Charles Dow's Six Secrets to Market Success

Applying the Dow Theory to Today's Markets

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The world of Charles Dow, of Dow Jones and Wall Street Journal fame, was very – and quite understandably – different to today's technology-driven world. When Dow died in 1902, the charting packages that we now take for granted did not exist, calculators would not be mass marketed for another 75 years and the high-speed information flows that we enjoy today were beyond investors' wildest dreams.

DOW'S SIX MAIN TENETS

1. **The Averages discount everything**
2. **The market has three trends**
3. **Major trends have three phases**
4. **The Averages must confirm each other**
5. **Volume must confirm the trend**
6. **A trend is assumed to be in effect until it gives definite signals that it has been reversed.**

However, with help from William Hamilton, S.A Nelson and Robert Rhea, Dow made a number of observations that are as relevant now as they were in the late nineteenth century. Though these observations have become known as the Dow Theory, perhaps Dow guidelines or principles would be a better description. They are not in truth mathematical or economic expressions that can be applied to derive an exact answer; financial markets simply do not work that way. Instead, they are a set of six common-sense guidelines that investors and traders should treat as the unseen foundations of their decision-making process.

The Dow Theory, by the Numbers

The first of these tenets, the Averages discount everything, is deeply woven into the philosophy of technical analysis. Dow's research was based on the Dow Jones Industrial, Transport and Utility Averages. If the words market price were substituted for averages, we are left with the observation that "market price discounts everything." This premise needs to be fully understood before we can move on. By focussing on price action, technical analysts are simply cutting to the chase, believing that anything that can affect the market price of a financial instrument is already reflected in its price.

This is such an uncomfortable concept to grasp that it is as far as many newcomers to technical analysis get before falling back to the safety net of economics and the financial press. However, the claim is neither as preposterous nor as presumptuous as it first appears. Consider a scenario where the FTSE-100 is temporarily frozen at a price of 3750. At that specific moment in time, the price reflects the net supply and demand of all the factors that affect the FTSE-100.

What are those variables? Firstly, there are the traditional 'fundamental' factors such as the state of the economy, interest rate movements and political considerations – plus future expectations of all three. If these factors were all that made up supply and demand (and therefore market price), technical analysts would simply be looking at the same variables as economists. However, there are more components, and these are what differentiate the two disciplines.

All financial markets have one common denominator – they are traded by people, and human psychology and behaviour play a huge part in price movement. As well as the economic fundamentals, prices reflect the hopes, fears, expectations, errors and speculation of market participants. By analysing price, technical analysts are focussing on all known, or expected, influences on supply and demand. To quote from Technical Analysis of the Futures Markets, by John J Murphy, "The chartist knows that there are reasons why markets go up or down, he or she just doesn't believe that knowing what those reasons are is necessary in the forecasting process."

Dow's Sixth Meets Newton's First

Dow's other tenets are intertwined, and relate to trends within the market. Firstly, he splits trends into three different time perspectives: long term (major), medium term (secondary or corrective), and short term. The major trend is where profits are readily available, as it is a trend that generally dominates for a year or more.

Dips in a major bull trend offer buying opportunities, while recovery attempts in a bear trend offer selling opportunities. These dips or recovery attempts are known as the secondary trend and are smaller waves that flow against the dominant (major) tide. They can be traded successfully, but it must always be remembered that the market will generally return to its major trend.

This introduces another of Dow's tenets: a trend is assumed to be in effect until it gives definite signals that it has been reversed. Dow

may have gained inspiration from Isaac Newton's law, expressed in Principia Mathematica, that argues that "a body in motion will continue in the same direction until it shows signs of reversing or slowing." I personally prefer an analogy from the courtroom, in that the major trend is innocent until proven guilty.

This begs the question: when does a secondary trend become so strong that it negates the major trend and becomes a new major trend itself? Trading or analysing the white water created by two clashing tides is arguably the most difficult part of technical analysis, and there are whole books dedicated to it. During a secondary or corrective trend, the analyst constantly monitors price patterns, retracement levels, moving averages, trendlines, volume, and momentum oscillators. Together, these tools are used to determine the critical point at which a major trend will reverse. By identifying this threshold, risks become controllable, therefore minimising losses from an incorrect decision. Often this sacrifice then becomes a loss leader. On breaking beyond a critical support or resistance, the market is generally signalling that a new trend is beginning, allowing a trader to quickly reverse exposure.

Phased Analysis

Identification of the current trading environment is essential when looking at any financial instrument, as tactics will differ between ranging and trending markets. By identifying three different phases within a major trend, Dow went deeper than this. This may appear a little academic at first; after all, if a market is rising, the obvious strategy is to continue buying until a definite reversal signal has been given. However, as investors who bought technology stocks as the bull trend in the NASDAQ matured will testify, forewarned is forearmed!

A new major bull trend actually begins before the preceding bear trend has ended. At this point, economic news and data is still bearish, but importantly this has already been priced in and discounted by the market. It is at this stage that the smart money begins to buy, creating a secondary wave higher. Sellers still believe that they possess overall control, but subsequent dips fail to reach a new low and a basing pattern develops. This is called the accumulation phase.

The second phase of a major bull trend is the strongest and longest. The basing pattern is completed and sellers, realising their mistake, are forced to cover or reverse their short positions. It is at this point that Dow would enter the market on the long side, sacrificing the uncertainty of the turning point for (lower risk) longer-term gains.

For the third and final phase, the market continues to rise as increasingly optimistic news stories are priced in. As with the final phase of the NASDAQ bull trend, everybody wants a piece of the action and the public begin to participate. However, during this climactic final phase, the smart money is already beginning to lock in profits by selling. At this point all the good news is priced in, fresh buying is merely based on speculation, the market is heavily overvalued and subsequent price rises are built on sandy foundations. The only way is down!

A Return to the Law of Averages

Dow's final two tenets provide an early warning system for this final 'distribution' phase. Firstly, volume must confirm the trend. If the major trend is bullish, volume should increase as prices head higher. Volume should also lighten during secondary corrective waves. If volume steadily declines during a bull trend, it should set alarm bells ringing, as there is a genuine risk that the rally is running out of steam.

Finally, Dow suggested that, "the Averages should confirm each other." He was looking at the Industrial, Utility and Transport Averages in the US, and believed that all three had to be moving in the same direction to give ultimate confidence in the longer-term direction of the market. If all three were making new lows, the market was inherently bearish and was likely to move lower still. If they gave conflicting signals, it suggested that investors should stay on the sidelines until they re-aligned. This is still a useful practise in the modern world. If the Dow Jones hits a new low, what is happening to the S&P500 and the NASDAQ? If EUR/USD reaches a new high, is the rally supported by evidence from USD/CHF, GBP/USD and the USD Trade-Weighted Index?

Charles Dow's Theory was not designed to pick out tops and bottoms as they develop. Instead, its goal was to identify a major trend reversal, and ride the subsequent wave higher until confirmation was given that it had ended. In isolation, knowledge of Dow Theory is not enough to trade the world's financial markets. However, when combined with the trading and analytical tools of technical analysis, his observations certainly help market participants to enjoy significant profits, while limiting losses. ■

Martin Scott joined the technical strategy team at the Royal Bank of Scotland in September 2000 after spending three years at MCM, where he managed the highly regarded CurrencyWatch. At RBS he works closely with the bank's FM clients, traders and sales people, developing technical strategies across a wide spectrum of financial markets. Martin began his career at UK stockbrokers James Capel & Co., where he was an FX trader four years. He then obtained an economics degree in banking and finance at Cardiff University before re-entering the City as a technical analyst at MMS International Standard and Poors in 1994.