

Bear raids

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Volume, support and resistance, and volatility combine in short-selling campaigns.

BY HENRY O. (HANK) PRUDEN, Ph.D.

Effective trading requires applying the appropriate strategy to a specific market condition. In bear markets, the concept of a “raid” is especially useful — and one that can be realized using the trade setups of

early technician Richard D. Wyckoff.

The raid concept has interesting parallels outside the world of trading. The destruction and theft of war-making capital by cavalry raiders was an important strategy during the U.S. Civil War. A

model for the bear-raider trader from that era is legendary Confederate Cavalry General Nathan Bedford Forrest — the only enemy leader who stirred fear in Union General Ulysses S. Grant, according to Archer Jones in his book *Civil War*

Command and Strategy. Forrest’s slashing, lightening-quick raids wreaked havoc upon Union Army supply depots, rail transport, and horse corrals. The following tenets, attitudes, and actions for the modern bear-raider trader are collected from the annals of military doctrine and Civil War history.

First, raids and raiders are successful when they avoid bull rallies and advances. Bear markets represent the destruction of capital; the raid’s essence is to rob the bulls with a quick strike. A raider’s strengths:

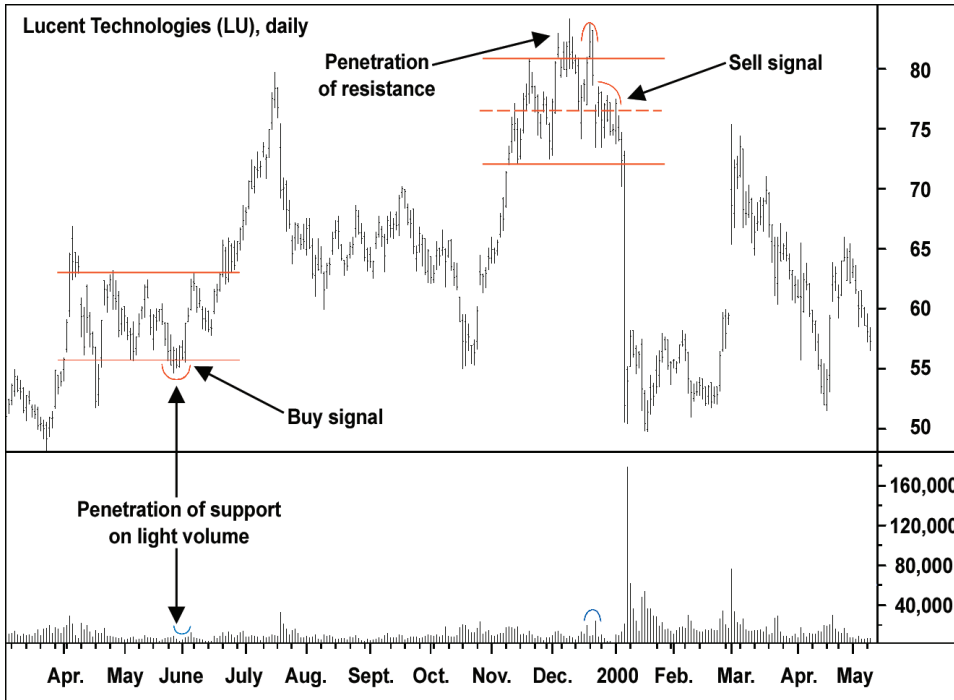
1. Elusive because of their transitory presence.
2. Superiority of retreat.
3. Unpredictability and surprise.
4. Concentration in time and space.

FIGURE 1: BEAR RAID



An example of a typical bear raid in Google (GOOG).
Source: info@publiccharts.com

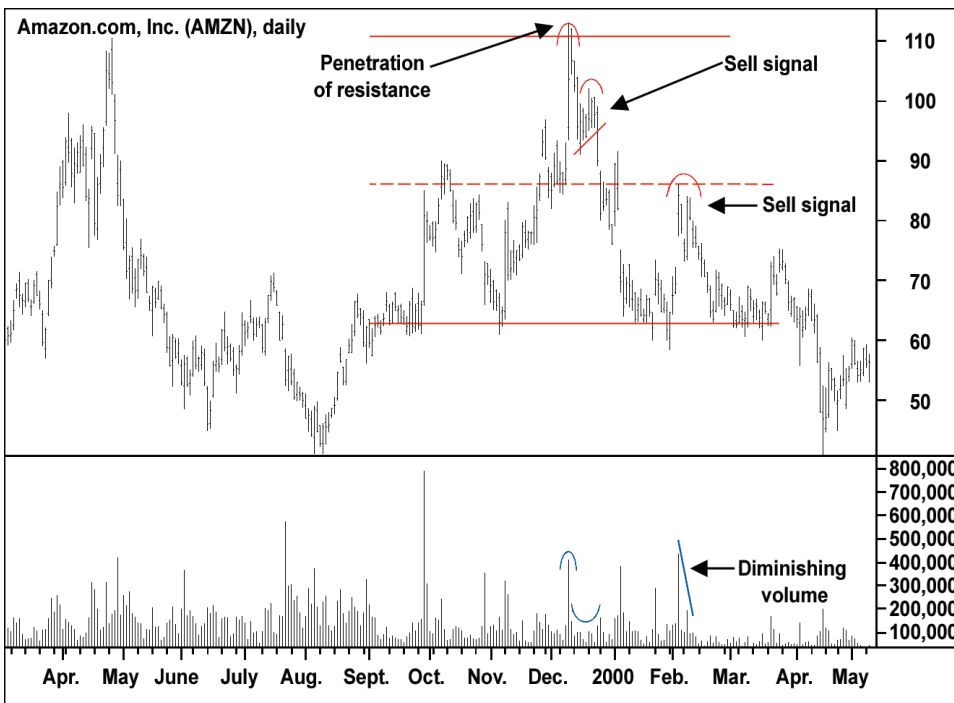
FIGURE 2: NO. 3 AND NO. 1 SPRINGS



When support is penetrated on light volume, a buying opportunity occurs. Likewise, a price drop through the middle of the trading range after penetration of resistance signals a sell.

Source: TradeStation

FIGURE 3: UPTHRUSTS



A penetration of resistance accompanied by a volume spike falls quickly; a subsequent test of resistance in February at the middle of the trading range confirms the downward bias.

Source: TradeStation

5. Pouncing on the weak, unguarded, and inadequately defended.
6. Continually hunting for vulnerable targets.

Traders can translate these historical military guidelines into principles for operating as a raider on the short side during market downswings.

Figure 1 shows an example of a typical bear raid in Google (GOOG). A bear raider might have sold GOOG short in January 2008 as the stock broke down out of a top formation, then covered in late March or early April 2008 as GOOG repeatedly failed to continue making downside progress (especially after the climactic volume day of Feb. 26, 2008). Those clues would have alerted bear-raider traders to exit their short positions in GOOG in the 415-440 price zone.

Ultimately the pullback toward the broken down trendline (on volume lighter than during the 410 to 460 rally) should have forced any remaining shorts out of their positions. Google was poised for a rally. Keep in mind the essential dictum of the raider: Be gone from your short position before the bulls rally the market.

The raid model has appeal

because bear markets are different than bull markets. As Thomas Stridsman wrote in “Bearing down on the short side” (*Active Trader*, July 2000), “Short selling isn’t just a matter of reversing the rules of your favorite long-side strategy. Uptrends and downtrends are two different animals, and you have to understand the nature of the bear before you can use strategies to trade it.” As Stridsman observed, “...it is well known that down moves or downtrends tend to be much shorter in duration than most up moves of similar magnitude.”

In his monumental work on market behavior, *The Behavior of Stock Prices*, Arthur Merrill observed that making reliable Elliott Wave counts during protracted bear markets was difficult because there were simply too many rallies.

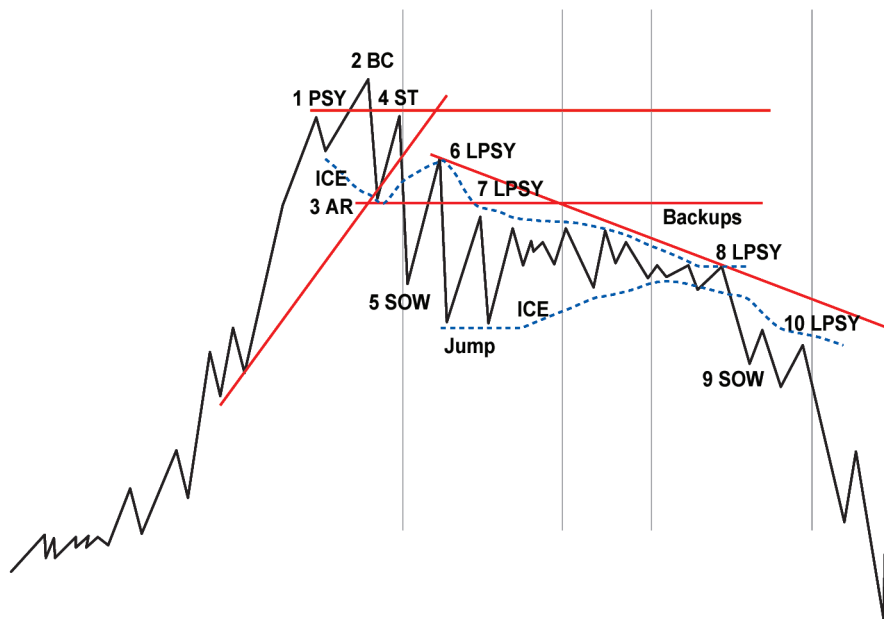
Given the understanding that in stocks bear markets are less frequent than bull markets and move more quickly than bull markets, let’s turn to the formulation and application of Wyckoff patterns and principles for bear raids.

Wyckoff patterns

The essential Wyckoff patterns and principles that set up bear-raid short-selling opportunities are: upthrusts, backups, and “tepee” tops. Figures 3, 4, and 5 show idealized models for each of the three patterns. These patterns and their accompanying principles are designed to arm the trader with tactics for entering the market when raider opportunities offer high rewards and low risks.

Upthrusts and backups were the subjects of “Trading the Wyckoff way:

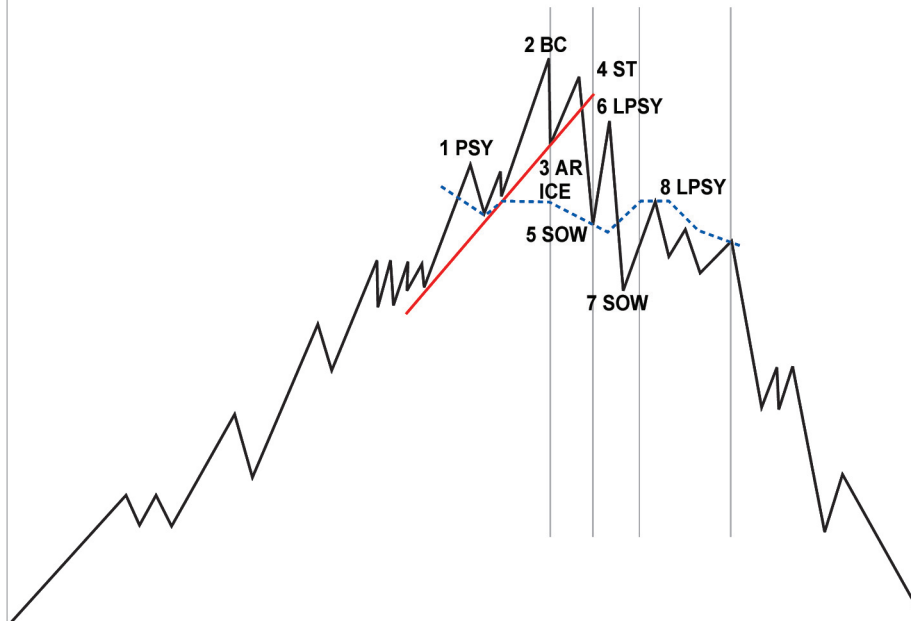
FIGURE 4: DISTRIBUTION STEPS: JUMPS AND BACKUPS



A jump is a relatively wider price-spread move made on comparatively higher volume that penetrates resistance or support. A backup is a test that immediately follows the jump — a relatively narrower price-spread reaction or rally on comparatively lighter volume that confirms the preceding jump.

Source: Choice Alternative Investments, Ltd.

FIGURE 5: DISTRIBUTION STEPS: TEPEE FORMATION



The tepee top represents the kind of spike top that often occurs at the peak of sharp bear-market rallies.

Source: Choice Alternative Investments, Ltd.

Wyckoff principles during a decline

1. Lower tops and lower bottoms as prices decline are normal during a downtrend. Be on the alert to exit when this pattern is threatened.
2. Corrective rallies: The normal expectation is for a 50-percent correction of the previous decline. When the shorted stock reaches an oversold condition or has a selling climax, determine whether or not it is worth riding out a bear market rally of one-half the previous decline.
3. To find reactions stronger than rallies is normal downtrend behavior. Comparing up to down price waves helps to inform the bear-raider trader about the quality of the decline. When reactions are weakening relative to rallies, be careful.
4. Narrowing spreads (price ranges) in a decline: This indicates buyers are willing to take a stock at current price levels and can be a signal the stock is vulnerable to a countertrend rally.
5. The Thrust Principle: When the net size of successive downside price waves becomes increasingly smaller, it means the bearish impulse that started the decline is dissipating. Be on the alert for a countertrend rally.
6. Expanding price spreads to the downside after a protracted decline: This often signals an oversold condition, making the stock vulnerable to a rally (especially when accompanied by a relatively high volume).
7. Unusually high volume compared to that registered during the prior decline — a strong sign of a selling climax.
8. Approaching prior support levels: Rallies frequently manifest themselves at these levels. Bear-raider trader beware!

The author wishes to thank Jerry Blythe, M.D., for organizing this list.

Buying springs and selling upthrusts” (*Active Trader*, August 2000) and “Wyckoff axioms: Jumps and backups” (*Active Trader*, January/February 2001).

A *spring* (Figure 2) is a price move below the support level of a trading range that quickly reverses and moves back into the range. A spring is an example of a “bear trap” because the drop below support appears to signal resumption of the downtrend. In reality, though, the drop marks the *end* of the downtrend, thus “trapping” the late sellers, or bears. The extent of supply, or the strength of the sellers, can be judged by the depth of the price move to new lows and the relative level of volume on that penetration.

An *upthrust* (Figure 3) is the opposite of a spring. It’s a price move above the resistance level of a trading range that quickly reverses itself and moves back into the trading range. An upthrust is a “bull trap” — it appears to signal a start of an uptrend but in reality marks the end of the up move. The magnitude of the upthrust can be determined by the extent of the price move to new highs and the relative level of volume on that movement.

A *jump* is a relatively wider price-spread move made on comparatively higher volume that penetrates resistance or support (Figure 4). A *backup* is a test that immediately follows the jump — a relatively narrower price-spread reaction or rally on comparatively lighter volume that tests and confirms the legitimacy of the preceding jump action.

The tepee top (Figure 5) is an innovation from J.C. Coppola III, a Wyckoff-oriented fund manager who manages a hedge fund operator called Choice

Alternative Investments, Ltd. in New York City and Singapore. Coppola, a chartered market technician (CMT), also authored extensive research in a Wyckoff and CANSLIM manuscript in 1994, a summary of which appeared in the *Market Technicians Association (MTA) Journal* in 1995. The tepee top concept reflects the spike-top that is often seen at the peak of sharp bear-market rallies. Figure 5 reveals that even given the spike-reversal conditions, there are clues that indicate a high-reward/low-risk setup is developing. The annotations in Figures 4 and 5 represent the following Wyckoff principles:

- Preliminary supply (PSY): the first major force of selling by the better-informed market players, who sense that the uptrend is nearing its end.
- Buying climax (BC): Sellers overcome buyers in size. This is the pivotal point where supply becomes more dominant than demand.
- Automatic reaction (AR): Buyers are nearing exhaustion. Price falls backward with ease.
- Secondary test (ST): A failing rally characterized by diminished price advances and lower volume than the preceding drive into the BC. This test of the preceding climactic action validates the BC as an authentic culmination of buying power and a control shift to the bears.

- Sign of weakness (SOW): A comparatively large downward price break, typically on expanded volume. The SOW means demand has become exhausted and the bears are on the cusp of starting the markdown phase of the cycle. (The SOW is the “jump” downward below prior support levels.) The secondary test of the SOW is typically a rally characterized by relatively smaller price ranges and lower volume; this rally leads up to the last point of supply.

- Last point of supply (LPSY): a rally or sidewise movement of weak price and volume is an ideal spot for taking a short position. An LPSY often occurs on a rally, when old support becomes new resistance and the diminishing strength of successive rallies creates a downward sloping price pattern. The trader can assume the smart money is lending temporary support to price along the lower “ICE” (price) level, and will continue giving support until the remaining demand is exhausted.

- ICE: A support line that becomes resistance once the bear market gets underway. The ICE line is created by connecting the low points in a trading range and it is most often a meandering line. A fall through the ICE is a sign of weakness.

“Wyckoff principles during a decline” lists Wyckoff principles that are useful for diagnosing price and volume behavior as a decline progresses during a bear market. Because it is vital for the bear raider to avoid being squeezed by the bulls, emphasis is placed on cautionary signs warning a market is becoming vulnerable to a rally.

There are three Wyckoff exit approaches for the bear-raider trader:

1. A downside price objective is reached on a selling climax (climactic volume action in addition to price action).

2. An oversold condition and a deterioration in the quality of the downtrend action.

3. The election of a trailing stop-loss order.

Let’s now turn to additional examples of bear raids.

Bear raid campaign in GM

Figure 6’s General Motors (GM) chart reveals three successive bear-raiding opportunities featuring vertical price plunges over several weeks. The first opportunity took place from November 2007 to January 2008 and the second was from February 2008 to March 2008. Separating these two bear plunges was a brief but powerful rally to remind the bear raider of the need to cover shorts before such rallies occur.

Raid 1: A downward jump took General Motors (GM) from 40 to 36. The subsequent backup rally occurred on narrower daily ranges and light vol-

ume compared to the downward jump. Such behavior indicated the bulls were exhausted. In early November 2007 a bear-raider trader could have shorted between 35 and 36 and placed a protective stop just above the prior rally peak at 40.

Cover 1: The first exit opportunity appeared about 10 weeks after entry as the stock made extreme lows on climactic volume between Jan. 10 and Jan. 22, 2008 (when price was between 21 and 24). Volume was expanding on rallies and a steep down trendline that could be drawn along the rally tops following “short #2” would be broken after the stock price had been cut in half, all of which suggested GM was vulnerable to a rally.

Raid 2: The peak of the bear market rally in GM that ended around \$29 in February 2008 offered an opportunity to use the tepee-top formation. A sharp downward break on increased volume brought the stock near \$25. The subsequent rally to \$27 sputtered out on diminishing volume. A short sale of GM could have been entered around \$26-27. A second short opportunity presented itself after the price breakdown below \$25. Stop-loss orders should have been placed just above the rally high at \$28.

Cover 2: After a four-week descent, the stock had fallen to \$18 by mid-March 2008. Not even one powerful countertrend rally interrupted the move.

The vertical drop (on high volume) to \$18 was a signal to cover shorts in GM. The next day’s up gap and close at the high of the day (around \$19) further sounded the alarm this bear raid had run its course.

Raid 3: GM provided another short-

FIGURE 6: RAIDING GM



Three shorting opportunities developed over the past several months in GM.
Source: info@publiccharts.com

selling setup in May 2008 around \$21. Again, the break below \$21 followed by the anemic rally on narrow ranges and diminishing volume as GM stalled at \$21 (old support, new resistance) was the short signal. A stop-loss order could have been placed above prior resistance at around \$24.

In contrast to the bull market dictum to “let your profits run,” the bear-raider trader must remember strength lies in elusiveness and the superiority of retreat — i.e., getting out of the market.

Strike swiftly and disappear

The trades in Google and GM illustrate the transitory nature of bear campaigns. Bear-raider traders must keep in mind that capital gains earned on short sides are taxed as ordinary income. Moreover, because bear markets involve the destruction of capital, bear-raider traders are not esteemed in the eyes of the general public. Hence, the bear-raider trader must remain hidden and elusive.

Stay with a bear campaign only so long as the honey pot is flowing freely, meaning during the “straight down” periods of the market. Much of the time the bear raider will be either out of the market and thus away from danger, or on the hunt for fresh, fat targets that are ripe to be raided. 📍

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Related reading

Books:

- Hank Pruden: *The Three Skills of Top Trading* (John Wiley & Sons, 2007)
- Arthur Merrill: *The Behavior of Prices on Wall Street* (published privately by the author, 1997)
- Edwin Lefevre: *Reminiscences of a Stock Operator* (John Wiley & Sons, 1994)

Henry O. (Hank) Pruden, Ph.D. articles:

- “**Trading the Wyckoff way: Buying springs and selling upthrusts**” *Active Trader*, August 2000.
- “**Wyckoff axioms: Jumps and backups**” *Active Trader*, January-February 2001.

Other articles:

- “**Bearing down on the short side,**” by Thomas Stridsman (*Active Trader*, July 2000).
- “**Trading System Lab: Wyckoff spring setup,**” *Active Trader*, July 2008. Historical back-test of a system is based on Richard Wyckoff’s spring setup, which consists of a test of a trading range.

“**Improving Returns while Controlling Risk: Integrating Wyckoff’s Tools with CANSLIM Stocks,**” by J.C. Coppola, III, CMT. (*MTA Journal*, winter 1994, spring 1995, pp. 53-71)

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