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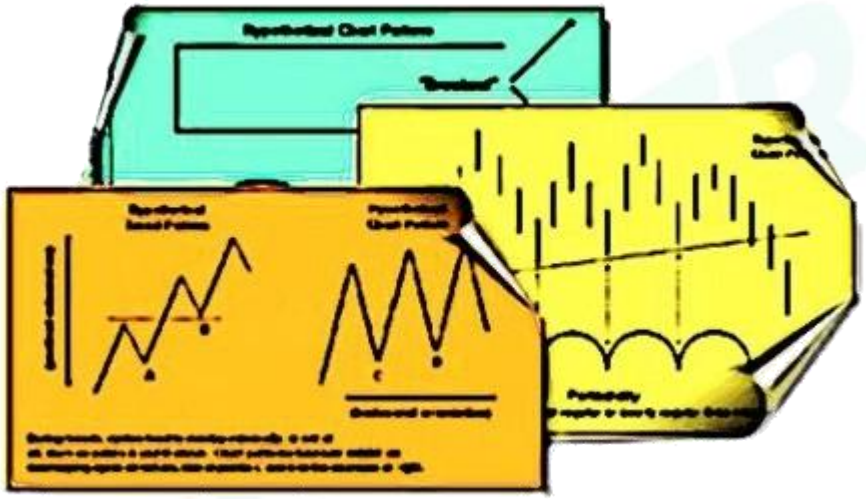
Chart formations

Preview

Full course: 150 page

Chart formations



- Theoretical background
- Categorisation of formations
- Trend continuation patterns
- Trend reversal patterns

Graph formations

- *Geometric formations* drawn by connecting the peaks and troughs of share prices
  - Give *highly reliable* information about expected price movements
  - Help to find *entry points with low risks*, where the potential profit is higher
  - ***Trend continuation patterns***
    - Traders can make sure they are on the right side when this formation develops
    - In case of a ***breakout***, one can increase his position, because the formation signals the continuation of the trend
  - ***Trend reversal patterns***
    - Show the ***end of a trend*** with high reliability
    - It is recommended to close the positions in the current trend's direction and open an ***opposite*** direction

Categorisation of formations

Trend continuation patterns

- **Triangles**
- **Flags**
- **Pennant**
- **Wedges**
- **Cup and Handle**
- **Gaps**

Trend reversal patterns

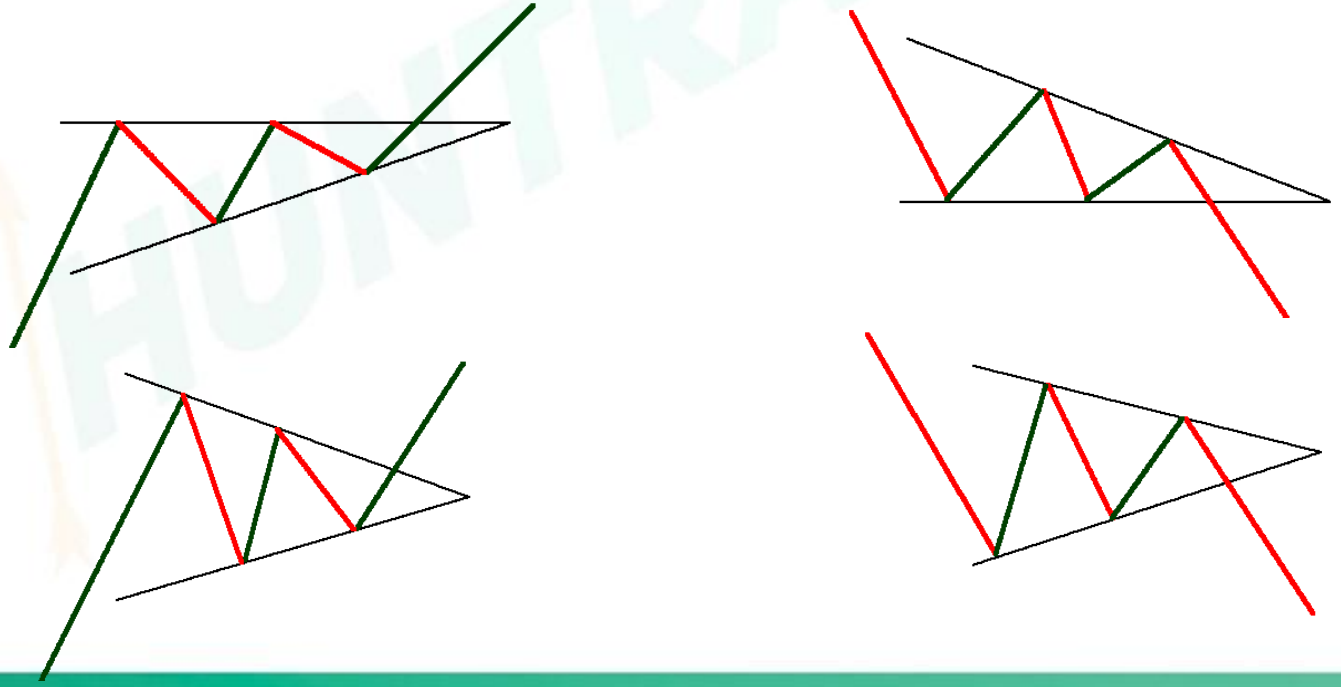
- **Double Bottom and Top**
- **Head and Shoulders**
- **Reversal points**
- **Wedges**
- **Triangles**

Triangles

- **General attributions**
  - The peaks and troughs *converge towards one point*
  - Narrowing bands *break out* in the direction determined by the triangle before its endpoint
  - *They can develop within trends*
    - hence, a breakout can happen in the current trend's direction, but signalling a trend reversal is also possible
  - *Breakout* from the triangle is usually accompanied by ***high trading volume***
  - The amount of *increase/decrease* equals the distance of the *height/width* measured on the vertex of the triangle
  - The *height of the triangle* (needed for the calculation) is located at the beginning of the formation where the trading volume is the largest
  - *Breakouts* usually happen between the 2/3 and 3/4 of the triangle

Categorisation of triangles

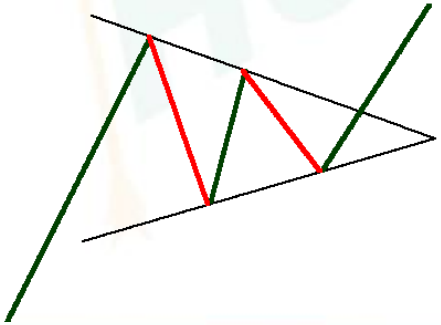
- There are 3 different types based on appearance (*broadening triangles* also belong here):
  - ***Symmetric Triangle***
  - ***Ascending Triangle**, as trend continuation formation*
  - ***Descending Triangle**, as trend continuation formation*

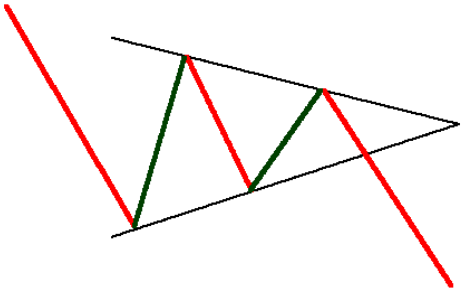


Symmetric Triangles

- **General attributions**
  - The steepness of the two sides *equals*
  - *Breakout* can happen in both directions with large trading volume
  - The volume during the development of the formation is *balanced*
  - The triangle requires *at least 2* descending troughs and ascending peaks - there can be more than 2
  - The foundation of the *price target calculation* is the combination of days with large trading volume at the beginning of the formation

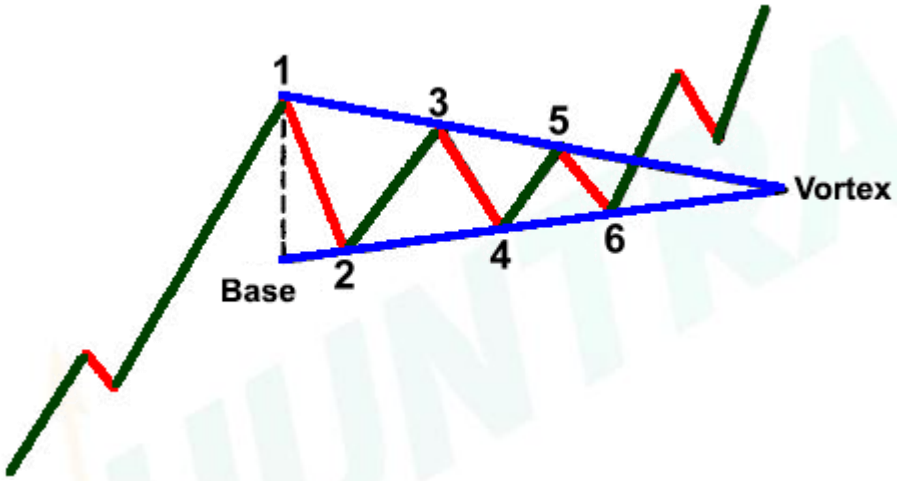
- **2 types**
  - *Symmetric Triangle in ascending trend*
  - *Symmetric Triangle in descending trend*





Symmetric Triangles

- Represents a pause in the current trend before it is continued.
- **At least 4 reversal points are needed** to interpret the triangle.



The consolidation phase starts at point 1. The share price pulls back to the 2nd point and then rise until point 3. Point 3 is lower than point 1. The top line can only be drawn once the share price fell from point 3.

The 4th point is higher than the 2nd. The bottom line can only be drawn once the share price rise from point 4. At this point, traders can suspect the development of a symmetric triangle. Thus, the formation consists of 4 consequent points and 2 converging trendlines.

In theory, 4 points are needed. In practice, usually 6 points are formed.

Time horizon of triangles

- The two lines of the triangle meet at a specific time, by the **vertex**.
- The breakout of the price happens around the **2/3** or **3/4** of the triangle's length. This distance can be calculated once the 4 consequent points have formed. If a triangle lasts 20 weeks (from the base to the vertex), the breakout can be expected between the 13th and 15th week.
- If the share price stays within the triangle longer than the 3/4 of its length, it *loses from its potential*.
- After an upward breakout, the upper trendline will become the **support**. After a downward breakout, the upper line will become the **resistance**. The price level defined by the vortex also define the support/resistance line.
- The *breakout is confirmed by the closing prices*, movements within one day do not count as breakout.

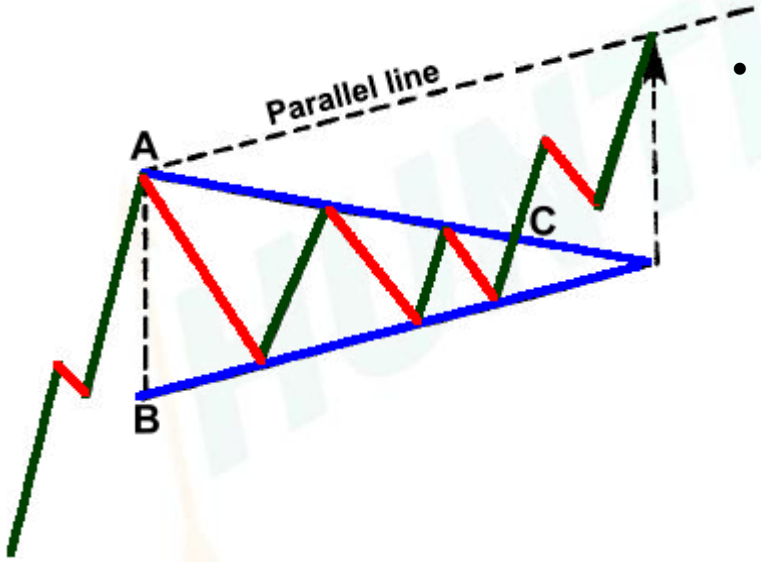
Volume is an important factor

- Volume must show descending tendency as the price moves horizontally within the triangle.
- The volume is high at the breakout, fulfilling the triangle.
- Testing back happens with low volume, the continuation of the trend's direction is signalled by strong activity.

- **There are two important rules when examining volume:**
  - *For trend reversal patterns, the volume is more important at the vortex than at the base. An increase in the volume is necessary to support the ascending trend's renewal.*
  - *The volume gradually drops along with the development of the triangle, but the observation of the volume is the tool to recognise the direction with stronger activity. Hence, forecasting the direction of the breakout. For example, in an ascending trend, there must be mild volume so it can increase if there is a rise (or decrease if there is a drop).*

Price target calculation

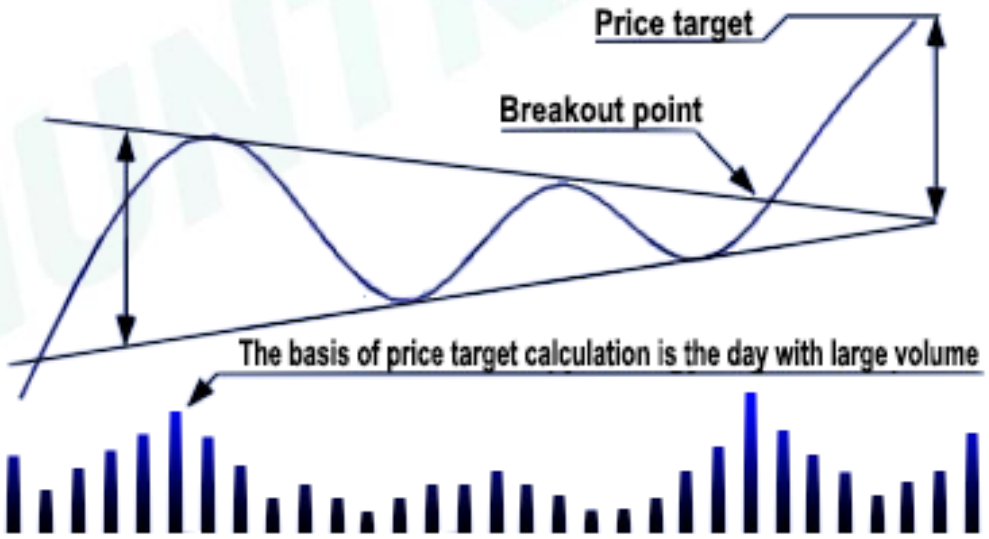
- There are **more techniques** to measure the price target of symmetric triangles.
  - *The distance between point A and B is measured on point C (breakout point) - this method is less common*
  - *The distance between point A and B is measured on the vortex of the triangle*



- Another useful method is to draw a line starting from point A, parallel to the trendline. Then, not only a price level is determined, but also a channel. The share price has to touch the top channel line. In general, the share price and the parallel line meets at the time defined by the triangle's vortex.

Symmetric Triangle in ascending trend

- **General attributions**
  - The share price enters the formation *from below*
  - The *width* of the triangle is determined by the days with the largest volume
  - The volume is high at the beginning of the triangle, then it drops until the breakout, when it becomes high again
  - The *expected value* is determined by measuring it on the vortex of the triangle
    - The result gives only the minimum expected target
    - The price will pass this level multiple times, but the price target determination is inevitable to calculate the expected return and to decide when to enter



Example for a Symmetric Triangle in ascending trend

BRCM - November 2009 - December 2009

Example for a Symmetric Triangle in ascending trend

NGD - January 2009 - May 2009

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