

THE EVOLUTION OF A THEORY

Charles H. Dow, founder of the country's greatest financial news agency-Dow, Jones & Company--was one of the owners of *The Wall Street Journal*, which he edited until his death in 1902. During the last few years of his life he wrote a few editorials dealing with stock speculation which are the only personal record we have of his observations of recurring characteristics of the stock market. These observations were based upon the movement of daily average prices of railroad and industrial stocks included in the Dow-Jones averages.*

Mr. Dow did not designate his stock market observations as the Dow Theory. That was done by his friend S. A. Nelson, who wrote *The A B C of Stock Speculation* in 1902. It was he who first attempted to explain Dow's methods in a practical manner.

Many successful men today believe the implications of the daily movement of the Dow-Jones rail and industrial averages to be the most dependable indicator of both price and business trends yet devised, and they usually refer to inferences drawn from the movement of the averages as "the Dow theory."

Until 1897 only one stock average had been kept by Dow, Jones & Co., but at the beginning of that year separate averages were started for railroad and industrial stocks. During the time Dow wrote, he had at the most only a five-year record of both averages to examine, and it is indeed remarkable that he was able, in so short a time, to establish the fundamentals of such a useful theory of price movements based on the dual averages. It is true that some of his conclusions later proved to be erroneous, but the fundamentals have proved sound when tested against market movements for 28 years after his death. William Peter Hamilton, who served under Dow, carried on the study and interpretation of the theory through occasional editorial forecasts. His observations and predictions generally proved to be accurate, with the result that they soon became one of the most popular features of *The Wall Street Journal* until his death in December, 1929.

* *The Dow-Jones public utility average was not started until late in 1929. It was carried back to the beginning of that year.*

In 1922, Hamilton wrote *The Stock Market Barometer*^{**}, a book in which he explained the Dow theory in more detail than was possible within the limitations of editorial comment. This book, which achieved a genuine success, is now out of print. It provoked a veritable storm of controversy, repercussions of which may yet be occasionally noticed in financial columns. One of the primary reasons for this controversy is the general unwillingness of those who claim ability to forecast stock market trends by means of elaborate statistical research to concede the usefulness of the Dow theory. These critics are usually entirely ignorant of the principles underlying this valuable and workable theory.

The development of the automobile and of the Dow theory since 1902 have certain similarities. To the automobile of 1902, our engineers later added improved motive power, demountable rims, electric lights, self-starters, and other needed refinements which eventually gave us a reliable and convenient means of transportation. In a similar manner, Hamilton tested and improved the Dow theory between 1902 and 1929. As the record of the averages unfolded with the years, he gave us a well-defined and exceptionally reliable method of forecasting the trends of both stock prices and business activity.

It is no great job to put together a mass of figures derived from past business records and to make an index which is supposed to forecast trends reliably. The trouble with all such methods is that they deal with the past and, of necessity, must, to a great extent, be based on the assumption that history will repeat itself. Then, too, before the value of such an index can be accepted, it must be tested for a great many years against actual developments. Dow's theory has survived just such a test.

The Dow theory provides a method of forecasting that is self-adjusting, and its effectiveness has been proved, year by year, for more than three decades. The proof lies in Hamilton's successful application of the theory through those years, the accuracy of whose forecasts made editorially in *The Wall Street Journal* cannot be questioned. It is a pity that his modesty never permitted him to evidence the soundness of his application of Dow's theory by republishing as a group his numerous clearly-reasoned forecasts. This book represents an effort to reduce the Dow theory to a manual for those wishing to use it as an aid in speculation, only a relatively small part of the subject matter represents original work or the ideas of the author.

^{**} *English economists were among the first to give fitting recognition to the value of The Stock Market Barometer as a valuable contribution to the subject of stock market speculation, as may be gathered from the election of Hamilton to fellowship in the Royal Statistical Society in 1923*

Everything written by Hamilton concerning the implications of the averages was collected and studied carefully. However, insofar as possible his phrasing is used, so that this may properly be considered as a scrap book of pertinent comment from his pen classified and arranged for the convenience of students of the averages. Unless otherwise indicated, all quotations are from Hamilton's writing in The Wall Street Journal or Barron's. The somewhat voluminous appendix presents the full text of every editorial dealing with the price movement appearing from 1903 through 1929. Any reader questioning the writer's interpretations of Hamilton's comment, therefore, may read the text of the original comment and draw his own conclusions. Students of the theory can attain a certain proficiency in forecasting the movements of the averages by careful study of each article quoted in the appendix.

However, before attempting such a study, one should procure the tabulated prices of the Dow Jones averages. In addition, it is essential that the student be provided with properly-drawn charts of the daily price movements of the railroad and industrial stock averages, the usefulness of which is enhanced if the volume of trading is also shown. Hamilton repeatedly made use of market activity when summing up evidence and arriving at conclusions. Parenthetically, it may be added that the student who draws his own charts is afforded an excellent opportunity to study price movement as the picture unfolds. ***

Students wishing to derive the greatest benefit from material presented in the appendix should first read carefully the entire collection of writings. This will disclose the fact that during the first 10 years Hamilton had not developed the lucidity of expression that characterized his later work. He always stated his case briefly and concisely, perhaps too much so in the earlier years. In later years, he apparently realized that students of the Dow theory desired more detailed explanations. In any event, his deductions were more fully and clearly reasoned during the last 20 years of his editorship. For this reason, the student may find it desirable to begin his examination of the forecasts with the year 1910 and work forward, afterwards going through the earlier material if he so desires. When one has obtained a fair working knowledge of the theory, he may make a more detailed study which can be converted into speculative profits.

*****Charts**; *This site contains a java based chart program for the industrial and rail averages dating back to 1897 that are constructed to meet the criteria outlined by Robert Rhea in his book The Dow Theory.*

Years ago we were given a problem in arithmetic and, after the answer had been determined, were allowed to verify the accuracy of our calculations by looking up the answer at the back of the book. This method is sound when learning to master the implications of the averages. It is suggested that a date be chosen from the forecasts contained in the appendix for the beginning of the study, that the corresponding date be located on the charts, and that the charted data following that date be covered so that the exposed portion of the chart will represent the picture which might have been before Hamilton on the day the forecast was made. Then the chart should be studied and a forecast, with the reasons for it, jotted down. This can later be compared with Hamilton's comment and the effectiveness of both forecasts be visualized.

The usefulness of the Dow theory improves with age. Certainly a more comprehensive study of the subject is possible with a 35-year record before us than when Dow worked with the figures of only a few years, while those who use it 20 years from now will have a greater advantage than we now enjoy. Dow always refrained from making definite forecasts, his caution probably being due to the fact that he had but little proof of the soundness of his theory. As the years passed by, Hamilton's precision in its use constantly improved, although he did make a bad mistake in 1926 as will be explained later. However, this mistake really rounds out the general usefulness of the theory, in that proof was thereby provided that it is not infallible, a fact often stressed by Hamilton during the years when he was scoring a bull's eye with every forecast.

Dow's theory, fundamentally simple and wholly empirical, was entirely based on his study of the Dow-Jones averages which he originated.

At no time did he attempt to define his theory as such, being content to present his observations in a series of editorials in *The Wall Street Journal* during 1900-1902 on the subject of stock speculation.

Using those articles as a basis, Hamilton later proceeded to apply Dow's observations in a practical manner by making forecasts of stock market movements, with the result that after a few years his editorial writings were utilized both as a reliable guide for future market trends and as a text which enabled many of his readers to become proficient in the art of understanding the implications of the averages according to the Dow theory. Because Dow wrote so little on the subject and Hamilton so much, and because Dow never dared use his observations to the extent of making a definite editorial forecast of stock market trends, whereas Hamilton did have the courage to attempt it, no examination of Dow's work is attempted here. It should always be remembered, however, that the fundamentals of the theory upon which Hamilton worked were developed by his predecessor, a fact he never allowed his readers to forget.

Such a phrase as, "On the late Charles H. Dow's well-known method of reading the stock market movement from the Dow-Jones average--" frequently prefaced Hamilton's forecasts.

One should also remember that The Wall Street Journal has never descended to the level of becoming a tipster's sheet, that Hamilton was a great editor rather than a professional "Investment Counselor," and that he made no attempt to write a forecast every time he saw a clear implication of future trend in the averages. Moreover, his active mind was, of course, often on other timely subjects, with the result that he had neither the time nor the inclination to follow the movements of the averages with unvarying attention. Moreover, we have certain knowledge that at times he became disgusted at the use made of his forecasts by unscrupulous advisory services, with the result that for long periods he refused to write his opinion on the inferences to be drawn from the price movement. In order that students may understand how completely Hamilton believed in the effectiveness of the averages as a forecasting medium, although recognizing the obvious limitations of the theory, a number of selections from his editorials over a 25-year period are quoted below:

"Study of the averages is based on 'Dow's theory,' propounded by the late Charles H. Dow, the founder of this newspaper. The books which published that theory seem to be out of print; but briefly it was this: Simultaneously in any broad stock market there are--acting, reacting and interacting--three definite movements. That on the surface is the daily fluctuation; the second is a briefer movement typified by the reaction in a bull market or the sharp recovery in a bear market which has been oversold; the third and main movement is that which decides the trend over a period of many months, or the main true movement of the market.

"It is with these facts well in mind that the student approaches analysis of the averages, premising that broad conclusions are valueless on the daily fluctuation and deceptive on the secondary movement, but possible and helpful on the main movement of the market, and of real barometrical value to general business. It may be said as a matter of record that studies in the price movement, with these facts well in view, published in these columns from time to time and especially in the years before the war, were far oftener right than wrong, and were wrong for the most part when they departed from Dow's sound and scientific rule." (Aug. 8, 1919)

"A sympathetic reader asks if the method of estimating the trend of the stock market by analysis of previous movements as shown in the industrial and railroad price averages is not empirical? Of course it is, but not entirely so, and the method is far removed from quackery. Any conclusion reached from a number of recorded instances is open to that charge. It depends on the scientific accuracy of the method of indication.

"It admits highly human and obvious limitations. But such as it is, it can honestly claim that it has a quality of forecast which no other business record yet devised has even closely approached." (The Stock Market Barometer)

"A number of students demand from. ..Dow's theory of the triple market movement, a degree of mathematical and even pictorial accuracy which it neither possesses nor needs." (Oct. 18, 1922)

"They can, of course, find plenty of movements, especially secondary ones, which they think the barometer failed to forecast. What of it? An instrument of any such accuracy as they demand would be a human impossibility, and indeed, I do not think that any of us in the present stage of man's moral development, could be trusted with such a certainty. One way to bring about a world smash would be for some thoroughly well-intentioned altruist to take the management of the planet out of the hands of its Creator.

"The stock market barometer is not perfect, or to put it more correctly, the adolescent science of reading it is far from having attained perfection.

"The data of the Weather Bureau are of the highest value, but they do not pretend to predict a dry summer or a mild winter. You and I know from personal experience that the weather in New York is likely to be cold in January and hot in July.

"The law that governs the movement of the stock market, ... would be equally true of the London Stock Exchange, the Paris Bourse, or even the Berlin Boerse. But we may go further. The principles underlying that law would be true if those Stock Exchanges and ours were wiped out of existence. They would come into operation again, automatically and inevitably, with the reestablishment of a free

market in securities in any great Capital. So far as I know, there has not been a record corresponding to the Dow-Jones averages kept by any of the London financial publications. But the stock market there would have the same quality of forecast which the New York market has if similar data were available.

"The theory makes little of cycles or systems, interesting and even well-grounded inferences or common fads. It uses them all so far as they are useful, together with every other scrap of information it is possible to collect. The market movement reflects all the real knowledge available.

"...the pragmatic basis for the theory, a working hypothesis if nothing more, lies in human nature itself. Prosperity will drive men to excess, and repentance for the consequence of those excesses will produce a corresponding depression. Following the dark hour of absolute panic, labor will be thankful for what it can get and will save slowly out of smaller wages, while capital will be content with small profits and quick returns.

"When, in the United States Senate, the late Senator Spooner, reading an editorial of The Wall Street Journal, said, 'Listen to the bloodless verdict of the market place,' he saw the merciless accuracy of that verdict; because it is, and necessarily must be, based upon all the evidence, even when given by unconscious and unwilling witnesses." (The Stock Market Barometer)

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