

# **The Geometry of Stock Market Profits**

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**A Guide to Professional  
Trading For a Living**

by  
**Michael S. Jenkins**



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*Books and Gifts  
for Investors and Traders*

**Biographical Sketch  
of**

***Michael S. Jenkins***

Michael S. Jenkins was born in Schenectady, New York on March 12, 1949. From earliest childhood he was fascinated with the stock market and studied every book and publication he could find regarding the subject. He studied Economics and Business Administration at Washington & Lee University and graduated with a B.S. in Commerce in 1971. In 1975 he received an MBA from George Mason University.

Mr. Jenkins held positions at various bank trust departments from 1971-75 and in 1976 was appointed portfolio manager for three mutual funds in Washington D.C.

In 1984 Mr. Jenkins moved to New York City to become a professional trader for a number of specialist firms on the NYSE. In 1985 he founded the investment newsletter *Stock Cycles Forecast*. Because of the widespread notoriety this letter received in precisely predicting the final stock market high in August 1987 and specifically calling for a 500 point drop in the Dow that would end by October 19th of that year, Mr. Jenkins has become a frequent commentator on television and often the subject of numerous popular financial magazine and newspaper articles.

Nearly every major high and low of significance in the past several years has been successfully forecasted in the *Stock Cycles Forecast* newsletter, many down to the exact day and in a few cases the exact hour on those dates! Mr. Jenkins is considered an authority on cycles in the financial markets and often lectures on this subject as well as providing investment seminars where his proprietary trading methods are taught. This book is an attempt to provide the investing public with a basic reference work to learn the art of market forecasting and professional trading for a living.

## Preface

As I look back over 42 years of life I vividly recall 33 years of interest in the stock market. I was 9 years old when I first learned about stocks. I had been watching a television program with my parents and one of the actors mentioned that someone had made a million dollars in the stock market. I recall commenting to my parents that this must be a mistake since nobody made money since the 1929 stock market crash. I had often heard this from my grandparents and associated the stock market and millionaires with days long gone by and it seemed inconceivable that a fairly modern day play would have people who were millionaires in the stock market.

My father pointed out to me that this was indeed the case and that the stock market was alive and well and that he himself bought stocks all the time. He opened a newspaper that was lying next to him and pointed out the tables of stocks. As I looked down through the stocks I noted one or two names that were very familiar to me.

One in particular was RCA. It was the very same RCA with the famous dog listening to the sound of his master's voice on the old victrola speaker. I was quite familiar with their logo and knew that this was a major company, but the number next to RCA was the number 9. This number seemed totally inconceivable when my father told me that it meant \$9.00 per share. That is, you could buy RCA stock and become an owner of RCA for only \$9.00.

I immediately assumed that my father had been mistaken since parents often do make mistakes, especially when you are 9 years old. I was convinced that he was wrong, it could not have been \$9.00, it must have been nine million dollars. Over the next several days, I proceeded to scan the newspaper columns and footnotes to see if this was not indeed the case.

After a number of inquiries of my father, and his insistence that this certainly was \$9.00 and not \$9,000,000, he showed me that he had been buying stocks that sold at \$5, \$10, \$15, and had even set up an account for me, under the Uniform Gifts to Minors Act and had been buying stocks for myself and my sisters. This immediately picked up my interest and I set about formulating a plan to buy some stocks for myself.

Over the next few years as I earned money, either through mowing lawns, or working odd jobs, I bought my first stocks which set me on the long road toward losses and disappointments that almost all investors go through when they initially learn to trade in the stock market.

My initial purchase was a cheap stock which was all I could afford. As I look back now over the years, especially that early 10 to 15 years of investing, I can clearly see the most common mistake that everybody makes in buying cheap stocks. Cheap stocks are cheap for a very good reason. If I could impress on everyone, **never, never under any circumstances buy a stock that sells for less than \$10.00. for** chances of that stock going anywhere are substantially lower than a stock that sells in the mid ranges.

Regardless of early setbacks, I struggled through for a number of years with an average track record. Early on, my father gave me a book or two from his library on the stock market. This set me on a course of going to the library each week and reading every book I could get my hands on. By the time I had entered high school I had read hundreds of books on the stock market, investing, and technical analysis.

My father was a banker and taught me analytical methods such as credit, debt, balance sheets and general fundamental research. Throughout high school and college I was a fundamentalist. In college I studied both economics and business. I later went on to get a masters degree in business. I passed the uniform CPA exam. I was taking the CFA exams and I started doing fundamental research on the stock market and investing like most fundamentalists.

My first jobs out of college were in bank trust departments, where I learned to invest for widows and orphans, trusts and estates: good, fundamental research, sound practices, typical of most big banks in this country. This was a real eye-opening experience.

One of the fast banks I worked for was a famous old trust department in Washington, D.C. It had as clients many of the original founding families in America, whose names still exist as corporate entities today. As I read through the trust documents I saw how year after year the portfolio managers bought growth stocks and diversified the various portfolios, however, I was shocked to learn that in a large trust department with a dozen or so portfolio managers, the bank did not even possess a single quote machine. I was told that it was totally irrelevant to what we did, to know what the stock market or what the prices of the stocks were doing. That was for day traders and scalpers and long term fundamental investing had nothing to do with current activities in the stock market.

At this time I started reading more and more books on technical analysis as my fundamental investments did not actually perform very well. I knew how to read a balance sheet better than anyone. It was my whole objective in getting undergraduate and graduate degrees in business and accounting to be able to decipher the finest little minute details of balance sheets. To be able to predict precisely each earnings per share adjustment of every company, and with this certain knowledge of being able to predict their earnings, I would be a success at investing in the stock market.

It was only after years of doing this with great precision, and having mediocre results, that I came to believe that fundamental investing had very little to do with making money. It was then that I tamed and devoted my full time to technical analysis and the study of cycles.

This book is the outcome of the last twenty to thirty years of my research in these areas. The orientation of this book is purely technical. That is, "fundamental investing" has to do with the earnings of individual companies, economic conditions of the country, Gross National Product, etc., under the belief that if economic conditions are improving, or the earnings of a company are improving, the price of the stock will go up.

"Technical" analysis as opposed to fundamental analysis has to do with supply and demand factors.

The price of the stock the volume of the shares trading, whether this forms a pattern of **accumulation** or buying the stock over periods of time, or the process of **distribution**, selling the stock.

Cycles are a particular subset of technical analysis. It is through the use of cycles that we can pinpoint possible highs and lows in the stock market, well ahead of time, rather than waiting for past history to confirm that we were right. In conventional technical analysis it is the breaking of a trendline or a moving average that tells us something has changed. But in theory, the breaking of a moving average, whether it be 3 days, 5 days or 200 days is based on events that have gone by and you can never predict the final high or the low day with conventional technical analysis.

By definition of what a high or low is, no human being looking through human emotional eyes will see the high day. On the high day even the bears who think the market will go down believe there is yet another day where it could go higher and they don't sell. The bulls don't sell because they think it will go higher also. It is only the next day, when mysteriously the stock market opens unchanged or down, that we have any evidence at all that the market has indeed topped on a given day, a given hour. Through the study of cycles we can know ahead of time with very high probability, that a top or bottom will be seen, and then fine tune our technical tools such as breadth, volume, price patterns and momentum. We watch closely various technical tools on that day to see if they justify our taking a position in the stock market.

If our technical tools indicate that a cycle is possible turning we can clearly define our risk. We can take a position by selling the high or buying the low and use a very close stop loss both in terms of price level and in terms of time before we find out if we are wrong. It is a tremendous advantage in trading to limit our losses quickly and to confine them to small amounts of money. This is the beauty of cyclical analysis. What you will learn in this book should teach you how to become independently wealthy and successful while gauging the amount of risk you wish to undertake in improving your rates of return substantially.

After concluding a number of jobs, in various bank trust departments doing fundamental analysis, I moved to a major mutual fund complex. I was chief accountant there for a number of years and eventually I became a portfolio manager. It was during this time period when I got to know the side of the street known as the "buy side." I was a portfolio manager in charge of several medium size mutual funds aggregating over \$100,000,000. I was quite successful at this, having had one fund that was up over 50% two years consecutively. This was quite an accomplishment if you understand that with a diversified portfolio of 40 or 50 different stocks, in order to have an overall rate of return of over 50% you might need 10 or 12 of those stocks to triple or quadruple to offset the other stocks that go nowhere and the few that go down. My success at trading as a portfolio manager was due to my switch out of fundamental analysis and into technical analysis. It was during this time that I learned many of the ideas and techniques of mathematics, numerology and time cycles that are discussed in this book which have been refined subsequently over the following 15 years.

After becoming fairly successful as a portfolio manager I made a major career move in late 1983 and decided to retire, at least in regard to working for other people. I moved to New York City to become

a professional trader. One of the lessons I learned was that to feel completely financially secure in life one must be able to take on a job that was totally financially insecure. In other words, security is not to be found in having a secure job with set hours and benefits. **Security can only be found by having absolute knowledge of what you are doing and the strength of conviction that only comes from within.**

So I became a professional trader. A job that on the surface had no draw, no salary, no benefits, and the only money I would ever receive would come from capital gains. It literally forced me to try to make money day in and day out, week after week month after month, to have a positive cash flow to pay the bills. It was this arena of professional day trading that was my best teacher.

Casual investing in the stock market, long term investing over years hoping to get annual rates of return of 15% to 20% a year is for the idle rich or people who do not plan to be successful. It is easy under these circumstances to make excuses for our failures and to wait for the next trade over several months or years to bail us out. The approach I took in becoming a professional day trader literally forced me for my very survival, to learn as fast as I could not to be biased in any manner as to what was the appropriate manner of trading.

The tuition I paid for this education was extreme. Fortunately, in those early years it was with other peoples' money. Whether they were the bank trust department customers, mutual funds or my various employers, early mistakes probably cost millions of dollars. However, soon I made more money than I lost and millions of dollars were made. But each of those prior losses was a tremendous learning experience.

The tuition I paid for learning how to trade the S&P futures was one of my most startling learning lessons. I remember very well my first experience in trading S&P's. On the ticker tape they looked just like stocks only they moved more rapidly. After getting permission from my business partners to trade up to 15 of these contracts a day I started trading with gusto. The first day I made \$8,000. A day or two later I made \$20,000 in a single day. The next day I made another \$2,000 or \$3,000. But, on the 4th or 5th day I lost over \$40,000, and I suddenly found out that they were a little different than stocks.

I immediately jumped into bond futures thinking they might be easier but the overnight gaps up and down were quite unfamiliar to me. I did not know that bonds literally traded round the clock around the world and that the markets were continuous even though futures stopped trading in Chicago at 2:00 PM. To make a long story short my initial 2 or 3 months tuition was close to \$500,000 for both S&P's and bonds combined. Fortunately, my profits in day trading stocks was about the same amount of money. However, the biggest lesson I learned from all this was that if one could master short term day trading, through the use of leverage it could be a spectacularly rewarding career.

I have been privileged over the years to know some of the world's greatest, most successful, professional traders. Many of whom use very esoteric techniques and are of strange and different personalities. What I have learned from all these various sources I now wish to share with you in this introductory book on Professional Trading.

Please keep in mind, while reading this book that my perspective has changed dramatically over the years. Starting as a fundamentalist, like most people, and ending up with a very rare, unique perception as to what drives the markets.

I have come to appreciate the fact that market movements day to day are not random. Market movements day to day have nothing whatsoever to do with economic statistics, fundamentals, politics, or any of the things that professional portfolio managers, bankers, mutual funds, or managers of brokerage firms tell you what the stock market is all about. I have come to the conclusion that the vast majority of books written on technical analysis and fundamental analysis are totally worthless.

In the stock market, price is reality. It is the only reality. The techniques that I use have to do with determining the price level and the direction of the price level and investing accordingly. Techniques in this book are based on explicit assumptions that there are immutable laws of nature, unseen forces that are known as "cycles." It is these cycles of which we can never know what causes them or where they come from, but it is these cycles that literally predetermine the stock trading price levels on a day to day basis.

This can be conclusively proven with the techniques in this book for forecasting, and by the time you get to the end of this book you should be able to forecast well out into the future with high reliability, at least as to the turning point days, when major turns in the market are almost certain to materialize. You may not know the direction of that turn ahead of time but you will be able to predict when you get to that point in time, that a major change of significance will take place in the market and you will be able to exploit that opportunity. None of these prediction methods would be possible if news items or fundamentals had anything to do with the stock market.

This book, as much as it is about making money in the stock market, is a book about philosophy. It is a philosophy about life, about the human condition, about the limited perceptions that human beings have, and about the distortions that are picked up through those perceptions. It is the pure reality of price in the stock market that is the truth that burns through these human perceptions and illusions.

Hopefully by the time you have finished this book you will come to the same conclusions I have, as to what it takes to make money in the stock market, especially the lesson that you must be extremely disciplined, have no subjective judgment and be very objective about taking losses. I have said over and over again, and I sincerely mean it, **the only thing easier than making money in the stock market is losing money**, and the one thing all professional traders abhor is losses.

To become a professional trader you must learn to cut your losses quickly and at reasonable levels without guilt as to whether you were right or wrong. **There is no right or wrong in the stock market...there is only the reality of price and profit or loss.**

There will be many people who will read this book and not believe it at all. They will not believe these techniques work because their minds will be so closed and so subjective based on their backgrounds, their perceptions and their upbringing. They will look at many successful multimillionaires from the

Wall Street community who will swear that these things do not exist, that the only way to make money is to invest on good fundamentals.

I will tell you from my viewpoint there are a great many people who are quite successful, but whose reasons and perceptions as to why they are successful are completely wrong. That either their gut instincts, their innate abilities, their own clairvoyance, or sixth sense allowed them to be in the right place at the right time, and their rational reasons for why they made money are not valid.

The hypothesis put forward in this book is that the market can be predicted. The tools described in this work are predictive tools that work. They work all the time, there are no exceptions. If you practice with the techniques in this book you will see that they work and you will also see there is no other logical conclusion if they do work, and they do forecast future price levels, than to say that cycles exist regardless of whether or not intelligent people perceive those cycles.

The market is a zero sum game, in that on each side of a transaction there is a buyer and a seller. One side has to win and one side has to lose. But what is not readily realized is usually that on one of those sides there is one infinitely intelligent wealthy person on the winning side of the transaction and on the losing side of the transaction there are thousands of little, uneducated, misguided people.

The purpose of this book is to put YOU on the winning side of each trade with almost certain knowledge and confidence that you will make a success in speculation.

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# Chapter #1

## Introduction to Cycles

*“With all of these (cyclical) findings, why is it so hard for man to believe that perhaps his buying and selling of stocks and bonds may not be rational behavior after all?”*

Since the beginnings of recorded history, mankind has debated the ageless philosophical questions of destiny and fatalism, and man's supposed free will to create his own individual life cycle. Natural catastrophes and large scale warfare have often been the philosophical catalysts in forming this debate of whether man actually has free will in determining his destiny.

In the natural realm, animal life was long known to exhibit life cycles of consistent regularity, and fisherman and fur trappers often recounted the years of abundance or scarcity in their harvests. Cycles of draughts and famines are well known to all farmers and workers of the land and weather prediction has become a modern day scientific marvel. Prior to the founding of the Federal Reserve System and centralized banking in this country, financial booms and busts were regular recurring phenomenon for over a century. The Rothschilds of Europe for years made use of the recurring economic cycle of 41 months to buy and sell, and were held in awe by the less cyclically educated because of their seemingly uncanny ability to pick the highs and lows of the economic cycle.

In the ancient world, fascination with the heavenly bodies at least made the masses aware of possible cyclical influences in their lives, although fatalism and superstition prevented any real serious study except on a limited scale. Religious bias and persecution often hindered the study of cyclical determinants of human behavior especially when recurring crop failures and droughts could be of better use to politicians within the religious governing bodies. Almost all rulers both secular and religious had appointed soothsayers and astrologers to provide official explanations for cyclical events that might rouse up the masses. Even in the more modern age, perhaps the greatest mental giant that ever walked the earth, Sir Isaac Newton was the official court astrologer and personally defended the practice with great zeal.

In the modern age rigid political and academic ideologies constantly persecute cyclists and fatalists in order to maintain their power structures even in the face of modern scientific evidence of an overwhelming magnitude. Tacit acknowledgment of the cyclical nature of the economy is the underlying principle of *Keynesian* economic planning, whereby the politicians decide to spend more money in bad times to stimulate the economy when the natural consumer cycle is sluggish. It is a shame that the

politicians seem to think that everyday things are bad enough to need their omniscient stimulation.

Wall Street, although one of the last bastions of real freedom and economic choice, has had a hard time dealing with the rise of "cyclical investing methodologies" since these do not intellectually lend themselves to generating ever more sales commissions on a daily basis. Who wants, or needs a Wall Street stock analyst if the cycles say stocks will decline for the next year or even more?

In the final analysis, the human being is primarily a *rational* being. At least he Thinks he is. Objective observation of human behavior would seem to indicate, however, that he is largely *emotional* by nature, and the more emotional he is the less it has to do with rationality.

Modern science has discovered biological clocks, circadian rhythms, estrogen and endocrine rhythms, sleep cycles, sunspot cycles, blood chemical cycles, cosmic rhythms and a multitude of others too numerous to even mention. Most of these are what we would term external determinants, even though they are found often internally, as opposed to rational thinking determinants. With all of these findings, why is it so hard for man to believe that perhaps his buying and selling of stocks and bonds may not be rational behavior after all?

Over the years I have come to the conclusion that there are only four major motivating influences in the world. These are money, sex, power, and religion. The perfect example of all of these is the U.S. Congress. Often all four will be excessively exhibited by individual members of Congress.

The stock market of course has to do with money and I would hypothesize that the smartest minds in the world that are motivated by money either are found on Wall Street or in Las Vegas. Why is it, that many of these great minds are not so successful in cracking the secret of stock price movements? I firmly believe it has to do with rational minds trying to battle emotional problems. What people buy and sell has very little to do with what they say they are doing (rationalizing) but more with what they feel. My work conclusively shows that these feelings are **CYCLICAL**.

The intellectuals have been attacking the problem with a rational understanding which is bound to fail. The problem is akin to the millions of people who go on diets to lose weight. Billions of dollars have been made by selling books on diet fads, vitamins, and exercise, and knowledge about losing weight is readily obtainable by everyone. But who actually loses weight and keeps it off? The answer lies in emotional behavior not rational knowledge.

The solution to the stock market mystery is to use our rational mind to develop a rational plan to control our emotions in buying and selling. **CYCLES ARE THE KEY**. If one merely believes in external cycles controlling our behavior, and uses a rational game plan to invest with that cycle, he will become a success. Notice that it is not necessary to prove that cycles even exist for this to work. This is merely a mental construct that will conveniently allow us, as rational beings, with tremendous perceptual blockages, to battle our emotions effectively when buying and selling.

It is not my purpose to tell you the **CAUSE** of cycles in this book. My approach is only to give you techniques to discover cycle rhythms and patterns, so you can gain mastery over the most difficult part

of professional trading for a living... pulling the trigger with a cool head and extreme confidence. As you go through this book, please remember that cycles do exist, and if we do not cloud our understanding with needless rational "reasons" why such and such a stock must go up or down, we will be much better off. I will feel that my efforts were successful if at the end of reading this book and practicing these techniques, you throw away your newspapers and analytical reports that serve as your rational crutches for your emotional behavior, and you find yourself slightly humbled, being merely an emotional human creature and not so smart after all.

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## Chapter #2

### Why Technical Analysis?

*"All losses in the market are entire attributable to not investing with the primary trend."*

For many years market observers have argued over the merits of various approaches to investing in the market. The two most widely accepted schools existing are the fundamental and the technical.

**The fundamental approach** utilizes an analysis of broad economic factors, so called "fundamentals," in an effort to predict the earnings growth and industry trends for stocks, in the belief that a rising earnings trend in a generally improving economic situation, to which the stock belongs, will sooner or later result in a rising price for that stock. Practitioners of this form of investing will tell you that the stock market cannot be predicted, except within a general trend of economic events. These fundamentalists usually detest technicians.

Many of the most successful stock investors of the past fifty years have been fundamentalists, who believed in a buy and hold strategy of investing in common stocks. This strategy worked well as the U.S. economy and the stock market grew secularly and dominated the world economic scene. I have serious doubts that the next fifty years will show a continuation of this same American secular growth. In retrospect those buy and hold players may have been simply lucky that the long term trend was up. The approach I favor to investing in the market, and what I believe to be the only valid intellectually sound method, is the technical approach.

**The technical approaches'** basic philosophy is that all economic, fundamental news of any significance is always reflected in the price and volume characteristics of a stock long before the economic improvement or deterioration is known to the general public.

Intellectually this has to be, since at the most basic level of the company, the chairman of the board and members of the board of directors, all know the outlook for the industry and their stock in particular, long before objective public evidence is available. These people are lifetime specialists in their field and must have information far better than any Wall Street analyst. Therefore, when a significant economic event occurs, these insiders know immediately whether their stock is relatively cheap or dear, and buy and sell it accordingly to the utmost available amount of their resources. It is their buying and selling that leaves its tell tale tracks on the ticker tape for the technical analyst to spot and to evaluate. No stock makes any significant rise or fall overnight, only through the day after day accumulation or distribution of shares in the open market.

Assuming for the moment, that even the board of directors of a company are completely unaware of a fortuitous event in the company, and an outside fundamental analyst has correctly evaluated the situation, the technical approach is still the only valid intellectual approach for investing for the following reasons:

- It is buying and selling of a stock which makes it go up or down and gives it any economic value for the investor. Earnings may skyrocket, a company may strike oil or gold, buy if someone, somewhere, with money, does not bid up the price of the stock, then such fundamental developments are of little worth to the capital gains stock investor.
- The technical approach will always reveal the direction of a stocks' movement from the very first instant of its move, and the able technician will always be long a rising stock and short a falling stock, before the reason for its rise or fall becomes apparent.

The secret to stock market investing was once stated by Will Roger when he said, "*One should buy good stocks that go up and if they don't go up, don't buy them.*"

Although this quote is somewhat facetious, in logic, it is exactly what the technical approach is all about, identifying stocks that are going up or ones that are going down. All losses in the market are entirely attributable to not investing with the primary trend. This should be our only goal as speculators or investors--identifying the primary trend.

Now let us review the basic cycle of a stock's rise and fall. At the end of a Bear Market or economic recession, stocks sell at very cheap, low levels since most people have sold out and no longer anticipate any favorable news from the company. If the company is not going bankrupt, but continues in business there will come a point when the daily volume of transactions will dry up to practically nothing, at a price low enough that all reasonable long term investors think is fair value, and at a level that the insiders consider cheap, relative to the future outlook of the company.

Executives who plan to spend their whole working lives in a particular venture, usually know when conditions are at rock bottom and can only improve. It is at this point that the process known as "**accumulation**" starts to take place. Day after day the insiders, their relatives, their families and a few outside analysts start to buy the stock.

At first, the stock will only move an eighth or so, as there are usually many sellers until around at slightly higher prices. But after a period of weeks, even months, most of the overhead supply of stock for sale has been accumulated by these long term insiders.

This class of investor is very long term by nature, thinking in terms of the industry economic cycle. They do not plan on selling the stock bought today for a few dollars more when it will be higher next week or next month, but rather several years down the road, at retirement, or when the economic cycle seems to have peaked and the stock has very likely doubled or tripled.

Since these long term investors have accumulated the available supply of stock for sale, effectively taking it off the market for several years, only new sellers coming into the market will be able to make the stock decline in price.

As this process of accumulation ages, the price of the stock, which at first creeps higher with small gains, then begins to fluctuate much more violently, and finally, literally explodes upwards from the day after day buying when fewer and fewer shares are available for sale.

Near the top of the cycle, after the stock has been rising for quite some time, the stock becomes very thin and a very small amount of buying can greatly move the price of the stock upwards. This is a natural, psychological phenomena. At that point, all holders of the stock have a profit on their position, and psychologically feel that they have been right all along and that the stock will go higher.

Naturally, feeling this way, they do not want to sell the stock now, even more than before. Soon the natural forces of greed take hold and these investors, who feel that they are "so right", increase their buying to include bank borrowing and margin purchases. At the top of the cycle this reaches an extreme, and the original insiders decide to sell some of their holdings.

This at first merely checks the rise of the stock but does not send it down. Only later when the margin interest expenses pile up and the stock stops moving do others start to sell and the "distribution phase" now begins.

Often the insiders will not only sell their own holdings, but since they feel the economic cycle for that company is near a peak, they will sell more company stock to the public in an effort to capitalize on easy money financing for the future. As soon as the stock becomes "waterlogged," it begins to go down and each successive lower break brings in more selling.

As in the Bible, the phrase "like begets like" applies equally well to the market, as buying will attract more buying and selling will attract more selling. (Specialists on the floor of the exchange know this well and raise and lower their quotes all day long according to this principle). On the way down, the stock also becomes thin, as the general consensus is reached where most people have become bearish sellers and the buyers are price cautious.

Near the lows, the volume increases until the price reaches a value level that the original insiders feel represents true value, and then step in and buy all the stock being sold. After this, the volume dries up and the stock goes dormant, awaiting the next anticipated upturn in the economic cycle.

It is the tools of technical analysis which identify the various phases of the accumulation, distribution life cycle and allows the speculator to capitalize on these movements. Remember we are talking cycles here, and our emphasis will be on identifying where we are in the cycle, so that we can determine the main trend and invest accordingly.

It should be noted however, that the average time for the accumulation, distribution cycle can be as short as a year or in some cases extend upwards or downwards to ten years and in some cases even thirty years.

In those situations it is accomplished within the frame work of what we call a "**Bull Market**" for the accumulation phase, and a "**Bear Market**" for the distribution phase. Most Bull Markets this century have lasted 3 to 5 years with Bear Markets 1 1/4 to 3 years. It is to be emphasized that the Bull or Bear Market characterization applies to psychological processes or emotional cycles and not just periods of time when prices rise and fall. It is these psychological processes that help us identify what cycle really is operating. There are many elements of each cycle and they are not of utmost importance in a work as technical as this but here are a few.

In the "**Bull Market**" expect to find easy credit, increasing margin buying, increasing public participation and rapid and easy upward price movement. Bad news is ignored and corrections against the primary trend seldom last more than six weeks. The economic backdrop is coming out of a recession with strong economic growth, and the economy is throwing off lots of excess cash flow from business profits to fuel the ever higher price movements. People are still used to the past, tough economic times, and this usually creates the "wall of worry" of stock prices.

In the "**Bear Market**" phase we find that confidence is still high from the Bull Market excesses and the attitude of "**buy the dip**" is prevalent. Economic statistics deteriorate, but most analysts call for a reversal any day now. Margin is being liquidated, credit is tight, rallies are short lived but very powerful, and the economy is "**sucking**" cash out of the system to finance inventories, debt etc.

In cycle analysis, we must remember to try and get a "**feel**" for the cycle, and the above general characteristics, although somewhat subjective, will at least point us in the right direction. In final analysis, only one consideration is of importance--if the stock goes up or down.

If one were to describe in simple terms how a rising stock behaves, one would see that in order to maintain an uptrend, a stock must over time, reach higher price levels both on each rally and on each subsequent decline. Each low for the correction would be higher than the previous correction low. This is referred to as making "**higher tops and higher bottoms.**" The same is true in reverse for declining stock patterns. For a stock to show a down trend it would make a series of lower lows and lower highs.

In evaluating the strength and duration of a move, one must keep his investing horizon in perspective.

- Long term investors - will only be concerned with correction lows that hold above long term prior lows, such as the prior year's low,

the prior quarter's low or the previous month's low.

- **Short term investors** - will pay close attention to the prior weeks' lows, to watch for violations.

- **Aggressive day traders** - will watch each daily high and low but usually the past three days' trading range is most important.

In analyzing this, please keep in mind the natural rhythm of the movement. Price patterns represent the over abundance of either buyers or sellers on a daily, weekly, monthly, etc. basis, and these forces react on a ticker tape much like the natural force of the tide at the beach. The following analogy should be studied until it is firmly understood.

*The first time beach visitor is not usually aware of the tide but only notices the boundary line of the waves pounding on the shore. After a while, he would notice that some waves are more powerful than others and subsequent reach further inland.*

*If he gets a chair and sits just past the waters edge, he would notice over the next few hours that the general line of demarcation between the shore and water, moves inland or recedes further out towards the sea.*

*If our first time beach visitor is observant enough to time the rising tide patterns, he would see the ever increasing inland penetration of water. He may now become alarmed, thinking that eventually the tide will swallow up the beach, threaten the local beach houses and eventually the town.*

*Our nervous beach visitor may now try to measure the rate of advance between each thrust of the waves, by marking the extreme penetration with perhaps a rock or stick and thereby begin to calculate the time when the water will reach the adjoining houses. He would note, that eventually the tide stops advancing, stays level at a certain marker, and then starts to withdraw. At first, this would seem like an anomaly which would grant a short reprieve to the beach front property owners, and our observer would still assume that the next wave, or perhaps one or two after that, would yet go further inland.*

*After spending more time observing, our visitor would begin to see that the tide is leaving, and never having experienced that before, may now conclude just the opposite, that the beach will be getting permanently larger and larger.*

This analogy with tides and stock market movements is very close, and has fascinated market technicians for generations. The wave patterns of buying and selling stock seems to indicate a human psychological tide of emotion, that varies in amplitude and intensity, manifesting as greed and fear.

This pattern of stock prices can then be analyzed to one's financial betterment, if one is only willing to make the assumption that this analogy is true and invests accordingly, without inferring subconscious fear, or intellectual bias in the process.

If this analogy holds, we should be able to benefit by making observations as to each wave thrust, how high it goes and the resulting pullback. Then we anticipate the next thrust by buying on the receding pullback and seeing our stock surge ahead almost immediately, rewarding our scientific methodology with a better rate of return over time.

Whether or not this analogy is true is irrelevant, because no stock can go up without making higher highs and higher lows, and such analysis will always keep one out of trouble, as it is losses that are the problem in investing. So determining the main trend is the only thing.

It is the tools of technical analysis that help us to measure these trends. The long term fundamental investor invests with the rising tide, but there is nothing to enhance his position throughout the entire movement and he must wait to sell at the end. The technical trader, on the other hand, can achieve much greater results by selling at each extreme thrust, and reentering on each receding decline and picking up a few extra dollars on each attempt.

I equate the fundamental approach to that of a blind man at the beach. He hears the tide and makes a general observation about its direction and movement, but he cannot spot each little thrust and recession and be able to time the next movement. A sharp-eyed scientist on the beach would be able to measure quickly and get a sense of the rhythm of each internal movement, in addition to the rhythm of the large crashes heard by the blind man.

Only now do we see that the definition of the main trend of higher highs and higher lows for advancing prices, and lower highs and lower lows for declining trends, will keep the observing technician invested with the main trend of the market.

Like the analogy of the blind man at the beach and the scientific visitor with sight, investors cannot possibly hope to accurately discern patterns of accumulation and distribution of stocks, unless one has in his possession a chart or graph of the stocks' activity over time.

Remember, it is the daily buying and selling, the price levels and volume fluctuations, that subtly reveal the sophisticated operations of insiders and large institutional investors whose immense power make the stocks rise and fall.

Investing without a record of the price and volume, is investing on hope, and one who invests solely on hope is bound to be disappointed before too long. Most investors can readily obtain weekly charts and subscription services at reasonable prices. However, for the casual investor who only trades five or six issues, he should be able to construct and maintain his own charts within a few minutes each day.

Although, I personally prefer charts because one can easily discern simple patterns and thus project future price movement, based on the symmetrical patterns of the past, one need not use pattern recognition to invest successfully. The basic necessity, is simply a log of each price swing high and the preceding and subsequent price lows, along with the daily volume. The investor then merely sells out whenever a prior low is broken and remains long as long as those lows hold.

A breakout to a new high would indicate that a move up to even higher highs is likely. This method has been used successfully for generations, and even the famous Jesse Livermore used such a rudimentary log of price levels to keep track of the main trend.

A log is necessary because memory is short and often a stock can remain dormant within a trading price range until most investor forget the stock. It is then very important to have a record of prior highs and lows so as to know when the main trend will be resumed or reversed.

Our next chapter will discuss the various charts one should keep and why.

## Chapter #3

### Charts

*"All buying and selling is reflected in the history of prices volume and dates of such movement."*

Basic Charts are of several types:

1. **Bar Chart** - the normal chart, where each price is graphed with price on the vertical column and time across the bottom. Volume is usually indicated by vertical lines along the base time line.
2. **Point and Figure Charts** - no time or volume is recorded. Point and figure charts presume that only price is important since that is what determines gain or loss.

Point and figure charts record reversal in price, usually with a series of X's, one on top of the preceding, as long as the price of each high exceeds the preceding high, and during declining periods a series of vertical declining O's are started.

The chart reader can instantly see if the rising X's are greater and more numerous than the declining O's and then see if the trend is rising or falling. Since these patterns say nothing about time, they can often wear out the patience of investors who see the stock in an up trend, since no low has been broken, but the stock may trade sideways for years and still appear to be in a rising trend.

It is therefore hard to compare relative performance of one issue verses another, since the investor's primary interest is in rate of return over time annualized and not just absolute return.

A stock that goes up 50% in 50 years is not the same as one that goes up 50% in 50 days, and yet the point and figure charts could look the same. Point and figure charts are **good when making an initial analysis** in picking stocks as its history is easily summarized.

3. **Logarithmic Charts** - charts drawn with prices over time but the vertical price scale part of the chart is graded logarithmically. This means, that each grid up on the scale is not an equal dollar price, but an equal percentage move from the last base price.

These charts are helpful in that a trendline drawn on such a chart connecting lows will show a growth rate such as 20% a year compounded since each move up is an equal percentage of the last. If the same slope trendline plotted on a long term logarithmic chart was drawn on a regular

normal chart with equal price increments, it would appear to be an upward parabolic growth curve.

Since we are investing for rate of return, these charts are excellent in comparing various stocks that trade at different price levels. For example, to compare a \$15 stock with an \$80 one, trendlines of the same slope will show the same rate of return.

Investors can be easily deceived into thinking that an \$80 stock going up \$10 to \$90 is better than a \$15 stock going up to \$18. When in reality, the first is returning a 12 1/2% yield and the second, a 20% yield. On a logarithmic chart the 20% return would easily be seen as a steeper slope trendline.

**4. Hybrid Price Volume Charts (Equal Volume charts)** - these are various charts that encompass the volume traded each day with the price movement so as to make a visible interpretation of volume price relationships easier.

For example, volume chart users use a very fat bar on a day when volume is large, and a thin bar when the volume is small. The height of the bar would be the same, the price range fluctuation would be identical, only the volume would be different.

In theory, accumulation patterns show volume rising with prices rising and volumes falling as prices ease into the correction period. Distribution patterns, selling or declining, show volume increasing on down days with light volume on rally days.

**5. Japanese Candlestick Charts** - these charts have been around in the East for hundreds of years. They try to visually relate the relationship of the opening high, low, and daily range with the closing level. For many people, these colored bars are easier to notice when changes are developing. The patterns can be quite complex and I would recommend that you get a good book on the subject if you are just learning. However, your effort will prove to be quite rewarding.

I usually recommend that traders use normal charts with price, time, and volume since other charts can be derived from the information therein. Serious students can reconstruct the patterns on one chart into all the other kinds of charts visually in their heads.

So now, with our preliminary starting point of the natural wave trend analogy and the belief that all buying and selling, regardless of nature or reason thereof, is reflected in the history of price, volume and dates of such movement, and with our charts showing such history, we are now ready to develop an objective, scientific analysis of stock prices to see how money can be made with such knowledge and losses avoided.



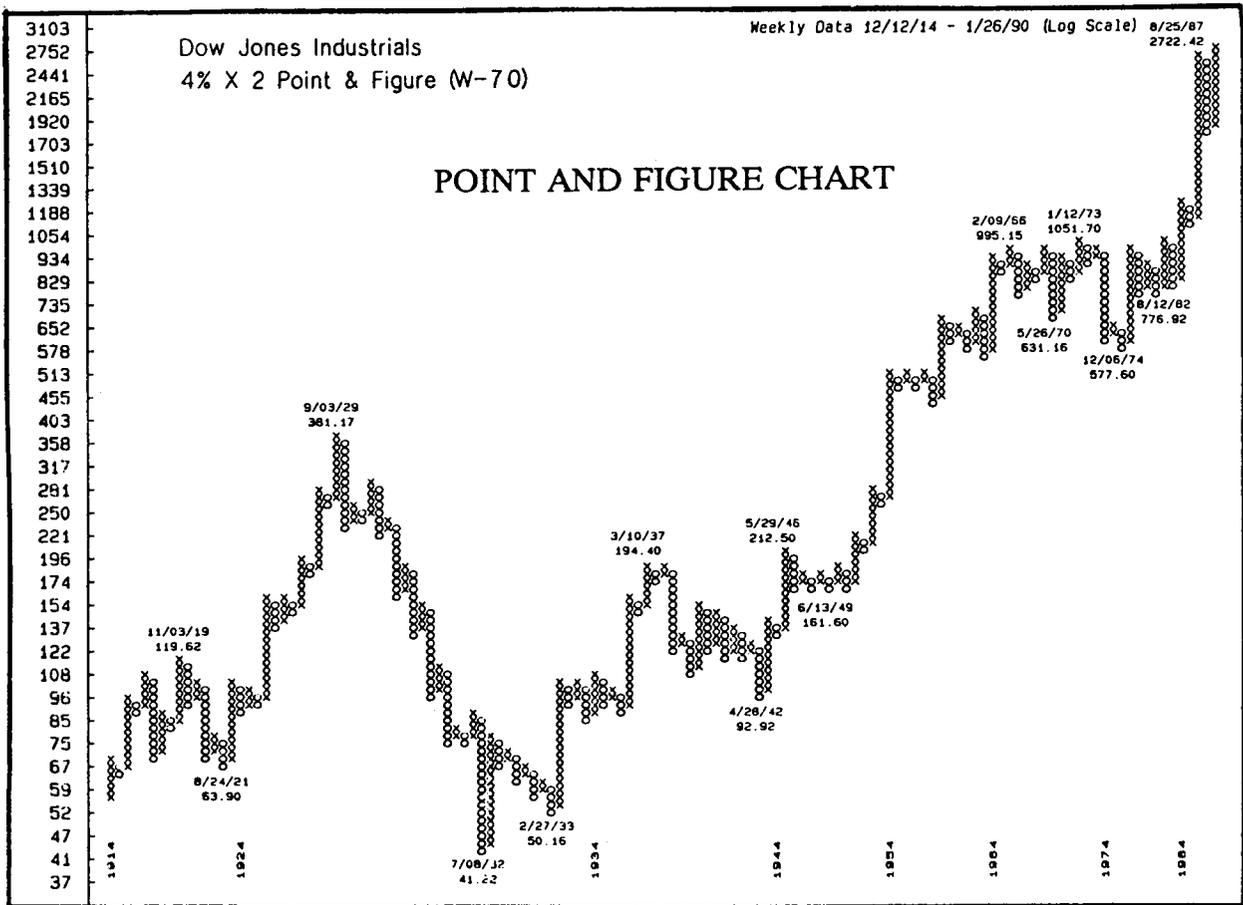


Chart courtesy of  
Ned Davis Research Inc.  
Atlanta, Georgia

## "SEMI-LOGARITHMIC CHART"

The charted trends reflect relative, or percentage changes. Thus, in this scale, the vertical linear distance for a 100% move is the same any place on the chart irrespective of whether the rise is from \$5 to \$10, \$20 to \$40 etc. This permits an accurate comparison from one chart to any other.

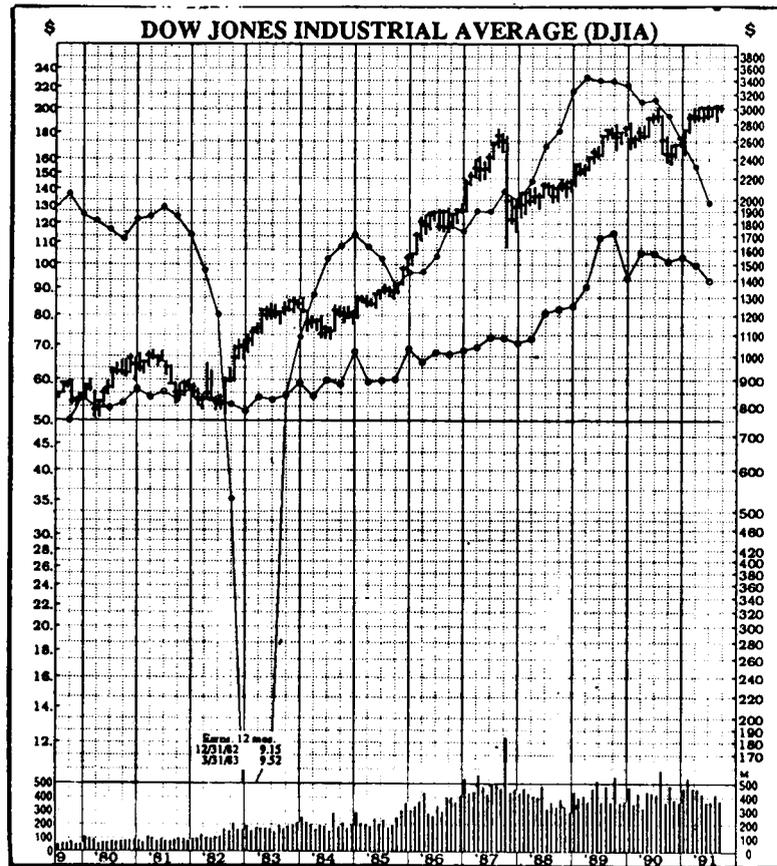


Chart courtesy of  
 Securities Research Company  
 Wellesley Hills, Massachusetts

## Chapter #4

### Theory of Geometry

*"The solution to the stock market enigma is nothing more than keeping track of all the fluctuations of the past."*

The concepts in this book may seem unusual from a rational, logical point of view, but trading is an emotional, not a rational experience. Our strategy therefore, must be a rational approach to conquering emotionalism.

In the twentieth century, one of the greatest frauds ever perpetrated on this planet was the blind acceptance of the science of economics. Although, great in theory, in practice, no economist, to my knowledge, was ever able to forecast anything but past events.

The reason for this dismal failure lies in the crude assumption of behavior on the part of the consumer. Given limited wealth and scarce resources, a consumer is supposed to rationally choose the best alternative to get the most for his money. This sounds great to academics, but in the real world it is totally devoid of any real meaning, because the assumption of the consumer's rational behavior is in error.

I maintain that not one major decision in life is decided rationally, but emotionally. Examples of this are when you get married or divorced, quit your job, tell your boss to shove-it because your raise wasn't big enough, or when you buy that \$50,000 red sports car. These are emotional reactions that we rationalize, in order to make us feel good about the decision we make. Even the seemingly, most rational decision we think we make, voting for the U.S. President, has bloodied many a nose, when the candidate's name was mentioned in the wrong bar.

The stock market is the perfect economic environment, where we see emotionalism at the extreme. Simple fear and greed drive the markets and people simply rationalize the events that they respond to emotionally.

After waking up and emotionally wanting to buy or sell, the masses search newspapers, television, or business analysts to find reasons to support their feelings and to allow them to be at peace when investing their life savings by the "*seat of the pants.*"

The proof of this is why technical analysis works. Predictions can be made months and years ahead of

time with technical analysis, even when the media reporters say that particular outcome is impossible.

Markets as a whole are great statistical laboratories for measuring mass emotions of fear and greed. Although, we know there are economic and fundamental reasons why the economy improves or deteriorates, it is clear that it is human beings that are buying and selling stocks. It is this human behavior of buying and selling that is accentuated by the amount of leverage in the buying and selling.

In the speculative markets, especially commodity markets or in the stock market, with the use of futures or options, where there is tremendous risk involved, emotionalism is at an extreme. Since these markets consist of millions of people all around the world, the emotions that are exhibited give us very reliable, predictable, mathematical certainties as to the timing and magnitude and duration of these basic human emotions.

In theory, if you examine the market from the last six months to two years, the same types of people are in the market, there are no new investors. In the last sixteen to eighteen months all players are essentially the same, but over fifty or sixty years the makeup of the investment community changes.

If we were to measure the extremes of emotions during those last eighteen months, such as fear of going to war or a current news item, every time that fear manifested itself, emotions would run to certain extremes. Perhaps the market would drop seven days in a row 100 points and then exhaust itself. Perhaps if there was a major financial crisis, the market would go down seven weeks in a row and several hundred dollars, and then exhaust itself.

We know from psychiatry and studying the behavior of animals under stressful situations in cages, that when under extreme pressure they will either adapt or break down totally and exhibit all kinds of nervous disorders and mental breakdowns. In the stock market, it is impossible to have a total nervous breakdown. What happens is that we have financial panics and the stock market collapses.

In reviewing the history of the financial market during the last two hundred years, we find that at recurring periodic intervals major crises occur. These crises cause people around the world to react in similar patterns, as they have done in the past, because the basic human emotion, fear, always manifests itself in the same manner.

The price levels may be different, the amount of volume that trades hands may be different, the leverage in the market may be different, but the amount of time it takes for a human being to go through a fear cycle, and have the fear exhaust itself, is usually the same. In most cases during the last century, normal panics run about seven weeks from the high to the low, or about 49 days, but we have seen extremes, where it can last 9 weeks, 13 weeks, a full quarter, sometimes even six months.

If we examine the history of the stock market for major events, major bullish events, sudden unexpected good news or major bearish events, such as the collapse of a major institution or the death of a famous person or of a president, we will have a pretty good idea of the extremes that emotions can run. In measuring these extremes, we can estimate the time it will take from a high to a low, and the magnitude of that particular drop, or advance, if it is a Bull Market.

There seems to be a unique life cycle to the emotions that feed fear and greed. In the early bullish phase of the market, some sudden, unexpected news, takes place and the market quickly rallies. At first, people are still a little suspicious, but the initial excitement is enough to get the market going.

After a modest pull back, another advance takes place, and people get more excited. This takes a course from being cautious and conservative, to more aggressive, outright speculative buying, and finally hysteria, with extreme bullishness at the top, and wild swings of the market.

Once we get to the top, we often see spike emotional tops. The market pulls back, people get a little cautious, but they are still wildly speculative, they buy every dip. A little while later, they start to lose by buying dips and become a little more conservative, and we start to see the emotions switch.

As the stock market continues to deteriorate, and they lose more money, they get downright cautious, and then slightly fearful, and then stop investing. As the market continues to go down, the people who are still long and losing money, become afraid and fear starts to manifest. It starts to turn into hysteria, and as it snowballs people sell and sell at any price, and we start to see the extreme measurement of fear.

An impartial observer can get a good understanding of this type of sentiment by reading headlines in the newspapers. He would see, if the behavior of people buying and selling was actually rational, or if they were doing crazy things, like selling at any price or buying at any price, being so confident or afraid, that they have lost all sense of reality.

Many successful investors over the years have used these "sentiment" measures, and there are many technical tools to gage sentiment. Different indicators can measure how overbought the market has been by how many days in a row it goes up, or how oversold it is, or the advance-decline line breadth deferential, but these are still approximations and are averages of the past.

My work proves conclusively that these things do not have to be approximations. They are exact, very precise and very mathematically defined, as you will see in the coming chapters when we deal exclusively with the geometry of the market and how we define these emotions.

Now, let us assume that the market is exhibiting the emotional behavior of fear and greed. We may not know the actual underlining connection between the emotionalism in the market, as exhibited in price fluctuations, or what causes that emotionalism. Many causes have been assumed, but I am not talking about fundamental economics, I am talking about the external causation of cyclic human behavior.

For instance, it could be the weather cycle, it could be barometric pressure, it could be tidal forces, it could be precipitation, wetness or dryness, it could be cosmic influences, electromagnetic radiation from outer space, it could be any of these things. However, for our purposes, it is irrelevant as to what the actual cause might be. What we need to do is to find a system that will identify these particular patterns and precisely measure the influence of these causes on the market. Then we need to find out when the cycle will reverse itself, and when these emotions will subside.

This is what separates my work from other great investors over the past years, who measured the sentiments of fear by some kind of gut feeling or intuitive knowledge or just practical hard experience. All great successful people in the market have had this ability to calculate these emotions, but it was not very objective and they could not communicate it to other people.

The mathematical approach, in particular, in the use of geometry and other mathematical formulas we get from physics, like vectors, define these emotions much more precisely, and can be communicated to anyone in a very objective fashion.

The overall philosophical underlying belief seems to be that on a subconscious psychic basis, mankind is connected. This may very well be associated with Jung's belief, of the collective unconscious, for we know that the mass's buying and selling in the stock market, with the tide of emotionalism, can be timed very precisely.

There seems to be a connection between the subconscious emotion and the movement of prices on a day to day basis. If we track the day to day price movements, and apply mathematical models to them, we can identify underlining currents of greed to fear and back to greed, thereby, timing the highs and lows in the market.

Some of these methods have been used by a number of others for several hundred years, but most are my own proprietary discoveries, and although they may appear illogical at times, I can assure you, that in over twenty years of actual experience with them, they have always worked to my extreme satisfaction.

The basic underlying premise was stated by Pythagoras, a few thousand years ago, in that "**Time and Space are connected by numbers.**" The angle or the angular momentum of the stock's initial rise has within it the ability to forecast the magnitude and duration of the movement, both in terms of the final price, and the approximate number of days or weeks until exhaustion of that particular movement.

It is similar to artillery gunnery calculations. There we put a projectile, with a specific charge of powder, into a cannon and fire it out several hundred yards into the distance. Instead of varying the amount of powder behind the bullet, we need only change the slope, or how high we tilt the barrel of the cannon. If we tilt it straight up, we find that the bullet will go straight up and come down and land a few feet from us. If we tilt it at a 45 degree angle, we find that it will go the furthest. If we tilt it less, say 30 degrees, we find that it will have the same effect as tilting it straight up, that is, it will land shorter, closer to us.

The initial thrust in the stock market, of stocks coming off the low prices or on a breakdown from the top prices, are what we term "**impulse waves.**" They are a lot like the trajectories out of these cannons, whereby, we can take measurements on these trajectories and forecast where they are going to go.

With this as a backdrop, we return to the theory that the subconscious mind of man is connected with

the price level of stocks, on a day to day basis, which has something to do with time cycles that are influencing human beings and their behavior, so we can make the following conclusion:

The price level at which a stock trades tells us something about its own internal time cycle. **This is the major secret key to the stock market!** That is, if a stock goes up to \$50 and it tops out, and then goes down, we can say that the \$50 price is more than just price, for price also has an intricate connection with the time cycle.

Indeed, the time cycle has a mathematical numerological equivalent of 50, just like the price of \$50, and we will find turning points in the future of that stock at units of 50 time periods. These units can be 50 minutes, 50 hours, 50 days, 50 weeks, 50 months, 50 years, but all the units of 50 from that high price will be evident in future cyclical behavior.

This can be proven conclusively to anyone by looking at any chart, whether it be stocks, commodities or even the prices of used cars. (*See Figure 1*)

One takes the high price, takes that time unit and measures over in days, week, months. The unit you want to use, should be applicable to the trading horizon. If you are a long term investor, you would use weeks and months. If you are a short term investor, you might want to use weeks and hours. However we measure it, we will find the turning point in harmonics (fractional mathematical parts) of the major high or low.

Now, when that stock at \$50 goes down and makes a new low, say \$30, and it turns up, we now have the same effect from the lows. The \$30 low will spin out time cycles, based on 30, not 50, but every 30 units over, and these will have a tendency to be lows to lows or highs to highs. For instance, the \$50 price might spin out a high every 50 time cycles, and the \$30 low might spin out lows every 30 time cycles.

What we find, is that the solution to the stock market enigma is nothing more than keeping track of all the fluctuations of the past. All the day to day highs and lows, are spinning out these future cycles, based on those highs and lows of past history. This is very similar to throwing a handful of pebbles in a pond. We know if we throw in one big boulder we get a giant wave, and if we throw in a little pebble, we get little tiny ripples.

These are a lot like the price levels of stocks. The great big boulder might be an all time high or low, the little tiny pebble, might be a recent high or low that might only last for a couple of weeks. The ripples in the pond, that spin out from these prices, give us our cycles. Remember, we are trading for profit here, so we are not concerned with what caused that pebble or boulder to be thrown in, just the fact that we can calculate its effect. The actual reasons and nature of the cause is a subject that I truly do not believe can be addressed in a book of general circulation to the masses at this time.

Now, if we study the physics of light optics or waves of sound, we know there are interference patterns. These waves will come together at some point, at a common denominator, and change the

pattern, making a much larger wave or entirely eliminating the wave completely. What we find, is that each individual high and low, in the history of the stock market ten years ago, a hundred years ago, two hundred years ago, six years ago, are spinning out their own eternal cycle, and we find time periods in the future, where all these cycles come together, creating major market movements (interference patterns), the end of Bull Markets, and the beginning of Bear Markets. The birth of newborn Bull Markets are nothing more than innumerable cycles all coming out at the same time.

The mathematics of this is fairly simple, although depending on how many highs and lows we want to use, it may get a little complex. However, with modern day computers it becomes relatively simple to program in two or three hundred observations of highs and lows over the last hundred years, and spin out these cycles, and let the computer tell us when they are all coming out together.

For instance, when a stock has a high at \$20 and a low at \$10, we know that at every twenty weeks there will be a major high, and at every ten weeks there will be a major low. Now, we would note that every other low of ten weeks would also be twenty weeks, so that a high and a low would come out together, reinforcing the cycle, making it even stronger, and this is where cycles can change on us.

If we have a common denominator cycle, that has a rhythm of 10 and 20, they will often come together at a new price. Let us say, the day that both cycles came together, the stock was at \$17. At that point forward we may very well generate a new cycle which eliminates the past highs and lows of 10 and 20, and make a whole new cycle of 17 units.

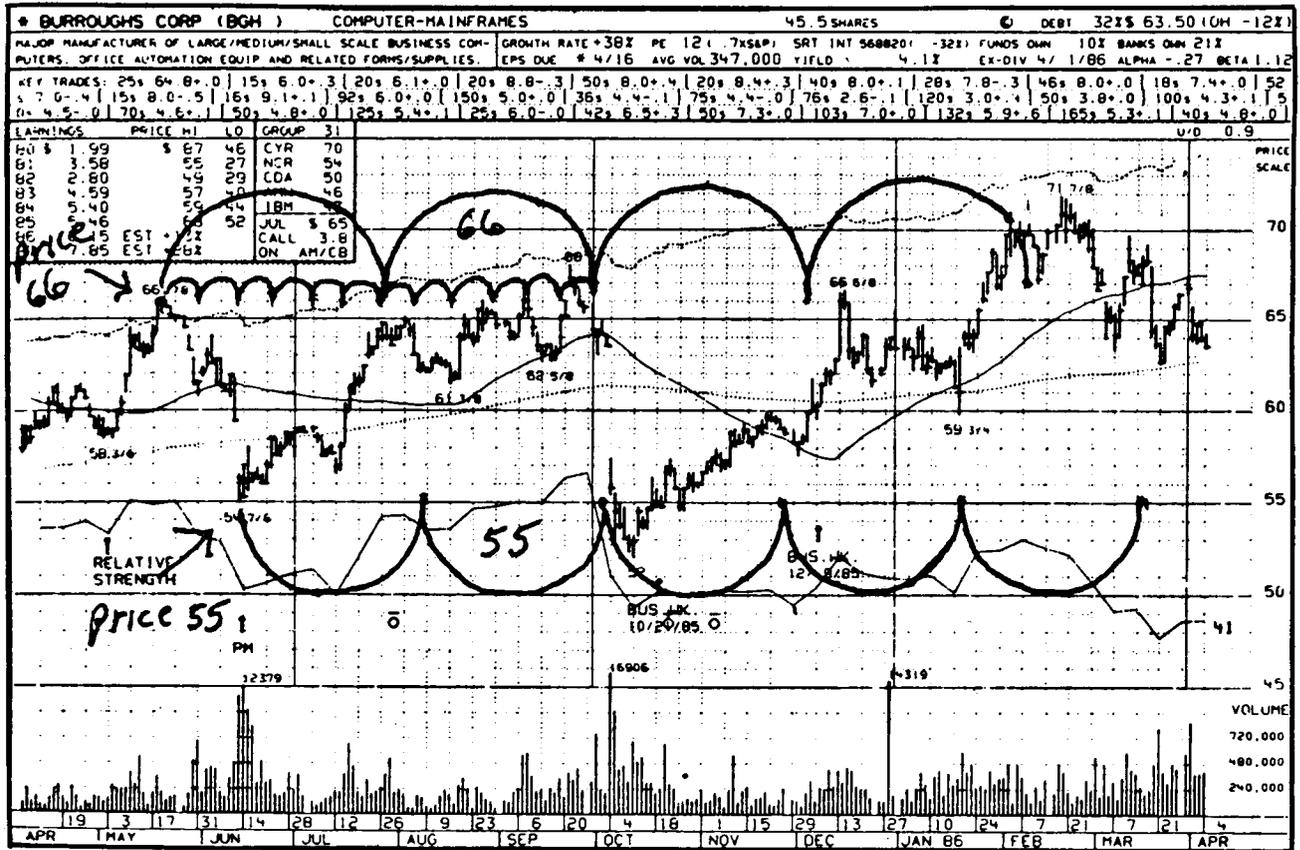
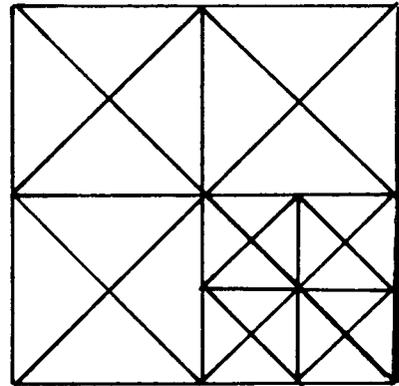
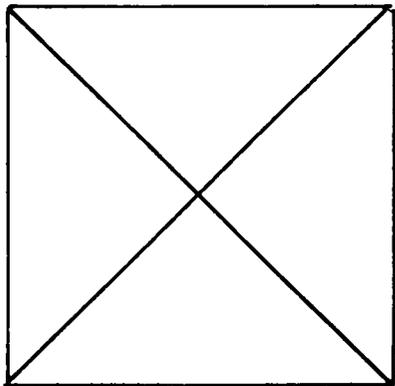
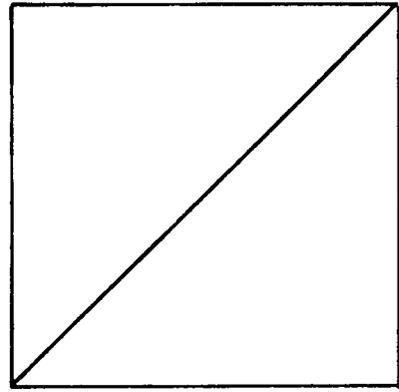
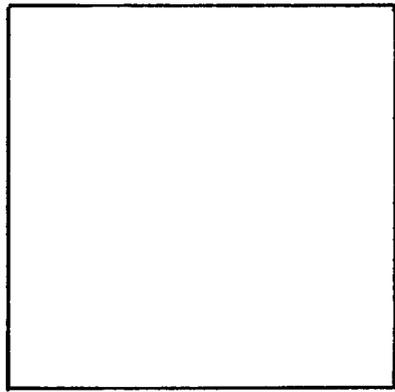


Figure 1

The above chart of Burroughs Corporation from 1985 shows a top cycle of 66 days spinning out from a high of 66 1/8.

Also shown are very small top cycles at 66 hours from that first top. The inner half shows low cycles of 55 days being spun out from the low of 54 7/8.

## TIME AND PRICE SQUARES



*Figure 2*

## ORIGIN OF TREND LINES

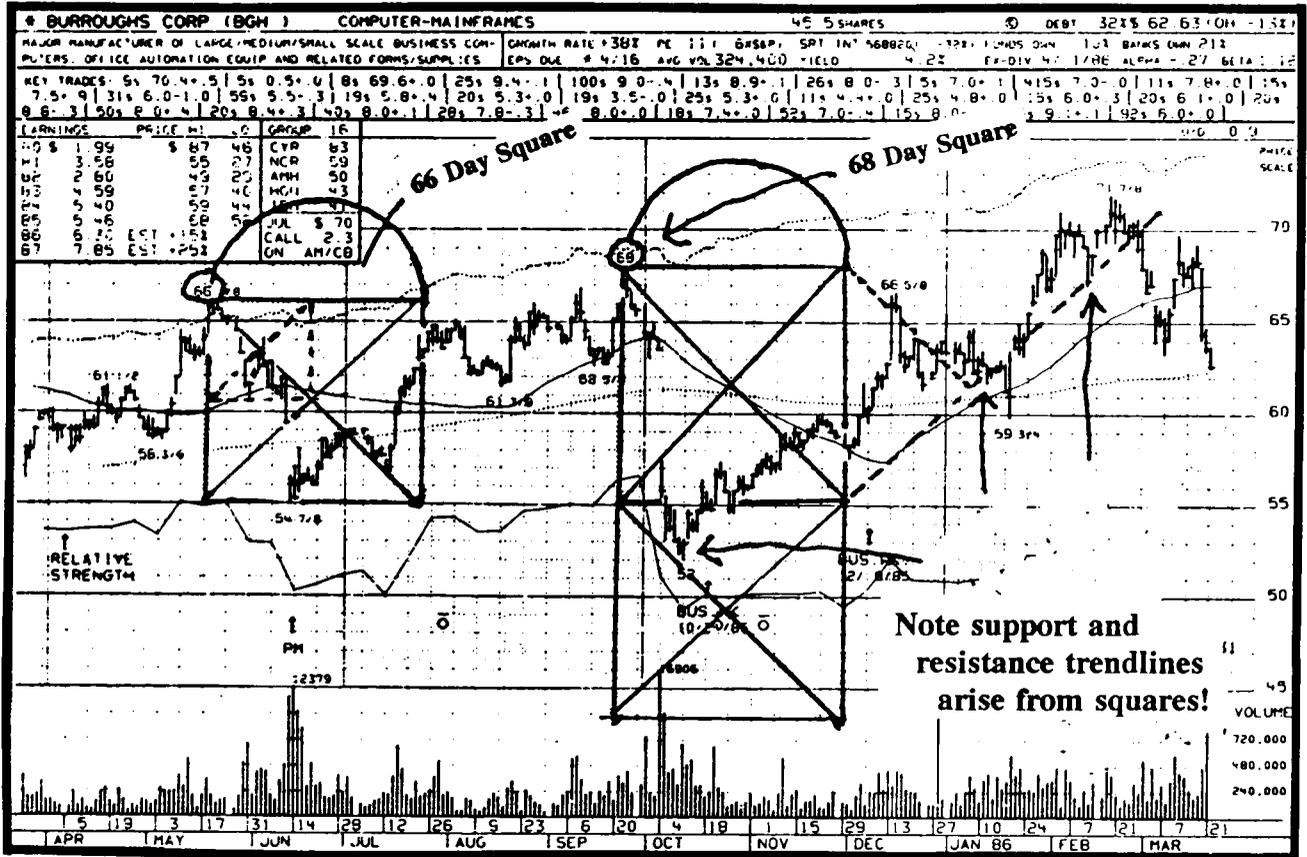


Figure 2A

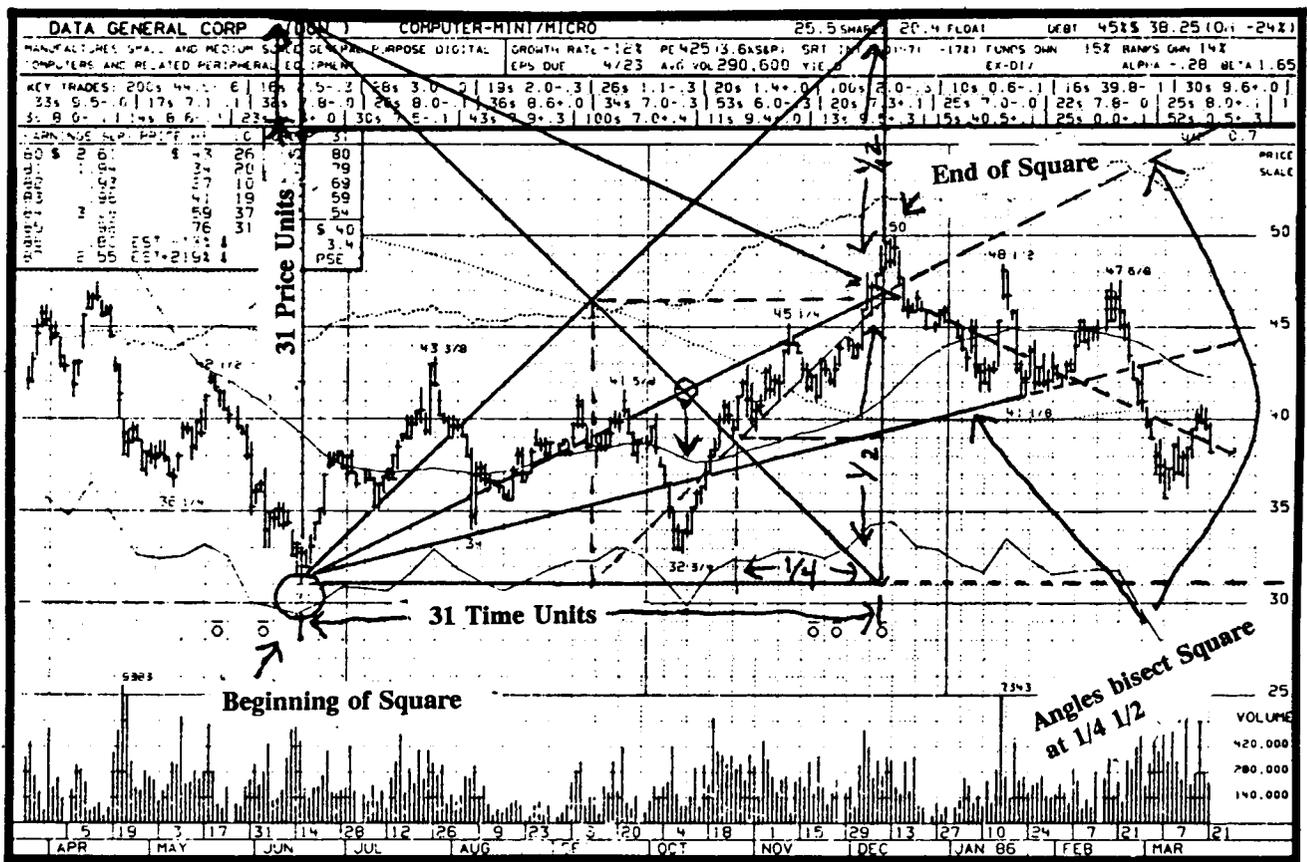


Figure 2B

# INTERSECTING LATTICES CREATE CYCLICAL CHANGE

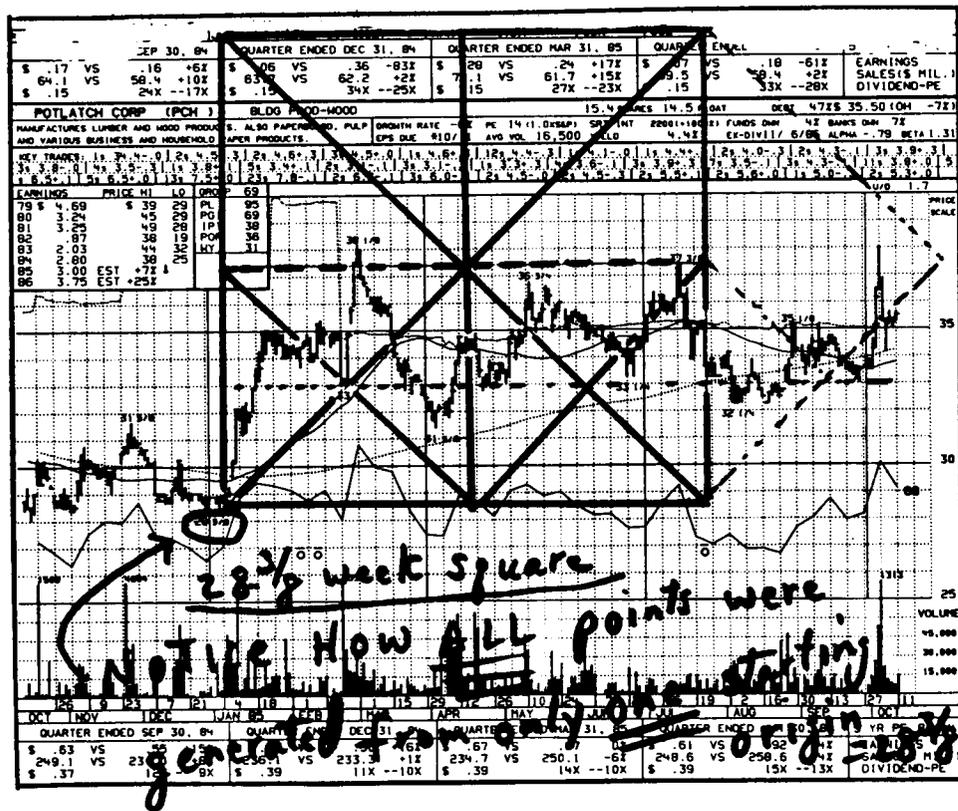
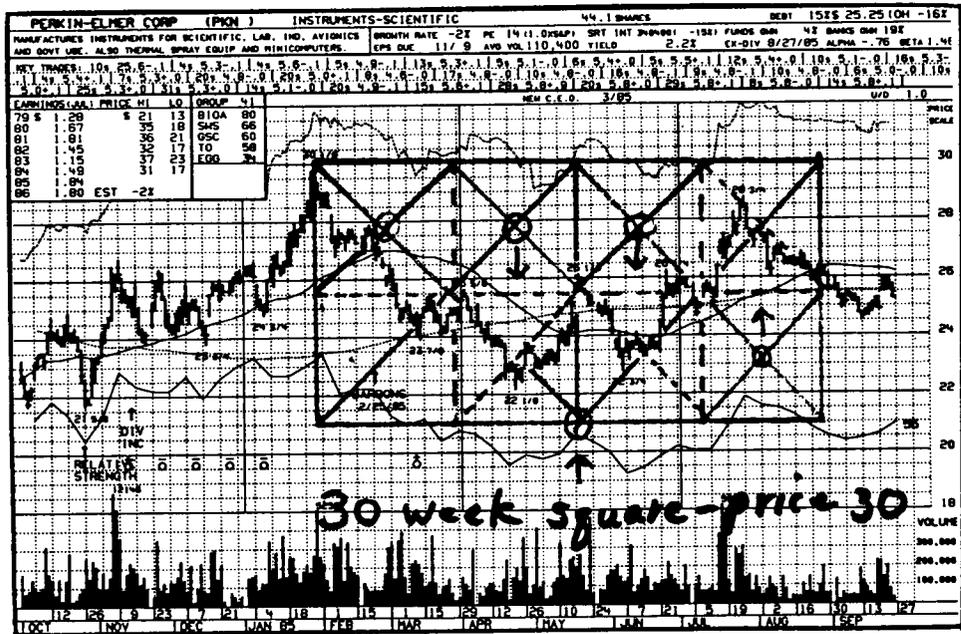


Figure 3

A similar thing would be, if we had a high at \$20 and a low at \$10, and then another price at \$12. We would merely look at the common denominator of these. We know that there would be a common denominator of  $20 \times 10 \times 12$  (2,400) for a very big cycle, but we can also reduce to the common denominator by dividing each by 2. For example, 10 divided by 2 gives us 5. 20 divided by 2 gives us 10 and 12 gives us 6. If we multiply the least common denominators  $6 \times 5 \times 10$  we will find a shorter time period (300) where these big cycles will come out. This is the theory, and we keep track of it through geometry, through the concept known as, "*time and price squaring.*"

Time and price are the same thing. By this, we mean, the price of \$50 on the stock, generates time cycles of 50 that are interchangeable for most purposes, and because they are the same thing, we can construct a geometric "square" around the price of \$50. If you were to take a ruler, and on your graph paper when the stock hits \$50 as a high, measure 50 weeks, or 50 days, whatever you want to try, draw a straight line horizontally across your paper from the \$50 high, and we would have our timing of 50 units measured out horizontally.

To square time and price we construct a square. We have the horizontal unit of the square. Now, we merely measure down and make a vertical unit of a square, which gives us a little geometric square of 50 units. (*See Figure 2 and 2A*)

To further complicate things, and yet make them easier, we do not necessarily have to use 50 units of time, in terms of days, weeks or months. On our graph we can also use 50 price units, by measuring how far 50 price units are vertically, on the particular graph we are using. Once we have made that measurement with a ruler, we can turn the ruler horizontally, and see what the measurement equals in terms of time periods. (*See Figure 2B*)

For example, you may find on the particular graph you are using, that our unit of \$50 may equate to 217 days, an unusual unit, and yet, since we know that units of time and price are the same thing, we can still construct a little square and achieve very accurate results.

So the initial step is to construct the square based on the high price. However, if you wanted to construct a square up from the low, you can take the low price and measure up and construct a square. This of course is very basic. Please try and keep an open mind until you grasp all of this, for the implications are staggering, and our minds are rigid through years of erroneous thinking. Trust me, the effort will be worthwhile! Besides, we are not trading for fun and profit, but only for profit. Let's not get biased by thinking too hard at this stage of the game.

The next step is to divide the square. We draw a diagonal line through the square, which will subdivide our square. As we subdivide the square diagonally, we would then have two halves of the square.

We then draw a vertical line through the middle of the diagonals, making it into two halves. Within each of the four quarters of the square, we can draw diagonals, making eighths, and then subdivide these little eighth divisions within each quarter.

As we continue the process of drawing diagonals within squares, within smaller squares, within smaller squares yet, we see that these diagonals are actually the trendlines that mysteriously appear from nowhere. We can now see conclusively, on our chart, the origin of all trendlines, how these trendlines arise from the mathematics of the high and low prices, and the square units that are spun out from these highs and lows. (See *Figure 2A*)

One of the reasons, in theory, as to why this all works, comes back to the original statement of Pythagoras, **"UNITS IN CIRCLE OR IN A SQUARE ARE RELATED TO EACH OTHER IN TERMS OF PRICE AND TIME AT SPECIFIC POINTS."**

Let us, for example, put a series of random dots on a piece of paper. There is nothing that relates those dots to each other. Now, if we draw a square on a piece of paper we can easily see that the dots that make up the lines or the sides of the square. The dots are related to each other in a very specific mathematical fashion, for they make up the sides of the square. On a truly innate level, human beings recognize the geometric shapes apart from randomness, so we must accept the interconnectedness of points that fall on the axis lines of these very special shapes. (Did you ever wonder why humans see shapes?)

So it is the same with any other geometrical shape, a circle, a triangle, whatever else, they are not just random dots. What we are seeing by joining these squares around the price levels of stocks are unifying cyclical influences.

Keep in mind that on a subconscious, psyche level, people are exhibiting emotional behavior caused by external cycles, that are influencing them to sell the stock at \$50. What our square shows, as it is broken down into little diagonals and sub-diagonals, is the minute subconscious emotional facets of the cycle that is currently operating.

We can, therefore, conclude that the masses as a whole will exhibit major cyclical behavior at the end of the big square of 50, say 50 weeks later. At the end of that point, time and price will be at a major mathematical point that ties in the original starting point of that cycle high. If there are indeed external cycles, and all the evidence points to such, this method is a way of subtly capturing all these subconscious, subcycles, of greed and fear that manifest in the market.

What we find is that when we take these squares and subdivide them, when we put diagonals in the squares, and when we subdivide them into quarters, and then into 8ths, and then into 16ths, and continue to subdivide the square down into trendlines, the stock appears to trade within these subdivisions.

It is these diagonals within a square, the subdivisions of an emotional cycle, which are the well known trendlines in technical analysis. The reason these trendlines work has to do with the origin point of the cycle.

Note that the random dots on a piece of paper have nothing in common, but dots that fall on the param-

eter of a square are connected. So when the price of a stock goes down from \$50 and hits one of these intersecting diagonals or trendlines, it is somehow mathematically, harmonically, related to the origin point, because we have a geometric shape, a structure, a square, a diagonal, that is mathematically connected.

We, therefore, have something that ties in our cycle and the force of the cycle can now be measured in a mathematical, very precise objective fashion. Remember the rule, when a stock price hits a trendline a change in trend will take place. For instance, if a stock declines, and hits a trendline, it will often bounce off that trendline. This is considered a change in direction. Sometimes though, a change in trend is a change in momentum or acceleration such as a stock going down to a trendline, and when it hits it, accelerates and collapses, bursting through the trendline. This too, is a change in trend, but not a change in direction, for the trend has changed to an acceleration of the existing trend.

Within a square, or geometric shape, the intersection of various trendlines, such as the center of the square, where two diagonals cross, represents a kind of a forcefield vector, where extreme emotionalism comes together. It is at this intersection or intersecting lattices, within the square, that we find major changes of a cyclical nature. (See *Figure 3*)

This is apparent in a chart where we have constructed a square over the price action. At these intersecting points you will find the stock will change direction or accelerate, and we will see an evidence of change brought about from a cyclical nature. Many of these changes are obviously insignificant and not worth trading as they are minor fluctuations. Therefore, when we are really investing off this cyclical methodology, we must keep track of major changes.

For instance, a major square of 50 years from a price of \$50, would have the diagonal intersecting at the midpoint, which would be 25 years later and we would expect to see a very major change at 25 years. Also, on a 50 week cycle, every 25 weeks we would expect a major change. Obviously, these changes would be much bigger than if we had a 25 minute chart or a 50 minute chart with the diagonals intersecting every 25 minutes. There would be a change there too, but it might be for 50 cents, whereas the one for 25 weeks might give you a \$10 fluctuation.

The theoretical implications of this are staggering. In my research of many years I have made some major conclusions from studying these things. Many of these are proprietary and I choose not to reveal them at this time, however those of you who grasp the basic fundamental truth as to how this works, can easily derive many of these concepts for yourself.

Now, let us see how this is used in a normal trading situation. The first thing we would want to do is go back over 10, 20, 30 years of stock market history data of a particular stock and find the highest price it ever sold at in history. Maybe the stock at one point sold over \$100, and today it is only trading at \$30. We would know that that was a major cyclical high.

For example, let us say that our stock topped at \$120. We would want to keep track in a tickler file, or

on a calendar, this cycle origin point. If the \$120 price was made on January 1, 1973, we would want to keep track of 120 weeks, especially 120 months, which would be 10 years later, January 1, 1983, or 120 quarters or 120 years.

First we need to get the really big cycles down. We know by subdividing these squares into halves, quarters and thirds, we would see that the simple division of the square, is what really gives us the well known technical observation of proportion and harmony in the price of the stock. If the stock's high was \$120, we know that 50% of that high is \$60, and we all know the 50% principle...when a stock pulls back to half of its all time high, it finds major supports. It finds major supports simply because of these diagonals coming up from the low, under this giant square, and at the midpoint all angles intersect at the 50% midpoint. This is why the strongest point on any movement is the 50% retracement point, whether the stock is going down and bouncing back from the 50%, or is going up from a correction low to the 50% point.

There are many logical conclusions to be made from an analysis of squares, or various methods of time and price squared. Since every high and low is connected with previous highs and lows, it stands to reason that a price of \$50 at a high, is really stopping at \$50, because of some unit in the past that has spun out these squares and circles into the future. Perhaps there was a square of 100 many years ago. As the stock currently goes up to \$50 it hits that midpoint of the giant square and stops at 50. If there had been a low of \$25 many years ago, we would have two squares on top of each other. A square of 25 units up from that low, would also come out at 50, and the stock would top at 50. We may not be able to identify the origin point of where the squares are coming from, but because of the theory of the square, we know that we can take the high price of 50 and draw a 45 degree diagonal line up and down from that price, and start a brand new square. This is why in most technical courses, people use 45 degree angles. For it is the 45 degree angle that neatly subdivides each square.

Because, the 45 degree angle is the intricate unit of the square, we can see, that we do not need to know where the actual time cycle began, because all the future highs and lows, all the current highs and lows, are bouncing around within these fractional diagonal points of various squares. Therefore, when we draw our 45 degree angles down, we are assuming there was a square with a diagonal coming down that caused the stock to top out. To find out if there was a diagonal coming up from a low that caused that price, we should draw a 45 degree diagonal down and to the left to see if it hits a lower price.

One useful means of doing this is known as, "squaring the range." The range of a stock, is defined as the price levels between a high and a low. For instance, if a stock trades over several weeks or several months, at a price range of \$25 to \$50, and back again, what we would do is to take the high price and draw a 45 degree diagonal down, until that diagonal intersects the low price, which would be \$25 in this case.

At that intersection point, the 45 degree timing line would square, or make equal the high price of \$50 and the low price of \$25. At that point, we should turn the "timing line" up again, and draw from the \$25 low, up at a 45 degree angle, to where it intersects \$50. We would continue doing this as a timing

mechanism with a zig zag up and down, back and forth between \$25 and \$50, until the stock breaks out of that trading range. You might want to draw a big square of \$50 at the high, and draw the 45 degree diagonal down to where it intersects with zero, as the intersection of zero price is the end of the square.

Instead of actually constructing a square geometrically on a piece of paper around that high price of \$50, the 45 degree diagonal neatly does it for us, because when it gets down to zero, we know it has divided a square with \$50 up at the top left hand corner, and the zero at the far right bottom corner. So, without actually constructing the square, we know when the end of that time cycle comes out, simply by drawing an angle.

We would also find, when half that time cycle comes out by drawing an angle down from \$50 to \$25. Again, we know that when the 45 degree angle comes down from the \$50 price, and intersects the price of \$25, we are at the midpoint of a giant square. Likewise, if we draw a line from \$50 down to \$37.50, which is the midpoint between \$25 and \$50, we would find that we are at the 3/4 point of the square.

So you can see, without actually constructing these squares, that we can **find all our cycle turns by constructing a simple timing line of 45 degrees and watching where that timing line intersects a proportionate part of the price level.** This is the same thing, as actually constructing a square with all the diagonals, only it is much faster and much easier. (*See Figure 4*)

It makes our analysis much easier to start with any stock and instantly draw a 45 degree angle up, or a 45 degree angle down, and start to get these turning points. For instance, if we have a \$25 low price on a stock, but did not know exactly what the high was, we could just draw an angle up 45 degrees, and when it intersected harmonic fractional parts of \$25 we would get turns. Remember, half of \$25 is \$12.50, so as the angle goes up from \$25 to \$37.50, we would know that it was a potential top, as it would be 50% higher.

We can continue this diagonal up through \$50 for a double, through \$75 for a triple and through \$100 for four times. The squares would get larger, and larger, and larger, and we would be able calculate these turning points from one simple 45 degree diagonal.

I apologize for repeating all this 45 degree angle stuff so much, but it is absolutely imperative that you learn this as second nature before we go on to the more complicated angles, as fractional parts of the analysis. The 45 degree angles are easy, because they represent one unit of time and price. Later you will use 30 degree angles, 60 degree angles, and a host of other angles that are just as important for determining trend, but which are more difficult to keep track of mentally, unless we understand this intersecting lattice groundwork.

## 45 DEGREE TIMING LINE INTERSECTING PROPORTIONAL PRICE LEVELS

### SECRET OF THE 45 DEGREE ANGLE

A 45 degree diagonal line evenly divides a square. Since we consider time and price on a chart to equate to the bottom and side of a square, the 45 degree diagonal becomes a timing line or moving average that equates one unit of time with one unit of price.

It additionally keeps track of mathematical relationships between time and price from any past high or low. So when a stock hits the line it again is in exact mathematical relationship to the original price and must change direction or accelerate the existing trend.

This is why trendlines work-- because they equate, at that exact timing point, a fractional harmonic of both the passage of time and price with the original high or low from which the angle is drawn. Since this is so, we can deduce the following:

- When a timing line (45 degree) intersects major price harmonics of the original high or low - **change will occur!** i.e. 1/8, 1/4, 1/3, 1/2, etc.
- Major "square outs" occur with 100% movements of price intersection, i.e. from top down to zero, or zero up to top (forms a square) hence, "square out".

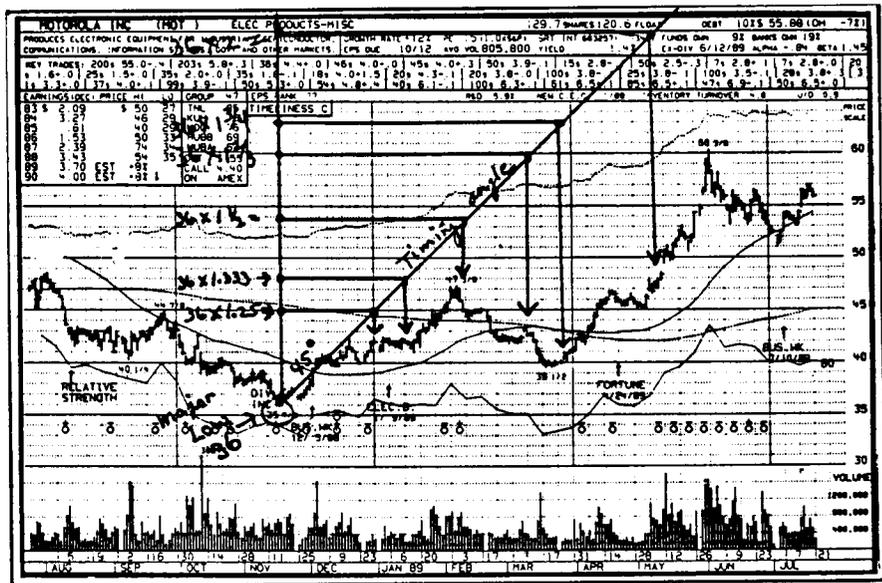
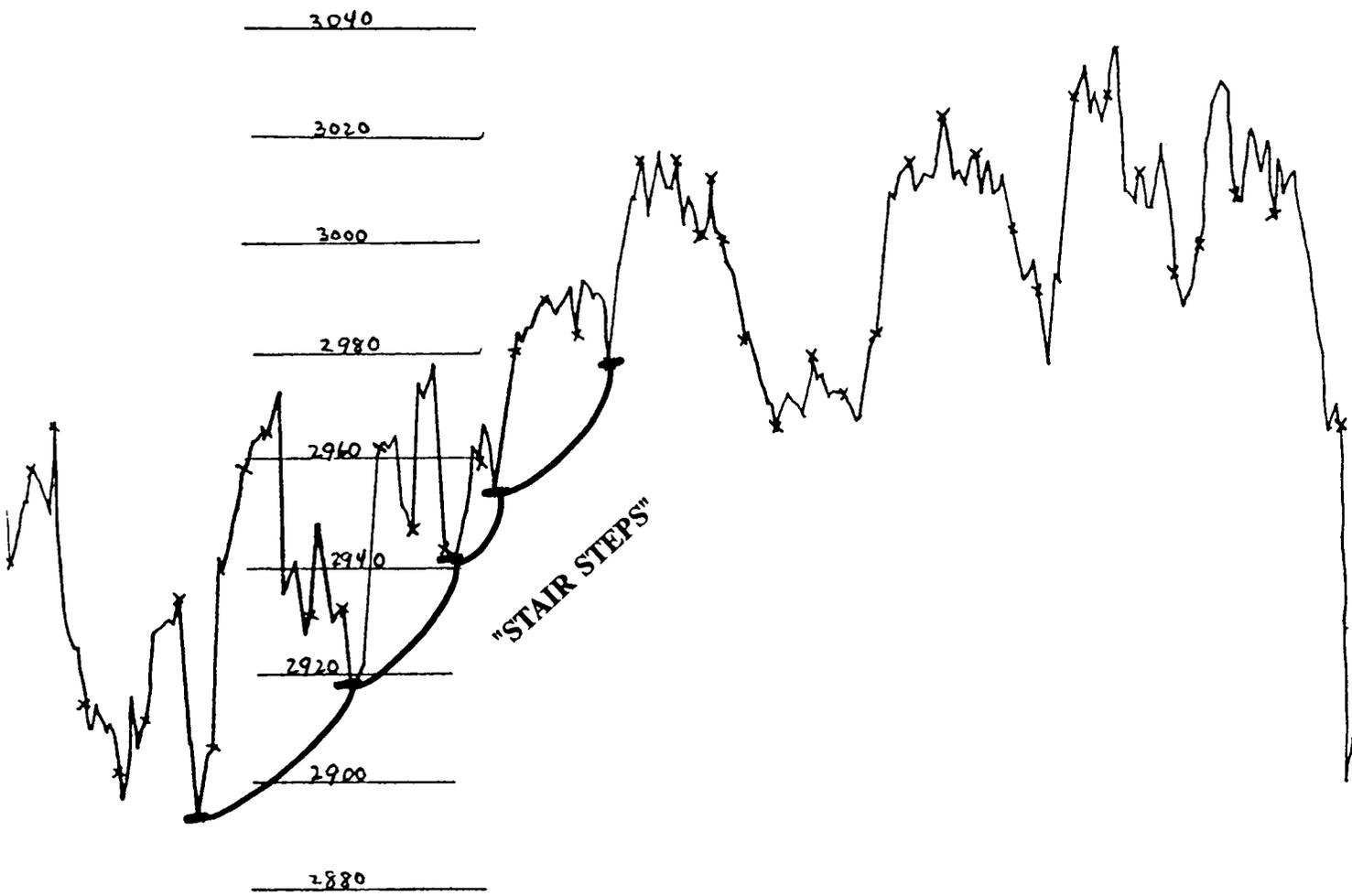


Figure 4



TYPICAL HOURLY CHART

20|21|24|25|26|27|28| 1|2|3|5|8|9|10|11|12|15|16|17|18|19| 22|23|24|25|26|29|30|31| 1|2|5|6|7|8|9|12|13|14|15|16|19

June

July

August

Figure 5

## Chapter #5

### The Hourly Chart

*"An Hourly Chart is our primary indicator of major turns."*

The very first place to start our practice of professional trading is with the corner piece of all professional trading, the hourly chart. This is the smallest chart, for practical purposes, one should maintain. Obviously, if one uses an hourly chart we are talking about short term trading that is good for three days to three weeks at a time. If you must trade for three months to a year at a time we are really talking daily or weekly charts. However, for most trading activity in the speculative markets, especially commodity markets, S&P futures, bond futures, gold, wheat, soybeans, stocks and certainly all options, we want to stick to trends that last 3 days to 6 days to 2 weeks. We will be using options and futures where we can make 50% to 100% on our money in just a few days.

A properly drawn hourly chart can forecast price events several months into the future as well as each minute hour to hour fluctuation each day. Hourly charts are better than daily charts, in that there are many waves or patterns that develop within the market, day to day and week to week, that are only observable on an hour to hour basis. These are easily identified by their shape and pattern but these patterns are only visible if one has an hourly chart. It is one of the best kept secrets I know, but I will tell you that you will NEVER understand the market until you see and use an hourly chart. It is only with the hourly chart that you will see the patterns that repeat over and over in the course of several months, that are the key to the market. Daily and weekly charts are good but rarely show the common key patterns that clearly identify the market's activity. We therefore start our professional trading career with the hourly chart.

It is my practice to use 6 hours in a day, 11:00 AM being the first hour. There are many reasons for this. One reason is numerological, in that the number 6 is the basis of a great many structures in mathematics, including the cube. God also created the world in 6 days.

There are many more reasons why the number 6 is important, but I shall not go into them at this time. I shall leave that important investigation to you. The 6 hours of a day will be labeled 11:00 AM, 12:00 PM, 1:00 PM, 2:00 PM, 3:00 PM and 4:00 PM which is the close. We need only to keep *a line drawing* which is merely drawing a dot at each hourly price and connecting the dots with a straight line. (See Figure 5)

It is usually best to use an "X" for the close at 4:00 PM each day, so when going over our series of line drawings we will see little "X's" that designate one day from the next.

The hourly chart that I use, and I have had twenty years experience practicing with it, is 6 hours in a day starting with 11:00 AM as the very first hour. I do not consider the 10:00 AM print a full hour, even though it is an hour on the clock. The market opens at 9:30 AM, so the 10:00 AM print is a half hour of time. It has been demonstrated, absolutely to my satisfaction, that **human beings are incapable of being totally committed** to the market without at least 45 minutes to an hour of actual trading. Therefore, most of the days' opening levels, if recorded, using the 10:00 A.M. print will often be erroneous.

If the market had been going down from 3:00 PM to 4:00 PM the preceding day, often the 10:00 AM print will be up \$3 or \$4 and by 11:00 AM the market will be right back down on the day. A line connecting the 3:00 PM or 4:00 PM reading of the previous day before, will show a smooth transition to the 11:00 AM reading and the 10:00 AM reading will not.

Now, obviously the chart you use should have a good correlation between the time period you trade and the trading hours in the day. So many people use the **theoretically perfect chart**, which is the 1/2 hour chart, because in each day you actually have 6.5 hours, from 9:30 AM to 4:00 PM. At least those are full units of 1/2 hrs or 6 1/2 hrs in a day, whereas the six hour chart I use is a little less than what is really going on. However, what most people use in the hourly chart with their 10:00 AM reading is a 7 hour chart and that is too many hours in a day.

I have found after years and years of study, if you are going to use an hourly chart rather than the superior 1/2 hr chart, the six hour chart will give better results than the 7 hr chart. Therefore I use 11:00 AM everyday as my first hourly reading, and that is the first little dot I put on my chart following the 4:00 PM close of the previous day. I have made many proprietary computer studies doing calculations of thousands of trading hours on both a seven hour basis and a six hour basis.

After tens of thousands of hours, the calculations on the six hour chart always work, but the seven hour yields only partial results which are unacceptable for my kind of work. I know all this six, seven hour discussion sounds repetitious, but the vast majority of traders in the world use seven hour charts and my proprietary cycles say those charts will just not work as well.

The reason hourly charts are so beneficial, is that within the hourly patterns of each day, there are many little corrective thrusts, retracements, impulse waves and all sorts of little wiggles that can help one discern the pattern of the market. These trends only go 2 to 3 hrs at a time, before there is a slight 1 or 2 hr pullback, which creates the little wiggles that we can measure quite accurately on an hourly chart, which **do not show up** on the daily chart.

On the daily chart we may have three days in a row straight up, but within those three days we are talking about a time period of 20 hrs or more. Within these hours there are many little wiggles, such as an impulse wave that lasts 6 hrs straight up, a pull back of 2 or 3 hrs, then another three hour advance and then a pull back for 3 or 4 hours. There could be many different combinations, but **it is the shape of these waves** that form a pattern. We will find through study that there are a number of set patterns that repeat over and over again.

Now, I have not cataloged every major pattern there is, but in my 20 years of experience in using hourly charts, I would say that there are probably 12 very reliable patterns that repeat over and over again, and that there are probably only five or six patterns that repeat 70% to 80% of the time.

If one maintains an hourly chart over a couple of years, he would see almost every single known pattern. There would be slight subtle innuendoes in changes to these patterns, but most of the patterns you would ever see could be found in an hourly chart. A brief analysis of the hourly chart also provides much more data to study, and can literally save you years of looking at daily data before you could see the same patterns and learn from them. The only thing different would be the major waves present. When the market is going through financial panics or major booms the hourly patterns are exaggerated. The shape is still the same, but the magnitude of these impulse waves and the retracement correction percentages have been exaggerated. The shape is still there to guide you to the number of "stair steps" up or down as before, until the final high or low is reached.

One trick that I have learned, and one I always use in determining the main trend, is that for an hourly chart to show an uptrend it is always best to wait until there are at least five easily identifiable bottoms in place. For instance, if the market is going down and plunges to a vicious low and spikes up, that low is the first little bottom. There is then a pull back that results in a higher bottom, then an advance, then another pullback, which is a third higher bottom. At this point you can still have a bearish pattern that fails and goes all the way down to new lows. This frequently happens, but if you then have a fourth higher bottom and a space for a fifth higher bottom, at least at this point you would probably be 80% to 90% certain that the trend has changed from being a down trend to an up trend. Note that I emphasize higher bottoms, not just five bottoms. Each of the five bottom probes must be higher than the preceding one.

Since we are dealing with hourly charts this gives us a big advantage, in that these five higher bottoms can be seen within only a two or three day observation period. Whereas, if we are dealing with a weekly or daily chart, and the trend is down, it may take several days to a week or more, before these respective chart patterns show any sequence of higher bottoms.

So the hourly chart is our primary indicator of major turns, even if we are long term oriented and we trade off of a weekly chart. If we are in an area where our time count is such that we expect the weekly charts to make a reversal or we have a major move in terms of where the average time to correction has run its course, we may want to switch our attention to the hourly chart to see if this is the beginning of a new trend.

I would like to emphasize that it is imperative that one draw an hourly chart by hand and not use a computer. Although in my trading I have several computers, that simultaneously draw all kinds of 5 minute, 15 minute, hourly, daily, and 1/2 hour charts, I always maintain at least one hand drawn hourly chart on the market averages.

I believe that the reason why this works, has to do with our subconscious mind. It is a well known fact that under hypnosis we can recall all kinds of elaborate details from our subconscious mind from

years ago, and that our subconscious mind is much more aware of what is going on than we realize.

When we actually sit down and draw an hourly chart on a piece of paper by hand, what we are actually doing is integrating our conscious, rational mind, with our subconscious mind, and as we draw these various price levels, you instinctively have a much better feel for the market when reversals take place. It will be much easier to recall where these highs and lows are placed, than with a chart book publication or a computer printout that we just have a cursory look at.

Keep in mind, when we are trading, *that these impulse waves, patterns and cycles are used to develop a trading strategy* of whether or not we want to be bullish or bearish. If we want to be bullish and the main trend is up, we want to buy every dip and scale out of our positions on rallies. If we are in a long term bearish trend we want to sell short all the advancing rallies and cover on the dips.

These cycles and the *forecast* of the probable price trend is only used to set our *trading strategy*. When we actually make a trade, there are hard and fast trading rules that we utilize to make money-- not predictions of probable future outcomes. For instance, once we have a pattern of 5 higher bottoms and we believe that the long term trend is up, we can make a "measured move" with a ruler on a piece of paper of what the average duration of the most previous advances has been. We can take a proportionate measurement of these impulse waves and make an approximation of where it is going and the average time period it will take for the move to be completed. We can also count our waves to find out where we are in a wave count.

However, these are just entry and exit points. The forecast at this point is discarded and our trading rules take over to insure that we put money in the bank at the end of the trade no matter what we hypothesize about its future forecasted course.

Once we have a main trend, we will buy the dips as they make a higher bottom, using a stop loss at the previous low. The safer thing to do is to buy a dip on an hourly chart and put our stop loss at two lows back. The rule being **you can usually break the immediate preceding low, but you will not break the second preceding low back** if the trend is legitimately up.

If you start to break the second low back and especially the third low back, the odds increase dramatically that the trend has indeed changed. If we assume that the main trend is up with five higher bottoms, by the time we start to break back through 2, 3, or 4 of the previous lows, we are creating a sequence of highs and lows that indicate we are making multiple lower tops and lower lows and that the trend is probably changing to the downside.

Trading comes down to simple probabilities:

- **Waiting to find a clearly identifiable uptrend.**
- **Waiting for a pullback for a higher bottom entry point.**
- **Placing a stop loss at the previous or the second previous back stopout point.**

**- Gauging the magnitude of risk that we want to take.**

Keep in mind too, that the number of "stair steps" up also determines the probability of being stopped out. If it is early in the movement and we have 4 or 5 higher bottoms, the movement is strong enough that we can still probably use our trend stop loss of the most immediate past bottom. If our advance already has 6, 7, 8 or 9 higher bottoms or little stair steps to it, we had better use the second bottom back for our stop loss, because at this point there will be many more "headfake" corrections down, even if the trend has not changed. Anyway, the odds are increasing that the trend is changing, so the probability of our success is not that great. Risk adverse traders will not bother trading at these "extended" time periods, but wait for the opportunity to establish a short position when the trend reverses. (See Figure 6)

In constructing the hourly chart, it is important that time and price are related to the same scale. That is, on a piece of graph paper **one hour in time should be equated to \$1 in price**. In a box with 10 squares we should have \$10 of price movement, versus 10 hours of time movement. This simplifies our calculations and it equates time and price to the same unit.

We now need data to make some projections. Start with any major high or low of a swing nature, such as the highest high or the lowest low, in the last 3 months. The data is readily obtained from daily newspapers in the public library and the hourly chart can be maintained in only 2 to 3 minutes a day.

Once we have several weeks, to a month and a half of data, we will see many minute wave patterns forming. We will also have a good idea of **the approximate average movement between reversals** that the market exhibits. It is only by maintaining hourly charts over several years that we will get to **measure the extremes** we can expect. However, in just 1 to 3 months of charting data hour to hour we can see 80% of all the normal fluctuation ranges. These we use to make estimates at each reversal point, as to approximately how far the move will go in both time and price.

Our calculating tools for cycles are our geometric angles. From any major high coming down off the top we draw a 45 degree angle as our primary tool. The 45 degree angle is equivalent to over 1 and down 1. **1 unit of time is equal to 1 unit of price and it is our master calculator.**

Therefore, we know that if there was a market fluctuation where the market averages moved from a low to a high of 50 points and at the high we drew an angle down at a 45 degree angle, we would know that it would intersect that low 50 hours later. We need only visually look at the angle coming off the top, intersecting the low point, to make that calculation. We need not count with our fingers and toes 50 individual hours. Likewise, we will want to draw angles twice as steep and four times as steep. Instead of over 1, down 1, we want to go over 1, down 2. This is an angle twice as steep as the 45 degree.

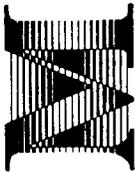
In theory, geometric angles are angles that are constructed from geometric figures, such as a square. The diagonal of the square from one low corner to the high corner is the 45 degree angle. If we then put a dot in the midside of the square and connect the lower corner with a line to the right midside, we will have an angle that is half as steep as the 45 degree angle. If we then put a dot on that right hand side, at the 1/4 point and draw our angle from the lower left hand corner to the right 1/4 up, we will have an angle that is 1/4 as great as our 45 degree angle. (*See Figure 10, Page 46*)

These angles are drawn both up and down, over the market averages to calculate time periods. We can also use standard angles such as 30 degrees and 60 degrees. Even though these are not geometric, they are natural angles and give us quite reliable results. Natural movements often follow along these angles.

Our basic methodology must consist of some method of keeping track of time. Especially time from the extreme high and the extreme low. We want to have some system of numbering on our chart, the number of hours going horizontally across our page after each major high and low. You can number every single hour, 1 through several thousand and have a special "tick" mark on certain numerological hours, such as at Fibonacci ratios and the Fibonacci absolute numbers 1, 3, 5, 8, 13, 21, 34, 55, etc. It is also good practice to make a "tick" mark on the natural square numbers. For instance, 2 squared is 4, 3 squared is 9, 4 squared is 16,...25, 36, 49, 64, etc. These natural squares have very strong support and resistance influences an the market.

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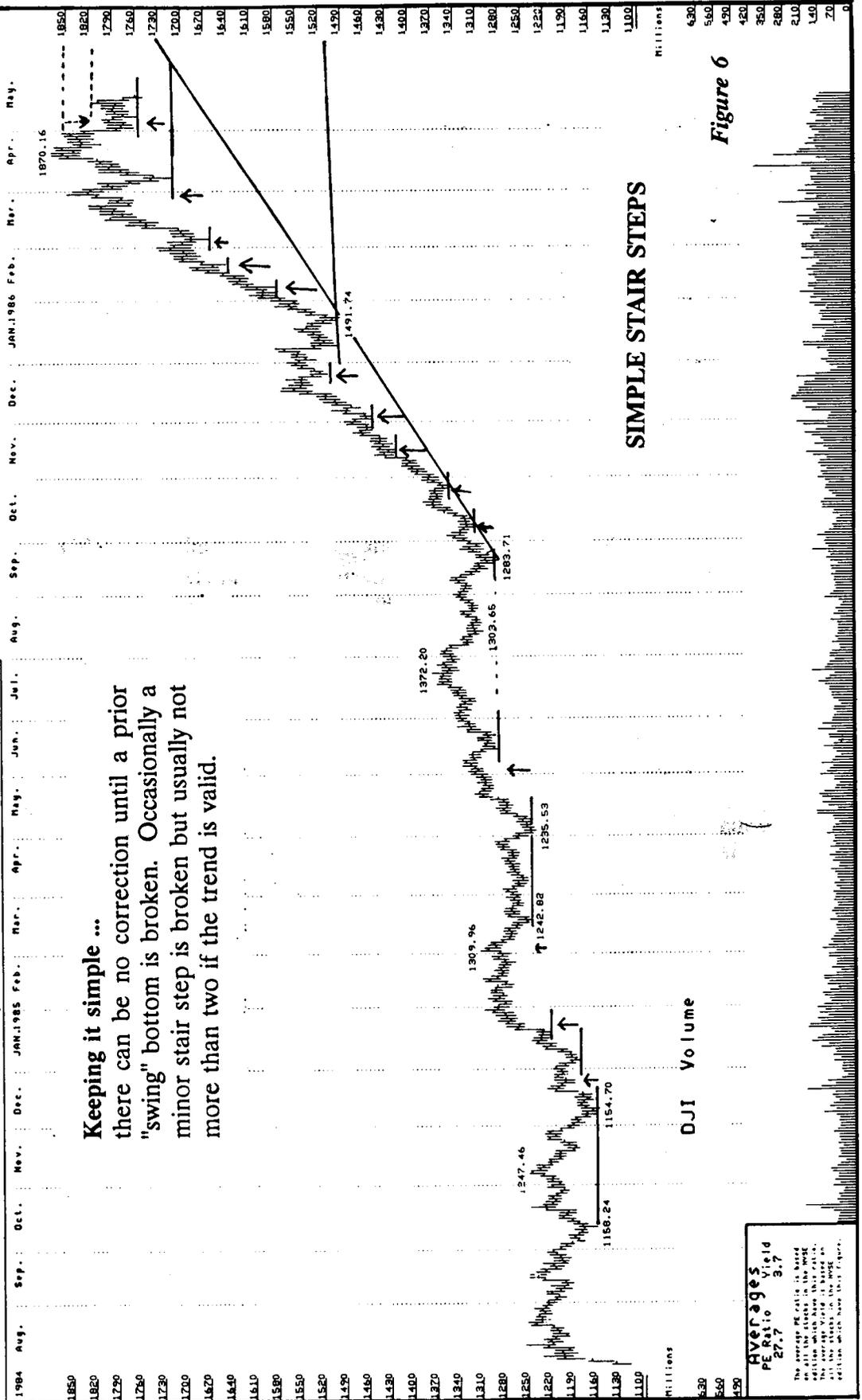
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**Dow Jones Industrial Averages**

	HIGH	LOW	CLOSE	CHANGE
MON	1804.32	1774.80	1787.33	-2.10
TUE	1804.07	1772.32	1785.34	-1.99
WED	1815.23	1775.55	1808.28	22.94
THU	1808.78	1766.99	1774.68	-33.60
FRI	1775.67	1749.88	1759.79	-14.89

CLOSE = 1759.79

**Keeping it simple ...**  
there can be no correction until a prior "swing" bottom is broken. Occasionally a minor stair step is broken but usually not more than two if the trend is valid.



When we do this procedure from each high and low in sequence and extend out our time cycles into the future, we will instantly see *cluster points*, where there are common denominator hour numbers of various highs and lows that come out within an hour or two of each other on certain dates in the future.

For instance, 55 Fibonacci hours from a major top may also coincide with 34 Fibonacci hours from a subsequent low. The fact that both of these come out at about the same time period, identifies for us, a potential turn, well ahead of the time where the market may change direction.

It is not uncommon to have a large hourly chart with 8, 10 or 15 different coincident turns within an hour or two projected several weeks into the future. These are the surest signs of major, significant market culminations. When trading off hourly charts, it is amazing to see the exactness of the market turns on each and every hour and the forecasting results that one can obtain using a good hourly chart.

For example, if the market tops out at 1:00 PM one afternoon, we can apply the simple Fibonacci sequence of numbers, in terms of hours. That sequence being 1, 3, 5, 8, 13, 21, 34, 55, etc. It is a sequence of numbers where each number is added to the previous number to get the next. So 1 and 2 are added together to get 3, 3 and 2 are added together to get 5, 5 and 3 are added together to get 8, 8 and 5 are added together to get 13, etc.

If we take these numbers and apply them in terms of hours, what usually happens is if the market topped out at 1:00 PM, we would have a decline that would last maybe 3 hrs, 5 hrs, 8 hrs, 13 hrs or 21 hrs downward. Within those downward time periods we would see our little waves developing and could count our little stair steps and patterns of those waves. The longer the advance, the more likely that the correction would be a little bit longer than with shorter advances. What happens is that the vast majority of market movements usually consists of hourly patterns of 8 hours, 13 hours or 21 hours and occasionally a long movement will go 21 hours, 34 hrs or 55 hours. But for most day to day markets, 8 hours, 13 hours and 21 hours are the keys.

If we had an advance that went approximately 21 hours and then topped out, it would be foolish to expect a low at the next hour or even the second hour. We would probably need a correction of 5 hours, 8 hours or 13 hours. If the market went down 5 hours and it looked like it started to rally, we may very well go long on the 5th hour, using the price level of the **5th hour** down from the top as our stop out point.

On the other hand, if it failed there and went down for a 6th hour, the odds would be very good that the trend would continue on down at least until the 8th hour, the next number in sequence, or if it didn't stop at the 8th hour, the 13th hour.

So if we have hour number 6 off the top we have valuable information. We know that even if we are looking for a reversal, and may be nervous about our short position, there is no need to be overly concerned until we go another two full trading hours to hour number 8, because markets do have a tendency to turn on these Fibonacci numbers. This is not only a natural tendency in the market, to run

in Fibonacci hours, but a great many professionals trade off these patterns, and in today's world with the advent of numerous computer trading systems, it becomes a self-fulfilling phenomenon.

Now, for these hourly turns to become even more reliable in our work, we should observe a series of highs and lows over the last several weeks. If we find that several days ago at 2:00 PM the market had a bottom, we may want to note over the next four or five weeks these Fibonacci hours, counting out 13, 21, 34, 55, 89, 144 and put a little "tick" mark on our paper, making a horizontal line of these "tick" marks. We would do this in sequence with all of our highs and lows of significant moves.

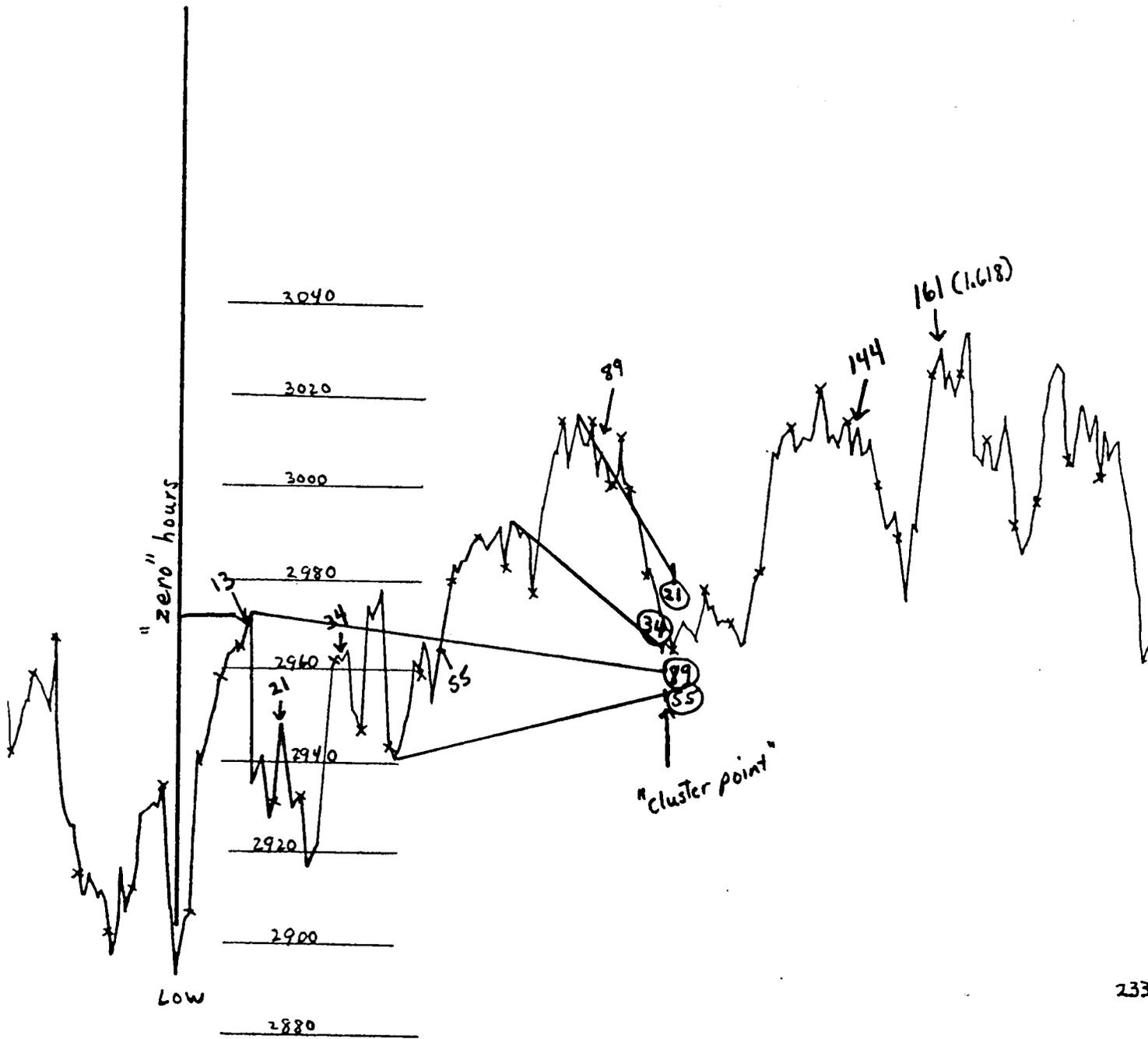
*(See Figure 7)*

One thing you will find by doing this, is that there will come a time in the future where there will be a whole cluster of Fibonacci numbers spun out from these various highs and lows, and they would fall within 1 or 2 hours of each other. For instance, we may have a time period two weeks from now that turns out to be 13 hours from the recent high, 144 hours from a low several weeks ago, 89 hours from some high or low, maybe 233 hours from a turn a long time back. We would find that all these highs and lows have a common denominator coming in Fibonacci time periods right about now. This immediately gets our attention that there is a significant cycle coming due within an hour or two.

During this hour or two we want to pay very close attention to our hourly chart, to see if it is trending down or if it is trending up and if we have 8, 9, 10, 12 or more stair step patterns up. If indeed, it has already had 12 or 13 upward stairstep patterns, then we are nearing some kind of probable top reversal in trend. With all these Fibonacci hours coming out, it would appear with almost certainty, that the market is going to top out and change direction, and we can anticipate that top and buy some very cheap put options.

Actually, even in guessing, with a close stop loss based on a number of hours rather than a point count, if the market continued to go through our Fibonacci time cycle period, and there was still no change, then something would be wrong and we would close out our position. But the odds would be very good that the market would indeed turn during one of these time periods.

You will find as we start to use our mathematical set of tools, our arsenal of counting waves, counting stairs steps, using Fibonacci numbers, using proportionate parts of the impulse waves identified on our hourly charts, we get into highly probable scenarios of what the direction is, how long it is going to go in that direction, and where the change will take place.



**FIBONACCI HOURS**

June 20 | 21 | 24 | 25 | 26 | 27 | 28 | 1 | 2 | 3 | 5 | 8 | 9 | 10 | 11 | 12 | 15 | 16 | 17 | 18 | 19 | 22 | 23 | 24 | 25 | 26 | 29 | 30 | 31 | 1 | 2 | 5 | 6 | 7 | 8 | 9 | 12 | 13 | 14 | 15 | 16 |  
 July August

*Figure 7*

If one uses a simple hourly chart like this, has extreme discipline and does not override the very objective facts and figures of these numbers of hours from the highs and lows, and uses these angles with cold, hard logic to mechanically trade off them, then one can be extremely successful in the market. So much so, that you will probably be right 80% of the time since you have a clearly defined stop out point. Let us say you buy an option at \$3 and you are 80% right, your average gain might be a double, a \$3 profit. Your average loss, since we have a clearly defined stop out point, might only be \$1. Now, if you are right 8 out of 10 and you are making a \$3 profit and 2 out of 10 you are losing \$1, you will see that you will be quite wealthy indeed, before very long.

Remember these Fibonacci numbers when you make an initial trade, especially with options. If there is a reversal at one of these number periods in the market, as things in the market are not random, there is evidence that cycles exist.

If the patterns show us that there is a reversal in trend, we have high reliability that these reversals in trend will persist, being cyclical in nature, in the new direction for a set number of hours. In normal movements, Fibonacci hours run to 8, 13, 21 most of the time.

So, if we were to buy a call option at \$3 and were lucky enough to define the low fairly precisely, one would not have to be nervous and quickly sell one hour later when the option went up to \$3.50 and have only a \$.50 profit. We could calmly sit back and say, "wait a minute, this movement will probably last 8 or 13 trading hours at a minimum." Keeping in mind there is only 6.50 hours in a day, an 8 hour movement on an hourly chart, will get us well through the whole trading day and into the next trading day. A 13 hour movement will last 2 full days before we even have to think about selling.

Now, during this time period, if the market does a truly spectacular move, our \$3 call option may very well go to \$8, \$10, \$15 or more, and we would have an enormous reward and it would be based on scientific trading and not guessing.

The only reason we want to close out our option, after we have a winning trade, is that the probabilities are going against us or we have been stopped out through cold hard discipline. There are many times we will be whipped-sawed and we will be stopped out even though we are right, but we still must maintain the discipline and stop ourselves out if the option goes much against us.

If the hourly chart turns down again and we try to buy a low and it violates that low, we are probably wrong and a downtrend is continuing. We must watch our entry and exist points, for our biggest risk will always be clearly defined but also be for a very short time period.

We need only to watch the market for an hour or two if we have done our homework, and during that hour or two, we are most vulnerable and we must keep our closest stop loss. After that, it should be very obvious that we are right or wrong with the trade.

Another good rule that I use, is that after we have done our homework, taken our position and are expecting a major turn to develop and nothing happens, we never want to carry options for more than 3 days at the most. Sometimes, if you carry an option for more than 5 or 6 trading hours, there is no need to carry it. You should close it out, scratch the trade at a small profit or a small loss and *reduce your risk*.

It is not that we are wrong, and it is not that we will not be proved right a day or two later, but **it is not professional to guess** when we do not have to guess at all. We are investing with the trend and if there is no trend, why risk our money, why take on risk? The professional trader is totally risk adverse. It is a lot like a professional gambler, but the element of chance is so reduced that we have stacked the odds at 80% to 90% in our favor and we know how much money we can afford to lose ahead of time.

This is what professional trading is all about. Not guessing, not hoping, not reading the newspaper, not believing in our company, but looking at the technical patterns of our charts. After having done the time count, having measured the waves, having some angles come up from the bottom for support or angles come down from the top for resistance, or having done a percentage retracement or a proportionate advance of an impulse wave, then you can make a cold, hard, mechanical entry point.

We have many, many tools in our arsenal now, to clearly define support and resistance in time cycles turns. We should now step up and make a commitment with a stop loss. Once we have made that commitment with a stop loss, the trade becomes very, very, easy.

## Chapter #6

### Proportion and Harmony

*"Most of the highs and lows of history have been near exact proportions of prior highs and lows in the past."*

All nature, art, music, and human behavior as reflected in stock prices, consists of mathematically defined proportion in harmonious arrangement. It would take several books just to begin to reveal such proportions.

However, in this book, we will just be concerned with simple mathematical ratios and their use in forecasting future support and resistance, and the estimate of the time period covered by such proportional ratios.

A proportion is simply the division of the whole into its respective parts. The starting point of life at the biological level, is the whole divided by two or 50%. If each of these halves are divided we get 1/4 (25%). The sequence goes something like 1, 1/2, 1/2 over 2 = 1/4, 1/4 over 2 = 1/8, 1/8 over 2 = 1/16 or 1/2, 1/4, 1/8, 1/16, 1/32, 1/64, etc. This is one starting point. Another starting point is to divide by 3. Then we have 1, 1 over 3 = 1/3, 1/3 over 3 = 1/9 or 1/3, 1/9, 1/27, etc. The natural sequence derives from this simple dividing by 2 and 3.

In the stock market, the major divisions of the 1/8 and 1/6 level are usually sufficient for all calculations, or 1, 7/8, 3/4, 2/3, 5/8, 1/2, 1/3, 3/8, 1/4, 1/8. Stock prices will gravitate towards these percentages of their prior highest or lowest price and will find support or meet resistance there.

A fundamental rule in investing is **always observe the 50% point**. From a low to a high, the subsequent pull back or counter trend decline, will almost always find major support at 50% of the range of the move. This is true of both time and price (i.e. the time duration of a reaction often approximates 50% or one half the length of time involved in the preceding advance).

For example, a stock that goes from \$50 to \$100 will usually retrace 50% to \$75 in a good correction, and in terms of time, if the advance lasted for twelve weeks the decline might take six weeks. The 50% point is the strongest support, but in strong moves the correction will rarely correct even that much. **Usually 1/4 to 1/3 retracements are the norm for strong trending markets.**

Retracements for more than 50% often show complete failure, especially if 2 prior lows are broken

and a move back to the starting point of the advance is likely.

The theoretical underpinnings of the 50% rule **go back to the basic diagram of the square**. In the division of a square along the diagonal, the diagonal or 45 degree angle evenly divides the square into two equal halves. It is this natural 45 degree slope which equates time and price with 50% of the high and low, since the 45 degree angle evenly divides any size square. Obviously, the use of the 50% rule is for entry and exit of our trades.

If we buy a double bottom and assume the trend is up, anytime the stock starts to decline from its highest advancing point, we must measure and keep track of the range from the double bottom to the high and calculate the 50% point of the move (remember a 45 degree timing line does this 50% calculation for us). Our sell stop point should be placed just under that point assuring a profit on the trade.

The market averages as a whole also reflect proportionate movements, and most of the highs and lows of history have been near exact proportions of prior highs and lows in the past. We have all noticed the fact that most stocks meet strong resistance when they double or meet the one hundred percent proportion. Since these proportions relate to time as well as price we can theorize about basic cycle origins.

If a stock tops at \$50, the major harmonic or proportion of this will also be 50 time units. Whether they be 50 days, 50 weeks, 50 months, etc. In terms of days, we would witness cyclical behavior at intervals of 50, 100, 150, 200, 250, etc. days from that high. We would also see cycles of 50% of 50 or 25, such as  $50 + 25 = 75$  days, 100, 125, 150, 175, 200, 225, etc. The day to day fluctuations in the market are nothing more than these interrelating cycle proportions of past high and lows coming out. Large movements occur when numerous harmonics of past highs and lows are near the same date.

It is important to note that this theory implies connection between price and time. As a consequence, proportional harmonics such as  $1/2$ ,  $1/3$ ,  $1/4$ , etc. relate to both time and price, and you will usually find that a **time cycle** from a price, such as \$100, might end on the 50% or  $1/2$  point 50 days later, and **on that date the price** will be 75% or  $3/4$  of \$100. In this way, time and price work out in independent proportions. Since this is a natural phenomena we can use the mathematics of physics to measure forces and vectors on stock price graphs.

More interesting, however, from a philosophical point of view, is the interrelationship to the mathematics of stock prices and the harmonic mathematical structure of music. Rhythms in music, pleasing to the ear, show up in stock price patterns that are pleasing to the eye. In music, a halving of the length of a string doubles the frequency and in mathematical terms this interplay between addition and multiplication takes form in the logarithmic function.

A useful mathematical relationship of stock prices and nature, relating to this interplay between addition and multiplication, is the Fibonacci sequence. As mentioned previously, this sequence is an additive sequence, where each number in the series is added to its neighbor to get the next number in the series. More important than the absolute number values themselves, however, is their relationship to every other number in the series. This proportion of each number divided by any other approaches



the "golden ratio" of 1.618, which is a constant. Most markets and individual stocks will be observed to begin and end their movements at these ratios.

This topic is of the utmost importance, but a simple work such as this cannot give it justice. Again I will have to leave this exploration to those of you who wish to master these secrets as opposed to the vast majority of casual readers (see chapter 8 on Impulse Waves). I would add, that the complete Fibonacci series is quickly obtained with a pocket calculator and the function  $Y=(1.618)^X$  to the "X" power. That power "X" can be positive or negative, such as the range -5 to +5. What this has to do with harmony and proportion in the market, is that we simply take our hourly chart and apply these proportional ratios (.382, .618, 1, 1.618, 4.236, etc.) to each high and low both to the price levels and the time periods of each advance or decline. For instance, if the market tops at a price of 1000 we would look for price support and resistance at 1000 plus or minus 382, 618, etc. We would also watch for hourly time counts at these time periods from the high or low hour. Additionally, if two tops occurred 100 hours apart, we would look for the next top in sequence 162 (100 x 1.618) hours later and the top after that, at 262 (162 x 1.618) hours. (See Figure 8)

What we are really dealing with, in discussing harmony and proportion in the stock market, would be better classified as "Progressions," since we want to predict the next time or price event in a series. These are properly classified as the Arithmetic, Geometric, and the Harmonic Progressions.

**The Arithmetic Progression** - yields a difference between terms of equality, or a set number value between each term such as 1, 2, 3, 4, 5, 6, etc. This would be as found in normal set cycle lengths like 100, 200, 300 hours, days, weeks etc. where the set number value is added to each term to get the next term.

**The Geometric Progression** - instead of adding a set term to each number, we multiply a set term as in the doubling process of multiplying by a factor of 2 as 1, 2, 4, 8, 16, 32, 64, etc. Here we have a set constant ratio between adjacent terms.

**The Harmonic Progression** - consists of the reciprocals of the arithmetical series or a series of fractions with the same numerator while the neighboring denominators share the same difference. Here we have 1/2, 1/3, 1/4, 1/5, 1/6.

These three progressions give us all the mathematics we will ever need to measure cycles in the market. Note that the Fibonacci ratio or series is both Arithmetic, as each number adds to get the next, Geometric as each number is a multiple of the prior by .618, and finally Harmonic, as each reciprocal of the series yields another number in the series.

A potential solution to our problem of forecasting is to use a computer to apply these above mentioned progressions to our series of hourly highs and lows to try and find where we presently are in the cycle. Once we have the progression key we will be able to accurately forecast for long periods into the future. For example, in my newsletter, *Stock Cycles Forecast*, I boldly predicted the final high as

August 24, 1987 (actual top 11 AM August 25th) because of a unique diminishing Fibonacci cycle series counting down backwards yearly, monthly, and weekly to August 1987! Count backwards from August 1987 by years 1, 3, 5, 8, 13, etc. to see this harmonic for yourself.

The more common technique on hourly charts is to simply use a premarked tape measure with all the important ratio hours in progression and just move this tape backwards and forwards over your charts, until you get a match of multiple highs and lows coinciding with the tape tick marks. Then simply complete the series on your chart for any desirable time period into the future.

One final hint before leaving proportion. Since these patterns on our charts are harmonic and proportional, we can use what architects use to keep track of symmetry -- **regulating lines**. These are merely lines that go from top to bottom of our chart, at preset angles, that reflect the proportion we are dealing with. These **angles** can be Geometric, Fibonacci, or Esoteric. *I leave the experiments to you...* words to the wise are sufficient!

## Chapter #7

### Trading Basics

*"We want to invest only on a rising tide, not high tide or a declining tide or even low tide."*

Our approach to trading must be one that is objective, simple and reliable. Obviously, the first three are prerequisites for a system of determining the main trend, which is our objective.

The concept of the main trend was touched upon in the prior section of the tide analogy, which relates each rising wave at the beach to each higher price that a stock trades during each "*swing*" period. I use the term "*swing*" to mark each beginning and end of a price movement.

For example, a stock that starts at 10 and goes to 20 and then 15 and then 18 would have the first swing low of 10, first swing top at 20, with another swing low at 15, etc. In trading, we wish to identify the point of each swing for our entry and exit point for each trade, as well as determining probable duration for each swing and estimate the time period and price movement so as to avoid minor and inconsequential movements that simply increase our trading costs.

Cyclical analysis presumes that history repeats and stocks behave in the future much like they did in the past. We must therefore become a market historian, an expert in the past history of a particular stock we wish to trade. To paraphrase one of my favorite quotes from the Bible:

*"The thing that hath been, it is that which shall be; and that which is done is that which shall be done: and there is no new thing under the sun."* Ecclesiastes, Chapter 1, 9. (i.e. history repeats)

Various stocks, like people, have specific personalities and certain types of investors seem to only trade in certain groups of issues. Just as the personality of a movie actress is different from the personality of a chemical engineer, so is the trading personality of IBM quite different from the trading personality of General Motors. The differences are much greater than the mere fact that these two groups differ in their response to different economic fundamentals.

When you look at the group patterns of all stocks, i.e., the automobile group or the computer group, you find that in tracking the group average, each individual issue that has movement, has a particular characteristic which identifies it from the group.

One quickly sees the subtle ways that different stock personalities make bottoms or tops. Some make a rounded bottom trading at near the same low price for several days to weeks before inching up, while others spike down on one low day reversing and dramatically advance.

The trading personality also has a timing rhythm that is peculiar. Some issues move in straight line movements lasting months without reversing, while others exhibit sudden, dramatic, up and down reversals almost weekly. Although much could be said, suffice it to say, you must complete a thorough analysis of a stock's history before investing.

If our trading method is to be of practical worth we must be overly concerned with losses. In the stock market anyone can make money, it's easy. In fact the only thing easier is to lose money.

One of my favorite sayings is, "*The quickest way to make a small fortune in the stock market is to start with a large one.*" Every losing trade that an investor makes is almost always, a function of deliberately looking the other way while the stock declines, because one is rationalizing why the decline is only temporary, and to sell out merely to buy back very shortly is a waste of time.

In this past century, psychiatrists have become wealthy describing persons who are *masochistic*, wanting to hurt themselves, *egocentric*, who are always right, no matter what the circumstance or suffering from *grandiose delusions* about the nature of reality. In the stock market the only truth is price. If you buy something and it goes down you are wrong, it does not matter how smart, wise or powerful you are...you are wrong!

Successful traders are people who recognize when they are wrong and are not inhibited by psychological factors in doing something about being wrong. The good trader and technician uses objective measures, to quantify the degree of error. He is willing to assume risk and then live by predefined rules. This is known as a "stop loss discipline." It can be a simple rule, such as using a 10% loss to sell, a \$3 loss or simply a time period, i.e., if you have not made money on the trade in three days or three weeks, sell and go to something else.

These rules work because stocks that are truly in an uptrend rarely go down much or rarely go sideways for too long a time period before resuming the uptrend by making a new high.

Remember the analogy of the tide...we want to only invest on a rising tide, not high tide or a declining tide or even low tide, since we can not afford to have our money tied up, not getting a rate of return when an alternative investment is working.

In my years on Wall Street, I have seen many successful business men make lots of money in Bull Markets and give it all back in Bear Markets. Most of the time this occurs because of one of two personality defects:

**The First Personality Defect - the positive thinking executive type who believes in the force of his will and that his analysis will ultimately be right. He will hold on for months and years because he is right.**

These people point out that many of today's fabulous, wealthy investors got their money just through such a buy and hold strategy. Having invested a small amount thirty years ago and never having sold.

Although it is quite true, statistics are deceiving. For every individual who bought IBM or Xerox or any other big winner and made millions by sitting tight there are probably five to ten million others who sat tight for thirty years and either lost everything, broke even or made what they would have made at a bank at 5% interest compounded. Unfortunately, books written about these not so famous people don't sell very well.

You do not have to believe that your stock will go up if you are a technician, you see it. Every stock that became a big winner in the market should have been purchased by technicians, since by definition, it was making patterns of higher highs and higher lows. If one has the attitude that a certain stock will go up indefinitely, there is no harm in trading it when using technical analysis tools. Since one would always buy it back when it made a higher high or would have bought it back when it made a minor higher low. Often times, a long term winner will consolidate for months or even years without going up or down and thereby tie up valuable capital that could be earning a return elsewhere.

**The Second Personality Defect - is the person who does all the ground work conscientiously and then buys a stock only to see it go down.**

In this case it is hard to admit being wrong because it seems psychologically unfair since all that work was done. It is easy to rationalize a decision of "let's wait and see, perhaps I'm not wrong, just early!" On Wall Street, the amount of work that you do has nothing to do with the rewards you reap, although usually hard work pays off.

The reality of Wall Street is price. Because of the reality of price, one could merely flip a coin and buy on heads and sell on tails to enter a trade. A good trader and successful speculator **knows what to do after he is in the trade**. If the trend goes against him, he merely doubles up and goes in the opposite direction. Since the main trend tends to persist over time, such a simple coin flipping methodology will work if one's stop loss discipline is vigorously followed.

For example, if the probability of a stock going up or down is 50/50 then the practice of selling at a \$1 loss and selling at a \$3 gain will always make money, assuming the trend persists for at least \$3 and it usually does.

Even better, is a system of selling at \$1 losses and using a rising sell stop point for the gain. If the stock runs up many points over several weeks, a rising sell stop point just under each swing low will keep you in most of the bigger moves. Hence, the old saying, "***Cut your losses and let your profits run.***" The good trader is not afraid to take a loss but also is not afraid to take a big unlimited gain over time as long as the trend is up.

What you try and not develop are preconceived ideas about how much money you will make. Otherwise, once or twice in a lifetime big winners will always get away because the investor grabs a quick

profit and indiscriminately sells without any technical sign of deterioration.

One standard psychological excuse for avoiding technical analysis and utilizing buy and hold long term strategy, is the old fear of paying taxes on short term gains. Although tax rates have varied over the years and long term capital gain rates are usually much smaller than short term income rates, I continually find that the people who are most concerned with paying taxes on short term gains of 30% to 40% usually end up getting a 5% to 8% taxable rate of return on bank CD's or even a non-taxable 6% on municipal bonds.

In almost all cases the 30% trading return will always yield more after tax dollars. However, its biggest advantage, I believe, is a psychological one. The annual paying of taxes on capital gains forces one to be liquid and not get trapped into holding a stock which is obviously going down, just because you have a low tax basis in the stock.

I have seen many wealthy investors suffer for years because their long term family heirloom stock is declining 50% and they can't sell because their cost is \$2 a share and the stock is currently \$80. The fear of paying the tax allows them to psychologically stand by helplessly watching their stock go from \$80 to \$50 and back to \$80. If they had paid taxes annually they would probably be better off.

Although many people are aware that stocks fluctuate 20% to 30% per year from high to low, many do not realize that these 20% to 30% swings sometimes occur two to three times over any given year. A trading philosophy allows one to be better prepared psychologically for opportunities in the market.

Most people know that compounding rates of return can add up to substantial amounts of money over time and recent advertisements for IRA and KEOH retirement accounts demonstrate this very well. However, many people are completely unaware of the truly speculative returns available through compounding. In today's speculative market, options and futures often fluctuate by 20% to 30% per day and options doubling or tripling over a few days, are likely, of course along with the commensurate risk.

My point is simply this, a speculative trading strategy combined with a vigorous stop loss discipline can yield phenomenal results. For example, if you start with a reasonable sum of \$10,000 and get 10% a month you will be a millionaire in only four years, ignoring taxes and losses. However, this is not so far fetched since many times you are making 30% or 40% or even a double in an exceptional month. The reason options appeal to all of us is that almost everyone who has ever bought them has at one time or another doubled or tripled his money. Obviously, since everyone is not a multimillionaire the *real secret* is not the doubling or tripling, but the NOT LOSING! Professionals trade entirely with this loss fear as the foundation of their operations.

We must develop a method to stop losses or limit our risk without unduly increasing our trading costs or frequency of turnover in commissions. My approach, being one of the better solutions, is to seek low risk entry points, where a \$1 or \$2 stop loss can be used. Most traders buy a prior swing low using those lows as a stop, or buy when the stock pulls back to a trendline and place a sell stop under that trendline. It is not glamorous or particularly hard, but the objective here is money and risk man-

agement. Remember, we are not trading for fun and profit, just profit! As is often said on Wall Street, *"happiness cannot buy money."*

I like to combine these rules with a timing entry point based on cyclic characteristics of the stock, whereby, you enter a trade after a stock has been declining and is just turning up, making it much more unlikely that your stop point will be hit. Determining those cyclic time periods is a function of the historical analysis of the chart, noting the probability of past time cycle patterns and trading off of them.

By the end of this book you should be able to find a good combination of stop loss and sell points based on trendlines, swing points and cycle turns, but for now we must concentrate on the basic trendlines.

As I mentioned previously, for a stock to show an uptrend, it must make a series of higher highs and higher lows. This is not always readily apparent from a casual glance at a chart. Most people therefore, draw trendlines.

Trendlines are simply lines that connect each rising successive low point to show uptrend and connect each declining top point to indicate a declining trend. Here again, the investment time horizon is of paramount importance.

Trendlines connecting each daily price will be much steeper than trendlines connecting weekly or monthly points and also will be violated much more frequently.

Trendlines are very useful tools in battling the traders worst enemy, his psychological propensity to become involved in a trade in an emotional way, thereby becoming biased as to the stocks trend.

Trendlines keep one honest. If the trendline is broken, so is the trend. The reality of price says that when the trend changes you will lose money unless you go with the new trend.

Trendlines are really a form of moving average. The slope of the trendline shows the rate of change, of price over time. The steeper the slope the greater the change.

Trendlines can also be considered good psychological measures of emotional sentiment by the masses. Stocks that are in favor exhibit steeper and longer uninterrupted trendlines than those less popular issues.

The rate of change in public acceptance can usually be measured along a series of ever increasing trendlines, starting with the steep weekly trend, which in turn becomes a steeper monthly trendline, and finally a steeper yearly change. As the accumulation process takes place, an investor examining the continuous chart over several years, will see a gradual, but ever increasing rate of change in the trendline slope up until the moment of the final top.

The long term chart's rate of change takes the visual form of a curve rather than a straight line, and this curve can be plotted mathematically to help predict the final point of emotional exhaustion, with the start of the beginning of the distribution and the declining phase. I might add, **the study of circular arcs is a science in itself and one I would recommend to everyone.** I do not have time in this simple work to discuss the theoretical ramifications of arcs but, suffice it to say, they lie at the heart of my personal proprietary methods. Arcs are the **ONLY** form of trendline that will conclusively show you where tops will appear. The end of all Bull Markets occur at the resolution of long term parabolic arcs. (*See Figure 9*)

The most important use and application of trendlines is through geometric charting or using **geometric angles** for trendlines. By this, I simply mean to change the slope of the trendline by proportionate divisions of the whole such as 1/2, 1/3, 1/4.

**Example:** A normal 45% diagonal line divides a square into 2 or a 1/2 division. This basic slope equates one unit of price with one unit of time. As from our school days, slope is equal to "over one and up one."

As we go over one time unit horizontally, we move up one price unit on a stock chart. A 1/4 division of a square gives us another slope half as great as the first. This would be over 2 units and up 1 unit, or a 1 by 2 angle. 1 unit price by 2 units of time. Similarly a 1 by 3 angle would be over three time periods, up 1 unit of price.

When slopes are more than the normal 45 degree angle for steeper or greater momentum moves, we use 2 by 1, or 3 by 1, or 4 by 1 angles where the price unit is raised a multiple amount for each time unit, as in a 3 by 1 angle up \$3 and over one time period. Time periods on your chart will be hourly, daily, weekly or monthly. These are natural slopes and most stocks tend to follow one or all of these division slopes at different times. To find a unique, natural slope for your particular stock we simply apply the same principal of fractional division.

1. First we connect the trendline by drawing a straight line between consecutive lows for an uptrend example.
2. Then we subdivide this natural angle to measure off an arbitrary horizontal amount on our time scale with "tick" marks every 1/2".
3. Note where the natural trendline intersects a particular price level at the first "tick" mark. Now at the same price we put a dot above each of our 1/2" increments.
4. We now merely draw slope angles from the original low price through each of our price dots. These slopes will give us natural 1 by 2, 1 by 3, 1 by 4, 1 by 5, etc. trendlines.

CIRCULAR ARCS TIME MARKET TOPS

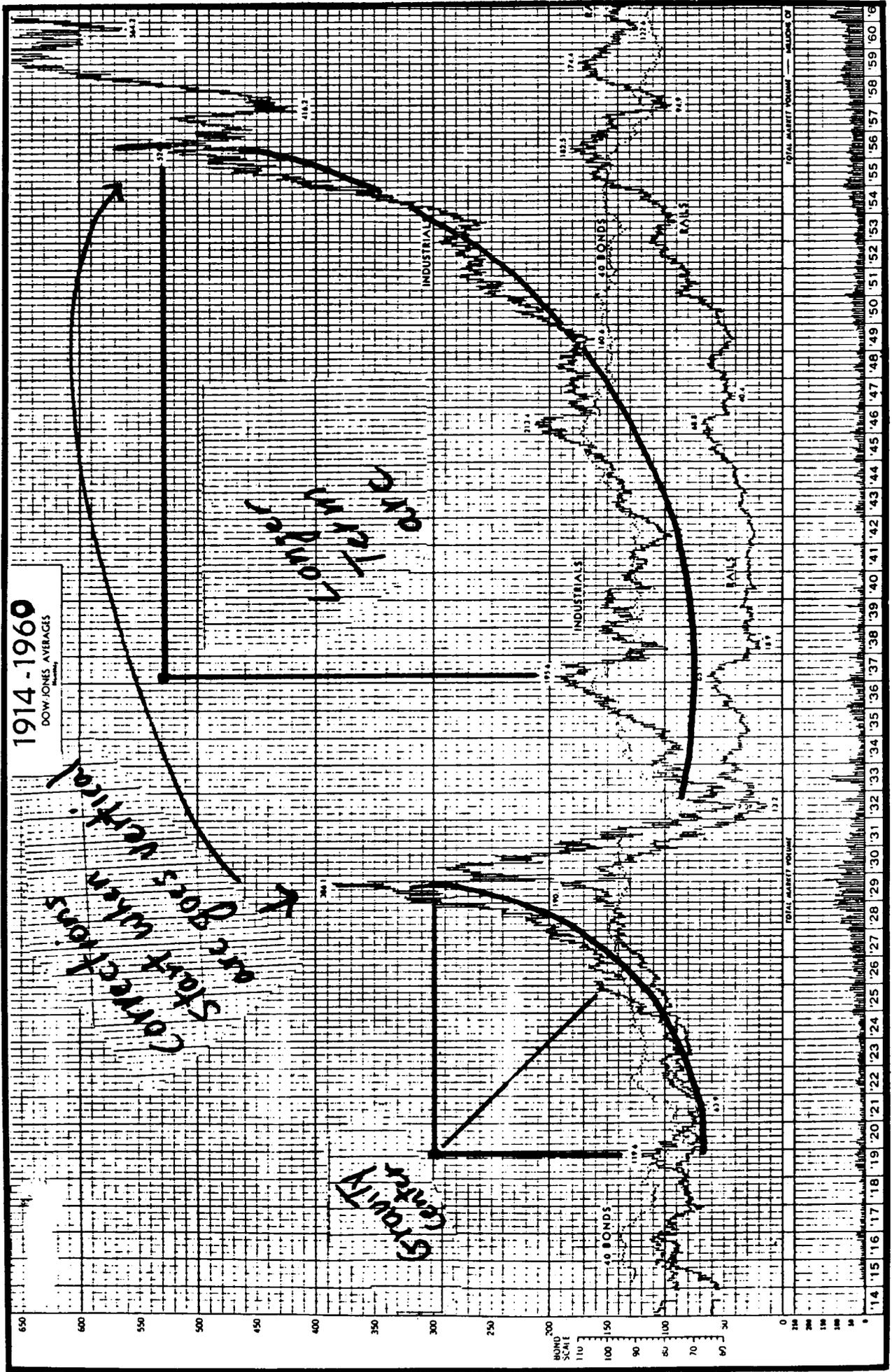
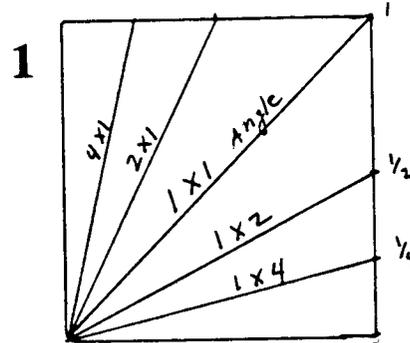
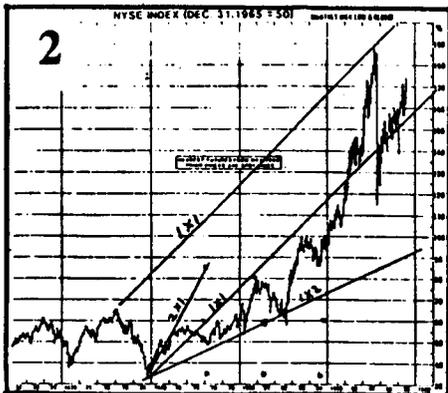


Figure 9

## TRADING WITH ANGLES

- 1- Angles are types of moving averages and tell you much more about sentiment and true market power than any oscillator or percentage bands.
- 2- They evenly divide time and price with space movements - thus you can forecast future price levels at time periods commensurate with the slope of the impulse angle.
- 3- When you break an angle you will always drop to the next angle down or go sideways until it catches up with you.

72



or: Draw set of fixed dots

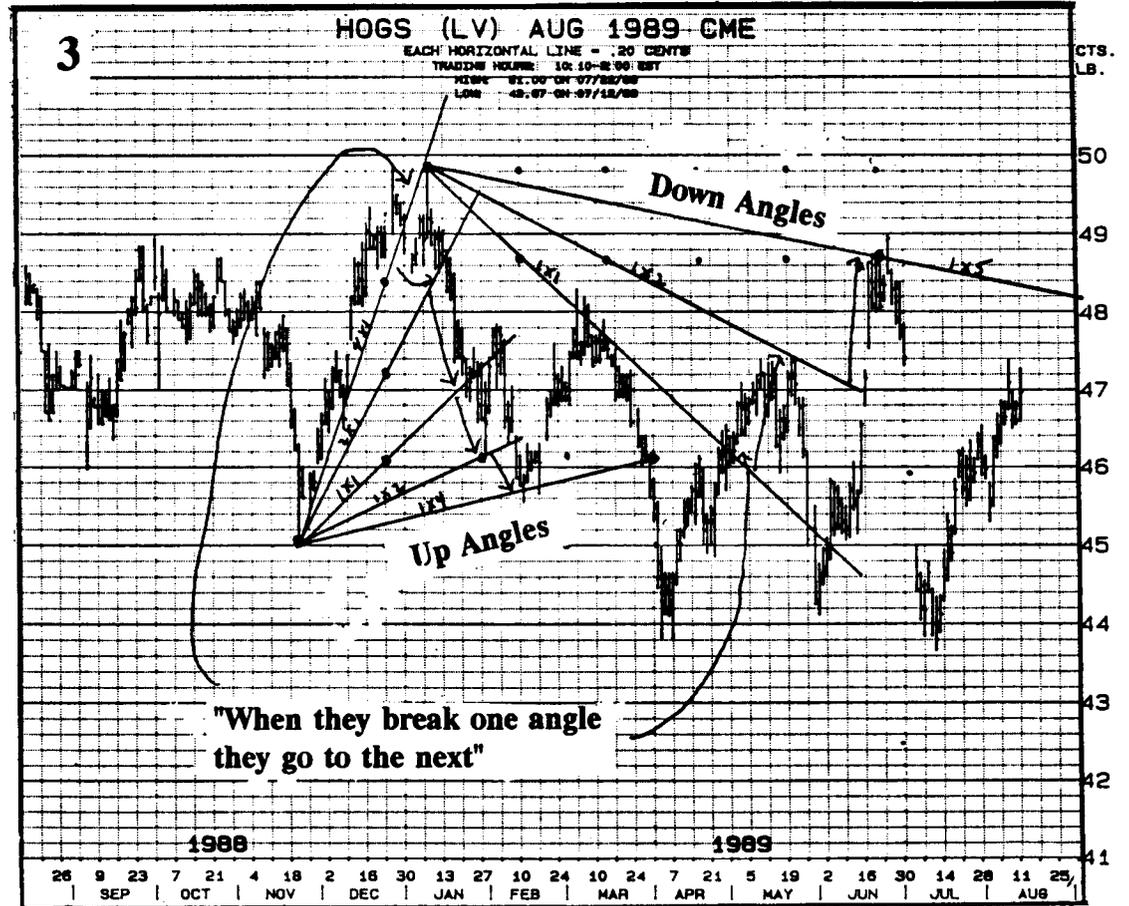
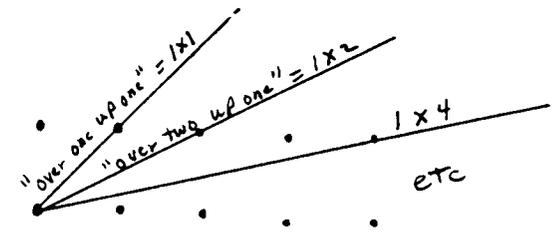


Figure 10

So why bother? My work shows conclusively that price movement in stock patterns are inextricably related in an exact mathematical relationship to time periods.

Furthermore, this implies of course, that in the masses, human greed and fear, as exhibited in the buying and selling of stocks, takes on mathematical predictability to a degree of exactness not even dreamed of by the common man. Utilizing some basic mathematical concepts and plotting trendlines will therefore give us vastly improved results in timing and trend analysis **if those trendlines are drawn correctly**. Once we have trendlines we can use a wonderful rule that is highly reliable and valuable for trading purposes if believed in and always followed. This rule can be simply stated as follows:

**"A stock's price will follow a geometrical trendline angle and when it breaks it can never regain that specific angle and must fall or will not advance until it touches the geometrical trendline below it"**

It is very important to know that since we are dealing with trendlines or slopes, we are not saying the price must fall if the trendline is violated. We are talking about rates of change. It is usually the case however, that when a trendline breaks a new direction is indicated. For example, if we are following a stock that is advancing along a trendline which is increasing at a rate of \$1 each week, the first time that trendline is broken does not tell us that the stock is going down or even that it has stopped advancing. It does tell us however, that it will not be \$1 higher next week as it can never regain its original trendline.

It also tells us that the stock will drift sideways or down or slightly up until at a later date it hits the next lower trendline which would be an angle advancing at a rate of \$.50 per week. If the beginning point of our original trendline was ten weeks and \$10 ago, the second angle would currently provide support \$5 lower today (1/2 per week) or at the same level in ten weeks as it catches up in the future. This is valuable information and we may want to invest our money elsewhere while we are waiting for the stock to consolidate or decline to find support. More importantly, we would certainly not want to own call options on that stock, but we may consider writing naked calls or covered calls at that point.

Likewise, in using such analysis in trading the overall market, there comes a time just after a top is reached and a trendline is broken, that the market cannot go higher but it may not go lower immediately. At these times a professional trader is just wasting his or her time in trying to trade stocks. For me, these are vacation periods or long weekends off.

When using these rules and trendlines you must always remember that these slopes of advance in prices or declines are reflections of mass psychology. In the masses as a whole, greed and fear manifest in the buying and selling of stocks and like any physical phenomena, waves of bullish or bearish sentiment will follow a natural course till exhaustion develops and arrests the trend.

We can track the development of these waves by noticing the relative slope of angles. Since success in the market and trading is dependent on getting a rate of return over time, the trendline slope defines this rate of return, i.e. slope equals price divided by time or the change in price related to the change in time. The steepest trendlines are the ones that interest us.

Stocks that are the most popular will always have steeper trendline rates of return. Please remember, that when I use the word popular, I am referring to the action of much more buying than selling. In pluralistic democracy, the rule is one man, one vote. In pluralistic capitalism, as in the stock market, it is \$1 one vote. This is why there are few very successful investors and many unsuccessful losers.

Now that we have a better appreciation for the value of trendlines to gauge the direction of the trend and its momentum, we now need to address the question of time. Although trendlines may break, we have noticed that this does not mean that the price will fall as the upward rate of momentum is slowing. In order to show a change in trend, we must now see successively lower lows and lower highs in order for the trend to have changed from upward to downwards.

The first thing we must do is keep a grasp on the big picture, the long term trend. A violation of a daily trendline, or a weekly trendline, does not necessarily mean that the longer trend, the monthly trend is down. Perhaps we have entered a consolidation period or sideways trading range. To see if the longer term picture is deteriorating, we need not resort to dozens of charts, but merely note the last major swing low on the longer term chart. For this purpose it would be convenient to maintain a log book of the highest price for the month and the lowest price for the month.

As long as the decline does not go lower than the low reached in the prior month, the trend cannot be down since any line drawn between the prior month's low and this month's higher low would still be an upward slope. A price decline to the same price level would show a horizontal slope.

We usually refer to these types of lows, as double bottoms or triple bottoms in the case of a decline, rally and another decline into the same price area. The general trading rule which is quite reliable, is to **buy at double and triple bottoms**, but to watch for a breakdown on any test of those lows after that 4th bottom or more. It will still be helpful to picture the rising tide analogy:

**When the tide reaches its highest or lowest point, there will be several waves reaching to a certain point without exceeding that point. Eventually the new direction penetrates this point as the tide advances or recedes as the case may be.**

In the stock market this change in tidal direction of buying and selling may take a long period of time to complete, say several weeks or months, before decisively reversing. So a strategically placed purchase or sale, at a prior swing price, will almost always result in immediate gain as the stock or market reverses to test again its prior direction.

At this point the trade is questionable, as the trader does not know if the bounce off of the prior price level, is the beginning of an eventual breakdown to new lows or merely only the test of a major support area prior to a much bigger advance. Chapter 6 on Proportion and Harmony deals with possible methods to resolve this issue.

We should mention a few more words on support and resistance areas. These are as follows:

- **Support area** is an area which has horizontally stopped many previous declines and resulted in subsequent price advances.
  
- **Resistance area** is a price range that has historically resisted any further advance and has resulted in a reversal of trend to the downside.

These historical time and price periods can be anywhere from the past few weeks, or to old highs or lows made at those price levels years ago.

Just like the tide analogy of small waves within bigger ones, **time is a function of the individuals perception, price is the reality.** A long term rising trend, i.e., IBM over the past 30 years will have within that trend many declining years and even within those declining years, weeks to months of advancing prices. So we might see an example of a minor decline on a monthly basis to a certain price level, a bounce off that level, giving rise to a three or four week rally, another failure to test that level, then a 3 year advance to new highs and then years later, a one or two year decline, all the way back to the original levels. Then support levels form double, triple or multiple bottoms on various charts.

In our historical analysis of a stock, before trading it, we should carefully note all these support and resistance areas. From a rational perspective, for those of you who need to grasp logical truths before you invest, support and resistance levels are psychological buy and sell points that last for long periods of time and they usually form at physiological, emotional times in the market.

Long term investors always remember where they bought or sold their positions and what their cost basis was. So when a stock finally returns to those same levels after long time periods, those same investors either add to their positions or eliminate them. In our theory of time squares, you will find these support and resistance areas at time and price proportional points. We can then see how big or important the square is, and thereby, get a feel for whether the pivot point will hold or how a consolidation should take.

## Chapter #8

### Impulse Waves

*"The real value of impulse waves is that they do accurately predict the length and price targets of the entire movement from the very first fluctuations."*

We have made the analogy that the stock market consists of emotional, psychological waves of fear and greed. This analogy likens the waves at the beach or the waves of sound striking the ear, or the waves of light striking the eye to the price levels in the market. Many of the known laws of physics and mathematics that we use to identify waves in the physical world, apply to measuring movements of emotional waves in the stock market.

The first place to start is at the beginning of the wave. These initial thrusts are called impulse waves that occur at the end of the prior movement and the start of a new trend. This idea of an impulse wave, as a start of a trend, is also helpful in identifying the main trend when the price pattern is choppy. **The rule is to go with the direction of the obvious impulse waves.**

For instance, a new Bull Market starts at the end of a Bear Market when the market stops going down and it gets dull and quiet. There does not seem to be any activity and then suddenly an impulse wave hits and the market goes up dramatically.

This initial surge is what we define as the impulse wave and is usually measured from the first day the trend reversal starts, to the time that the first minor correction sets in. This can be a couple of days to several weeks later and may amount to a few points on an individual stock, whereas, on the Dow Jones Averages it may amount to several hundred points of an advance before the first significant correction sets in.

What we want to do is make measurements of the **time duration of this impulse wave and the price distance** it travels during that time, to get an idea as to the strength and probable time period to exhaustion of this move. To do this, we must define a series of expanding number cycles and apply them to the initial magnitude of the impulse wave.

Keep in mind the analogy of our main trend which consists of a series of stair step higher highs and higher bottoms. Each of these little stair steps is a type of impulse wave and each are related to the very first impulse of the whole movement.

It has been shown historically that there are expansion multiples of exact proportions of the initial impulse wave that calculate each of the subsequent waves. For instance, if the first wave measured 100 dow points we could say that this was unit 1. We might say that our second wave might be a proportionate part of that, such as 1 1/2 times or 2 or 3 times the first wave. If we apply these fractional proportions to the initial wave it will give us some guesstimate as to its probable time duration and price level.

After each impulse a correction follows. The correction retraces a percentage of that initial impulse advance, but the correction is not usually 100 percent of the advance, otherwise, we would not have one of these stair step patterns. Usually it is a proportionate part not more than 1/2 or 1/3 of the distance back.

As we recall from our 50% rule, the 45 degree diagonal line coming off of a low intersects a square at the 50% point. So after an initial impulse wave a 45 degree diagonal line coming up off the initial low would provide *major support* any time the corrective wave came down and touched it.

There are a number of ways of calculating the correction percentage after the initial impulse wave. We can use our standard mathematical angles of 30 degrees, 45 degrees or 60 degrees. Each of these may be less or more steep than the other, but each of these provide good support for a correction.

We could also take a percentage retracement like 25%, 1/3, 1/2, etc. of the initial impulse. When we see the correction "*losing momentum*" or "*running out of velocity*," at one of these price levels, we can assume that the movement is just about finished and that our next impulse wave is about to begin. This next impulse wave will be proportionately related to the first one.

Now, there are many other ways of looking at impulse waves and measuring them. Most of these are called **Pattern Recognition Systems** and are the most accurate ways of forecasting stock price movements.

**The Elliott Wave System** is the most popular by far. Here the market is seen as a series of waves in units of 3, 5 and 8. The primary trend consists of 5 waves up with a counter trend of 3 waves down. If you have 5 waves up, the count would be 3 impulse waves and 2 corrective waves. So the first impulse would be 1, the corrective wave down would be 2 and another bigger impulse wave 3 with a corrective wave 4 and then a big finishing impulse wave labeled 5. This 5 wave sequence is really only 3 impulses up and 2 that are corrective waves.

After that sequence is complete, a major down trend ensues which consists of 5 waves down. An initial thrust down, a counter rally back, another big thrust down, a counter rally back and then a final thrust down. You would have 3 thrusts down and 2 little counter waves that would complete the down wave.

As often as the Elliott System works, I have found it to be perhaps no more than 70% accurate.

There are many other wave pattern systems that I find to be more reliable. Some of these patterns instead of consisting of 3, 5 and 8 waves, consist of 7 or 12 waves, or even equal proportions of 2 and 2.

I do not think it is particularly relevant to rely exclusively on any one of these particular recognition systems. However, it is important when we examine our historical record of data, **to see if there is a particular wave that is unique to that particular market** or stock we are trading and thereby, make some measurements to see how many waves it usually follows. Each of these waves of course are percentage proportionate parts of the preceding waves.

The Elliott Wave school of thought has popularized the so called "*Fibonacci sequence*." The Fibonacci sequence is the approximate ratios of .382, .618, 1, 1.618, 2.618, 4.236, etc. This is also known as the golden proportion, the golden ratio or golden spiral and it is the **logarithmic growth curve of almost everything in life** and in the great galaxy itself. It is a natural, proportionate, mathematical sequence which adapts itself quite readily to stock market movements. This is an additive series that starts by adding each number to its neighbor, so 1 plus 1 = 2, 2 plus 1 = 3, 3 plus 2 = 5, 5 plus 3 = 8, etc. until we have the series 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, etc. The numbers are not absolute so much as the ratios between them are constants. All other additive number series also eventually meld into these ratios and they, therefore, become quite useful.

For instance, if the initial impulse wave is considered unit 1, even though it was \$5, \$7.50 or \$12, we would multiply that one unit by 1.618 and we would get an expected expansion on the next impulse wave of something like a fractional part of that, like .382, 1.618, 2.618, 4.236, would be an expansion of that initial impulse. However, the Fibonacci ratio is not the only expansion numerical series that applies to the stock market, so feel free to experiment.

I might add, that when there is difficulty in determining the main trend, and we invest only with the main trend, and not the counter movements, sometimes it is easy to identify the main trend by watching for impulse waves. Over a series of months if the market is trading in a big flat and we are not certain whether it is going up or down, every few weeks or every few months, there will usually be a big spike impulse wave that occurs in the direction of the main trend.

For instance, if we are in a flat and suddenly one day the stock shoots up \$2 on heavy volume and a couple days later trades right back down into the base and then two weeks later there is another big spike of \$3 or \$4 upwards and then trades down, we can assume these impulse waves are accumulation patterns and are precursors to a major breakout.

Likewise, if there is a drifting pattern downward, but the stock keeps coming back to where it was and we see a sudden thrust to the downside, these too, are impulse waves, as they clearly show that the impulse is to the downside and we can expect that the main trend will resume in that direction fairly soon.

We also want to pay close attention to the number of impulses within the wave. The more there are, the

more likely it is that the wave is coming to an end. As previously mentioned, the Elliott Wave movement consists of 3, 5 and 8 wave movements which are quite common.

In a little "stair step" pattern where you have an impulse up, a little corrective to a "higher stair step", then another impulse to a "higher stair step," each of these higher lows in an uptrend can be numbered 1, 2, 3, 4, 5. You will find that in almost all markets when you get to 7, 8, 9 higher lows we are running out of time and the odds overwhelmingly favor that a counter trend movement of significance is about to start.

Usually five higher bottoms is about the minimum, although occasionally in dull markets only three will appear. Five higher is a normal movement, but the 7th, 8th, 9th is the danger point. If the impulses go past 9 they will usually complete 12 or 13 little movements. However, by the time we get to 12 or 13 movements one should basically be out of longs or using very close stop losses because the trend almost always reverses.

Of course the reason for this, as we know, is that the market is following a natural cycle. We do not know what these cycles are, whether they be weather patterns, biorhythms, cosmic radiation or whatever, but we do know there are natural cycles that repeat. History has shown time and time again that these impulse waves just do not go up forever, but they are a series of impulses and then they reverse.

Remember, when trading we want to enter and exit our trade at low risk points that are clearly defined. Where we can define both probable direction of the movement and be able to reverse and get out when we make a mistake with the smallest loss. Obviously, if a stock had a corrective low of \$30 and shot up to \$36 and we blindly buy at \$36 there would be no justification for putting a stop loss of \$35. Since the last low was \$30, the stock could decline all the way to 30 again and still find major support.

So, what we would want to do is to buy the stock on a pull back towards \$30 **anytime it made a higher bottom from \$30**, and then we would use \$30 as our stop out point. If we were to buy the stock at \$32 we would only have a \$2 risk before if it actually broke that \$30 support level. So a professional trader, even though the main trend may be up, would not necessarily take a trade at \$35 or \$36 simply because there is no clearly identified exit at that point. He would just have to wait until the next correction low even if it took three weeks.

If he finds out that this low is only \$34 and then advances, he could then buy it with \$34 as a stop loss and have an identifiable stop out point. Keep in mind that **when the \$34 point is established**, if it is the 7th, 8th, 9th higher bottom, so far the odds are pretty good that we are going to get stopped out and we may not want to make that trade.

The real value of impulse waves is that they do accurately predict the length and price targets of the entire movement from the very first fluctuations. What I do is initially construct a box or "Gann Square" around the initial low to high sequence and expand these boxes by various ratios. For instance, if the initial thrust was \$10 for a stock and it lasted 50 days, we could expect a maximum expansion of 4.236  $[(1.618)^3]$  times 10 or \$42.36 as a target price with a time horizon of possibly 212 days (4.236 x 50).

Basically, one would start two expansion series. The first, would be simple linear boxes of equal size as the first thrust, and the other would be growth expansion such as with the Fibonacci sequence. Other sequences could be the square root series, such as the roots of 2, 3, 4, 5, 6 multiplied by the initial box size, or the use of universal constants such as pi (3.14159). We would keep expanding these box size squares until it eventually became obvious that the major trend had changed. Here again our historical examination of extreme measurements will give us good approximations as to what to look for.

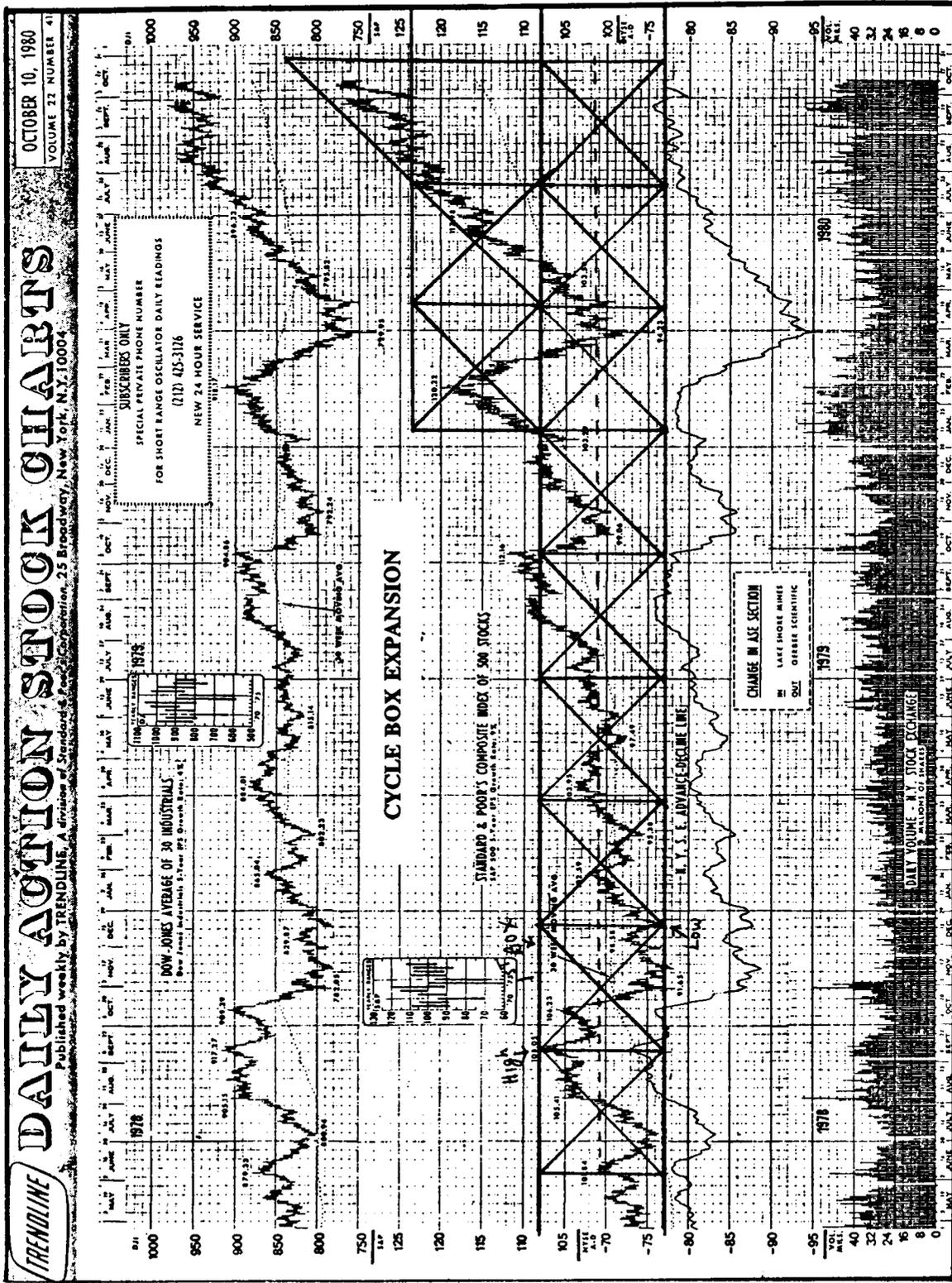


Figure 11

