WYCKOFF LAWS AND TESTS

By

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EUROMED MARSEILLE ECOLE DE MANAGEMENT

Wyckoff is a name gaining celebrity status in the world of Technical Analysis and Trading. Richard D. Wyckoff, the man, worked in New York City during a "golden age" for technical analysis that existed during the early decades of the 20th Century. Wyckoff was a contemporary of Edwin Lefevré who wrote The Reminiscences of A Stock Operator. Like Lefevré, Wyckoff was a keen observer and reporter who codified the best practices of the celebrated stock and commodity operators of that era. The results of Richard Wyckoff's effort became known as the Wyckoff Method of Technical Analysis and Stock Speculation.

Wyckoff is a practical, straight forward bar chart and point-and-figure chart pattern recognition method that, since the founding of the Wyckoff and Associates educational enterprise in the early 1930's, has stood the test of time.

Around 1990, after ten years of trial-and-error with a variety of technical analysis systems and approaches, the Wyckoff Method became the mainstay of The Graduate Certificate in Technical Market Analysis at Golden Gate University in San Francisco, California, U.S.A. During the past decade dozens of Golden Gate graduates have gone to successfully apply the Wyckoff Method to futures, equities, fixed income and foreign exchange markets using a range of time frames. Then in 2002 Mr. David Penn, in a Technical Analysis of Stocks and Commodities magazine article named Richard D. Wyckoff one of the five "Titans of Technical Analysis." Finally, Wyckoff is prominent on the agenda of the International Federation of Technical Analysts (IFTA) for inclusion in the forthcoming Body of Knowledge if Technical Analysis.

The Wyckoff Method has withstood the test of time. Nonetheless, this article proposes to subject the Wyckoff Method to the further challenge of real-time-test under the natural laboratory conditions of the current U.S. Stock market. To set up this "test," three fundamental laws of the Wyckoff Method will be defined and applied.

THREE WYCKOFF LAWS

The Wyckoff Method is a school of thought in technical Market analysis that necessitates judgment. Although the Wyckoff Method is not a mechanical system *per se*, nevertheless high reward/low risk opportunities can be routinely and systematically based on what Wyckoff identified as three fundamental laws (see Table #1):

Table #1

1. The Law of Supply and Demand – states that when demand is greater than supply, prices will rise, and when supply is greater than demand, prices will fall.

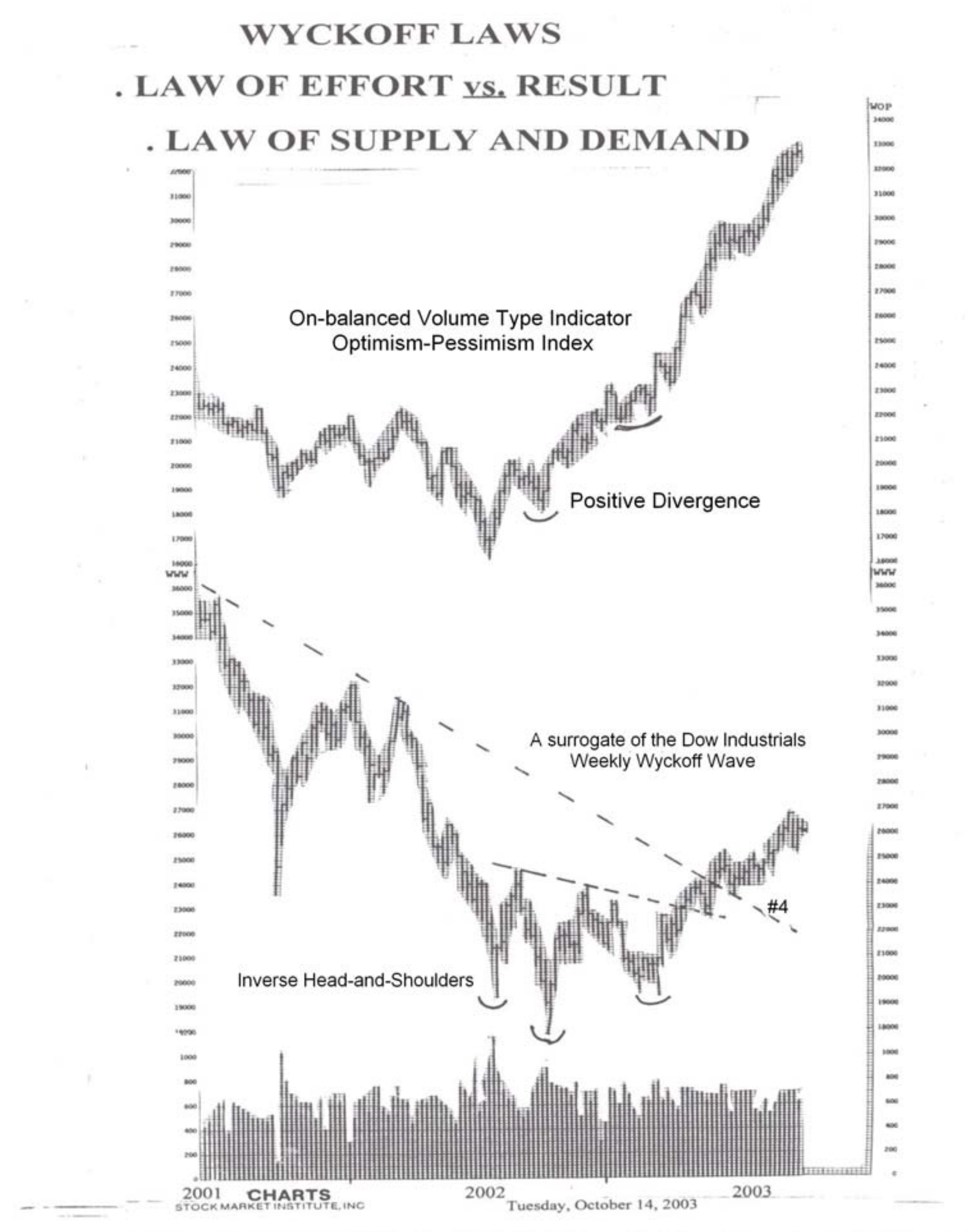
   Here the analyst studies the relationship between supply vs. demand using price and volume over time as found on a barchart.

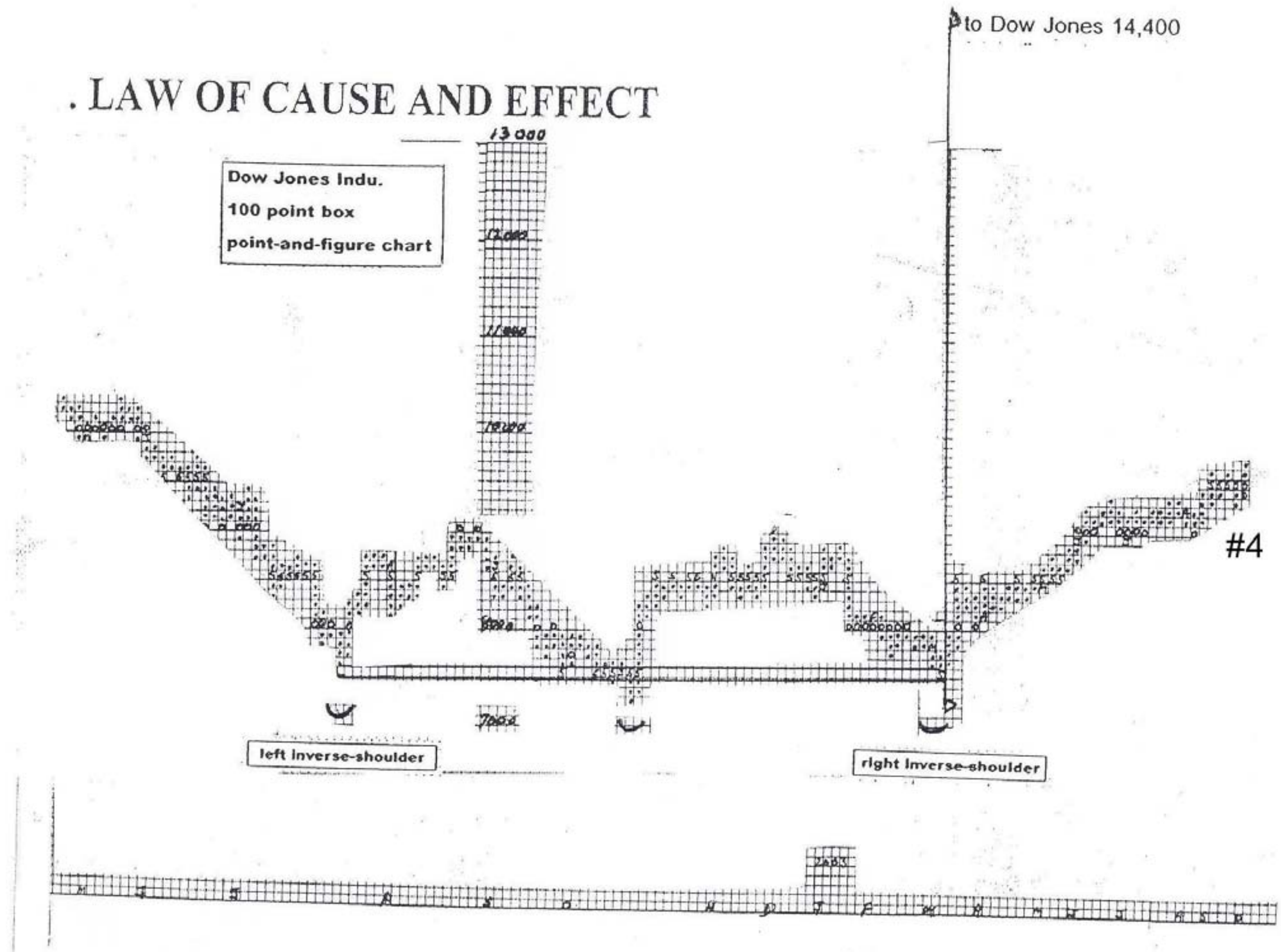
2. The Law of Effort vs. Results – divergencies and disharmonies between volume and price often presage a change in the direction of the price trend. The Wyckoff "Optimism vs. Pessimism" index is an on-balanced-volume type indicator helpful for identifying accumulation vs. distribution and gauging effort.

3. The Law of Cause and Effect – postulates that in order to have an effect on you must first have a cause, and that effect will be in proportion to the cause. This law's operation can be seen working as the force of accumulation or distribution within a trading range works itself out in the subsequent move out of that trading range. Point and figure chart counts can be used to measure this cause and project the extent of its effect.

PRESENT POSITION OF THE U.S. STOCK MARKET IN 2003: BULLISH

Charts #1 and #2 show the application of the Three Wyckoff Laws to U.S. Stocks during 2002-2003. Chart #1, a bar chart, shows the decline in price during 2001-02, an inverse head-and-shoulders base formed during 2002-2003 and the start of a new bull market during March-June 2003. The upward trend reversal defined by the Law of Supply vs. Demand, exhibited in the lower part of the chart, was presaged by the positive divergencies signaled by the Optimism Pessimism (on-balanced-volume) Index. These expressions of positive divergence in late 2002 and early 2003 showed the Law of Effort (volume) versus Result (price) in action. Those divergences reveal an exhaustion in supply and the rising dominance of demand or accumulation.





The bullish price trend during 2003 was confirmed by the steeply rising OBV index; accumulation during the trading range this continued upward as the price rose in 2003. Together the Laws of Supply and Demand and Effort vs. Result revealed a powerful bull market underway.

THE "NINE CLASSIC BUYING TESTS" OF THE WYCKOFF METHOD

The classic set of "Nine Classic Buying Tests" (and "Nine Selling Tests") was designed to diagnose significant reversal formations: the "Nine Classic Buying Tests" define the emergence of a new bull trend (See Table #2). A new bull trend emerges out of a base that forms after a significant price decline. (The "Nine Selling Tests" help define the onset of a bear trend out of top formation following a significant advance.) These nine classic tests of Wyckoff are logical, timetested, and reliable.

TABLE #2
Wyckoff Buying Tests: Nine Classic Tests for Accumulation
Nine Buying Tests (applied to an average or a stock after a decline)*

Indication:	**Determined From:**
1) Downside price objective accomplished	Figure Chart
2) Preliminary support, selling climax, secondary test	Vertical and Figure
3) Activity bullish (volume increases on rallies and decreases on reactions)	Vertical
4) Downward stride broken (i.e., supply line penetrated)	Vertical or Figure
5) Higher supports (daily low)	Vertical or Figure
6) Higher tops (daily high prices rising)	Vertical or Figure
7) Stock stronger than the market (i.e., stock more responsive on rallies and more resistant to reactions than the market index)	Vertical Chart
8) Base forming (horizontal price line)	Figure Chart
9) Estimated upside profit potential is at least three times the loss if protective stop is hit	Figure Chart for Profit Objective

* *Adapted with modifications from Jack K. Hutson, Editor, Charting the Market: The Wyckoff Method (Technical Analysis, Inc., Seattle, Washington, 1986), page 87.*

As the reader approaches this case of "Nine Classic Buying Tests," he/she ought to keep in mind the following admonitions from the Reminiscences of a Stock Operator (See Appendix):

"The average ticker hound – or, as they used to call him, tapeworm – goes wrong, I suspect, as much from overspecialization as from anything else. It means a highly expensive inelasticity. After all, the game of speculation isn't all mathematics or set rules, however rigid the main laws may be. Even in my tape reading something enters that is more than mere arithmetic. There is what I call the behavior of a stock, actions that enable you to judge whether or not it is going to proceed in accordance with the precedents that your observation has noted. If a stock doesn't act right don't touch it; because, being unable to tell precisely what is wrong, you cannot tell which way it is going. No diagnosis, no prognosis. No prognosis, no profit.

"This experience has been the experience of so many traders so many times that I can give this rule: In a narrow market, when prices are not getting anywhere to speak of but move within a narrow range, there is no sense in trying to anticipate what the next big movement is going to be – up or down. The thing to do is to watch the market, read the tape to determine the limits of the get-nowhere prices, and make up your mind that you will not take an interest until the price breaks through the limit in either direction. A speculator must concern himself with making money out of the market and not with insisting that the tape must agree with him.

"Therefore, the thing to determine is the speculative line of least resistance at the moment of trading; and what he should wait for is the moment when that line defines itself, because that is his signal to get busy."

Point #4 on the charts identifies the juncture when all Nine Wyckoff Buying Tests were passed. The passage of all nine tests confirmed that an u[trending or markup phase had begun. The passage of all Nine Buying Tests determined that the speculative line of least resistance was to the upside.

FUTURE: A MARKET TEST IN 2004

The authors as academics are intrigued by the natural laboratory conditions of the stock market. A prediction study is the *sine quo non* of a good laboratory experiment. The Wyckoff

Law of Cause and Effect seemed to us to provide an unusually fine instrument of conducting such an experiment, a "forward test." Parenthetically, it has been our feeling, shared by academics in general, that technicians have focused too heavily upon "backtesting" and not sufficiently upon real experimentation. The time series and metric nature of the market data allow for "forward testing." Forward testing necessitates prediction, then followed by the empirical test of the prediction with market data that tell what actually happened.

How far will this bull market rise? Wyckoff used the Law of Cause and Effect and the Point-and-figure chart to answer the question of "how far." Using the Inverse Head-and-Shoulders formation as the base of accumulation from which to take a measurement, of the "cause" built during the accumulation phase, the point-and-figure chart (Chart #2) indicates 72 boxes between the right inverse-shoulder and the left inverse-shoulder. Each box has a value of 100 Dow points. Hence, the point-and-figure chart reveals a base of accumulation for a potential rise of 7,200 points. When added to the low of 7,200 the price projects upward to 14,400. Hence, the expectation is for the Dow Industrials to continue to rise to 14,400 before the onset of distribution and the commencement of the next bear market. If the Dow during 2004-2005 comes within + or - 10% of the projected 7,200 points we will accept the prediction as having been positive.

CONCLUSIONS

In summary, U.S. equities are in a bull market with a potential to rise to Dow Jones 14,400. The anticipation is for the continuance of this powerful bull market in the Dow Industrial Average of the U.S.A. through 2004. This market forecast is the "test" to which the Wyckoff Method of Technical Analysis is being subjected.

Part (B) of "Wyckoff Laws: A Market Test" will be a report in year 2005 about "What Actually Happened." As with classical laboratory experiments, the results will be recorded, interpreted and appraised. This sequel will invite a critical appraisal of the Wyckoff Laws and in particular a critical appraisal of the Wyckoff Law of Effort vs. Result. The quality of the author's application of the Wyckoff Laws will also undergo a critique. From these investigations and appraisals, we shall stive to extract lessons for the improvement of technical market analyses. Irrespective of the outcomes of this market test, we are confident that the appreciation of the Wyckoff Method of Technical Market Analysis will advance and that the stature of Mr. Richard D. Wyckoff will not diminish.

ABOUT THE AUTHORS

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Hank Pruden is a professor in the School of Business at Golden Gate University in San Francisco, California where he has been teaching for 20 years. Hank is more than a theoretician, he has actively traded his own account for the past 20 years. His personal involvement in the market ensures that what he teaches is practical for the trader, and NOT just abstract academic theory.

He is the Executive Director of the Institute of Technical Market Analysis (ITMA). At Golden Gate he developed the accredited courses in technical market analysis in 1976. Since then the curriculum has expanded to include advanced topics in technical analysis and trading. In his courses Hank emphasizes the psychology of trading and as well as the use of technical analysis methods. He has published extensively in both areas.

Hank has mentored individual and institutional traders in the field of technical analysis for many years. He is presently on the Board of Directors of the Technical Securities Analysts Association of San Francisco and is past president of that association. Hank was also on the Board of Directors of the Market Technicians Association (MTA). Hank has served as vice chair, Americas IFTA (International Federation of Technical Analysts): IFTA educates and certifies analysts worldwide. For eleven years Hank was the editor of The Market Technicians Association

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Charts, courtesy of WYCKOFF/STOCK MARKET INSTITUTE, 13601 N. 19th Avenue #1, Phoenix, Arizona, U.S.A. 85029-1672.