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Course Teacher: Dr. M.RAJA

Email ID: drmraja@ bdu.ac.in

Scheme of Presentation
UNIT-II

- **Dow Theory**
- **Significance of Dow Theory**
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- **Elliot wave theory**
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- **key components and principles of Elliott Wave Theory**
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Dow Theory

Significance of Dow Theory:

Dow Theory is a foundational principle in technical analysis that offers insights into market trends and trading signals.

Developed by Charles Dow, the founder of the Wall Street Journal, it consists of several key principles that are still relevant today:

Market Trends:

Dow Theory asserts that markets move in primary trends - namely, uptrends, downtrends, and sideways trends (ranges).

These trends are identified based on the sequence of higher highs and higher lows (uptrend) or lower highs and lower lows (downtrend).

Dow Theory

1. **Confirmation**: To confirm a trend change, Dow Theory suggests that both the Dow Jones Industrial Average (DJIA) and the Dow Jones Transportation Average (DJTA) should move in the same direction. If one index reaches a new high or low but the other does not follow suit, it may signal a weakening trend.
2. **Volume Confirmation**: Changes in price trends should ideally be accompanied by changes in trading volume. An increase in volume can confirm the strength of a trend, while decreasing volume may indicate weakness.
3. **Reversal and Continuation Patterns**: Dow Theory also identifies patterns that indicate potential reversals (such as double tops or bottoms) or continuation of trends (like flags and pennants).

3. Implications for Investors:

- Investors and traders use Dow Theory to make informed decisions about market entry and exit points, as well as to manage risk.
- By understanding the prevailing trend and its potential reversals, they can adjust their investment strategies accordingly.
- Overall, Dow Theory remains relevant because it provides a framework for understanding market dynamics and offers guidelines for interpreting price movements and trends.
- While it is a fundamental concept in technical analysis, its principles can also be complemented by other indicators and tools to enhance trading strategies and investment decisions.

Problem with Dow Theory:

While Dow Theory has been influential in shaping technical analysis and understanding market trends, it's important to recognize some potential limitations and criticisms:

1. Subjectivity in Trend Identification: Identifying trends based on Dow Theory involves subjective judgment. Different analysts may interpret the same price movements differently, leading to potential discrepancies in trend identification.

2. Lagging Indicators: Dow Theory relies on historical price data and patterns to identify trends and confirmations. As a result, the signals provided by Dow Theory can sometimes lag behind real-time market movements, potentially causing delayed reactions.

3. Limited Scope: Dow Theory primarily focuses on two indices (DJIA and DJTA) and may not fully capture the complexity and diversity of modern financial markets, which include various sectors, asset classes, and global markets.

4.**Lack of Quantitative Rigor**: Dow Theory's principles are qualitative rather than quantitative. While it provides guidelines for interpreting market behavior, it doesn't provide precise mathematical models or statistical measures to validate its hypotheses.

5. Market Evolution: Financial markets have evolved significantly since Charles Dow's time, with increased globalization, algorithmic trading, and complex financial instruments. Dow Theory, developed over a century ago, may not fully address these modern market dynamics.

6. Over-Reliance: Over-reliance on Dow Theory alone for investment decisions can lead to missed opportunities or incorrect assessments, especially in fast-moving or volatile markets where other factors (such as geopolitical events or macroeconomic data) play crucial roles.

In summary, while Dow Theory laid the groundwork for technical analysis and remains a useful framework for understanding market trends.

It's essential for investors and analysts to consider its limitations and complement its principles with other analytical tools and methodologies for more robust decision-making.

Elliot wave theory

- Elliott Wave Theory is a complex and widely studied concept in technical analysis, developed by Ralph Nelson Elliott in the 1930s.
- It proposes that market prices unfold in repetitive patterns, or waves, which reflect the collective psychology of investors.
- Elliott Wave Theory is a concept in technical analysis that attempts to explain market trends and forecast future price movements by identifying repetitive wave patterns in financial markets.
- Developed by Ralph Nelson Elliott in the 1930s, this theory is based on the premise that market prices unfold in specific and predictable patterns due to investor psychology and collective human behavior.

Elliot wave theory

Here are the key components and principles of Elliott Wave Theory:

Wave Patterns: According to Elliott, market price movements can be classified into two main types of waves:

- **Impulse Waves**: These are directional waves that move with the overall trend of the market. Impulse waves consist of five sub-waves labeled 1, 2, 3, 4, and 5. Waves 1, 3, and 5 move in the direction of the trend (either up or down), while waves 2 and 4 are corrective waves that move against the trend.
- **Corrective Waves**: These are counter-trend waves that correct the preceding impulse waves. Corrective waves consist of three sub-waves labeled A, B, and C. There are various types of corrective patterns, such as zigzags, flats, triangles, and combinations.

Elliot wave theory

Wave Degrees: Elliott Wave Theory categorizes waves into different degrees based on their size and duration.

These include Grand Super cycle, Super cycle, Cycle, Primary, Intermediate, Minor, Minute, and Minuette degrees, which span from centuries down to minutes.

Wave Rules and Guidelines: Elliott Wave Theory provides several guidelines and rules that waves typically follow.

These rules help analysts identify valid wave counts and patterns. Examples of rules include the requirement that Wave 2 cannot retrace more than 100% of Wave 1 and that Wave 4 cannot overlap with the price territory of Wave 1.

Elliot wave theory

Fibonacci Relationships: Elliott observed that the lengths of waves often conform to Fibonacci ratios, such as 0.618, 1.618, and others.

These ratios are believed to reflect natural proportions found in many aspects of nature and can help identify potential reversal or continuation points in the market.

Psychological Basis: Central to Elliott Wave Theory is the idea that market movements are driven by shifts in investor psychology and sentiment.

For instance, strong upward movements (impulse waves) are fuelled by optimism and greed, while corrective waves occur as sentiment shifts and fear or profit-taking prevails

Elliot wave theory

Application and Criticism: Elliott Wave Theory is used by traders and analysts to forecast future market movements and identify potential trading opportunities.

However, it is also criticized for its subjective nature and the difficulty in applying it consistently across different market conditions.

In conclusion, Elliott Wave Theory provides a structured framework for understanding market cycles and trends based on repetitive wave patterns.

While it has both supporters and critics, it remains a significant tool in the arsenal of technical analysts seeking to decipher the complexities of financial markets.

Elliot wave theory

Fundamental Concepts of Elliott Wave Theory:

Wave Principle: At its core, Elliott Wave Theory posits that market prices move in a series of waves, both up (impulse waves) and down (corrective waves), which collectively form larger patterns.

These waves are fractal in nature, meaning they occur at multiple degrees of trend simultaneously.

Wave Structure: The theory identifies two main types of waves:

- **Impulse Waves**: These are five-wave patterns that move in the direction of the larger trend (either up or down).
- **Corrective Waves**: These are three-wave patterns that move against the larger trend, representing temporary counter-trend movements.

Elliot wave theory

Wave Degrees: Elliott Wave Theory categorizes waves into different degrees based on their size and duration:

- **Grand Super cycle**: largest degree, spanning centuries.
- **Super cycle**: large degree, spanning decades.
- **Cycle**: Intermediate degree, spanning months to a few years.
- **Primary**: Medium degree, spanning several weeks to a few months.
- **Intermediate**: Smaller degree, spanning several weeks.
- **Minor**: Very small degree, spanning a few days to a couple of weeks.
- **Minute**: Very small degree, spanning a few hours to a couple of days.
- **Minuette**: Smallest degree, spanning a few minutes to hours.

Elliot wave theory

Wave Rules and Guidelines: Elliott Wave Theory provides guidelines and rules that waves typically follow, such as:

- Wave 2 cannot retrace more than 100% of Wave 1.
- Wave 3 cannot be the shortest wave among Waves 1, 3, and 5.
- Wave 4 cannot overlap with the price territory of Wave 1.
- Wave 5 often shows divergence with an oscillator like the RSI or MACD.

Psychological Basis: The theory is grounded in the idea that market movements reflect changes in investor psychology and sentiment

. For instance, strong upward movements (impulse waves) are driven by optimism and bullish sentiment, while corrective waves occur as sentiment shifts and profit-taking ensues.

Elliot wave theory

In essence, Elliott Wave Theory seeks to provide a framework for understanding market cycles and trends by analyzing repetitive wave patterns.

It is used by traders and analysts to anticipate potential price movements and identify opportunities for trading or investment based on the principle that market behavior is not purely random but follows recognizable patterns over time.

However, it is important to note that Elliott Wave analysis requires subjective interpretation and is often criticized for its complexity and the potential for different analysts to derive conflicting wave counts from the same data.

After Elliot Wave theory market Efficiency

Elliott Wave Theory's application to market efficiency is an interesting topic, as it intersects with the broader debate on the efficiency of financial markets.

Here’s how Elliott Wave Theory relates to market efficiency:

Efficient Market Hypothesis (EMH) Context: The Efficient Market Hypothesis suggests that financial markets reflect all available information, meaning that prices instantaneously adjust to new information, making it impossible to consistently beat the market on a risk-adjusted basis.

This theory implies that any predictable patterns in asset prices, such as those suggested by Elliott Wave Theory, should be fleeting or non-existent in efficient markets.

After Elliot Wave theory market Efficiency

Elliott Wave Theory Perspective: In contrast to the EMH, Elliott Wave Theory posits that market prices move in recognizable and repetitive patterns driven by investor psychology.

According to Elliott, these patterns can be classified into specific wave formations (impulse waves and corrective waves) that unfold in sequences, reflecting the underlying sentiment and behavior of market participants.

Challenges to Market Efficiency: Proponents of Elliott Wave Theory argue that if markets were truly efficient, price movements would be purely random and unpredictable.

However, Elliott Wave proponents believe they can identify repeating patterns that suggest future price movements.

This challenges the strong form of the EMH, which asserts that even past price patterns (like Elliott Waves) cannot be used to predict future prices consistently.

After Elliot Wave theory market Efficiency

Criticism and Empirical Evidence: Critics of Elliott Wave Theory argue that its subjective nature and the ability to interpret wave patterns differently among analysts undermine its reliability as a predictive tool.

Empirical studies testing the effectiveness of Elliott Wave Theory in predicting market movements have yielded mixed results, with many studies concluding that the theory's predictions do not consistently outperform random chance or simple market benchmarks.

After Elliot Wave theory market Efficiency

Behavioral Finance Insights: From a behavioral finance perspective, Elliott Wave Theory aligns with the idea that investor sentiment and herd behavior can drive market movements, even in ways that temporarily depart from fundamental values.

This suggests that while markets may not always be fully efficient in the strong form, they are influenced by both rational and irrational factors.

In summary, Elliott Wave Theory provides a framework for understanding market cycles and trends based on repetitive wave patterns, challenging the notion of market efficiency in its strong form.

While it remains a popular tool among technical analysts, its application to market efficiency underscores ongoing debates about the predictability of asset prices and the role of investor behavior in shaping market dynamics.