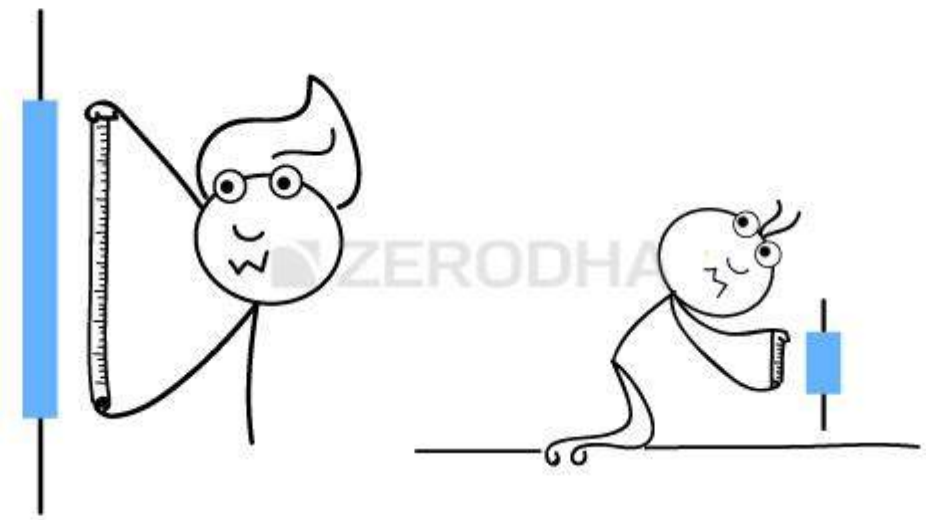
Module 2 — Technical Analysis
Chapter 5

Single Candlestick patterns (Part 1)

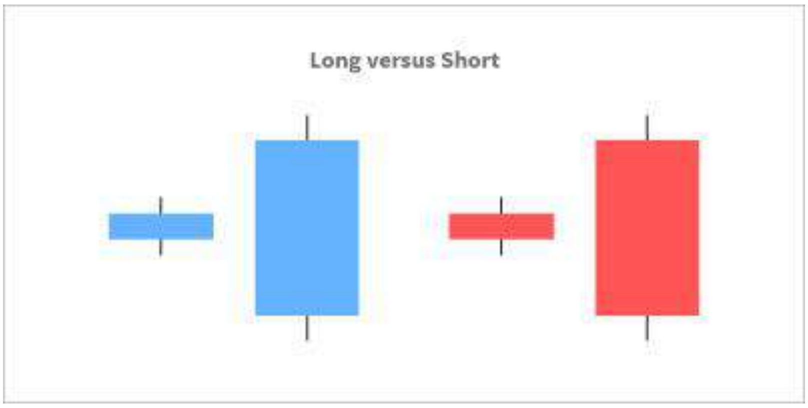


5.1 – Overview

As the name suggests, a single candlestick pattern is formed by just one candle. So as you can imagine, the trading signal is generated based on 1 day's trading action. The trades based on a single candlestick pattern can be extremely profitable provided the pattern has been identified and executed correctly.

One needs to pay some attention to the length of the candle while trading based on candlestick patterns. The length signifies the range for the day. In general, the longer the candle, the more intense is the buying or selling activity. If the candles are short, it can be concluded that the trading action was subdued.

The following picture gives a perspective on the long/short – bullish, and bearish candle.



The trades have to be qualified based on the length of the candle as well. One should avoid trading based on subdued short candles. We will understand this perspective as and when we learn about specific patterns.

5.2 – The Marubozu

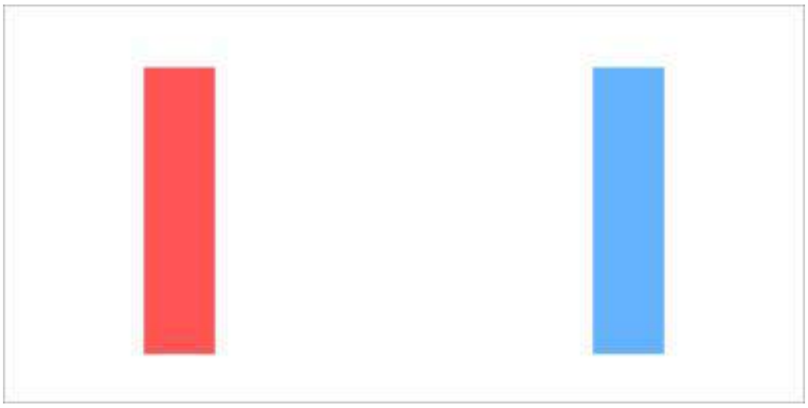
The Marubozu is the first single candlestick pattern that we will understand. The word Marubozu means “Bald” in Japanese. We will understand the context of the terminology soon. There are two types of marubozu – the bullish marubozu and the bearish marubozu.

Before we proceed, let us lay down the three important rules pertaining to candlesticks. We looked at it in the previous chapter; I’ve reproduced the same for quick reference:

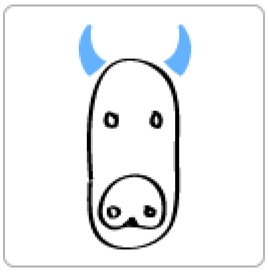
1. Buy strength and sell weakness
2. Be flexible with patterns (verify and quantify)
3. Look for prior trend

Marubozu is probably the only candlestick pattern which violates rule number 3 i.e look for prior trend. A Marubuzo can appear anywhere in the chart irrespective of the prior trend, the trading implication remains the same.

The text book defines Marubozu as a candlestick with no upper and lower shadow (therefore appearing bald). A Marubuzo has just the real body as shown below. However there are exceptions to this. We will look into these exceptions shortly.



The red candle represents the bearish marubuzo and the blue represents the bullish marubuzo.



5.3 – Bullish Marubuzo

The absence of the upper and lower shadow in a bullish marubuzo implies that the low is equal to the open and the high is equal to the close. Hence whenever the, **Open = Low and High = close**, a bullish marubuzo is formed.

A bullish marubuzo indicates that there is so much buying interest in the stock that the market participants were willing to buy the stock at every price point during the day, so much so that the stock closed near its high point for the day. It does not matter what the prior trend has been, the action on the marubuzo day suggests that the sentiment has changed and the stock in now bullish.

The expectation is that with this sudden change in sentiment there is a surge of bullishness and this bullish sentiment will continue over the next few trading sessions. Hence a trader should look at buying opportunities with the occurrence of a bullish marubuzo. The **buy price** should be around the closing price of the marubuzo.

In the chart above (ACC Limited), the encircled candle is a bullish marubuzo. Notice the bullish marubuzo candle does not have a visible upper and a lower shadow. The OHLC data for the candle is: Open = 971.8, High = 1030.2, Low = 970.1, Close = 1028.4

Please notice, as per the text book definition of a marubozu **Open = Low, and High = Close**. However in reality there is a minor variation to this definition. The variation in price is not much when measured in percentage terms, for example the variation between high and close is 1.8 which as a percentage of high is just 0.17%. **This is where the 2nd rule applies – Be flexible, Quantify and Verify**.

With this occurrence of a marubuzo the expectation has turned bullish and hence one would be a buyer of the stock. The trade setup for this would be as follows:

Buy Price = Around 1028.4 and Stoploss = 970.0

As it is evident, candlestick patterns do not give us a target. However we will address the issue of setting targets at a later stage in this module.

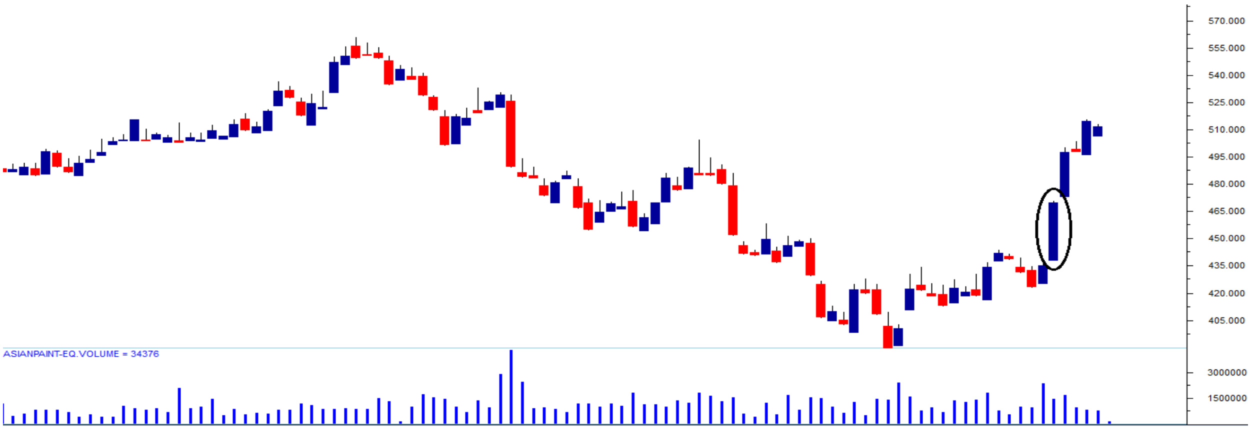
Having decided to buy the stock, when do we actually buy the stock? The answer to this depends on your risk appetite. Let us assume there are two types of trader with different risk profiles – the risk taker and the risk averse.

The risk taker would buy the stock on the same day as the marubozu is being formed. However the trader needs to validate the occurrence of a marubozu. Validating is quite simple. Indian markets close at 3:30 PM. So, around 3:20 PM one needs to check if the **current market price (CMP) is approximately equal to the high price for the day, and the opening price of the day is approximately equal to the low price the day**. If this condition is satisfied, then you know the day is forming a marubozu and therefore you can buy the stock around the closing price. It is also very important to note that the risk taker is buying on a bullish/blue candle day, thereby following rule 1 i.e buy on strength and sell on weakness.

The risk averse trader would buy the stock on the next day i.e the day after the pattern has been formed. However before buying the trader needs to ensure that the day is a bullish day to comply with the rule number 1. This means the risk averse buyer can buy the stock only around the close of the day. The disadvantage of buying the next day is that the buy price is way above the suggested buy price, and therefore the stoploss is quite deep. However as a trade off the risk averse trader is buying only after doubly confirming that the bullishness is indeed established.

As per the ACC's chart above, both the risk taker and the risk averse would have been profitable in their trades.

Here is another example (Asian Paints Ltd) where both the risk taker, and the risk averse trader would have been profitable.



Here is an example where the risk averse trader would have benefited :

Notice in the chart above, a bullish marubuzo has been encircled. The risk taker would have initiated a trade to buy the stock on the same day around the close, only to book a loss on the next day. However the risk averse would have avoided buying the stock entirely because the next day happened to be a red candle day. Going by the rule, we should buy only on a blue candle day and sell on a red candle day.

5.4 – The Stoploss on Bullish Marubuzo

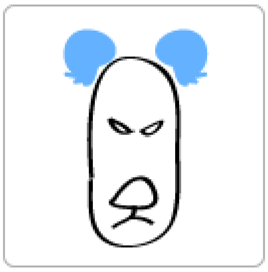
What if after buying, the market reverses its direction and the trade goes wrong? Like I had mentioned earlier, candlestick patterns comes with a inbuilt risk management mechanism. In case of a bullish marubuzo, the low of the stock acts as a stoploss. So after you initiate a buy trade , in case the markets moves in the opposite direction, you should exit the stock if price breaches the low of the marubuzo.

Here is an example where the bullish marubuzo qualified as a buy for both the risk averse and the risk taker. The OHLC is : O = 960.2, H = 988.6, L = 959.85, C = 988.5.

But the pattern eventually failed and one would have booked a loss. The stoploss for this trade would be the low of marubuzo, i.e 959.85.

Booking a loss is a part of the game. Even a seasoned trader goes through this. However the best part of following the candlestick is that the losses are not allowed to run indefinitely. There is a clear agenda as to what price one has to get out of a trade provided the trade starts to move in the opposite direction. In this particular case booking a loss would have been the most prudent thing to do as the stock continued to go down.

Of course there could be instances where the stoploss gets triggered and you pull out of the trade. But the stock could reverse direction and start going up after you pulled out of the trade. But unfortunately this is also a part of the game and one cannot really help it. No matter what happens, the trader should stick to the rules and not find excuses to deviate from it.



5.3 – Bearish Marubuzo

Bearish Marubuzo indicates extreme bearishness. Here the open is equal to the high and close the is equal to low. Open = High, and Close = Low.

A bearish marubuzo indicates that there is so much selling pressure in the stock that the market participants actually sold at every price point during the day, so much so that the stock closed near its low point of the day. It does not matter what the prior trend has been, the action on the marubuzo day suggests that the sentiment has changed and the stock is now bearish.

The expectation is that this sudden change in sentiment will be carried forward over the next few trading sessions and hence one should look at shorting opportunities. The sell price should be around the closing price of the marubuzo.

In the chart above (BPCL Limited), the encircled candle indicates the presence of a bearish marubuzo. Notice the candle does not have an upper and a lower shadow. The OHLC data for the candle is as follows:

Open = 355.4, High = 356.0, Low = 341, Close = 341.7

As we had discussed earlier a minor variation between the OHLC figures leading to small upper and lower shadows is ok as long as it is within a reasonable limit.

The trade on the bearish marubuzo would be to short BPCL approximately at 341.7 with a stoploss at the high point of the candle. In this case the stoploss price is 356.0. Of course at this stage we still haven't dealt with setting targets, and we will figure that out much later in this module.

Do remember this, once a trade is initiated you should hold on to it until either the target is hit or the stoploss is breached. If you attempt to do something else before any one of these event triggers, then most likely your trade could go bust. So staying on course of the plan is extremely crucial.

Trade can be initiated based on the risk appetite of the person. The risk taker can initiate a short trade on the same day around the closing. Of course, he has to make sure that the candle is forming a bearish marubuzo. To do this at 3:20PM the trader has to confirm if the open is approximately equal to the high and the current market price is equal to the low price. If the condition is validated, then it is a bearish marubuzo and hence a short position can be initiated.

If the trader is risk averse, he can wait till the next day's closing. The short trade will go through only by 3:20PM next day after ensuring that the day is a red candle day. This is also to ensure that we comply with 1st rule – Buy strength, and Sell weakness.

In the BPCL chart above, both risk taker and risk averse would have been profitable.

Here is another chart, Cipla Limited, where the bearish marubuzo has been profitable for both risk taker, and a risk averse trader. Remember these are short term trades and one needs to be quick in booking profits.

Here is a chart which show bearish marubuzo pattern which would have not worked out for the risk taker but a risk averse trader would have entirely avoided initiating the trade, thanks to rule 1.

5.4 – The trade trap

Earlier in this chapter we did discuss about the length of the candle. One should avoid trading during an extremely small (below 1% range) or long candle (above 10% range).

A small candle indicates subdued trading activity and hence it would be difficult to identify the direction of the trade. On the other hand a long candle indicates extreme activity. The problem with lengthy candles would be the placement of stoploss. The stoploss would be deep and in case the trade goes wrong the penalty to pay would be painful. For this reason, one should avoid trading on candles that are either too short or too long.

Key takeaways from this chapter

1. Remember the rules based on which candlesticks work
2. Marubuzo is the only pattern which violates rule number 3 i.e Look for prior trend
3. A bullish marubuzo indicates bullishness
    1. Buy around the closing price of a bullish marubozu
    2. Keep the low of the marubuzo as the stoploss
4. A bearish marubuzo indicates bearishness
    1. Sell around the closing price of a bearish marubozu
    2. Keep the high of the marubuzo as the stoploss
5. An aggressive trader can place the trade on the same day as the pattern forms
6. Risk averse traders can place the trade on the next day after ensuring that it obeys rule number 1 i.e Buy strength, and Sell weakness
7. An abnormal candle lengths should not be traded
    1. Short candle indicates subdued activity
    2. Long candle indicates extreme activity, however placing stoploss becomes an issue.