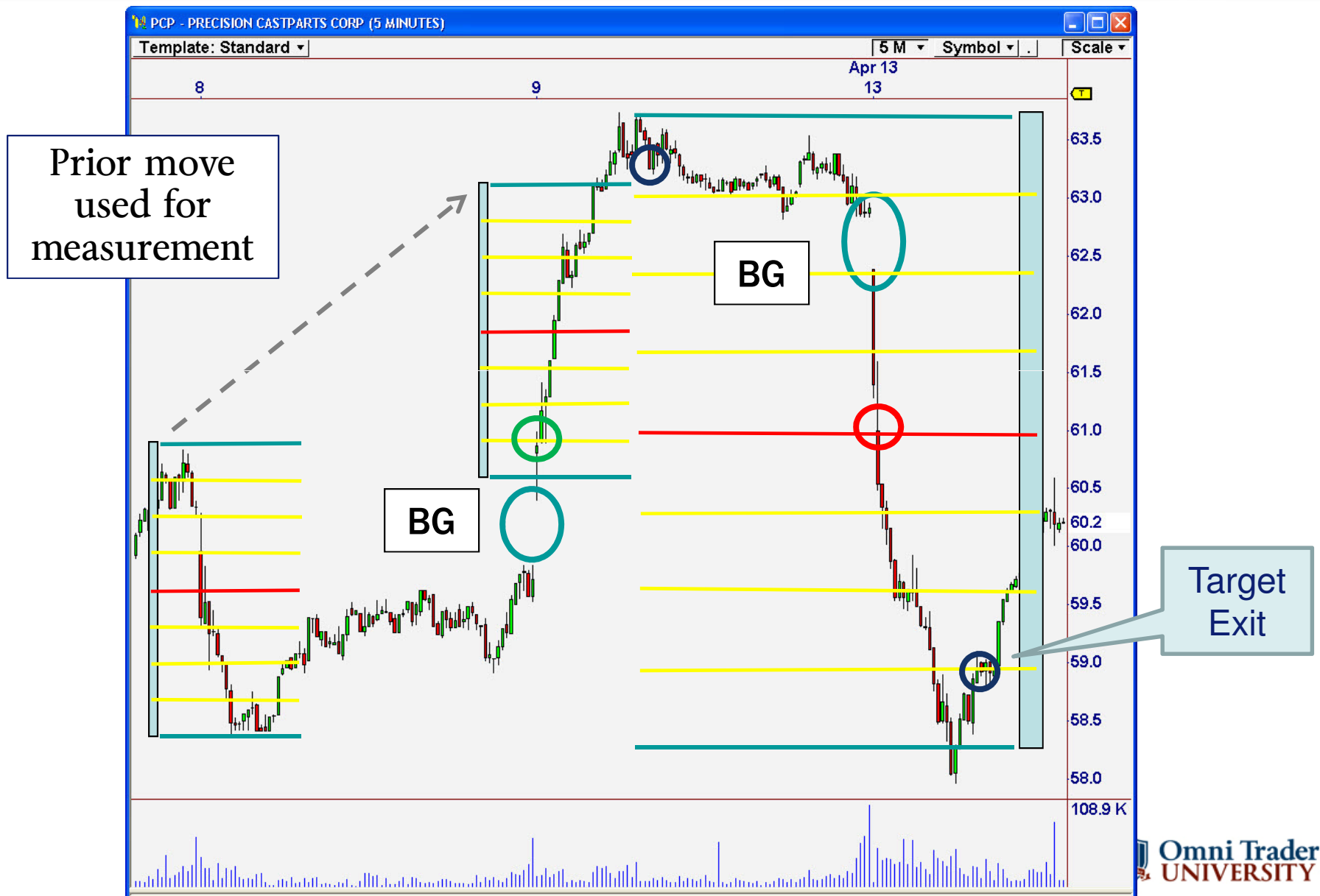
## MSFT - Microsoft Corp.





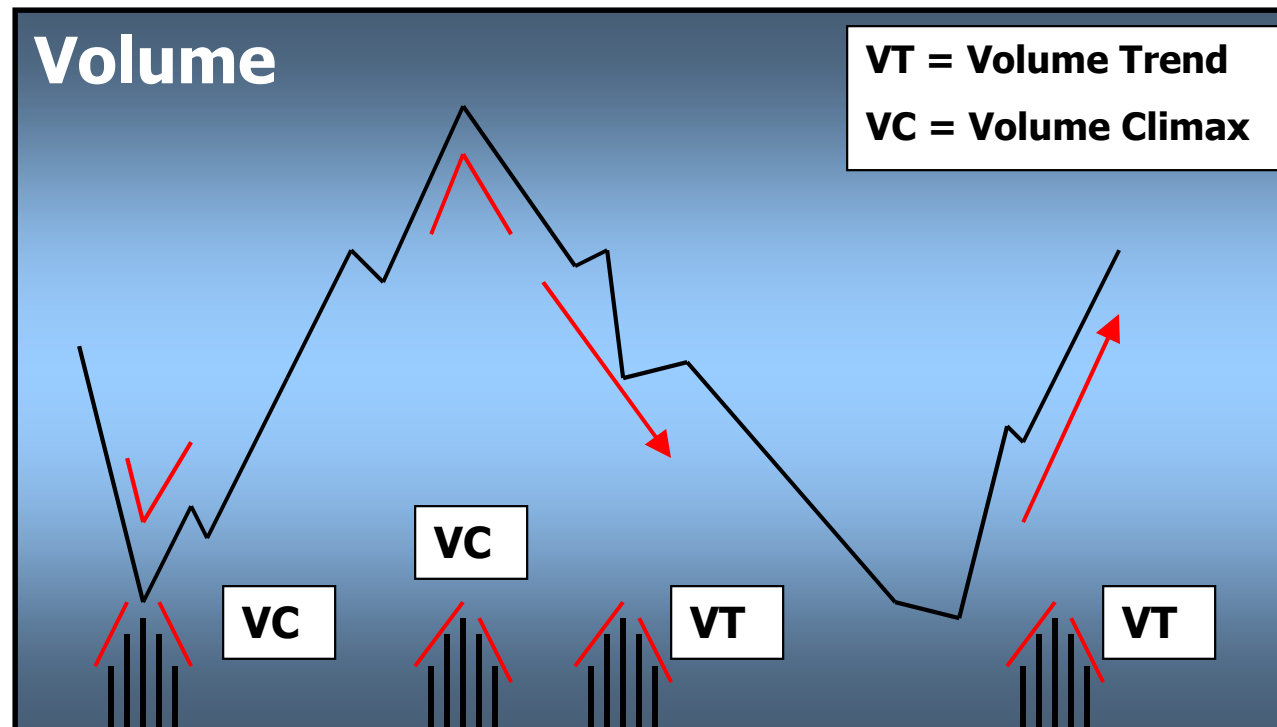
# Breakaway Gaps

## PCP - Precision Castparts Corp.





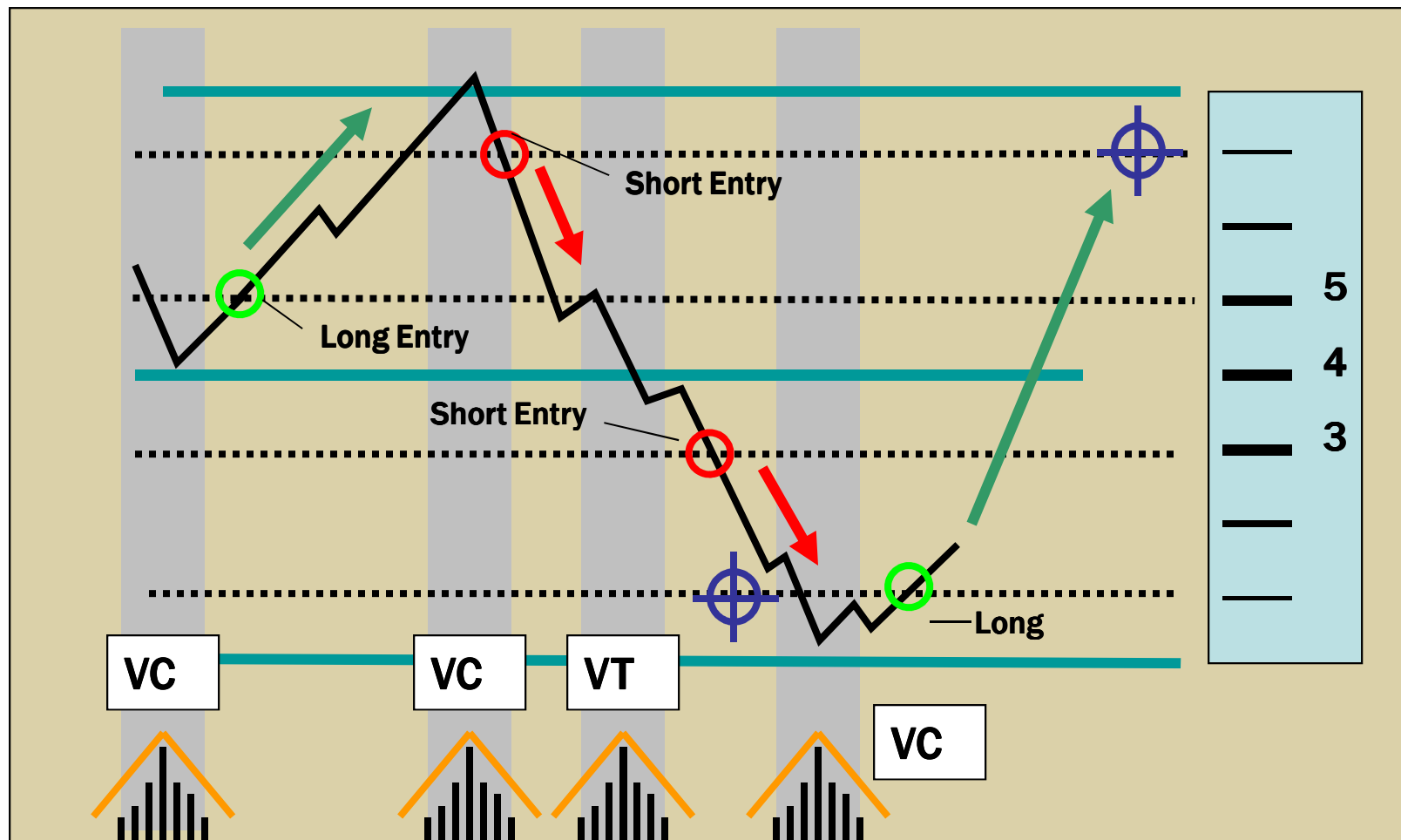
## 6. Volume Climax & Trend



“Climaxes form powerful patterns, indicating an exhaustion of supply or demand. If the market does not reverse, it becomes a trend indication.”



# Volume Climax & Trend Structures





# Volume Climax and Trend

## RES - RPC, Inc.

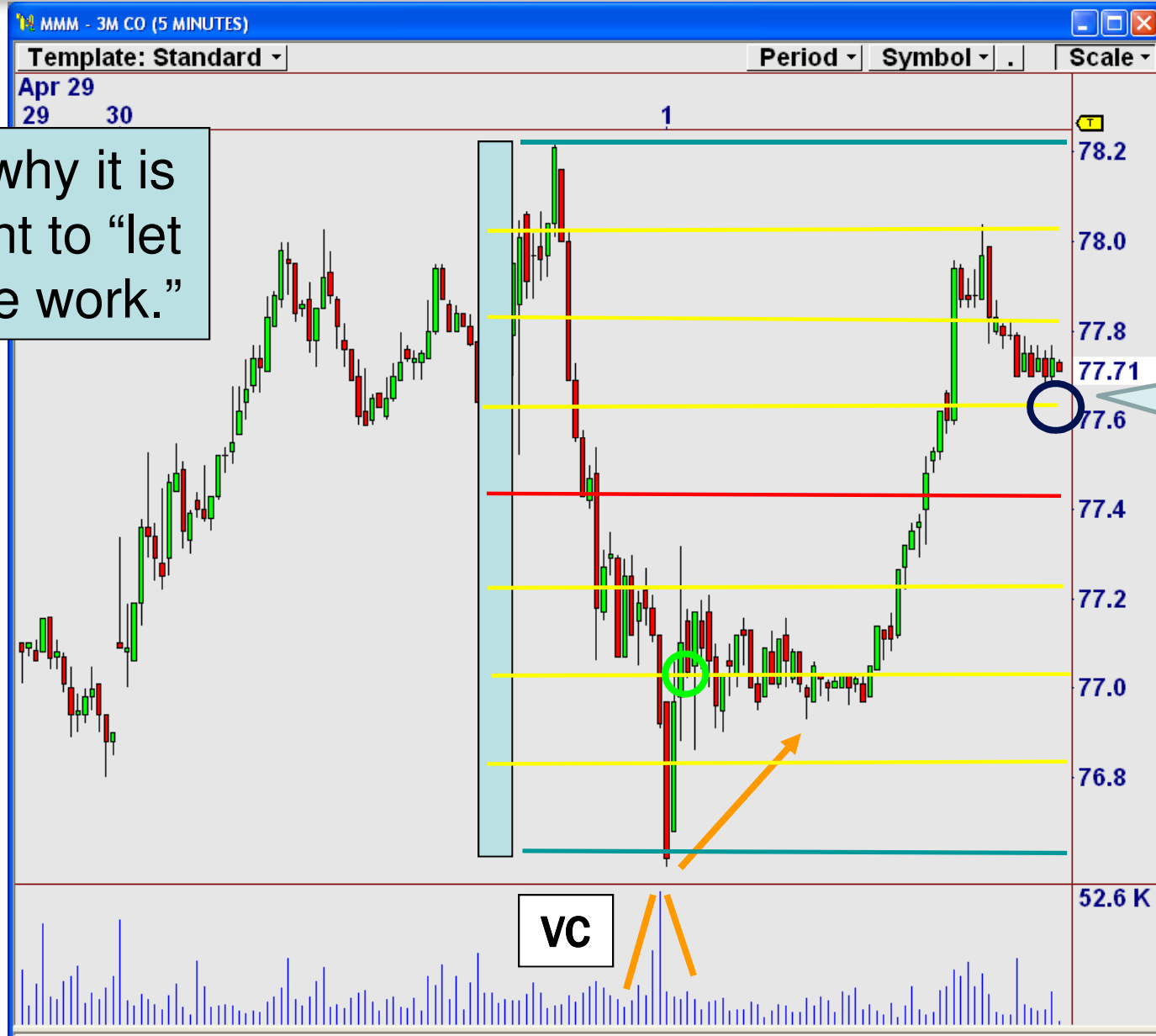




# Volume Climax

## MMM - 3M Co.

Shows why it is important to “let the trade work.”

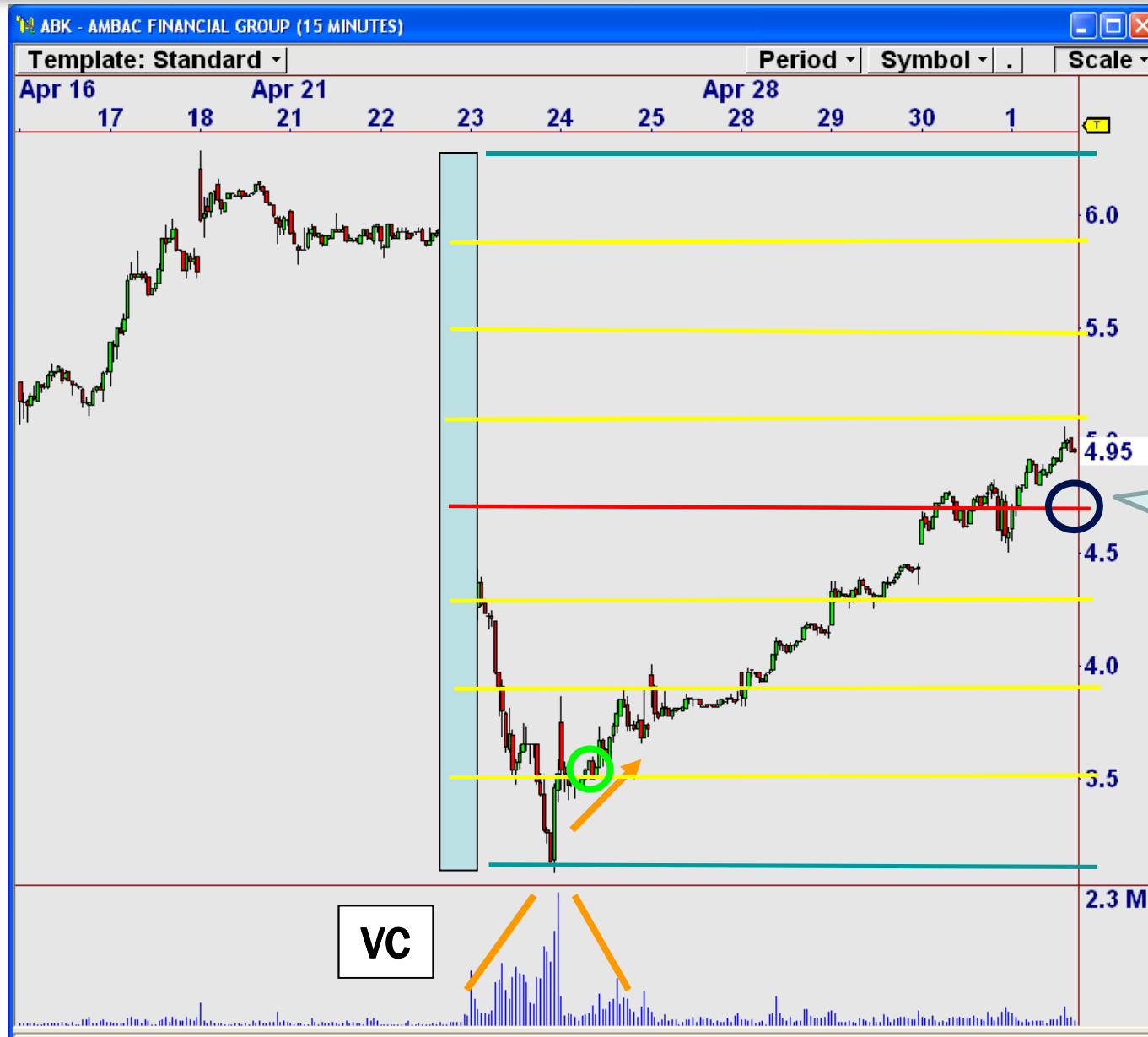


Current  
Stop



# Volume Climax

## ABK - Ambac Financial Group



Current  
Stop



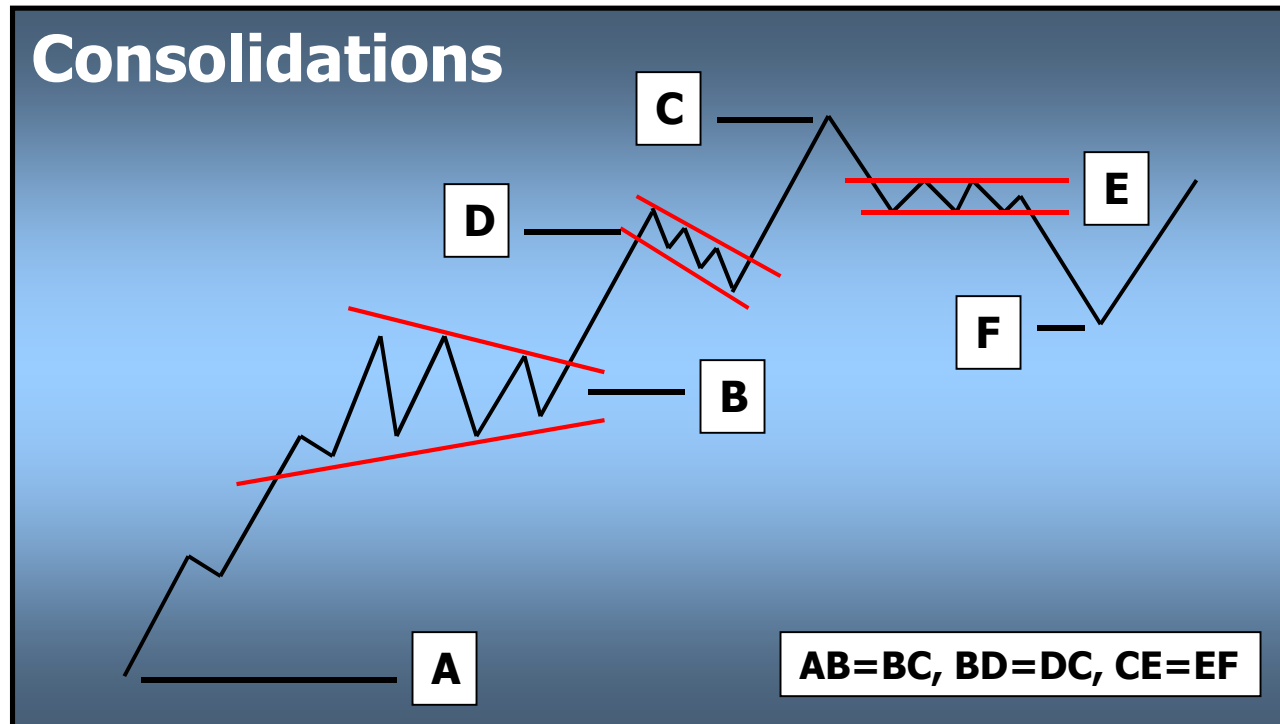
# Volume Climax

## FL - Foot Locker, Inc.





## 7. Consolidations

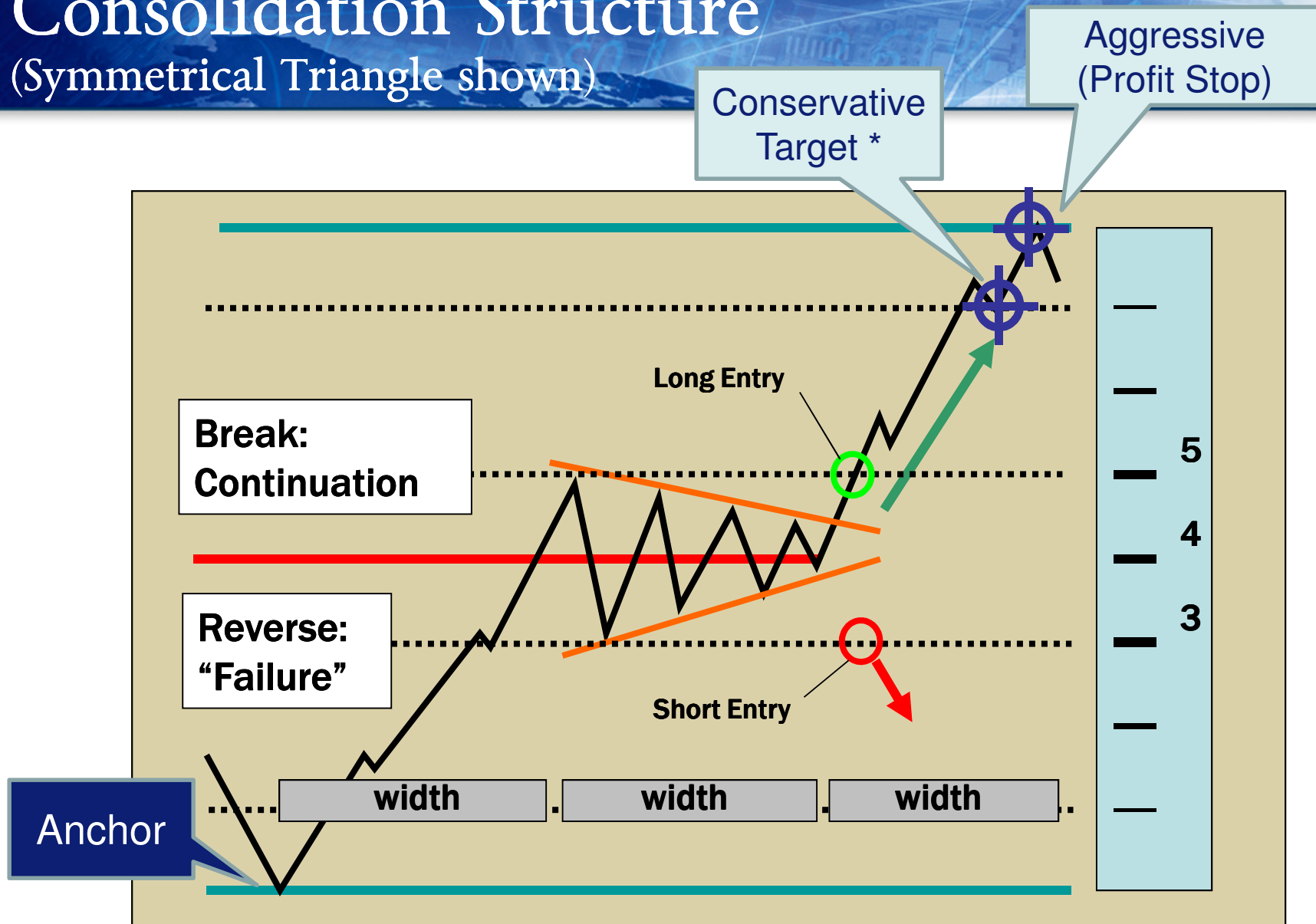


“**Consolidations** are the most powerful pattern. There are many different forms (ascending, rectangle, etc.), but a consolidation is any tight trading range with an Anchor.”



# Consolidation Structure

(Symmetrical Triangle shown)

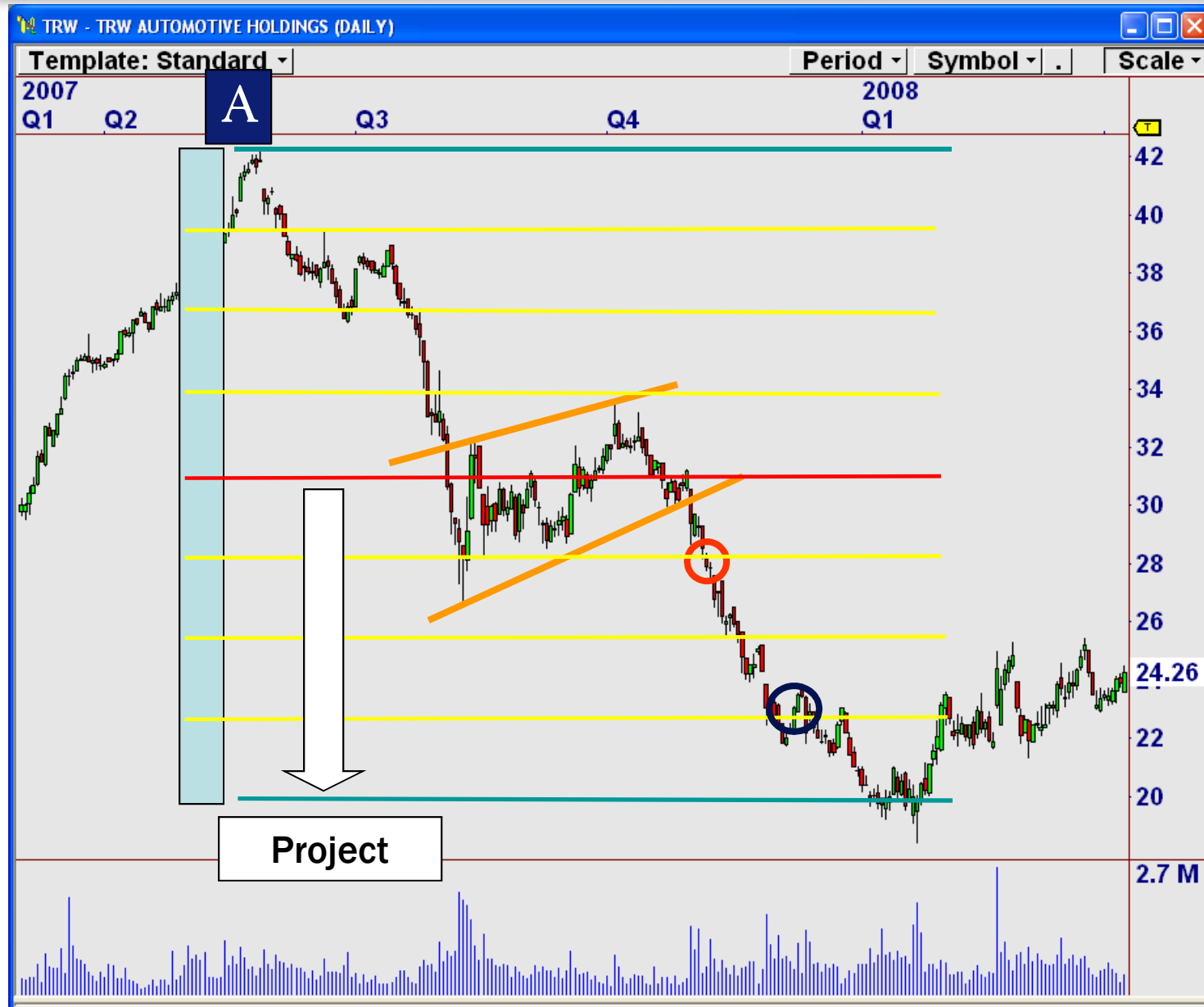


\* In our examples, we will use the Conservative Target.  
But note how often the Aggressive Target is reached!



# Consolidation

## TRW - TRW Automotive Holdings





# Consolidation

## WNR - Western Refining, Inc.





# Consolidation

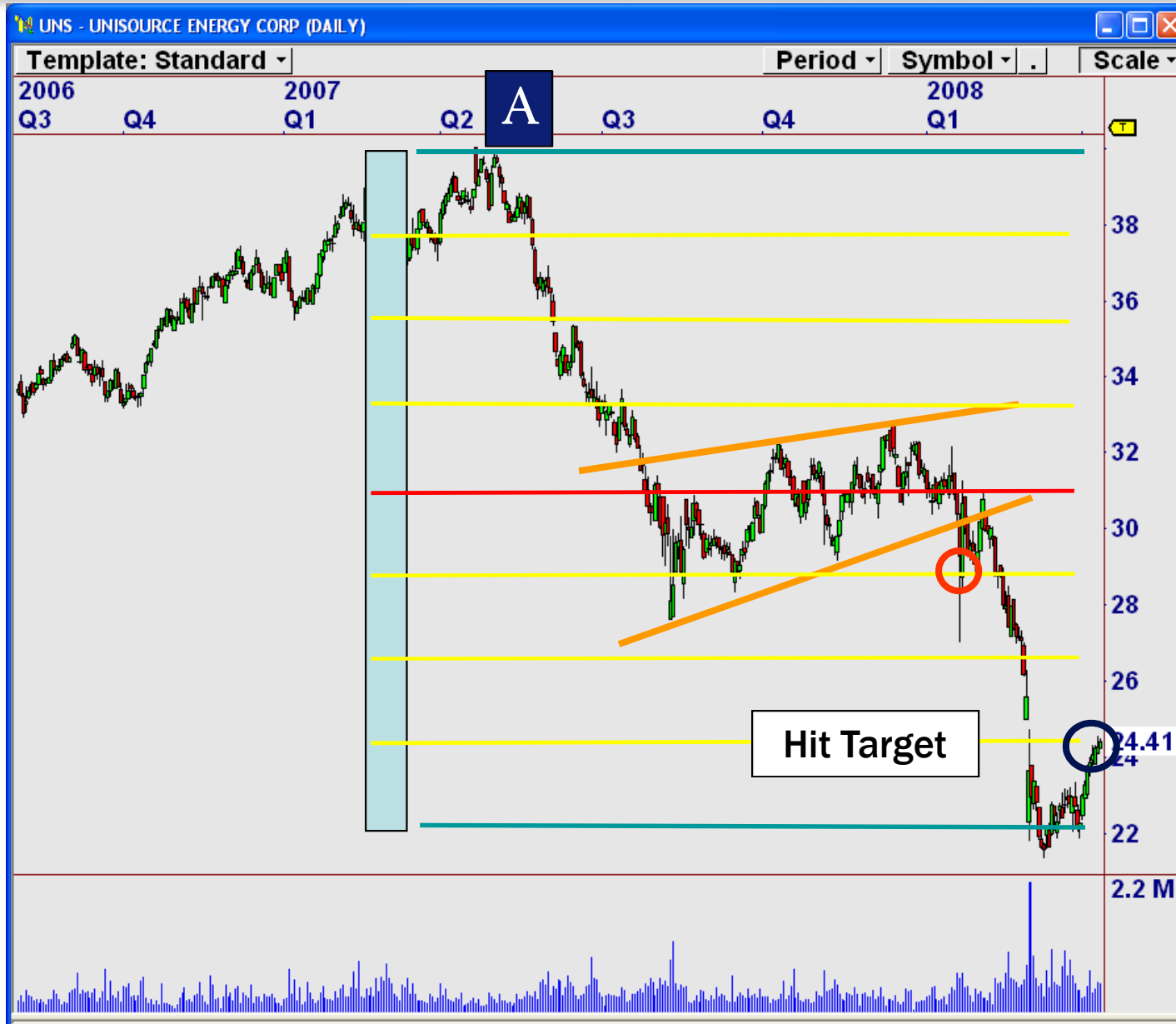
## IMMR - Immersion Corp.





# Consolidation

## UNS - Unisource Energy Corp.





# Consolidation

## C - Citigroup, Inc.

Nice move, but  
we are already at  
the Target.

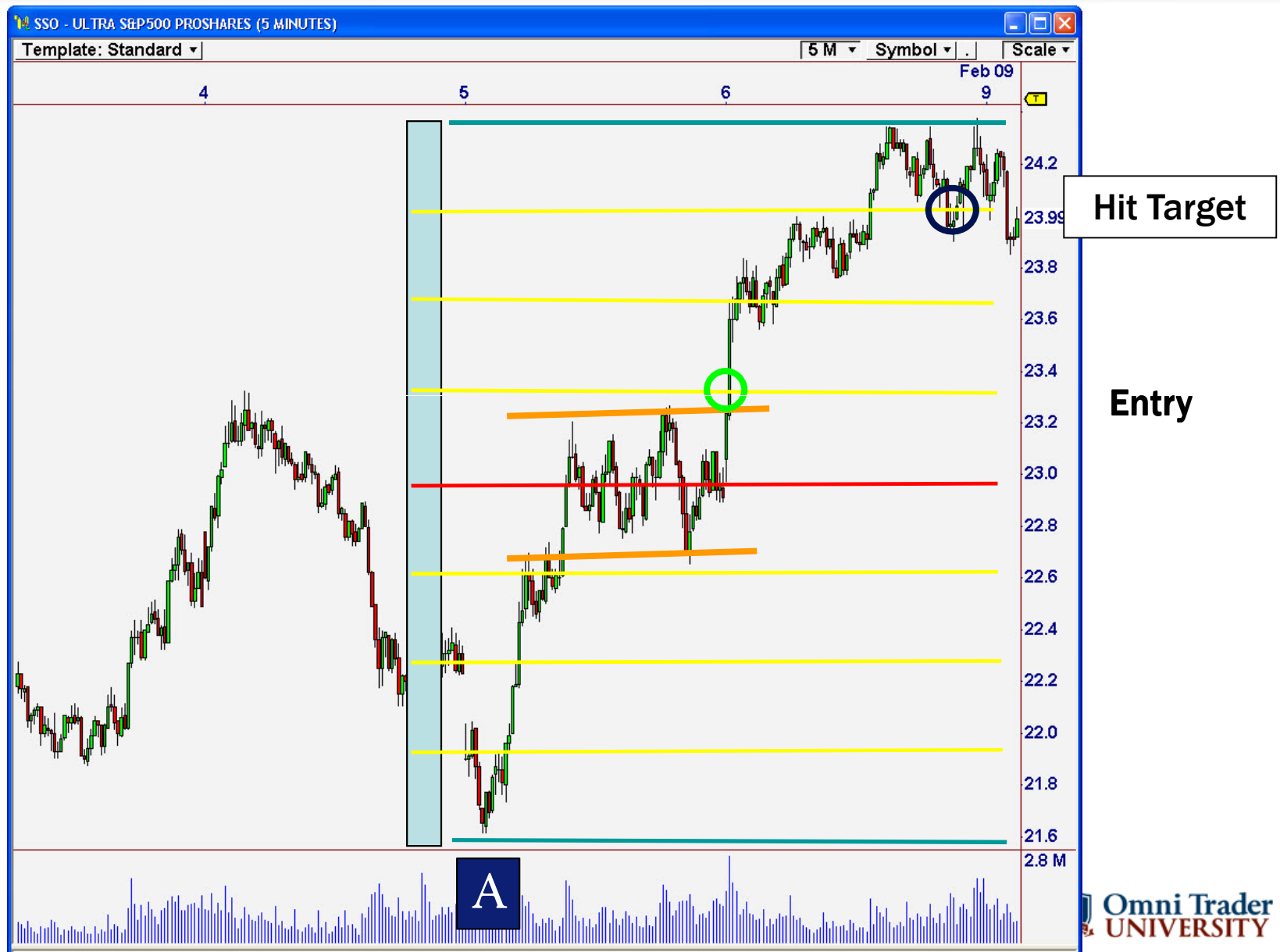






# Consolidation

## SSO - Ultra S&P 500 Proshares





# Consolidation

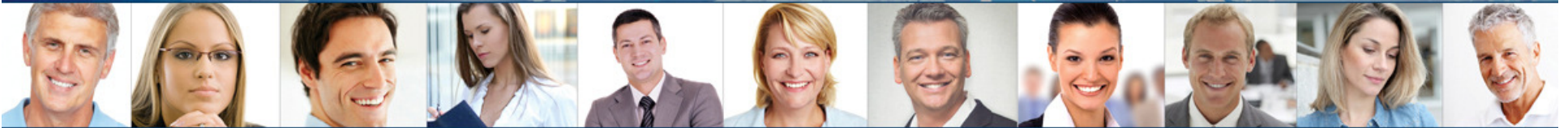
## EXPE - Expedia, Inc.







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## Part I

### Section 4: Combinations of Patterns





# Combinations of Patterns

The following patterns are combinations of Base Patterns.

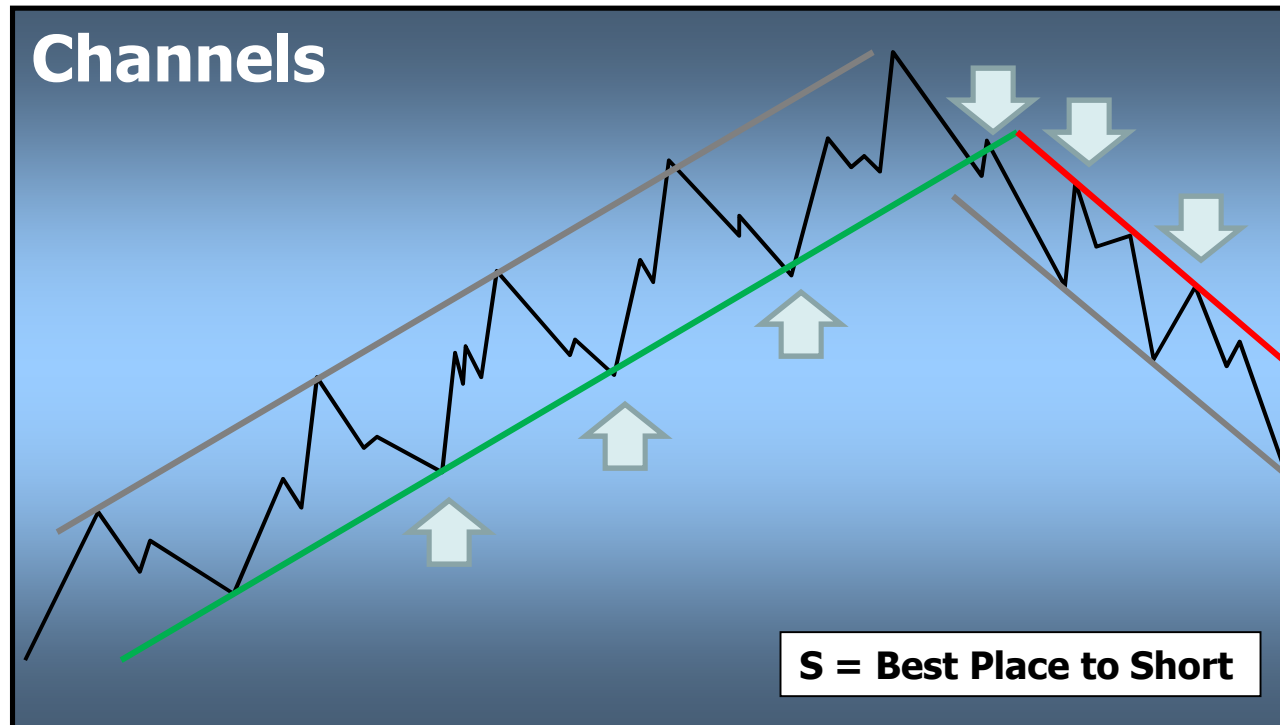
- 8. Channels
- 9. Cup & Handle
- 10. Head and Shoulders
- 11. Tops & Bottoms
- 12. Ranges



Two patterns combine to create a new combination.



## 8. Channels



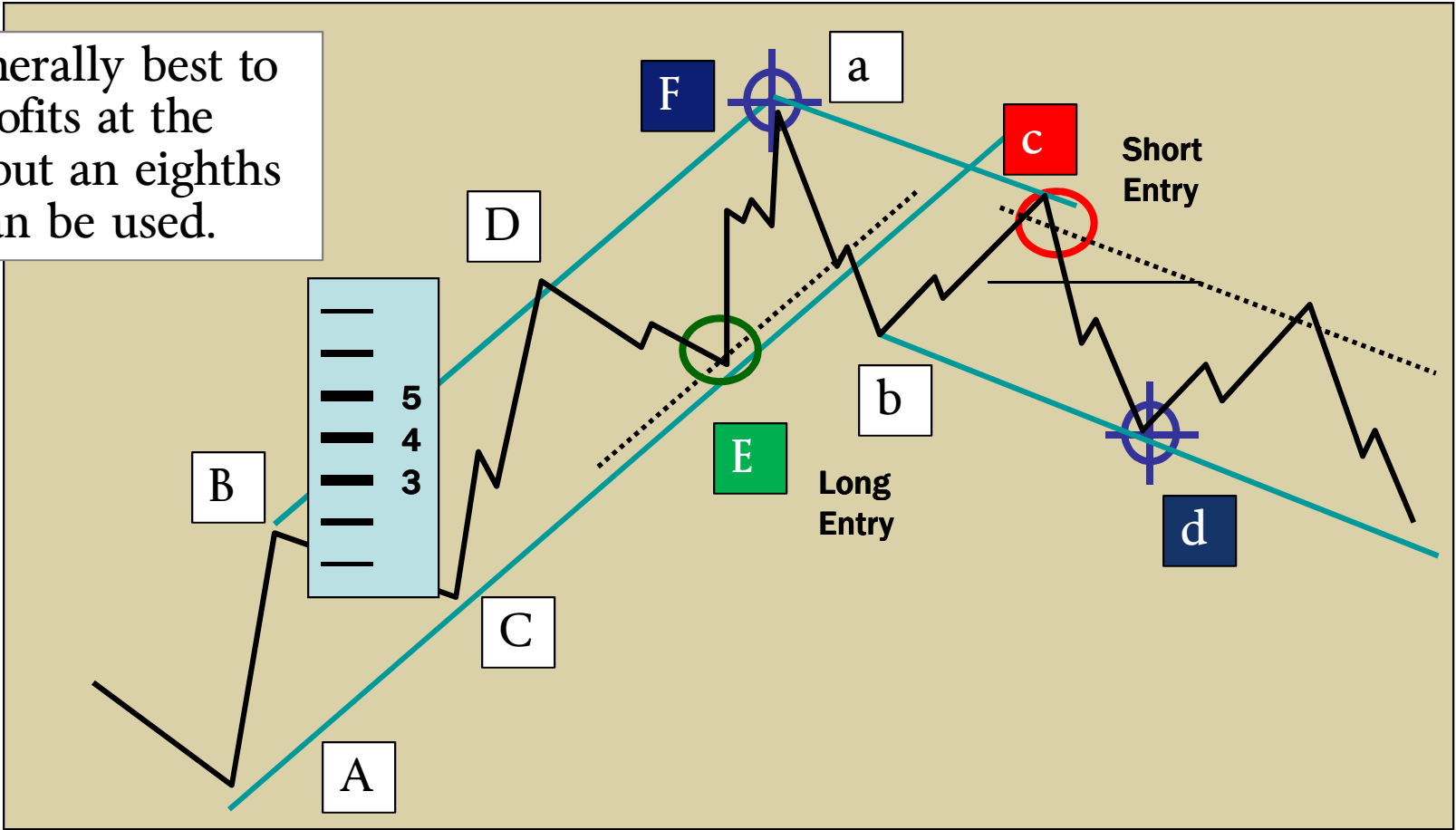
“Channels are formed by **2 parallel Trend Lines**. The objective is to Buy near the lows of an up-sloping Channel and Sell at the highs of a down-sloping one.”





# Channel Structure

It is generally best to take profits at the target, but an eighths scale can be used.



Formed Channel:  
Project point “F” based  
on BDF || ACE

Forming Channel:  
 Project point “d” based  
 on bd || ac.



# Channels

## ABV – Companhia de Bebidas



Channels can be narrow or wide. Here is a wide Channel formed on ABV.

In this case, volatility in the middle of the channel caused the 8ths Tool to exit.

A strategy on Channels is to hold the Fixed Loss Stop at the base and a Profit Stop at the Target, without using the 8ths tool.



# Channels

## BHI – Baker Hughes

BHI showing Channel Construction using the 3 Point Method.

Point "D" is projected from "C" as parallel to line AB.

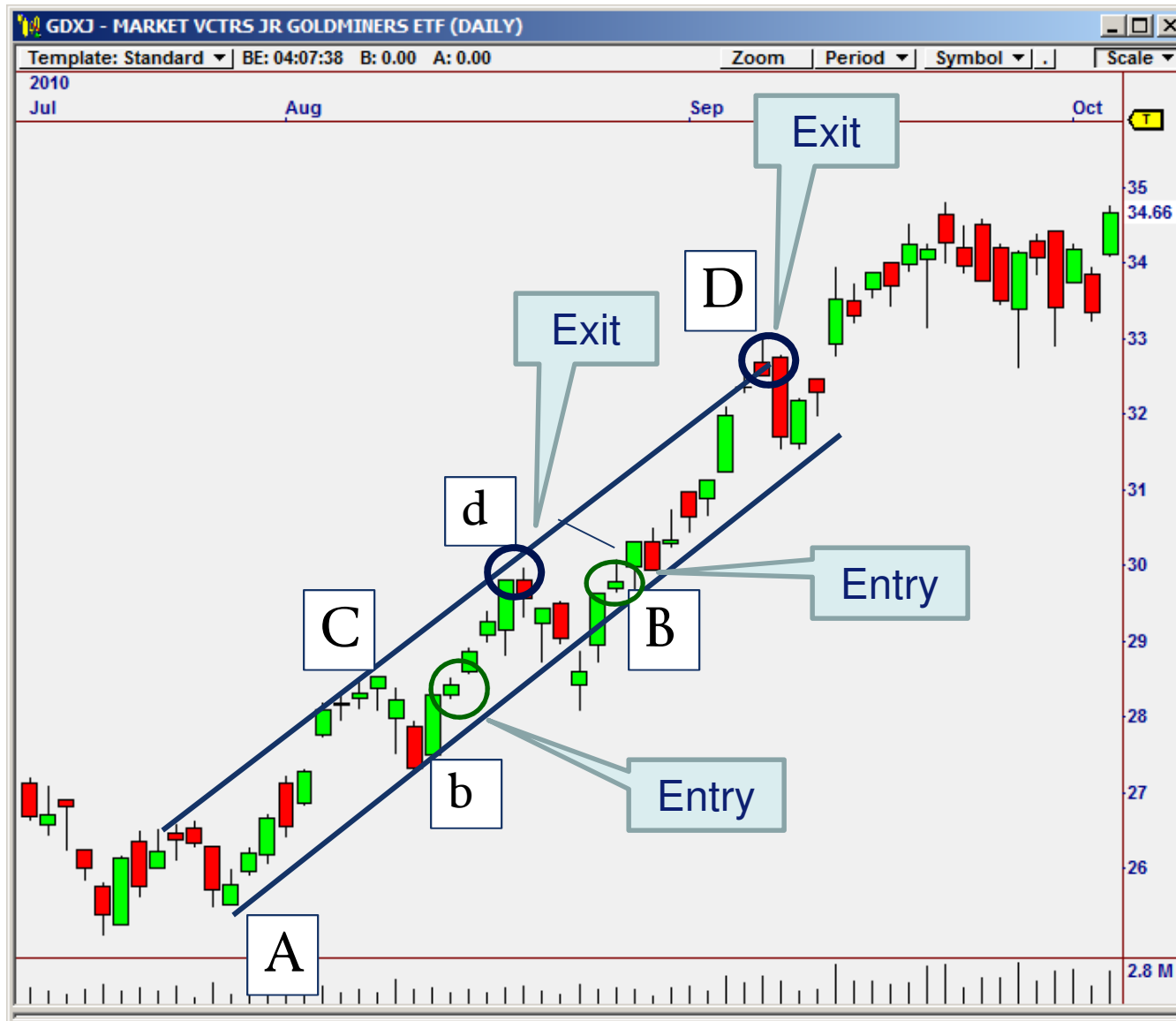
Channels often break out the top as this one did.





# Channel

## GDXJ – Market Vectors Goldminers



GDXJ formed a very nice channel that was actionable at two points.

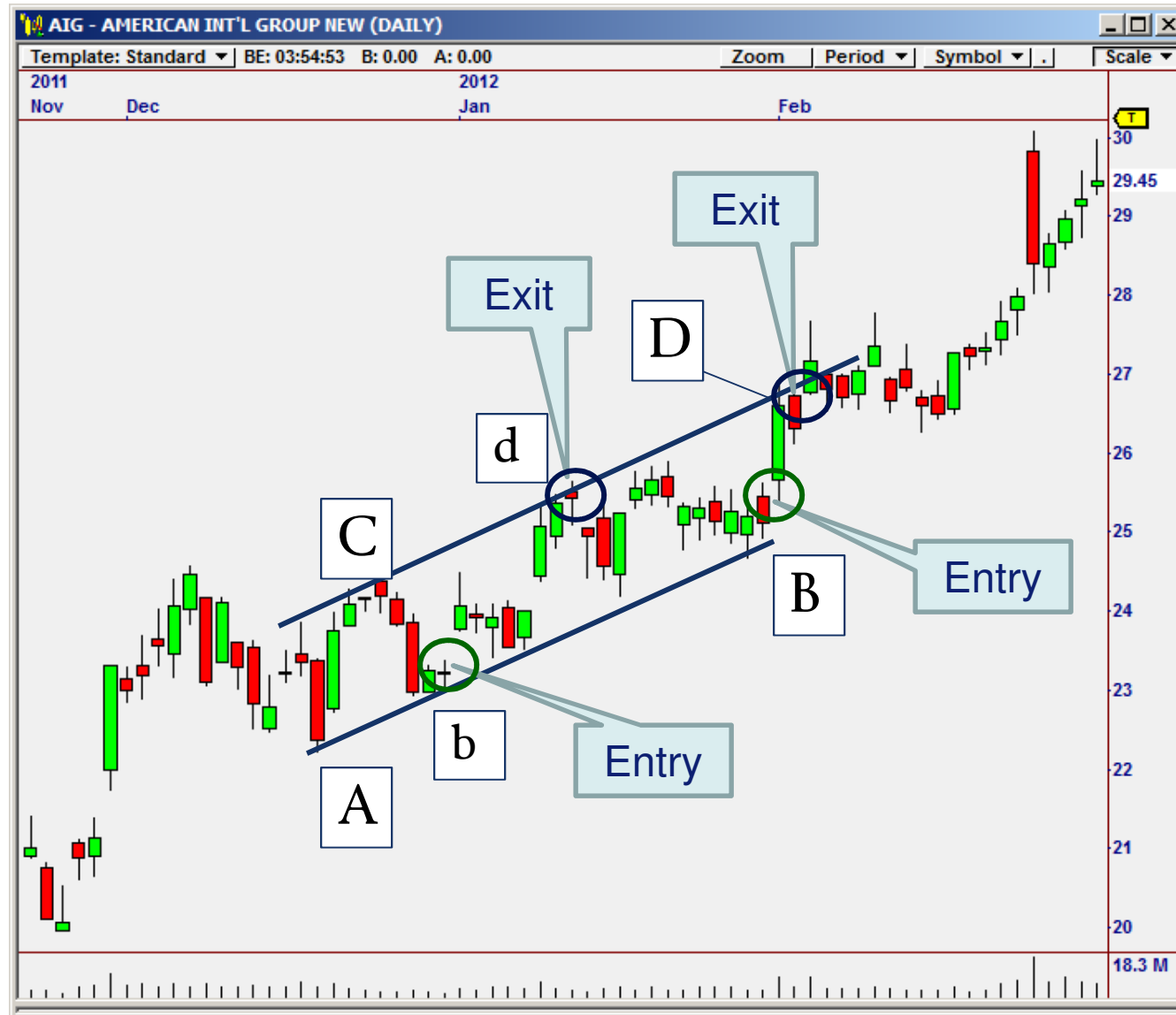
The trade from b to d only lasted 5 days and made 3%.

The trade from B to D lasted 7 days and made 10%.



# Channels

## AIG – American International Group



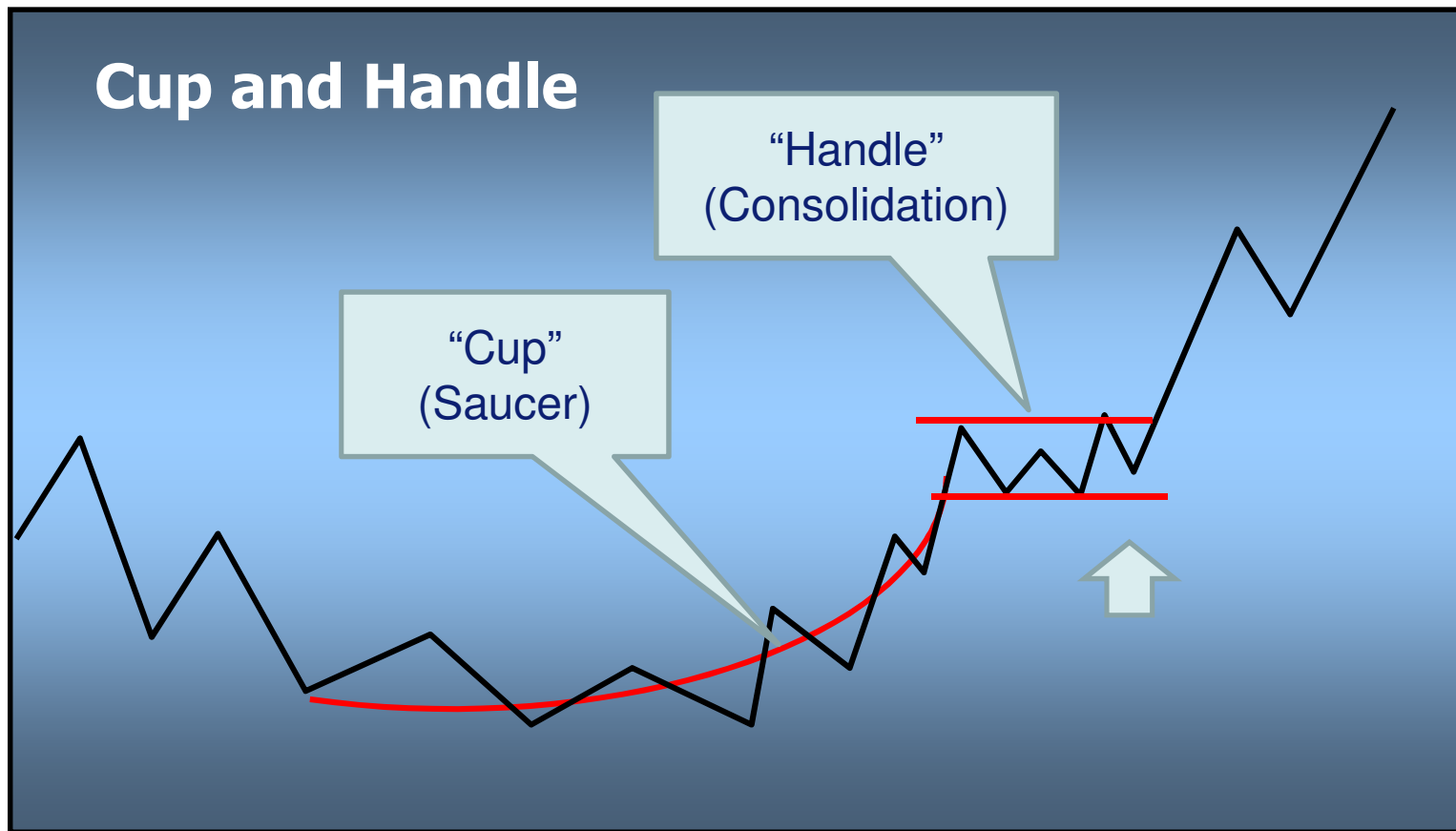
AIG also has 2 trades in the same channel.

The Entries happen on the Open of the bar after the lower pivot is formed (point b and B)

The Exits happen on the bar AFTER the upper line is reached.



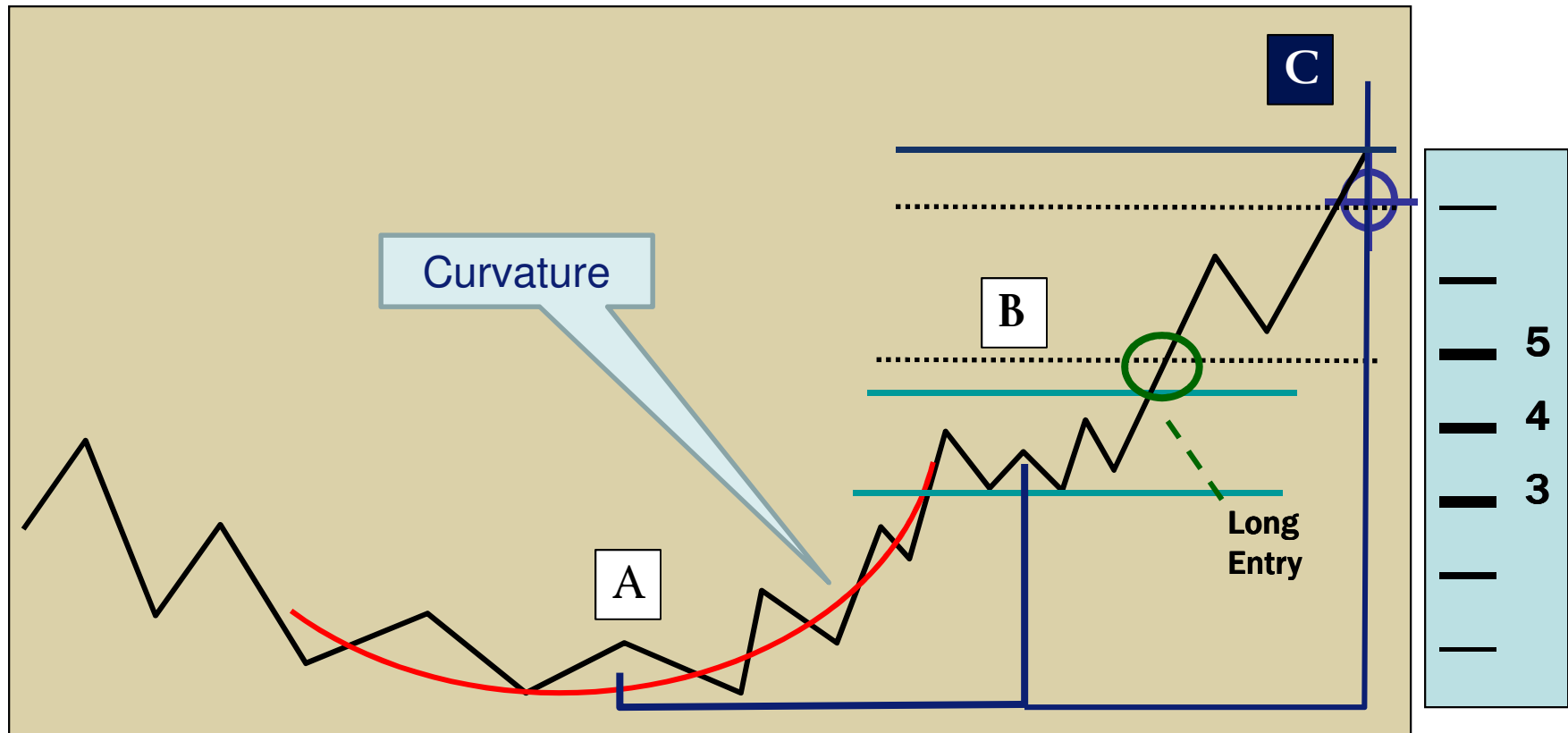
## 9. Cup & Handle



“A Cup and Handle is a curved price formation (**Saucer Pattern**) followed by a **Consolidation**. It’s power comes from the Consolidation Break.”



# Cup & Handle Structure



Projecting a Target:

A is at Center of Cup Pattern

B is at Center of Consolidation

C is projected target, equal to AB in Price & Time



# Cup & Handle

## CI - Cigna



Sometimes, these patterns are very small and quick.

The rally after this Cup & Handle formed hit its target on the 2nd day.



# Cup & Handle

## WAG - Walgreens

Curvature was slight on WAG in the summer, but the Consolidation was clear.





# Cup & Handle

## WDC - Western Digital



Curvature was less noticeable on WDC.

The Consolidation is the key feature in this pattern.



# Cup & Handle

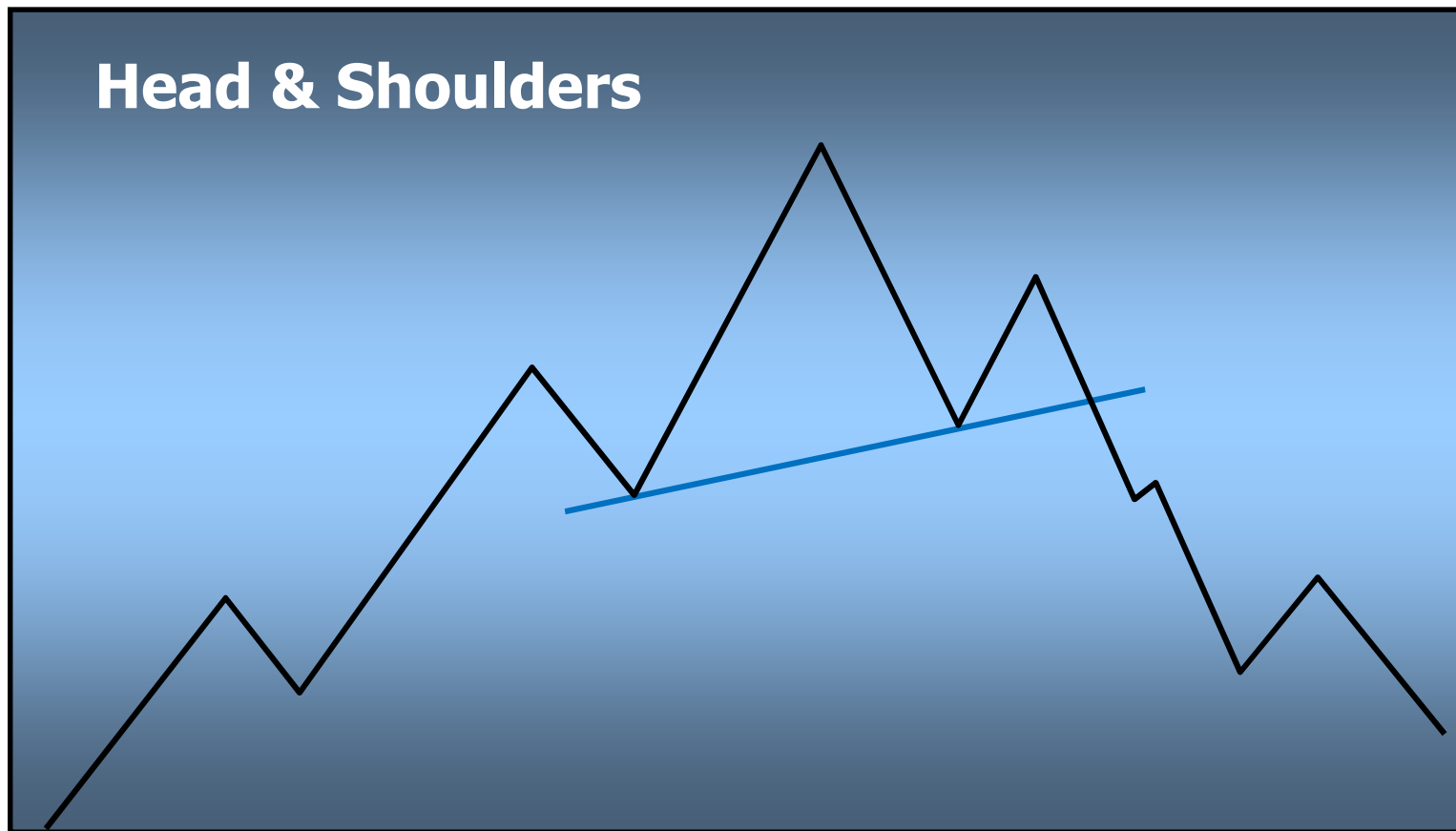
## RIG - Transocean



Consolidation on RIG was easy to miss, but there definitely was a range formed in Feb after the very clear Saucer pattern.



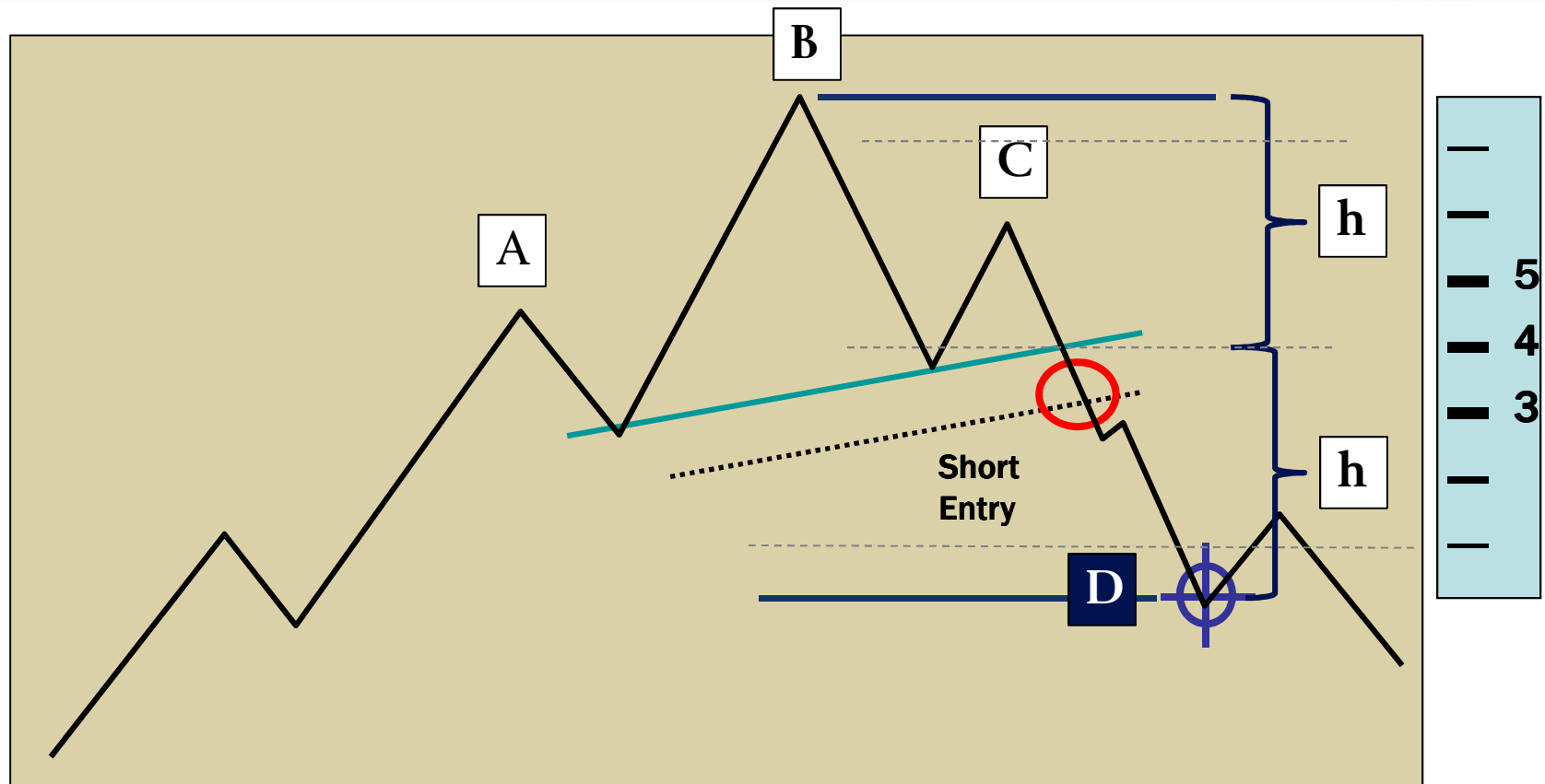
## 10. Head & Shoulders



“A Head and Shoulders Pattern is formed by a **High** (or Low) (the “Head”) followed by a **Trend Line Break** (“Neck”).



# Head & Shoulders Structure



For a Bearish Head & Shoulders:

A and C are lower than B

Drawing a Trend Line through the "Neck" forms the Signal

Projected Target "D" is the height of the Head (or "h")



# Head & Shoulders

## AEO – American Eagle



Inverted HS:

AEO showed a classic higher low before rallying.

Both an inverted Head & Shoulders AND a Consolidation were present.



# Head & Shoulders

COH - Coach Inc.



Inverted HS:

COH shows a very nice higher low in a classic inverted Head & Shoulders.

The Bullish sentiment on COH was strong enough to send it further than the Target.



# Head & Shoulders

## CSCO – Cisco Systems, Inc.



Bearish HS:

Cisco falls hard as the lower neckline of this well-formed Head & Shoulders is violated.

Since we exceeded the target, we should apply the 8ths tool now.



# Head & Shoulders

## DECK – Deckers Outdoor



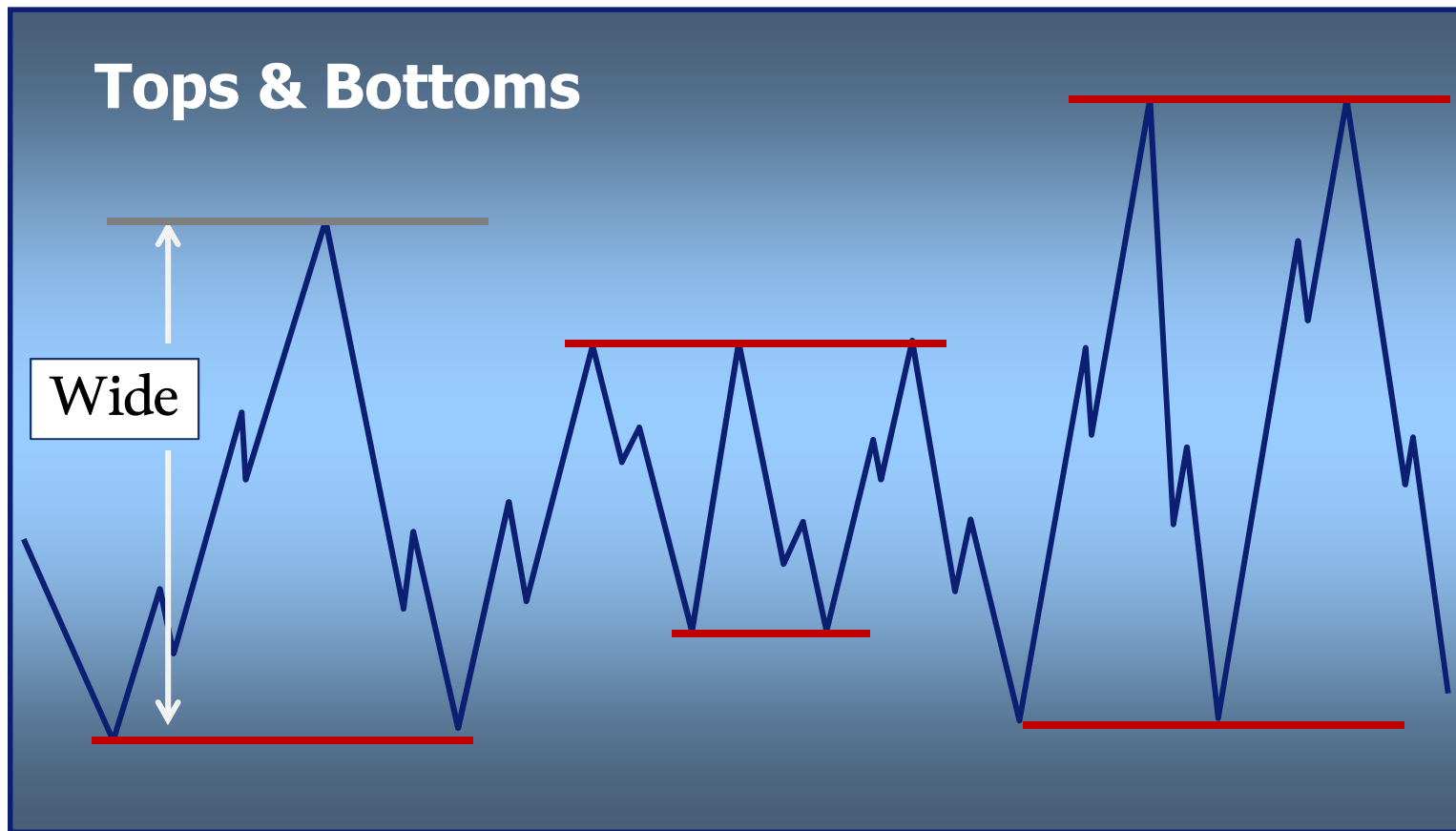
Bearish HS:

Deck generates a Short after the Lower High of the Bearish Head & Shoulders.

Hit Target



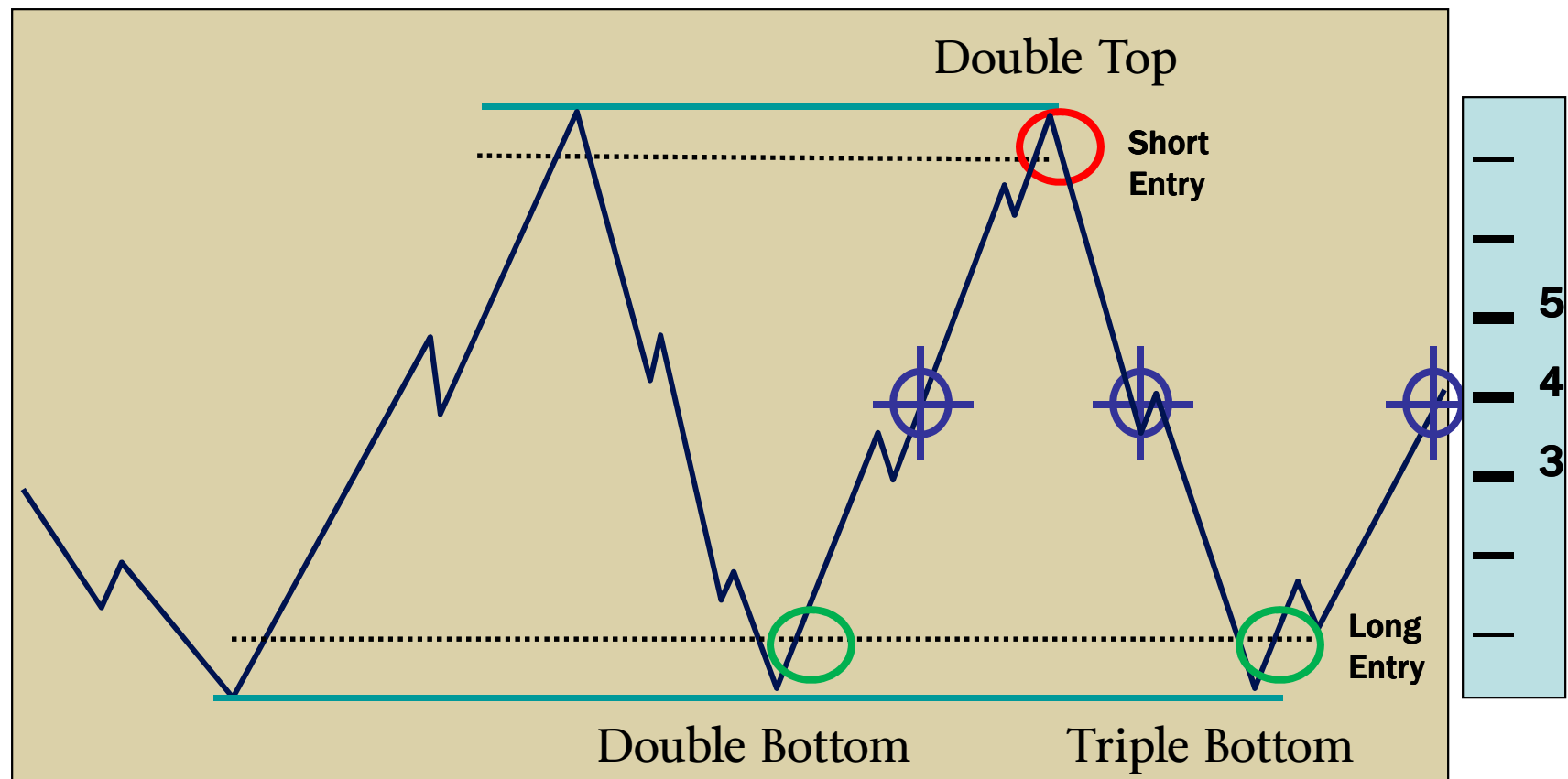
# 11. Tops & Bottoms



“Tops and Bottoms are **Support and Resistance Reversals**, with a wide price range leading up to the reversal.



# Top & Bottom Structure



Wide ranges create solid Double and Triple Tops and Bottoms. A good place for an initial Target is the 50% point, though a more aggressive Target can be established at 7/8 of the range.



# Double Bottom

## IGT – International Game Technology



This wide range Double Bottom on IGT led to a spectacular rally.



# Double Top

## MSFT - Microsoft Corporation



Microsoft failed to get past its prior high of 31.5 in the Spring of 2010, leading to a dramatic selloff of 30% of its value.



# Triple Bottom

## AMGN – Amgen Inc.



AMGN formed a classic Triple Bottom in September 2010.



# Triple Top NRG – NRG Energy

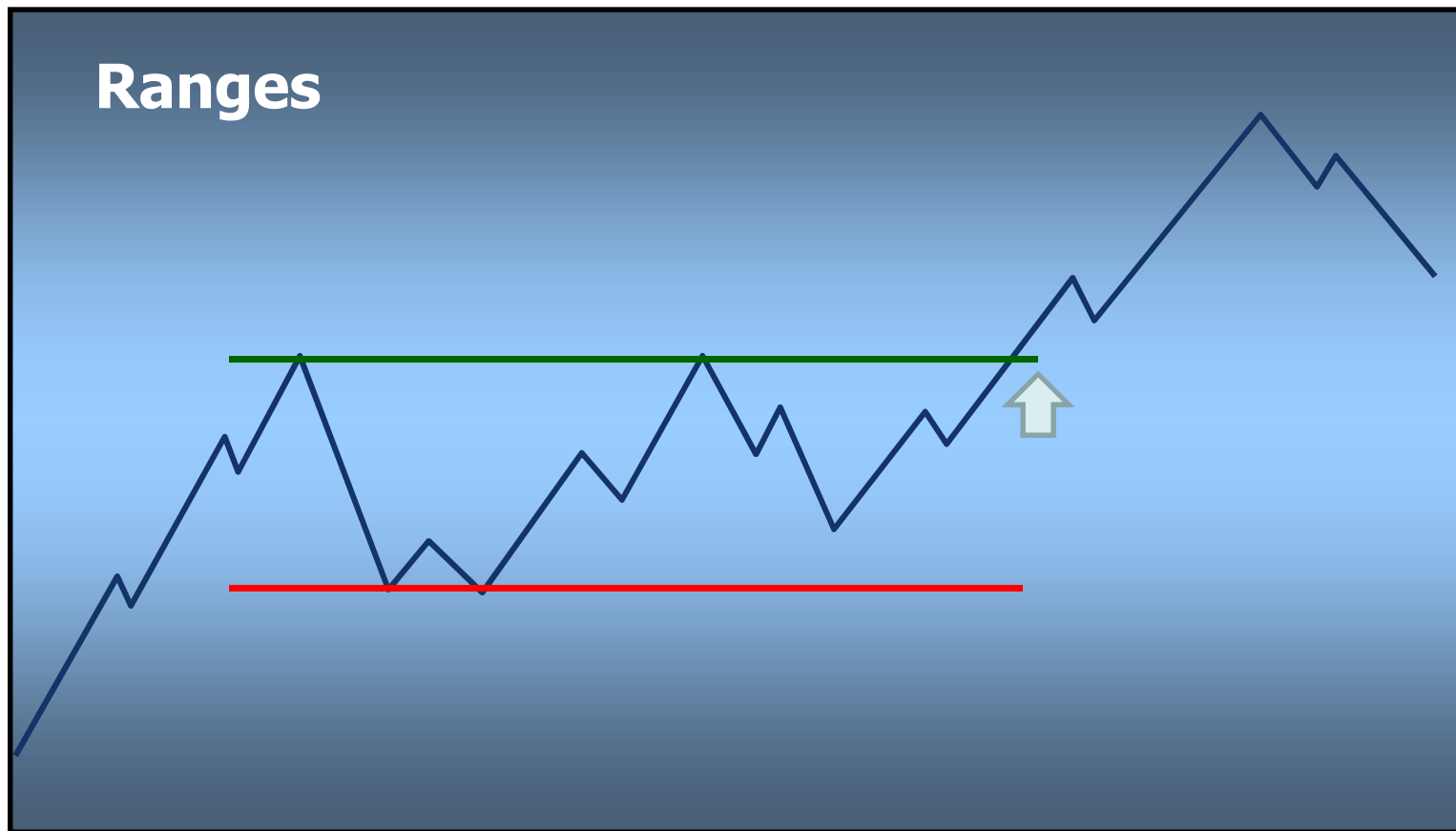


Triple Top patterns are rare. In fact, it was hard to find this one on NRG,

This example is more of a Range Breakout because the range of the pattern is small.



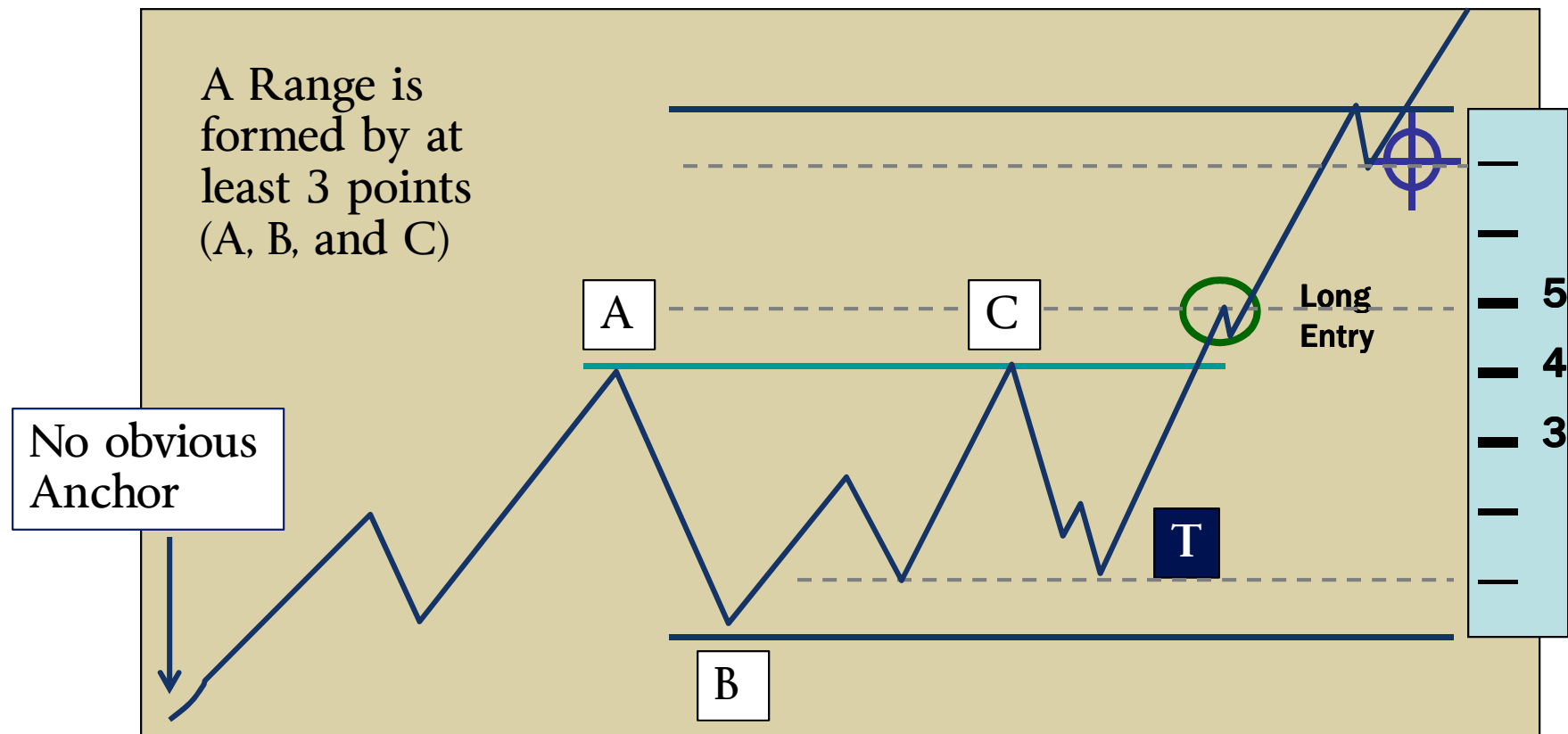
## 12. Range Breakouts



“Ranges are **Consolidations without a defined reference** for target projection. We look for Range Breaks on the side with the most touches.



# Range Breakout



Ranges are like Consolidations except they do not have an Anchor (see Consolidations). They are generally smaller patterns than traditional Tops and Bottoms (i.e., they look like Consolidations without an Anchor.)



# Range Breakout

## ADP – Automatic Data Processing, Inc.



ADP formed a range in the Summer of 2011, from Support at 51 to Resistance at 55.

In August, Support gave way and the stock dropped fast.



# Range Breakout

## TEG – Integrys Energy Group, Inc.



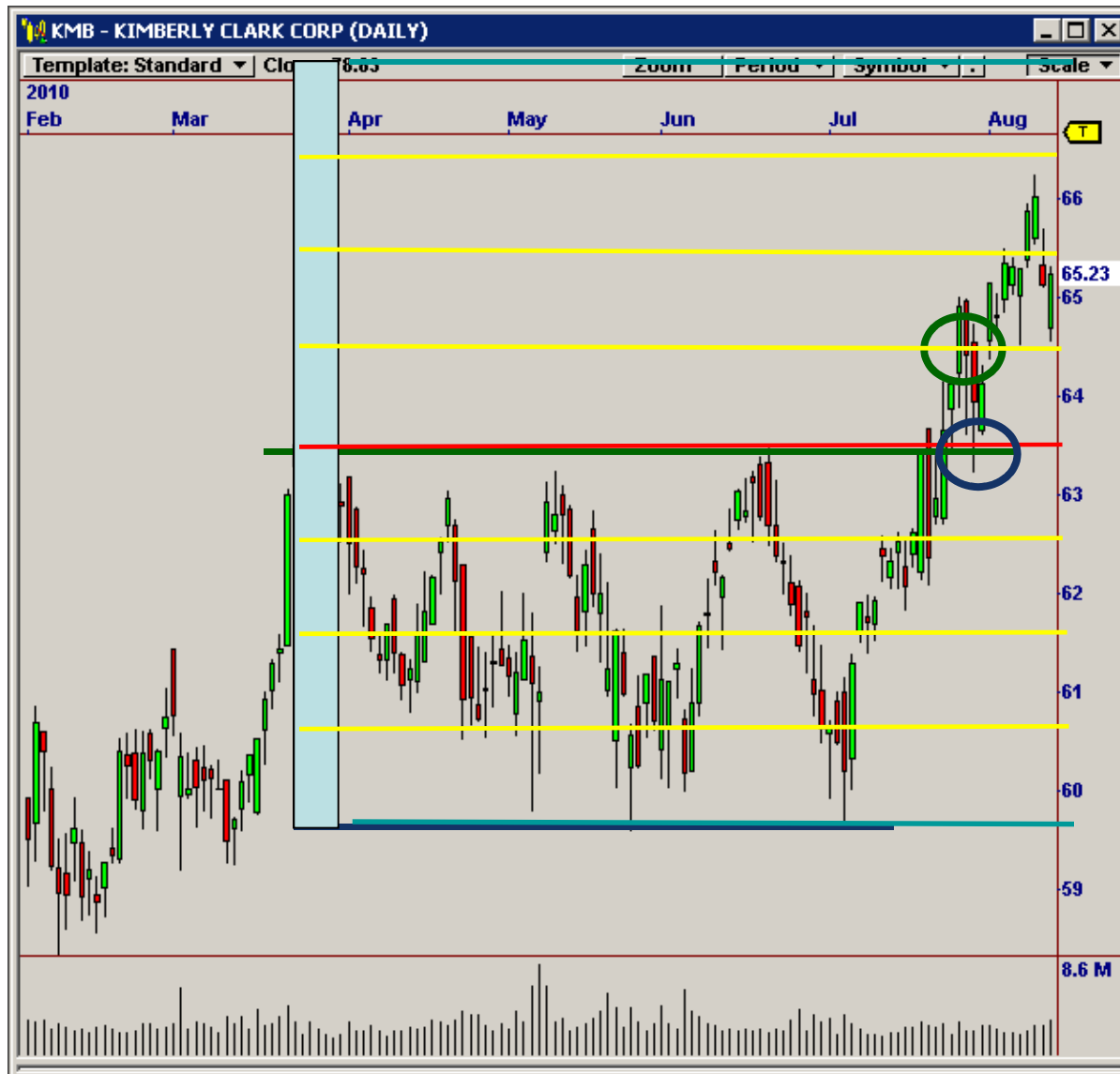
TEG forms a classic 3 point range and breaks out to gain 5% in a few weeks.

(the Eighths tool caused us to stop out at breakeven)



# Range Breakout

## KMB – Kimberly Clark Corp.



Is it a Triple Top  
or a Range  
Breakout?

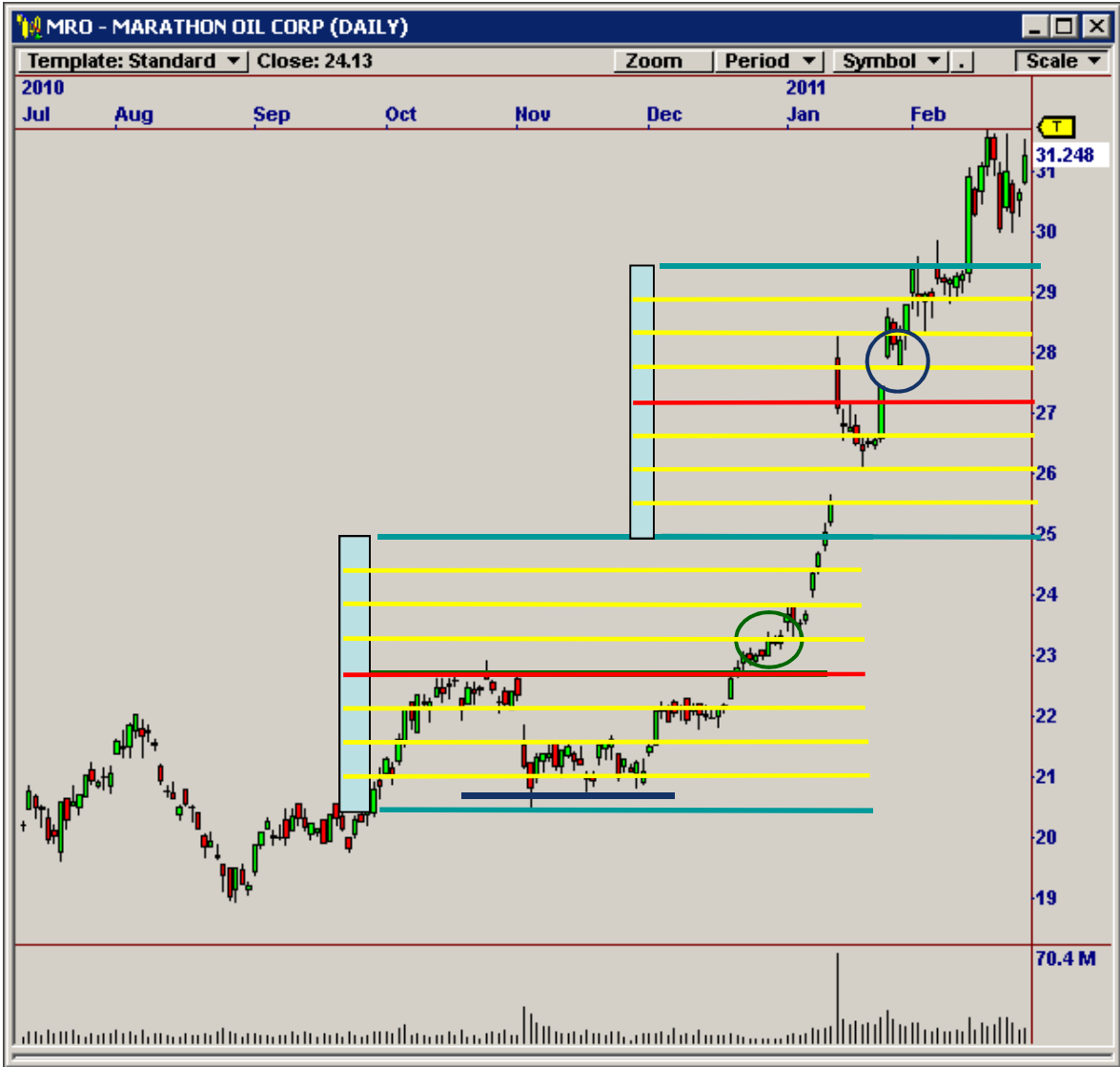
Doesn't matter;  
the principle is  
the same. Clear  
Resistance is  
broken leading to  
a move.

(in this case the  
8ths tool stopped  
out for a loss)



# Range Breakout

## MRO – Marathon Oil



MRO formed a subtle range before breaking Resistance.



# Summary for Part I

We reviewed 12 Patterns:

1. Support & Resistance
2. Trend Line
3. Saucer
4. Fibonacci Retracement
5. Gap
6. Volume Climax
7. Consolidation
8. Channels
9. Cup & Handle
10. Head and Shoulders
11. Tops & Bottoms
12. Ranges



Which ones are most accurate? See Part II for the answer.





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