

## THE DOW THEORY WHICH HAMILTON INTERPRETED

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To a stock trader, a knowledge of the past movements of the Dow-Jones averages is as necessary as a record of the tides is to a ship's captain, but the record of the averages over 35 years is difficult to study until reduced to a graphic picture. Changing the simile slightly, a trader's charts of the daily movements of the averages are as useful to him as are navigation charts to a mariner. But the mariner, also, finds a barometer a necessary part of the equipment of a safe navigator. A barometer able to forecast fair, foul, and unchanged market weather was given the trader by Charles H. Dow and William Peter Hamilton. This barometer is called the Dow Theory, and an ability to read it correctly is as vital to a trader as the understanding of his barometer is to the ship's captain.

The closing average prices of the Dow-Jones industrial and railroad stocks, together with the daily total of transactions in the New York Stock Exchange, are the only material needed by students desiring to utilize the now theory as an aid in fore-casting the trend of stock prices and business.

In this chapter, the writer's definitions of terminology and of the theory will be given, classified as to subject matter in a manner that has proved helpful. As neither Dow nor Hamilton ever attempted an exact definition, it is perhaps presumptuous to do so now. The writer has undertaken the task only after more than 10 years of actual trading based upon the implications of the averages, a study of the writings of both Dow and Hamilton extending over many years, and an exchange of opinions and experiences with students of the theory in many parts of the country, many of whom are successful traders. In addition to this, literally hundreds of charts were drawn for the purpose of studying the movements of the averages. Every statement made by Hamilton concerning the price movement was tested against the charted averages. In fact, for more than 10 years a consistent effort has been made to sift out and arrange the data in order to define the Dow Theory, not as Dow left it to us at the time of his death in 1902, but as the idea developed from Hamilton's application and refinement of that theory.

Since exceptions can be found to every part of the defined theory, there is no better way in which the student can become familiar with the subject than to study the charted averages and locate the exceptions, the times when he might have been misled in his market operations by assuming the theory to be infallible. Such study, over a reasonable period of time, is certain to develop his ability in the art of reading the averages, and to a trader such ability means financial gain, although mistakes will be made, because reading the averages is an empirical science. It somewhat resembles surgery, and a good surgeon is sometimes wrong in his diagnosis.

Perhaps the greatest danger in the application of the theory to speculation in stocks lies in the fact that the neophyte, having beginner's luck, may arrive at correct conclusions several

times and then, thinking that he has discovered a sure method of beating the market, read his signals wrong. Or, what is even worse, he may be right at the wrong time. In either of these events, the Dow Theory is usually blamed, when the fault lies with the trader's impatience.

Each portion of the theory and its terminology, as here defined, will be discussed in detail in subsequent chapters. If the subject matter proves perplexing, the reader should realize that the Dow Theory, like algebra, is not readily understood after a mere casual reading of a textbook on the subject.

The successful use of the theory as an aid in stock speculation must be predicated upon the acceptance, without any reservations whatsoever, of a few hypotheses, viz:

**Manipulation:** *Manipulation is possible in the day-to-day movement of the averages, and secondary reactions are subject to such an influence to a more limited degree, but the primary trend can never be manipulated.*

**The Averages Discount Everything:** *The fluctuations of the daily closing prices of the Dow-Jones rail and industrial averages afford a composite index of all the hopes, disappointments, and knowledge of everyone who knows anything of financial matters, and for that reason the effects of coming events (excluding acts of God) are always properly anticipated in their movement. The averages quickly appraise such calamities as fires and earthquakes.*

**The Theory Is Not Infallible:** *The Dow Theory is not an infallible system for beating the market. Its successful use as an aid in speculation requires serious study, and the summing up of evidence must be impartial. The wish must never be allowed to father the thought.*

If these essential elements, around which the theory has been built up, cannot be accepted as axioms, then further study of the subject will prove to be confusing, if not actually misleading. Reducing the theory to definite theorems proved to be a difficult task, but this was done in 1925. Subsequent study, together with application of these theorems to trading operations, has not indicated the advisability of altering them now.

**Dow's Three Movements:** *There are three movements of the averages, all of which may be in progress at one and the same time. The first, and most important, is the primary trend: the broad upward or downward movements known as bull or bear markets, which may be of several years duration. The second, and most deceptive movement, is the secondary reaction: an important decline in a primary bull market or a rally in a primary bear market. These reactions usually last from three weeks to as many months. The third, and usually unimportant, movement is the daily fluctuation.*

**Primary Movements:** *The primary movement is the broad basic trend generally known as a bull or bear market extending over periods which have varied from less than a year to several years. The correct determination of the direction of this movement is the most important factor in successful speculation. There is no known method of forecasting the extent or duration of a primary movement.*

**Primary Bear Markets:** *A primary bear market is the long downward movement interrupted by important rallies. It is caused by various economic ills and does not terminate until stock prices have thoroughly discounted the worst that is apt to occur. There are three principal phases of a bear market: the first represents the abandonment of the hopes upon which stocks were purchased at inflated prices; the second reflects selling due to decreased business and earnings, and the third is caused by distress selling of sound securities, regardless of their value, by those who must find a cash market for at least a portion of their assets.*

**Primary Bull Markets:** *A primary bull market is a broad upward movement, interrupted by secondary reactions, and averaging longer than two years. During this time, stock prices advance because of a demand created by both investment and speculative buying caused by improving business conditions and increased speculative activity. There are three phases of a bull period: the first is represented by reviving confidence in the future of business; the second is the response of stock prices to the known improvement in corporation earnings, and the third is the period when speculation is rampant and inflation apparent—a period when stocks are advanced on hopes and expectations*

**Secondary Reactions:** For the purpose of this discussion, a secondary reaction is considered to be an important decline in a bull market or advance in a bear market, usually lasting from three weeks to as many months, during which intervals the price movement generally retraces from 33 per cent to 66 per cent of the primary price change since the termination of the last preceding secondary reaction. These reactions are frequently erroneously assumed to represent a change of primary trend, because obviously the first stage of a bull market must always coincide with a movement which might have proved to have been merely a secondary reaction in a bear market, the contra being true after the peak has been attained in a bull market.

**Daily Fluctuations:** Inferences drawn from one day's movement of the averages are almost certain to be misleading and are of but little value except when "lines" are being formed. The day-to-day movement must be recorded and studied, however, because a series of charted daily movements always eventually develops into a pattern easily recognized as having a forecasting value.

**Both Averages Must Confirm:** The movements of both the railroad and industrial stock averages should always be considered together. The movement of one price average must be confirmed by the other before reliable inferences may be drawn. Conclusions based upon the movement of one average, unconfirmed by the other, are almost certain to prove misleading.

**Determining the Trend:** Successive rallies penetrating preceding high points, with ensuing declines terminating above preceding low points, offer a bullish indication. Conversely, failure of the rallies to penetrate previous high points, with ensuing declines carrying below former low points, is bearish. Inferences so drawn are useful in appraising secondary reactions and are of major importance in forecasting the resumption, continuation, or change of the primary trend. For the purpose of this discussion, a rally or a decline is defined as one or more daily movements resulting in a net reversal of direction exceeding three per cent of the price of either average. Such movements have but little authority unless confirmed in direction by both averages, but the confirmation need not occur on the same day.

**Lines:** A "line" is a price movement extending two to three weeks or longer, during which period the price variation of both averages move within a range of approximately five per cent. Such a movement indicates either accumulation or distribution. Simultaneous advances above the limits of the "line" indicate accumulation and predict higher prices; conversely, simultaneous declines below the "line" imply distribution and lower prices are sure to follow. Conclusions drawn from the movement of one average, not confirmed by the other, generally prove to be incorrect.

**The Relation of Volume to Price Movements:** A market which has been overbought becomes dull on rallies and develops activity on declines; conversely, when a market is oversold, the tendency is to become dull on declines and active on rallies. Bull markets terminate in a period of excessive activity and begin with comparatively light transactions.

**Double Tops and Double Bottoms:** "Double tops" and "double bottoms" are of but little value in forecasting the price movement and have proved to be deceptive more often than not.

**Individual Stocks:** All active and well distributed stocks of great American corporations generally rally and decline with the averages, but any individual stock may reflect conditions not applicable to the average price of any diversified list of stocks.

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