Dow Theory

Unit 3-Topic 10

Introduction

- Dow Theory is named after Charles H. Dow, who is considered as the father of Technical Analysis.
- Dow Theory is very basic and more than 100 years old but still remains the foundation of Technical Analysis.
- Dow theory comments about his belief on stock market behaviour.

Principles of Dow Theory

The Dow Theory is made up of six basic principles:

- **1st Principle:** The stock market discounts all information.
- **2nd Principle:** The stock market has three trends.
- **3rd Principle:** Primary' trend has three phases.
- **4th Principle:** Stock market indexes must confirm each other.
- **5th Principle:** volume must confirm the trend.
- **6th Principle:** Trend Remains Intact Until Clear Reversal Signals Occur.

First Principle: The Stock Market Discounts All Information:

- The first principle of Dow Theory suggests that stock price represents sum total of hopes, fears and expectation of all Participants.
- It suggests stock market discounts all information, be it interest rate movement, macroeconomic data, central bank decision, future earnings announcement by the company etc.
- The stock market is barometer of the economy and takes trend ahead of changes in real economy.

Second Principle: The Stock Market Have Three Trends:

- Dow Theory says stock market is made up of three trends.

    (1) Primary Trend

    (2) Secondary trend

    (3) Minor Trend.

- **(1) Primary Trend :** Dow Theory says primary trend is the main trend and trader should trade in direction of this trend. It says primary trend is trader's best friend which would never ditch trader in this volatile stock market. If prices are making higher tops and higher bottoms, the primary trend is considered up (bullish). If the prices are making lower tops and lower bottoms, then the primary trend is considered down (bearish). The primary trend is the largest trend lasting for more than a year.

- **(2) Secondary Trend:** Dow Theory says secondary trends are found within the primary trend i.e. corrections when primary trend is rising and pullback when primary trend is falling. More precisely secondary trend is the move against the direction of the primary trend.

- **(3) Minor Trend:** Dow Theory says that secondary trend consists of short term price movements which is known as minor trends. The Dow Theory says minor trends are unimportant and needs no attention. If too much focus is placed on minor trends, it can lead to total loss of capital as trader gets trapped in short term market volatility.

Third Principle: Primary Trend Have Three Phases:

- **The Dow Theory says primary trend have three phases:**

  (1) Accumulation Phase

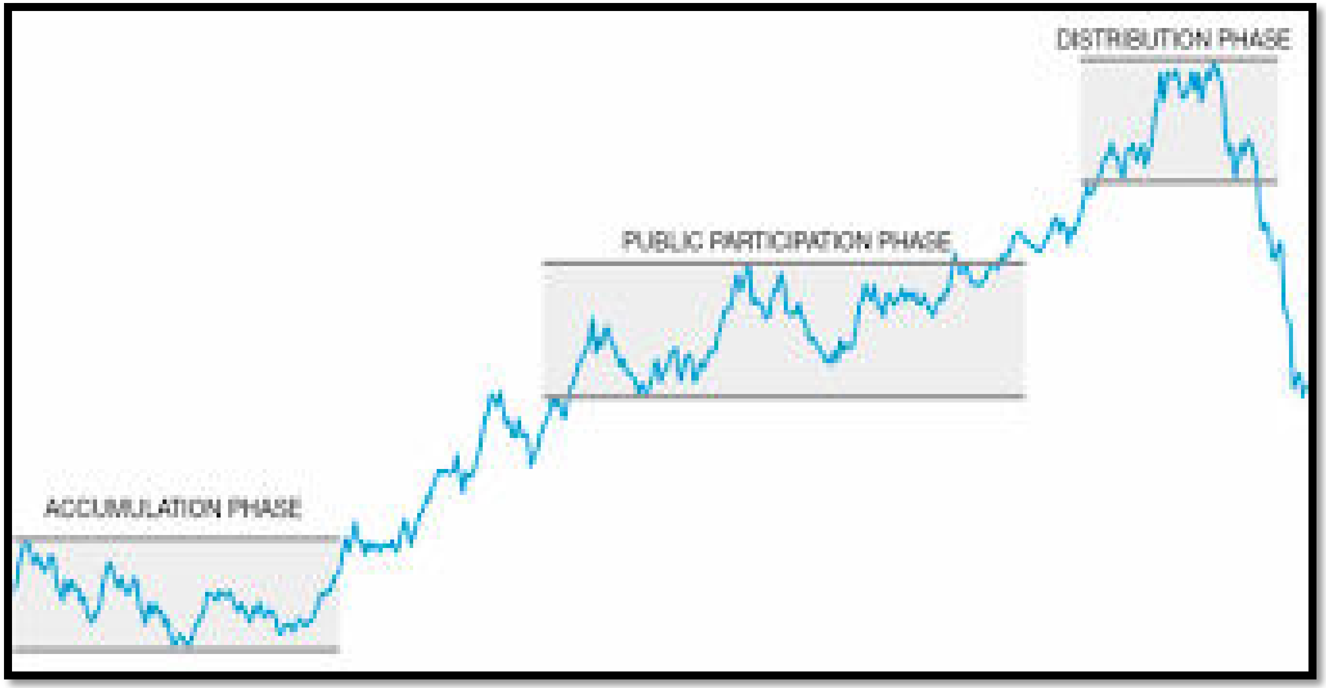
  (2) Participation Phase

  (3) Distribution Phase.

- **(1) Accumulation Phase:** The Dow Theory says that the accumulation phase is made up of buying by investor who thinks stock is undervalued and expects economic recovery and long term growth. When the new trend emerges, environment is totally pessimistic and majority of investors are against equities and above all nobody at this time believes that market could rally from here. This is because accumulation phase comes after a significant down move in the market and everything appears at its worst. Practically this is the beginning of the new bull market.

- **(2) Participation Phase:** The participation phase is characterized by improving fundamentals, rising corporate profits and improving public sentiment. More and more trader participates in the market, sending prices higher. This is the longest phase of the primaly trend during which largest price movement takes place.

- **(3) Distribution Phase:** distribution phase is characterized by too much optimism, robust fundamental and above all nobody at this time believe that market could decline. It is during this time those investors who bought during accumulation phase sell in anticipation of a decline in the market.


DISTRIBUTION PHASE
PUBLIC PARTICIPATION PHASE
ACCUMULATION PHASE

Fourth Principle: Stock Market Indexes Must Confirm Each Other:

- Charles Dow believed that stock market as a whole reflected the overall business condition of the country.

- Dow first used basis of his theory to create two indexes namely:

  (i) Dow Jones Industrial Index

  (ii) Dow Jones Rail Index (now Transportation Index)

- Dow created these two indexes because those days U.S. was a growing industrial nation and urban centres and production centres were apart. Factories have to transport their goods to urban centres by rail road.Dow felt these two indexes would reflect true business condition within the economy.

- (a) Rise in these two indexes reflects that overall business condition of the economy is good. The basic concept behind this is that if production is increasing then transportation of goods to customer should also .According to Dow Theory, two averages should move in the same direction and rising Industrial Index is not sustainable as long as Production Index is not rising.

- (b) The divergence in these two indexes is a warning Under Dow Theory, a reversal from a bull market to bear market or vice versa is not signalled until and unless both indexes i.e. Industrial Index and Transportation Index confirm the same.

Fifth Principle: Volume Must Confirm the Trend:

- Dow Theory says that trend should be confirmed by the volume.
- If primary trend is down, then volume should increase with the market decline.
- If primary trend is up, then volume should increase with the market rally.
- Basically volume is used as a secondary indicator to confirm the price trend and once the trend is confirmed by volume, one should always remain in the direction of the trend.

Sixth Principle: Trend Remains Intact Until Clear Reversal Signals Occur:

- Stock prices do not move smoothly in a single line. It is sometimes up and sometimes down, creating zig zag formation.

- Basically Dow Theory suggests that one should never assume reversal of the trend until and unless clear reversal signals are there and one should always trade in the direction of the primary trend.

Problems with Dow Theory

- As per Dow theory, a trend is considered reverse when security makes a significant move in a particular direction. Uptrend would reverse when stock prices make lower top - lower bottom formation and downtrend would reverse when stock prices make higher top - higher bottom formation. Due to this conservative nature of trend reversal, one may miss the large gain.

- Charles Dow propounded this theory on two indexes, namely Industrial and Transportation, which is not major part of the economy today. Technology and financial services i.e. banking constitutes major part of the economy today.

Thank you