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# Dow Theory Part 1

## Introduction

The Dow theory has been around for almost 100 years, yet even in today's volatile and technology-driven markets, the basic components of Dow theory still remain valid. Developed by Charles Dow, refined by William Hamilton and articulated by Robert Rhea, the Dow theory addresses not only technical analysis and price action, but also market philosophy. Many of the ideas and comments put forth by Dow and Hamilton became axioms of Wall Street. While there are those who may think that it is different this time, a read through The Dow Theory will attest that the stock market behaves the same today as it did almost 100 years ago.

The Dow theory presented below has been taken from Robert Rhea's book, The Dow Theory. Although Dow theory is attributed to Charles Dow, it is William Hamilton's writings that serve as the corner stone for this book and the development of the theory. Also, it should be noted that most of the theory was developed with the Dow Jones Rail and Industrial averages in mind. Even though many concepts can be applied to individual stocks, please keep in mind that these are broad concepts and best applied to stocks as a group or index. When possibly, we have also attempted to link some of the realities of today's market with the Dow theory as explained by Dow, Hamilton and Rhea.

## Background

Charles Dow developed the Dow theory from his analysis of market price action in the late 19th century. Until his death in 1902, Dow was part owner as well as editor of The Wall Street Journal. Although he never wrote a book on the subject, he did write some editorials that reflected his views on speculation and the role of the rail and industrial averages.

Even though Charles Dow is credited with developing the Dow theory, it was S.A. Nelson and William Hamilton who later refined the theory into what it is today. Nelson wrote The ABC of Stock Speculation and was the first to actually use the term "Dow theory." Hamilton further refined the theory through a series of articles in The Wall Street Journal from 1902 to 1929. Hamilton also wrote The Stock Market Barometer in 1922, which sought to explain the theory in detail.

In 1932, Robert Rhea further refined the analysis of Dow and Hamilton in The Dow Theory. Rhea read, studied and deciphered some 252 editorials through which Dow (1900-1902) and Hamilton (1902-1929) conveyed their thoughts on the market. Rhea also referred to Hamilton's The Stock Market Barometer. The Dow Theory presents the Dow theory as a set of assumptions and theorems.

## Assumptions

Before one can begin to accept the Dow theory, there are a number of assumptions that must be accepted. Rhea stated that for the successful application of the Dow theory, these assumptions must be accepted without reservation.

### Manipulation

The first assumption is: The manipulation of the primary trend is not possible. When large amounts of money are at stake, the temptation to manipulate is bound to be present. Hamilton did not argue against the possibility that speculators, specialists or anyone else involved in the markets could manipulate the prices. He qualified his assumption by asserting that it was not possible to manipulate the primary trend. Intraday, day-to-day and possibly even secondary movements could be prone to manipulation. These short movements, from a few hours to a few weeks, could be subject to manipulation by large institutions, speculators, breaking news or rumors. Today, Hamilton would likely add message boards and day-traders to this list.

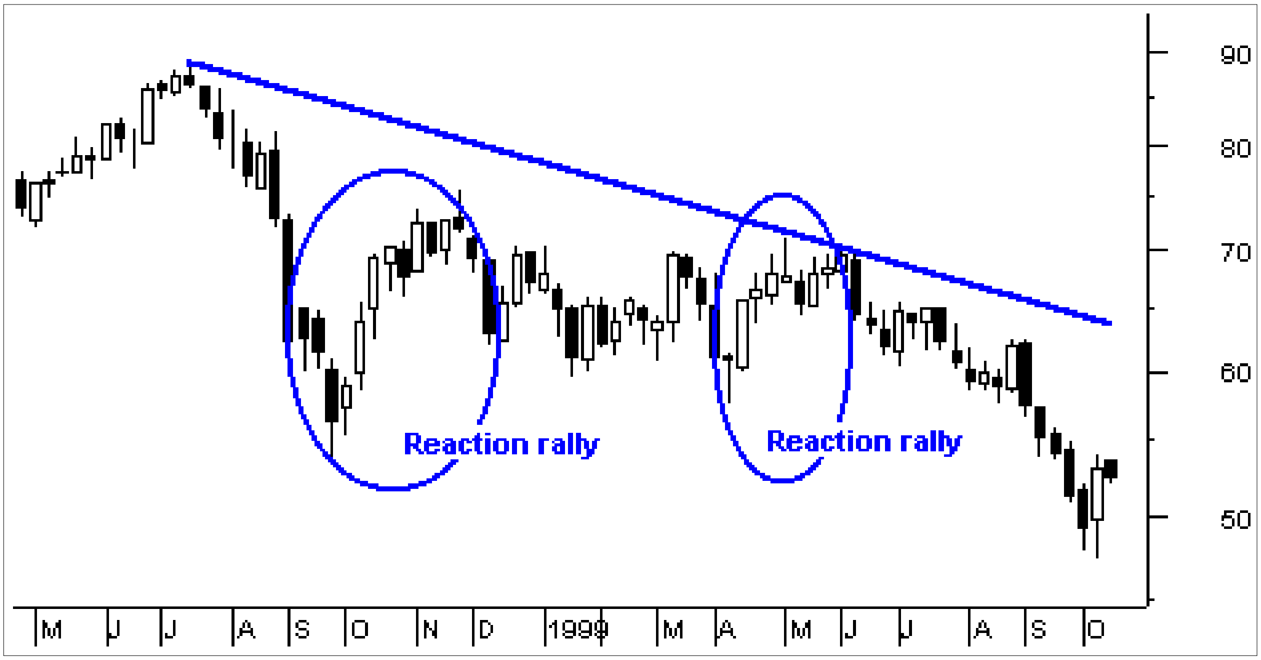
Hamilton went on to say that individual shares could be manipulated. Examples of manipulation usually end the same way: the security runs up and then falls back and continues the primary trend. Examples include:

- PairGain Technology rose sharply due to a hoax posted on a fake Bloomberg site. However, once the hoax was revealed, the stock immediately fell back and returned to its primary trend.
- Books-A-Million rose from 3 to 47 after announcing an improved web site. Three weeks later, the stock settled around 10 and drifted lower from there.
- In 1979/80, there was an attempt to manipulate the price of silver by the Hunt brothers. Silver skyrocketed to over 50$ per ounce, only to come back down to earth and resume its long bear market after the plot to corner the market was unveiled.

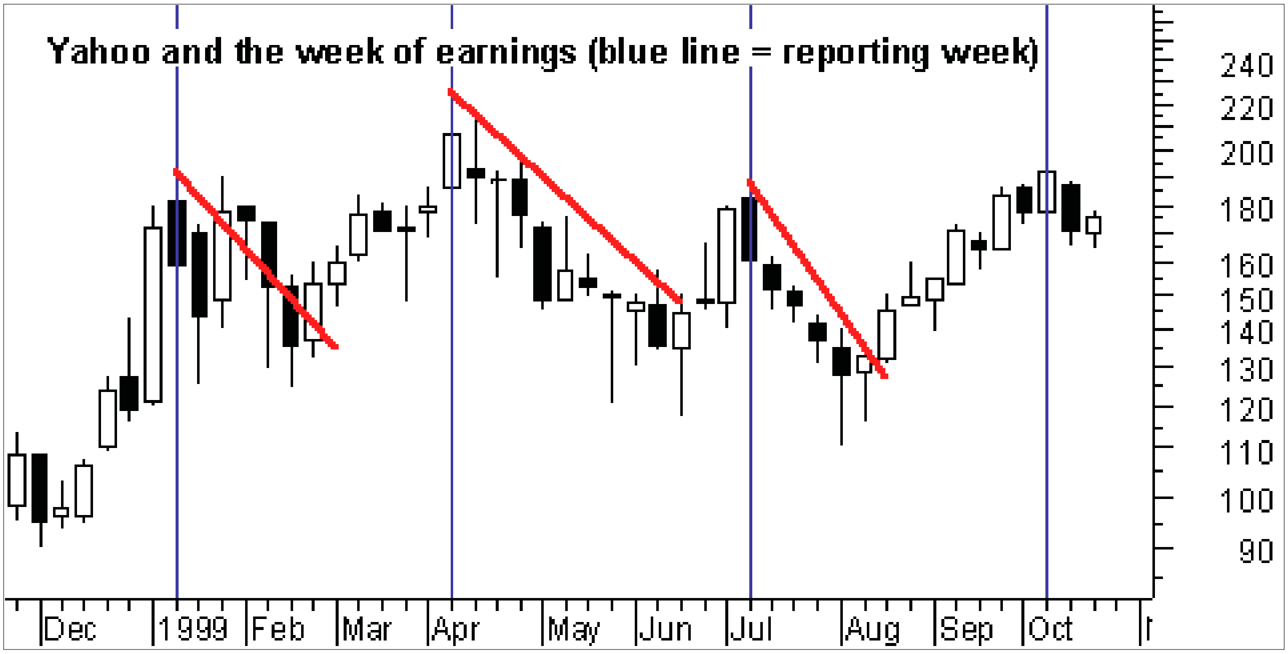
While these shares were manipulated over the short term, the long-term trends prevailed after about a month. Hamilton also pointed out that even if individual shares were being manipulated, it would be virtually impossible to manipulate the market as a whole. The market was simply too big for this to occur.

Averages Discount Everything
The market reflects all available information. Everything there is to know is already reflected in the markets through the price. Prices represent the sum total of all the hopes, fears and expectations of all participants. Interest rate movements, earnings expectations, revenue projections, presidential elections, product initiatives and all else are already priced into the market. The unexpected will occur, but usually this will affect the short-term trend. The primary trend will remain unaffected.

The chart below of Coca-Cola is a recent example of the primary trend remaining intact. The downtrend for Coca-Cola began with the sharp fall from above 90. The stock rallied with the market in October and November 1998, but by December started to decline again. According to Dow Theory, the October/November rally would be called a secondary move (against the primary trend). It is likely that the stock was caught up in the general market advance at the time. However, when the major indices were hitting new highs in December, Coca-Cola was starting to flounder and resume its primary trend.




Hamilton noted that sometimes the market would react negatively to good news. For Hamilton, the reasoning was simple: the market looks ahead. By the time the news hits the street, it is already reflected in the price. This explains the old Wall Street axiom, "buy the rumor, sell the news". As the rumor begins to filter down, buyers step in and bid the price up. By the time the news hits, the price has been bid up to fully reflect the news. Yahoo! and the run up to earnings is a classic example. For the past three quarters, Yahoo! has been bid up leading right up to the earnings report. Even though earnings have exceeded expectations each time, the stock has fallen by about 20%.




Theory Not Perfect
Hamilton and Dow readily admit that the Dow theory is not a sure-fire means of beating the market. It is looked upon as a set of guidelines and principles to assist investors and traders with their own study of the market. The Dow theory provides a mechanism for investors to use that will help remove some of the emotion. Hamilton warns that investors should not be influenced by their own wishes. When analyzing the market, make sure you are objective and see what is there, not what you want to see. If an investor is long, he or she may want to see only the bullish signs and ignore any bearish signals. Conversely, if an investor is out of the market or short, he or she may be apt to focus on the negative aspects of the price action and ignore any bullish developments. Dow Theory provides a mechanism to help make decisions less ambiguous. The methods for identifying the primary trend are clear-cut and not open to interpretation.

Even though the theory is not meant for short-term trading, it can still add value for traders. No matter what your time frame, it always helps to be able to identify the primary trend. According to Hamilton (writing in the early part of the 20th century), those who successfully applied the Dow theory rarely traded more than four or five times a year. Remember that intraday, day-to-day and possibly even secondary movements can be prone to manipulation, but the primary trend is immune from manipulation. Hamilton and Dow sought a means to filter out the noise associated with daily fluctuations. They were not worried about a couple of points, or getting the exact top or bottom. Their main concern was catching the large moves. Both Hamilton and Dow recommended close study of the markets on a daily basis, but they also sought to minimize the effects of random movements and concentrate on the primary trend. It is easy to get caught up in the madness of the moment and forget the primary trend. After the October low, the primary trend for Coca-Cola remained bearish. Even though there were some sharp advances, the stock never forged a higher high.

End of Part 1

*In Part 2 we talk about the different market movements (daily fluctuations, secondary and primary) and the three phases of bull and bear markets.*

Written by Arthur Hill

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