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Dow Theory

Charles Dow was one of the founders of Dow Jones & Company and the first editor of the Wall Street Journal. In 1884 they issued their first stock market average which in time became known as the Dow Jones averages. Dow was a member of the New York Stock Exchange and a partner of the brokerage firm Goodbody, Glyn & Dow.

Jesse Livermore, one of the most colorful stock operators of his time, started his career as a quotation-board boy in a stock brokerage office. He tells us in his autobiography, Reminiscences of a Stock Operator: "I noticed in advances as well as declines, stock prices were apt to show certain habits, so to speak. There was no end of parallel cases and these made precedents to guide me. I was only fourteen, but after I had taken hundreds of observations in my mind I found myself testing their accuracy, comparing the behavior of stocks to-day with other days. It was not long before I was anticipating movements in price. My only guide, as I say, was their past performance. I carried the 'dope sheets' in my mind. I looked for stock prices to run on form. I had 'clocked' them. You know what I mean." Unfortunately for us, Jesse never said what his secret method was.

Charles Dow, on the other hand, being more journalist and less speculator, did disclose what he observed in over fifteen years of studying the stock market averages. His musing became known as the Dow Theory. William Peter Hamilton, editor of the Wall Street Journal from 1908 to 1929 wrote many editorials based on the Dow Theory and Robert Rhea, while bed ridden (1932), made a very readable recompilation of the theory (and of Hamilton's editorials), in his book: The Dow Theory

The Dow Theory is quite simple, it is based on two market averages that must confirm each other for their signals to have forecasting abilities. These averages are the DJ Industrial Average and the DJ Railroad Average (now known as the DJ Transportation Average). In chapter XII, Rhea explains why it is these two averages and not any other that have the forecasting powers. The Dow Theory pays attention to two primary trends, bull and bear, as well as to two shorter secondary counter trends. Daily price movements by themselves are ignored.

When there in neither a bull or a bear trend then a "line" might manifest itself, a line being a time when the price of the average is confined within a few points. Even though Hamilton said the volume is not an indicator, his and Rhea's writing seem to indicate that they did pay attention to volume which also behaved in characteristic ways.

Rhea warns that the prediction of stock market price movements is not a science but an art and that most people never manage to apply the Dow Theory correctly when they make their predictions.

Chapters 18 and 19 are specially interesting because they deal the morals of speculation and the philosophy of investing, timeless subjects both.

Michael D. Sheimo is a modern student of the Dow Theory. I found his book: Cashing In on the Dow, poorly written and a waste of time, he adds nothing to Rhea's well written exposition. Sheimo does cover many of the modern mathematical forecasting tools like Bollinger Bands, moving averages, relative strength index, and many, many more. If that is your interest, then this is probably a book for you.

I'm sticking with Long Term Buy and Hold but an understanding of the Dow Theory is useful for all investors, specially at the time you want to buy or sell shares.

Denny
"Demand creates queues. Supply gets rid of them."