Donchian Trading Guidelines

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Introduction

First published in 1934, many of the 20 trading guidelines from Richard Donchian are as relevant today as they were during the golden age of technical analysis. Considered by many as the father of trend following, Donchian developed one of the first trend following systems based on two different moving averages, which were cutting edge in the early thirties. Based on his experiences over time, Donchian developed 20 trading guidelines split into two groups: general and technical. The guidelines shown below have been paraphrased for a clearer explanation. The original guides are also shown in the bottom half of this page.

Eleven General Guidelines

1. Be careful buying when the crowd is excessively bullish or selling when the crowd is excessively bearish. Even when the crowd is correct, excessive sentiment in one direction or another can delay a move.

International Herald Tribune, October 27, 1989.
Kal, Cartoonists and Writers Syndicate, 1989.

2. When prices trade in a narrow range with little volatility, look for a volume increase to confirm the direction of the next move. Subsequent strength on higher volume is bullish, while subsequent weakness on higher volume is bearish.

3. Let your profits run and cut your losses short. This guideline overrides any other guideline.

4. Trade in smaller amounts during times of uncertainty. Trading losses and whipsaws can be reduced by focusing on solid setups and robust signals.

5. Do not chase a position after a three-day move. Wait for a one-day reversal to improve the risk-reward ratio.

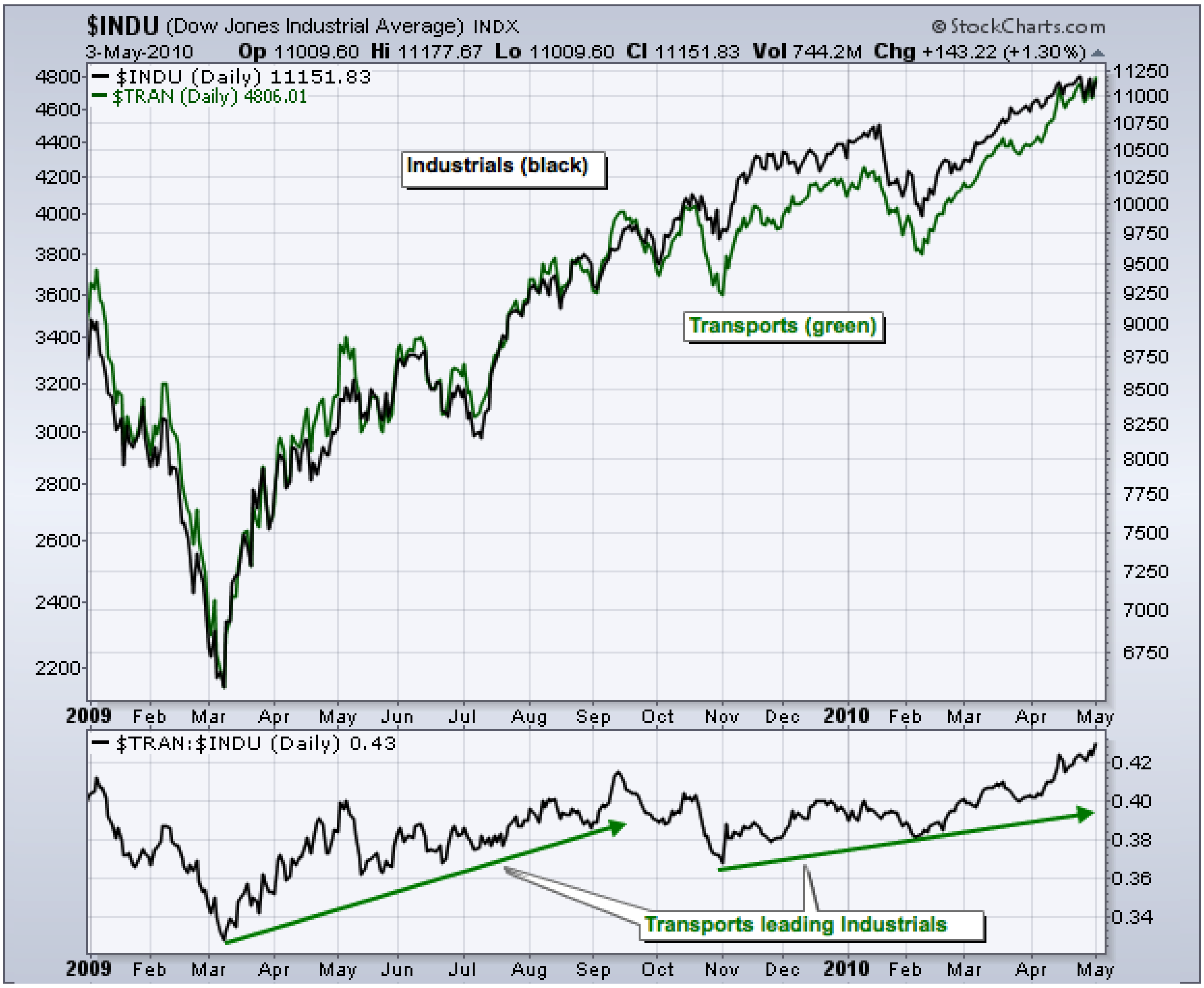
6. Use a stop-loss to limit losses and protect accrued profits. Stop-losses should be based on the trading pattern at work. A triangle pattern will have a different stop-loss structure than a rising wedge or head-and-shoulders pattern.

7. Due to the law of percentages, long positions should be larger than short positions during a broad uptrend. This assumes that the upswings will be larger than the downswings as a series of rising peaks and troughs evolves. A short position on a decline from 50 to 40 would produce a 20% profit, but a long position on an advance from 40 to 50 would produce a 25% profit. The percentage gain on advances will be greater and the trading amount should also be greater.

8. Use limit orders when initiating a position. Use market orders when closing a position.

9. uy securities that are in uptrends and show relative strength. Sell securities that are in downtrends and show relative weakness. These two guidelines are subject to all other guidelines.

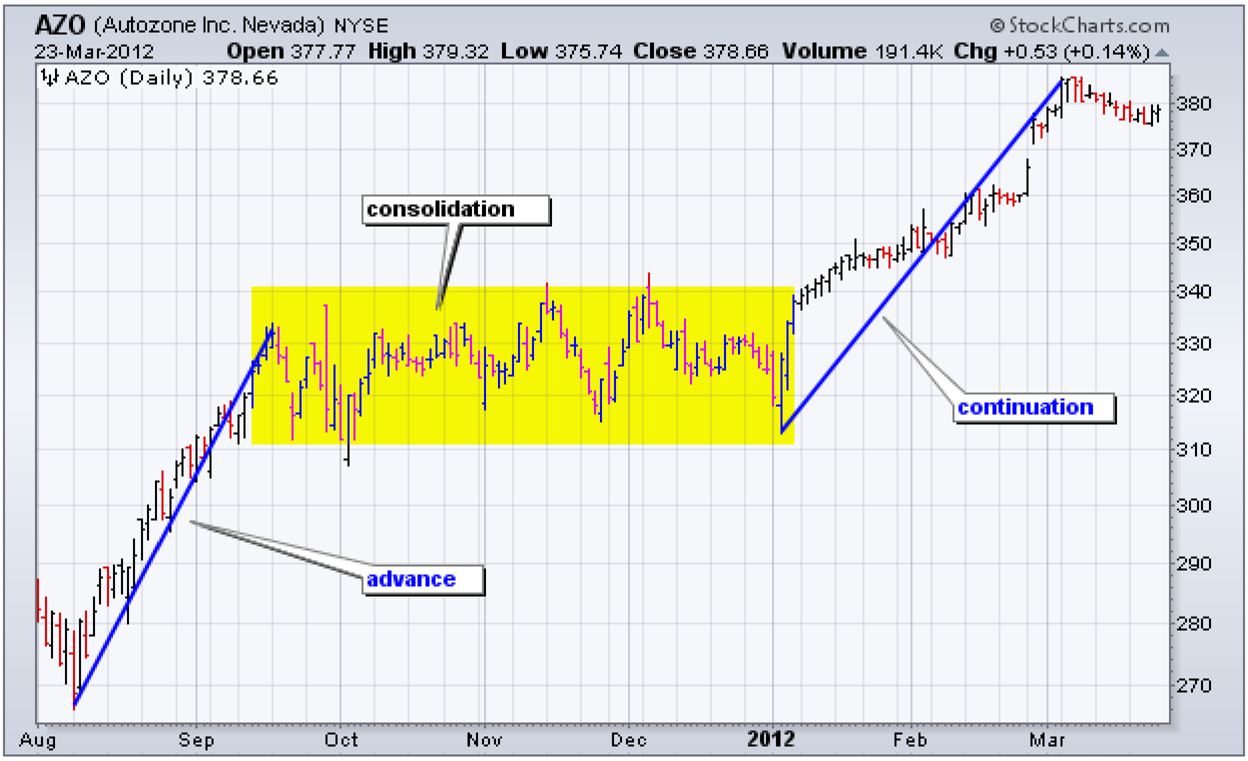
10. A broad market advance is more likely to continue when transportation stocks lead (Dow Transports). A broad market advance is suspect when transportation stocks lag.



11. A security's capitalization, its activity level in the marketplace and its trading characteristics are just as important as its fundamentals. (The interpretation of this guideline is rather difficult because it is unclear what Donchian means with “capitalization”).

Nine Technical Guidelines

12. A consolidation or sideways trading range after an initial advance often leads to another advance of equal proportions. After this second advance, chartists can expect a counter move and decline back towards the consolidation. Similarly, a consolidation or sideways trading range after an initial decline often leads to another decline of equal proportions. After this second decline, chartists can expect a counter move and advance back towards the consolidation.



13. A long sideways consolidation after an advance marks future resistance. Expect resistance or a bearish reversal when prices decline and then return to this level. A long sideways consolidation after a decline marks future support. Expect support or a bullish reversal when prices advance and then return to this level.

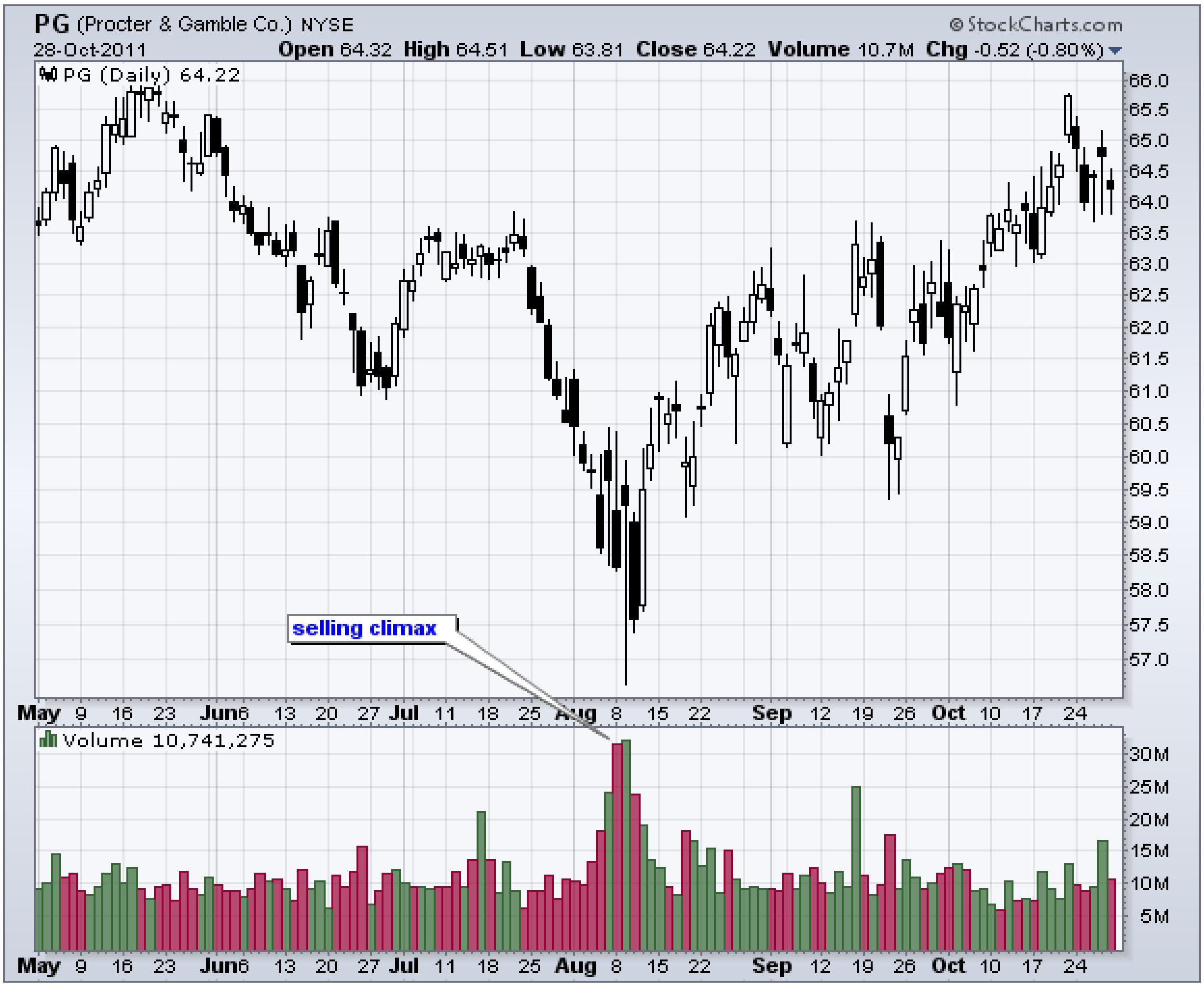
14. Look for buying opportunities when prices decline to a trendline on average or low volume. Conversely, look for selling opportunities when prices advance to a trendline on average or low volume. Be careful if prices stall around the trendline (hug) or if the trendline has been touched too often.

15. Prepare for a bearish trendline break when prices decline to a rising trendline, fail to bounce and subsequently crawl along the trendline. Prepare for a bullish trendline break when prices advance to a falling trendline, hold most of their gains and crawl along the trendline. Repeated bumping of a trendline also increases the chances of a break.

16. Major trendlines define the longer trend. Minor trendlines define the shorter trend. When prices are above a major trendline (rising), use minor trendlines (falling) to define short pullbacks and generate buy signals with upside breaks. When prices are below a major trendline (falling), use minor trendlines (rising) to define short bounces and generate sell signals with downside breaks.

17. Triangles are usually broken on the flat side. This means an ascending triangle is usually broken with an upside breakout, while a descending triangle is usually broken to the downside. Chartists must look for other clues to determine if a triangle signals accumulation or distribution.

18. Look for a volume climax to signal the end of a long move. An extended advance sometimes ends with a volume surge that marks a blow-off. Conversely, an extended decline sometimes ends with a volume surge that marks a selling climax.



19. Not all gaps are filled. Breakaway gaps signal the start of a new trend and are not filled. Continuation gaps mark a continuation of the existing trend and are not filled. Exhaustion gaps mark a trend reversal and are filled. Chartists should not count on a gap being filled unless they can determine what kind of gap it is, which is easier said than done.

20. During an advance, initiate or add to long positions after a one day decline, no matter how small the decline and especially when the decline is on lower volume. During a decline, initiate or add to short positions after a one-day advance, no matter how big the bounce and especially if the bounce is on lower volume.

Conclusions

At least three themes emerge from these rules. First, direction of the underlying trend determines position preference. Chartists should focus on long positions during an uptrend and short positions during a downtrend. Second, volume plays an important part in the analysis process. Price moves in the direction of the bigger trend should be on higher volume, while counter trend moves should be on lower volume. However, note that volume climaxes can mark the end of an extended move. Third, trading ranges and consolidations are important chart patterns. Long consolidations can mark reversals and future support or resistance levels. Short consolidations often mark a rest in the ongoing trend.

Further Study

Trend Trading for a Living shows traders how to trade in the direction of the underlying trend. This hands-on book will also show readers how to configure a bullish and bearish watch list from which to set your entry and exit prices. Michael Covel's book introduces the fundamental concepts and techniques for a variety of trend following systems, including a system made famous by the Turtles. Covel shows why market prices contain all available information. Readers will learn how to interpret price movements and profit from trend following.

Original Guides

A version of Donchian's original guidelines can be found on the Trading Tribe website (www.seykota.com). Ed Seykota is an original “market wizard” from Jack Schwager's book of the same name. He is a trend following disciple who credits Richard Donchian as a major influence in the development of his trading philosophy.

General Guides:

1. Beware of acting immediately on a widespread public opinion. Even if correct, it will usually delay the move.

2. From a period of dullness and inactivity, watch for and prepare to follow a move in the direction in which volume increases.

3. Limit losses and ride profits, irrespective of all other rules.

4. Light commitments are advisable when market position is not certain. Clearly defined moves are signaled frequently enough to make life interesting and concentration on these moves will prevent unprofitable whip-sawing.

5. Seldom take a position in the direction of an immediately preceding three-day move. Wait for a one-day reversal.

6. Judicious use of stop orders is a valuable aid to profitable trading. Stops may be used to protect profits, to limit losses, and, from certain formations such as triangular foci, to take positions. Stop orders are apt to be more valuable and less treacherous if used in proper relation to the chart formation.

7. In a market in which upswings are likely to equal or exceed downswings, heavier positions should be taken for the upswings for percentage reasons - a decline from 50 to 25 will net only 50% profit, whereas an advance from 25 to 50 will net 100%

8. In taking a position, price orders are allowable. In closing a position, use market orders.

9. Buy strong-acting, strong-background commodities and sell weak ones, subject to all other rules.

10. Moves in which rails lead or participate strongly are usually more worth following than moves in which rails lag.

11. A study of the capitalization of a company, the degree of activity of an issue, and whether an issue is a lethargic truck horse or a spirited race horse is fully as important as a study of statistical reports.

Technical Guides:

12. A move followed by a sideways range often precedes another move of almost equal extent in the same direction as the original move. Generally, when the second move from the sideways range has run its course, a counter move approaching the sideways range may be expected.

13. Reversal or resistance to a move is likely to be encountered upon reaching levels at which in the past the commodity has fluctuated for a considerable length of time within a narrow range or on approaching highs or lows.

14. Watch for good buying or selling opportunities when trend lines are approached, especially on medium or dull volume. Be sure such a line has not been hugged or hit too frequently.

15. Watch for “crawling along” or repeated bumping of minor or major trend lines and prepare to see such trend lines broken.

16. Breaking of minor trend lines counter to the major trend gives most other important position taking signals. Positions can be taken or reversed on stops at such places.

17. Triangles of ether slope may mean either accumulation or distribution depending on other considerations although triangles are usually broken on the flat side.

18. Watch for volume climaxes, especially after a long move.

19. Don't count on gaps being closed unless you can distinguish between breakaway gaps, normal gaps and exhaustion gaps.

20. During a move, take or increase positions in the direction of the move at the market the morning following any one-day reversal, however slight the reversal may be, especially if volume declines on the reversal.