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Rounding Bottoms



RESULTS SNAPSHOT

Appearance	A long, rounded upward turn in prices
Reversal or consolidation	Long-term (over 6 months) consolidation
Failure rate	38%
Failure rate if waited for upside breakout	5%
Average rise	54%, with most likely rise being 20%
Percentage meeting predicted price target	36%
Synonyms	Rounding Turns, Saucers
See also	Bump-and-Run Reversal Bottom; Cup with Handle; Head-and-Shoulders Bottom, Complex; Scallops, Ascending and Descending

Rounding bottoms, rounding turns, and saucers are synonyms for the same formation. The pattern differs from the cup-with-handle and scallop formations in subtle ways, so be sure to study those formations if you are unsure about identification.

If you consider that this formation acts as a consolidation of the prevailing trend and anything acting contrary to that is a failure, then the failure rate for this pattern is very high at 38%. However, if you consider upside breakouts

only (a breakout being when prices move above the left saucer lip), then the failure rate drops to just 5%. I consider failure rates above 20% to be alarming. The chart pattern sports a 54% average gain with a likely rise of 20%. Almost a quarter of the formations have gains over 90% and that pulls the average upward. The large gain masks the performance of the most likely rise. With a deep cup formed over many months, it makes sense that the measure rule would have trouble predicting accurate price targets. Prices fulfill the measure rule just 36% of the time for successful formations with upside breakouts.

Tour

Figure 34.1 shows an example of a rounding bottom on a daily scale. I would not call it a good example because the bottom is too irregular. In mid-May there is an out-of-pattern downward price decline that ends with prices quickly rebounding. In late June prices jump up then fade back down. The June rise is not uncommon so do not get too excited when it happens in a stock you own. Prices should return to near the base of the rounding bottom before continuing to rise. The volume trend takes on the appearance of being rounded if you ignore the four annoying spikes in the center.

A rounding bottom marks a struggle between buying demand and selling pressure that is nearly equal. Through the first part of the formation, the

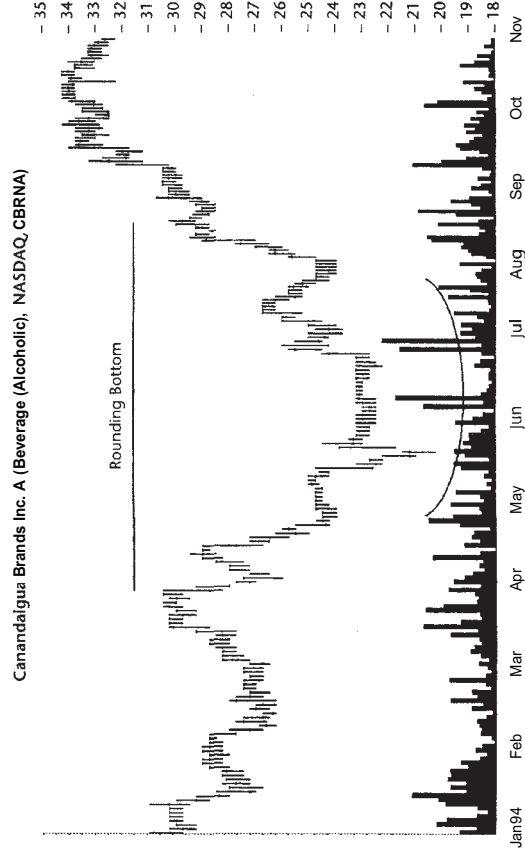


Figure 34.1 A rounding bottom on a daily scale. The bottom takes a brief dip in mid-May and a quick rise in late June.

sellers have the upper hand as they drive prices lower. Eventually, the forces come into balance and the stock bottoms out and moves horizontally. Later still, buying demand picks up and the stock inches upward. The climb is not always a smooth one. Sometimes, a large upward demand spike occurs sending the price skyrocketing, but in a month or so prices head back down and plane out slightly above where they left off. Then they resume their climb. When the stock reaches the old high, selling pressure usually drives prices lower, forming a handle. Prices recover and break through the old high and push higher still.

Identification Guidelines

As chart patterns go, rounding bottoms are easy to identify. Table 34.1 lists guidelines for their identification. Since rounding bottoms are often quite long (in this study, the longest is over 2½years), I usually use the weekly scale to make identification easy. I search for a price pattern that looks like a bowl or saucer. Once I discover the pattern, a quick glance backward finds prices trending upward for quite a while. The rounding bottom is usually a gentle retrace of some of the gains.

Consider Figure 34.2. The most recent up leg of the climb to the formation begins in late December 1991 on very high volume. Prices climb from a weekly low of about 4 to a high of 9½/16, a gain of 235% in about 3 months. Then the stock eases over. Prices move lower and retrace much of their gains. The decline is not a quick straight-down affair. Rather, the stock moves lower on its way to 4¾ by curving around and flattening out.

Once prices reach the low, they move hesitantly higher by traveling horizontally for several weeks before beginning an accelerated climb. Prices reach the level of the left saucer lip and do not pause. They keep climbing until they reach 13 and then 16 before backing down to 11.

Table 34.1
Identification Characteristics of Rounding Bottoms

Characteristic	Discussion
Weekly scale	I use the weekly scale to identify these behemoths, although you can use the daily scale if you wish.
Rounded bowl shape	The price trend curves gently usually over many months and usually after an upward price trend. Connect the weekly low prices to visually construct a saucer or bowl shape in your mind.
Curving volume trend	The volume trend sometimes mimics the price trend by appearing as a bowl.

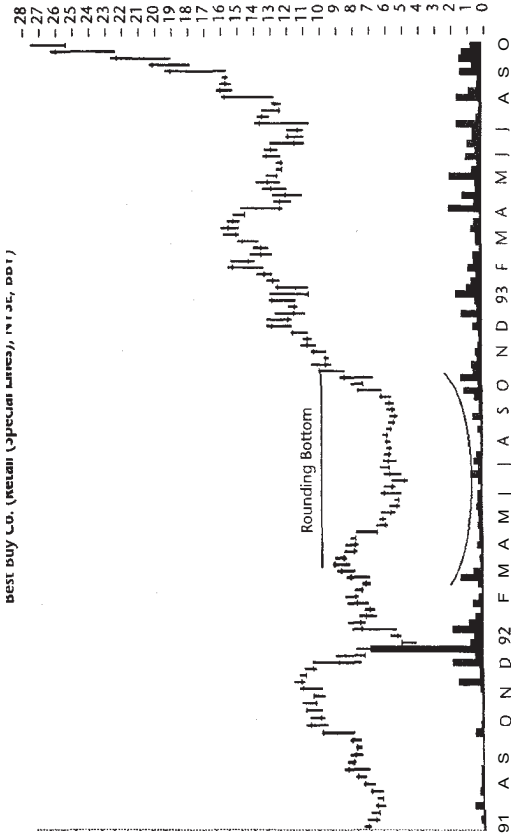


Figure 34.2 This is a good example of a rounding bottom on the weekly scale. Notice the bowl-shaped volume trend.

A rounding bottom does not require a handle, which is a price consolidation area that commonly forms immediately after the right saucer lip, but most times you will see one. After reaching the lip of the saucer, prices usually drop and consolidate before heading higher. A handle is typical behavior when prices reach an old high. The rise falters as tepid demand or excessive selling push prices lower; then, the two highs act as a resistance zone. Sometimes, prices make several attempts before pushing through the resistance and moving higher; sometimes, prices just give up and roll back downhill.

The volume trend usually echoes the price trend by rounding upward too. You can see this in Figure 34.2 although it is not as pronounced as it sometimes is.

Focus on Failures

To be fair, the preponderance of failures are probably due to semantics. When studying this formation, I discovered that most act as consolidations of the prevailing trend. After moving upward, prices round down, swing around, and head back up. I label those chart formations that do not fit this template as failures. Figure 34.3 shows an example of such a failure; it acts as a reversal of the primary trend. Prices trend down beginning on the left side of the chart to the base of the rounding bottom. Then, prices swing around and begin a new trend upward.

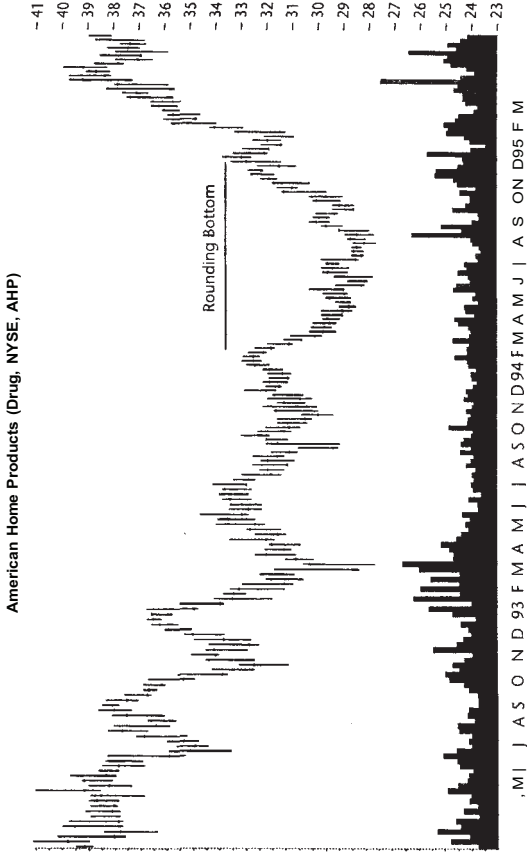


Figure 34.3 Rounding bottom that acts as a reversal of the trend.

The formation is a rounding bottom, but it does not act like a consolidation. If you had shorted this formation with the expectation that prices would continue down, you probably would have wound up with a loss. Thus, I consider this formation and others like it as failures.

Another type of failure, called a 5% failure, is when prices move in the intended direction after the formation completes but fail to travel more than 5% before turning around and heading substantially in the opposite direction. Only 11 of the formations with upside breakouts are 5% failures. This means once a formation breaks out upward, there is a good chance it will continue moving up.

Statistics

Table 34.2 shows general statistics related to rounding bottoms. I uncovered 243 formations in 2,500 years of daily price data. Of the formations I discovered, about 67% are consolidations of the prevailing trend and the rest are reversals.

The failure rate is exceedingly high at 38%. As explained in the Focus on Failures section, I label every formation that is not a consolidation of the trend a failure and include 5% failures too. If we consider only formations that break out upward, the failure rate drops to a more palatable 5%, which is very good.

Table 34.2
General Statistics for Rounding Bottoms

Description	Statistic
Number of formations in 500 stocks from 1991 to 1996	243
Reversal or consolidation	163 consolidations, 80 reversals
Failure rate	93 or 38%
Failure rate if waited for upside breakouts	11 or 5%
Average rise of successful formations	54%
Most likely rise	20%
Of those succeeding, number meeting or exceeding price target (measure rule)	50 or 36%
Average formation length	8.5 months (259 days)

Obviously, the statistic suggests a trading tactic: Wait for prices to climb above the right saucer lip before buying the stock (watch out for handles too; buy after the handle forms and prices move up).

The average rise of successful formations is 54% compared with a usual gain of 40% in other bullish chart patterns. However, the most likely rise is 20%. Figure 34.4 shows a frequency distribution of gains for successful round-

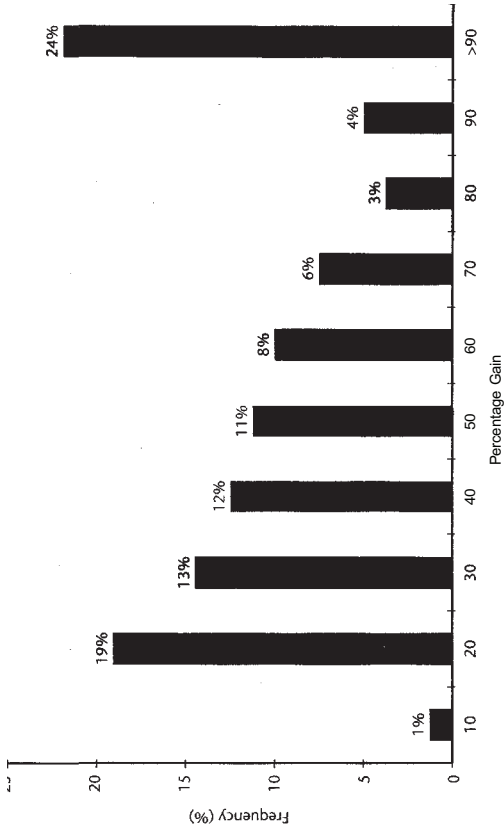


Figure 34.4 Frequency distribution of gains for rounding bottoms. Almost a quarter of the rounding bottoms have gains over 90%.

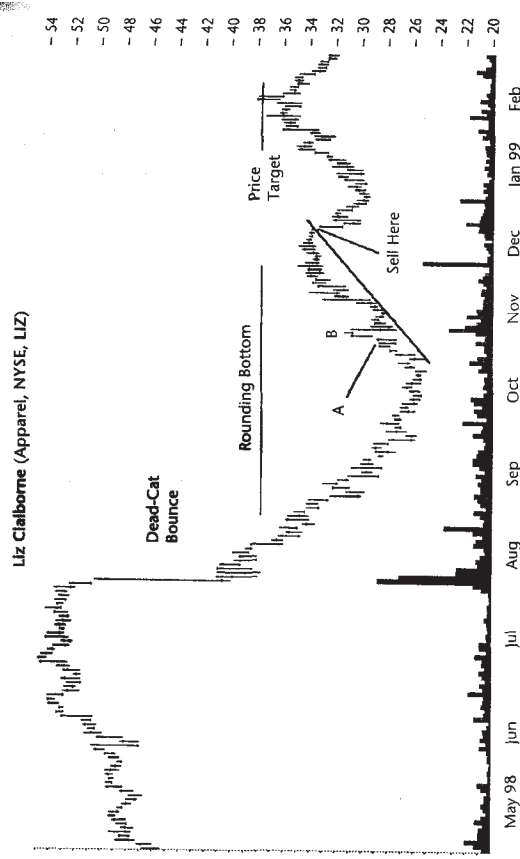


Figure 34.5 A treacherous example of a rounding bottom that has no left saucer lip. The rounding turn forms after disappointing earnings send the stock into a dead-cat-bounce.

climb above the handle high (or right cup lip). When it did (point A), or so I thought, I paper traded the stock and bought in, just as it crested (point B). That turned out to be a minor high. Prices dropped the next day then slowly recovered making another handle. A good place to sell is when prices pierce the up trendline in early December.

Sample Trade

How do you use the trading tactics to improve your investment performance? Consider what Glen did with the situation shown in Figure 34.6. It was his dream to become a day trader but he had neither the trading capital nor the necessary skills for the job. He decided to get there one trade at a time.

In December, as he was flipping through his charts, he came across what appeared to be a mild double bottom. On the daily chart the two bottoms in August and November were barely discernible. Was it a valid formation and should he buy the stock now? Glen decided that the retrace between the two bottoms was not high enough and the two bottoms not clear enough to be worth considering. He justified his action by thinking that if he was having a hard time spotting the formation, then others would have the same trouble. If no one spots the formation, then prices will not rise.

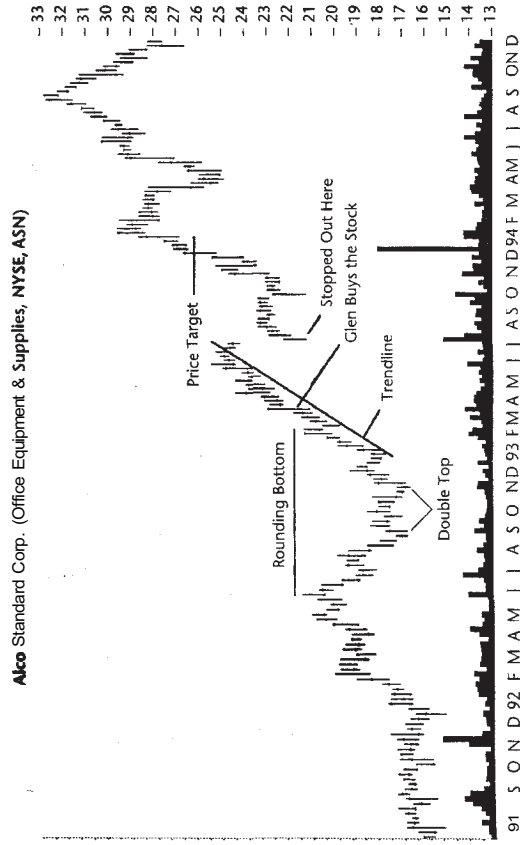


Figure 34.6 The double bottom formation is barely discernible within the rounding bottom on the weekly scale.

When he flipped to the weekly chart, it changed the characterization of what he was seeing. On his screen was an obvious rounding bottom. The volume pattern supported the conclusion: receding as prices declined and rounding up as prices rose. So, he decided to wait for the rounding bottom to stop near the prior saucer lip at about $2\frac{1}{8}$. When it paused for 2 weeks in February, he knew the formation was primed. The question then became, what was it going to do next? The only way to find that out was to wait.

The following week prices dropped. He waited until prices closed above the right saucer lip and headed higher. He knew that to buy earlier risked a downturn in the stock from which it might not recover for a long time. If the stock ventured above the right saucer lip, then the probabilities suggested a continuing push higher.

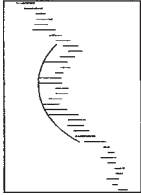
When prices hit 22, he bought. He looked back at his chart and decided to put a stop-loss order $\frac{1}{8}$ below the saucer lip, just below a support level. He decided that if the stock hit his stop, in all likelihood it was going down. Content with his investment decision and trading plan, he was confident that his career change to day trading was a simple step away. He was even more confident as the stock climbed. He began looking through brochures from several companies that offered seminars on day trading. Then the stock declined and closed below the up trendline. It was a warning sign that anyone could have missed. Glen certainly did.

The following week when he received a call from his broker saying prices had hit his stop-loss order, he was shocked. Glen booked a loss of about a buck a share. As he watched the stock, he became even more upset. It turns out the stock sold at the low for the week.

Three years later, after day trading was over for the day, Glen happened to review this trade. He decided to pull up the chart and gasped at what he found. The stock peaked at 66, exactly triple his purchase price.

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Rounding Tops



RESULTS SNAPSHOT

Appearance	As prices move up, they curve around then breakout upward.
Reversal or consolidation	Long-term (over 6 months) bullish consolidation
Failure rate	19%
Failure rate if waited for upside breakout	6%
Average rise	41 %, with most likely rise between 20% and 40%
Percentage meeting predicted price target	69%
Surprising finding	Most of the time prices rise after a rounding top completes.
Synonyms	Domes, Rounding Turn
See also	Bump-and-Run Reversal, Top ; Head-and-Shoulders Tops, Complex

When is a top not a top? When it is a rounding top or dome and prices breakout upward. That is the real surprise with this formation as most of the rounding tops have upside breakouts. The failure rate is 19%, a sliver below the maximum rate of 20% that I consider reliable formations to possess. If you wait for an upside breakout, then the failure rate drops to 6%. At first, I set the break-