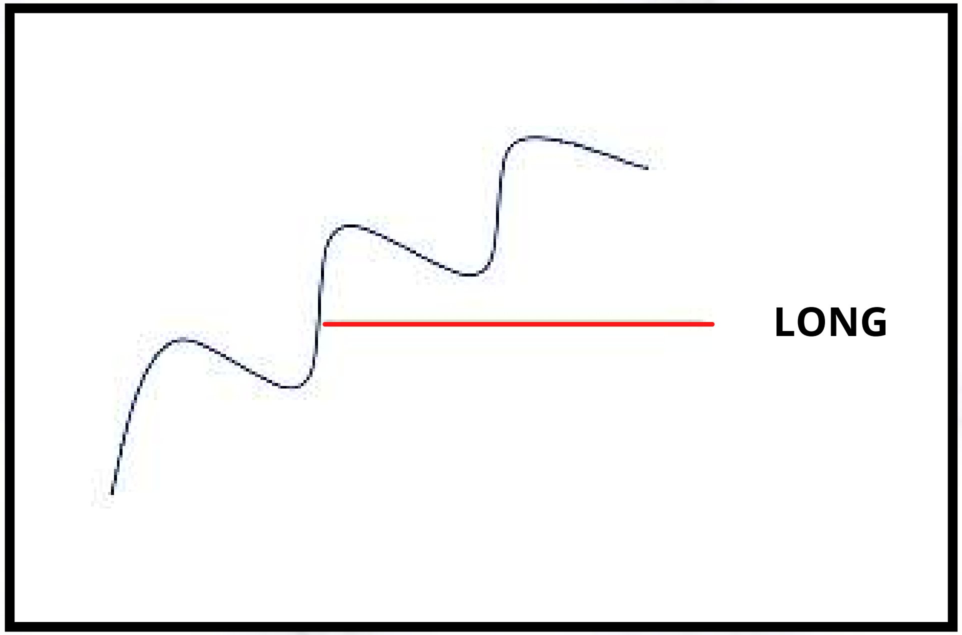
PYRAMID TRADING

The ‘Pyramid Trading’ tool is not as much a technical analysis tool it is a trading technique. This is one of the most simple tools to follow. This is built around the theory that in an advancing market, the asset price will form multiple highs and each high will be higher than the previous high. Similarly, in a declining market, the market will form multiple lows and each low will be lower than the previous low. Based on this theory, pyramid analysis is done and positions are taken.

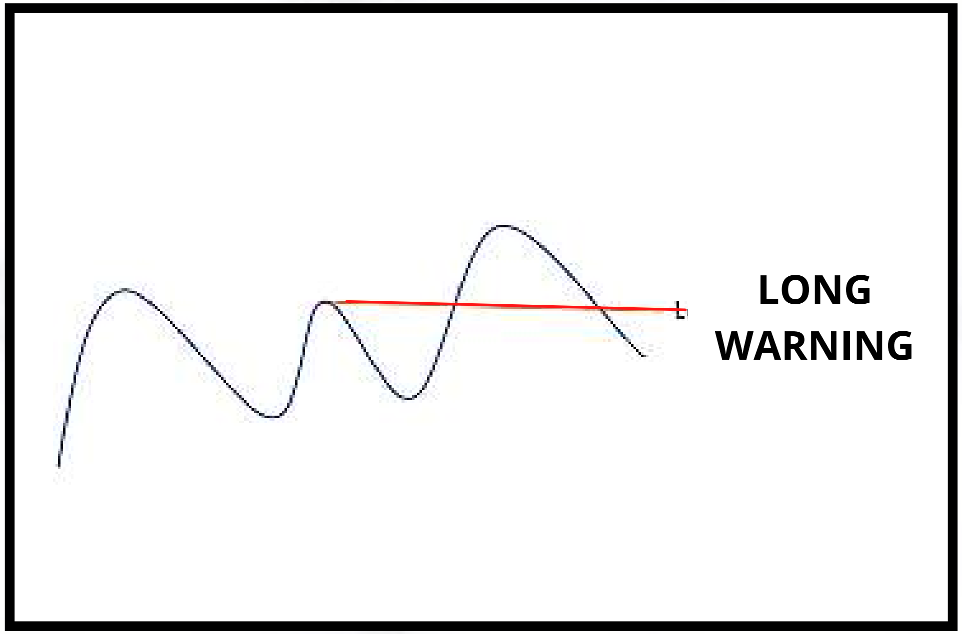
This is suitable over longer-term only. This is because, in the shorter term, markets are affected by a lot of factors. However, in longer-term, many of these factors get neutralized and the primary trend holds up. By long term, we mean a few months as compared to intraday trades. To understand the concept of pyramid trading, we will have to understand the concept of higher highs, lower high, lower low and higher low. We will use these together to understand pyramid trading in greater detail going ahead.

Whenever the market rises, it does not do so in a single straight line. The primary trend is upwards. However, the market will have multiple short terms upward and downward secondary trends. So, in the case of pyramid theory, we will mainly be concerned with the secondary trend forming these patterns. Let us move forward and understand these better.



HIGHER HIGHS

We see that higher highs occur when in each secondary bullish trend, a high, higher than the high formed by the previous secondary bullish trend, forms. We will go long the asset when a higher high is formed.

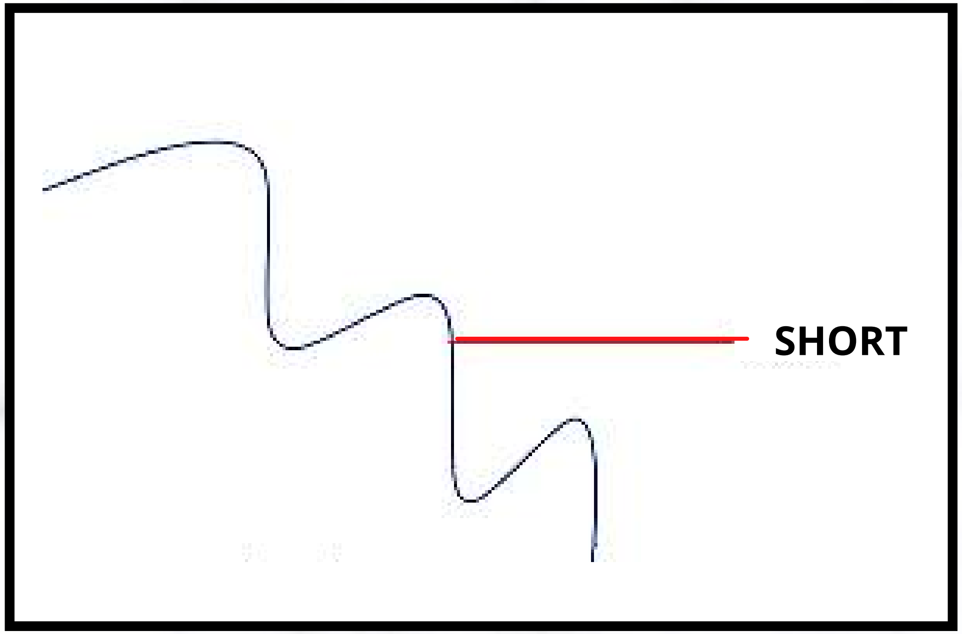


LOWER HIGHS

As we were continuously forming higher highs, a subsequent high is formed that is lower than the previous high, and we should consider this a warning signal in case we are long that asset.

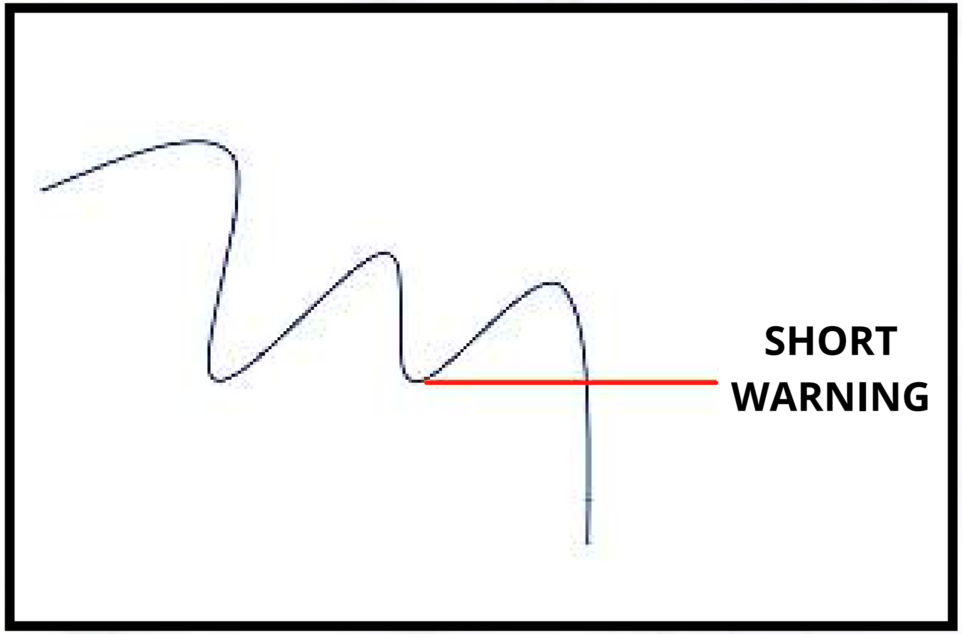
LOWER LOWS

It is the opposite of higher highs. When the market is in a downtrend, we will see that multiple secondary curves are forming lower lows. This means that the low of each secondary curve will be lower than the previous level of support. We will short the asset when a lower low is formed. This level is also the point where we book our profits in case we are long the asset.



HIGHER LOWS

When secondary curves form multiple lows but the subsequent low is higher than the previous low, we can say that it is alarming if we are short the asset that a reversal might be around the corner.



Source - Trading View

This is how pyramid theory looks like in practice. A large uptrend is divided into multiple secondary trends. Each curve is forming a higher high in the uptrend. Towards the top, it is forming lower high before it finally begins the downward journey. We see that the downward journey is confirmed when the asset forms lower highs and then lower lows too. This confirms that the uptrend has ended.

NSE:ONGC, 1D 96.65 ▼ −4.75 (−4.68%) O:101.40 H:101.85 L:96.05 C:96.65

Source - Trading View

This is an example of downtrend using pyramid theory. The primary trend is divided into multiple smaller secondary trends. Each secondary trend is forming lower lows and till the time we can ride it, we will have benefited from a huge downtrend which is very difficult to identify using any other technical indicator.

Source - Trading View

We would have entered the trade the moment the secondary trend crossed the previous secondary curve's high. This means we would have gone long on the asset around October 2018. We would have stayed longer for a very long period till the asset started forming lower highs around June 2019. We would have squared off our position in June 2019 when a lower low was formed and the primary trend seemed to have reversed. However, in the process, we would have had a profitable trade. Also, we would have gone short when the lower low was formed and the second curve crossed that limit and we would stay short till March 2020 when higher was again formed.

Source - Trading View

This is an again similar example where we would have gone long when the asset price was forming higher highs and stayed short when asset price was forming lower lows. Trades based on these last months and generally give an excellent return. We are trying to benefit from reversals of the primary trend and as a result using higher highs and lower lows.

Source - Trading View

Pyramid trading works exceptionally well with the trending market. However, they do not work well with a sideways market. We see that in a sideways market, there is no higher high, lower low and any of those things that make the pyramid theory work. So, we will avoid the use of the theory in a sideways market.

Source - Trading View

This is yet another example of a sideways market. We see that the use of pyramid theory is not possible in such a market and as a result, we will avoid such markets. With this, we end the discussion on the pyramid trading theory. The concept is relatively simple. It is the practice that counts.

With this, we finish our discussion of multiple analytical tool-sets to conduct technical analysis. We have talked about price and volume, candlesticks, chart patterns, trendlines, indicators and oscillators, pyramid trading and so on. We understood how to use each of them. Going ahead, we will understand how to use them in a systematic manner such that we can have sustainable profitable strategies and systems created for us. So, let us move ahead and learn more about their uses together.