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Stock Market Trading Strategies

Step Three of the Wyckoff Method

Step three of the Wyckoff method is intended to help traders avoid marginal trades. Wyckoff teaches us to select only those issues that have built a cause. A cause can be defined in more than one way.

In step three, Wyckoff is referring to the use of a figure chart to get an indication as to how far from its current level, the price of an issue is likely to move. This indication is derived by taking a count on a figure chart.

While an issue is in preparation for a move, its action produces a horizontal formation on a figure chart. The horizontal formation contains the count. When the price has completed its preparation and begins to move out of the area in which the preparation was done, the count has been completed and can be measured. To measure the count, the trader selects the appropriate price level within the horizontal formation and simply counts the number of horizontal divisions on the chart beginning at the right side of the formation and ending at the left side of the formation. The trader counts all the horizontal divisions both those that have a posting in them and those that do not. The total number of horizontal divisions is the count. It provides an indication as to how far from the level at which the count was taken the price is likely to move.

If the price leaves the zone of preparation, normally referred to as the trading range, to the up side, Wyckoff says to add the count to the level at which it was measured to get an indication as to how high the price is likely to go. If the price leaves the trading range to the down side Wyckoff says to subtract the count from the level at which it was measured to get an indication as to how low the price is likely to go.

The anticipated ending point of a move indicated by a count is called its objective. An objective may be a single level, but is more often than not a range of values referred to as the objective range. If a count for an advance is taken at the very bottom of the trading range, it will indicate a single level as the objective of the move. However, if the count is taken at some other level within the trading range, the result will be an objective range.

This range is determined by adding the count to the level at which it was measured and by adding it to the lowest level in the trading range. If a count for a decline is taken at the very top of the trading range, it will indicate a single level as the objective of the move. If the count is taken at a lower level in the trading range, the result will be an objective range. In this case, the objective range is determined by subtracting the count from the level at which it was measured and by also subtracting it from the highest level in the trading range.

Individual issues are not the only place were counts are taken and objectives are measured. They can also be taken and measured for a general market index. If a trader is operating in the options or futures derived from an index, it is essential that the trader take a count and determine an objective for the index that is being traded. When the index reaches its objective range, the move is likely to end and the position in the derivative trading vehicle can be closed. Measuring counts and determining objectives on the underlying index usually provides more reliable indications than does taking the counts and determining objectives on the particular trading vehicle that has been selected.

Traders who only operate in individual issues should not ignore the indications for the general market. Situations where both the general market and an individual issue are indicating an objective above or below current levels are the most desirable. If the market and an individual issue both have higher or lower objectives, the movement of the market as a whole is likely to help the individual issue reach its objective. If the general market does not have an objective that is in harmony with that of an individual issue being considered, the individual issue may still reach its objective, but the odds of that happening are not as good as they are when the market has a similar objective to that of the individual issue.

Wyckoff does not provide specific directions as to how large of a count an issue should have to be considered for a trade. In making this determination, the trader needs to be realistic. If the trader only wants to hold positions for a short period of time, smaller counts should be identified with relatively nearby objectives. Identifying much larger counts with much higher or lower objectives and expecting those objectives to be reached in a short period of time is not realistic. Traders who are comfortable with the idea of holding a position for an extended period of time should also be realistic. It is a waste of time and effort for these traders to focus on small counts and nearby objectives. A trader who is willing to wait for his reward to develop should demand a larger count and more distant objective before taking a position.

All Wyckoff traders should always remember what Wyckoff says about figure charts, counts and objectives. They provide indications only. Above all else is the character of the price and volume action. If it supports the idea of the indications being realized, positions can and should be held. However, if the character of the action does not support the idea of the indications being realized, positions should be closed.