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Security Analysis & Portfolio Management

Miscellaneous - 2

Q: Explain in detail the Dow Theory. *(www.prepnext.com)*

Ans:
The Dow Theory was originally proposed by Charles Dow in 1900. According to Charles Dow, "The market is always considered as having three movements, all going at the same time. The first is the narrow movement from day-to-day. The second is the short swing, running from two weeks to a month or more; and the third is the main movement, covering at least four years in its duration".

The Dow Theory only describes the direction of market trends and does not attempt to forecast future movements or estimate either the duration or the size of such market trends. It is assumed that most of the stocks follow the underlying market trend, most of the times.

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Dow developed the theory on the basis of certain hypothesis. The **first hypothesis** is that no single individual or buyer can influence the major trend of the market. However, an individual investor can affect the daily price movement by buying or selling huge quantum of particular scrip. The intermediate price movement also can be affected to a lesser degree by an investor.

His **second hypothesis** is that the market discounts everything. Even natural calamities such as earthquake and plague also get quickly discounted in the market. The Pokhran blast affected the share market for a short while and then the market returned back to normalcy.

His **third hypothesis** is that the theory is not infallible. It is not a tool to beta the market but provides a way to understand it better.

Basic Tenets of Dow Theory:

The basic tenets of Dow Theory are:-

1. The average (index numbers) discounts everything.

2. The 'market' meaning the price of shares in general, swings in trends which may be primary, secondary and minor. Primary movements, which last from a year to several years, represent the major market trends. It can be either a rising (bull) trend or a falling (bear) trend. Movements in the direction of primary trend are interrupted at intervals by secondary swings in the opposite direction. The secondary trends usually last from several weeks to several months. The minor trends are day to day fluctuations in the market.

3. So long as each successive price advance reaches a higher level than the one before it and each secondary reaction or price decline, stops at a higher level than the previous one, the primary trend is up. This is called a "bull market".

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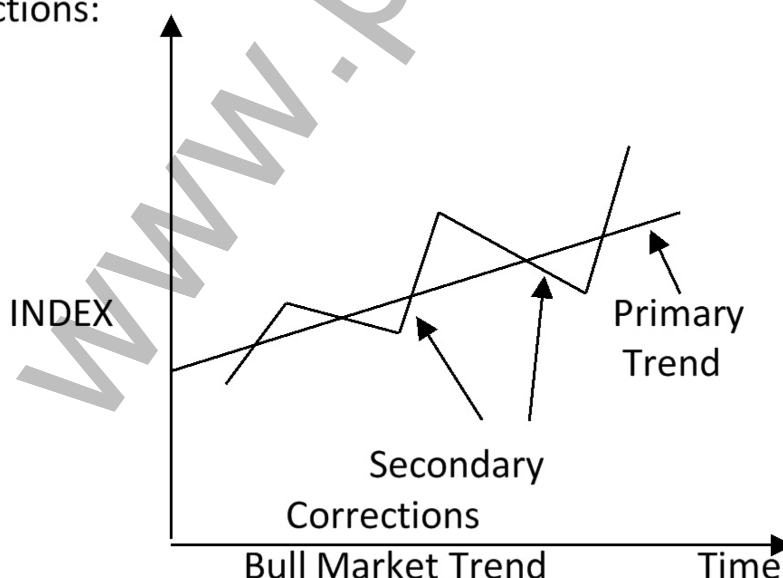
4. when each intermediate decline carries prices to successively lower levels and each intervening advance fails to bring them back upto the top level of the preceding advance, the primary trend is down and that is called 'bear market'.

5. The secondary trends are the intermediate declines or corrections which occur in bull market and the intermediate advances or recoveries which occur in bear markets. Normally, these last from a few weeks to a few months.

6. The minor trends are the brief fluctuations lasting usually for a few days. In theory, this is the only trend that can be manipulated.

7. A trend should be assumed to continue in effect until such time as its reversal has been definitely signalled. The end of a bull market is signalled when a secondary reaction of decline carries prices lower than the level recorded during the earlier reaction and the subsequent advance fails to carry prices above the top level of the preceding recovery. The end of a bear market is signalled when an intermediate recovery carries prices to a level higher than the one registered in the previous advance and the subsequent decline halts above the level recorded in the earlier reaction.

The following figure shows a bull market trend, interrupted by reactions:



Bull Market Trend

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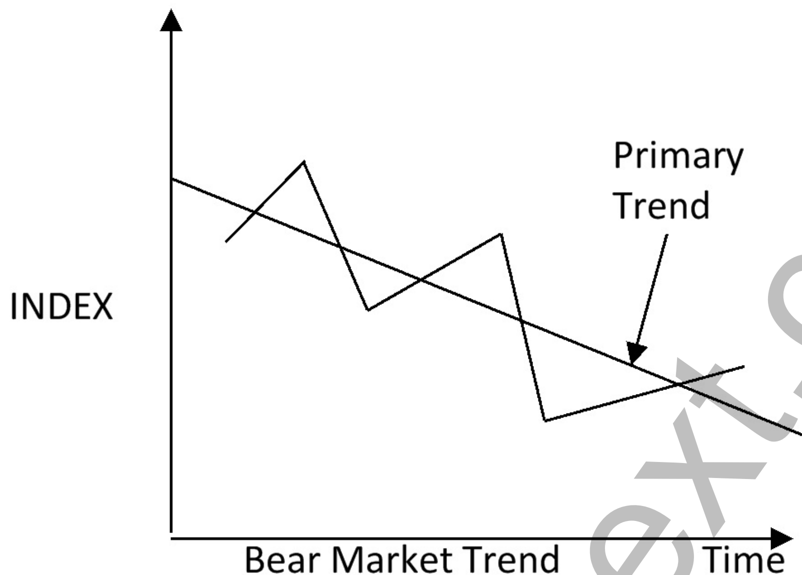
The following figure shows a bear market trend, interrupted by recoveries:



Shortcomings of Dow Theory:

The Dow Theory, though widely applied by technical analysts, has been criticized on the following grounds:-

1. The Dow Theory provides a signal of change in the trend, often too late. It is estimated that the theory confirms a reversal in trend often 20 to 25% after a peak or trough has occurred.

2. The Dow Theory depends on interpretation and is subject to all the limitations of human ability to interpret.

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