

Dow Theory

The Key To Understanding Stock Market Movement

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The Dow theory has been around for almost 100 years. Developed by Charles Dow and refined by William Hamilton, many of the ideas put forward by these two men have become axioms of Wall Street.

Background:

Charles Dow developed the Dow theory from his analysis of market price action in the late 19th. Century. Until his death in 1902, Dow was part owner as well as editor of the Wall Street Journal. Even though Charles Dow is credited with initiating Dow theory, it was S.A. Nelson and William Hamilton who later refined the theory into what it is today. In 1932 Robert Rhea further refined the analysis. Rhea studied and deciphered some 252 editorials through which Dow and Hamilton conveyed their thoughts on the market.

Main Assumptions:

1. Manipulation of the primary trend as not being possible is the primary assumption of the Dow theory. Hamilton also believed that while individual stocks could be influenced it would be virtually impossible to manipulate the market as a whole.
2. Averages discount everything. This assumption means that the markets reflect all known information. Everything there is to know is already reflected in the markets through price. Price represents the sum total of all the hopes, fears and expectations of all participants. The unexpected will occur, but usually this will affect the short-term trend. The primary trend will remain unaffected. Hamilton noted that sometimes the market would react negatively to good news. For Hamilton the reason was simple: the markets look ahead, this explains the old Wall Street axiom "buy on the rumour and sell on the news".

Even though the Dow Theory is not meant for short-term trading, it can still add value for traders. Thus no matter what your time frame, it always helps to be able to identify the primary trend. According to Hamilton

those who successfully applied the Dow Theory rarely traded on too regular a basis. Hamilton and Dow were not concerned with the risks involved in getting exact tops and bottoms. Their main concern was catching large moves. They advised the close study of the markets on a daily basis, but they also sought to minimise the effects of random movements and recommended concentration on the primary trend.

Price Movement:

Dow and Hamilton identified three types of price movement for the Dow Jones Industrial and Rail averages:

- A. Primary movements
- B. Secondary movements
- C. Daily fluctuations

A. Primary moves last from a few months to many years and represent the broad underlying trend of the market.

B. Secondary or reaction movements last for a few weeks to many months and move counter to the primary trend.

C. Daily fluctuations can move with or against the primary trend and last from a few hours to a few days, but usually not more than a week.

Primary movements, as mentioned, represent the broad underlying trend. These actions are typically referred to as BULL or BEAR trends. Bull means buying or positive trends and Bear means negative or selling trends. **Once the primary trend has been identified, it will remain in effect until proven otherwise.** Hamilton believed that the length and the duration of the trend were largely undeterminable. Many traders and investors get hung up on price and time targets. The reality of the situation is that nobody knows where and when the primary trend will end.

The objective of Dow theory is to utilize what we do know, not to haphazardly guess about what we do not. Through a set of guidelines. Dow theory enables investors to identify the primary trend and invest accordingly. Trying to predict the length and duration of the trend is an exercise in futility. **Success according to Hamilton and Dow is measured by the ability to identify the primary trend and stay with it.**

Secondary movements run counter to the primary trend and are reactionary in nature. In a bull market a secondary move is considered a correction. In a bear market, secondary moves are sometimes called reaction rallies. Hamilton characterized secondary moves as a necessary phenomenon to combat excessive speculation. Corrections and counter moves kept speculators in check and added a healthy dose of guess work to market movements. Because of their complexity and deceptive nature, secondary movements require extra careful study and analysis. He discovered investors often mistake a secondary move as the beginning of a new primary trend.

Daily fluctuations, while important when viewed as a group, can be dangerous and unreliable individually. Getting too caught up in the movement of one or two days can lead to hasty decisions that are based on emotion. **To invest successfully it is vitally important to keep the whole picture in mind when analyzing daily price movements.** In general they agreed the study of daily price action can add valuable insight, but only when taken in greater context.

The Three Stages of Primary Bull Markets and Primary Bear Markets.

Hamilton identified three stages to both primary bull and primary bear markets. The stages relate as much to the psychological state of the market as to the movement of prices.

Primary Bull Market

Stage 1. Accumulation

Hamilton noted that the first stage of a bull market was largely indistinguishable from the last reaction rally in a bear market. Pessimism, which was excessive at the end of the bear market, still reigns at the beginning of a bull market. In the first stage of a bull market, stocks begin to find a bottom and quietly firm up. After the first leg peaks and starts to head down, the bears come out proclaiming that the bear market is not over. It is at this stage that careful analysis is warranted to determine if the decline is a secondary movement. **If is a secondary move, then the low forms above the previous low**, a quiet period will ensue as the market firms and then an advance will begin. When the previous peak is surpassed, the beginning of the second leg and a primary bull will be confirmed.

Stage 2. Movement With Strength

The second stage of a primary bull market is usually the longest, and sees the largest advance in prices. It is a period marked by improving business conditions and increased valuations in stocks. This is considered the easiest stage to make profit as participation is broad and the trend followers begin to participate.

Stage 3. Excess

Marked by excess speculation and the appearance of inflationary pressures. During the third and final stage, the public is fully involved in the market, valuations are excessive and confidence is extraordinarily high.

Primary Bear Market

Stage 1. Distribution

Just as accumulation is the hallmark of the first stage of a primary bull market, distribution marks the beginning of a bear market. As the "smart money" begins to realise that business conditions are not quite as good as once thought, and thus they begin to sell stock. There is little in the headlines to indicate a bear market is at hand and general business conditions remain good. However stocks begin to lose their lustre and the decline begins to take hand. After a moderate decline, there is a reaction rally that retraces a portion of the decline. **Hamilton noted that reaction rallies during a bear market were quite swift and sharp.** This quick and sudden movement would invigorate the bulls to proclaim the bull market alive and well. **However the reaction high of the secondary move would form and be lower than the previous high.** After making a lower high, **a break below the previous low,** would confirm that this was the second stage of a bear market.

Stage 2. Movement With Strength

As with the primary bull market stage two of a primary bear market provides the largest move. This is when the trend has been identified as down and business conditions begin to deteriorate. Earnings estimates are reduced, shortfalls occur, profit margins shrink and revenues fall.

Stage 3. Despair

At the final stage of a bear market all hope is lost and stocks are frowned upon. Valuations are low, but the selling continues as participants seek to sell no matter what. The news from corporate America is bad, the economic outlook is bleak and no buyers are to be found. The market will continue to decline until all the bad news is fully priced into the stocks. Once stocks fully reflect the worst possible outcome, the cycle begins again.

Signals

Identification Of The Trend

The first step in the identifying the primary trend is to analyse the individual trend of the Dow Jones Industrial Average and the Dow Jones Transport Average. Hamilton used peak and trough analysis to ascertain the identity of the trend. **An uptrend is defined by prices that form a series of rising peaks and rising troughs [higher highs and higher lows].** In contrast, a **downtrend is defined by prices that form a series of declining peaks and declining troughs [lower highs and lower lows].**

Once the trend has been identified, it is assumed valid until proven otherwise. A downtrend is considered valid until a **higher low forms** and the ensuing advance off the higher low **surpasses the previous reaction high.** Conversely, an uptrend is considered in place until a lower low forms.

Averages Must Confirm

Hamilton and Dow stressed that for a primary trend or sell signal to be valid, both the Dow Jones Industrial and The Transport averages **must confirm each other.** For example if one average records a new high or new low, then the other must soon follow for a Dow theory signal to be considered valid.

Volume

Though Hamilton did analyse statistics, price action was the ultimate determinant. Volume is more important when confirming the strength of advances and can also help to identify potential reversals. Hamilton thought that volume **should increase in the direction of the primary trend**. For example in a primary bull market, volume should be heavier on advances than during corrections. The opposite is true in a primary bear market. Volume should increase on the declines and decrease during the reaction rallies. **Thus by analysing the reaction rallies and corrections, it is possible to judge the underlying strength of the primary trend.**

Trading Ranges

In his commentaries over the years, Hamilton referred many times to "lines". Lines are horizontal lines that form trading ranges. Trading ranges develop when the averages move sideways over a period of time and make it possible to draw horizontal lines connecting the tops and the bottoms. These trading ranges indicate either accumulation or distribution, but it was virtually impossible to tell which **until there was a clear break to the upside or the downside.**

Conclusion

The goal of Dow and Hamilton was to identify the primary trend and catch the big moves up and be out of the market the rest of the time. They well understood that the market was influenced by emotion and prone to over-reaction, both up and down. With this in mind, they concentrated on identification and following the trend.

Dow theory [or set of assumptions] helps investors **identify facts**. It can form an excellent basis for analysis and has become the cornerstone for many professional traders in understanding market movement. Hamilton and Dow believed that success in the markets required serious study and analysis. They realised that success was a great thing, but also realised that failure, while painful, should be looked upon as learning experiences.

Technical analysis is an art form and the eye and mind grow keener with practice. Study both success and failure with an eye to the future.

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