Bulkowski’s Trading 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!): 2 triangles, head-and-shoulders, scallop, island.
Instead of the usual quiz, two people asked me how to draw trendlines. Let’s take the above chart. I am interested in buying the stock because of the head-and-shoulders bottom with an upward breakout (price has closed above the red neckline and it looks to have completed a throwback. It’s a buy signal.

**Question:** How do I know if price has changed trend from up to down? A trendline can help determine that. How do I draw the trendline to show a possible trend change?

The answer appears on the next page.
This method is from Victor Sperandeo’s book, *Trader Vic: Methods of a Wall Street Master*. Find the highest high and lowest low on the chart. I show these circled above. Draw a line connecting the two points such that price does not cross the line until AFTER PRICE REACHES THE HIGHEST HIGH.

If you draw a line connecting the lowest low with the highest high, price will cross the line many times. Anchor the line on the lowest low and swing the top downward until price does not cross the trendline until AFTER it passes the highest high. The next page shows this.
That is a properly drawn trendline for this situation. According to Sperandeo’s 1-2-3 trend change method, point 1 is where price pierces the trendline. Point 2 is a test of the high after the trendline break. If price were to close below the low between points 1 and 2 (shown as point 3, the green horizontal line), then that would confirm price has changed trend from up to down. In this example, price has not dropped to the green line, so the trend may still be up.

You can use this trendline method on any time scale that shows a trend.

Let’s try another example using a down trendline. See the next page.
I changed the price at the high because it made the example clearer. Anyway, the highest high of interest is the top circle and the lowest low is the bottom circle. Has price changed trend after the March low?

Draw a down-sloping trendline such that price does not cross the trendline until AFTER it passes the lowest low. I show that as a blue trendline. To determine whether the trend has changed, here are the 3 steps.

Point 1 is where price pierces the trendline, moving up.
Point 2 is a test of the lowest low.
Point 3 is where price has climbed above the peak between points 1 and 2. This is where price confirms the trend change.

Notice how much you lose waiting for a confirmed trend change. If you sold this stock short, you would give back a bundle if you waited for price to close above the green line at 3.

Sperandeo writes “The 2B Rule. In an uptrend, if a higher high is made but fails to carry through, and then prices drop below the previous high, then the trend is apt to reverse. The converse is true for downtrends. This observation applies in any of the three trends; short-term, intermediate-term, or long-term.”

I show an example of this on the next page.
Has the trend changed from up to down?

The next page shows the answer.
Pretend we are looking at the chart before point 2 occurs. Draw the blue trendline from the lowest low to the highest high such that the trendline does not cross price until AFTER the highest high. I show that as the blue line. Price crosses the line at 1, moving down. It’s the first hint of a trend change. Point 2 is the 2B point Sperandeo speaks of. Price makes a higher high but fails to continue moving higher. Point 3, would complete the trend change if price drops below it. On this chart, that hasn’t happened yet. The next page shows the final chart.
Price continued dropping just as the 2B point predicted. Price confirmed the trend change when it dropped below point 3.

Notice that point 2 completes a double top. I found that price resumes moving up 65% of the time in a bull market before it confirms a double top (by closing below point 3). Keep that in mind when you use the 2B rule to exit. Chances are, price will recover before dropping too much.

As a final word, please remember that this method of drawing trendlines is used to determine when the trend changes. I often draw trendlines along the prevailing price trend regardless of whether it’s between the lowest low and highest high on the chart.

The end.