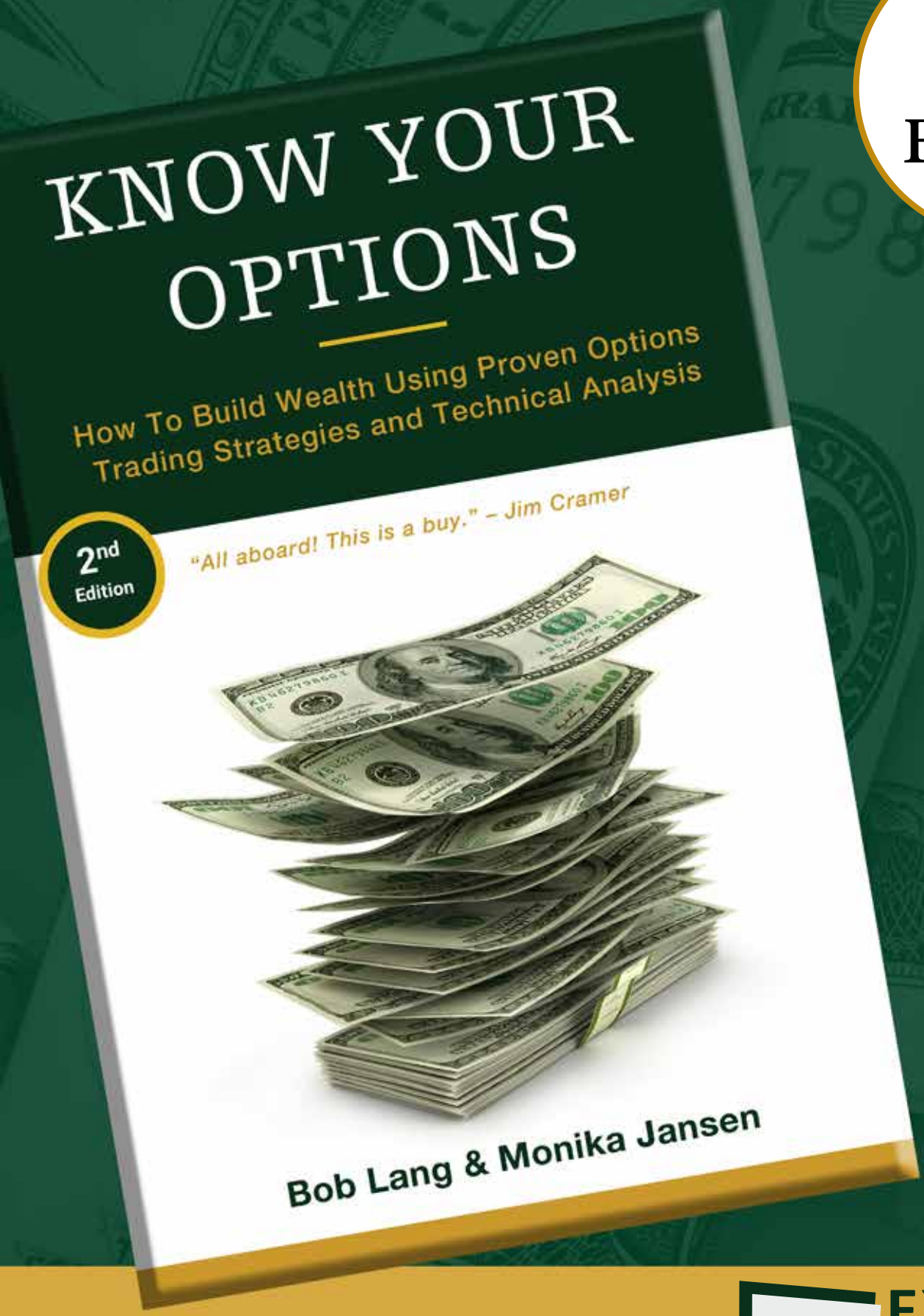


2nd Edition

EXPLOSIVE OPTIONS

CHAPTER 4
TAKE YOUR CHARTS TO HEART: HOW TO ANALYZE TECHNICAL PATTERNS

"You're neither right nor wrong because other people agree with you. You're right because your facts are right and your reasoning is right - and that's the only thing that makes you right."

- Warren Buffett

Technical analysis and charting is often mistaken for mysterious and mystical practices, like voodoo or tarot cards. In reality, charts offer a look at past behavior, and I can tell you without hesitation that past behavior informs future behavior. Our behavioral patterns are ingrained in our DNA; they never change over time. Every decision we make is based on prior experience.

Behavioral Psychology and Trading

You can learn a lot about trading from behavioral psychologists **Ivan Pavlov** and **B.F. Skinner.** They taught us about:

Classical conditioning: Learning to associate an unconditioned stimulus that already brings about a particular response with a new (conditioned) stimulus, so that the new stimulus brings about the same response.

Operant conditioning: If behavior is reciprocated with a certain consequence, whether it is a positive or a negative reinforcement, the behavior is more likely to be repeated and become constant.

You can use these two theories to discover patterns and trends in stock charts that repeat over and over again. And, you can combine the theories with your knowledge of fear and greed (I covered this in-depth in Chapter 3) to place directional bets via stocks, options, and futures.

(Keep in mind that people rush into fear but not greed. With greed, we will wait for some sort of confirmation before buying. With fear, we will

rush for the exits in a stampede. As the old saying goes on Wall Street, *"You take the elevator up and the window down".)*

The chart below shows the dynamics of fear and greed, which you can watch play out in real-time as well.

Simply put, a down session (red bar) indicates fear, while an up session (green bar) indicates greed. The amount of movement indicates the degree of fear or greed (which usually isn't extreme).

Technical Patterns Every Trader Must Know

Your job as a technical analyst is to look for behavioral clues and patterns that occur over and over again and then follow them to place a high probability bet. Markets trend up and down based on the flow of liquidity, which is directly connected to fear and greed. If investors are emboldened and believe the market will rise, more money pours in and prices go up. If investors are worried, money flows out and prices drop.

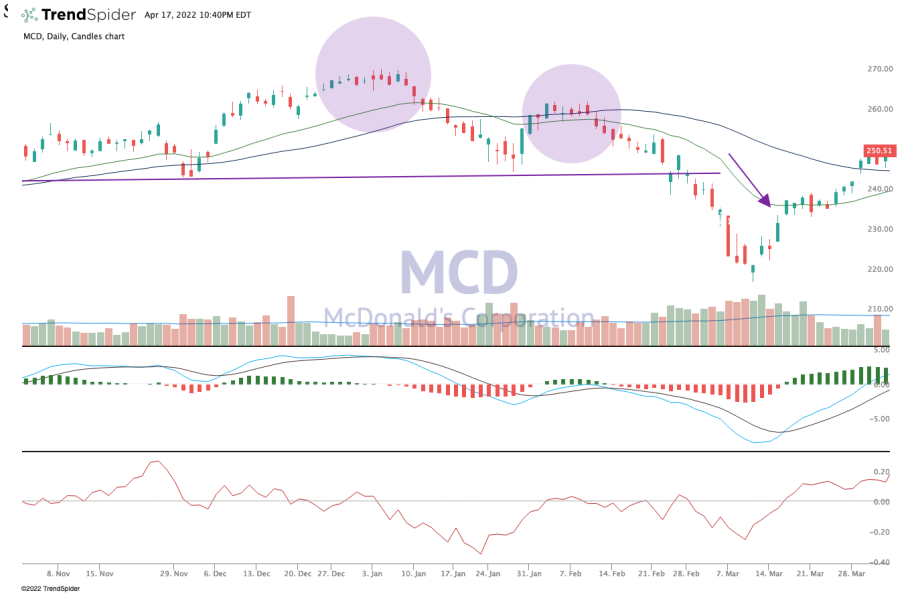
The notion that the crowd is often late and wrong is something that shows up in sentiment polls, equity flows, and fear/greed indicators. Market corrections happen without much warning; nobody stands out on the street waving a white flag and yelling, "Get out!" There are a million reasons to sell stocks, but only one reason to buy - a stock is going higher.

Some of the most obvious technical patterns can easily be explained by human behavior. Take a **W chart pattern**, a formation that happens when a stock drops to an interim bottom, rallies to resistance, retests that bottom, and then moves past resistance to new highs. The Costco chart below is a great example.

This pattern is simply telling you to only trust the bottom if it is not penetrated. Buying into a decline is painful and highly discouraged unless your timeframe is forever. You want to be risk averse in a down stock or index until you have confidence the trend has changed. The W pattern tends to be a bullish one that plays out in a continuation move as a base is carved out on the right side of the chart.

How about the reverse of the W - the **M pattern**? As you might suspect, this is a bearish pattern that occurs when you see a **double top** forming. Buyers are not interested in paying higher prices twice at the same level; that rejection causes sellers to appear and the pattern is established. Naturally, the downside action often accelerates quickly as fear takes hold.

The **head and shoulders pattern** is one that always needs to be considered. This is a classic trend reversal pattern that is often associated with a bearish follow-on move after the pattern has been established. As we see in the chart below, a high is made (left shoulder) followed by a higher high (head), then a pullback and lower high (right shoulder). Below the two shoulders is the neckline (support). A break of that level is typically a signal that more downside action is coming. A price objective would be the difference between the head and the neckline. In the case of McDonald's, a break of the neckline around $242 would set up a measured move to roughly $222, about a $20 move down from the right



Now, if a head and shoulders pattern is bearish, you should consider the opposite pattern as bullish. An inverse head and shoulders pattern is a reliable pattern that plays out when a price tests a low and makes a higher low pattern on the chart. A break of the neckline is a measured move (difference between the head and the neckline). In the case of Intel, a move of roughly $3 past the neckline, or nearly $33, completed the pattern.

Moving average crossovers, aka, long term crossovers, must always be respected, as pressure to buy and sell tends to shift trends quickly. Institutional players also pay very close attention to them, which will affect the flow of money. Two classic examples are the golden cross and the death cross.

The **golden cross** happens when the 50-day moving average crosses above the 200-day moving average. It provides long-term fund managers with confidence that the market will move higher. Fifty days is the equivalent of roughly two and a half months, while 200 days is the equivalent of one year (remember, we're talking about trading days - not the calendar year). When a shorter term moving average crosses above the longer-term average, it is considered a bullish event by technical analysts. If higher trading volume occurs at the same time as a crossover, you have a strong signal that stocks may propel higher.

Conversely, a **death cross** occurs when the 50-day moving average crosses under the 200-day moving average, indicating that prices are going down, at least in the short-term. When this happens, institutions are likely to **distribute** stock (sell long-term holdings) and lock in profits. This event is often viewed as a negative over the long-term, but only if the condition persists or happens when price is well below the moving averages.

There have been times when a death cross was a great buy signal, so the results are somewhat mixed (see chart). However, a death cross normally occurs near the end of a bull cycle, and in fact it's often the final sign that we are shifting into a bear cycle. When price is below the moving averages, you'll see heavy resistance keeping the price down as sellers

John Bollinger is a legendary contributor to the technical analysis community for creating a valuable tool called **bollinger bands**. These are a simple statistical tool that use probability with data points. A volatility band around the mean (price) shows the probability of where a data point will land. (If you want a more technical explanation: Bollinger bands are an adaptation of keltner bands, envelopes and donchian channels, but bollingers use the purest statistical data to estimate a probable outcome.)

Here's how I use them in a stock chart: I will plot two standard deviations around the mean (bands), because there is a 95% probability that a new price level (daily) will land inside the bands. Since price action is dynamic, the tool takes into consideration volatility.

Bandwidth is an important consideration when analyzing bollinger bands. The dynamics of price will move the bands from wide to narrow, depending on how historical data points move the bands. Narrow bands imply price contraction, and it may signal a large move is coming. In the chart below, note how the narrow bands indicate a decrease in volatility, while the widening bands imply a jump in volatility (or panic) but are generally short term in nature.

Famed investor George Soros once said, "The biggest profits are made in the **fat tails**." Fat tail events are outliers on the frequency distribution spectrum; they sit in the 5% probability zone. But they do happen! And when they do, you can win – BIG. In fact, as an options trader, you can ride a fat tail for big profits in a very short timeframe. I know it's possible, because I've done it - and not just once.

While seemingly rare (especially when you consider that price only lives in the fat tail area 5% of the time), fat tail events happen more frequently than one would believe, and they have a substantial effect on a portfolio.

As you can see in the Tesla chart above, there were a couple of very profitable fat tail trades (arrows) in 2021 and 2022.

Trading a fat tail condition is tricky. It requires some finesse and speed, identification and confirmation. As we see from the Netflix chart above, there were a couple of very profitable fat tail events in 2015.

Chaikin Analytics: A Suite of Must-Use Technical Tools

Some of the best and most popular technical tools were created by **Marc Chaikin**, a 50-year veteran of markets in just about every capacity. Marc's work refined the analytical tools developed by famed commodities trader and technician Larry Williams (creator of the %R oscillator) and others.

Marc's goal was to get a better feel for price movement under regular market conditions. While creating computerized stock selection models for fund managers, Marc discovered that money flow and accumulation and distribution were key technical elements that complemented price and volume activity.

Today, Marc's name is well-recognized around the world of finance for his Chaikin Oscillator and Chaikin Money Flow indicators, both of which

are vital tools for technical analysts. Any trader not using them is missing a critical part of his or her analysis.

In the late 2000's, ChaikinAnalytics.com launched to help individual, retail, and institutional investors better tap into changing signals and trends. Marc is a believer that trend analysis provides better profit opportunities than reversals, yet it is extremely important and valuable to know when a trend is turning towards the other direction. The analytics provide a way to see these changes in real time and with amazing accuracy and quickness; a chart sample is below.

Technical Analysts to Follow

Carolyn Boroden (www.Fibonacciqueen.com) identifies mathematical and timing patterns based on historical trends and **Fibonacci** numbers (numbers that appear over and over in nature), a common occurrence in financial markets. Her very accurate analysis does not include fundamentals, only statistics that are often so overwhelming it's obvious you need to trade in a particular direction. Carolyn also uses timing mechanisms and symmetry analysis to confirm previous patterns and accuracy.

Alan Farley is simply the best teacher of technical analysis for the swing trader. I have used his book, the *Master Swing Trader*, extensively to find some of the most reliable patterns. In fact, it is a book that every technical trader should have in their book library (but finish reading this one first before you start his!).

Alan teaches why price action is key and to look at breakout and breakdown levels for potential. He covers concepts like 7 Bells (specific patterns that should ring loud like an alarm) and patterns like Dip Trip, Coiled Spring, and Power Spike, all of which will give you an edge in determining the next price move.

When I was starting out as an options trading, I told a friend that I really wanted to learn about technicals from a true authority on the subject. He did not hesitate in his answer: "Check out **Dave Landry**." Boy, did he point me in the right direction! I signed up for Dave's email newsletter, and I read all of his books (*Dave Landry on Swing Trading* is the first book I ever owned on technical analysis and, while brief, it immediately got me hooked on the art of technicals).

Dave is a wonderful teacher, because he explains everything clearly and simply. His technical pattern descriptions are legendary. He has identified patterns like Trend Knockout, Bowtie, Micro Double Bottom, and Micro Cup/Handle, and he fully explains chart pattern techniques so you can maximize the opportunity presented by specific price action.

Dave's guidance around risk management and swing trading have made a huge difference to my success as a trader. Like Alan Farley, Dave relies on time-tested patterns to determine trade entry, and he uses disciplined stop-losses to manage risk. The most important lesson I learned from Dave is preparation: You can gain an edge over the rest of the crowd simply by being armed with the best and most up-to-date information at all times.

Todd Gordon (www.tradinganalysis.com) uses Fibonacci numbers in his technical analysis, too, but he also applies the **Elliot Wave Theory** to help him discover points where trends might possibly reverse. This theory is based on historical price action patterns and posits that movements come in waves, usually over five segments (up, down, up, down, up and vice versa). Elliot Wave is not a perfect science. You'll want to mark up a chart with a pencil (keep a good eraser handy) rather than a pen, but Todd is usually quite accurate in pinpointing trend changes using his combined methodology.

Chapter 4 Takeaways

- *Technical analysis is the key to understanding short term market movements.*
- *The market exhibits specific behavior patterns based on fear and greed.*
- *Reliable technical patterns are key to identifying trends and opportunities.*
- *Learn from the technical traders - they'll help you understand the game - and elevate it.*

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- ☑ The role the Federal Reserve plays in the markets
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- ☑ 5 case studies (with charts)
- ☑ A glossary of options trading terms
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