

Three-Line Price Break Charts

Private trader and President of a financial research and development company, Suri Duddella goes beyond Candlesticks to 3LPB to time the 'reversal bar' and confirm a trend.

Introduction

Technicians are always looking for ways to recognize market direction and market trends. Mostly technicians use technical indicators to detect signs of momentum shift, rising/falling trends and market volatility for price projections. A price chart gives the visual display of the underlying strength and weakness of a stock or commodity. A chart display coupled with trend-indicators, momentum indicators with support and resistance levels are essential in any technician's arsenal.

Three-Line Break charts (3LPB) display a series of vertical boxes that are based on changes in prices. The 3LPB method entirely dispenses with the recording of the volume sales and time data. The other major charting techniques like Point & Figure, Kagi and Renko Charts also ignore the passage of time and volume.

As Steve Nison describes in his "Beyond Candlesticks" book, "The three-line break chart is a more subtle-form of point and figure charts where reversals are decided by the market and not by the arbitrary rules. That means we can gear it to the strength and dynamism of the market".

Why Chart Analysis?

The understanding of the effect of supply and demand on any product or commodity or stocks is necessary for successful investing. When demand is greater than supply, prices move upward. Should supply be greater than demand, the prices are forced downward. When demand has absorbed all the supply at any given price, it will begin to absorb the supply available at the next higher price at which offerings are available. As the demand decreases, prices correspondingly increase. Prices recede as a result of absence of demand or an oversupply.

The fluctuations of price changes, when plotted by means of the principles of any charting techniques like Bar Charts, Candlesticks, Kagi or Point and Figure, will more accurately indicate

the technical condition, the relationship of supply and demand, than any other known method, which can be used for the purpose.

An Example of 3LPB Chart

Three-Line Break Charts defines the underlying trend and considered as an adjunct to the candlestick charts. A basic understanding of "3LPB" is when there are three white successive candles, the major trend is up and when there are three black successive candles, the major trend is down. The major reversal signals (based on the "3LPB" technique) are given when the turnaround lines (white to black or black to white) are formed.

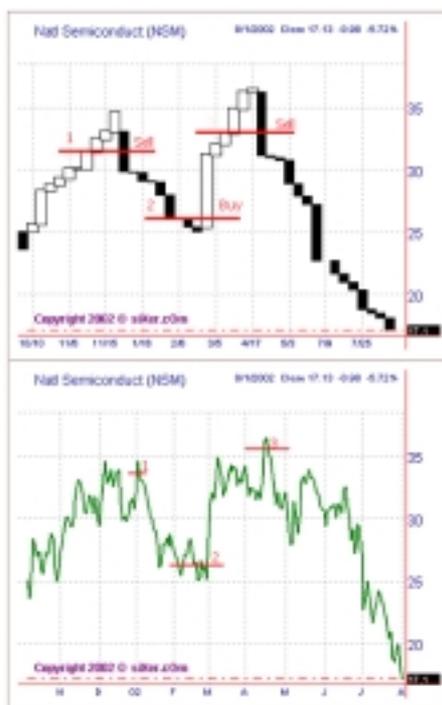


Figure 1

Construction Of 3LPB Chart

Three-Line Break Charts are always constructed based on closing prices. Many software programs and websites have the capability of drawing "3LPB" charts. The construction of a 3LPB chart starts from a base price (beginning of the chart data) and compare the base prices to the daily price closings.

FIRST CANDLE (BASE CANDLE)

- A White candle is drawn if today's price is higher than the base price; Or
- A Black candle is drawn if today's price is lower than the base price.

SECOND CANDLE

- Draw next WHITE candle (in the next column) if today's high is traded above the high of the first WHITE candle; Or
- Draw next BLACK candle (in the next column) if today's low is traded below the low of the first BLACK candle.

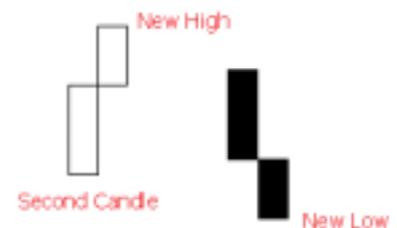


Figure 2

THIRD CANDLE

- Draw a third WHITE candle (in the next column) if today's high traded above (a new high) the previous two candles; Or
- Draw a third BLACK candle (in the next column) if today's low traded below (a new low) the previous two candles; Or
- NO Candle will be drawn if the price is within the range of the first two candles.

The next successive candles can be drawn using the THIRD CANDLE principle until a Three-Line Break candle is formed. Also note that today's prices should trade entirely above or below previous candles high or low.

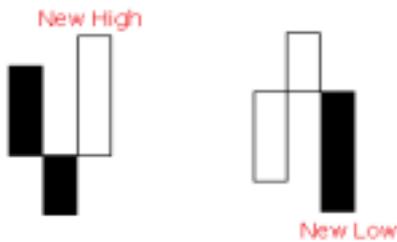


Figure 3

Three-Line Break Candle (The Most Important Candle)

The Three-Line Break Price Chart gets its name from this candle. If the price chart forms three successive WHITE or BLACK candles, it confirms a bullish (WHITE) and bearish (BLACK) trend. After forming a confirmed trend (by 3-successive same color candles), the reversal is triggered only if the today's price is traded below the lowest of all prior three candles (in case of BULLISH trend reversal) or if the today's price is traded above the highest of all prior three candles (in case of BEARISH reversal).

CASE A: THREE SUCCESSIVE WHITE CANDLES

- Draw a WHITE Candle (in the next column) if today's high is above the THREE WHITE CANDLES high; OR
- (REVERSAL CANDLE) Draw a BLACK CANDLE (in the next column) if today's low is below the THREE WHITE CANDLES low.

CASE B: THREE SUCCESSIVE BLACK CANDLES

- Draw a BLACK Candle (in the next column) if today's low is below the THREE BLACK CANDLES low; Or
- (REVERSAL CANDLE) Draw a WHITE CANDLE (in the next column) if today's high is above the THREE BLACK CANDLES high.

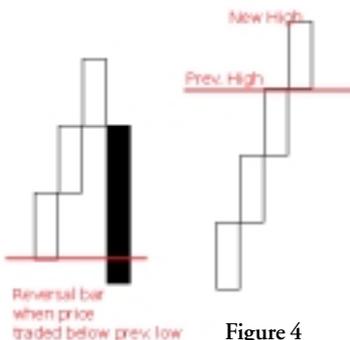


Figure 4

Basic Rules Of "3LPB" Construction

- A new Candle (BLACK or WHITE) can be only added in the next column if today's price trades higher than previous WHITE candle's high or if today's price trades lower than previous BLACK candle.
- If three successive WHITE or BLACK candles are formed, the reversal CANDLE can be only drawn in case if today's price is traded above the high of all the previous three successive white candles high or if the today's price is traded below the low of all the three successive black candles low.

Trading With 3LPB Charts

The Three-Line Price breaks indicate major trend changes. A trend change confirmation is generated when a reversal bar is formed. However, a trend confirmation bar could be late and substantial move to the upside or downside may have already happened. A solution for this problem could be an intra-day trading signal for confirmation of the trend. But traders are comfortable to wait until a trend-confirmation is formed. The confirmation of the trend-reversal involves a tradeoff between risk and reward.

Example 1: Johnson And Johnson (JNJ)

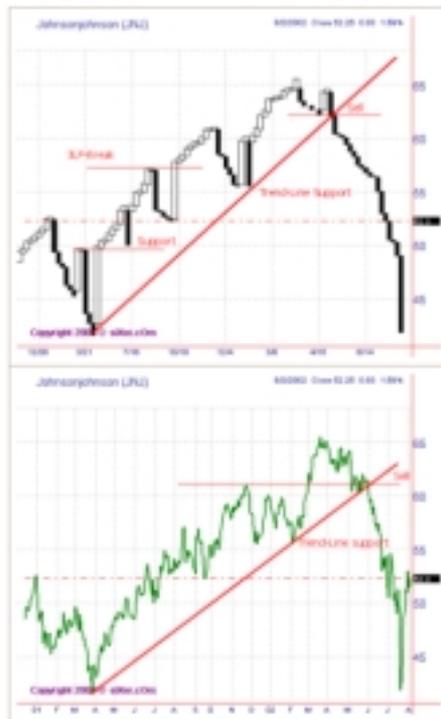


Figure 5: Johnson and Johnson

Example 1 presents the chart of Johnson and Johnson (JNJ) from January 2001 to August 2002. The overall trend provided by the 3LPB charts refine trading based on Trend-Line and Support/Resistance indicators.

The first trading opportunity is provided (end of March 2001) by the 3LPB full-range reversal bar (\$49). This level also acts both as an entry into the JNJ as well as support level. The Black reversal bar formed in mid-June 2001 (around \$57) closes the long-trade. A second long position can be taken in late January 2002 after a successful test of the trend-line and reversal of downtrend to the upside (around \$55). A downtrend followed by Black-Candle reversal and Trend-line breakout to the downside confirms the end-of the up trend (around \$62).

Example 2: (Microsoft Corporation)

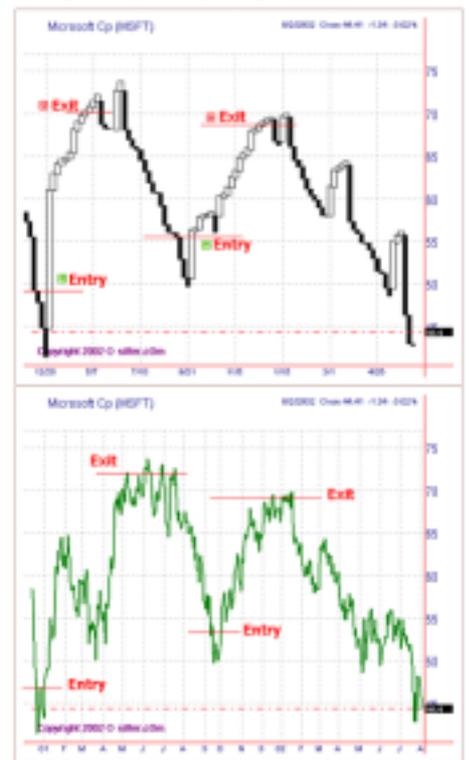
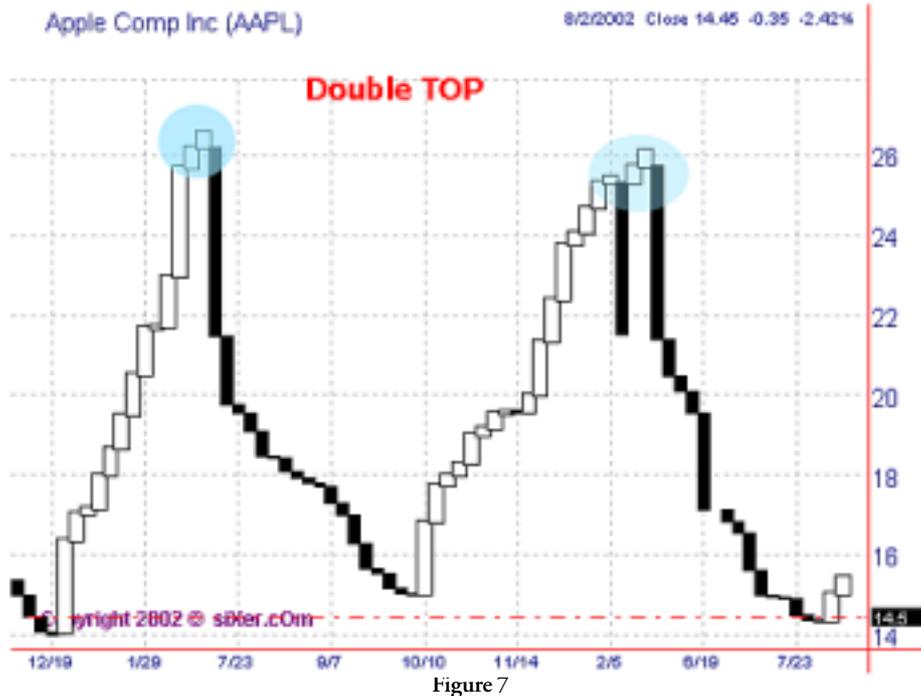


Figure 6

Example 2 presents 3LPB charts of Microsoft from January 2001 to Aug. 2002. The 3LPB chart confirms a long-entry (\$49) in January 2001 after a WHITE bar reversal of previous downtrend. Even though there was a temporary pullback in February 2001 to the entry level, there were no signals from 3LPB chart to confirm the downtrend. A major reversal and consolidation region was signaled in the beginning of the May 2001. The line/bar charts would have kept the investor in the trade without giving any sell signal until late August during the consolidation region. But 3LPB gave a sell signal in May 2001. Another long-entry signal was given in September 2001, reaching previous reversal level (\$50), acts as support. A long-entry position was taken on 3LPB reversal bar around \$55 in September 2001. This trade was exited in late December 2001 on next "3LPB" reversal (downtrend) bar around \$68.

Chart Patterns / Support And Resistance

Most of the techniques that apply to conventional chart analysis can also be applied to Three Line Price Break Charts. The chart patterns like 'Double Tops' and 'Head and Shoulder' can also be applied. Support/Resistance and Trendlines can be drawn in 3LPB charts to confirm with the 'Bar Charts' or 'Candle Charts'.



CONCLUSION

Three-Line Price Break charts are mainly used to confirm the underlying trend, trend-reversals and the balance of supply and demand. On many occasions "3LPB" charts show this ideal information developing while conventional charts (Bar, Candle) show nothing more than a temporary halt in a trend. Two important points to consider while using 3LPB are the timing of the 'reversal bar' and 'confirmation' of the trend. A Reversal bar is generated when three successive bullish (WHITE) or bearish (BLACK) bars are formed and today's price is traded below the lowest of all prior three WHITE bars (in case of bearish reversal) and vice-versa. The drawback for 3LPB charts is a trend-reversal bar could be late, as substantial move might have already happened. But many traders are willing to wait for the trend-confirmation as it involves a trade-off between risk and reward. Traders can also adjust the sensitivity of the 3LPB charts for 2, 5-Day Price Line break charts. Overall, 3LPB charts are very valuable tool in addition to the conventional charts to any technician's arsenal.

References

1. Steve Nison "Beyond Candlesticks" John Wiley & Sons, Inc.
2. William Arnold "Three-Line Break Reversal"
3. Gary Wagner and Bradley M. "Using Candlesticks and Oscillators"

Suri Duddella is the President of siXer.cOm, inc., a Financial Research and Development Company specializing in Web-Based Software Technologies and components for the financial markets. Suri Duddella's website (www.siXer.cOm) provides daily market/stock analysis, indicators, newsletter and a daily Gameplan for active traders. Suri Duddella is also successful and private trader for the past 8 years using his proprietary mathematical models/analysis. Duddella can be reached at suri@siXer.cOm.