



Head and Shoulders Top (Reversal)

A head and shoulders reversal pattern forms after an uptrend, and its completion marks a trend reversal. The pattern contains three successive peaks with the middle peak (head) being the highest and the two outside peaks (shoulders) being low and roughly equal. The reaction lows of each peak can be connected to form support, or a neckline.



As its name implies, the head and shoulders reversal pattern is made up of a left shoulder, head, right shoulder and neckline. Other parts playing a role in the pattern are volume, the breakout, price target and support turned resistance. We will look at each part individually and then put them together with some examples.

1. **Prior Trend:** It is important to establish the existence of a prior uptrend for this to be a reversal pattern. Without a prior uptrend to reverse, there cannot be a head and shoulders reversal pattern, or any reversal pattern for that matter.
2. **Left Shoulder:** While in an uptrend, the left shoulder forms a peak that marks the high point of the current trend. After making this peak, a decline ensues to complete the formation of the shoulder (1). The low of the decline usually remains above the trendline, keeping the uptrend intact.

3. **Head:** From the low of the left shoulder, an advance begins that exceeds the previous high and marks the top of the head. After peaking, the low of the subsequent decline marks the second point of the neckline (2). The low of the decline usually breaks the uptrend line, putting the uptrend in jeopardy.
4. **Right Shoulder:** The advance from the low of the head forms the right shoulder. This peak is lower than the head (a lower high) and usually in line with the high of the left shoulder. While symmetry is preferred, sometimes the shoulders can be out of whack. The decline from the peak of the right shoulder should break the neckline.
5. **Neckline:** The neckline forms by connecting low points 1 and 2. Low point 1 marks the end of the left shoulder and the beginning of the head. Low point 2 marks the end of the head and the beginning of the right shoulder. Depending on the relationship between the two low points, the neckline can slope up, slope down or be horizontal. The slope of the neckline will affect the pattern's degree of bearishness: a downward slope is more bearish than an upward slope. Sometimes more than one low point can be used to form the neckline.
6. **Volume:** As the head and shoulders pattern unfolds, volume plays an important role in confirmation. Volume can be measured as an indicator ([OBV](#), [Chaikin Money Flow](#)) or simply by analyzing volume levels. Ideally, but not always, volume during the advance of the left shoulder should be higher than during the advance of the head. This decrease in volume along with new highs that form the head serve as a warning sign. The next warning sign comes when volume increases on the decline from the peak of the head. Final confirmation comes when volume further increases during the decline of the right shoulder.
7. **Neckline Break:** The head and shoulders pattern is not complete and uptrend is not reversed until neckline support is broken. Ideally, this should also occur in a convincing manner with an expansion in volume.
8. **Support turned resistance:** Once support is broken, it is common for this same support level to turn into resistance. Sometimes, but certainly not always, the price will return to the support break and offer a second chance to sell.
9. **Price Target:** After breaking neckline support, the projected price decline is found by measuring the distance from the neckline to the top of the head. This distance is then subtracted from the neckline to reach a price target. Any price target should serve as a rough guide and other factors should be considered as well. These factors might include previous support levels, Fibonacci retracements or long-term moving averages.



Xircom (XIRC) formed a head and shoulders reversal with an upward sloping neckline. This is not the most symmetrical of patterns, but the neckline is well marked. Key points include:

1. The low at 46 1/4 marked the end of the left shoulder and the beginning of the head (1).
2. During the advance to 72 5/8, volume soared. However, during the second advance to 75 15/16, volume tapered off significantly.
3. When the decline from 75 15/16 began, volume accelerated (note red line on volume bars).
4. The decline from 75 15/16 to 48 1/2 broke the trendline extending up from Apr-99 and formed the second low point (2).
5. During the decline of the right shoulder and neckline break, volume expanded (red oval) and Chaikin Money Flow turned negative.
6. After the initial decline, there was a return to the neckline break (black arrow). Even during this decline, Chaikin Money Flow remained negative. The subsequent decline took the stock below 30.
7. The measurement from neckline to the top of the head was 27. With the neckline break at 50, this would imply a move to around 23. The April low was 29 1/8. After a decline from 75 15/16, at least a reaction rally can be expected.



DLJ formed a head and shoulders reversal with a horizontal neckline. Again, it isn't the prettiest head and shoulders pattern, but neckline support is well established. Key points include:

1. The low at 60 1/2 marked the end of the left shoulder and the beginning of the head (1).
2. During the advance to 100 3/4, volume soared.
3. When the decline from 100 3/4 began, volume exceeded the levels witnessed in the previous advance and Chaikin Money Flow turned negative almost immediately.
4. The decline from 100 3/4 broke the trendline extending up from Oct-98 and the ensuing low formed the second point of the neckline (2).
5. Volume increased during the decline and Chaikin Money Flow dipped below -30%, indicating serious selling pressure.
6. During the advance of the right shoulder, volume was fairly heavy, but Chaikin Money Flow remained at level indicating continued distribution.
7. The high of the right shoulder was just short of the previous reaction high in late April. The decline after this lower high saw an increase in volume as neckline support was broken.
8. The stock returned to the scene of the crime with an advance to 61 in early July. The newfound resistance level was never broken and the stock gapped down on heavy volume (red arrows) to

start the decline below 40.

The head and shoulders pattern is one of the most common reversal formations. It is important to remember that it occurs after an uptrend and usually marks a major trend reversal when complete. While it is preferable that the left and right shoulders be symmetrical, it is not an absolute requirement. They can be different widths as well as different heights. Identification of neckline support and volume confirmation on the break can be the most critical factors. The support break indicates a new willingness to sell at lower prices. Lower prices combined with an increase in volume indicate an increase in supply. The combination can be lethal and sometimes there is no second chance return to the support break. Measuring the expected length of the decline after the breakout can be helpful, but don't count on it for your ultimate target. As the pattern unfolds over time, other aspects of the technical picture are likely to take precedence.

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