Bulkowski’s Trading Quiz

Here’s the latest quiz. What chart patterns can you find? A hint appears below and answers on the next page.

**Hint.** Look for the following chart patterns (If you find others, great!): the start of a dead-cat-bounce and a symmetrical triangle.
If you hold stocks long enough you will come across this situation – price makes a large drop in one day. I call it a dead-cat bounce (DCB) and you’ll see why in the coming charts. Notice that price dropped below the lower trendline boundary a few days before the DCB started. On Sept 30, the last day shown on the chart, the company pulled Vioxx from the market because a clinical trial indicated people were twice as likely to have a heart attack after taking the drug for 18 months, according to published reports.

**Question 1:** Do you buy, short, or avoid trading this stock?

The answer appears below and a chart on the next page.

**Answer 1:** Do nothing. If you own the stock, hold on and wait for a bounce.
Has the bounce phase of the DCB begun? In other words, should you have sold your holding 3 days ago when price peaked after the large decline? That’s the challenge when trading a DCB. I’ve been fooled into selling too soon. The price decline measures from the close the day before the announcement of 45.07 to the event low, the lowest low before the bounce of 32.46, for a decline of 28%. The event decline (prior close to trend low) measured 31% in the 337 stocks I looked at. Thus, so far, this one is short of the average. The larger the event decline the larger the bounce. Don’t expect a large bounce based on what we see here. Most times, the bounce is longer. Selling now might be a mistake.

What happened next? See the following page.
In the coming days, price continued down until hitting the low on 11/10 at a price of 25.60. From the close the day before the announcement, the decline measured 43%. Whether you can call the new low the event low is open to debate. If the answer is yes, then expect a large bounce. The average bounce from this point is a rise of 28%. That would put the target price at 32.77. I show the target in red.

The next page shows what happened.
To cut a long story short, I show the remainder of the chart. Price bounced up from the event low before tumbling as it does in nearly every dead-cat bounce. The surprising thing about this DCB is the drop to the event low took so much time. Usually it’s a short drop, a day perhaps 2. In fact, 46% make a lower low the day after the announcement, 17% make a lower low the next day, and so on.

For trading, a hedge fund manager I know looks for DCBs and waits for the bounce. When the stock begins to turn down, he shorts and rides price lower. In two out of three trades, price will drop below the event low during the post-bounce phase, so if you think the decline is over, you’re in for a surprise.

Study the behavior of DCBs because sooner or later you’ll be caught by one. When price bounces, sell near the bounce top then go short if you dare.

The end