# Donchian's 20 guides to trading commodities

*By Barbara S. Dixon*

Richard D. Donchian first compiled these "Twenty Trading Guides" in 1934 to help stock market traders. He unearthed a complete copy of the rules again in 1966, and he found that most of them applied to commodities as well as to stocks and that all 20 of them had maintained their usefulness and validity. They still make sense in 1978.

Donchian is one of the most respected technicians on Wall Street — especially in commodities. He began his career in 1930 and says he became hooked on markets when read Edwin LeFevre's fictionalized biography of Jesse Livermore, *Reminiscences of a Stock Operator*.

His interest in technical analysis arose after he suffered some losses following the 1929 crash. This led to his discovery that only the chartists made sense and money.

Donchian wrote his first market letter in 1930 at the age of 25, and Shearson's present "Trend Timing" commodity letter originated in 1960 when Donchian joined Hayden Stone. These letters have served as primers for countless commodity traders. The "Twenty Trading Guides" make a fine supplement to the letters and will probably survive and prove valid for the next 44 years as well.

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## General Guides

1. Beware of acting immediately on widespread public opinion. Even if correct, it will usually delay the move.
2. From a period of dullness and inactivity, watch for and prepare to follow a move in the direction in which volume increases.

*3. LIMIT LOSSES, ride profits — irrespective of all other rules.

4. Light commitments are advisable when a market position is not certain. Clearly defined moves are signalled frequently enough to make life interesting, and concentration on these moves to the virtual exclusion of others will prevent unprofitable "whipsawing."
5. Seldom take a position in the direction of an *immediately preceding* three-day move. Wait for a one-day reversal.
6. Judicious use of stop orders is a valuable aid to profitable trading. Stops may be used to protect profits, to limit losses and to take positions from certain formations such as triangular foci. Stop orders are apt to be more valuable and less treacherous if used in proper relation to the chart formation.
7. In a market in which upswings are likely to equal or exceed downswings, a heavier position should be taken for the upswings for percentage reasons — a decline from 50 to 25 will net only 50% profit, wheareas an advance from 25 to 50 will net 100%.
8. In taking a position, price orders are allowable. In closing a position, use "market" orders.
9. Buy strong acting, strong background commodities and sell weak ones, subject to all other rules.
10. Moves in which rails (now the Transportation Index) lead or participate strongly are usually worth following more than moves in which rails lag.
11. A study of the capitalization of a company, the degree of activity of an issue (a varying factor), and whether an issue is a lethargic truck horse like Consolidated Edison or Exxon or a spirited, volatile race horse like Teledyne (NYSE) or Resorts International (American) is fully as important as a study of statistical reports. (Volatile stocks are 1978 counterparts of the two issues mentioned in 1934, Aluminum Co. of America, then on the Curb, and Case Threshing Machine, now J. I. Case, a part of Tenneco.)

## Technical Guides

All nine of these technical guides apply equally well to major and minor formations.

1. A move followed by a sideways range often precedes another move of almost equal extent in the same direction as the original move. Generally, when the second move from the sideways range has run its course, a counter-move approaching the sideways range may be expected.
2. Reversal or resistance to a move is likely to be encountered (a) on reaching levels at which the commodity has fluctuated for a considerable length of time within a narrow range in the past or (b) on approaching previous highs or lows.
3. Watch for good buying or selling opportunities when trend lines are approached, especially on medium or dull volume. Be sure such a line has not been hugged or hit too frequently (see No. 4).

*4. Watch for "crawling along" or repeated bumping of minor or major trend lines and prepare to see such trend lines broken.

*5. Breaking of minor trend lines counter to the major trend gives most other important position-taking signals. Positions can be taken or reversed on stops at such places. (This is possibly the most important of all the technical guides).

6. Triangles of either slope may mean either accumulation or distribution, depending on other considerations, although triangles are usually broken on the flat side.
7. Watch for volume climax, especially after a long move.
8. Don't count on gaps being closed unless you can distinguish between breakaway gaps, normal gaps and exhaustion gaps.

*9. During a move, take or increase positions in the direction of the move at the market the morning following any one-day reversal, however slight the reversal may be, especially if volume declines on the reversal. (This has proved to be a very valuable guide.)

•More than 40 years of experience later, Donchian feels that the most useful of these 1934 guidelines for commodity traders are No. 3 under the general guidelines and Nos. 4, 5 and 9 under technical guidelines. The chart of December 1978 Comex gold futures helps to further illustrate technical guide No. 5.

Donchian defines a counter-trend as a sequence which lasts at least four days (see inset in gold chart which illustrates the pattern). Traders can either take positions on a stop as the price crosses the extreme of the fourth day or on a stop at the extreme of the move. Place stop orders just under the low of the bottom day or right above the high of the top day. Several examples of successful four day counter-trends are indicated on the December gold chart.

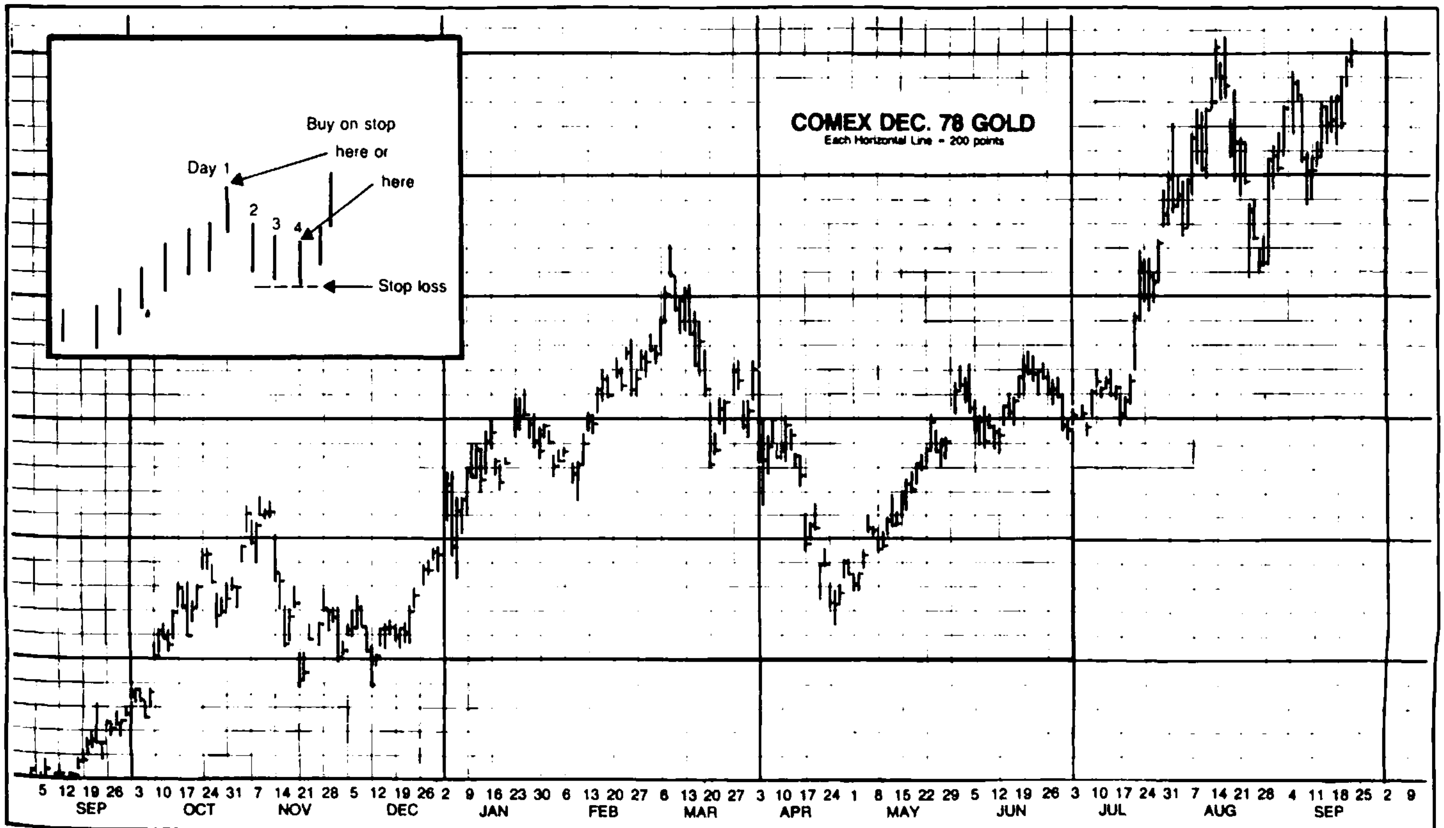
Please note this caveat: If the counter-trend is steep, the price often requires a correction of more than four days. Also, even if a steep four-day counter-trend emerges in the direction of the existing trend, it might prove a warning that the rate of price change may be slowing.

Longer counter-trend sequences can also provide good market signals. For example, the correction in late January-early February gave a fine buy signal. When you follow longer counter-trends or consolidations, watch that the speed of the correction proves inferior to the prior leg of the major move. Also, watch for low volume on the corrections and high volume and fast momentum on the breakouts. These clues reinforce the likelihood that the major trend still prevails.

All these guides serve as general trading tools. Their successful application requires some individual interpretation. For example, in No. 5, you must know the major trend before you can use minor counter-trends. Sometimes that major move will be unclear or subject to opinion.

The guides can help you the most when used in conjunction with other basic technical tools — trading with the trend, having a disciplined plan, diversifying, cutting losses short, letting profits ride, using adequate capital and having patience. □

**Richard Donchian**

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