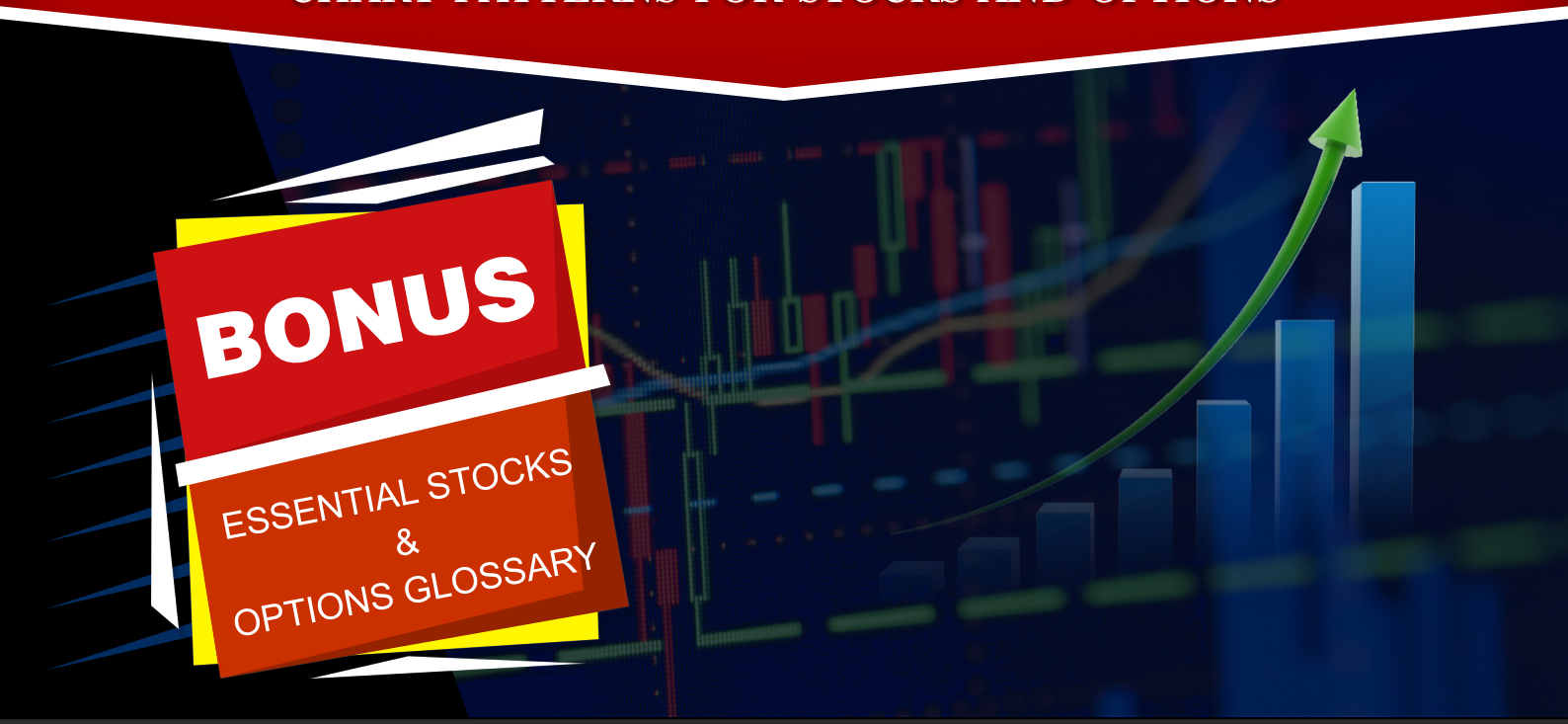
The Steady Trader Presents

Trader's Guide to Top Performing Chart Patterns for Stocks & Options

Trader's Roadmap to Financial Freedom

- Chart Patterns for Stocks and Options -



Serge Berger

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Letter from Serge

You may want to trade because of your interest in the financial markets and strong aspirations of becoming more active about managing your finances. Or you may want to trade because you've earned enough money and now want to be free of a boss, enjoy life, and yet still earn an income.

Whatever the reason for being interested in a more active investing/trading approach, this profession if approached the right way will allow you to actively manage money in all market situations while having the freedom to work for yourself. All the while you will want to be a student of the markets and gain an appreciation for some of the things that are critical for success as a trader.

Investors and traders are often overwhelmed by the choices available to them. From stocks and exchange traded funds (ETFs) to options and more, at the outset it can seem like an endless journey.

After 20 years as a professional trader I can tell you that a) the simpler one's approach to trading the stock market the better the returns over time and b) that mastering just a few specific chart patterns can make a massive difference in one's portfolio returns.

You see, stocks, indices and other asset classes often form predictable patterns with decisively bullish or bearish outcomes. The fact is that being able to recognize these patterns as they develop, and pouncing on the confirmed high quality signals, over time can amass wealth beyond your wildest dreams. Be persistent, specific and patient!

So, do yourself a favor and study the powerful yet simple price (chart) patterns described in this ebook.

To your success

Serge Berger

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Chart Pattern Types

Pick any random book on technical analysis off the library shelf and you are likely to encounter more 'chart pattern' types than you can shake a stick at. While surely most of these patterns have some merit, the fact is that only a few of them occur frequently enough and even fewer flash high probability signals to make them worth learning and paying attention to.

The chart patterns I discuss in this ebook are the ones that have given me a great edge over the course of my trading career. They have not just helped me reap great profits but also allowed me to contextualize trade setups and helped me analyze the broaders markets. Lastly, these patterns allowed me to navigate the markets with good risk management, i.e. well defined stop-loss and profit targets.

As a big advocate of keeping things simple, I find that all of my high probability chart patterns fit into one of these three categories:

- **Trend Reversals**
- **Trend Continuation**
- **Mean-reversion (i.e. overbought/oversold)**

Trend reversal patterns signal the end of a trend in any given time frame and set up high probability trades in the new (opposite) direction

Trend continuation patterns or 'consolidation patterns' take place along an existing trend. After a stock in an up-trend gets near-term overbought it will slip into a consolidation phase to work off those overbought readings. The inverse happens on down trends. After some time these overbought readings have subsided and investors once again find enough appetite to push the stock higher along the primary trend and out of the consolidation pattern. Again, the inverse holds true for stocks in down-trends.

Mean-reversion patterns form when a stock becomes overbought or oversold and signals that it is in need of a pause and move lower (in up trends) or bounce (in down trends) before possibly resuming along it primary trend.

Traders and investors alike often fall into the trap of thinking they need to need to be able to determine whether a stock is about to end its trend or is just taking a pause. Focusing on high probability patterns solves this problem and allows investors to focus on profits.

Chart Patterns

Head & Shoulders Pattern

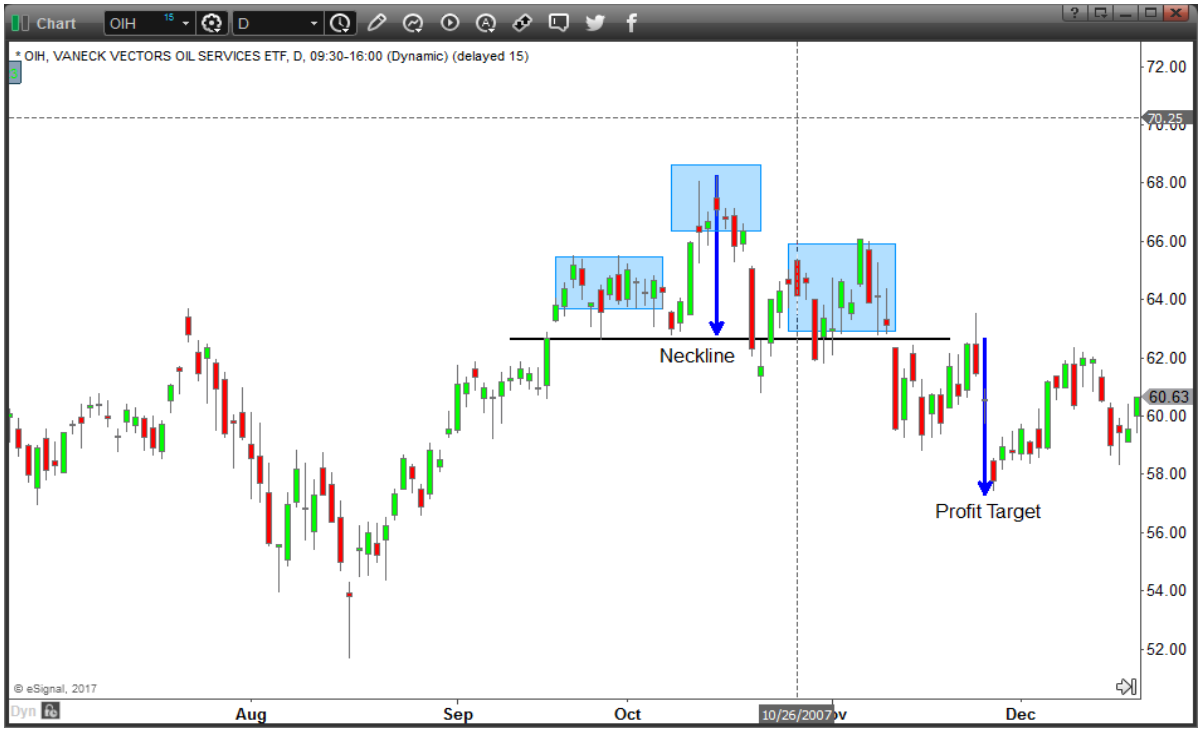
The formation of a head and shoulders pattern is one indication that a rising stock may be reversing its course.

Why it works

One of my key market observations over the years has been that stock market tops are process, i.e. take time, while stock market bottoms are points, i.e. happen quicker. The head and shoulders pattern represents this observation. The process by the bulls to hand the baton over to the bears takes time. But once it's obvious this has taken place, then a great trading setup takes hold.

How it works...

The bulls are large and in charge but by the time they reach the 'left shoulder' of the pattern (left-most box on chart) they start to exhibit some exhaustion. After a little pause they attempt one more exhaustion rally that forms a higher high and thus the 'head' of the formation. This move signaled peak bullishness. The stock then drops but does not yet fall apart and begins developing the right shoulder. All of this is taking place above the 'neckline,' which is the black horizontal on the chart. The pattern triggers once the stock breaks below the neckline. A simple first profit target is measured by taking the difference between the neckline and the top of the head and subtracting it from the neckline.



Inverse Head & Shoulders pattern

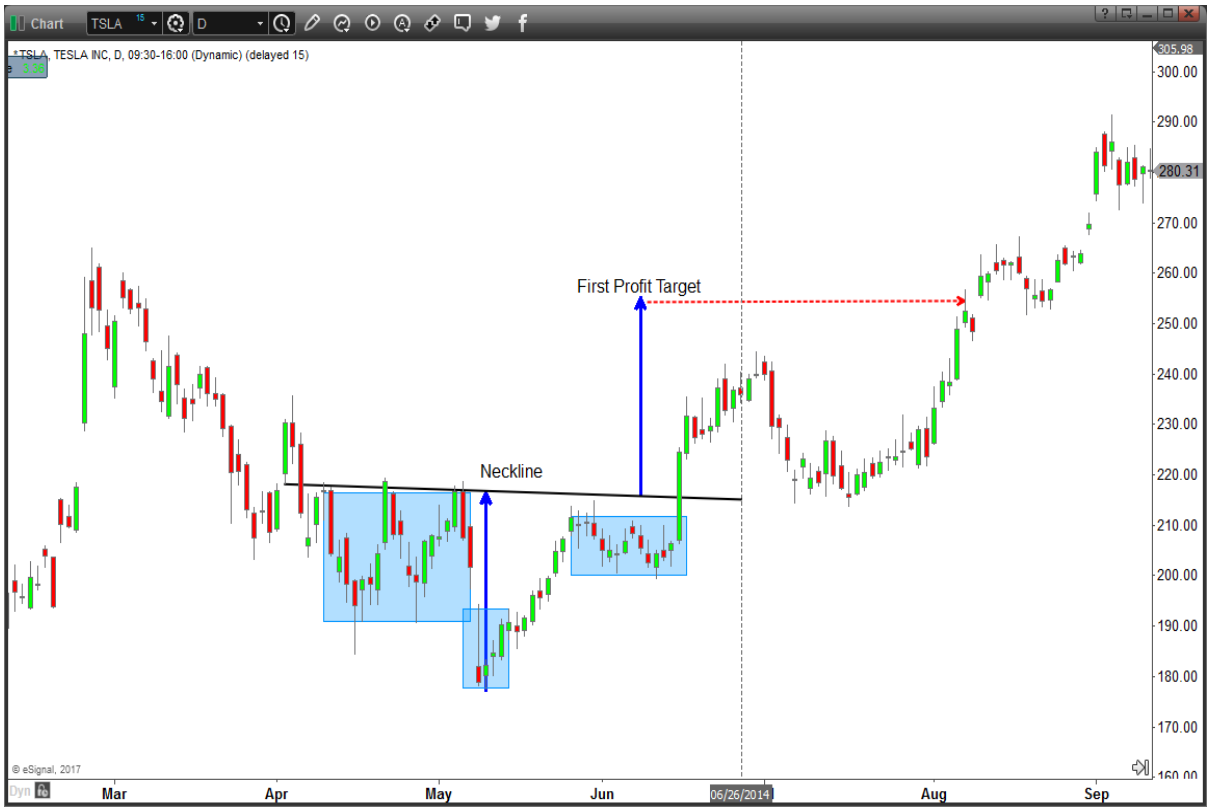
As the name indicates, the inverse head and shoulders pattern is literally the inverse of the 'regular' head and shoulders pattern. This pattern is one indication that a falling stock may be reversing its course higher.

Why it works

While bottom formations in stocks have a greater tendency to be briefer in nature than topping processes, bottoms can still take some time. Once it becomes apartent that a bottom has built, bulls get more confident and price begins to accelerate higher, which is what this pattern shows.

How it works...

We apply the same strategy as with the regular head and shoulders pattern, just inverse. Once the stock breaks above the neckline the signal triggers. The first upside price target is measured by taking the difference between the head and the neckline and adding it to the neckline - as the image shows. One thing about these patterns is that before the first price target is reached it is not to be ruled out that a re-test of the neckline takes place. In the example here this is exactly what happened. This re-test should not lead to a stop-loss trigger because more often than not the retest is a healthy move that ultimately leads to a move back higher to the first price target or beyond.



Rising Wedge Pattern

A rising wedge, in its traditional sense is a bearish pattern. The rising prices in an ever more narrow trading range signal that the security is likely nearing a consolidation period where the stock trots sideways or begins to fall. In extreme cases the trendlines of this pattern converge, with both trendlines slanted in an upward direction.

Why it works

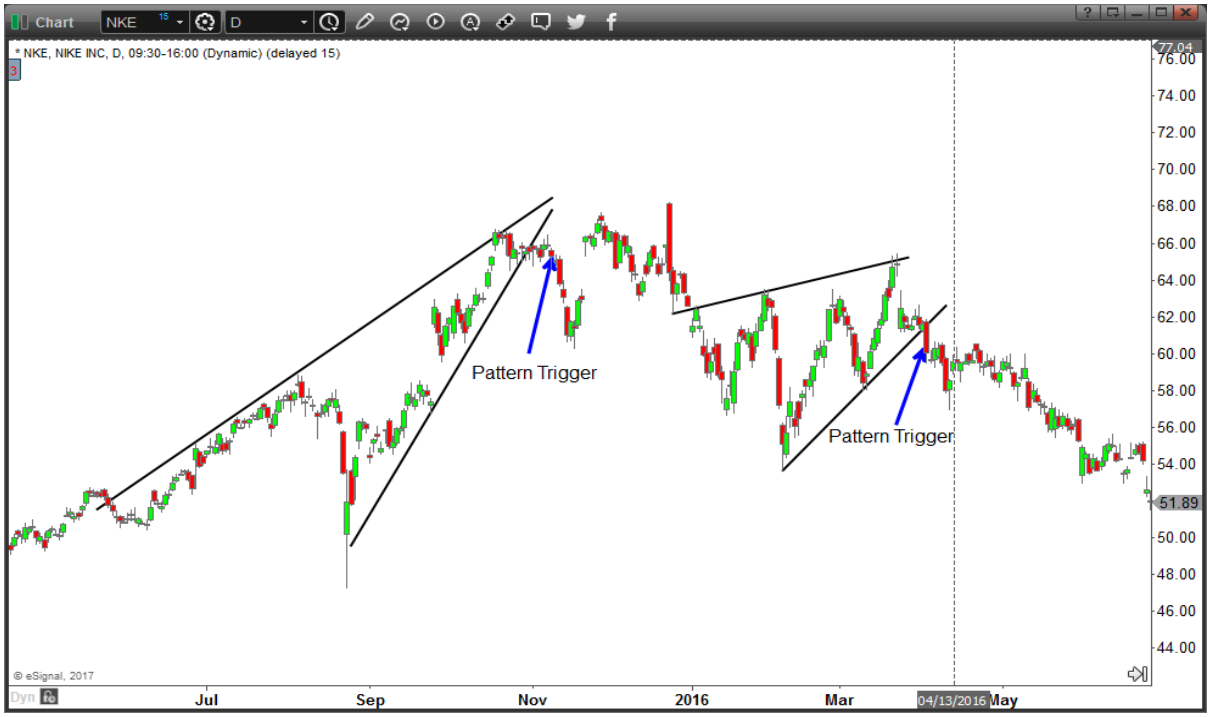
As a stock or other asset moves higher and complacency among investors begins to increase. The more investors 'chase' a stock higher the steeper the slope and the more narrow the rising wedge pattern becomes. The rising wedge pattern thus in that sense represents greed and fear of missing out on the part of traders and investors.

How it works

The price movement is bounded by the two converging trendlines. As the price moves towards the apex of the pattern the end of the pattern is nearing. Finally, only a clear move below the lower support line would be viewed by traders as a reversal in the upward trend. For traders focusing on daily charts, a daily close below the lower support line is needed to confirm the triggering of this bearish pattern.

Put differently, as the strength of the buyers wears off, the sellers start to gain momentum. The pattern is complete once the sellers visibly take control of the security, by pushing the price below the supporting trendline.

Typically a good first downside price target is 50% of the distance of the low of the rising wedge and the top of the wedge.



Falling Wedge Pattern

Whereas the rising wedge is a bearish pattern, the falling wedge is its bullish cousin.

The falling prices in an ever more narrow trading range signal that the security is likely nearing a consolidation period where the stock trots sideways or begins to break higher. In extreme cases the trendlines of this pattern converge, with both trendlines slanted in a downward direction.

Why it works

As a stock or other asset moves lower and bearishness/negativity among investors begins to increase. The more investors sell a stock as fear spreads the steeper the slope and the more narrow the falling wedge pattern becomes. The falling wedge pattern thus in that sense represents pure fear as everyone runs for the exit.

How it works

The price movement is bounded by the two converging trendlines. As the price moves towards the apex of the pattern the end of the pattern is nearing. Finally, only a clear move above the upper resistance line would be viewed by traders as a reversal in the downward trend. For traders focusing on daily charts, a daily close above the upper resistance line is needed to confirm the triggering of this bullish pattern.

Put differently, as the strength of the sellers wears off and maximum bearishness is reached, the buyers start to gain momentum. The pattern is complete once the buyers visibly take control of the security, by pushing the price above the resistance trendline.

Typically a good first upside price target is 50% of the distance of the high of the falling wedge and the bottom of the wedge.

Flags, wedges and pennant patterns

These are important patterns but rather than picking these three types of patterns apart into different categories let's recognize that in essence they are all 'consolidation' patterns. What these patterns have in common is that they represent an asset consolidating a rally (or selloff), which then ultimately stands a good chance of continuing in the primary direction.

In fact, these three pattern types are so similar that one could with only little imagination (for example) draw a pennant formation out of a flag formation.

Why it works

After a stock rallies for some time it ultimately reaches a price level where investors (all else being equal) are no longer willing to buy the stock for the time being. The reasons why investors stop buying the asset will vary depending on their respective time frames and can range from short term momentum (overbought) to more fundamental reasons. However because from the world of physics we learn that an object in motion stays in motion with the same speed and in the same direction unless acted upon by an unbalanced force, ultimately after some consolidation the odds favor that the stock will resume its primary trend higher. The inverse works for assets that are falling.

How it works

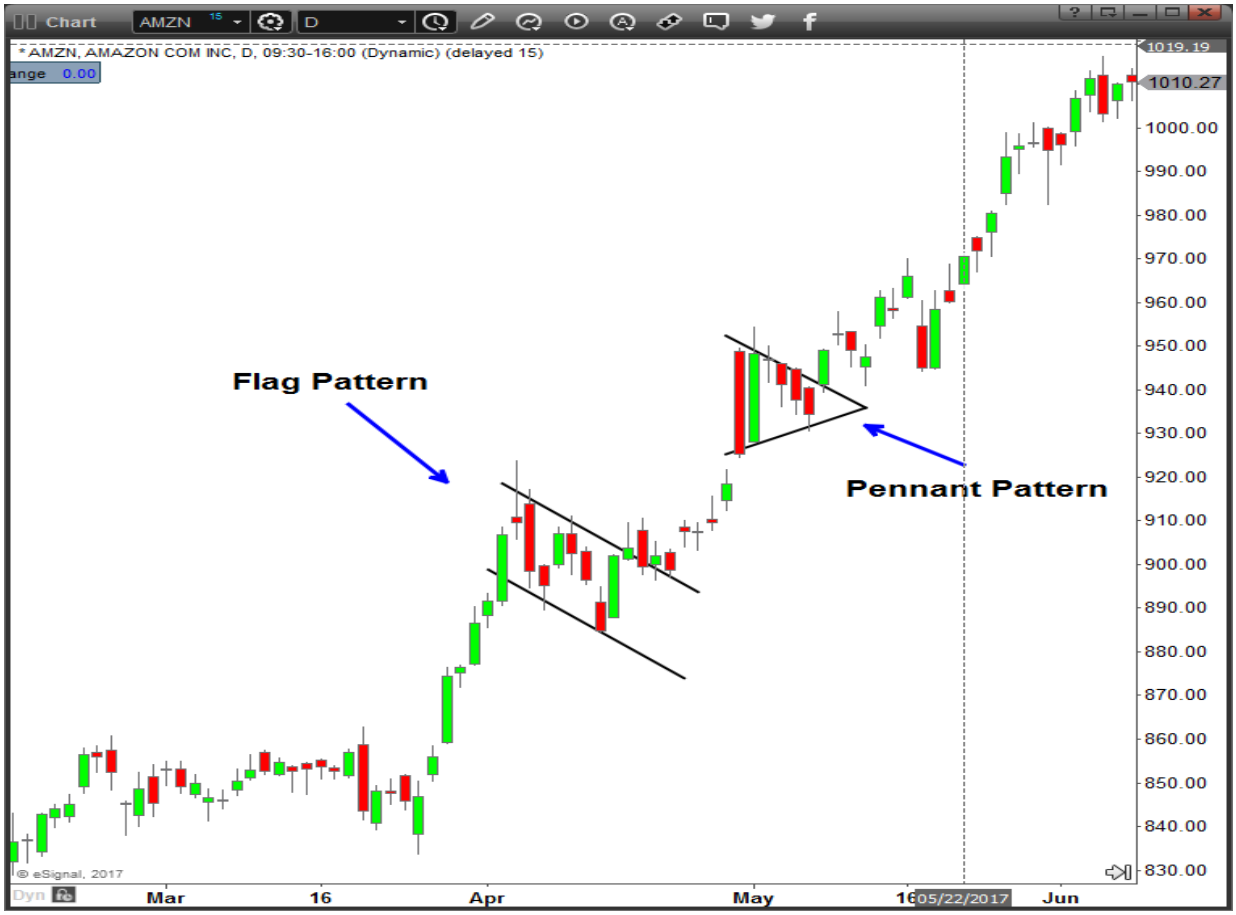
Generally speaking, the tighter and more well defined a consolidation pattern the better and more straightforward it is to profit from. Why? Because the tighter the pattern the better a trader and investor can define his or her risk.

On the below two charts I drew in the flag pattern, the pennant pattern on one chart and the sideways consolidation pattern no a separate chart. Much like other patterns already discussed above in this ebook, a valid trigger of these consolidation patterns does not occur until a clear breakout has taken place on whatever time frame one is focused on. For example, a trader or investor focused on charts with daily increments, a valid breakout of either a pennant, flag or sideways pattern does not trigger until a visually clear breakout has taken place on a daily closing basis.

Targets and stops:

One of the keys to consistent profits in the stock market is to be consistent and clear with profit targets and stop losses. A simple but effective way to measure the first upside price target in any of the three aforementioned consolidation patterns (once a breakout has occurred) is to add the distance of the rally leading up to the top of the pattern, and add it to the breakout point.

For example on the flag pattern example on the chart below, the first upside price target is measured by taking the distance between the rally that preceded the top of the flag pattern and adding that to the breakout point where the stock began to break out of the pattern.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AMZN
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Flag Pattern
Pennant Pattern
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Mar
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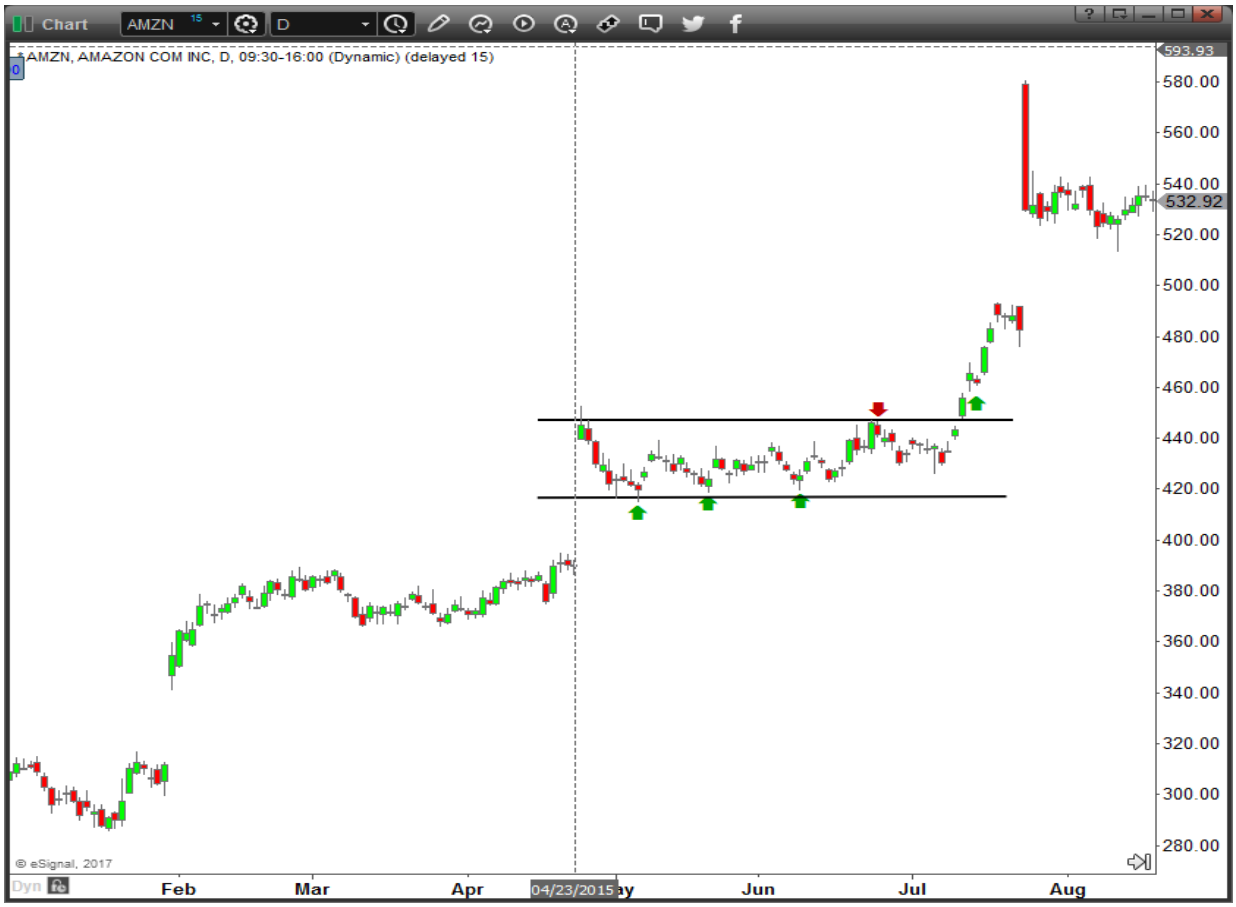
Chart
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*AMZN, AMAZON COM INC, D, 09:30-16:00 (Dynamic) (delayed 15)
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440.00
420.00
400.00
380.00
360.00
340.00
320.00
300.00
280.00
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Feb
Mar
Apr
04/23/2015
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Jul
Aug

Island Reversal

Island reversals, however silly the name are some of the most powerful reversal patterns. After fifteen years of watching this pattern I have no doubt that upon completion of such a pattern, a very high probability trade sets up. This pattern comes both in the bullish and the bearish variety.

Why it works

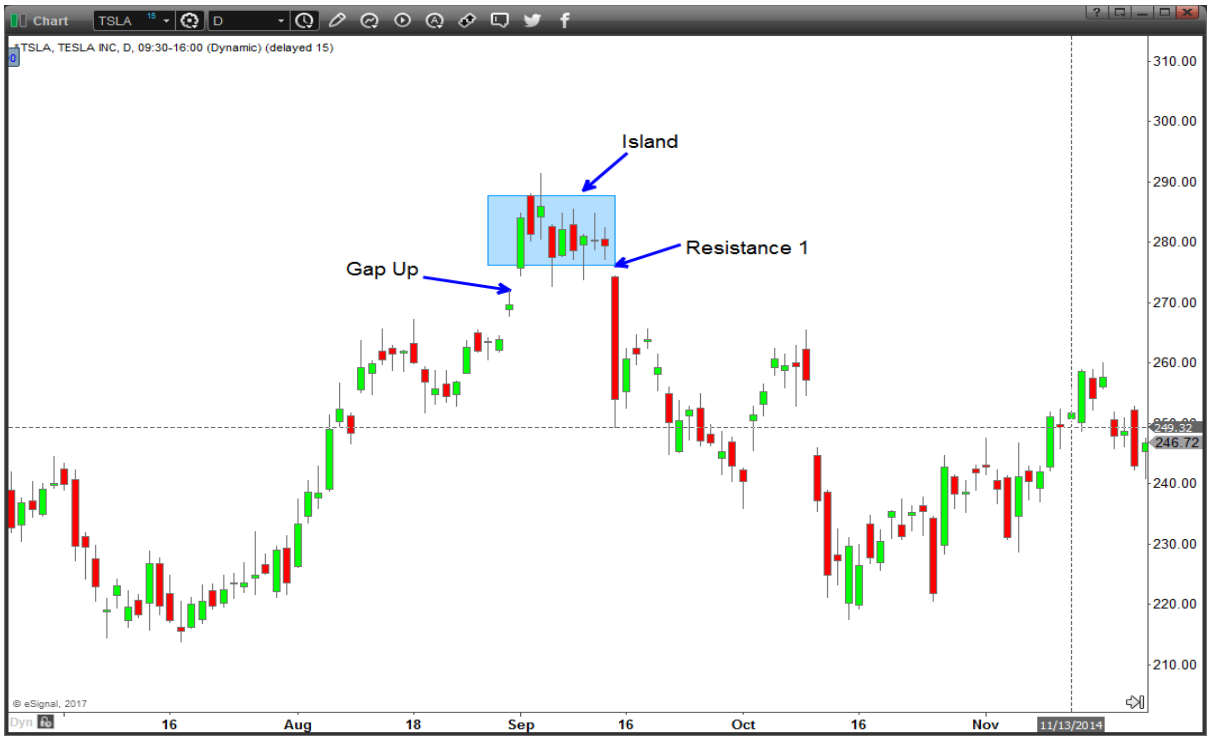
(Below I describe the bearish island reversal. For the bullish island reversal the inverse holds true)
Like any reversal pattern, the island reversal is a sign of buyer exhaustion, i.e. maximum bullishness/greediness is reached. Often times in a last attempt of buying desperation the greedy bulls will give it all and chase a stock higher regardless of price, valuation or any other possible analytics. This can lead to exhaustive final up-gaps, which then however mark a near, intermediate term or possibly even a longer term top in a stock or other asset.

How it works

The island reversal has this name because it is the result of an up gap, followed by a down gap some time later. This leaves an island or price action remotely alone atop the chart, which clearly marked the exhaustion buying, i.e. maximum bullishness within any given time frame.

Looking at the pattern example on the chart we see that this stock rallied for weeks but after a final up-gap the bulls finally had enough. This however is not clear until we see a down-gap of equal or greater size as the final up-gap, because the down gap confirms that the most recent price action preceding it was just a last gasp exhaustion buying.

A first price target following a confirmed island reversal then becomes the 50% mark of the most recent rally.



Cup and handle

A cup and handle chart pattern resembles just that, the profile of a cup with a handle. The cup has a 'U' or even a 'V' shape of sorts and the handle has a slight downward drift. The right-hand side of the pattern typically has low trading volume.

The classic 'cup and handle' pattern definition has great focus on the how long it 'should' take to form the various stages of the pattern . In my eyes that is less important, particularly if one only takes a trade when a qualified signal from the pattern actually flashes. Namely, upon the confirmation of a breakout and not in anticipation of it.

In other words, don't get too detailed about all the small intricacies of various patterns or you will lose sight of the bigger picture. This holds true for all technical patterns. In reality most patterns rarely show up in their perfect academic state but rather take slightly less perfect forms.

Why it works

The cup-and-handle pattern is a consolidation pattern that represents the consolidation of a stock within its primary up trend. Much like the aforementioned flags, wedges and box patterns, along this consolidation path some weaker investors leave the market and new buyers and steadfast holders stay in the security.

The only real difference is that the cup and handle is a slightly more complicated consolidation pattern but ultimately offers just many high probability trading and investing signals as the simpler patterns.

How it works

Although the classic textbook cup formation is truly round, if over the years I had only focused on taking these 'perfect' formations I would have left much money on the table. The reality is that markets don't trade in a linear fashion and will thus also not act in a perfectly geometrical matter either when it comes to patterns.

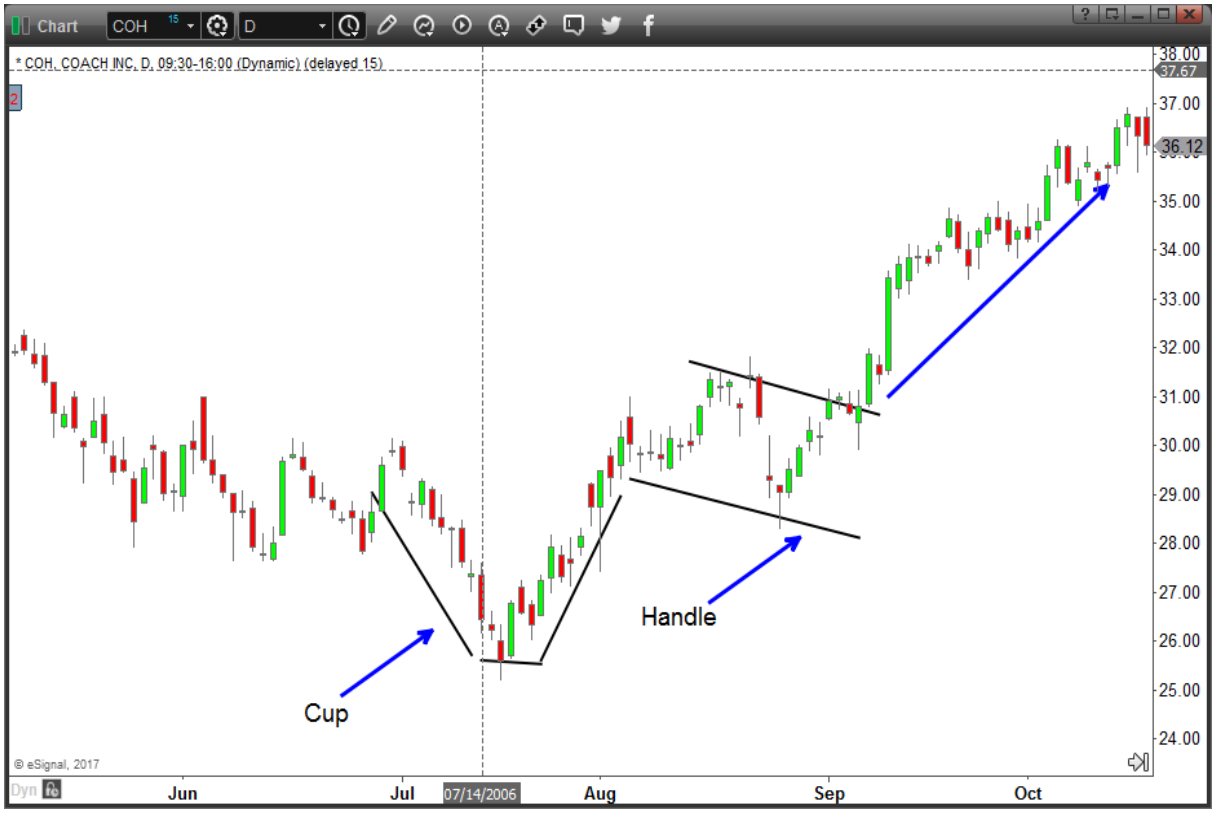
The cup of the formation is the consolidation phase which shows buyers getting exhausted and some weak holders of the stock jumping ship.

As the market begins to rally again and the right side of the cup completes its formation, another round of nervous investors jump back out when the price gets back to the previous highs, i.e. the highs of the left side of the cup as they get to 'breakeven' on their positions. This then leads to the handle of the pattern.

The handle ultimately completes the pattern and results in a buy signal. The handle is the downward move by the security after the upward move on the right side of the cup. Traditionally speaking, if the handle is downward moving then the handle's downward movement can retrace up to one-third of the gain made in the right side of the cup.

During this downward move where some investors get back out of the stock, a descending trendline can be drawn. A move by the security back above this descending trendline is a signal that the prior upward trend is set to begin.

Alternatively, a more conservative breakout signal would flash if the security breaks above the price point of the two peaks in the cup. This is the price where the initial upward trend peaked and the point where the cup's upward move on the right side peaked before entering the handle. A breakout above this point is a strong signal that the prior uptrend is set to resume.



Simple support & resistance lines

While all of the above patterns are high probability in nature, the one common denominator is that they all ultimately must punch above or below a well defined line of resistance or support in order to trigger a trading or investing signal.

Why it works

A pattern is just a pattern until it breaks a price area on the chart around which the pattern is based. Once this price area is broken the momentum in that direction tends to increase as other market participants also notice the move, which leads to the snowball effect.

How it works

The beauty in the break above/below a simple line is its simplicity. Two things of note however:

1) A break of a line is not confirmed until it has actually taken place on a daily closing basis or a 60 minute closing basis (whatever one's time frame is for looking at the break). In other words, do not

anticipate the breakout but rather react to it. A true breakout will give you plenty of time to buy it once it has taken hold.

2) The more often a resistance/support line gets tested the more powerful the ultimate breakout move tends to be. This statement also implies that a first attempt at a breakout may not be the true move but rather that a good breakout may need several attempts to work up the courage.

Chart pattern checklist

Understand your time-frame. For example, if you are noticing one of these patterns on the daily time frame, then it is to be looked at through a multi-day/week lens and not as an intraday trade or a long-term trade.

Be aware of general trend in the sector/group/asset class of the stock or other security you are noticing a pattern in. Generally speaking the odds favor trading patterns in the direction of the general market or subsector that the stock in question belongs to.

Wait for confirmation. Do not take any trades prematurely, i.e. before the chart pattern in question has actually signaled a qualified buy or sell signal. Taking trades in anticipation of a pattern buy or sell signal will over time lead to significantly worse returns, bad habits and ultimately a loss of confidence in one's strategy.

Check your opinions at the door. Over the years I have learned to respect a qualified pattern signal and even if it goes against what I think about where that stock should move to. The market's move trumps all conviction.

The Case for Active Investing or Swing Trading

No stress, no boredom: Swing trading captures a sweet-spot in the world of trading when it comes to time-frames. Swing trading doesn't require the trader to be glued to the screens all day, nor is it too hands off. Swing traders can check on the markets a couple of times per day, while maintaining their day job, hobby or whatever else keeps them busy.
Comfortable holding time-frames: The typical holding period for a swing trading position is anywhere from two days to four or more weeks. This time-frame allows individuals to follow the news flow and price action without having to worry about the intraday ticks and noise.
Un-crowded trades: The holding periods of two days to multiple weeks is too long for day traders and typically too short for institutional investors, hence allowing us to profit from less crowded trades with clean patterns.
Plethora of setups: Swing trading yields a steady stream of trading setups every week and month.
Defined risk: Every new trade automatically has a clearly-defined stop-loss level and profit target. No emotions, just a focus on flawless execution.

Trading is an art, not a science, but a clear trading plan is of essence for success.

My active investing/trading approach and plan I have developed over the years is straightforward to understand and forces me to focus on only executing high probability setups, all the while understanding and closely following the ever evolving bigger picture. I strongly encourage everyone to structure their trading plan in a similar way, i.e. in that it focuses on execution rather than too complex an analysis plan.

Here are just a few of the vast benefits of diversifying investments/trades across several types of trading setups (and ideally in different time-frames):

Increased consistency of profits
Decreased correlation of one's portfolio vs. the broader market performance
Market participant gains significantly better perspective of the market's current standpoint and opportunities
Market participant can act from a more neutral standpoint and will trade without stress
Market participant will find more trades with the most favorable risk/reward ratio

Today's dynamic markets demand flexibility in trading timeframes and adaptability of trading 'systems.' The objective is to thereby reach more consistent profits. Active investing and trading does not have to be hectic. Understanding the bigger picture, not fighting trends and having a well-defined and repeatable process is 95% of the key to consistent success.

STOCKS AND OPTIONS GLOSSARY

Some of the most important terms you need to know

Arbitrage

A trading technique that involves the simultaneous purchase and sale of identical assets or equivalent assets in two different markets with the intent of profiting by the price discrepancy.

Ask / Ask Price

The price at which a seller is offering to sell an option or a stock.

Assignment

Notification by OCC to a clearing member that an owner of an option has exercised their rights. For equity and index options, OCC makes assignments on a random basis.

At-the-Money Option

A term that describes an option with a strike price that is equal to the current market price of the underlying stock.

Bearish

An adjective describing the opinion that a stock, or a market in general, will decline in price; a negative or pessimistic outlook.

Bid / Bid Price

The price at which a buyer is willing to buy an option or a stock.

Bullish

An adjective describing the opinion that a stock, or the market in general, will rise in price; a positive or optimistic outlook.

Closing Price

The final price of a security at which a transaction was made.

Contingency Order

An order to execute a transaction in one security that depends on the price of another security. An example might be to sell the XYZ May 60 call at $2.00, contingent upon XYZ stock being at or below $59.

Contract Size

The amount of the underlying asset covered by the option contract. This is 100 shares for 1 equity option unless adjusted for a special even.

Cover

To close out an open position. This term most often describes the purchase of an option or stock to close out an existing short position for either a profit or loss.

Cycle

The expiration dates applicable to the different series of options. Traditionally, there were three cycles:

Cycle	Available Expiration Months
January	January, April, July, October
February	February, May, August, November
March	March, June, September, December

Today, most equity options expire on a hybrid cycle, which involves four option series: the two nearest-term calendar months and the next two months from the traditional cycle to which that class of options has been assigned. For example, on January 1, a stock in the January cycle will be trading options expiring in these months: January, February, April and July. After the January expiration, the months outstanding will be February, March, April and July.

Decay

A term used to describe how the theoretical value of an option erodes or declines with the passage of time. Time decay is specifically quantified by Theta.

Discount

An adjective used to describe an option that is trading at a price less than its intrinsic value.
Exchange Traded Funds (ETF's)
Exchange traded funds (ETFs) are index funds or trusts listed on an exchange and traded in a similar fashion as a single equity. The first ETF came about in 1993 with the AMEX's concept of a tradable

basket of stocks— Standard & Poor's Depositary Receipt (SPDR). Today, the number of ETFs that trade options continues to grow and diversify. Investors can buy or sell shares in the collective performance of an entire stock portfolio (or a bond portfolio) as a single security. Exchange traded funds allow investors to enjoy some of the more favorable features of stock trading, such as liquidity and ease of equity style, in an environment of more traditional index investing.
Exercise
To invoke the rights granted to the owner of an option contract. In the case of a call, the option owner buys the underlying stock. In the case of a put, the option owner sells the underlying stock.

Expiration Date

The date that an option and the right to exercise it cease to exist.
Expiration Friday
The last business day prior to the option's expiration date during which purchases and sales of options can be made. For equity options, this is generally the third Friday of the expiration month. If the third Friday of the month is an exchange holiday, the last trading day is the Thursday immediately preceding the third Friday.

Hedge

A position established with the specific intent of protecting an existing position. For example, an owner of common stock may buy a put option to hedge against a possible stock price decline.

Leverage

A term describing the greater percentage of profit or loss potential when a given amount of money controls a security with a much larger face value. For example, a call option enables the owner to assume the upside potential of 100 shares of stock by investing a much smaller amount than that required to buy the stock. If the stock increases by 10%, for example, the option might double in value. Conversely, a 10% stock price decline might result in the total loss of the purchase price of the option.

Limit Order

A trading order placed with a broker to buy or sell stock or options at a specific price.
Margin / Margin Requirement
The minimum equity required to support an investment position. To buy on margin refers to borrowing part of the purchase price of a security from a brokerage firm.

Market Order

A trading order placed with a broker to immediately buy or sell a stock or option at the best available price.

Market-on-Close Order (MOC)

A type of market order that requires that an order be executed at or near the close of trading on the day the order is entered.

Naked Option

A short option position that is not fully collateralized if notification of assignment is received. A short call position is uncovered if the writer does not have a long stock or deeper-in-the-money long call position. A short put position is uncovered if the writer is not short stock or long another deeper-in-the-money put.

Non-equity Option

Any option that does not have common stock as the underlying asset. Non-equity options include options on futures, indexes, foreign currencies, Treasury security yields, etc.
Open Interest
The total number of outstanding option contracts on a given series or for a given underlying stock.

Option

A contract that gives the owner the right, but not the obligation, to buy or sell a particular asset (the underlying stock) at a fixed price (the strike price) for a specific period of time (until expiration) . The contract also obligates the writer to meet the terms of delivery if the owner exercises the contract right.

Physical Delivery Option

An option whose underlying entity is a physical good or commodity, like a common stock or a foreign currency. When its owner exercises that option, there is delivery of that physical good or commodity from one brokerage or trading account to another.

Premium

1. Total price of an option: intrinsic value plus time value.
2. Often (Erroneously) this word is used to mean the same as time value.

Put Option

An option contract that gives the owner the right to sell the underlying stock at a specified price (its strike price) for a certain, fixed period (until its expiration). For the writer of a put option, the contract represents an obligation to buy the underlying stock from the option owner if the option is assigned.

Resistance

A term used in technical analysis to describe a price area at which rising prices are expected to stop or meet increased selling activity. This analysis is based on historic price behavior of the stock.

Rolling

A trading action in which the trader simultaneously closes an open option position and creates a new option position at a different strike price, different expiration, or both. Variations of this include rolling up, rolling down, rolling out and diagonal rolling.

Settlement

The process by which the underlying stock is transferred from one brokerage account to another when equity option contracts are exercised by their owners and the inherent obligations assigned to option writers.

Stop Order

A type of contingency order, often erroneously known as a stop-loss order, placed with a broker. It becomes a market order when the stock trades, or is bid or offered, at or through a specified price.

Stop-Limit Order

A type of contingency order placed with a broker that becomes a limit order when the stock trades, or is bid or offered, at or through a specific price.

Straddle

A trading position involving puts and calls on a one-to-one basis in which the puts and calls have the same strike price, expiration and underlying stock. When both options are owned, the position is called a long straddle. When both options are written, it is a short straddle. Example: a long straddle might be buying 1 XYZ May 60 call and buying 1 XYZ May 60 put.

Strike / Strike Price

The price at which the owner of an option can purchase (call) or sell (put) the underlying stock. Used interchangeably with striking price or exercise price.

Support

A term used in technical analysis to describe a price area at which falling prices are expected to stop or meet increased buying activity. This analysis is based on previous price behavior of the stock.

Tick

The minimum price increment for an option's bid or ask.

Underlying Security

The security subject to being purchased or sold upon exercise of the option contract.

Volatility

A measure of stock price fluctuation. Mathematically, volatility is the annualized standard deviation of a stock's daily price changes.