

## Bear-y Significant Patterns

# Identifying Bearish Chart Patterns (I)

*Bearish chart patterns form at the top of a bear market. What do they look like?*

by Thomas N. Bulkowski

**S**ince March 2003, the market has been trending upward. As I write this in August 2003, I'm starting to see bearish chart patterns dotting the stock market landscape like storm clouds brewing. What should you know about bearish chart patterns? This two-part article takes a close look at them.

## BROADENING FORMATION, RIGHT-ANGLED AND ASCENDING

Figure 1 shows a right-angled and ascending broadening formation. Prices along the bottom of the pattern follow a horizontal trendline; along the top, a trendline connects higher highs. Thus, the pattern broadens out, but only on the topside. The pattern portends a bearish price reversal. In this example, prices started climbing in late March, entered the pattern, then tumbled after the breakout, reversing the short-term uptrend.

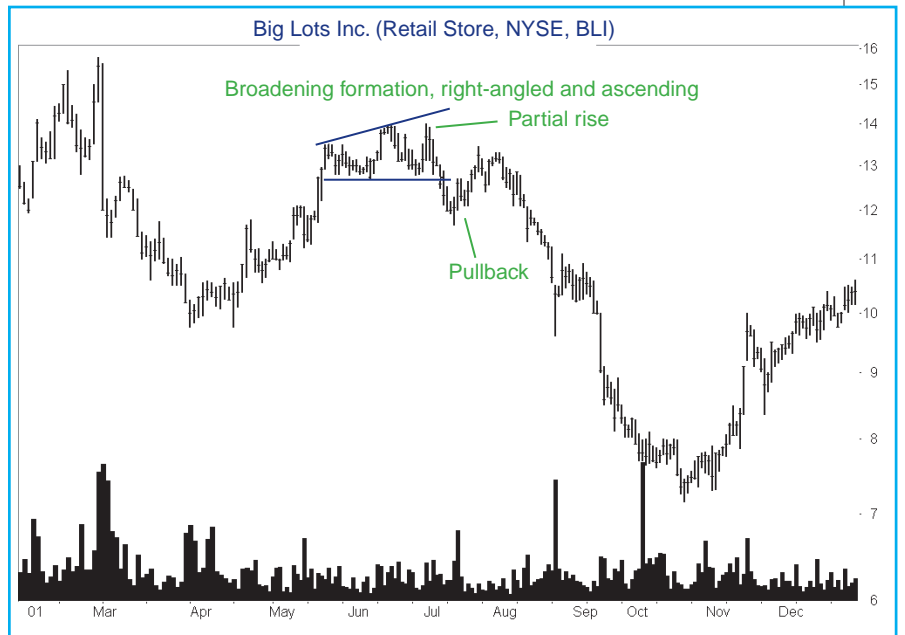
A key to this pattern and other broadening patterns is the partial rise. If prices touch the bottom trendline and climb but don't touch the upper trendline, then there is a good chance that prices will break out downward. I call that hump a partial rise because prices partially make their way across the pattern. Look for partial rises *after* four touches of the trendlines occur (at least two on each side). Only then is a partial rise valid.

As a bearish chart pattern, the right-angled and ascending broadening formation isn't very bearish. Although prices can tumble, as shown in Figure 1, the average decline measures 18% for the 181 patterns I looked at. That's shy of the average 21% decline for other bearish chart patterns.

## BROADENING TOP

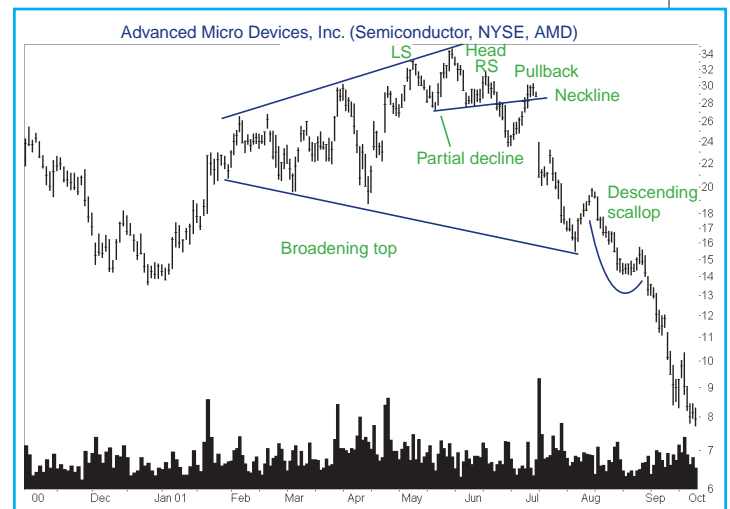
Figure 2 shows what a broadening top looks like. It sports higher highs and lower lows bounded by two trendlines that widen over time. The price broadens out. A *top* means that prices enter the pattern from the bottom. The direction they exit is unknown until the breakout occurs.

In this example, prices tumbled despite the partial decline



**FIGURE 1: RIGHT-ANGLED AND ASCENDING BROADENING FORMATION.** A partial rise in this chart pattern correctly predicts a downward breakout.

predicting an upward breakout. A partial decline is similar to a partial rise flipped upside down. You need at least two touches of each trendline before you start looking for partial declines. A partial decline occurs when prices touch the top



**FIGURE 2: BROADENING TOP.** The smaller head & shoulders buried within the larger broadening top was another indication of the upward trend ending.

trendline, then dip but don't touch the bottom trendline before reversing. When prices touch the top trendline, expect an upward breakout. Partial declines work 86% of the time, and partial rises work 65% of the time for broadening tops, according to the 189 patterns I looked at. If the breakout is downward, expect a decline averaging 23%, but your results will vary.

Figure 2 also shows other bearish patterns. A head & shoulders top appears just as prices peak. Prices break through the neckline, then pull back before continuing down. A descending scallop with its characteristic rounded bowl appears in August and suggests a continued decline.

### BROADENING WEDGE, ASCENDING

Figure 3 shows an ascending, broadening wedge. It appears on the chart as a megaphone tilted up, hence the "ascending" part of the name. Higher highs and higher lows, each bounded by an upsloping trendline, form this pattern; thus, prices broaden over time.

I uncovered 157 of these in the stocks I looked at. Of those showing a partial rise, 84% successfully broke out downward. That's key. Look for a partial rise sometime after two touches of each trendline. Once prices break out downward, the average decline measured 20% for the patterns I examined.

### BUMP-AND-RUN REVERSAL TOP

I discovered this pattern, and Figure 4 shows a complicated example of what the bump-and-run reversal (BARR) top looks like. Prices start in the lead-in phase of the pattern following an upsloping trendline. In the bump phase, the trend climbs even faster, following a steeper trendline. Prices then round over and crash through the trendline connecting the lead-in phase.

That's how it's supposed to work. Figure 4 shows a dual BARR top, so called because it has a second bump. Of the 650 patterns I looked at, just 8% had more than one bump. The average decline measured 24% below the trendline.

BARR tops are complicated to spot, so here are the guidelines. First, look for prices following an upward trendline that approximates 30 to 45 degrees. Avoid steep trendlines. The lead-in section is just before prices jump up in the bump phase. The lead-in height should be at least \$1 (preferably \$2 or more), measured vertically from the highest high to the trendline.

Prices gather momentum and the trendline slopes upward at 45 to 60 degrees, or more, on high volume. The height of the bump should be at least twice the lead-in height. What we are looking for is excitement in the stock — momentum players bidding up the price. When they stop pushing prices up, the downhill run phase begins.

The downhill run sees prices return to the 30-degree trendline that connects the lead-in phase to the bump phase. Prices may slide along this trendline but usually work their way lower. Occasionally, prices bounce upward and form a second bump, as shown in Figure 4. That does not change the bearish picture.

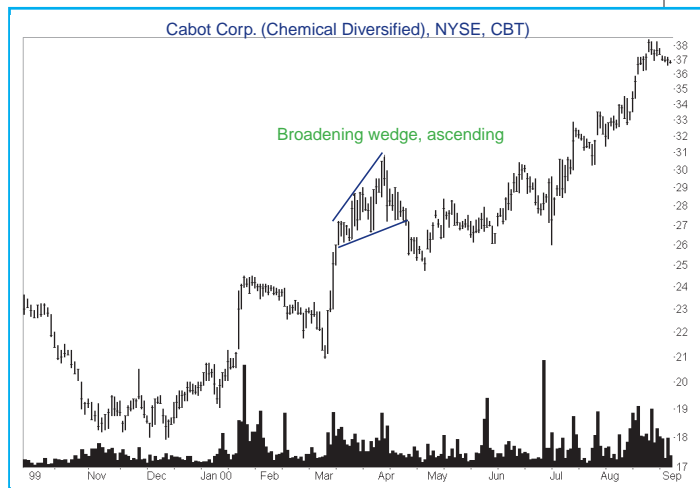


FIGURE 3: ASCENDING BROADENING WEDGE. Prices didn't decline much from this wedge.

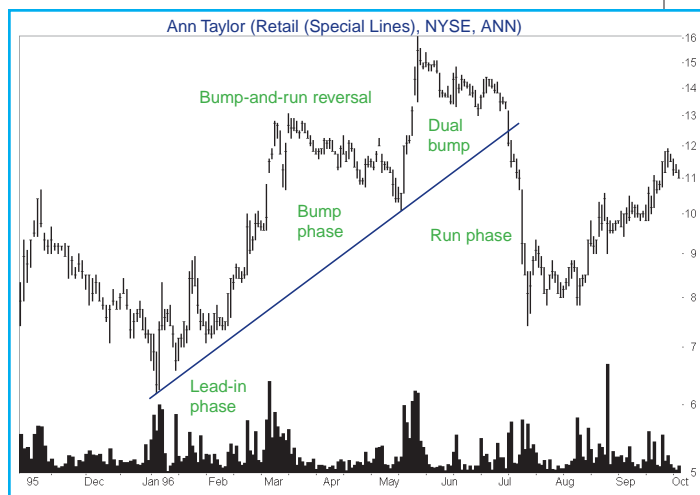


FIGURE 4: DUAL BUMP-AND-RUN REVERSAL. Sometimes a second bump appears after a BARR top.

### DIAMOND TOP

I bought many trinkets for my ex-girlfriend (if you can call a shiny red Corvette a trinket — she loved the snap-together model), but a diamond wasn't one of them. Even though I proposed and she accepted, I was never fond of the stones. The diamond chart pattern I view in a similar way. I cannot recall ever buying a stock because I saw a diamond bottom, but I do recall selling because I saw a diamond top. Figure 5 shows a typical example.

You might first scoff at its shape, but diamond chart patterns are rarely perfect. The diamond shape is usually pushed to one side or the other, making the diamond harder to spot. Prices trend up to the pattern, but the breakout can be in any direction, including horizontal. Most of the 111 diamond tops I looked at broke out downward. Thus, they acted as reversals of the prevailing short-term uptrend. The pattern's volume tends to recede, as it does in so many other chart patterns.

One of the things I do like about diamonds is that a quick decline often follows a quick rise. The quick rise occurs when prices shoot higher, taking just a few days to make a vertical climb of several points. After the diamond reverses the quick rise, prices often tumble back to the point where the rise began. Keep that quick rise, quick decline pattern in mind, as it occurs often.

## DOUBLE TOP

Figure 6 shows a classic double top, but they actually come in four varieties: Adam & Adam, Adam & Eve, Eve & Adam, and Eve & Eve. An Adam top appears narrow, pointed, with perhaps a single spike at the top. An Eve top is more rounded, broader. The figure shows an Eve & Eve double top.

A twin top pattern is not a true double top until prices close below the lowest low in the pattern. That's called the confirmation price, and Figure 6 shows an example. It's also the breakout price, and I found that prices dropped 20% in the 454 patterns I looked at.

In a study of 1,280 twin peak formations, I found that 65% continued higher without dropping below the confirmation price. That's why it's so important to wait for confirmation. If you own a stock in a bull market, chances are the price will continue rising. Don't sell until you are sure the price is going down. That's not a license to let losses run away from you. Use common sense and good money management.

## HEAD & SHOULDERS TOP

The head & shoulders top looks just like it sounds. First a left shoulder forms, then a higher head, then a right shoulder. A neckline joins the shoulder valleys (the armpits, if you will). When prices close below the neckline, the pattern becomes a valid head & shoulders top. Expect lower prices to the tune of 23%, on average.

When looking for head & shoulders tops, search for symmetry. Often, the shoulders will appear similar in width and height, and will be nearly the same distance from the head.

The typical volume pattern shows the highest volume on the left shoulder, followed by the head, with the lowest volume on the right shoulder. That's a typical pattern, and Figure 7 shows a different combination that occurs about a third of the time — volume is highest during formation of the head. If you have a volume pattern that's different from the typical pattern, don't worry. It's *price* you should be worried about, because you can't deposit volume into your bank account.

If you own a stock showing a head & shoulders top, wait for confirmation, then sell. A pullback to the breakout price occurs about 45% of the time, giving you another opportunity to dump it before the decline resumes. Take it or suffer the loss.

## HEAD & SHOULDERS COMPLEX TOP

Now that you know how to find a head & shoulders top, look to the left and right of the pattern and search for additional shoulders. You will often find them. Figure 8 shows an example of a complex head & shoulders top. This one has two

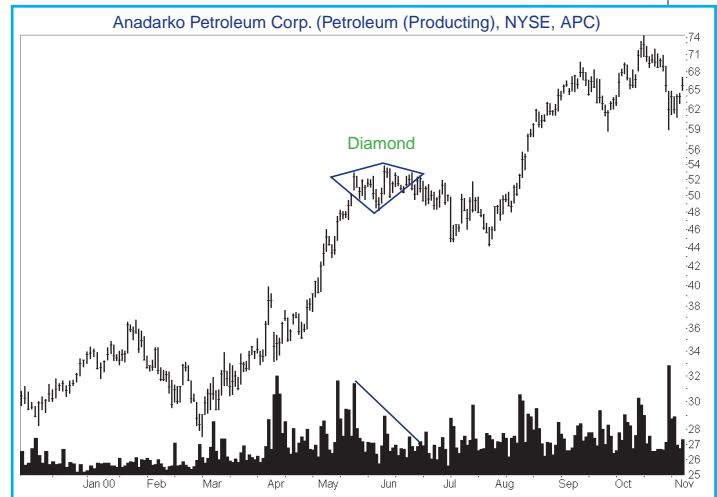


FIGURE 5: DIAMOND TOP. Diamonds rarely show a perfect diamond shape.

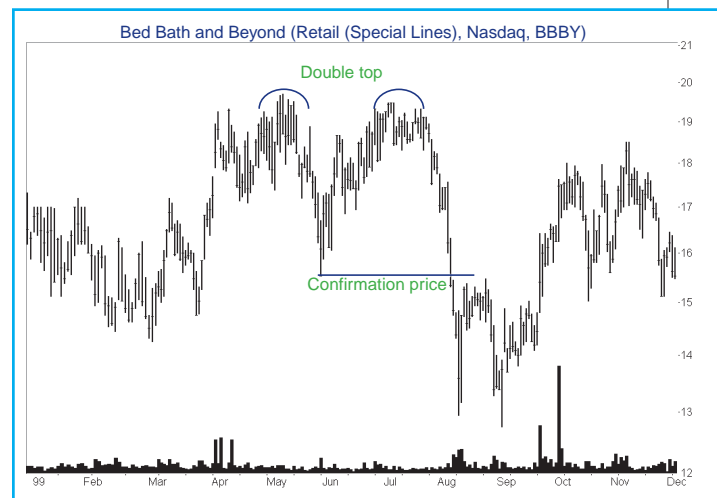
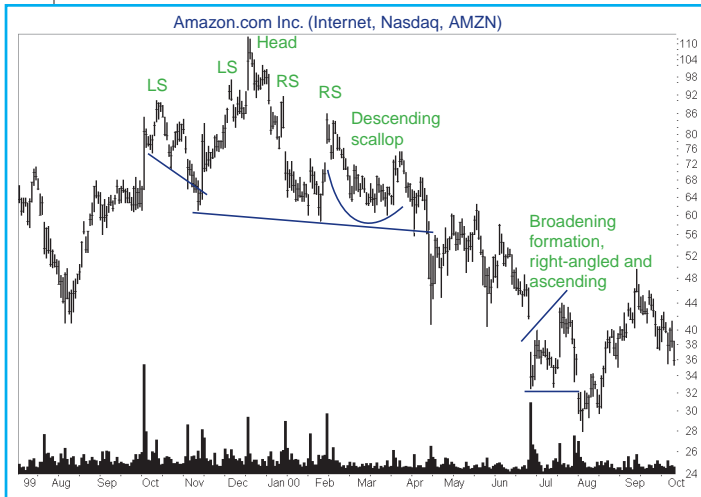


FIGURE 6: DOUBLE TOP. This is an example of an Eve & Eve double top.



FIGURE 7: HEAD & SHOULDERS TOP. This chart pattern is a popular and reliable performer.



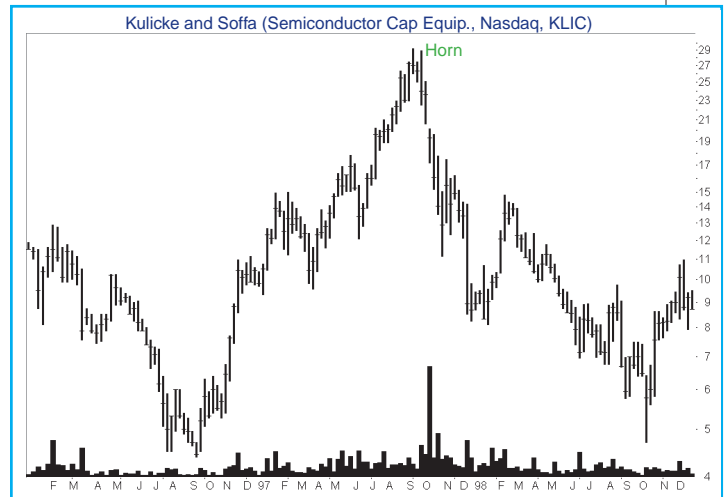
**FIGURE 8: COMPLEX HEAD-AND-SHOULDERS TOP.** Once you locate a head & shoulders top, look to the left and right for additional shoulders.

left shoulders, a single head, and two right shoulders. Symmetry is important, and the two left shoulders often appear similar in width and shape to the two right ones. The distance to the head is similar to its mirror image. For example, see how the inner left and right shoulders are just two days wide and are about the same distance from the head? Their heights are not exact, but patterns are rarely perfect.

The outer left shoulder forms its own head & shoulders top, with the left shoulder high being the head of the smaller pattern. Note how a downsloping neckline — if it's steep enough — will never trigger a sell signal. For steep necklines, sell if prices drop below the right shoulder valley (which will be the lower of the two armpits). The small head & shoulders doesn't really suffer from an excessively steep neckline because prices do close below it, but you give up a few points waiting for a neckline confirmation. Another example of a right-angled and ascending broadening formation appears in July.

### HORN TOP

Horns are another pattern I discovered as I was searching for double tops on the weekly scale. Horns appear as two tall spikes separated by a week and look like a steer's horns, hence the name. To identify them, switch to the weekly price chart and find two upward spikes that appear longer than most others over the prior year. Expect a price variation between the two highs. Look for clear visibility to the left of the pattern, meaning that the pattern should be at the top of a minor high like the one shown in Figure 9. The middle week of the three-week pattern should have a high well below the two outer spikes. The week after the pattern should show prices dropping down, with the high price well below the horn top. The pattern confirms when prices close below the lowest low in the three-bar pattern.



**FIGURE 9: HORN TOP.** The twin spikes of the horn top on the weekly chart form at the pinnacle of this stock.

The average decline I measured in the 188 horn tops was 21%, which is about average for all bearish chart pattern types.

### CLOSING POSITION

If you own a stock and see a bearish chart pattern forming, ask yourself how far prices might fall. Look for a support zone below the pattern. Always wait for confirmation (that's usually when prices fall below the lowest low in the pattern) before selling. In a bull market, the tendency is for prices to keep climbing, so it may pay to be patient.

*Contributing Writer Thomas Bulkowski is a private investor and the author of two books, Encyclopedia Of Chart Patterns and Trading Classic Chart Patterns.*

### SUGGESTED READING

- Bulkowski, Thomas N. [1997]. "The Bump-And-Run Reversal," *Technical Analysis of STOCKS & COMMODITIES*, Volume 15: June.
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- \_\_\_\_ [1997]. "The Head & Shoulders Formation," *Technical Analysis of STOCKS & COMMODITIES*, Volume 15: August.
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Charts by Thomas Bulkowski

