The Dow Theory

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Although the Dow Theory has withstood the test of time and has been most efficient in timing the market over the last one hundred years, it remains one of the most misquoted and misinterpreted market-timing methodology to this day. The Dow Theory is actually based on a series of stock market writings written by Charles Dow (founder of the Wall Street Journal) at the turn of the century, with a major emphasis on valuations and the primary trend. After Dow passed away, William Hamilton (Dow's understudy) continued Dow's writings. The Dow Theory, as interpreted by William Hamilton, forms the basis of all technical analysis today. Other notable mentions who wrote about the Dow Theory were Robert Rhea, E. George Schaefer, and Richard Russell - the last living great Dow Theorist.
The Dow Theory Charles H. Dow It is interesting and amazing to note that not until Charles Dow started compiling the Dow Jones Industrial and Dow Jones Rail Index and started writing about the stock market a little over a hundred years ago, stock speculation was regarded merely as a game for the rich or as gambling for the brave. Sure, there were the tape readers, but the majority of the public regarded Wall Street as a source of excitement - the entertainment provided freely (unless you were on the wrong side) by figures such as Cornelius Vanderbilt, Jay Gould, and the infamous Daniel Drew. In a series of stunning editorials for the Wall Street Journal at the turn of the century, Dow laid out the foundation of his own theory on the stock market. Among them were:
 - The market is always to be considered as having three movements, all going on at the same time.
 - The first thing to consider is the value of the stock in which the speculator proposes to trade, the second the direction of the main movement, and the third the direction of the secondary movement (i.e. stocks fluctuate together, but prices are controlled by values in the long run).
 - There are three phases to both a primary bull market and a primary bear market (not to be confused with the three movements mentioned above).
 - The formation of a "line" in the averages indicates accumulation or distribution
 - The market represents a serious well-considered effort on the part of far-sighted and well-informed men to adjust prices to such values as exist or which are expected to exist in the not too remote future. The method of making money in stocks, according to Dow, was to study basic conditions and exercise enough patience to capture the major movements. One of the few speculators who discovered this relatively new concept of making money on Wall Street at the time was Jesse Livermore. He was able to accomplish this only through trial and error and the making and losing of several fortunes. William P. HamiltonWilliam P. Hamilton, Dow's understudy and the fourth editor of the Wall Street Journal, continued Dow's legacy after his death in 1903. The Dow Theory as interpreted by Hamilton forms the basis of all modern technical analysis today. He wrote about the Dow Theory for the Wall Street Journal for more than 20 years. His additions to the Theory included:
 - The Averages discount everything
 - The primary trend cannot be manipulated
 - Both the Industrials and Rails (the modern day Transports) must confirm each other in order for the signal to have authority
 - The Theory is not infallible. If someone did find such a system, then he or she will own the world in relatively short order and speculation as we know it will not exist.
 - Determining the trend by spotting "higher highs" or "lower lows" Hamilton's predictions of the trends were uncannily accurate, even as he developed a wide following from his editorials. A major reason why he was accurate almost all the time was his lack of a writing schedule - choosing only to write when he had something to say about the market, sometimes going for weeks without writing a single word. The one significant time when he erred was in late 1925 and early 1926 when he erroneously labeled a serious secondary reaction in a primary bull market as a bear market. Followers of Hamilton lost heavily during that period, as the market bottomed out in March 1926 (Industrials 135.20 and Rails 102.41) and was getting ready to resume its long advance that would not end (tragically) until September 1929. Even so, Hamilton would always be remembered for penning the following editorial on October 25, 1929, just days before the crash. His words proved prophetic - calling for the beginning of a new primary bear market. Part of his now-famous editorial is reproduced below: A Turn in the Tide - October 25, 1929 On the late Charles H. Dow's well known method of reading the stock market movement from the Dow-Jones averages, the twenty railroad stocks on Wednesday, October 23 confirmed a bearish indication given by the industrials two days before. Together the averages gave the signal for a bear market in stocks after a major bull market with the unprecedented duration of almost six years. It is noteworthy that Barron's and the Dow-Jones NEWS service on October 21 pointed out the significance of the industrial signal, given subsequent confirmation by the railroad average. Hamilton passed away six weeks after he wrote the above editorial. It is a tragedy that probably not a great number of people at the Wall Street Journal or Barron's today have even heard of the Dow Theory, let alone have a complete understanding of it. Robert RheaThe next great Dow theorist, Robert Rhea, initially stumbled upon the Dow Theory during his endeavor to find "a system" for helping him make money in the stock market. In his attempts to disprove the theory, he became a convert. Rhea was a very serious student, and he was able to utilize the Dow Theory as interpreted by Hamilton to his advantage, buying and holding stocks in 1921, and basically holding them until late 1928 (he reversed his short position when he realized Hamilton's advice was incorrect in early 1926), missing only the final blowoff phase. He also "played" the short side successfully during the subsequent deflation. In 1932, he began publishing his newsletter based on the Dow Theory, called the "Dow Theory Comment." Rhea called the bottom of the stock market in July 1932 almost to the exact day and the subsequent top in 1937. On July 21, 1932, with the Industrials at 46.50 and the Rails at 16.76, Rhea instructed his broker to tell his friends "the Dow Theory implied

heavy buying for the first time in over three years." Further, on July 25, 1932, Rhea sent a memo to 50 correspondents, part of which is reproduced below: The declines of both Rail and Industrial averages between early March and midsummer were without precedent. The thirty-five year record of the averages shows a fairly uniform recovery after every major primary action, and such recoveries average around 50% of the ground lost on the decline; are seldom less than a third and more than two thirds. Such recovery periods tend to run to about 40 days, but are sometimes only three weeks - and occasionally three months. The time element is in favor of a normal reaction at this time - because the slideoff was normal (the normal time interval of major declines being about 100 days). The market gave the unusual picture of hovering near the lows for more than seven weeks, and might be said to have made a "line" during the latter weeks of that period. Because of all these things, and because the volume tended to diminish on recessions and increase on rallies during the ten days preceding July 21, almost any one trading on the Dow Theory would have bought stocks on July 19 th . Those who did not, had a clean cut signal again on the 21 st . Since that date the implications of the averages have been uniformly bullish, and it is reasonable to expect that a normal secondary will be completed, even though the primary trend may not have changed to "bull". So much for the speculative viewpoint. Followers of Rhea who bought stocks during that period and held until 1937 made a fortune. E. George SchaeferIn July 1949, with the Dow Jones Industrials registering a low at 161.60 and with the country in the midst of a severe recession, a new primary bull market was born. E. George Schaefer, a Dow Theory disciple for more than 20 years, started his newsletter writing career near that time, calling his subscribers to load up on common stocks in June 1949. He remained steadfastly bullish in the great corrections of 1953 and 1957 and cautiously bullish since 1960 until the final top in 1966. Schaefer believed that Hamilton strayed away from Dow's original principle of investing in "values" and that Rhea spent most of his life improvising Hamilton's "system" of trying to trade the markets when 95% of the population just cannot duplicate what the emotional-less professional traders can do. He also emphasized that some of the "rules" that Hamilton and Rhea developed did not apply to the more modern and more emotional markets of today (such as the claim that secondary reactions tend to retrace one-third to two-thirds of the preceding primary swings). The best course of action was to buy "great values" and staying fully invested through the primary trend. In his 1960 book "How I Helped More than 10,000 Investors to Profit in Stocks," Schaefer stated: As noted before, my extremely bullish market letters of June and July, 1949, appeared just a few days and weeks after the low day of 161.60 was registered on June 13, 1949 by the Dow-Jones Industrials. Since that time, and for the next 11 years, my letters have been consistently bullish on the Primary Trend. The stock market has borne me out, and I would say that the majority of my readers have benefited as they stayed fully-invested in the way I have counseled. Schaefer also developed some additional technical tools and made additional observations along with his study of the Dow Theory. Among them are:

- The 50% retracement concept
- The yield cycle
- The ratio of short interest to daily volume
- The study of odd-lot trading
- The 200-day investment line (the 200-day simple moving average) Schaefer turned bearish at the most opportune time in 1966 and became bullish in gold and gold mining shares shortly afterwards. He was, however, too early with his bullish calls when he asked his subscribers to buy them in 1974. Gold immediately proceeded to suffer a huge short-term correction. The losses may have broken him since he committed suicide shortly afterwards. From thereon, the Dow Theory torch was passed on to Richard Russell. Richard RussellRichard Russell was another Dow Theorist who stumbled upon the Dow Theory during a quest to find useful literature regarding the stock market. He became a convert after reading the writings of Robert Rhea. Russell decided to follow in the footsteps of Rhea and Schaefer - establishing his newsletter "Dow Theory Letter" in 1958, partly inspired by the extreme bearishness of the public during the great correction of late 1957 (Russell was bullish at the time). He also urged subscribers to sell at the top in February 1966, and he rightly turned bullish in December 1974. Following are excerpts from his newsletter during those periods. February 10, 1966 (two days after the final top) - While Russell mentioned that although technical conditions are getting weaker, there is no indication that the bull market was over yet. However, on the simultaneous decline of the Dow Jones 40 Bond Average and the Dow Jones Utility Average, he commented: " In the present ... instance the 40 Bonds turned down in February, 1965. The real decline in Utilities began in April, 1965. Therefore, the joint decline in both components can be said to have started in April, 1965, nine months ago. Based on past history, the decline of Utilities and Bonds together should be taken as a warning of dangerous monetary conditions ahead as well as a warning of unsatisfactory stock market conditions. At very least, the shaded areas identify periods in which informed investment money is distributing or leaving the market." Russell began his February 22, 1966 newsletter with the following paragraph : I dislike emphasizing "the drama of the marketplace" (in contrast with the cold, analytic approach), but it does seem to me that 1966 is shaping up as a most exciting year for market students. Not since 1907 has a booming economy run head-on into a monetary crisis, but I believe there is a reasonable chance that 1966 will see just that type of situation repeated. Furthermore, the monetary squeeze is occurring at a time when (unlike 1907) few businessmen, economists or Governmental leaders have the foggiest idea of the overall situation or the vaguest notion of how to deal with it. What we are seeing is an explosive demand for money from all sectors of the economy with a "built in" booster of $1 billion a month for the Vietnam war - all this in the face of world money markets which are literally "panting for breath." Note that these were very strong comments since the public was very enthusiastic about the stock market at that time. In fact, according to Russell in the same newsletter, mutual fund purchases by the public in December 1965 were the highest of any December in history. At the same time, the initial offering by the newly-formed Manhattan Fund (headed by Gerald Tsai) was nearly five times oversubscribed. 1966 was a very speculative period, indeed. The period during late 1974 was a world full of contrasts to that of early 1966. Pessimism was prevalent. The Dow Jones Industrials was selling at a P/E ratio of 6 and at below book value. Some subscribers canceled their subscriptions of Dow Theory Letter after Russell's

special report on December 20, 1974 - thinking that Russell had clearly gone out of his mind. Part of that newsletter is reproduced below: Now this is how I view it. I think the odds are probably better than 50/ 50 that the Dow and most shares hit a bottom in December 1974. I put this thesis together with a number of other facts. As you will see in a later section, the unweighted NYSE average is now down around 77% from the high. In 1929-32 the unweighted NYSE average went 12% further on the downside - to an 89% loss. I feel that most shares have now discounted all the forthcoming bad news, and I am including recession-depression conditions in 1975. We have been in the third phase of a great primary bear market. We are finally in the zone of "great values". In many cases, stocks are selling "below known values". Here's an interesting statistic: The price/ earnings ratio for the 30-Dow Industrials is now around 6.0 while the yield on the Dow is 6.36. This means that the Dow P/E is below the yield on the Dow. This happened only once before in the last forty years, and that was during 1948-50. Second item: The Dow is now selling below its book (or break-up) value. This has not occurred since 1942. Are these two above Dow "tests" infallible indications of the final bottom? Not at all, but they do indicate that the Dow is sure getting down there. There is no doubt that the 1974 bottom call was one of the greatest stock market calls in modern history, right up there with Hamilton's 1929, Rhea's 1932, and Schaefer's 1949 calls. Based on the Dow Theory and his own observations, he told his subscribers the market was a "sell" in August 1987, even though no Dow Theory sell signal has been triggered at the time (Hamilton and Rhea has always emphasized that one does not usually need to wait for a Dow Theory buy or sell signal to tell one to buy or sell). That signal, however, was triggered just days before Black Monday, October 19, 1987, as the Dow Transports confirmed the Dow Industrials on the downside by breaking through its preceding secondary lows on October 15 (such a signal in the third phase of a primary bull market is taken to be a primary bear market signal). Russell stayed cautiously bullish during the late 1990s. In September 1999, the Dow Theory generated a primary bear sell signal. Today, Russell still maintains that we are in a primary bear market, and that the market will not bottom until stocks have reached the point of "great values" with P/E ratios below 10 and with dividend yields of greater than 5%. At the age of 79, Russell is still going strong, publishing a market commentary every Monday to Saturday.The Dow Theory Today The Dow Theory has withstood the test of time - the latest "proof" being Russell's primary bear market call based on the Dow Theory in September 1999. As with his 1974 primary bull market call, numerous stock market analysts ignored him, including some of his own subscribers. Various "trading systems" come and go, but the Dow Theory has been a reliable tool for the trader/investor for over a century - mainly because the Dow Theory is not a system, but merely a theory based on the principles as first developed by Charles Dow, and which is open to interpretation. Since the 1999 primary bear market signal, a great deal of interest has been revived in the Dow Theory. However, not a day goes by without spotting someone who claims an understanding of Dow Theory but who actually only has a cursory understanding at best. More recently, numerous traders have tried to reduce the Dow Theory to a "system," where a series of confirmations of the Dow Jones Industrials by the Dow Jones Transports (or vice-versa) is taken to be "buy" or "sell" signals without regards to other factors such as valuation, economic conditions, and investor sentiment. It is to be said here at none of the above Dow Theorists interpreted the confirmations of the indexes in that manner. None of them actually waited for such "signals" to buy or sell - they bought or sold in advance. Waiting for such "signals," they claimed, would cause them to have missed a significant part of the move, and such moves can be costly. The primary purpose of this indicator is to serve as a confirmation of the current trend, and if one index does not confirm the other (or if it takes a long time to confirm) then it is a warning sign that the current trend may be over, and positions may need to be liquidated (or stops may have to be tightened) or may need to be covered if one is short. Again, the confirmation of one index by the other is not to be taken as a buy or sell indicator. Another variation of this fallacy is that the July and October 2002 bottom were the true bottoms, and that unless those bottoms were jointly penetrated by the Dow Jones Industrials and Transports, we are now in a bull market as interpreted by the Dow Theory since we have made higher highs in both indexes. Nothing can be further from the truth. Please remember that Dow's original emphasis was on valuation and economic conditions. All the major indexes are still overvalued today judging by their P/E and P/D ratios. Moreover, the higher highs indicator can only be treated seriously in the third phase of a primary bear market, when pessimism runs extreme and when stocks are liquidated without regards to values. We had none of that in this bear market so far. We believe any serious investor/trader should take the time and try to gain a true understanding of the Dow Theory. I sincerely believe that the Dow Theory is even more valuable today than it ever was - in a world full of hedge funds using price, volume, and volatility breakout systems and with anyone willing to jump in at the sign of a potential trend. Today's markets are more emotional than ever and only by knowing the true tenets of the Dow Theory can one stay firmly planted on the ground with both feet. Ignore the presses and anyone else who has not taken the time to learn the Theory. Read all the historical writings by the above Dow Theorists, and I promise you that this education will be immensely more valuable than any secondary education you can obtain in a top ten business school or a top five investment bank today. Our site will try to incorporate the Dow Theory in our analysis, but please bear with us from time to time since we are still students of the Dow Theory ourselves.