

Richard D. Wyckoff and The Composite Man: A Traders's Study

“Anyone who buys or sells a stock, a bond, or a commodity for profit is speculating if he employs intelligent foresight. If he does not, he is gambling.” - Richard D. Wyckoff

Richard D. Wyckoff was a famous trader, back in the days of Jesse Livermore (Edwin LeFevre), and when stock trading in the U.S. was becoming a way of life. Wyckoff was curious about the logic behind market action. His work concentrated on Volume-Price analysis, Point and Figure analysis and a methodology of ranking sectors or stocks or commodities within various sectors to arrive at relative strength for the best possible trade. He was systematic and methodical in his work, and could calm an investor's own protocol with “rules of the game” and logic.

Wyckoff Associates, Inc. began in Chicago in the 1940's as Wyckoff's methods were finally approved and “written up” and a course of study created. My dad was the first teacher of Wyckoff and I was trained in “Wyckoff thinking” from a young age.

Three Key Principles

Using three key principles of psychology, Wyckoff taught:

1. Supply and demand (utilizing a point and figure chart)
2. The law of effort versus result
3. The law of cause and effect

Supply and demand is “seen” using X's and O's, point and figure charting, but even more completely visualized using bar charts and watching for shifts between prices and volume. This is an example of effort versus result. During a rally in the market, both price AND volume will move UP. When prices move up, but volume is lower, Wyckoff taught that a shift or change was imminent.

Point and figure charting, invented by Charles Dow in the late 1800's, was used by Wyckoff for the law of **cause and effect**. He saw that when prices were in a trading range **CAUSE** was being built up, with both accumulation and distribution. **Effect** is realized during that trading range, because it will be realized during the trend. Volume on a bar chart is analyzed as the “trigger” or

the last point of resistance or support. A “count” is defined by finding the volume junctures on a bar chart and completing an arithmetic count of the number of boxes times the size of the boxes. This is multiplied to define the “count.”

Part of what Wyckoff so effectively teaches is that all stock prices have phases. Accumulation, mark up, distribution, mark down, and a repeating cycle around whatever is influencing the stock, (earnings, acquisition, new products, news). When a stock moves sideways Wyckoff articulates how, by reviewing a chart, one can view accumulation as effort vs. result.

The “Composite Man”

Wyckoff views the trader as the “composite man” and effectively averages thinking. If the stock, for example, is in a trading range and the trader has a stock under accumulation he will watch the supply, and appropriately try to shake out traders by driving prices down. As the “trader” here is the composite man, or the totality of the stock ownership, FEAR takes place, new lows are created, and the “spring” occurs at the end of this shakeout, at the bottom of support lines. This “**spring**” is the time the Wyckoff trader watches for new entry. If support is hesitant, the smart Wyckoff trader waits for a bit of accumulation, assuring that the bears are finished, and adds to a winning position when it rallies as a second test, increases volume, lightly pulls back, while the “spring” is in process, not just starting.

There is more risk to buying during a shake out, and as the “spring” begins, as the market may well not be past its final support pushes.

Wyckoff teaches that to buy a position there, effectively, (index or stock), one would use a combination of vertical charts for volume, and point and figure charts for the analysis of profit objectives, and /or when support/resistance lines are met, or broken.

Part of Wyckoff’s genius was the simplicity of the elimination of opinion and emotion. His methods articulate a series of tests the trader follows to identify WHEN the stock or index is ready for movement.

Pattern Recognition

Pattern recognition is key to Wyckoff. There are strong intuitive interpretations to the Wyckoff method also, led by his theories on the patterns of reoccurring events. Smart traders develop the right brain as part of pattern recognition.

This is done best by watching the obvious, which is typically never seen until long after the obvious has ended.

- Do not expect the market to behave the same way twice.
- Everything the market is doing now must be compared to what the market did before.
- Price and volume are keys together, to know if buyers’ demands are more powerful than sellers’ supply. It doesn’t matter what the price is now if the demand is shifting.

When the market corrects, there are also some investors that have kept their positions, typically too long. They hit a point of fear and panic and are suddenly willing to unload their positions “at any price”. When this heavier volume take place, it sets the stage for a selling climax, which than has rebound, whipsaw return back down (a test), before the market moves up again.

This is when the true trader is now buying. Volume typically dips and the price ranges move up. The average investor at this point believes the market is now bullish, but this is where there will be another reaction and it's HERE that we analyze where the market is going.

Often buyers don't hold here, they may have been manipulating to shore up prices, and if a great amount of stocks are suddenly thrown back in the market, there may be TOO much supply, and prices can then drop lower than the prior lows.

This is where Wyckoff studied volume. If the initial rally back up is on LOW volume, this is a clear sign that the selling may now be over, and that a stronger upturn may be on the way.

Excessive volume+excessive low price followed by rallying prices+low volume= now watch for the next reaction. If the reaction holds at core support lines, the decline has bottomed, and traders would now watch for prices rising to and above core resistance lines.

Using the support lines, Wyckoff shows that if volume is steadily expanding during the down turn, it's less likely that the support lines will hold. Buyers still see an attractive bargain and continue to buy. But, if the decline slows on aggressive volume, it's a sign in the stock, or market, that there may be short, quick rallies. This is called the "shake out," where investors begin to believe all is better. These rallies can be identified by a lack of volume, affirming that the buying power is really still weak.

Part of Wyckoff's genius can be seen in what we now call "sector" or ETF investing. Wyckoff taught to chart composite market averages, overlaying charts of industry group averages, and then comparing the trends of a specific stock within a sector.

Charting

Imagine hand-creating charts of different industry stocks in a sector, carefully averaging them together, and creating a new chart. This was Wyckoff. It's now done for us with any good sector fund or ETF. What Wyckoff created, however, can still be very effectively utilized to understand the relative strength of a particular stock within a sector, and how it will perform within its industry sector. Group averages help institutional traders analyze well beyond broad market trends, and help to see what sectors will soon shift into favor or not. Investors Business Daily (IBD) has done a marvelous job creating sector review and even identifying where the sector is in growing strength. This is Wyckoff.

In all composites/groups, the trader is looking for "what is next," to either short or take an area long. Wyckoff long ago taught "sector rotation," before the advent of the computer or computerized charting, and my Father spent many hours analyzing how the five big steel companies, for example, were doing; which was doing best, and if they, as a sector, were in a "good or bad time." Dad taught it to me as sometimes a stock is Popular, and made the "varsity team," only to later have to sit on the side and not play at all for some time. Stocks are like this, rising and falling around specific seasonal and financial time periods.

Rotation works well for institutional traders to help camouflage their campaigns. For example, if a stock is still leading in a sector in a falling market, and then begins to falter itself, selling may now move to other sectors. Smart Wyckoff traders always follow the lagging sectors first, to see what stocks may lead during market shifts.

Wyckoff taught *a form of emotional physics*. As stocks are first marked up and bought, they are accumulated. As the accumulation becomes rampant, the stocks hit resistance areas and new highs, and are suddenly noted for being “pricey.” This leads to distribution, after the supply has gone scarce and when demand builds (the accumulation). As the stock or index distributes, the laws of supply and demand are merely reversing. Prices are now marked down, rather than up, and this continues until the market (“composite man”) has gained and seen momentum exhausted. Demand will soon start up again.

Part of Wyckoff’s physics is to watch and feel the emotions of price-volume relationships the same way you can “feel or hear” if your car is running rough. This is what we call “watching the market breathe.” We are watching the complete breath, not just the inhalation and exhalation.

One of the keys to Wyckoff’s study is the understanding of the volume price pressure moves, up or down, and the thrusts downward, or shakeouts upward, that finally hit a point of leading a stock or index to a “dead center area.” This is a form of flat lining...little bursts and valleys around a mean, and finally settling into a mean. It’s during this time period that Wyckoff traders are looking for a “spring,” when a stock is close to breakout, or sharper action. “Springboards” occur for a bullish move at the bottom of a decline, and conversely, for a bearish move, and also occur during a flat lining period during decline, where hesitancy builds. There may be a low volume “bump” during such a decline, yet another sign the stock or index may “spring” again, but this time to go beyond support lines, and hit new lows.

“It is possible to judge the future course of the market by its own action—that the basic law of supply and demand governs all price changes—that the best indicator of the future course of the market was the relation to supply and demand.”-Richard D. Wyckoff

Again, here’s where we watch volume. If a move shows volume, it’s typical that it is the beginning of something to “change,” if this is occurring during a decline. The key here is simply to watch the amount of volume. Any change from prior volumes during the same time period is a key something is up. If the volume decreases, it merely indicates that selling is now drying up, and not really even wanted at the lower price. Volume increases as the price of the option goes up, as more are willing now to pay up.

Wyckoff students use vertical or bar charts to understand VOLUME. They use point and figure charts to understand PRICE, or supply and demand. While the typical point and figure chart uses a 3:1 ratio, Wyckoff uses 1:1.

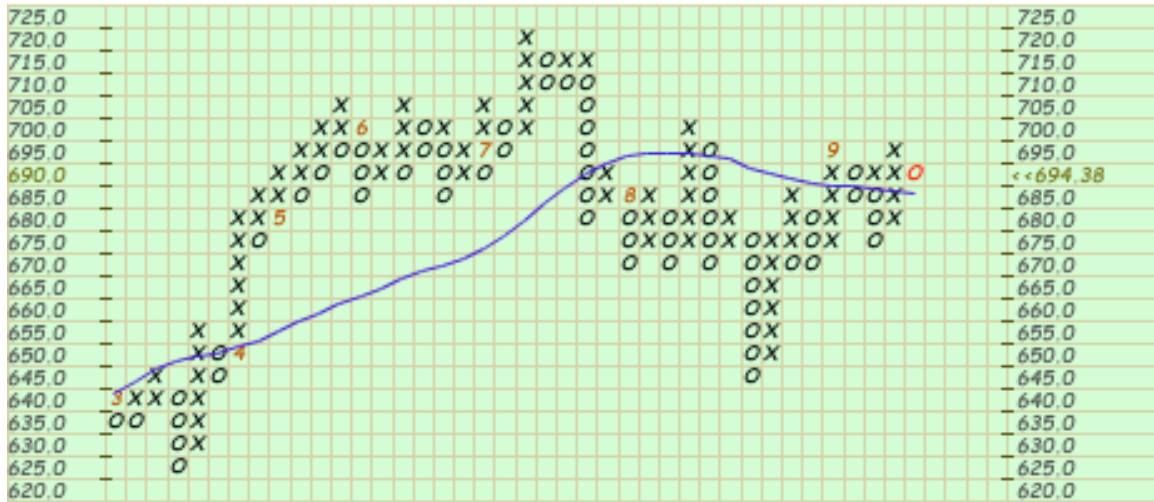
S&P 100 Index (\$OEX) INDEX

14-Sep, 16:00 ET, daily, H: 695.34, L: 689.88, C: 694.38, Chg: -0.62

No New P&F Pattern

Traditional, 1 box reversal chart

© StockCharts.com



This is a 1:1 Wyckoff Chart

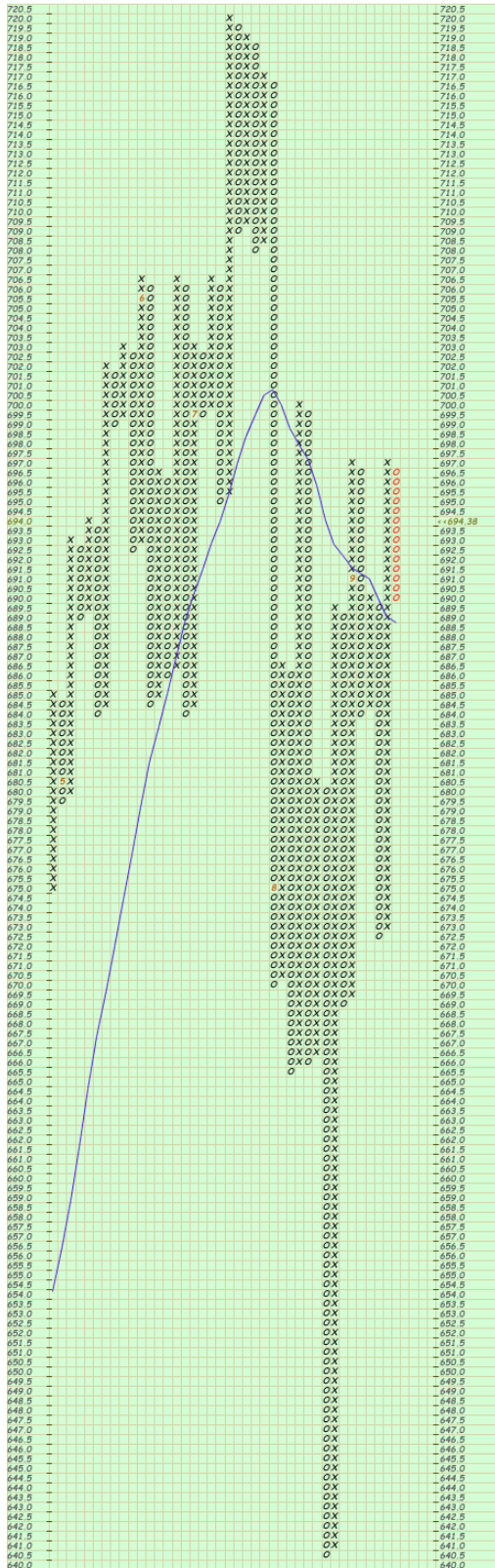
S&P 100 Index (\$OEX) INDX

14-Sep, 16:00 ET, daily, H: 695.34, L: 680.88, C: 694.38, Chg: -0.82

No New P&F Pattern

User-Defined, 0.5 pts/box 3 box reversal chart

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Above is the same chart using a .50 ratio, and just below the traditional 3:1 formation.

What Wyckoff tries to teach is what supply and demand MEAN in relation to CAUSE and EFFECT.

S&P 100 Index (\$OEX) INDX

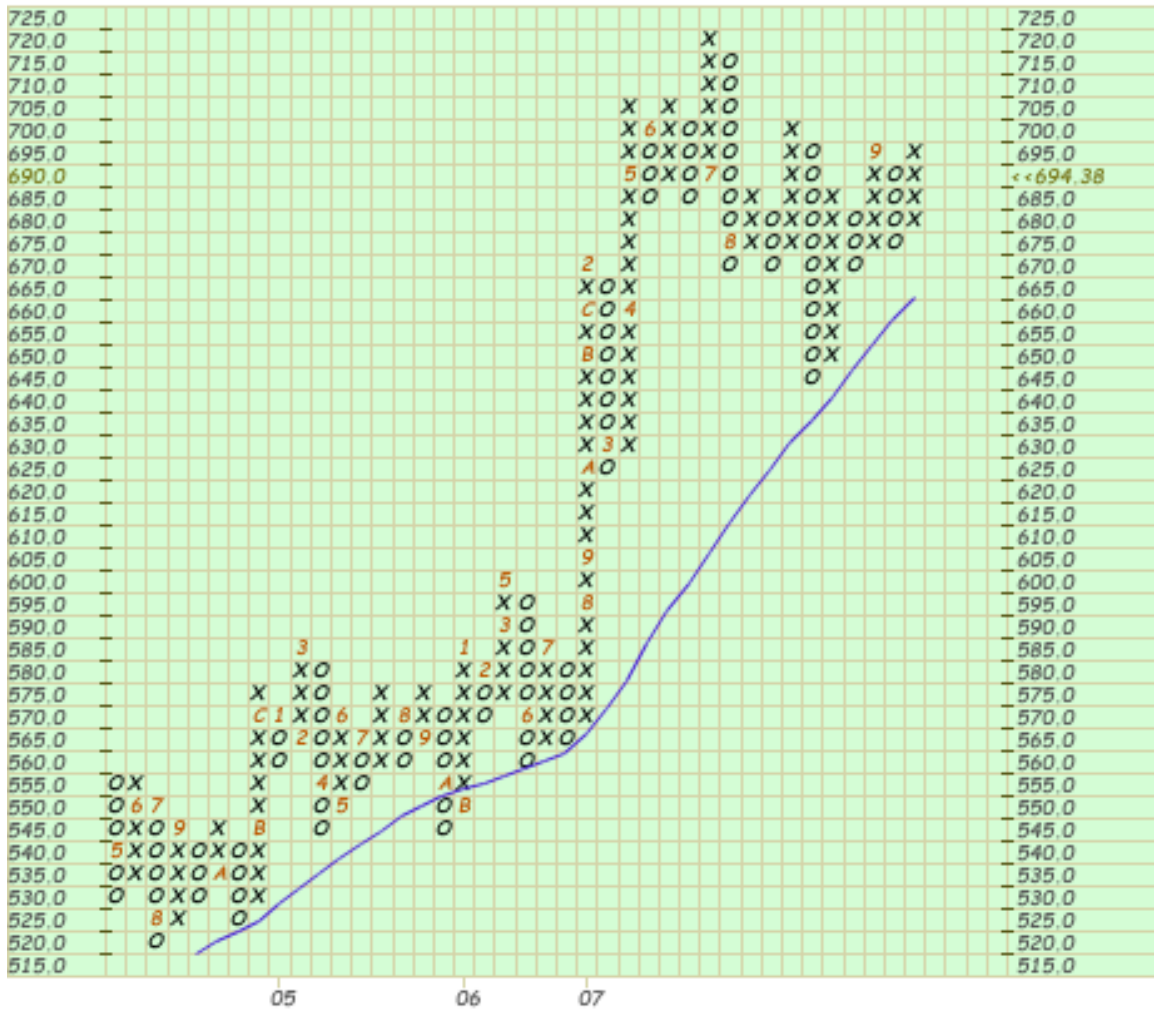
14-Sep, 16:00 ET, daily, H: 695.34, L: 689.88, C: 694.38, Chg: -0.62

No New P&F Pattern

Traditional, 3 box reversal chart

Bullish Price Obj. (Rev.): 750.0

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Much of Wyckoff’s methodology calculates around mathematics, historical averages, past behavior, and volume. Where Wyckoff stood out as a trader was that he saw the market as a “composite man” – a mixture of complex multi-parts of unlimited resources and knowledge – an all knowing force that buys the lows and sells the highs - and created a map to follow in those footsteps – and gave typical traders a way to follow the smart money.

By composite man Wyckoff taught the market was led by facts and historical patterns ONLY after the influence of the mass psychology of the “composite man” (the total of all investors) and the emotional reactions to trading.

With a vertical bar chart we watch VOLUME, which defines the intensity and interest in trading. Volume helps define when to buy and sell. Volume is defined by “news,” open interest (the composite man) and market NEED.

With a point and figure chart we are watching accumulation/distribution around supply and demand, the cause and effect, which helps the trader know the best opportunities for WHEN to buy, and how far the movement UP or DOWN will be.

When a Wyckoff trader creates their own “index” chart of applicable stocks within a sector we are watching for how the market reacts to the sector, and the hesitancy or renewal points the market finds during a trend. Does the market literally “listen” to the trend is what a Wyckoff trader watches for.

The simplicity of Wyckoff is to use historical patterns for what they are, and to find leading indicators of where supply/demand will begin to AFFECT the stock itself.

Understanding Trendlines with Wyckoff:

All we want with a trendline is our own visual confirmation of what the bar and point and figure charts should be showing us.

When a stock is being bought (accumulation) this is the force of demand leading the price. This demand creates higher stock prices until the growing force of supply begins to cancel the demand and the price lowers. This is a self repeating behavior that often results in a form of flat lining, as the equilibrium between supply and demand finally averages.

Trendlines help us understand the price movement, and when topping or bottoming occurs.

Wyckoff traders use support/resistance to watch for the “tops” and “bottoms”, conjunctively analyzing point and figure charts with trendlines. Since Wyckoff’s days it’s also very helpful to use Bollinger Bands to analyze where prior tops and bottoms have occurred.

Creating a Position Sheet:

In 1916 Wyckoff created a very simple study that tracked a number of individual stocks. Much of Wyckoff is deductive in logic, analyzing prior trends.

Position sheets add to this inductive reasoning with a position sheet, as they define with the group of stocks whether there are any of the five (5) basic moves of the market:

1. The stock moves up 10 to 15%
2. The stock moves up 10 to 15% and is noticed...in other words, volume shows that demand is building
3. The stock begins to drop 10 to 15%, without substantial volume
4. The stocks begins to drop 10 to 15%, with more volume, where supply is building

5. The stock itself is neutral

A good position sheet makes specific note of each of the stocks that the Wyckoff trader is becoming an expert in. Some Wyckoff traders will study and position sheet up to 100 stocks, others as few as 20. My Dad used the position sheet to become an expert in no more than 20 stocks, and these 20 stocks became what he “breathed”. He knew the company so well that watching a chart was almost second nature, as the moves became obvious to him.

It’s with a position sheet that today’s traders can become such experts and play puts and calls, or buy/sell the stock itself around the trendlines, the supply and demand, and their understanding of the five (5) core moves of the market.

Understanding Manipulated Markets

Wyckoff believed that markets are always manipulated by what he called “large operators”, and we would now call the hedge funds or institutional investors. These investors accumulate a position at the lowest possible price. When a stock is being accumulated, or an index is holding, we begin to see a long consolidation period where the stock/index builds with much sideways movement, on consistently low volume. This is while the institutional investors are daily building “quiet inventory” to a position.

When this type of investor has accumulated enough they begin “marking up” the position and putting it out on the market, trying to slowly raise the DEMAND, showing just enough interest in the market to get the average investor thinking the stock will rise more.

Volume rises during this period.

Next comes the actual distribution. The “operator” is now trading out partials of their large position, trying to show the stock has strength, and to catch the attention of the investing public.

The stock tends to “congest” here, prices settle, and the average investor is “tricked” into thinking the stock is ready to take off again. Actually, Wyckoff’s “operator” is beginning to sell off the stock, or “marking it down”. As the stock starts to fall this “operator” now shorts the position, expecting the actions calculated earlier to cause the stock to decline.

This is manipulated supply and demand and happens every day...in 1910, and in 2007. It’s quite amazing that the same stock market that “breathes” has cause and effect in place all the time, as does money as a commodity.

It’s understanding this that maximizes profits and limits losses.

Effective Stop Loss/Paper Trading

Back in the 1920’s when Wyckoff traded stop loss methodologies weren’t yet considered, yet he worked with 3:1 ratios, and believed stop loss should be in place at all times.

My Dad taught me stop loss, and that paper trading was as important all the time as real trading. To hone skills one should paper trade for months before actual trading, and should paper trade at different times in their trading career just to more effectively watch the emotions, without having to lose money to them.

Part of learning to trade is learning when to lose, when to let profits run, and when to stop yourself. Part of creating position sheets is to learn certain stocks well, and thusly LIMIT emotions.

Any use of money is speculation. Every day we pay prices for things, and sell our services for money. We invest our money to save it, and have it grow. If we sell anything we hope to sell it to make money, or at least lose little to no money.

**Money is speculation. Know that you do this,
and that trading is speculation.**

Price and Volume = Supply and Demand

All the market is today is what it was before. We cannot create a market now without a history.

Support is the lowest price set in the recent past, and resistance the highest.

Hesitancy occurs near support and resistance lines. Calculations of support and resistance lines off prior day history, or in a longer term point and figure chart show the trader where the hesitancy has occurred before.

Higher highs and lower lows, or new tops and bottoms, are created everyday in the world with any currency, just as the market itself is a currency.

Wyckoff saw the period where prices hit dead center, or stabilized as what he called the “hinge” “on the springboard” and where breakout will occur.

In years to come William O’Neill will make famous the “cup and handle,” and the entire concept of finding breakout stocks.

Wyckoff worked price/volume and supply and demand around his always suspicious mind of the real cause and effect of the market.

Learning What to Think

“ A stock market operator must be as hard boiled as a five minute egg; cold-blooded as a fish; deaf to all gossip; blind to the news; and dumb as a doorknob when it comes to discussing the market with others” .-Richard D. Wyckoff

Simply, follow charts, methods and rules, and take the emotions out of trading. This is what Wyckoff taught. He believed once you used these very simple principles to enforcing your investing that the trader should limit his knowledge, and simply not try other methods, systems, or approaches. Wyckoff called this “clutter”; at OEX and Blue Chip Options we call this “noise”.

Most certainly the noise has gotten much larger, there is far more clutter than in Wyckoff’s time, so the trader must be even more vigilant to believe NO facts, not interested in what the analysts

think, unless what they think influences the stock price, and to use news only as the tool to trade, recognizing supply and demand are always the cause, and the effect.

The Rules of the Market:

When demand for a stock exceeds supply, prices rise. When supply is greater than demand, prices decline.

Use your investing capital by selecting stocks or indexes that will move soonest, fastest and farthest, and trade the edges of these moves.

That's Wyckoff in a simple nutshell.

Set stop loss.

Hold partials of your position as it sells up, sell partials, and hold partials. Take profits, and hold for profits.

Wyckoff was a bond trader first. He saw first-hand on the stock market floor how much volume could affect price. It's important to realize that Wyckoff was the first writer on the market, the first real technical analysis of its kind, and his "newsletters," precursors to services like OEX or Blue Chip Options or the myriad of other publications and web based information now available.

What is interesting with this is that the Wyckoff principles remain as important and core today as they did in the early 1900's.

TERMINOLOGY

Accumulation

This is an addition to your original market purchase. It is also the first phase of a major trend in which investors are buying.

Bar Charts

Vertical charts of price movement (OHLC) and their corresponding volume. Bar Charts are followed by traders to understand supply and demand.

Composite Man

Wyckoff's name to the total sum of more informed forces that move the market.

Count

A method for finding the volume junctures on a bar chart and completing an arithmetic count of the number of boxes times the size of the boxes. This is multiplied to define the count.

Demand

Buying power.

Distribution

An area where informed forces sell stocks or futures with the intention to mark-down prices. At the same time less informed forces tend to buy in that area.

Mark Down

The phase of the market where prices decline, from the beginning of a bear market to its bottom.

Mark Up

This is the phase of the market where prices rise, from the beginning of a bull market to its top.

News

Wyckoff said: “Unless you completely discard all news, reports, tips, corporate statements, crop situations and other types of news – you will be unable to get the best results from your market operation.”

Point and Figure Charts

A price only chart that plots up prices as Xs and down prices as Os. The minimum price recorded is called the box size. Typically, a three box reversal indicates a change in the direction of prices.

Rally

A rally is a phase in the market that experiences a rise in price. That is, higher highs and higher lows.

Resistance

This is an area where supply overcomes demand. A price level at which rising prices have stopped rising and either moved sideways or reversed direction on a chart.

Selling Climax

A selling climax is a major panic that occurs at the end of a steep decline in prices. In its classical form, it is typified by large range reversal in prices accompanied by large volume.

Spring

Spring is a form of a test of a trading range to check the status of supply. A two-day pattern in which on the first date, the market declines below a support point, while the next day sees the market move strongly back up into the congestion area. The market's response to the spring indicates the nature of supply and demand forces for the near future.

Stop Loss

The risk management technique to exit a trade to halt any further decline in value is called a stop loss. According to Wyckoff, stop losses are best placed at points where previous market definitions fail to materialize.

Supply

Selling power.

Support

Support is an area where demand is overcoming supply. A historical price level at which falling prices have stopped falling and either moved sideways or reversed direction on a chart.

Trading Range

A period of balance between supply and demand forces is referred to as a trading range. Prices move within a range where the bottom represents demand and the top represents supply forces.

Trendlines

A line (trendline) can be drawn that connects either a series of highs or lows in a trend on a chart. The trendline can represent either support (uptrend line) or resistance (downtrend line). According to Wyckoff, the way a market reacts and responds to trendlines is a good indication of the status of supply and demand forces. It's not what the market does around a trendline, but how it does it that counts.

Volume

Volume is the number of units bought and sold, or the quantity of trading. According to Wyckoff, it is the force which moves the market. It is an essential component in any Wyckoff analysis.