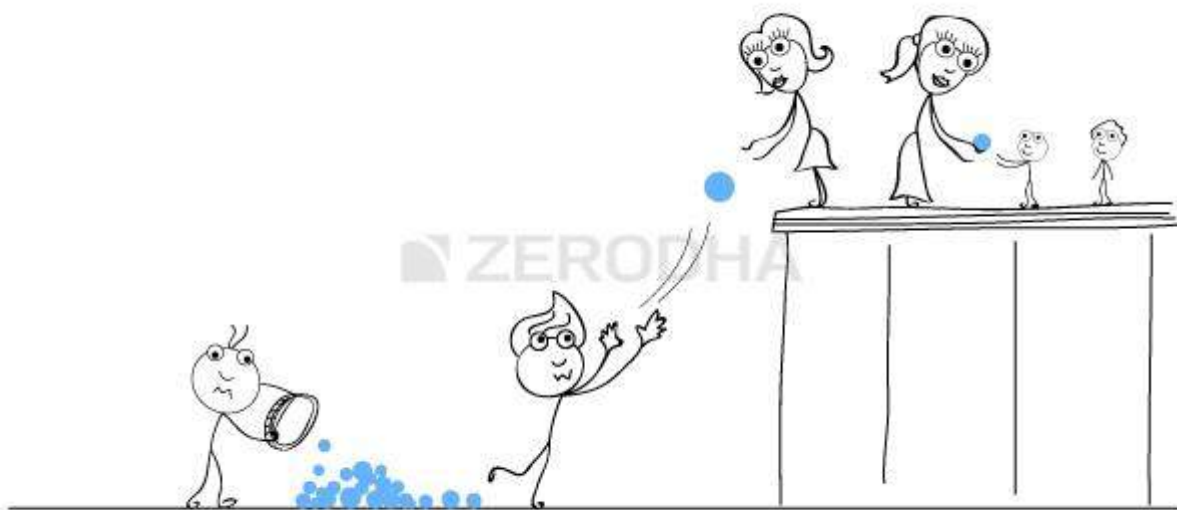


## The Dow Theory (Part 1)

The Dow Theory has always been a very integral part of technical analysis. The Dow Theory was used extensively even before the western world discovered candlesticks. In fact even today Dow Theory concepts are being used. In fact traders blend the best practices from Candlesticks and Dow Theory.

The Dow Theory was introduced to the world by Charles H. Dow, who also founded the Dow-Jones financial news service (Wall Street Journal). During his time, he wrote a series of articles starting from 1900s which in the later years was referred to as 'The Dow Theory'. Much credit goes to William P Hamilton, who compiled these articles with relevant examples over a period of 27 years. Much has changed since the time of Charles Dow, and hence there are supporters and critics of the Dow Theory.



### 17.1 – The Dow Theory Principles

The Dow Theory is built on a few beliefs. These are called the Dow Theory tenets. These tenets were developed by Charles H Dow over the years of his observation on the markets. There are 9 tenets that are considered as the guiding force behind the Dow Theory. They are as follows:

Sl No	Tenet	What does it mean?
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01	Indices discounts everything	The stock market indices discount everything which is known & unknown in the public domain. If a sudden and unexpected event occurs, the stock market indices quickly recalibrates itself to reflect the accurate value
02	Overall there are 3 broad market trends	Primary Trend, Secondary Trend, and Minor Trends
03	The Primary Trend	This is the major trend of the market that lasts from a year to several years. It indicates the broader multiyear direction of the market. While the long term investor is interested in the primary trend, an active trader is interested in all trends. The primary trend could be a primary uptrend or a primary down trend
04	The Secondary Trend	These are corrections to the primary trend. Think of this as a minor counter reaction to the larger movement in the market. Example – corrections in the bull market, rallies & recoveries in the bear market. The counter trend can last anywhere between a few weeks to several months
05	Minor Trends/Daily fluctuations	These are daily fluctuations in the market, some traders prefer to call them market noise
06	All Indices must confirm with each other	We cannot confirm a trend based on just one index. For example the market is said to be bullish only if CNX Nifty, CNX Nifty Midcap, CNX Nifty Smallcap etc all move in the same upward direction. It would not be possible to classify markets as bullish, just by the action of CNX Nifty alone
07	Volumes must confirm	The volumes must confirm along with price. The trend should be supported by volume. In an uptrend the volume must increase as the price rises and should reduce as the price falls. In a downtrend, volume must increase when the price falls and decrease when the price rises. You could refer chapter 12 for more details on volume

08	Sideway markets can substitute secondary markets	Markets may remain sideways (trading between a range) for an extended period. Example:- Reliance Industries between 2010 and 2013 was trading between 860 and 990. The sideways markets can be a substitute for a secondary trend
09	The closing price is the most sacred	Between the open, high, low and close prices, the close is the most important price level as it represents the final evaluation of the stock during the day

## 17.2 – The different phases of Market



Dow Theory suggests the markets are made up of three distinct phases, which are self repeating. These are called the Accumulation phase, the Mark up phase, and the Distribution phase.

The Accumulation phase usually occurs right after a steep sell off in the market. The steep sell off in the markets would have frustrated many market participants, losing hope of any sort of uptrend in prices. The stock prices would have plummeted to rock bottom valuations, but the buyers would still be hesitant of buying fearing there could be another sell off. Hence the stock price languishes at low levels. This is when the 'Smart Money' enters the market.

Smart money is usually the institutional investors who invest from a long term perspective. They invariably seek value investments which is available after a steep sell off. Institutional investors start to acquire shares regularly, in large quantities over an extended period of time. This is what makes up an accumulation phase. This also means that the sellers who are trying to sell during the accumulation phase will easily find buyers, and therefore the prices do not decline further. Hence invariably the accumulation phase marks the bottom of the markets. More often

than not, this is how the support levels are created. Accumulation phase can last up to several months.

Once the institutional investors (smart money) absorb all the available stocks, short term traders sense the occurrence of a support. This usually coincides with improved business sentiment. These factors tend to take the stock price higher. This is called the mark up phase. During the Mark up phase, the stock price rallies quickly and sharply. The most important feature of the mark up phase is the speed. Because the rally is quick, the public at large is left out of the rally. New investors are mesmerized by the return and everyone from the analysts to the public see higher levels ahead.

Finally when the stock price reaches new highs (52 week high, all time high) everyone around would be talking about the stock market. The news reports turn optimistic, business environment suddenly appears vibrant, and everyone one (public) wants to invest in the markets. The public by and large, wants to get involved in the markets as there is a positive sentiment. This is when the distribution phase occurs.

The judicious investors (smart investors) who got in early (during the accumulation phase) will start offloading their shares slowly. The public will absorb all the volumes off loaded by the institutional investors (smart money) thereby giving them the well needed price support. The distribution phase has similar price properties as that of the accumulation phase. In the distribution phase, whenever the prices attempt to go higher, the smart money off loads their holdings. Over a period of time this action repeats several times and thus the resistance level is created.

Finally when the institutional investors (smart money) completely sell off their holdings, there would be no further support for prices, and hence what follows after the distribution phase is a complete sell off in the markets, also known as the mark down of prices. The selloff in the market leaves the public in an utter state of frustration.

Completing the circle, what follows the selloff phase is a fresh round of accumulation phase, and the whole cycle repeats again. It is believed that that entire cycle from accumulation phase to the selloff spans over a few years.

It is important to note that no two market cycles are the same. For example in the Indian context the bull market of 2006 – 07 is way different from the bull market of 2013-14. Sometimes the market moves from the accumulation to the distribution phase over a prolonged multi-year period. On the other hand, the same move from the accumulation to the distribution can happen over a few months. The market participant needs to tune himself to the idea of evaluating markets in the context of different phases, as this sets a stage for developing a view on the market.

## 17.3 – The Dow Patterns

Like in candlesticks, there are few important patterns in Dow Theory as well. The trader can use these patterns to identify trading opportunities. Some of the patterns that we will study are:

1. The Double bottom & Double top formation
2. The Triple Bottom & Triple Top
3. Range formation, and
4. Flag formation

The support and resistance is also a core concept for the Dow Theory, but because of its importance (in terms of placing targets and stop loss) we have discussed it much earlier a chapter dedicated to it.

## 17.4 – The Double bottom and top formation

A double top & double bottom is considered a reversal pattern. A double bottom occurs when the price of a stock hits a particular low price level and rebounds back with a quick recovery. Following the price recovery the stock trades at a higher level (relative to the low price) for at least 2 weeks (well spaced in time). After which the stock attempts to hit back to the low price previously made. If the stock holds up once again and rebounds, then a double bottom is formed.

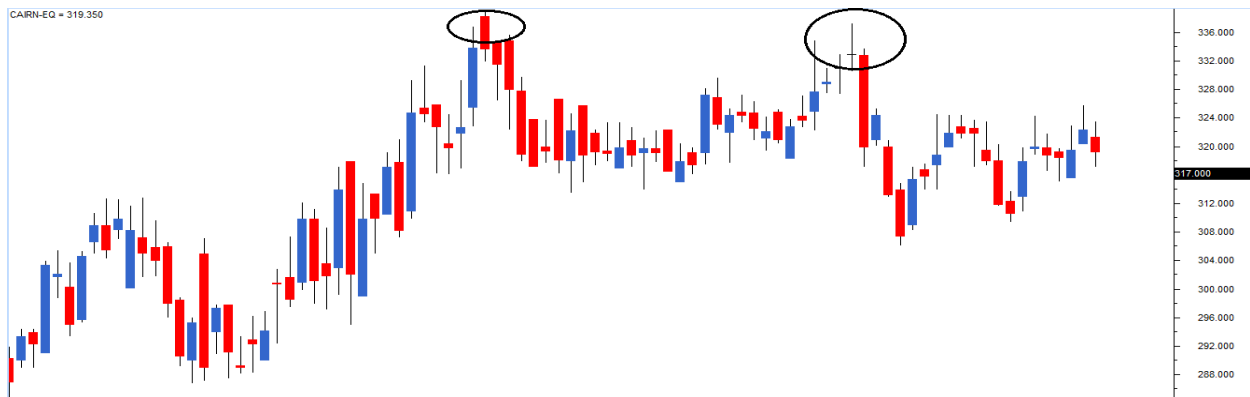
A double bottom formation is considered bullish, and hence one should look at buying opportunities. Here is a chart that shows a double bottom formation in Cipla Limited:



Notice the time interval between the two bottom formations. It is evident that the price level was well spaced in time.

Likewise in a double top formation, the stock attempts to hit the same high price twice but eventually sells off. Of course the time gap between the two attempts of crossing the high should at least be 2 weeks. In the chart below (Cairn India Ltd), we can notice the double top at 336 levels. On close observation you will notice the first

top was around Rs.336, and the second top was around Rs.332. With some amount of flexibility a small difference such as this should be considered alright.



From my own trading experience, I find both double tops and double bottoms very useful while trading. I always look for opportunities where the double formation coincides with a recognizable candlesticks formation.

For instance, imagine a situation where in the double top formation, the 2<sup>nd</sup> top forms a bearish pattern such as shooting star. This means, both from the Dow Theory and candlestick perspective there is consensus to sell; hence the conviction to take the trade is higher.

## 17.5 – The triple top and bottom

As you may have guessed, a triple formation is similar to a double formation, except that the price level is tested thrice as opposed twice in a double bottom. The interpretation of the triple formation is similar to the double formation.

As a rule of thumb the more number of times the price tests, and reacts to a certain price level, the more sacred the price level is considered. Therefore by virtue of this, the triple formation is considered more powerful than the double formation.

The following chart shows a triple top formation for DLF Limited. Notice the sharp sell off after testing the price level for the 3<sup>rd</sup> time, thus completing the triple top.



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### **Key takeaways from this chapter**

1. Dow Theory was used in the western world even before candlesticks were formally introduced
2. Dow Theory works on 9 basic tenets
3. Market can be viewed in 3 basic phases – accumulation, mark up, and distribution phase
4. The accumulation phase is when the institutional investor (smart money) enters the market, mark up phase is when traders make an entry, and the final distribution phase is when the larger public enter the market
5. What follows the distribution phase is the mark down phase, following which the accumulation phase will complete the circle
6. The Dow theory has a few basic patterns, which are best used in conjunction with candlesticks
7. The double and triple formations are reversal patterns, which are quite effective
8. The interpretation of double and triple formations are the same

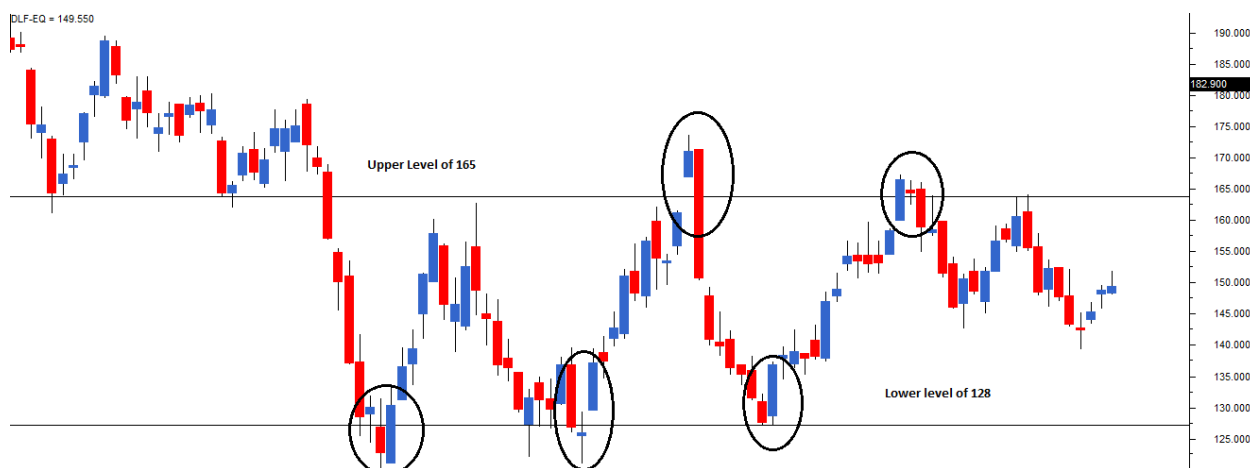
## The Dow Theory (Part 2)

### 18.1 – Trading Range

The concept of range is a natural extension to the double and triple formation. In a range, the stock attempts to hit the same upper and lower price level multiple times for an extended period of time. This is also referred to as the sideways market. As the price oscillates in a narrow range without forming a particular trend, it is called a sideways market or sideways drift. So, when both the buyers and sellers are not confident about the market direction, the price would typically move in a range, and hence typical long term investors would find the markets a bit frustrating during this period.

However the range provides multiple opportunities to trade both ways (long and short) with reasonable accuracy for a short term trader. The upside is capped by resistance and the downside by the support. Thus it is known as a range bound market or a trading market as there are enough opportunities for both the buyers and the sellers.

In the chart below you can see the stock's behaviour in a typical range:



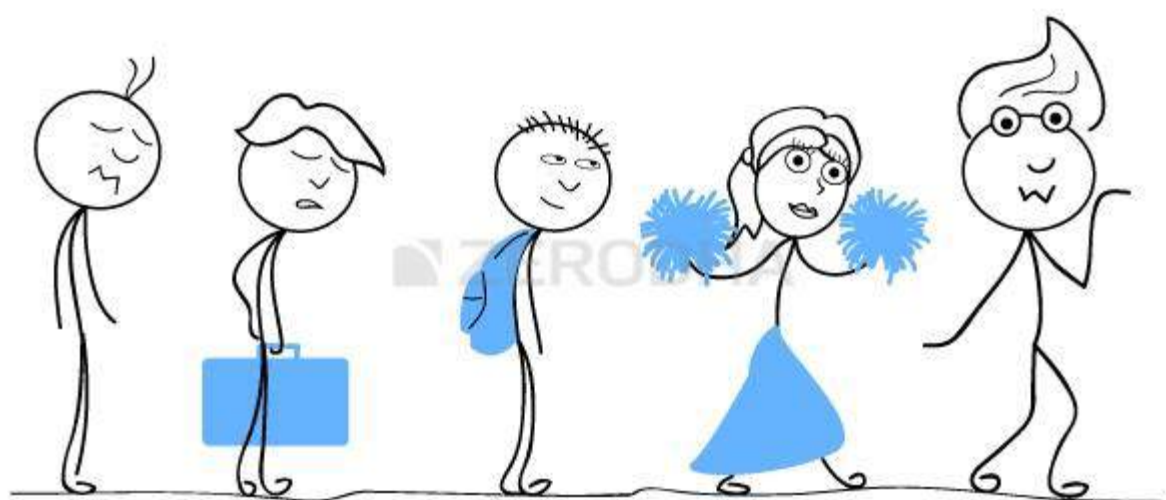
As you can see the stock hit the same upper (Rs.165) and the same lower (Rs.128) level multiple times, and continued to trade within the range. The area between the upper and lower level is called the width of the range. One of the easy trades to initiate in such a scenario would be to buy near the lower level, and sell near the higher level. In fact the trade can be both ways with the trader opting to short at the higher level and buying it back at the lower level.



In fact the chart above is a classic example of blending Dow Theory with candlestick patterns. Starting from left, notice the encircled candles:

1. The bullish engulfing pattern is suggesting a long
2. Morning doji star suggesting a long
3. Bearish engulfing pattern is suggesting a short
4. Bearish harami pattern is suggesting a short

The short term trader should not miss out such trades, as these are easy to identify trading opportunities with high probability of being profitable. The duration of the range can be anywhere between a few weeks to a couple of years. The longer the duration of the range the longer is the width of the range.



## 18.2 – The range breakout

Stocks do breakout of the range after being in the range for a long time. Before we explore this, it is interesting to understand why stocks trade in the range in the first place.

Stocks can trade in the range for two reasons:

1. When there are no meaningful fundamental triggers that can move the stock – These triggers are usually quarterly/ annual result announcement, new products launches, new geographic expansions, change in management, joint ventures, mergers, acquisitions etc. When there is nothing exciting or nothing bad about the company the stock tends to trade in a trading range. The range under these circumstances could be quite long lasting until a meaningful trigger occurs
2. In anticipation of a big announcement – When market anticipates a big corporate announcement the stock can swing in either directions based on the outcome of the announcement. Till the announcement is made both buyers and sellers would be hesitant to take action and hence the stock gets into the range. The range under

such circumstances can be short-lived lasting until the announcement (event) is made.

The stock after being in the range can break out of the range. The range breakout more often than not indicates the start of a new trend. The direction in which the stock will breakout depends on the nature of the trigger or the outcome of the event. What is more important is the breakout itself, and the trading opportunity it provides.

A trader will take a long position when the stock price breaks the resistance levels and will go short after the stock price breaks the support level.

Think of the range as an enclosed compression chamber where the pressure builds up on each passing day. With a small vent, the pressure eases out with a great force. This is how the breakout happens. However, the trader needs to be aware of the concept of a 'false breakout'.

A false breakout happens when the trigger is not strong enough to pull the stock in a particular direction. Loosely put, a false breakout happens when a 'not so trigger friendly event' occurs and impatient retail market participants react to it. Usually the volumes are low on false range breakouts indicating, there is no smart money involved in the move. After a false breakout, the stock usually falls back within the range.

A true breakout has two distinct characteristics:

1. Volumes are high and
2. After the breakout, the momentum (rate of change of price) is high

Have a look at the chart below:



The stock attempted to breakout of the range three times, however the first two attempts were false breakouts. The first 1<sup>st</sup> breakout (starting from left) was

characterized by low volumes, and low momentum. The 2<sup>nd</sup> breakout was characterized by impressive volumes but lacked momentum.

However the 3<sup>rd</sup> breakout had the classic breakout attributes i.e high volumes and high momentum.

### **18.3 – Trading the range breakout**

Traders buy the stock as soon as the stock breaks out of the range on good volumes. Good volumes confirm just one of the prerequisite of the range breakout. However, there is no way for the trader to figure out if the momentum (second prerequisite) will continue to build. Hence, the trader should always have a stoploss for range breakout trades.

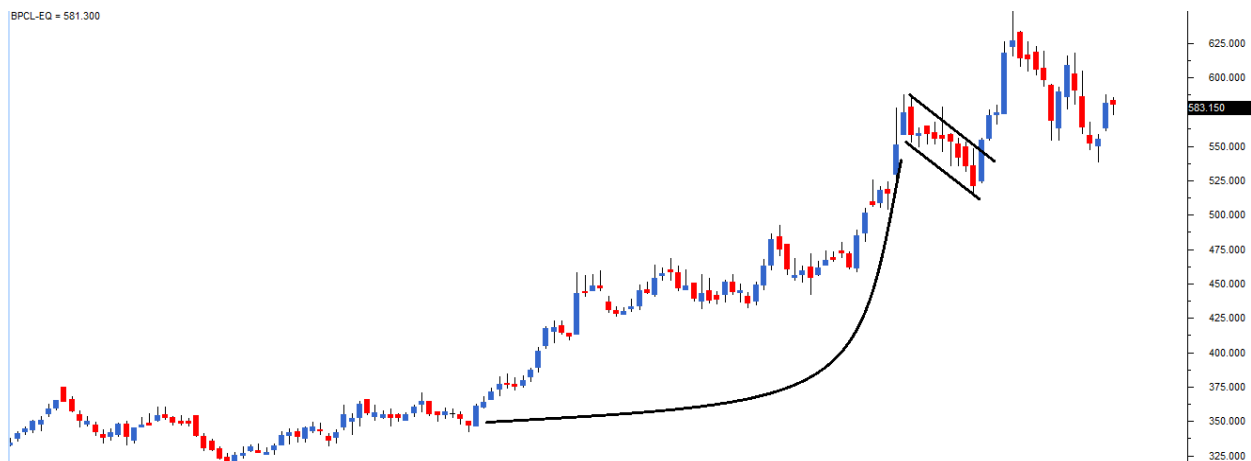
For example – Assume the stock is trading in a range between Rs.128 and Rs.165. The stock breaks out of the range and surges above Rs.165 and now trades at Rs.170. Then trader would be advised to go long 170 and place a stoploss at Rs.165.

Alternatively assume the stock breaks out at Rs.128 (also called the breakdown) and trades at Rs.123. The trader can initiate a short trade at Rs.123 and treat the level of Rs.128 as the stoploss level.

After initiating the trade, if the breakout is genuine then the trader can expect a move in the stock which is at least equivalent to the width of the range. For example with the breakout at Rs.168, the minimum target expectation would be 43 points since the width is  $168 - 125 = 43$ . This translates to a price target of  $\text{Rs.}168 + 43 = 211$ .

### **18.4 – The Flag formation**

The flag formation usually takes place when the stock posts a sustained rally with almost a vertical or a steep increase in stock prices. Flag patterns are marked by a big move which is followed by a short correction. In the correction phase, the price would generally move within two parallel lines. Flag pattern takes the shape of a parallelogram or a rectangle and they have the appearance of a flag on the pole. The price decline can last anywhere between 5 and 15 trading session.



With these two events (i.e price rally, and price decline) occurring consecutively a flag formation is formed. When a flag forms, the stock invariably spurts back all of a sudden and continues to rally upwards.

For a trader who has missed the opportunity to buy the stock, the flag formation offers a second chance to buy. However the trader has to be quick in taking the position as the stock tends to move up all of a sudden. In the chart above the sudden upward move is quite evident.

The logic behind the flag formation is fairly simple. The steep rally in the stock offers an opportunity for market participants to book profits. Invariably, the retail participants who are happy with the recent gains in the stock start booking profits by selling the stock. This leads to a decline in the stock price. As only the retail participants are selling, the volumes are on the lower side. The smart money is still invested in the stock, and hence the sentiment is positive for the stock. Many traders see this as an opportunity to buy the stock and hence the price rallies all of a sudden.

## 18.5 – The Reward to Risk Ratio (RRR)

The concept of reward to risk ratio (RRR) is generic and not really specific to Dow Theory. It would have been apt to discuss this under 'trading systems and Risk management'. However RRR finds its application across every type of trading, be it trades based on technical analysis or investments through fundamentals. For this reason we will discuss the concept of RRR here.

The calculation of the reward to risk ratio is very simple. Look at the details of this short term long trade:

Entry: 55.75

Stop loss: 53.55

Expected target: 57.20

On the face of it, considering it is a short term trade, the trade looks alright. However, let us inspect this further:

What is the risk the trader is taking? – [Entry – Stoploss] i.e  $55.75 - 53.55 = 2.2$

What is the reward the trader is expecting? – [Exit – Entry] i.e  $57.2 - 55.75 = 1.45$

This means for a reward of 1.45 points the trader is risking 2.2 points or in other words the Reward to Risk ratio is  $1.45/2.2 = 0.65$ . Clearly this is not a great trade.

A good trade should be characterised by a rich RRR. In other words, for every Rs.1/- you risk on a trade your expected return should be at least Rs.1.3/- or higher, otherwise it is simply not worth the risk.

For example consider this long trade:

Entry: 107

Stop loss: 102

Expected target: 114

In this trade the trader is risking Rs.5/- ( $107 - 102$ ) for an expected reward of Rs.7/- ( $114 - 107$ ). RRR in this case is  $7/5 = 1.4$ . This means for every Rs.1/- of risk the trader is assuming, he is expecting Rs.1.4 as reward. Not a bad deal.

The minimum RRR threshold should be set by each trader based on his/her risk appetite. For instance, I personally don't like to take up trades with a RRR of less than 1.5. Some aggressive traders don't mind a RRR of 1, meaning for every Rs.1 they risk they expect a reward of Rs.1. Some would prefer the RRR to be at least 1.25. Ultra cautious traders would prefer their RRR to be upwards of 2, meaning for every Rs.1/- of risk they would expect at least Rs.2 as reward.

A trade must qualify the trader's RRR requirement. Remember a low RRR is just not worth the trade. Ultimately if RRR is not satisfied then even a trade that looks attractive must be dropped as it is just not worth the risk.

To give you a perspective think about this hypothetical situation:

A bearish engulfing pattern has been formed, right at the top end of a trade. The point at which the bearish engulfing pattern has formed also marks a double top formation. The volumes are very attractive as they are at least 30% more than the 10 day average volumes. Near the bearish engulfing patterns high the chart is showing a medium term support.

In the above situation, everything seems perfectly aligned to short trade. Assume the trade details are as below:

Entry: 765.67

Stop loss: 772.85

Target: 758.5

Risk: 7.18 ( $772.85 - 765.67$ ) i.e [Stoploss – Entry]

Reward: 7.17 ( $765.67 - 758.5$ ) i.e [Entry – Exit]

RRR:  $7.17/7.18 = \sim 1.0$

As I mentioned earlier, I do have a stringent RRR requirement of at least 1.5. For this reason even though the trade above looks great, I would be happy to drop it and move on to scout the next opportunity.

As you may have guessed by now, RRR finds a spot in the checklist.

## 18.6 – The Grand Checklist

Having covered all the important aspects of Technical Analysis, we now need to look at the checklist again and finalize it. As you may have guessed Dow Theory obviously finds a place in the checklist as it provides another round of confirmation to initiate the trade.

1. The stock should form a recognisable candlestick pattern
2. S&R should confirm to the trade. The stoploss price should be around S&R
  1. For a long trade, the low of the pattern should be around the support
  2. For a short trade, the high of the pattern should be around the resistance
3. Volumes should confirm
  1. Ensure above average volumes on both buy and sell day
  2. Low volumes are not encouraging, and hence do feel free to hesitate while taking trade where the volumes are low
4. Look at the trade from the Dow Theory perspective.
  1. Primary, secondary trends
  2. Double, triple, range formations
  3. Recognisable Dow formation
5. Indicators should confirm
  1. Scale the trade size higher if indicators confirm to your plan of action
  2. If the indicators do not confirm go ahead with the original plan
6. RRR should be satisfactory
  1. Think about your risk appetite and identify your RRR threshold
  2. For a complete beginner, I would suggest the RRR to be as high as possible as this provides a margin of safety
  3. For an active trader, I would suggest a RRR of at least 1.5

When you identify a trading opportunity, always look how the trade is positioned from the Dow Theory perspective. For example if you are considering a long trade based on candlesticks, then look at what the primary and secondary trend is suggesting. If the primary trend is bullish, then it would be a good sign, however if we are in the secondary trend (which is counter to the primary) then you may want to think twice as the immediate trend is counter to the long trade.

If you follow the checklist mentioned above and completely understand its importance, I can assure you that your trading will improve multiple folds. So the next time you take a trade, ensure you comply with above checklist. If not for anything, at least you will have no reason to initiate a trade based on loose and unscientific logic.

## **18.7 – What next?**

We have covered many aspects of technical analysis in this module. I can assure you the topics covered here are good enough to put you on a strong platform. You may believe there is a need to explore other patterns and indicators that we have not discussed here. If we have not discussed a pattern or an indicator here on Varsity, do remember it is for a specific purpose. So be assured that you have all that you need to begin your journey with Technical analysis.

If you can devote time to understanding each one of these topics thoroughly, then you can be certain about developing a strong TA based thinking framework. The next logical progression from here would be to explore ideas behind back testing trading strategies, risk management, and trading psychology. All of which we will cover in the subsequent modules.

In the next concluding chapter, we will discuss few practical aspects that will help you get started with Technical Analysis.

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### **Key takeaways from this chapter**

1. A range is formed when the stock oscillates between the two price points
2. A trader can buy at the lower price point, and sell at the higher price point
3. The stock gets into a range for a specific reason such as the lack of fundamental triggers, or event expectation
4. The stock can break out of the range. A good breakout is characterized by above average volumes and sharp surge in prices
5. If the trader has missed an opportunity to buy a stock, the flag formation offers another window to buy
6. RRR is a critical parameter for trade evaluation. Develop a minimum RRR threshold based on your risk appetite
7. Before initiating a trade the trader should look at the opportunity from the Dow Theory perspective

## The Finale – Helping you get started



### 19.1 – The Charting Software

Over the last 18 chapters we have learnt many aspects of Technical Analysis. If you have read through all the chapters and understood what is being discussed, you are certainly at a stage where you can start trading based on Technical Analysis. The objective of this chapter is to help you get started with identifying technical trading opportunities.

Kindly note, the suggestions I have put forth in this chapter are based on my trading experience.

To begin with, you need a chart visualization software, simply called the 'Charting Software'. The charting software helps you look at the various stock charts and analyze the same. Needless to say, the charting software is a very important tool for a technical analyst.

There are many charting software's available. The two most popular ones are 'Metastock' and 'Amibroker'. Majority of the technical analysts use one of the two charting software's. Needless to say, these are paid software's and you need to purchase the software license before using it.

There are a few online free charting tools that are available which you can use – these are available on Yahoo Finance, Google Finance and pretty much all the business media websites. However, my advice to you is – if you aspire to become a technical analyst, get access to a good charting software.

Think of the charting software as a DVD player, once you have a DVD player installed, you will still need to rent DVDs to watch movies. Similarly, once you have a



charting software installed, you will still need to feed it with data to actually view the charts. The data feed required is provided by the data vendors.

There are many data vendors in India giving you access to data feeds. I would suggest you look up on the internet for reliable vendors. You just need to inform the data vendor which charting software you have, and he will provide you the data feeds in a format that is compatible with your charting software. Of course, the data feeds come at a cost. Once you sign up with a data vendor, he will first give you all the historical data, after which you will have to update the data from his server on a daily basis to stay current.

From my experience buying the latest version of a good charting software (Metastock or Amibroker) can cost you a onetime fee of anywhere between Rs.25,000/- and Rs.30,000/-. Add to this another Rs.15,000/- to Rs.25,000 towards the data feeds. Of course, while the software cost is one time, the cost of data feeds recurs annually. Do note, the older versions of the charting software may cost you much lesser.

Now, if you are in no mood to spend so much for the charting software & data feed combination there is another alternative. And that would be Zerodha's Pi.

As you may know, Zerodha has a proprietary trading terminal called 'Pi'. Pi helps you in many ways; I would like to draw your attention to some of its features in the context of Technical Analysis:

1. **It is bundled** – Pi is a charting software and a data feed package bundled into a single software
2. **Great Visualizations** – Pi helps you visualize charts across multiple time frames including intraday charts
3. **Advanced Features** – Pi has advanced charting features and includes 80 built-in technical indicators and over 30 drawing tools
4. **Scripting your strategy** – Pi has a scripting language employing which you can code technical strategies and back test the same on historical data. Do note, on Varsity we will soon include a module on building trading strategies and scripting
5. **Easy Opportunity Recognition** – Pi has pattern recognition feature that lets you draw a pattern on the screen. Once you draw, just command Pi to scout for that pattern across the market and it will do just that for you
6. **Trade from Pi** – Pi also lets you execute trades directly from the chart (a huge plus point for a technical trader)
7. **Data Dump** – Pi has a massive historical data dump (over 50,000 candles) which means back testing your strategy will be more efficient
8. **Your personal trading assistant** – Pi's 'Expert Advisor', keeps you informed about the patterns being developed in the live markets

9. **Super Advanced features** – Pi has Artificial Intelligence and Genetic Algorithms. These are optimisation tools which helps you optimize your trading algorithms
10. **It is free** – Zerodha is giving it free of cost to all its active traders

The list is quite exhaustive ranging from the basic to advanced features. I would strongly suggest you try out Pi before you decide to venture out for charting package and data feed bundle.



## 19.2 – Which timeframe to choose?

We discussed 'Timeframes' in chapter 3. I would request you to read through it again to refresh your memory.

Selecting the timeframe while scanning for trading opportunities is perhaps one of the biggest confusion a newbie technical analyst has. There are many timeframes you can choose from – 1 minute, 5 minutes, 10 minutes, 15 minutes, EOD, Weekly, Monthly, and Yearly. It is quite easy to get confused with this.

As a thumb rule, the higher the timeframe, the more reliable the trading signal is. For example a 'Bullish Engulfing' pattern on the 15 minute timeframe is far more reliable than a 'Bullish Engulfing' pattern on a 5 minute timeframe. So keeping this in perspective, one has to choose a timeframe based on the intended length of the trade.

So how do you decide your intended length of your trade?

If you are starting out fresh or if you are not a seasoned trader I would suggest you avoid day trading. Start with trades with an intention to hold the trade for a few days. This is called 'Positional Trading' or 'Swing Trading'. An active swing trader usually keeps his trading position open for a few days. The best look back period for a swing trader is 6 months to 1 year.

On the other hand, a scalper is a seasoned day trader; typically he uses 1 minute or 5 minutes timeframe.

Once you are comfortable with holding trades over multiple days, graduate yourself to 'Day Trading'. My guess is, your transition from a positional trader to a day trader

will take some time. Needless to say for a dedicated and disciplined trader, the transition period is remarkably lesser.



### 19.3 – Look back period

Look back period is simply the number of candles you wish to view before taking a trading decision. For instance, a look back period of 3 months means you are looking at today's candle in the backdrop of at least the recent 3 months data. By doing this you will develop a perspective on today's price action with reference to last 3 months price action.

For swing trading opportunities, what is the ideal look back period? From my experience, I would suggest that a swing trader should look for at least 6 months to 1 year data. Likewise a scalper is better off looking at last 5 days data.

However, while plotting the S&R levels you should increase the look back period to at least 2 years.



### 19.4 – The opportunity universe

There are roughly about 6000 listed stocks in the Bombay Stock Exchange (BSE) and close to about 2000 listed stocks in the National Stock Exchange (NSE). Does it make sense for you to scan for opportunities across these thousands of stocks, on a daily basis? Obviously not. Over a period of time you need to identify a set of stocks that you are comfortable trading. These set of stocks would constitute your "Opportunity

Universe'. On a daily basis you scan your opportunity universe to identify trading opportunities.

Here are some pointers to select stocks to build your opportunity universe:

1. Ensure the stock has adequate liquidity. One way to ensure adequate liquidity is to look at the bid ask spread. The lesser the spread, the more liquid the stock
1. Alternatively you can have 'minimum volume criteria'. For example you can consider only those stocks where the volume per day is at least 500000
2. Make sure the stock is in the 'EQ' segment. This is basically because stocks in the 'EQ' segment can be day traded. I agree, I discouraged day trading for a newbie, however in a situation where you initiated a positional trade and the target is achieved the same day, there is no harm in closing the position intraday
3. This is a bit tricky, but make sure the stock is not operator driven. Unfortunately there is no quantifiable method to identify operator driven stocks. This comes to you by sheer experience

If you find it difficult to find stocks that comply with the above points, I would advise you to simply stick to the Nifty 50 or the Sensex 30 stocks. These are called the index stocks. Index stocks are carefully selected by the exchanges, this selection process ensures they comply with many points including the ones mentioned above.

Keeping Nifty 50 as your opportunity universe is probably a good idea for both swing trader and scalper.



## 19.5 – The Scout

Let us now proceed to understand how one should go about selecting stocks for trading. In other words, we will try and indentify a process, employing which we can scan for trading opportunities. The process is mainly suited for a swing trader.

We have now set the 4 important aspects –

1. The charting software – Suggest you use Zerodha's Pi
2. Timeframe – End of Day data

3. Opportunity Universe – Nifty 50 stocks
4. Trade type – Positional trades with an option to square off intraday, provided the target hits the same day
5. Look back period – Between 6 months to 1 year. Increase to 2 years while plotting the S&R level

Having fixed these important practical aspects, I will now proceed to share my methodology of scanning trading opportunities. I have divided the process into 2 parts:

### **Part 1 – The Short listing process**

1. I look at the chart of all the stocks within my opportunity universe
2. While looking at the chart, my attention is only on the recent 3 or maximum 4 candles
3. While looking at the recent 3 candles, I check if there is any recognisable candlestick pattern being developed
4. If I find an interesting pattern, I short list this stock for further investigation and I continue the scouting process. I always ensure I check all the 50 charts

### **Part 2 – The Evaluation process**

At this stage, I am usually left with 4-5 shortlisted stocks (out of the 50 stocks in my opportunity universe) which exhibit a recognisable candlestick pattern. I then proceed to evaluate these 4-5 charts in detail. Typically I spend at least 15 – 20 minutes on each chart. Here is what I do when looking at the shortlisted chart:

1. I generally look at how strong the pattern is – I am specifically interested in checking if there is any need for me to be more flexible
1. For example, if a Bullish Marubuzo has a shadow, I evaluate the length of the shadow with reference to the range
2. After this I look at the 'prior trend'. For all bullish patterns, the prior trend should be a downtrend, and for all bearish patterns the prior trend should be an uptrend. I do pay a lot of attention to prior trends
3. At this stage if everything looks good (i.e. I have identified a recognizable pattern with a well defined prior trend), I proceed to inspect the chart further
4. After this I look at the volumes. The volume should be at least equal to or more than the 10 day average volume
5. Provided both the candlestick pattern and volumes confirm, I then proceed to check the existence of the support (in case of a long trade) and resistance (in case of a short trade) level
1. The S&R level should coincide (as much as possible) with the stoploss of the trade (as defined by the candlestick pattern)

2. If the S&R level is more than 4% away from the stoploss, I stop evaluating the chart further and proceed to the next chart
6. I then look for Dow patterns – particularly for double and triple top & bottom formations, flags formations and the possibility of a range breakout
1. Needless to say, I also establish the Primary and secondary market trend
7. If the steps 1 to 5 are satisfactory, I proceed to calculate the risk to reward ratio (RRR)
1. To calculate RRR, I first establish the target by plotting either the support or resistance level
2. The minimum RRR should be at least 1.5
8. At last I look at the MACD and RSI indicators to get a perspective, if they confirm and if I have spare cash I increase my trade size

Usually out of the 4-5 shortlisted stocks, at the most 1 or 2 may qualify for a trade. There are days when there are no trading opportunities. Deciding not to trade in itself is a big trading decision. Do remember this is a fairly stringent checklist, if a stock is confirming to the checklist, my conviction to trade is very high.

I have mentioned this many times in this module, I will mention this for one last time – once you place a trade, do nothing till either your target is achieved or stoploss is triggered. Of course you can trail your stoploss, which is a healthy practice. But otherwise do nothing, if your trade complies with the checklist and do remember the trade is highly curreted; hence the chance of being successful is high. So it makes sense to stay put with conviction.



## 19.5 – The Scalper

For a seasoned swing trader, scalping is another option. Scalping is a technique where the trader initiates a fairly large trade with an intention of holding the trade for a few minutes. Here is a typical example of the trade done by a scalper –

1st Leg of the trade

2nd leg of the trade

Time – 10:15 AM	Time – 10:25 AM
Stock – Infosys	Stock – Infosys
Price – 3980	Price – 3976
Action – Sell	Action – Buy
Quantity – 1000 shares	Quantity – 1000 shares

Overall profit after applicable charges = Rs.2653/-

Do note, the overall profit is calculated considering that you are trading with Zerodha, the overall profitability would shrink remarkably if you are scalping with an expensive brokerage rates. Containing transaction charges is one of the keys to successful scalping.

A scalper is a highly focused trader with a sharp sense for price. He utilizes highly precise charts such with 1 minute and 5 minute timeframe to make his trading decisions. A successful scalper executes many such trades within the day. His objective is simple – large quantity trade with an intention to hold for a few minutes. He intends to profit from the small moves in the stock.

If you aspire to be a scalper, here are few guidelines –

1. Do remember the checklist we have mentioned but do not expect all the checklist items to comply as the trade duration is very low
2. If I were to handpick just 1 or 2 items in the checklist for scalping, it would be candlestick pattern and volume
3. A risk reward ratio of even 0.5 to 0.75 is acceptable while scalping
4. Scalping should be done only on liquid stocks
5. Have an effective risk management system – be really quick to book a loss if need be
6. Keep a tab on the bid ask spread to see how the volumes are building
7. Keep a tab on global markets – for example if there is a sudden drop in the Hang Seng (Hong Kong stock exchange) it invariably leads to a sudden drop in local markets
8. Choose a low cost broker to ensure your costs are controlled

9. Use margins effectively, do not over leverage
  10. Have a reliable intraday charting software
  11. If you sense the day is going wrong, stop trading and move away from your terminal
- Scalping as a day trading technique requires a great presence of mind and a machine like approach. A successful scalper embraces volatility and is indifferent to market swings.
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#### Key takeaways from this chapter

1. If you aspire to become a technical trader ensure you equip yourself with good charting software. Zerodha's Pi is my preference
2. Choose EOD chart for both day trading and swing trading
3. Look at intraday charts if you like scalping the markets
4. The look back period should be at least 6 months to 1 year for swing trading
5. Nifty 50 is a great opportunity universe to begin with
6. The opportunity scanning can be done in 2 parts
7. Part 1 involves skimming through the charts of all the stocks in opportunity universe and short listing those charts that display a recognizable candlestick pattern
8. Part 2 involves investigating the shortlisted charts to figure out if they comply with the checklist
9. Scalping is advisable for seasoned swing traders