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Revisiting the Strength of Dow Theory in Assessing Stock Price Movement

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Abstract: An endeavor to sketch the starting point of technical analysis would inexorably lead to Dow Theory. Despite more than 100 years old, Dow Theory continues the basis of much of what is recognized now-a-days as technical analysis. The Dow Theory holds that there are three components in the movement of stock prices. Dow Theory stands upon the philosophy that the market prices reflect every significant factor that affects supply and demand - volume of trade, fluctuations in exchange rates, commodity prices, bank rates, and so on. In other words, the daily closing price reflects the psychology of all players involved in a particular marketplace or the combined judgment of all market participants. The target of the theory is to find out changes in the major trends or movements of the market. In view of above discussion, the present article tries to revisit the strength of Dow Theory in assessing stock price movement. Even though, there are weaknesses in Dow Theory, it will always be important to technical analysis. The ideas of trending markets and peak-and-trough analysis are found constantly within technical writings and ideas. More important in Dow Theory is the idea of emotions in the marketplace, which remains a characteristic of market trends. The basic facets of Dow Theory continue to remain functional and applicable to variety of situations and outcomes.

Keywords: Stock market, Industrial index, Transportation index, Primary trend, Secondary trend, Minor trend, Dow Theory.

1. Introduction:

An endeavor to sketch the starting point of technical analysis would inexorably lead to Dow Theory. Despite more than 100 years old, Dow Theory continues the basis of much of what is recognized now-a-days as technical analysis. . The term "Dow Theory" emerges to have first been used in a 1902 book by Samuel Armstrong Nelson entitled ‘The ABC of stock speculation’. Charles Dow was one of the founders of Dow Jones & Co. (DJ, NYSE), publisher of The Wall Street Journal. He is at times credited with being the originator of the point and figure chart. The Dow Theory holds that there are three components in the movement of stock prices. The primary trend is the long-term direction of the market and is the most important. The terms bull and bear originated with the direction of Dow Theory’s primary trend. The secondary trend refers to a temporary reversal in the primary trend, one that does not persist long enough to become the primary trend. Finally, daily fluctuations in the stock price are meaningless and contain no useful information.

Charles Dow explored the DJ Industrial Average and DJ Rail Index and semi-published his papers on Dow Theory suggesting stock markets move in similar ways over time. Dow created these indexes because he believed that these indexes were a perfect reflection of the business conditions within the economy because they covered two major economic segments: industrial and rail (transportation). While these indexes have changed over the last 100 years, the theory still applies to current market indexes. He is thought of as the founder of Technical Analysis. The Dow Theory stands on the price movement of the Dow Jones Industrial Average (DJIA). Changes in the primary trend of the DJIA are confirmed by the Dow Jones Transportation Average. The argument behind is that industrial firms make products, and transportation companies carry them. When both averages are moving forward, the economy is in excellent form. Dow believed that the stock market as a whole was a consistent measure of overall business conditions within the economy and that by analyzing the overall market; one could precisely estimate those conditions and identify the direction of major market trends and the likely direction of individual stocks.

Dow Theory stands upon the philosophy that the market prices reflect every significant factor that affects supply and demand - volume of trade, fluctuations in exchange rates, commodity prices, bank rates, and so on. In other words, the daily closing price reflects the psychology of all players involved in a particular marketplace or the combined judgment of all market participants. The target of the theory is to find out changes in the major trends or movements of the market. Markets tend to move in the direction of a trend once it becomes established, until it demonstrates a reversal. Dow Theory is paying attention in the direction of a trend and doesn't present any forecasting ability for determining the ultimate duration of a trend.

In view of above discussion, the present article tries to revisit the strength of Dow Theory in assessing stock price movement.

2. Evolution of Dow Theory:

Precisely, the birth of technical analysis, especially in the Western world, was with Charles Dow in New York at the end of the 19th century. Charles Dow, a luminous market observer and theorist, initiated his career as an investigative reporter, specializing in business and finance. Dow became a member of the New York Stock Exchange in 1885 and this provided him with an intimate knowledge of how the market works. Dow joined with Edward Jones in publishing an afternoon newsletter to the banks and brokerages on Wall Street. Dow and Jones are remembered in the name of the US Index, the Dow Jones Industrial Average, and in other indices. Dow became enthralled by the markets, and wrote many articles about them in the newsletter. In 1884 he invented a gauge of the health of the economy by putting together an average of 11 stock values, including nine railroad shares. Twelve years later, in 1896, he decided that industrial stocks and transportation stocks should be separated, and so the Dow Jones Industrial Average (DJIA) and the Dow Jones Transportation Average (DJTA) were born. The industrial average started with 12 stocks and now contains 30. The transportation average had 20 railroad stocks. The reason Dow split the indices was that he wanted to have a gauge of the health of each sector. Most of the time Dow dealt only with the averages and not necessarily with individual shares in developing his concepts. He maintained that both transportation and industrial sectors had to be in sync to provide a true reflection of the state of the economy.

In 1889, Dow began publishing a little newspaper which he called ‘The Wall Street Journal’ even published today. Between 1899 and 1902, Dow wrote a series of editorials for his Journal, and these editorials are as relevant and precious today as they were in those days they were written almost 100 years ago. It was Dow who first noted in print the tendency of shares at prices to move in trends for much of the time. He identified the three basic trends, an uptrend, a downtrend, and a line, which is what he called a price fluctuating around the same value, sometimes called trading sideways. He also noted that in many trends, there are short setbacks, or secondary trends which run counter to the original direction, and those trends tend to continue in the same direction until something acts to stop them. Dow himself never thought of his ideas as a way to trade the stock market, but merely as a commentary on the general economic health of the markets. Nonetheless, the principles that Dow put forward are still considered valid.

Owing to his death, Dow never published his whole theory on the markets, but numerous followers and associates have published works that have expanded on the editorials. Some of the most important contributions to Dow Theory were William P. Hamilton's "The Stock Market Barometer" (1922), Robert Rhea's "The Dow Theory" (1932), E. George Schaefer's "How I Helped More Than 10,000 Investors to Profit in Stocks" (1960) and Richard Russell's "The Dow Theory Today" (1961).

The Dow Theory was named after Charles Dow. Charles Dow published around the turn of the century 255 articles in the Wall Street Journal about the behavior of stock market movements. A year after his death Samuel A. Nelson selected fifteen articles by Charles Dow for his book The ABC of Stock Speculation and he commented Dow's observations. Nelson first used the term Dow Theory.

William P. Hamilton, who was the fourth editor of the WSJ, wrote a brilliant series of 252 editorials. These pieces appeared in the Journal between 1903 and 1929, and in Barron's (the Journal's sister publication) during 1922 to 1929. As time passed, Hamilton's writing attracted a wide and devoted following. In 1922, William P. Hamilton formed the basis for technical analysis. The book, titled The Stock Market Barometer is a comprehensive summary of the findings that Charles Dow and Nelson have gathered.

Hamilton had been Dow's understudy at the Journal, and in his book he included much of Dow's market observations and philosophy. But Hamilton also presented his own views on Dow Theory, and it was Hamilton who first defined the confirmation principle of the Averages. Hamilton died in 1930 soon after writing his most famous editorial, "The Turn of the Tide" (written on October 25, 1929). This fateful forecast served as the obituary for the remarkable and hugely speculative 1921-'29 bull market.

Ten years later, in 1932, as the low point of the turmoil has been reached, Robert Rhea published a book with the title The Dow Theory. Robert Rhea summarizes what Charles Dow and William P. Hamilton wrote down in 20 years for the Wall Street Journal.

Rhea, one of the great writers in the Dow Theory chain, was a devoted student of Hamilton's, and Rhea adhered closely to Hamilton's version of Dow Theory. Over a period of many years, Rhea codified and refined Dow Theory, always deferring to Hamilton in his explanations. Rhea possessed a wonderful, intuitive gift for reading the Averages. He had a mysterious ability to recognize and trade on the secondary as well as the primary trend of the market. On November 12, 1932, Rhea started a stock market service which he titled, "Dow Theory Comment." The service was successful from the start. Rhea called the exact bottom of the bear market on July 8, 1932, a feat which was considered as one of the most noteworthy in the history of stock market analyses. Following Rhea's death, the Dow Theory lay dormant for the many years during World War II and afterwards.

In 1960, George E. Schaefer returned to the findings of Charles Dow for his book ‘How I helped More than 10,000 Investors to Profit in Stocks’. Schaefer took a critical link to Hamilton and Rhea. He noted that they went too far away from the findings of Charles Dow. Schaefer pointed out again the importance of the primary trend and recommended not to reduce the Dow Theory to a mechanical trading system. Schaefer believed that both Hamilton and Rhea placed too much emphasis on the pattern of the Averages and not enough emphasis on the principle of buying great values and holding those values throughout the life of a bull market. Although Hamilton and Rhea took careful note of the secondary reactions in bull and bear markets, Schaefer advised his subscribers to ignore these "temporary reactions," and to remain invested in harmony with the primary trend of the market. In his historic report of June 18, 1949, Schaefer wrote, "Once stocks are purchased, both the minor and secondary movements in the market should be completely disregarded. A new period of prosperity will follow, once the present recession has run its full course." Another book on the Dow Theory was published in 1961. The author, Richard Russell, provided a good introduction and History of the Dow Theory. Charles Dow, however, never wrote a book and never used the term Dow Theory.

3. Basic Assumptions of Dow Theory:

The six tenets that were taken from his essays are usually approved to outline the Dow Theory, which are as follows: –

- the averages reflect everything that can be known about the price,
- the markets exhibit 3 types of movement, primary, secondary and minor,
- primary movements have three phases,
- it takes both the industrial average and transportation average to confirm a trend,
- a valid trend should have volume increasing in the direction of the trend, and
- The trend will continue until there is a clear reversal.

The Dow Theory comprising six assumptions is discussed in details below:

(i). *The Averages Discount Everything:*

The Stock Market is discounting all Informations .An individual stock price reveals everything that is known about the security. As new information arrives, market participants hurriedly disseminate the information and stock prices swiftly incorporate new information as soon as it becomes available. Once news is released, stock prices will change to reflect this new information. On this point, Dow Theory agrees with one of the premises of the efficient market hypothesis. Likewise, the market averages discount and reflect everything known by all stock market participants.

This indicates that the stock markets, Forex markets, commodity markets etc have priced on the basis of all news coming into the market. The market is "information efficient" on all news, whether it is fundamental economic news, interest rate data, pending earnings announcements, or general sentiment This principle is one of the main arguments for Technical Analysis as technical analysis simply looks at predicting future price movements based on chart patterns, price action, historical support and resistance levels and technical indicators - not other factors like fundamental news.

(ii). The Market comprises of three trends:

At any particular point of time in the stock market, there are three trends: the primary trend, secondary trends, and minor trends. Therefore, the markets can be divided into three trends:

- Primary Trend
- Secondary Trend
- Tertiary Trend

Primary Trend

One of the most fundamental rules of technical analysis is trade with the trend within one’s trading horizon and not against the trend, accordingly, for all time, it is prudent to come across the long term primary trend first when making trading decisions. The primary trend can either be a bullish (rising) market or a bearish (falling) market. The primary trend by and large lasts more than one year and may last for several years. Dow indicates that the primary trend will last between 1 and 3 years, but may vary in some circumstances. Nevertheless, this primary trend is the most important trend in the market and will have an effect on the Secondary and Minor market trends.

It is significant to note that trends are not straight forward, but tend to go up and down in a crisscross movement making peaks and troughs along the way. Dow used Peak and Trough analysis to recognize these trends. If the market is making successive higher-highs and higher-lows, the primary trend is up. If the market is making successive lower-highs and lower-lows, the primary trend is down. Therefore, the definition of an up trend is a trend making higher highs (higher peaks) and higher lows (higher troughs) and a down trend makes lower highs and lower lows. This primary trend will continue unless and until there is a trend reversal. This reversal is confirmed when the current price starts closing below a previous established trough in the last primary trend.

Secondary Trend

Secondary Trends can be found within the primary trend. They represent correction phases to the primary trend. The secondary trend moves in the opposite direction to the primary trend, before the primary trend resumes. If the secondary trend takes place in a primary up Trend then the secondary trend will be down consisting of lower highs and lower lows. The secondary trend ends when the trend resumes to higher highs and higher lows. The secondary trend should not fall below the last observable trough of the primary trend. If it does, it Is not a secondary trend and could be the making of a new primary counter-trend.

Charles Dow observed that their duration is usually three weeks to three months. The length of the secondary trend does vary and can be longer than 3 months, especially if we observe a long primary trend. Dow also observed that volatility was found to be greater than the primary trend and these reactions are often 1/3 to 2/3 of the secondary movement of the previous trends.

Minor Trend

Minor trends are short-term movements lasting from one day to three weeks and are generally the corrective moves to the secondary trend. Secondary trends are typically comprised of a number of Minor trends. According the Dow Theory, short-term price movements can be influenced by higher order volumes. Primary and secondary trends are excluded hereof.Minor trends are unimportant and can be misleading. Dow suggests that traders and investors should give attention to the primary and secondary trends as these minor trends are usually volatile and must be treated with the long term picture in view.

(iii). Primary trends have three phases:

Charles Dow's third principle is "The market trend has 3 phases". These are called the Accumulation, Public Participation and Excess Phases in an up trend (or bull market) and the Distribution, Public Participation and Panic Phase in a down trend (or bear market).

Primary Upward Trend (Bull Market):

The Accumulation Phase (Bull Market)

The Accumulation Phase is where the up trend start, which is usually at the bottom of a down trend (but not always). This is the point where the savvy, professional traders/investors enter the market at the best prices when the market is under valued. In the Accumulation Phase, shares were bought by informed investors which expect an economic recovery and anticipate a long-term growth. This is also considered the point at which informed investors start to enter the market. During this phase, most investors stood apposed to equities. In the accumulation phase, investors begin to build up stocks. The accumulation phase usually comes at the end of a downtrend, when everything is apparently at its worst. But this is also the time when the price of the market is at its most attractive level because by this point, most of the bad news is priced into the market, thereby limiting downside risk and offering attractive valuations. This phase will also be characterized by persistent market pessimism because investors think that things will only get worse. From a more technical standpoint, the beginning of the accumulation phase will be marked by a period of price consolidation in the market. This occurs when the downtrend starts to flatten out, as selling pressure starts to dissipate.

The Public Participation Phase (Bull Market)

The Participation Phase is characterized by rising corporate profits and better economic conditions. More and more Investors buy shares. The Public Participation Phase happens after the good news starts to be taken on board by the general population. When informed investors entered the market during the accumulation phase, they entered with the conjecture that the worst was over and a recovery lay ahead. As this starts to happen, the new primary trend moves into what is known as the public participation phase. During this phase, negative sentiment starts to drive away as business conditions - marked by earnings growth and strong economic data - improve. As the good news starts to permeate the market, more and more investors move back in, sending prices higher. The Public then start buying sending prices ever higher. This phase does not inevitably have to be steeper than the Accumulation phase, but it is generally the longer lasting where prices moves the most.

The Excess Phase (Bull Market)

This is the last part of the 3 phases within the primary trend and interestingly, this is where the savvy traders start to reduce their exposure and begin to take some profits. The last stage in the upward trend, the excess phase, is the one in which the smart money starts to scale back its positions, selling them off to those now entering the market. . At this point, the market is hot again for all investors. The perception is that everything is running great and that only good things lie ahead. This is also usually the time when the last of the buyers start to enter the market - after large gains have been achieved. This is the part of the trend that traders should start looking for signs of upward momentum weakness. The excess phase is generally seen in a bubble market.

Primary Downward Trend (Bear Market):

The Distribution Phase (Bear Market)

The first phase in a bear market is known as the distribution phase, the period in which informed buyers sell (distribute) their positions. This is the opposite to the accumulation phase, in that savvy traders sell or short there positions thinking that the market is overbought and the informed buyers are now selling into an overbought market instead of buying in an oversold market. . Again, this phase is difficult to spot and buyers may still be coming into the market trying to capitalize on what they may have missed - it may even be a ranging market. Technical Analysis may be helpful here to identify this phase as it generally comes after an up trend and consolidation period. In this phase, overall sentiment continues to be optimistic,

with expectations of higher market levels. It is also the phase in which there is continued buying by the last of the investors in the market, especially those who missed the big move but are hoping for a similar one in the near future. From a technical standpoint, the distribution phase is represented by a topping of the market where the price movement starts to flatten as selling pressure increases.
Public Participation Phase (Bear Market)

This phase is analogous to the public participation phase that has been noticed in a primary upward trend in that it lasts the longest and will represent the largest part of the move - in this case downward. Therefore, like the Public Participation in a bull market, this is generally the longest portion of the trend with the largest price move. During this phase it is clear that the business conditions in the market are getting worse and the sentiment is becoming more negative as time goes on. Trend followers will often exit the market or take a short position. A short position is when a trader borrows shares from a broker and sells them on the open market. The investor must eventually return the borrowed stock by buying it back from the open market, hoping the price will fall. The market continues to discount the worsening conditions as selling increases and buying dries up.

The Panic Phase (Bear Market)

The last phase of the primary downward market tends to be filled with market panic and can lead to very large sell-offs in a very short period of time. This is the flip of the excess phase. A jerk of negativity enters the market and a barrage of selling takes place sometimes at panic levels. So, in the panic phase, the market is shaped up with negative sentiment, including weak outlooks on companies, the economy and the overall market. Some savvy traders will start to look at entering the market at this point trying to profit on bad news. We'll go on to talk about trading on the news later.

In sum, the Dow Theory confirms that the first phase is made up of aggressive buying by informed investors in anticipation of economic recovery and long-term growth. The general feeling among most investors during this phase is one of "gloom and doom" and "disgust." The informed investors, realizing that a turnaround is inevitable, aggressively buy from these distressed sellers.

The Second phase is characterized by increasing corporate earnings and improved economic conditions. Investors will begin to accumulate stock as conditions improve.

The Third phase is exemplified by record corporate earnings and peak economic conditions. The general public now feels comfortable participating in the stock market--fully convinced that the stock market is headed for the moon. They now buy even more stock, creating a buying frenzy. It is during this phase that those few investors who did the aggressive buying during the first phase begin to liquidate their holdings in anticipation of a downturn.

(iv). Averages Must Confirm Each Other:

In view of Charles Dow, a rising Industry Index was not sustainable as long as the Transport Index did not also rise. The idea behind it was the following: If the producers reported rising profits, then they have produced more. If they produced more, they had transported their goods to the customers. Consequently, an investor has to notice the Industrial Index as well as the Transport Index. The Industrials and Transports must confirm each other in order for a valid change of trend to occur. Both averages must extend beyond their previous secondary peak (or trough) in order for a change of trend to be confirmed.Both Indices should show in the same direction. Therefore, Dow Theory argues that similar indices must have a correlation as they have the same exposure to current economic conditions. A divergence is to evaluate as a warning sign. If there is any kind of divergence then Dow argues there will be a change in trend in one of the indexes, so it's difficult to predict where this new primary trend will begin or if the primary trend will develop at all. If they are in agreement, then this can confirm the trend.

(*v). Trends must be confirmed by volume:*

According to Charles Dow, trends should be confirmed by the volume. The Dow Theory focuses primarily on price action. Volume is only used to confirm uncertain situations. Dow Theory assumes that volume accompanies price movements as an indicator. If higher volumes accompany a rising/falling trend, then this is a good indicator of a strong trend confirmation. If there are low volumes, then the there still may be a trend, but it's not as representative of the overall view.

Ideally, the volume should move in the direction of the primary trend. If the primary trend is down, volume should increase during market declines. If the primary trend is up, volume should increase during market advances.

(vi). A trend remains intact until it gives a definite reversal signal:

An up-trend is defined by a series of higher-highs and higher-lows. In order for an up-trend to reverse, prices must have at least one lower high and one lower low (the reverse is true of a downtrend).When a reversal in the primary trend is signaled by both the Industrials and Transports, the odds of the new trend continuing are at their greatest. However, the longer a trend continues, the odds of the trend remaining intact become progressively smaller.

A clear trend reversal must happen before a new primary trend starts. The trend is usually ended with a change in business or economic conditions strong enough to force the trend change. A trend may go through a correction into a secondary trend before continuing the primary trend. Looking at Technical analysis will help to establish trend ending indicators. The goal of trend traders is not to mistake a correction with the start of a new primary trend. This is why they wait for the weight of evidence to conclude the trend has definitely ended.

4. Validity of Dow Theory:

Alfred Cowles' article 'Can stock market forecasters forecast?' published in *Econometrica* in 1934 has been broadly regarded as landmark paper in the development of the efficient market theory. In the paper ,Cowles tests the Dow theory by coding each of Hamilton's editorials in The Wall Street Journal or Barron's as 'Bullish', 'Bearish' or 'Neutral'.Cowles then assumes that on a bullish signal, an investor places all of his wealth in stock(50 percent in the stocks comprising the Dow Industrial Index and 50 percent in those comprising the Dow Transportation Index).A bearish signal is taken as a recommendation to short the market and a neutral signal is taken as recommendation to invest in riskless asset.Cowles adjusts the Dow index for splits and dividends and estimated transaction costs to calculate total returns to the Dow timing strategy. For periods, when Hamilton is out of the market, Cowles assumes that he earns a riskless rate of 5 percent .He then compares his strategy with the alternative of investing 100 percent in the stock market over the same period.

Alfred Cowles in his study showed that trading based upon the editorial advice would have resulted in earning less than a buy-and-hold strategy using a well diversified portfolio. Cowles concluded that a buy-and-hold strategy produced 15.5% annualized returns from 1902–1929 while the Dow theory strategy produced annualized returns of 12%.

After numerous studies supported Cowles over the following years, many academics stopped studying Dow Theory believing Cowles's results were conclusive. In recent years however, Cowles' conclusions have been revisited. William Goetzmann, Stephen Brown, and Alok Kumar believe that Cowles' study was incomplete and that Dow Theory produces excess risk-adjusted returns. Specifically, the return of a buy-and-hold strategy was higher than that of a Dow Theory portfolio by 2%, but the riskiness and volatility of the Dow Theory portfolio was lower, so that the Dow Theory portfolio produced higher risk-adjusted returns according to their study.

On the 160th anniversary of Charles Dow's birthday, Jack Schannep of TheDowTheory.com, delivered a speech to the Market Technicians Association, describing recent contributions to the evolution of the Dow Theory and showed that traditional Dow Theory gives a total annualized return, from 1953 until 2011, about 1.5% per year greater than Buy and Hold. Many technical analysts consider Dow Theory's definition of a trend and its insistence on studying price action as the main premises of modern technical analysis.

Charles Dow observed the interconnectedness of production and distribution in the economy, as reflected by his Industrial and Transportation averages. Both economic aspects had to be in good physical shape for the overall market to go up—if this was the case, the averages would move in tandem or confirm each other's trend otherwise there was a lack of confirmation or divergence between the two averages, signaling an upcoming downturn in the economy and in stock market prices, which reflect the economy. This Dow Theory assists in generating other ideas which tied confirmation and divergence not only to each other but to various technical indicators, a key concept of technical analysis today.

Dow first portrayed the cyclical nature of market cycles, with their reoccurring patterns of accumulation and distribution of stocks, which was in turn associated to varying degrees of public enthusiasm or avoidance of stocks. He observed these patterns repeating over and over, which is a foundation of technical analysis and its rationale.

Dow was one of the first to describe the workings of human psychology and behavior as it applied to the stock market. A reversal in the market's trend can occur any time after that trend has been confirmed by the other average. Even if you are concerned only with the major or primary trend and take an attitude that you are in the market for the long haul, it's also true that a major bull market can deteriorate or end relatively suddenly and shake up this thinking. Therefore, Dow's practical and hardheaded advice is not to get complacent and to continue to monitor and pay attention to how the averages are behaving. This advice is as valuable in 2010 as it was in 1900.

Dow used closing prices as the only price history he considered important to study the price movement because daily price fluctuations were generally narrow during that era.

Dow's basics on Dow Theory still hold good today and are the basic assumptions chartists use in their technical analysis to this day. It's important to note that while Dow Theory itself is focused on price movements and index trends, implementation can also incorporate elements of fundamental analysis, including value and fundamental oriented strategies. TA focuses mainly on the technical's of the chart, but will still have a handle on the broader fundamental activity. Having said that, Dow Theory is much more suited to technical analysis. He died prior to publishing all his theories, but his works were completed by his associates and published in financial journals around the world. He believed that the stock markets were a good measure of business conditions and by analysis one could identify trends and predict future price movements. All traders using technical analysis should get to know Dow's 6 Tenets (beliefs) and keep them in mind when using technical analysis to form their trading strategies.

5. Problems of Dow Theory:

Dow Theory's significance as a impartial analytical technique has diluted since its original adaptation and subsequent updates. The reason for this has been the arrival of more advanced techniques and tools, which in part build off of Dow Theory, but to a great extent expand upon it. There were a number of inbuilt troubles with Dow's Theory that a lot of Dow critics point out.

One of the major problems with the theory is that followers can miss out on large gains due to the conservative nature of a trend-reversal signal. A signal is long-established when there is an end to successive highs (uptrend) or lows (downtrend).

Another pertinent difficulty with Dow Theory is that over time, the economy and the indexes originally used by Dow has changed. Accordingly, the association between them has weakened. The industrial and transportation sectors of the economy are no longer the dominant parts and technology now-a-days takes up a substantial portion of economic production and growth.

Most analysts that criticize Dow's Theory are that it is always late because they believe that it does not accurately indicate top or bottom market moves. These criticisms are erroneous since Dow's Theory was never intended to designate top or bottom market moves and consequent trading positions, but rather point out the overall business cycle and the direction of the primary trend. It is often straightforward for many technical analysts in modern society to relate Dow's Theory to that of day trading, and it is an unwise comparison since the two are measuring completely different time spectrums.

Technological changes have quickly decreased the amount of freight that is delivered by railroad in modern society, and as a result the comparison between the two averages does no longer represent a complete economic picture of the market. While the Dow-Jones Railroad Average and the Dow-Jones Transport indexes exist, the future of their use remains in doubt with the increase of services as a proportion of output which will mean that these indexes will no longer be as useful.

All other Dow Theory considerations are secondary to the value thesis. Therefore, price action, support lines, resistance, confirmations, and divergence – all are of much less importance than value considerations, although critics of the Theory seem totally unaware of that fact.

6. Conclusion:

Undoubtedly, Dow Theory is of major significance in the history of technical analysis. Dow Theory aims to identify the primary trends in stock markets, lasting from one year to several years. It specifies that the industrials index must "confirm" a high or a low in the Dow Jones Transportation Average. "The Dow Theory is the granddaddy of all technical market studies" and "It is built upon and concerned with nothing but the action of the stock market itself (as expressed in certain" averages"), deriving nothing from the business statistics on which the fundamentalists depend" as Edwards and Magee observed .Surprising, Charles Dow had little to do with the development of this theory. The Wall Street Journal, in fact, suggests that the entire field of technical analysis may have originated from "the distortion and selective editing of Mr. Dow's ideas." There is also no evidence Dow ever suggested prices would be predicted by interpreting charts.

Nevertheless, Dow's basics on Dow Theory still hold good at the moment and are the basic assumptions chartists use in their technical analysis. It is imperative to note that while Dow Theory itself is focused on price movements and index trends, implementation can also incorporate elements of fundamental analysis, including value and fundamental oriented strategies. The Dow Theory has existed for nearly 100 years; Even though there are weaknesses in Dow Theory, it will always be important to technical analysis. The ideas of trending markets and peak-and-trough analysis are found constantly within technical writings and ideas. More important in Dow Theory is the idea of emotions in the marketplace, which remains a characteristic of market trends. The basic facets of Dow Theory continue to remain functional and applicable to variety of situations and outcomes.

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