

Profiting

with Chart Patterns

by Ed Downs

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About This e-Book

Ed Downs has spent the last 32 years developing successful trading techniques using chart pattern analysis. This book provides step by step instructions on how to analyze and identify patterns that produce dramatic profits—trade after trade.

The purpose of this e-book is to give you information helpful in identifying some of the most predictable patterns with the highest probability.

1.

Manual Conventions

The following conventions are used in this e-book:

<> Angle brackets that contain a keyboard command indicate that you should press the indicated button on your keyboard—for example, <Spacebar> means that you should press the spacebar key on your computer keyboard.

»

The » symbol leads you through nested menu items and dialog box options to a final action. The sequence **File»Page Setup»Options** directs you to pull down the **File** menu, select the **Page Setup** item, and select **Options** from the last dialog box.



This icon denotes a tip, which alerts you to advisory information.



This icon denotes a note, which alerts you to important information.

bold

Bold text denotes items that you must select or click in the software, such as menu items and dialog box options.

italic

Italic text denotes variables, emphasis, a cross reference, or an introduction to a key concept. This font also denotes text that is a placeholder for a word or value that you must supply.

monospace

Text in this font denotes text or characters that you should enter from the keyboard, sections of code, programming examples, and syntax examples. This font is also used for the proper names of disk drives, paths, directories, programs, subprograms, subroutines, device names, functions, operations, variables, filenames, and extensions.

Confirming Entries & Managing Exits

Chart patterns are *the* most powerful technique for finding great trades and managing the trades once they are entered. Chart patterns truly indicate the psychology of the market. They are very important for any trader to know and understand in order to manage risk in the market. The name of the game in trading is getting risk as low as possible.

This chapter explains what chart patterns are and how they are useful. You will also learn about the psychology of patterns and the goals of chart pattern analysis.

What is a Pattern?

The interesting thing about chart patterns is that they really have two different definitions that are commingled and dependent on each other. The first is that patterns *indicate* the psychology of the market. When you see a pattern in the chart, it will tell you whether the market is getting bullish or bearish based on the shape of the pattern.

The more interesting thing about patterns is that they also *determine* the behavior of the market. When certain patterns form, the market can see them very readily in the chart. Even though people do not think in these terms, they definitely can see that support is being violated or resistance is being tested. When traders see this happen, they will jump in and either buy or sell because of the existence of the pattern. Patterns work together and the reason they work is because investors, traders, and fund managers react the same emotional way to them.

Psychology of Support Bounces

This example shows the psychology of patterns with a support level. In this chart of Delta Air Lines, you can see that we had a support level at \$40 in June, August, and February that was hit four times. Each time the support level was hit, price bounced off of it fairly readily. This tells the market that there is a solid value at \$40 for Delta Air Lines. Whenever the market jumped in to buy the stock, driving it back up, the stock fell to \$40.



Figure 1-1. Support Level Example for DELTA AIR LINES

After the fourth bounce in February, we came up and crossed the \$47 level early in February. We had multiple chart points throughout the last year where \$47 was not crossed. Then, it was solidly crossed in early February. The market just saw price bounce off \$40 and then break through the \$47 resistance level with strong buying pressure. That told the market that this stock was going higher. The subsequent move took it all the way to \$\$49 a share, a 22% increase in a very short period of time.

This example illustrates how powerful chart psychology is. These kinds of patterns happen all of the time in the market as we will see in further examples.

Goals of Chart Pattern Analysis

In chart pattern analysis, you want to do these things:

- **Identify the most predictable patterns possible**—There have been many books written on Technical Analysis and pattern recognition, including *Technical Analysis of Stock Trends* by Edwards and McGee. This book is full of chart pattern examples. A lot of patterns that are written about are just not very predictive. We want to isolate those patterns that really give us an edge in the market.
- **Define a set of rules that result in winning trades**—There are specific rules that you can use that will help you react to and trade with the pattern as it forms from its base and culminates in the move that it started with. You will see that we have identified concise rules throughout this book.
- **Find more winners than losers, and the losses should be smaller than the gains**—More than 50% of our trades should make money. When we do lose money, which we will do, we want to make sure that our losses are much smaller than our gains. If you have more winners than losers and your losses are smaller than your gains, then you will make money. Actually, you can have more losers than winners if your losses are kept small enough. These patterns are so good and so predictive that if you trade with them, you should be able to get a higher than 50% success rate. Like I say, managing your losses to a small value should be all you need to generate a good healthy profit week after week, month after month.

Tools of the Trade

There are certain things that we need to cover about chart pattern analysis. This is related to the work that I have developed over the last 10-12 years in looking at these patterns. You will not find this material anywhere else. There are certain tools that I use that help me quantify and isolate the best patterns and trade them. That is what we are going to talk about in this section.

Seven Chart Pattern Method

I have here a list of steps that I go through as I am looking at chart patterns. It will just take you a few seconds to analyze these various aspects of patterns before you trade them.

1. Identify one of the seven patterns—We are going to be talking about seven patterns that you can find in charts. We will give you information to clearly identify each one.
2. Establish a timeframe and a prior move—This has to do with getting the size of the pattern properly proportioned, relative to the rest of the chart. We will be looking at how you identify what the prior move is so that you can use it.
3. Draw an Eighths reference scale—I invented this tool several years ago. The Eighths tool is simply a money management tool that will help you to manage a trade to closure, relative to a pattern once you have identified its prior move.
4. Apply the volatility test—You do not want to trade charts that are too volatile. This will help you avoid those charts.
5. Set your initial stop at the pattern base—Once you have drawn the Eighths scale, you have the point at which the pattern base is marked and that is where you want to set your initial stop.
6. Manage trades by applying trailing stops on the Eighths lines—Once you are in the trade, you will apply trailing stops based on the lines in the Eighths tool.

Pattern Timeframe

The first step is to identify the pattern timeframe. Here is a chart of EBAY. I have marked two Saucer patterns in the chart. You can see that the first Saucer pattern on the left, which occurred in July and August of 2015, was a relatively small pattern spanning about a month and a half in time. We recognize that and it tells us where to go back in the chart to look at the prior timeframe that led up to the pattern. The area marked Timeframe A is the zone that the pattern is operating in psychologically.



Figure 1-1. Saucer Patterns Identify Timeframes for Open Market, Inc.

In timeframe B, the pattern actually formed over about three months. You can see that it is a wider and larger pattern. The point is that someone looking at the chart and detecting the Saucer pattern in timeframe B is going to be looking at the chart going back to July. The dimension of the pattern is something like November to January — through the end of the chart, as opposed to December Through January. The pattern actually goes all the way back to October on a psychological basis. Again, this all has to do with where the pattern is (and its size), relative to the prior area of the chart.

Prior Move Test

Next, we want to look at the prior move test. Look at this conceptual example. On the left, I have a support level at the bottom of the chart and a resistance level at the top. If I were trying to trade a bounce off that support (A), we could use the prior trading range (H) which is likely being observed by the market. It is not the bottom zone of that chart or something larger to the left. It is the zone—from the resistance line to the support line. That is what the market would recognize as the prior move ahead of A.

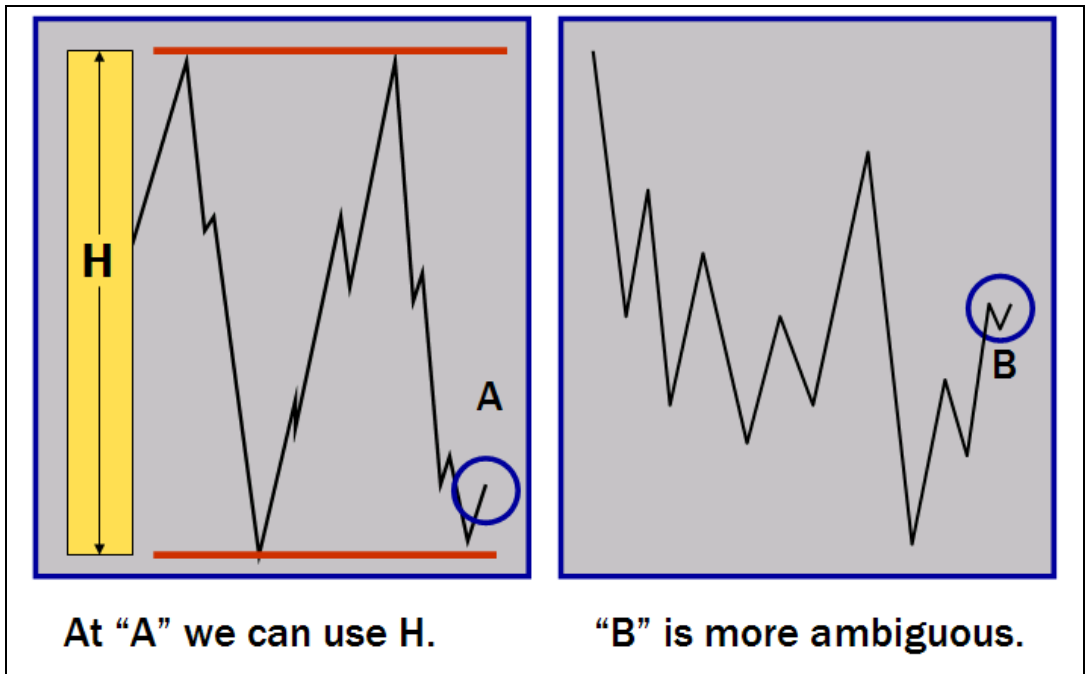


Figure 1-2. Identify Prior Moves by Identifying Clear Moves Ahead of the Signal

In the second chart, we have a lot of things going on ahead of point B. You could argue that there is a prior move in the middle of the chart going down before rising up to B. The point is that B is much more ambiguous. If you have a chart that is moving all over the place and there is not a clear prior move leading up to the pattern, the pattern is probably not going to work the way they usually do. Again, all of this has to do with psychology. You want to pick out a prior move that the market is going to say something like, “This stock, futures contract, or whatever was trading between these two points before this pattern formed.” That is the prior move that relates to the

pattern and that you will use to draw your Eighths tool. If the pattern is not clear, then do not trade that symbol because the pattern is most likely not going to work the way they usually do.

Volatility Test

One of the last things we look at is volatility. The chart on the left is much more volatile than the one on the right. What do I mean by volatile? In any given bar, the odds of a sudden, rapid adverse move in the other direction is high because of how this chart behaves.

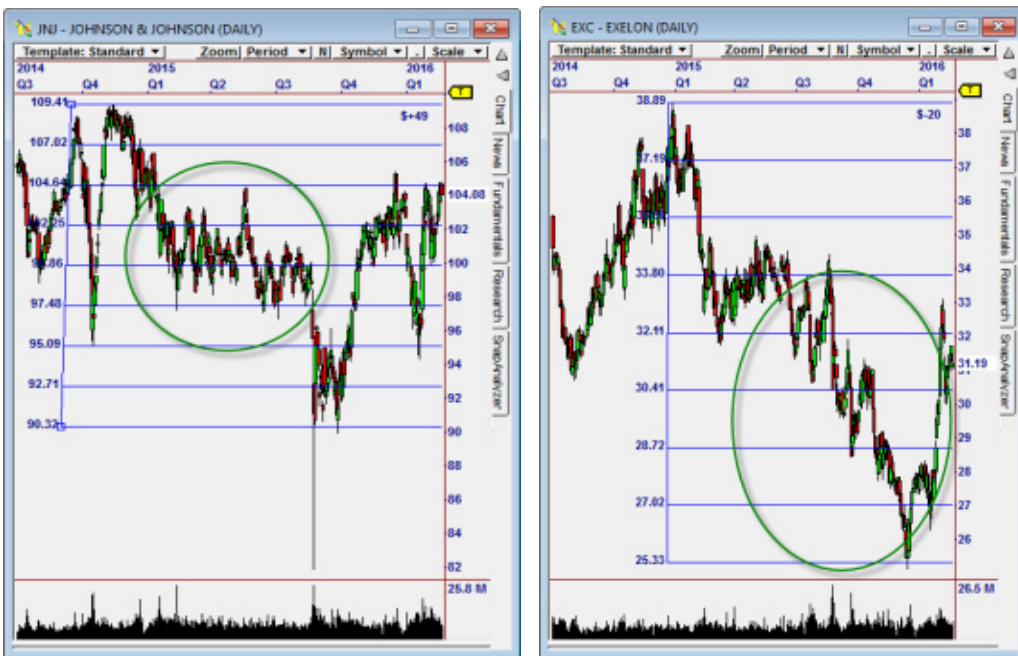


Figure 1-3. Avoid Charts that Cross Two or More Lines Within Five Bars

If you look at Johnson & Johnson from December to January, we had a lot of Gaps. The chart is jumping up and down. It is trending down and you could trade a short trade there on the idea that the chart is going to keep going down. But, it jumps up and down so much that your risk is higher.

Now, compare that to Exelon on the right. You can see that the moves in this chart are actually pretty smooth. In August of 2015, the drop is pretty smooth. The chart just keeps moving down and does not have any gyrations one way or the other. If you have an Eighths scale drawn on the chart as a tool, you can apply the volatility test by asking yourself whether or not there is movement that crosses two of the lines in the Eighths tool.

If you look at the chart on the left, you can see that several bars do cut through two lines in the Eighths tool, indicating that it is a volatile chart and is best avoided.

Reward:Risk Criterion

Another point that you can look at that will help increase profitability is to assess risk and reward. I did not list this in my steps earlier because, honestly, if you get the right pattern identified and you set your stop correctly, this is not that important. Where it helps is when you have several opportunities that you are looking at in a given day, and you want to pick the best one. The best trade is the one with the highest Reward:Risk ratio. What you are going to find in all of the patterns we are going to look at is that you can generally calculate a target for the move from the pattern. In this example, we have a Consolidation. By looking at that Consolidation, I can calculate a target at the point that is marked in the illustration.

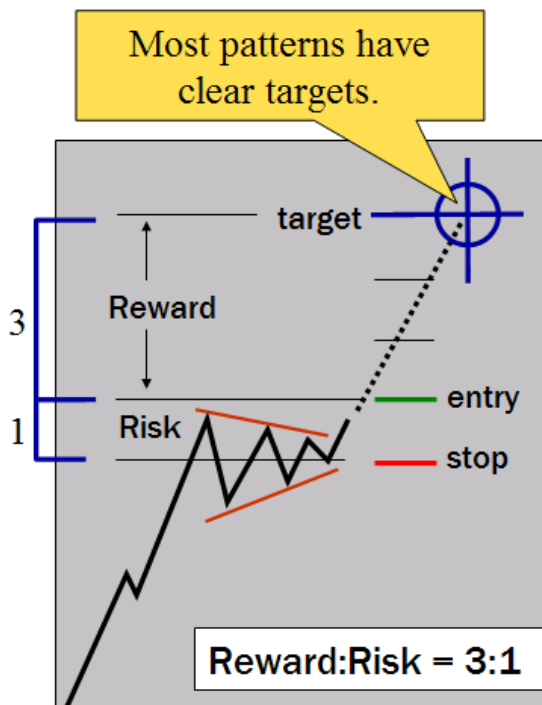


Figure 1-4. Calculate the Target Point to Get the Highest Reward:Risk Ratio

Once I calculate a target, I can set a stop at the point marked Stop on the chart, which is the center of the pattern. You can see that from the entry point to the stop, if I divide that distance into the distance from the entry to the target, I have a 3:1 ratio. So, my potential gain is three times my potential loss from that point in the chart. Now, again,

you can see that if you are only half right and you make three times as much as you lose, you are going to do very well. That is why this Reward:Risk ratio is important. It is not a critical condition for trading these patterns, but it will really help you to only trade the best opportunities.

Eighths Tool

We had the Eighths Tool added to OmniTrader because I was using it so much for trading. The reason it is called an Eighths tool is because it divides a range into eight equal parts. This tool is a very good mechanical way to manage stops in the market. In OmniTrader, click on the Eighths tool icon in the drawing tool bar, and then drag it across the chart. To drag it, click on a relative high point and pull down. As it expands, you will see the price numbers for each line in the Eighths tool.



Figure 1-5. Eighths Tool Plotted as Comb for IBM



Note I have so many examples that it is more convenient for me to use a likeness of the Eighths tool, because I can size it in my presentation to show the examples better. So, I am going to be using this comb as an Eighths tool. It does exactly the same thing as an Eighths tool—divides a range into eight equal parts.

Rule of Eighths

This section covers the Eighths tool and how you use it. You will note right away, if you are a fan of the Fibonacci Retracement technique, that Fibonacci numbers (62%, 50%, 38%) are eighths— $5/8$, $4/8$, and $3/8$. That is partly why this works. Eight is a number used by Gann and others to divide charts into tradeable segments. It just works.

To use the rule of eighths, you are going to follow the lines of the Eighths tool up. The rule is that if you are Long, you wait until you have a close above one of the lines, and then you move your stop up to the prior lower line. For Shorts, you do the opposite.

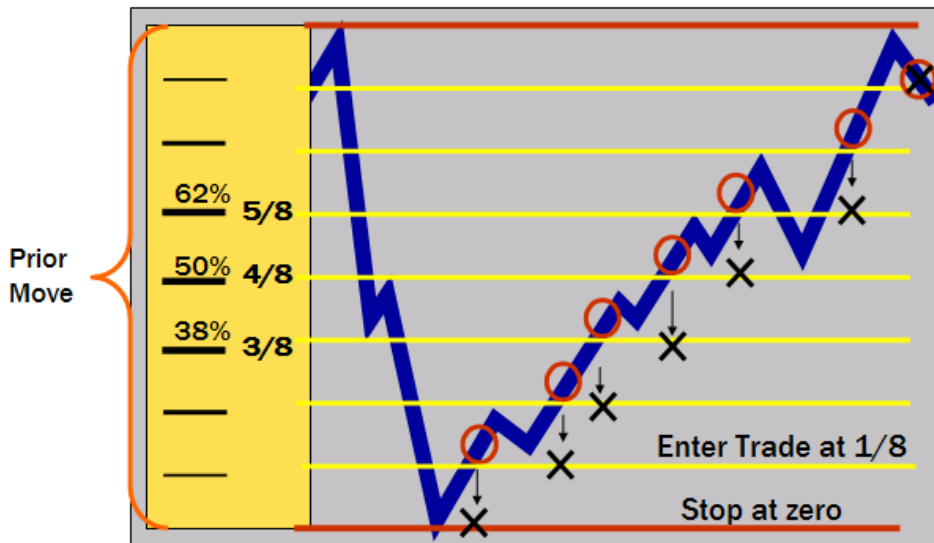


Figure 1-6. Rule of Eighths—Price Must Close Above An Eighths Line for Longs

You can see that each of the red circles represent a closing point above the given line, and I just move my stop up to the next lower line. The stop is always two lines below a close. You keep moving it up. Now, look at the zone between $5/8$ and $4/8$ in about the right third of this illustration. You will often get these retracements where the chart will pull back. If you do not have the Eighths tool, you will probably get stopped out because you are using a trailing stop or you just plain get scared that you are going to give back your profits.

The Eighths tool keeps you in the trade a little bit longer with a mechanical method so that you can profit from the ultimate culmination of the move.

In the example on the right, you would have stayed in the trade because your stop would have been left at the 4/8 line. Of course, then the chart takes off and goes through 5/8, 6/8, 7/8 and eventually exits. Actually, you would not have exited at that last point because we did not close above the last Eighths line.

Now, you may be wondering what happens if you keep going up past that top line. You will put an identical Eighths tool on top of where you were. In OmniTrader, you can actually just move the tool up to the next level. The Eighths tool gives you a rational method for the stop placement. As the chart moves up, you can just move it around and use it wherever you want on the chart.

Definitions, Structures, & Examples

We have covered the tools that will be used to analyze our patterns. Now let's look at each of the seven patterns individually. We will discuss how they are defined, structures that support them and review specific examples in the market. With most examples, we are going to use the Eights tool to manage our trades after confirming them.

Pattern Classifications

Here are the seven patterns that I have found to be most predictive in the market. I actually wrote a little book a number of years ago called *7 Chart Patterns that Consistently Make Money*. When traders read it, they often comment on how simple, yet powerful, these patterns are. The seven patterns we will discuss are as follows:

- Support and Resistance
- Trend Line Break and Reversal
- Saucer Formations
- Fibonacci Retracements
- Price Gaps
- Volume Climax and Trend
- Consolidations

There are a lot of books out there that talk about chart patterns of all kinds—from channels to head and shoulder patterns, double tops, double bottoms, and so on. But, if you carefully look at these other patterns, they are all derivatives of these first seven. A head and shoulder pattern is really a break of the trend line or support level. A double top is a bounce off a resistance level. A double bottom is a bounce off a support level. So, all patterns can be broken down into these seven patterns.

Pattern Structures

We are going to be talking about pattern structures as we go through the seven patterns. Pattern structure tells us when to get in and when to get out of the trade based on the pattern. Each of the patterns that we are going to look at has a defined target. Most of them also have an optimal entry zone defined.

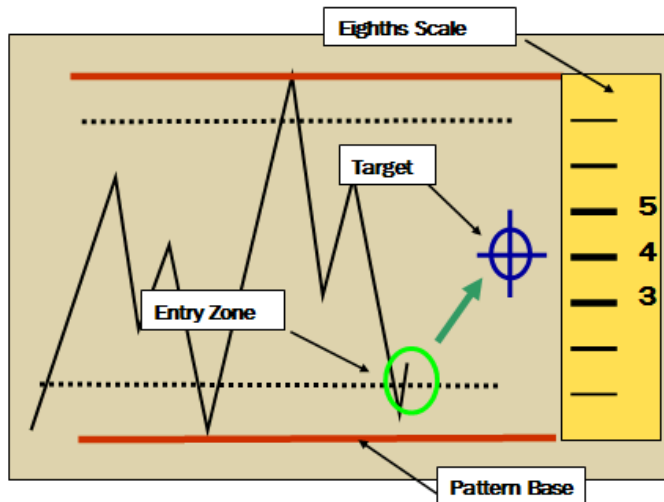


Figure 3-1. Structures Tell Us When to Get In and When to Get Out of a Trade

This chart is a support and resistance level example. I have my Eighths scale drawn and you can see that the ideal entry would be at the 1/8 line, and your target (the amount you are trying to make off the chart) is at the 4/8 line. What if the trade is signaled higher? This gets back to Reward:Risk. If you enter at the 1/8 line and you get out at the 4/8 line, the Reward:Risk is 3:1. You expect to make the move from 1 to 4, and you risk from 1 to 0. So, that is a 3:1 ratio. This is what we are trying to maintain if we can. A pattern structure picture will be defined for each of the seven patterns as we go through these essential elements and how to use them.

Support & Resistance

The first pattern is Support and Resistance. I group these together because they operate the same way in the chart. But, they are very different psychologically. Whenever you touch a support level for the third time, that usually indicates that you are going to bounce off and move to the upside. If you break through a support level that was formed with two prior points, that is usually a very powerful indication of a sell off. Support breaks can create panic and should therefore be shorted.

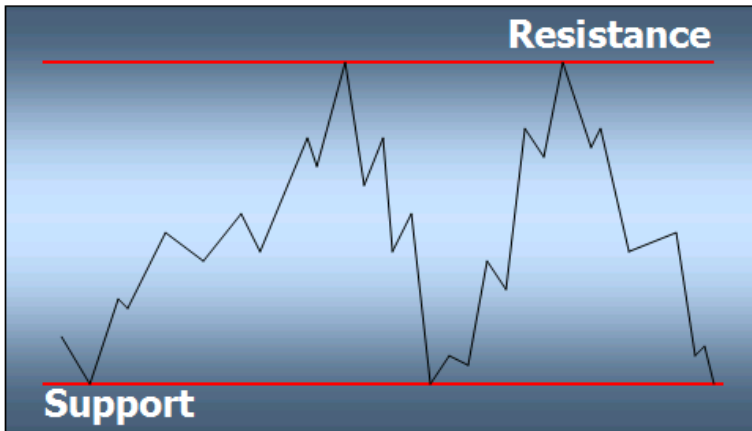


Figure 3-2. Support and Resistance Pattern

Resistance is equally powerful on the short side. If you approach a resistance line and reverse, the market will typically sell off at the reversal, and you will have a nice big drop that can be shorted. Conversely, if you break through a resistance level, as we saw in our first example, then the chart is most likely going to make a strong move in the positive direction. Again, the reason this happens is because the market is watching that line. As price goes through the line, people pile on their buy orders because they think the stock is going higher. It is a self-fulfilling prophecy. All of these patterns work the same way. They are all based on the psychology of the market seeing the pattern and reacting to it, thereby accelerating the pattern formation.

Support & Resistance Structures

Here is our expanded structure diagram for Support and Resistance. The reason we have two Eighths tools is that you can have a bounce or a break. The more powerful of the two is going to be a break. Support breaks do create panic, and you really want to watch for those. But, equally tradeable is a support bounce. Again, you are looking for the third bounce. Typically you will see where the chart bounced off a price level and now it is coming down for the third time. It is that third bounce that is typically the most tradeable. But, you can trade the second bounce as well.

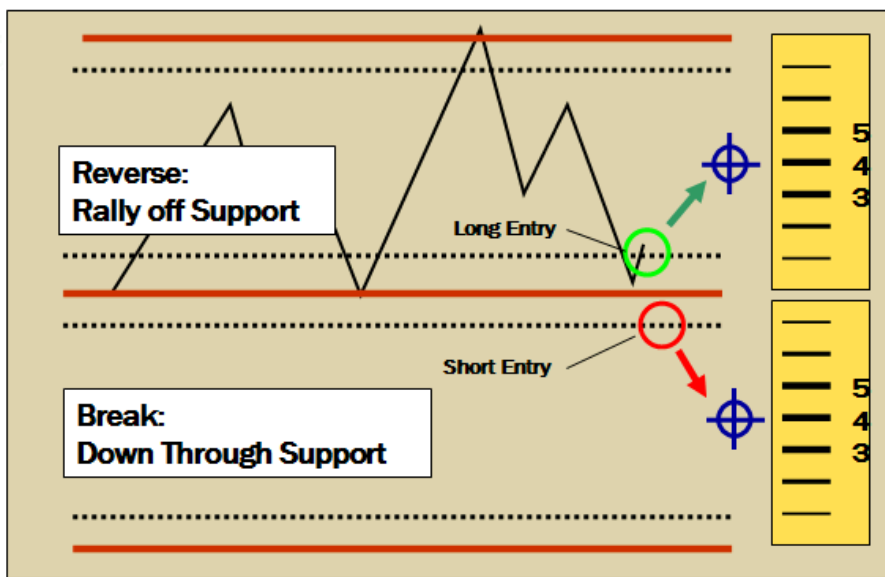


Figure 3-3. Support & Resistance Structure Diagram

Looking at our structure, you can see that the target is drawn at the 50% level on both the upside and the downside, which gives us our 3:1 Reward:Risk from the ideal entry point.

Support & Resistance: Bank of America.

The first Support and Resistance example we will look at is Bank of America (BAC). If I look at the 2015 trading year you can see there is a zone around the \$18 mark that could be penetrated. The market tried to rally Bank of America through it in July 2015 as it pushed right up to that \$18 range and just could not hold above it. When it

backs off for that third time and starts coming down to the \$17 range, you know the market is going down from there with very high odds. We just do not know how much it is going to move. We draw our Eights scale across the prior move. If I look on this chart -- this is very subjective -- I would say that relative to the size of the prior movement, that setting your Eights scale towards the lower support at \$15 would be a good starting range. Remember that the placement of the Eights scale is not critical; However, it is better if you place one that is closer to the dimensionality of the chart.



Figure 3-4. Support and Resistance Pattern Shown on the Chart for Bank of America

Using the scale that I chose, from \$18 to \$15, you can follow the move all the way down from the hypothetical short trade at \$17.40. You can see that I did not close below an Eights scale line and go back up across the prior to the end throughout our Eights scale. In cases like this I like to draw another Eights scale as an extension.

What the Eights tool is doing in this chart is it is keeping me in the trade through several places in the chart where it is bouncing up and down. Again, you have to look at where the price bars close. You have to wait for the close of the day and look at the

closing price. If they close below the line, in this example because we are going short, then I move my stop down to the prior Eighths scale line. If you look at the end of January into February, we did not close just below the \$13 level so that is why we did not get taken out near the cross of the \$13.75. The market did not close through there until we actually broke down and starting moving lower.

The Eighths tool will keep you in trade much better than any other trailing stop. It does this because you are matching the stop values to the dimensionality of the chart.

Support & Resistance: Delta Airlines

The second example is on Delta Airlines (DAL). There is a very clear support level at \$40. I see four bounces. The third and fourth bounce were tradeable. If I had been using the Eighths tool off those points, I would have still been in the trade when it finally took off in February. If you just follow that Eighths scale all the way up you will see that it kept you in though the printing of this e-book.



Figure 3-5. Support and Resistance Pattern Shown on the Chart for Delta Airlines.

Sometimes you will get stopped out just early of a big move as seen in September 2015 this will happen sometimes. You will rarely get the whole move. You will see that generally, the Eighths tool really does keep you in the trades for the longest possible time.

Trend Line Break & Reversal

Pattern number two is equally powerful. In fact, you could just trade this one pattern and make money every day in the market—especially in Real Time. It is the Trend Line Break and Reversal pattern. The breaks are more powerful than the reversals. I believe all of our examples are going to only talk about breaks.

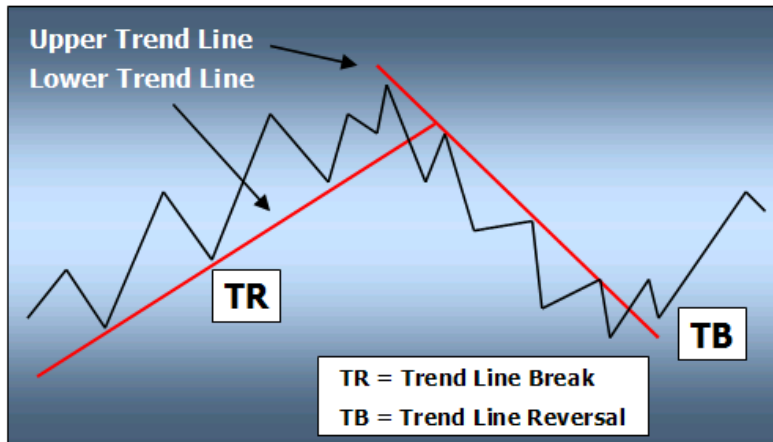


Figure 3-6. Trend Line Break and Reversal Pattern

The concept is the same. A trend line is essentially a sloping support or resistance line. If it is below the chart and the chart is rising, it acts as a support line. If it is above the chart and the chart is falling, it acts as a resistance line. The support trend line is called a lower trend line and resistance is an upper trend line. Bounces are very tradeable but the most tradeable patterns are the breaks because they are the most easily visible in the chart. If you break to the downside, just like with a support level, you can have a panic sell off follow the break.

Trend Line Structures

Here is a picture that shows both a trend line bounce as well as a lower trend line break. You can see that we have two different Eighths scales. The reason for that is if I am trading those bounces on the trend line as the chart moves up, I want to use the relative move to the bounce, which is going to be those short little moves going up. So, that is the size of my Eighths scale. On the break however, I am looking at the size of the pattern being the entire move ahead of the break, which would be the wider scale.

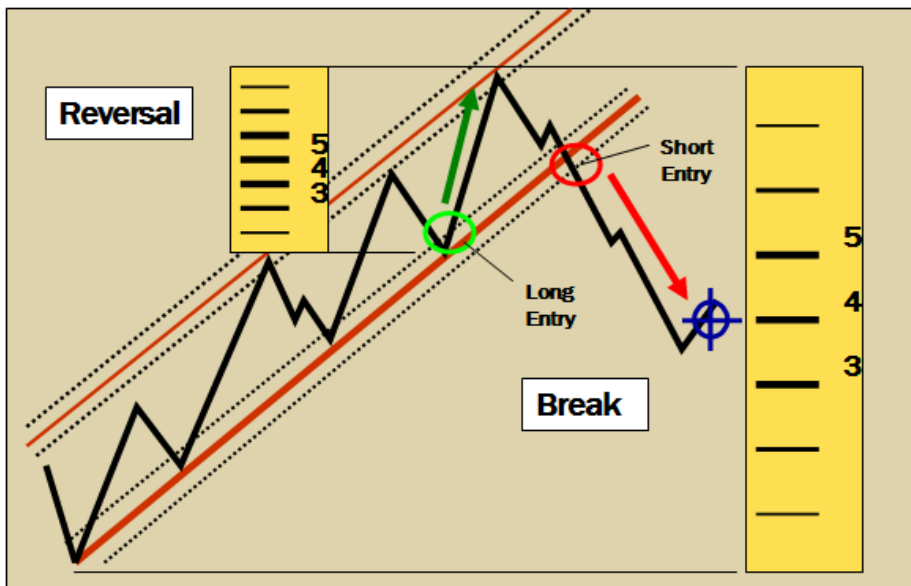


Figure 3-7. Trend Line Structure Diagram

You can see that Reward:Risk for trend line breaks is typically going to be much higher because you can trade much quicker on the break of a line and set a reasonably tight stop behind it at the prior Eighths line. So, getting a 3:1 Reward:Risk is easier with trend lines than most of the patterns.

Trend Line Break: Nordstrom

The first example is a very clear lower trend line break on Nordstrom in mid April of 2015. You can see that the trend line touches about five points in the past. What you want to do is to draw a line up through at least three points—you can use two points but it is always better to have three or more points when you are talking about support and resistance or trend lines. In this example I actually had four or five, depending on how you look at it. You can see the points are pretty close to the line, even at the low in February.



Figure 3-8. Trend Line Break Pattern Shown on the Chart for Nordstrom

We break that line in April and see immediate weakness right after it. That is a strong indication that the chart is going down. Apply the Eighths tool across the prior move and you will see that you are kept in the trade down to \$76. That would have been good for about a 5% profit on that trade. Again, the Eighths tool tends to keep you in for a very long time on daily charts. In this example it was a three month trade and that is great. As I keep reiterating, we are looking for these long trending trades.

Trend Line Break: Realty Income

The trend line break for Realty Income (O) is not quite so obvious, but the trend line still had four touches. We broke it near \$51. You can follow the Eighths tool back up to about 55 and see how we stayed in the trade because we did not close below the second test of \$55.



Figure 3-9. Trend Line Break Pattern Shown on the Chart for Realty Income

This is the second example where we have doubled the Eighths tool. We stacked another Eighths tool on top of the original Eighths tool. That is why there are two of them, sixteen divisions in total. We just kept following the Eighths rule all the way up in the chart until the print of this e-book where we are still currently in trade.

Trend Line Break: Goldman Sachs Group

This chart shows a very clear trend line on Goldman Sachs Group. The lower trend line was violated in mid August. This was an excellent place to go short. Our initial stop would be at the prior Eighths scale line which was \$210.50. It fell all the way down and finally exited at about \$185. That was good for a little more than a 8% move.



Figure 3-10. Trend Line Break Pattern Shown on the Chart for Goldman Sachs Group

Trend Line Break: 3M

The following example shows a trend line break on 3M (MMM) to the upside. You can see that the line does not have to be perfect. It just needs to be approximately hitting highs in the chart going to the left.



Figure 3-11. Trend Line Break Pattern Shown on the Chart for 3M

In this example we had four touches that formed that line. Again, you are looking for patterns that are obvious. If a market is looking at this chart it sees the gradual decline in price on the left and a sudden move up through that trend line at about \$144. Then it breaks resistance that was formed at \$150, which was formed in early October. At either of those points the market gets bullish on the stock. In this example, we are taken out of the trade by the small bar in early December that closed above \$154. We only got about 7% on it and this is going to happen sometimes.

Saucer Patterns

Our third pattern is Saucers. Saucers are very tradeable patterns and have strong psychology. The idea is that you have a smooth transition in price from a downward trend to an upward trend. People looking at the chart can see that curvature. This pattern takes advantage of human nature—when we see something curving up, that is good. You want to get on the bandwagon and trade the move because it is probably going to keep curving up. The smooth transition reinforces the buy decision. More buyers jump on and there you go—it reinforces itself and accelerates.

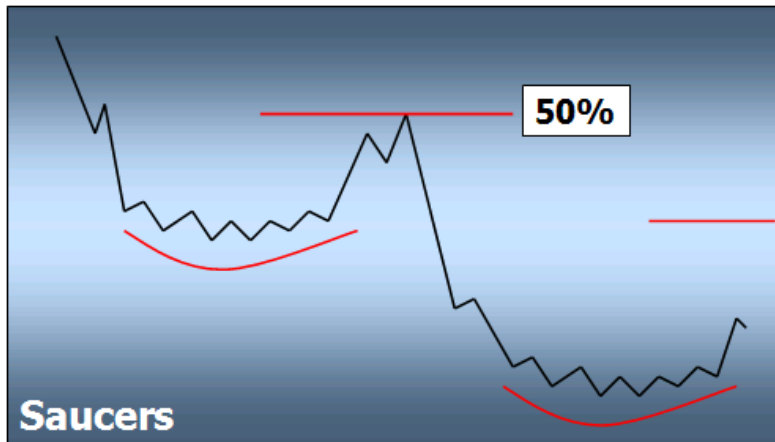


Figure 3-12. Saucer Pattern

Saucer Pattern Structures

Here is the structure for a saucer. It is a little different from the prior structures. It actually has some dimensionality to it. We have several patterns like this that we are going to cover in subsequent sections. In this example look at the center of your saucer and go back to the relative high which formed ahead of the saucer. The target will be at a distance of about 6/10 of that to the right and about half way up. So, draw your Eights scale from the previous high to the low and go to the 50% level. Project this level right of center and this is about where the chart should move. This also gives you a great Reward:Risk calculation.

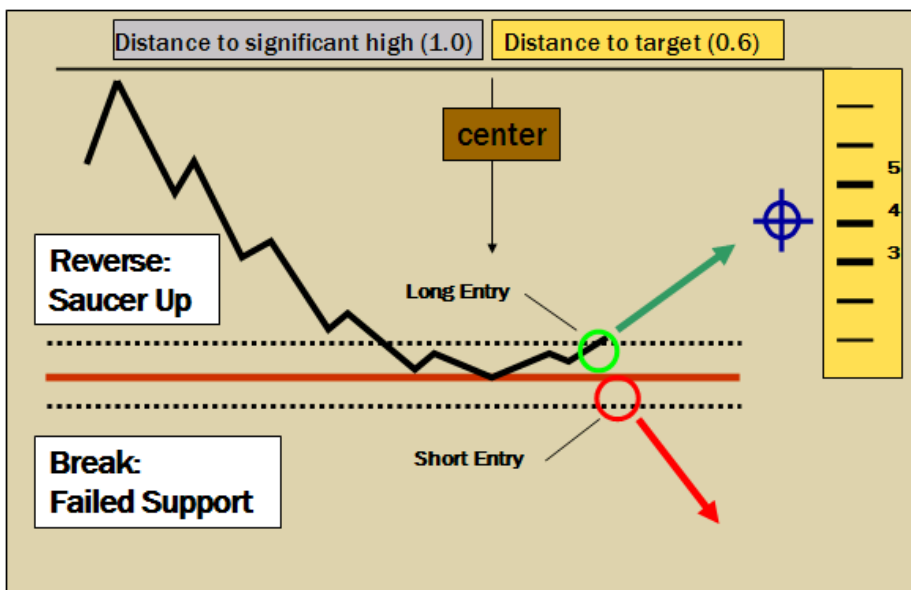


Figure 3-13. Saucer Structure Diagram

If we break through the lows formed by the saucer, that is an equally tradeable pattern. This is a very rare occurrence but does happen sometimes if bad news enters the market. If that occurs the stock is going down.

Saucer Pattern: Parker Hannifin

Saucer patterns are difficult to identify because they do not form smoothly. On the left of this chart going from November to the middle of January, we really did not have a very smooth downtrend. We kind of jumped around in December but you can see in January that the lows being formed were successively higher. We actually gapped up there at about \$93, which tells you that the chart is gaining more momentum. This is not a very well-formed Saucer pattern but it is a pretty good example of the psychology of transitioning from a downtrend to an uptrend.



Figure 3-14. Saucer Pattern Shown on the Chart for Parker Hannifin

Again, the Eighths tool did a great job of keeping us in this trade through all the jumping around between \$90 and \$100. We closed out in early February because the price dropped below our prior Eighths line. This is a great example of the Eighths tool.

Saucer Pattern: Newfield Exploration.

This saucer is better formed than the prior one. You can see that we ran up to about \$41 and started turning down at successively lower highs. We then broke through support at about \$37 on a strong bar. You can see momentum picking up at the end of the saucer. We would have carried it all the way down to about \$25, which is a whopping 32% move in a very short period of time.



Figure 3-15. Saucer Pattern Shown on the Chart for Newfield Exploration

Fibonacci Retracements

Pattern number four is Fibonacci Retracements. We do not know why this happens but it does—markets retrace on even Eighths levels in a chart, either 38%, 50%, or 62% of the prior move. This observation is what led me to start looking at prior moves in the quantification of these patterns. The prior move in a chart has everything to do with the psychology to the right. As you retrace the distance in a prior move by these levels, the market tends to become overbought or oversold and turn around and go the other way.

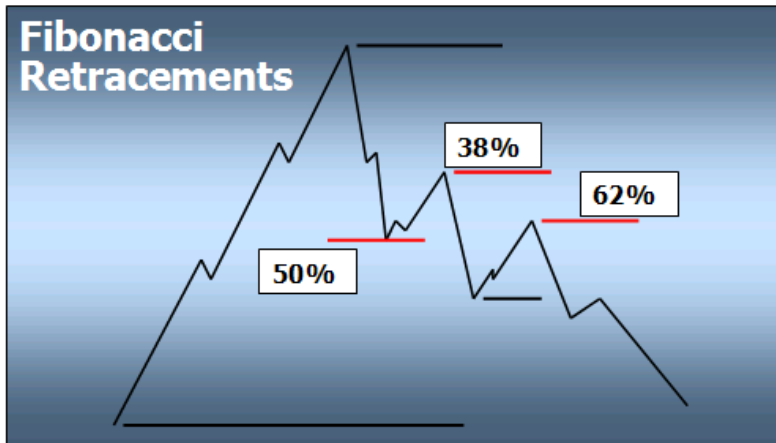


Figure 3-16. Fibonacci Retracement Pattern

Fibonacci Retracement Structures

Here is the structure of the Fibonacci Retracement. You can see that I have the three primary retracement levels drawn: 38%, 50%, and 62%. As you hit one, what you are looking for is a reversal off the level through an Eighths line and that is your indication to get in. The target will typically be the support or resistance level to the left of the entry point.

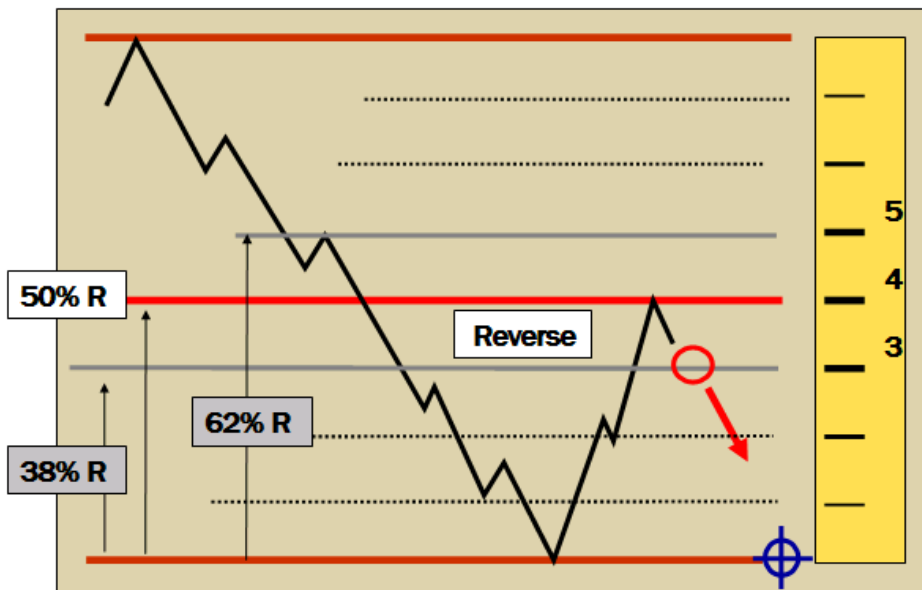


Figure 3-17. Fibonacci Retracement Structure Diagram

38% Retracement: Mosaic

As you see a retracement occur in the market, draw your Eighths scale across the retracement and see if you land on one of these lines and turn around off of it. In Mosaic, you can see that in August we came up to the 38% level, turned around and dropped through an Eighths line after drawing the scale. That would be the place to get in and we stayed in the trade all the way down to about \$37. That is more than a 14% move in about two months off that trade.

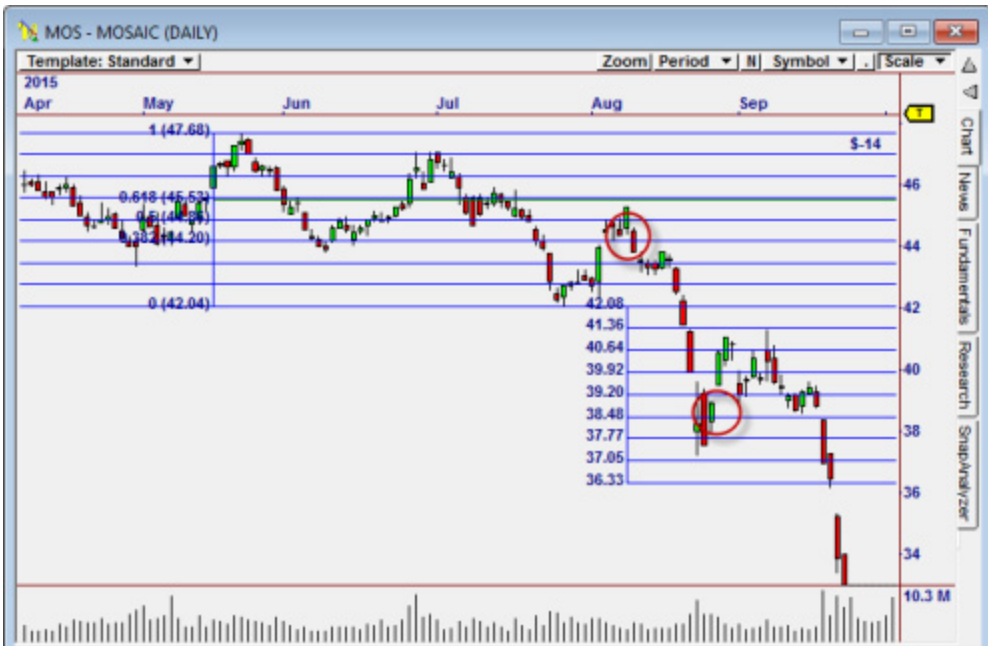


Figure 3-18. 38% Retracement Shown on the Chart for Mosaic

50% Retracement: Waste Management

Here is a 50% Retracement on Waste Management. Going back to August, price started down and moved in to a consolidation at the 50% Retracement level of the prior move. We quickly draw an Eights scale across that range. As price started moving up and exceeds our Eights scale we extend the levels as seen in earlier examples. You can see how well the Eights scale kept us in trade throughout some choppiness and gave us a safe exit and 6% gain.



Figure 3-19. 50% Retracement Shown on the Chart for Waste Management

Price Gaps

Pattern example number five is Gaps. There are three different types of gaps: Breakaway, Measured, and Exhaustion. Breakaway mark the beginning of a move, Measured the center of a move and Exhaustion the end of a move. These patterns offer powerful insight into the psychology of the current market.

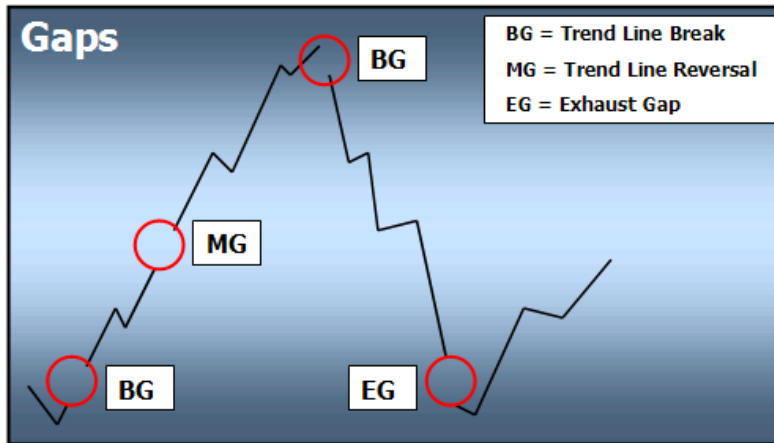


Figure 3-20. Price Gap Pattern

While trading gaps you will want to look at the personality of the chart. Avoid charts that have gaps all over. These types of charts greatly reduce the significance of the gap pattern. Look for charts that have a gap here and there. This will indicate true changes in supply and demand relative to the chart. We are going to look at each of these in turn starting with a Breakaway Gap example.

Price Gap Structures: Breakaway, Measured, & Exhaustion

With a Breakaway Gap, you want to look for a gap off a support or resistance level. As soon as you detect a gap, give it a bar or two after the gap for confirmation that the chart is actually moving from that point. The problem with gaps is that you really cannot calculate a good target easily. One idea would be to use the prior resistance level, in the case of a Breakaway Gap going to the upside. But it is difficult to validate good targets. You want to use your Eighths scale to manage the trade and follow through the change in supply or demand to the upside or downside.

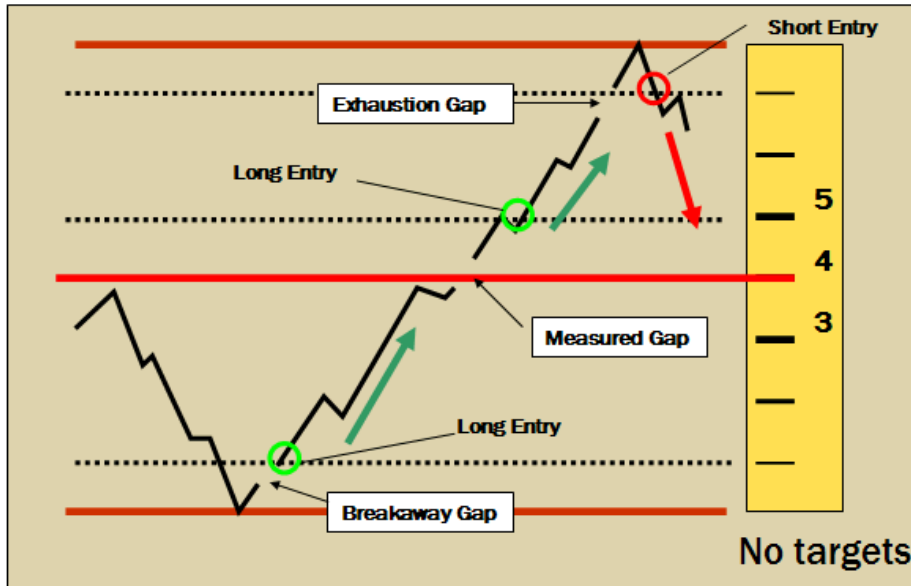


Figure 3-21. Price Gap Structure Diagram

What is amazing about Measured Gaps and the way they got their namesake is that they really do tend to measure the halfway points in moves. You will start to notice how gaps near the center of a chart or gaps that happen away from support or resistance tends to be the midpoint of the move.

Measured Gaps are related to Exhaustion Gaps. With Exhaustion Gaps, what you have is a gap that occurs at the end of a move. The difference between an Exhaustion Gap and a Measured Gap is that you have price turned back into the gap in the case of an Exhaustion Gap. After you have had a move occur for some distance, you want to give it about three or four bars after the move to make sure that you have price continuing in the same direction. In that case, it is a Measured Gap. However, if price turns around and enters the gap then it probably is an Exhaustion Gap. There is no way to tell until you see what happens after the gap. Keep that in mind as you are looking at these patterns. When you see a gap in the middle of a move, well after a recent support or resistance level has formed, you want to wait two or three bars to see what kind of gap it is before you trade it. The entry points for both Measured and Exhaustion Gaps are marked on the Eighth lines. The best gaps are those that are very obvious in the charts.

I cannot stress enough that there is nothing magic about a gap or support level or anything else. What you are looking at is how the market is reacting to the picture. That is what is key. You want only to trade the very obvious gaps.

Breakaway Gaps: Anthem Inc.

In the following example of Anthem Inc., go back through the end of January and just follow those bars as it went along. You can see that the distance from one bar to the next is very consistent. There is one small gap there at the early in February, but generally, those bars are right next to each other until you get to February 16th.



Figure 3-22. Breakaway and Measured Gaps Shown on the Chart for Anthem Inc.

We have almost a dollar gap from the 12th to the 16th this tells you that the chart is probably going up. The Breakaway Gap is labeled a Breakaway Gap because it occurs fairly close to the low point at \$117.

Breakaway Gap: Teradata

Here is a very good example of a Breakaway Gap that occurred on Teradata. Note that the size of the gap is very large compared to other places in the chart.



Figure 3-23. Breakaway Gap Shown on the Chart for Teradata

If we go back to the left of the chart, there are two fairly large gaps that are not marked. The first one occurs at the end of February where we have prices moving in a trading range. It suddenly takes off with a Breakaway Gap to the downside. Then we have another gap a little bit later around May. Move forward to August where we have the gap marked and you can see that it is a true gap with an actual distance across to the next bar. That is your Breakaway Gap. Using the Eighths tool and we could stay in the trade all the way to November and get out at about \$28. That was 13% profit on that trade. This illustrates how well the Eighths tool works in managing trades.

Volume Climax & Trend

Pattern number six is one of my favorites. The Volume Climax is something that I believe I discovered. I had not seen it written up in any Technical Analysis literature until I started using these patterns to trade with several years ago. A Volume Climax pattern is a place where volume increases and then decreases. You notice we have two different kinds of patterns, one called a Volume Climax and the other is called a Volume Trend. The difference is that in a Volume Climax pattern, when you have volume turning around, the price chart also turns around. It can either turn to the downside or to the upside. On a Volume Trend pattern, you have the price continuing to move in the same direction that it was moving before. Volume Trend almost works like a Measured Gap to measure the midpoints of moves in charts.

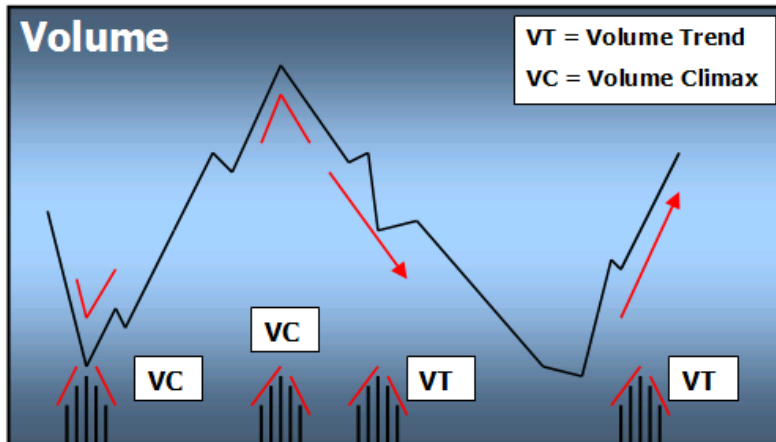


Figure 3-24. Volume Climax and Volume Trend Pattern

These are very powerful chart patterns. They do not form that often, especially not the very obvious ones. But, when they do form they are very tradeable. The psychology behind the Volume Climax and Volume Trend pattern is that you have a large amount of buying and selling going on—a suddenly increased amount that then backs off. What has occurred is that most of the players that wanted to transact around that price have done so and so there is very little resistance to continued direction of movement. Whatever direction the chart is going when the Volume Climax completes, that is typically the direction that it will continue moving.

Volume Climax & Trend Structures

Here is a structure diagram for Volume Climax and Volume Trend. You can see on the Volume Climax patterns that price is reversing. Whether it is going up or down ahead of the volume pattern, price reverses in the other direction and that constitutes a Volume Climax. The illustration is annotated with gray tones around the area of the Volume Climax itself.

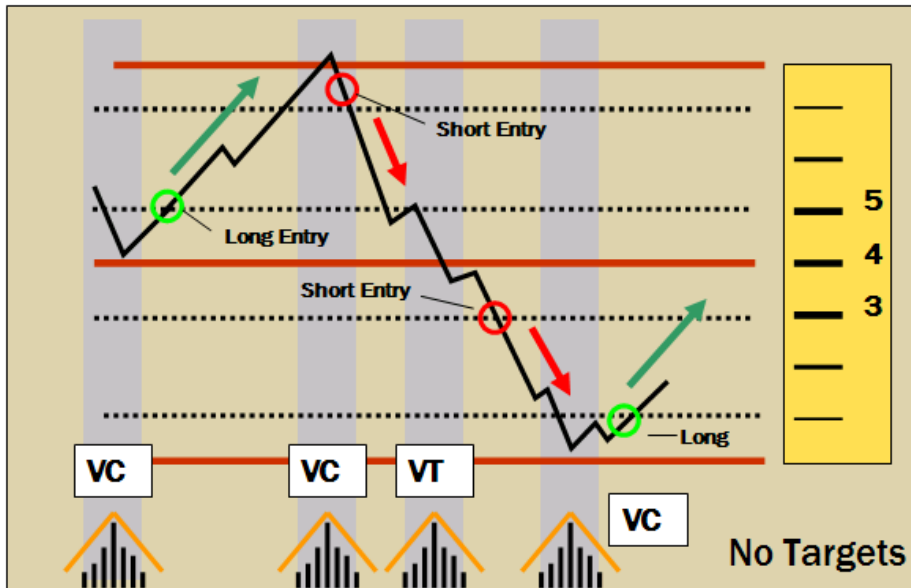


Figure 3-25. Volume Climax and Volume Trend Structure Diagram

At the very center of this illustration, you can see a Volume Trend pattern. We know it is a Volume Trend because price continued going down as volume reduced on the right side of the pattern.

The other thing to note about Volume Climax is that you typically do not have a target, except in the case of Volume Trend. Volume Trend typically marks the mid-point of a move, much the same way as a Measured Gap does. When you have a Volume Climax pattern, you know that it is a good pattern to trade but you do not know how far the move is going to be because there really is nothing relative to measure to.

Volume Trend: ST Jude Medical.

This example of a Volume Trend occurred on ST Jude Medical (STJ). You can see that price is shooting way down and very hard with a lot of volume on that final bar at about \$55. Then, volume begins to reduce on the back side of that spike. It takes two to four bars and is reducing in size, but the price is continuing to the downside so that constitutes a Volume Trend pattern.



Figure 3-26. Volume Climax and Volume Trend Shown on the Chart for First Energy Corp.

As volume is decreasing, price is actually decreasing as well. That indicates that the trend is intact. This particular trade would have lasted from \$53.30 to the exit at \$51, giving us a 4% gain on that trade.

Figure 3-27.

Volume Climax: Facebook.

The next Volume Climax pattern occurred on Facebook (FB). This one came on a big down in the market that only lasted one or two bars. But, we did have a reversal in the chart to the upside with a decrease in volume, which was a good indication that the chart was going up.



Figure 3-28. Volume Climax Shown on the Chart for Facebook

Now, more significantly on this chart, we were actually going through resistance levels at about \$97, which was even better confirmation that this chart was going to rally from that point.

Volume Trend: Procter & Gamble

This chart of Procter & Gamble (PG) is a good example of a Volume Trend pattern confirmed by a Breakaway Gap to the downside through \$78 in August. As the price shot down on heavy volume of selling, the volume started to decrease, but price continued to go down with the decrease.



Figure 3-29. Volume Trend Shown on the Chart for Procter & Gamble.

Consolidations

The last pattern is my favorite and it is the most powerful pattern. Essentially, a Consolidation is a trading range. In a chart, it is a zone between Support and Resistance. It can be sloped Support and Resistance. But, in all cases, you have price moving back and forth between those two support and resistance lines until finally, one of the lines is broken decisively. Consolidations can be symmetrical triangles, pennant patterns, flag patterns, rectangles. Any tight trading range is a Consolidation.

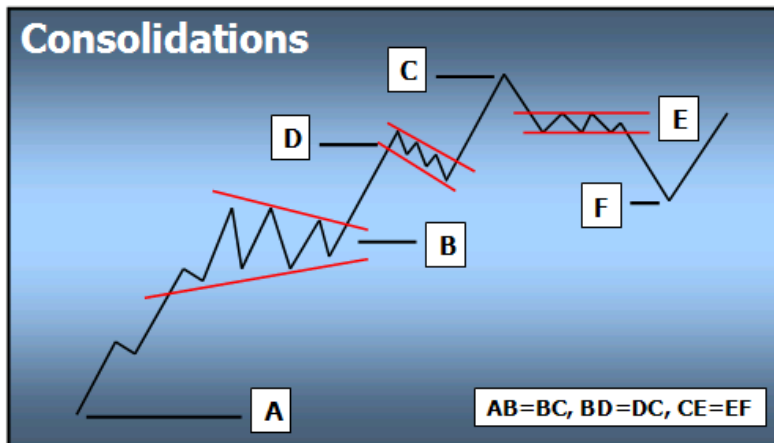


Figure 3-30. Consolidation Pattern

Consolidation Structure

The following diagram illustrates the structure of the ideal Consolidation. There are several things to note about it. First, let's go to the very left of this illustration, where you have a low point. Consolidations always form from a prior move. You cannot just have a trading range in the middle of a chart somewhere and call it a Consolidation. You have to look to the left of the chart and see if you have a prior move from which the Consolidation came. In this example, we formed a low point, we rallied, formed the Consolidation, and finally broke out to the upside where it is labeled Long entry.

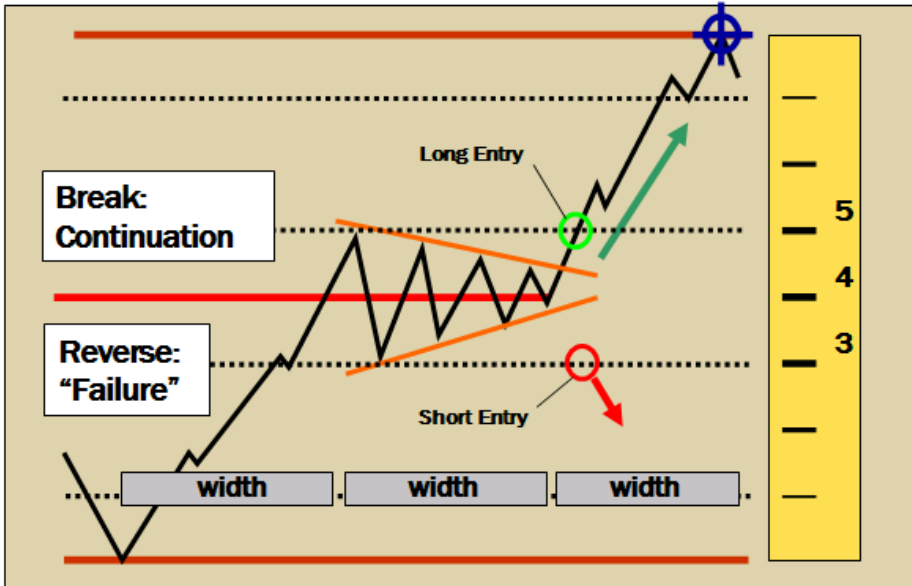


Figure 3-31. Consolidation Structure Diagram

Here is the reason Consolidations are so powerful. Measure the width of that range. What you will find is, if you go to the left of the chart the same width, moving the exact same distance to the left, you will almost always find a low point that same distance away. Now, take the width again and move to the right to find out where the target is. You will also find that Consolidation occurs in the center of the ultimate move. You can also go up twice the distance from that relative low that we found on the left to the center of the Consolidation to get the vertical distance to the target. Those two dimensions very accurately pinpoint where the chart is most likely going to go from that formation of Consolidation.

In the following examples, I think you will see that this really does work and is an amazing, powerful, and trade-able pattern. If a Consolidation fails and goes in the opposite direction, that pattern is equally trade-able. The psychology of the market has suddenly shifted in the wrong direction and something is wrong with the chart. It should be shorted in this example.

Consolidation: Metlife.

In this first example of a Consolidation, you can see that we had a trading range form around the price of \$48. Price moved back about three or four times before breaking through at \$47.



Figure 3-32. Consolidation Shown on the Chart for Metlife

The width of that Consolidation is approximately midway between the high and low from December. You draw your Eighths scale starting with the low point, but instead of moving relative to a prior move in the chart, we move through the Consolidation so that the Eighths scale is actually centered on the Consolidation with the 4/8 line through the middle of the Consolidation. We once again use our Eighths scale extension and you can see our exit would have been near \$43 for a 7.5% gain.

Consolidation: Sherwin-Williams

This example shows a very well-formed Flag Continuation Consolidation on Sherwin-Williams (SHW). To find the *anchor* for this Consolidation, start with the width, which is approximately a month and a half from early September to the beginning of October. Go back in the chart and you will find the low point at \$220, almost precisely. Using the Eights scale I go from high of the range to the low. This allows us to stay in through some pull backs but ultimately was stopped out for a small gain of 3%.



Figure 3-33. Consolidation Shown on the Chart for Sherwin-Williams

Consolidation: Western Union.

The next example shows a Symmetrical Triangle Consolidation on Western Union (WU). Again, same rules—you take the width of the Consolidation and move to the left of the chart to find the high point, then draw the Eighths tool going to the cross of the triangle



Figure 3-34. Consolidation Shown on the Chart for Unocal

Using our Eighths scale extension we find our target at \$16. In this example, the chart ran in to another consolidation pattern later in January, but I think we can all agree that making a 5.8% gain in a half a month is very good. We do not need to make huge moves.

Consolidation: Charles Schwab

In this chart of Charles Schwab (SCHW) we see a nice Broadening Continuation. As we see price break through the lower range of this consolidation pattern we quickly locate the prior high and low for our Eights scale. Price quickly reaches the lower boundaries without closing our position so we once again use the Eights scale extension where we get an exit around \$24 for a fast 23% gain.



Figure 3-35. Consolidation Shown on the Chart for Charles Schwab

Profit-Taking Rule

This section discusses the Profit-Taking Rule. Here we have an broadening bottom pennant triangle formed in Sysco (SYY), which is a average-priced stock and also a fairly volatile stock, as you can see from this chart. As we push up through the top of our consolidation, the price chart crossed 6 of our Eighths tool lines in 4 bars. Then we Sysco started moving back down with in a few bars.. Whenever we cross three Eighths lines in rapidly in just a few sessions, we usually should just go ahead and take profits.



Figure 3-36. Profit-Taking Rule Shown on the Chart for Sysco

Generally speaking, when you see a big sudden move after you take a position, that is a windfall profit, and it is a good idea to go ahead and take that profit.

Summary: Profiting with Chart Patterns

Alright, that brings us to the close of our *Profiting with Chart Patterns* book. I hope the examples have clearly illuminated in your mind what these patterns look like, why they form, what the psychology of the patterns is, and how to trade them using the Eighths tool once you find them.

The 7 Chart Pattern Method has six basic steps. First, we identify the pattern and establish a prior move, which is important for drawing the Eighths scale. Then we draw the Eighths scale and look for extreme volatility, which is indicated by bars within the range where we drew the Eighths scale crossing two or more bars. We set an initial stop at the pattern base, or at the prior Eighths line if we entered the trade higher in the pattern. If we did not enter at the exact pattern base, we would set our initial stop at the prior Eighths line in the chart. Then, we manage the trade to closure by successfully applying trailing stops on the Eighths line. When we get a windfall profit crossing three or more Eighths rule lines on one bar, we will go ahead and take a profit at the open of the following bar.

I can tell you from personal experience in looking at and using these patterns over the last several years, and also publishing about them on our SignalWatch.com website, that these seven patterns are absolutely magical. They will help you find the best possible entry points and manage the trades to closure to generate the highest, most consistent profit at the least risk. The whole point of using these seven patterns and the techniques discussed is to manage risk. The more we can reduce risk on our trades, the more we are going to improve our odds for success and that is what we are all trying to do.

On behalf of Nirvana Systems, I wish you the best of luck in all of your trading endeavors.