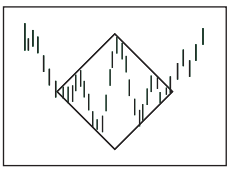
11

Diamond Bottoms



RESULTS SNAPSHOT

Upward Breakouts

Appearance	Diamond pattern forms after a downward price trend. Breakout is upward.	
Reversal or continuation	Short-term bullish reversal	
	Bull Market	**Bear Market**
Performance rank	8 out of 23	2 out of 19
Break-even failure rate	4%	3%
Average rise	36%	36%
Change after trend ends	–33%	–36%
Volume trend	Downward	Downward
Throwbacks	53%	60%
Percentage meeting price target	81%	60%
Surprising findings	The best performers have breakouts near the yearly low. Throwbacks hurt performance but breakout day gaps help. Tall or wide patterns perform better than short or narrow ones.	
See also	Diamond Tops	

Downward Breakouts

Appearance	Same, but breakout is downward.	
Reversal or continuation	Short-term bearish continuation	
	Bull Market	**Bear Market**
Performance rank	**1 out of 21**	2 out of 21
Break-even failure rate	10%	0%
Average decline	21%	44%
Change after trend ends	59%	48%
Volume trend	Downward	Downward
Pullbacks	71%	40%
Percentage meeting price target	63%	80%
Surprising findings	The best performers have breakouts near the yearly low. Pullbacks hurt performance. Tall patterns perform better than short ones. Patterns with a random volume shape or heavy breakout volume outperform.	
See also	Same as for upward breakouts	

How is a diamond bottom like asking a girl out on a date? When dealing with either, it is all in the approach. Diamond bottoms have prices entering the pattern from the top; diamond tops have prices entering from the bottom. What more is there to know? Plenty, and the Results Snapshot just scratches the surface. Here is a quick review.

Diamond bottoms have low break-even failure rates, usually in the single digits. The average rise is respectable, too, 36%. After reaching the ultimate high, prices tumble and give back nearly all of their gains. Thus, you will want to take profits and not buy and hold.

Downward breakouts perform well for bearish patterns, dropping 21%. The 44% average decline in a bear market is based on too few samples to be believable. In fact, many of the statistics use few samples, so be careful drawing conclusions.

Tour

Figure 11.1 shows an example of what a diamond bottom looks like. Notice that the price trends downward into the pattern then the diamond appears and prices reverse. Prices dropping into the pattern mean it is a diamond bottom and not a top.

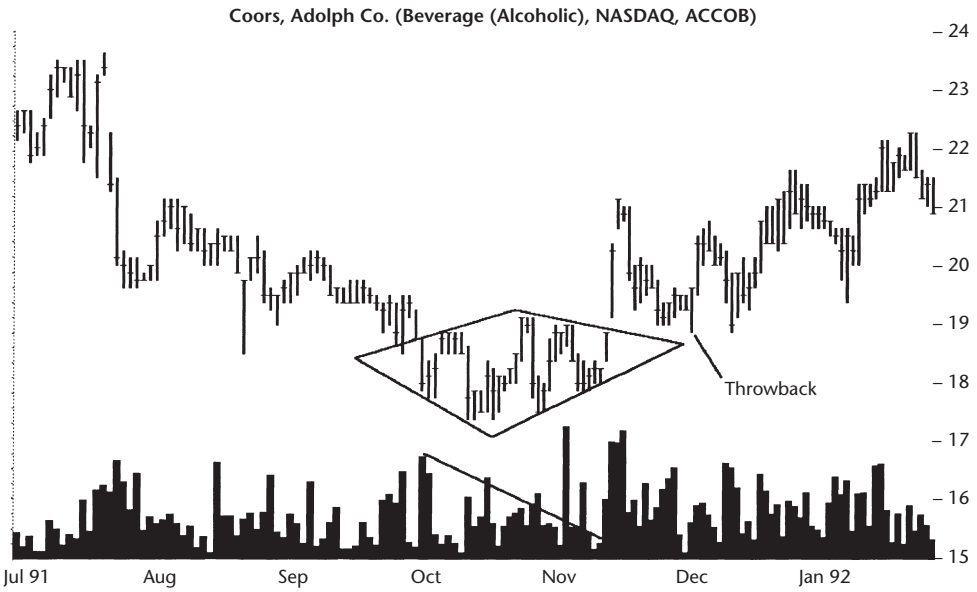


Figure 11.1 A diamond bottom reversal. Volume typically recedes through the formation until the breakout day.

The diamond bottom begins by widening out and tracing higher highs and lower lows, then the process reverses. The price range narrows until the breakout occurs.

Volume throughout the formation is diminishing. The breakout usually sports a significant rise in volume. Figure 11.1 shows high volume on the breakout when prices gap through the diamond boundary. In less than 3 months, the stock climbs over 20% to a high of 22.25.

A diamond bottom represents the struggle between buyers and sellers. Buying demand pushes prices up to a new minor high until selling pressure forces prices back down. If the selling pressure is strong enough, prices drop to a new minor low. The widening pattern continues, but usually not for many swings.

On the other half of the diamond, greedy holders—seeing a good price for the stock—sell, and the price rise stops, turns around, and drops. Sellers buy but do so before prices make a new low. They are excited about the stock and buy in before prices can reverse and leave them without a position. This activity blunts the downward momentum and creates a higher minor low. Thus, prices begin narrowing on the far side of the diamond.

Eventually, one of the warring parties will win, and overwhelming buying demand or selling pressure will cause prices to break out of the pattern. Prices continue in the breakout direction until they pause several points beyond the diamond boundary. For upward breakouts, the pause may be frightening enough that holders sell, driving the price back to the diamond trend line (a throwback).

For downward breakouts, buying demand from traders believing they are getting the stock at fire sale prices creates a pullback. The smart money knows

the score and takes the last opportunity to dump their holdings. This additional selling pressure forces the stock down again, usually for quite some time (weeks to months).

That is the life of a diamond. If you are nimble enough, you can participate in the intraformation buying and selling. Buy when prices bottom and sell near the top then go short and cover at the bottom of the diamond. It sounds easy, but it is not (unless you like losing money).

Identification Guidelines

How do you identify a diamond bottom? Review the identification characteristics shown in Table 11.1.

Prior price trend. Since we are dealing with diamond bottoms and not tops, the prevailing price trend is downward leading to the diamond.

The hardest part of identifying any pattern is seeing the shape prices make. For diamonds, they are especially difficult to identify. However, they occur many times at price turning points. Thus, look for diamond bottoms at the end of a downward price trend. Rarely, diamonds appear in the middle of the trend and prices continue lower instead of reversing.

Diamond shape. When prospecting for diamonds look for prices to widen out over time forming higher highs and lower lows. The price pattern should look like a broadening bottom chart pattern. Then, prices narrow, forming lower highs and higher lows. The second half should look like a symmetrical triangle. If you draw trend lines around the minor lows and highs, the result should appear diamond shaped. More likely, the diamond's top or bottom will be pushed to one side, making it appear as though the chart pattern is leaning over.

Volume trend. Volume usually trends downward over the course of the pattern, but need not. Do not discard a chart pattern simply because volume trends upward instead of downward. In fact, the volume *shape* most often resem-

Table 11.1
Identification Characteristics

Characteristic	Discussion
Prior price trend	Prices trend down into the pattern.
Diamond shape	Prices form higher highs and lower lows in the first part of the pattern then lower highs and higher lows. Trend lines surrounding the price action look like a diamond. The diamond need not appear symmetrical.
Volume trend	Downward from the start of the pattern to the end, with a surge during the breakout.

bles a dome 44% of the time, a U-shape 32% of the time, and a random pattern the remainder. The volume *trend* (slope) is downward 69% of the time and upward the remainder.

The breakout day volume is usually high—meaning it is above the 1-month average 53% of the time. Again, do not discard a diamond because the breakout volume is light instead of heavy.

Here are three examples of diamonds. Figure 11.2 shows the first example. The price trend is downward for nearly 2 months, leading to the formation. Prices rebound slightly and the range widens as higher highs and lower lows appear. Then the tide turns and the range narrows; higher lows follow lower highs. The diamond pattern takes shape after connecting the boundaries of the price movements.

Trading volume throughout the formation is receding. This occurrence is typical but not a prerequisite for a well-formed diamond bottom. There are often wide variations in the volume pattern. Overall, however, the volume trend diminishes over time until the breakout, then volume usually jumps upward. Figure 11.2 shows that breakout volume is four times the prior day but is just slightly above average for the stock.

Figure 11.3 illustrates the support area often promoted by diamond bottoms. The figure shows support at the $10 level on a weekly scale. Although support varies from diamond to diamond, when it appears after a diamond

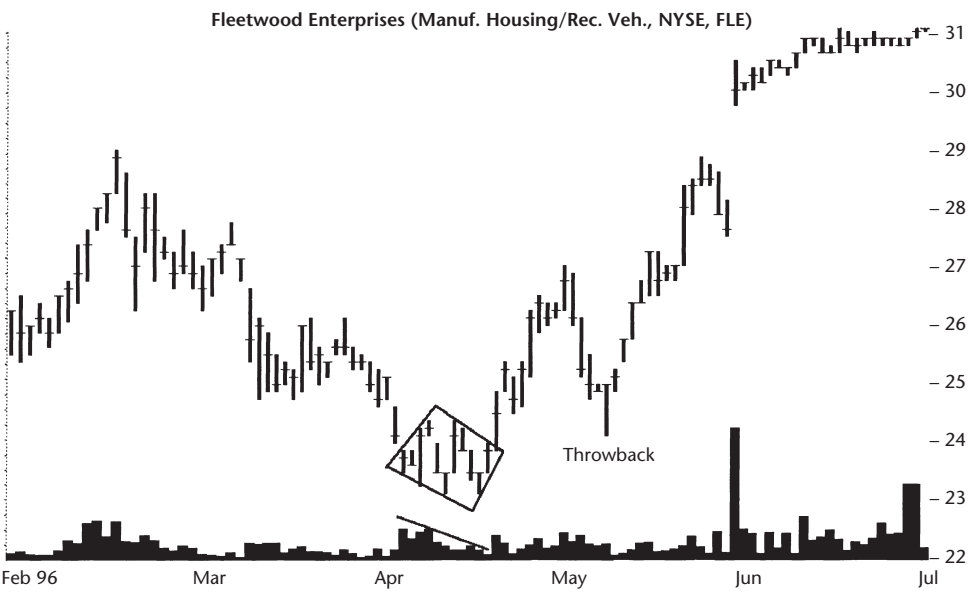


Figure 11.2 A diamond bottom with receding volume trend. Prices quickly recover and reach new highs.

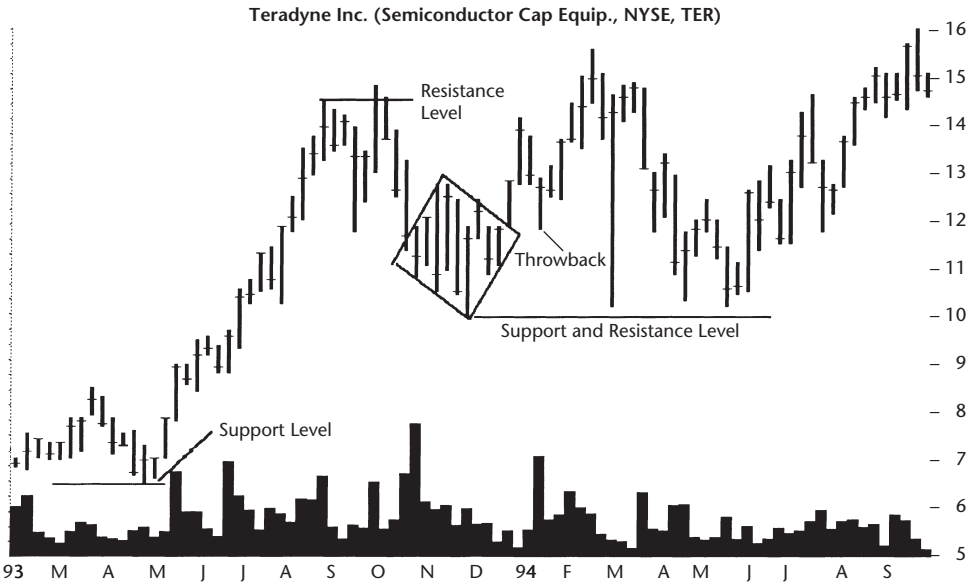


Figure 11.3 Support areas for diamond bottoms are near the base of the formation. Shown here is support at 10 on a weekly scale.

bottom, it is usually near the base of the formation. Another area of support commonly appears when the stock throws back to the level of the breakout. Figure 11.3 shows an example of this. Climbing away from the formation after the breakout, a stock sometimes pauses, reverses course, and heads lower. Support meets prices that decline into the formation area, usually stopping briefly near the breakout price, then prices turn around again and head back up. This throwback to the formation happens more than half the time (53%) and represents another opportunity to initiate a trade or add to a position.

Figure 11.4 shows the last example of a diamond bottom. Does it obey the identification characteristics from Table 11.1? Yes. The prevailing price trend is downward leading to the diamond. The minor highs and lows touch the associated trend lines often enough except on the upper left facet. I scratched my head drawing the slope of that edge because it does not have two minor highs to connect, but one (the top of the pattern). I connected the high of a day and joined up with the lower left trend line. Does that make it any less of a diamond? I will let you decide.

The volume trend slopes downward (very high on the left side and diminished on the right). Breakout day volume is high, too.

The diamond is also a head-and-shoulders bottom. I have marked the two shoulders (S) and head (H) to illustrate the pattern. The down-sloping neckline is the trend line marking the right top of the diamond. Whether you conclude it is a diamond bottom or a head-and-shoulders, the bullish implications are clear. The rise after the breakout is exquisite.

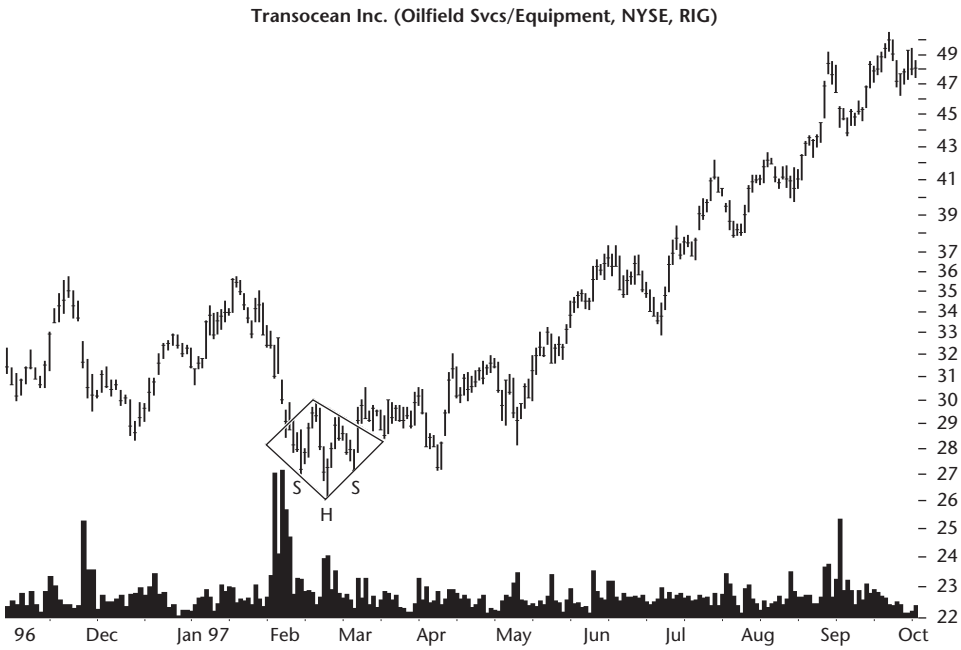


Figure 11.4 A diamond bottom also appears as a head-and-shoulders bottom with bullish implications.

Focus on Failures

I changed the definition of a failure for chart pattern types. I no longer consider a breakout in the adverse direction as a failure. If you want to trade a diamond with an upward breakout and it breaks out downward, you will simply look for another trade. Thus, only 5% failures remain. These are when price breaks out of the pattern, moves in the intended direction, but stops and reverses direction before moving far.

Figure 11.5 shows an example. Is this a valid diamond? Prices trend downward into the pattern, the diamond shape is clear, but volume trends upward (higher on the right than the left). Is the rising volume trend cause for concern? No. Breakout day volume is also low instead of high. Everything looks fine except for volume. If this were my trade, the volume anomalies would not even register. I would be more worried about something else. Do you know what it is?

Look at the figure again. See that descending triangle hanging above the diamond like storm clouds? Although you may not recognize the triangle pattern, you should be on the lookout for overhead resistance. That solid block of near horizontal price movement starting in October—where the triangle begins—to December where it ends, would scare me off. The only way I would take this trade would be to short it once prices turned down at the triangle.

That is essentially what happened. Price broke out upward and the massive overhead resistance stopped the rise. Prices threw back to the diamond

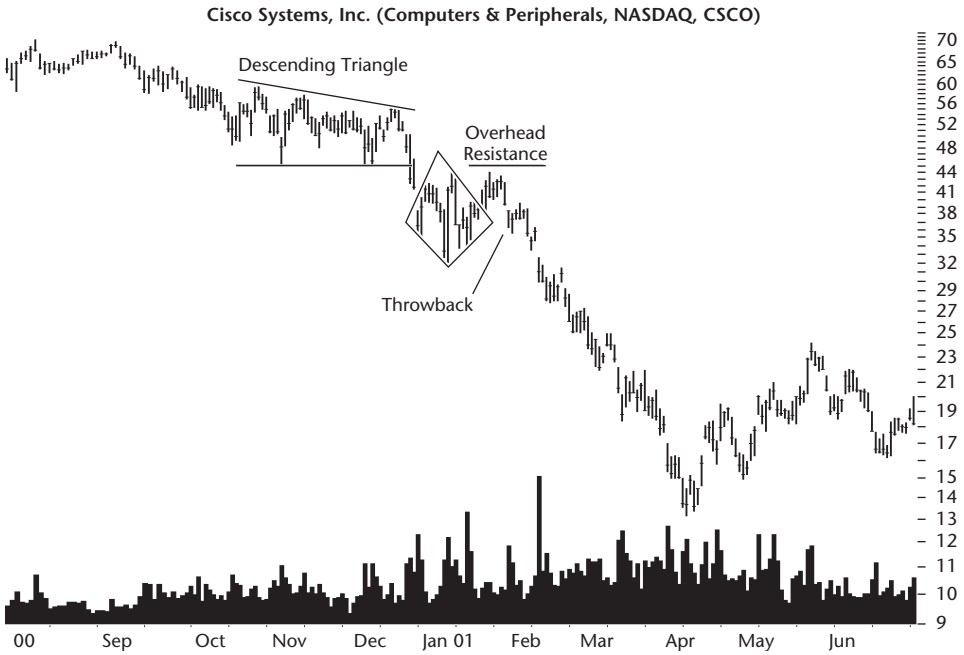


Figure 11.5 Overhead resistance blocks the upward breakout from this diamond bottom.

but kept going down. Let me also mention that this pattern occurred in the middle of a bear market. So, we had a bear market, a falling price trend leading to the diamond, and massive overhead resistance. The only surprise would be if the price floated like pumice instead of sinking as does a diamond tossed into a pond. Your job as a trader is to find the gems that float.

Statistics

Table 11.2 shows general statistics for this chart pattern.

Number of formations. In the first edition of this book, I found only 45 bottoms, so I am pleased to report that I have now located 295. Unfortunately, that is not enough for a good statistical analysis when you split it into four columns. You will see a notation in many of the tables (for individual entries or the entire column) when samples are below 30. Diamonds in a bear market with a downward breakout are a good example. I found only 20.

Reversal or continuation. As the table shows, most often diamonds act as reversals of the prevailing price trend. For a bottom pattern, that means prices usually break out upward. The low sample count makes a fair comparison of reversal and continuation performance impossible.

Average rise or decline. The average rise is 36% and the average decline is 21%. Ignore the 44% decline. No bearish pattern that I know of has such a

Table 11.2
General Statistics

Description	Bull Market, Up Breakout	Bear Market, Up Breakout	Bull Market, Down Breakout	Bear Market, Down Breakout
Number of formations	140	63	72	20
Reversal (R), continuation (C)	140 R	63 R	72 C	20 C
R/C performance	36%R, 58%C[a]	36%R, N/A C	23%R[a], 21%C	82%R[a], 34%C[a]
Average rise or decline	36%	36%	–21%	–44%
Rises or declines over 45%	47 or 34%	16 or 25%	3 or 4%	5 or 25%
Change after trend ends	–33%	–36%	59%	48%
Busted pattern performance	25%[a]	N/A	–21%[a]	–26%[a]
Standard & Poor's 500 change	11%	2%	–2%	–8%
Days to ultimate high or low	119	72	35	28

Notes: Minus sign means decline. N/A means no samples available.

[a]Fewer than 30 samples.

large average decline. In other words, expect additional samples to drop the number almost in half.

Rises or declines over 45%. About a third of the bull market diamonds with upward breakouts climb at least 45%. That is the best of the bunch. As one might expect, downward breakouts do less well in this category.

Change after trend ends. Once price reaches the ultimate high, it drops over 30%, giving back most or all of the prior gain. For downward breakouts, after price reaches the ultimate low, it rebounds an astonishing 59% in a bull market! That may sound unbelievably large, but other chart pattern types do better.

Busted pattern performance. I found no busted diamonds with upward breakouts in a bear market. The other combinations moved in a percentage range from the low to mid-20s. Additional samples will change results.

Standard & Poor's 500 change. The index helped prices rise in a bull market and sucked them down in a bear market. What is surprising is that the 36% rise in bull and bear markets for upward breakouts are the same despite the general market moving 11% to 2% upward. It sounds as if the bear market had a few stocks with powerful rallies.

Days to ultimate high or low. How long does it take price to reach the ultimate high or low? Answer: between a month and 4 months. Most of the time, you will see upward breakouts taking longer to reach the ultimate high than do downward breakouts reaching the ultimate low. Compare the bear market,

downward breakout's 44% decline in 28 days with the bull market, up breakout's 36% climb in 119 days. Clearly, the bear market decline must be at a much steeper slope than the bull market rise.

Table 11.3 shows how often the pattern fails. For example, 4% of the diamonds in a bull market with an upward breakout fail to rise more than 5%. A total of 12% fail to rise at least 10%. One last example for downward breakouts in a bear market: 30% fail to drop more than 25%.

That is how the table works, but what do all the numbers mean? Since there are so few samples for bear market, down breakouts, remove that column from consideration. The lowest failure rates usually accompany diamonds with upward breakouts in a bull market. In second place is the bear market, up breakout column.

Bottom line: Buy diamonds with upward breakouts for the lowest rate of failure.

Table 11.4 shows breakout- and postbreakout-related statistics.

Formation end to breakout. How long does it take from the end of the diamond to the breakout? Just a few days (2 to 3). Much of this delay is due to the way my computer displays the diamond and from the requirement that price must *close* outside the diamond boundary, not just pierce it.

Yearly position. Where in the yearly price range do diamonds breakout? Most often, the breakout occurs near the yearly low or middle.

Yearly position, performance. Where are the best performers located in the yearly price range? Diamonds that perform best break out near the yearly low most of the time.

Table 11.3
Failure Rates

Maximum Price Rise or Decline (%)	Bull Market, Up Breakout	Bear Market, Up Breakout	Bull Market, Down Breakout	Bear Market, Down Breakout
5 (breakeven)	5 or 4%	2 or 3%	7 or 10%	0 or 0%
10	17 or 12%	10 or 16%	20 or 28%	2 or 10%
15	34 or 24%	14 or 22%	26 or 36%	3 or 15%
20	44 or 31%	17 or 27%	37 or 51%	5 or 25%
25	53 or 38%	26 or 41%	46 or 64%	6 or 30%
30	61 or 44%	34 or 54%	53 or 74%	8 or 40%
35	72 or 51%	41 or 66%	60 or 83%	12 or 60%
50	99 or 71%	47 or 75%	69 or 96%	15 or 75%
75	116 or 83%	58 or 92%	72 or 100%	19 or 95%
Over 75	140 or 100%	63 or 100%	72 or 100%	20 or 100%

Table 11.4
Breakout and Postbreakout Statistics

Description	Bull Market, Up Breakout	Bear Market, Up Breakout	Bull Market, Down Breakout	Bear Market, Down Breakout[a]
Formation end to breakout	3 days	2 days	3 days	3 days
Percentage of breakouts occurring near the 12-month low (L), center (C), or high (H)	L37%, C41%, H22%	L59%, C35%, H6%	L49%, C33%, H19%	L45%, C45%, H10%
Percentage rise/decline for each 12-month lookback period	L42%, C37%, H26%	L37%, C38%[a], H20%[a]	L22%, C21%, H15%	L57%, C31%, H31%
Throwbacks/pullbacks	53%	60%	71%	40%
Average time to throwback/ pullback ends	11 days	12 days	12 days	16 days
Average rise/decline for patterns with throwback/pullback	30%	33%	–18%	–22%
Average rise/decline for patterns without throwback/pullback	43%	42%[a]	–26%[a]	–53%
Performance with breakout gap	40%	56%[a]	–26%[a]	–44%
Performance without breakout gap	36%	33%	–20%	–45%
Average gap size	$0.34	$0.85	$0.51	$0.62

Note: Minus sign means decline.

[a]Fewer than 30 samples.

Throwbacks and pullbacks. Throwbacks and pullbacks—when price returns to the breakout price or diamond border—occur over half the time. The exception is the 40% pullback rate for diamonds in a bear market, but the sample count is low.

When a throwback or pullback occurs, it takes 11 to 16 days, on average, to complete the move back to the breakout price. When a throwback or pullback occurs, performance suffers as the numbers show. To avoid a throwback or pullback, look for overhead resistance or underlying support before trading. Avoid the diamond when congestion is nearby.

Gaps. I compared the performance of diamonds with and without breakout day gaps. Most often, gaps help performance, but that finding might change with additional samples.

Table 11.5 shows a frequency distribution of time to the ultimate high or low. This table is useful because you want to find a pattern in which prices move as far as they can as quickly as they can. I know from experience and statistical measures that downward breakouts drop *faster* than upward breakouts rise. Upward breakouts take longer but rise *farther*.

Diamonds in a bear with upward breakouts seem to congregate near the ends of the table. Fully 46% reach the ultimate high in the first 2 weeks, and 32% take longer than 70 days. Bull market, down breakouts show a similar drop (46%) in the first 2 weeks.

Notice the slight upticks just over a month after the breakout. More diamonds in a bear market with upward breakouts begin reaching the top near day 35 to 42. Diamonds with upward breakouts in a bull market top out a bit sooner, days 21 to 28. Thus, look for your diamond to top or bottom out around a month after the breakout.

Table 11.6 shows statistics related to size.

Height. Tall formations perform better than short ones. To use this result, compute the diamond height by subtracting the lowest low in the diamond from the highest high and then divide by the breakout price (the point where price

Table 11.5
Frequency Distribution of Days to Ultimate High or Low

Days:	7	14	21	28	35	42	49	56	63	70	>70
Bear market, up breakout	25%	21%	5%	2%	5%	8%	2%	0%	2%	0%	32%
Bull market, up breakout	19%	4%	8%	6%	1%	4%	4%	1%	2%	2%	49%
Bear market, down breakout	20%	10%	25%	10%	5%	10%	0%	5%	0%	10%	5%
Bull market, down breakout	22%	24%	13%	4%	6%	6%	7%	7%	3%	0%	10%

Table 11.6
Size Statistics

Description	Bull Market, Up Breakout	Bear Market, Up Breakout	Bull Market, Down Breakout	Bear Market, Down Breakout[a]
Tall pattern performance	43%	42%	–23%	–63%
Short pattern performance	31%	30%	–19%	–23%
Median height as a percentage of breakout price	13.19%	19.69%	13.42%	17.78%
Narrow pattern performance	33%	34%	–22%	–33%
Wide pattern performance	40%	39%	–20%	–53%
Median length	27 days	26 days	27 days	24 days
Average formation length	36 days	35 days	39 days	25 days
Short and narrow performance	29%	34%[a]	–19%[a]	–27%
Short and wide performance	36%[a]	25%[a]	–18%[a]	–17%
Tall and wide performance	42%	50%[a]	–21%[a]	–70%
Tall and narrow performance	44%[a]	34%[a]	–28%[a]	–46%

Note: Minus sign means decline.

[a]Fewer than 30 samples.

closes outside the diamond trend-line boundary). If the result is larger than the median, then you have a tall pattern.

Width. Most wide diamonds perform better than narrow ones, with the exception being diamonds with downward breakouts in a bull market. I used the median length as the separator between narrow and wide.

Average formation length. How wide are diamonds? Although it varies, the average width is about a month long. Do not be alarmed if your diamond is very short or excessively long.

Height and width combinations. Diamonds that are both tall and wide perform better than most of the other combinations. The worst performers are short and wide diamonds. Avoid those.

Table 11.7 shows volume-related statistics.

Volume trend. The results paired with market conditions: Diamonds having a rising volume trend in bull markets performed best postbreakout; diamonds in bear markets did best with a falling volume trend.

Volume shapes. I see no consistent trend except the random shape does well for downward breakouts. Diamonds with upward breakouts do well with dome-shaped volume (bull market) and U-shaped volume (bear market).

Breakout volume. Does heavy volume breakout propel prices farther? Yes, most of the time. The lone exception happens to diamonds with light breakout volume, but the performance difference is insignificant.

Table 11.7
Volume Statistics

Description	Bull Market, Up Breakout	Bear Market, Up Breakout	Bull Market, Down Breakout	Bear Market, Down Breakout[a]
Rising volume trend performance	41%	28%[a]	–25%[a]	–40%
Falling volume trend performance	35%	41%	–19%	–46%
U-shaped volume pattern performance	37%	47%[a]	–21%[a]	–22%
Dome-shaped volume pattern performance	38%	38%[a]	–19%[a]	–47%
Neither U-shaped nor dome-shaped volume pattern performance	32%[a]	26%[a]	–24%[a]	–53%
Heavy breakout volume performance	36%	42%[a]	–23%[a]	–44%
Light breakout volume performance	37%	32%	–18%	–43%

Note: Minus sign means decline.

[a]Fewer than 30 samples.

Trading Tactics

Table 11.8 shows trading tactics.

Measure rule. The Results Snapshot ("Percentage meeting price target") at the beginning of this chapter shows how often the measure rule works. For an example, refer to Figure 11.6. In both diamonds, compute the height by subtracting the lowest price in the pattern (point B) from the highest high (point

Table 11.8
Trading Tactics

Trading Tactic	Explanation
Measure rule	Measure the diamond height from the highest high to the lowest low and then add the result to the breakout price if the breakout is upward; subtract the result from the breakout price for downward breakouts. The result is the target price.
Quick rise/fall	Prices often return to the base following a quick rise or fall preceding the diamond.
Wait for breakout	The diamond can break out in any direction, so wait for the breakout.

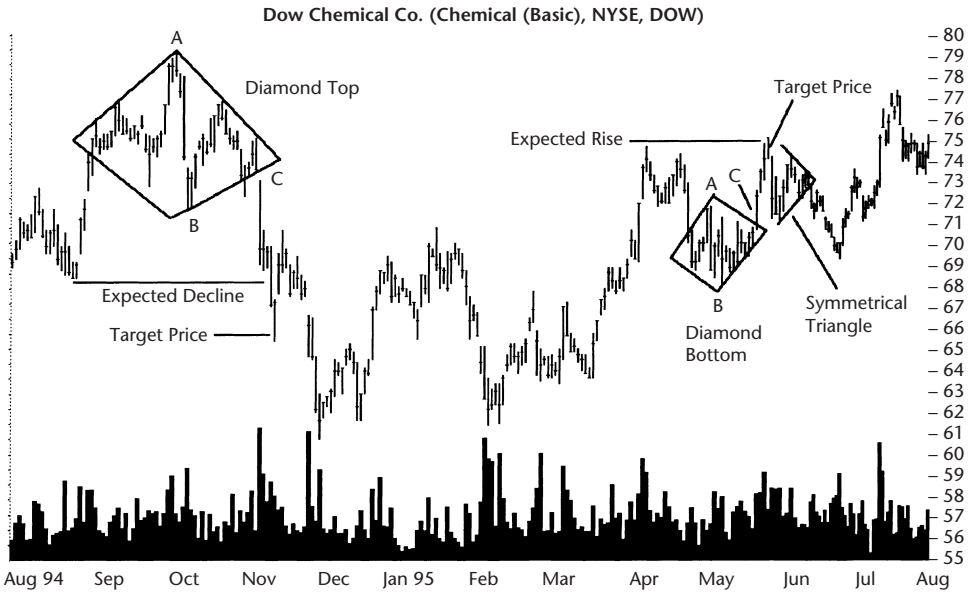


Figure 11.6 A diamond top and a diamond bottom. Compute the measure rule using the formation height by subtracting point B from point A. For diamond tops, subtract the difference from point C; for bottoms, add the difference. The result is the expected minimum price move. Diamonds often return to their base. The "Expected Decline" and "Expected Rise" lines are another way to gauge the minimum price move. A symmetrical triangle appears in late May.

A) then adding to (upward breakouts) or subtracting from (downward breakouts) the breakout price (point C). The breakout occurs the day price closes outside the diamond boundary.

Specifically, the diamond top in Figure 11.6 shows a height of 7.62. That is, 79.25–71.63, the high minus the low. Since the breakout is downward, subtract the result from the breakout price. That gives a target of 65.88 or 73.50–7.62 (the breakout price minus the height).

Quick rise/fall. Figure 11.6 also shows an alternative way of guessing the magnitude of the rise or decline. When prices shoot upward (in the case of the diamond top, pictured), a quick decline often follows, which takes prices back to the launch point. I show this as the "Expected Decline" in the figure.

The diamond bottom shows a similar situation. Prices make a steep drop into the pattern and soar back out in a similar trend. They stop climbing near the launch point (shown as the "Expected Rise").

Wait for breakout. Before you invest in a stock showing a chart pattern, wait for the breakout. Since diamonds break out either up or down, you cannot predict the breakout direction with much certainty. Thus, wait for the breakout—a close outside the pattern boundary—before taking a position. Yes, premature breakouts do occur but they are rare. A premature breakout is when price closes outside the diamond boundary but returns in a day or two. In the 288 diamonds I looked at, I found less than a dozen with premature breakouts.

Sample Trade

Scott graduated from engineering college and took his first professional job at a growing software company. The job pays well, but he has many school loans and a mountain of dept. He thought of using his paycheck to keep ahead of the bills while depending on the bull market to furnish the luxuries.

He had his eye on a new stereo system and wanted it for a party he was hosting during the Fourth of July festivities. That did not leave him much time, so he searched for a chart pattern he could trade profitably. He chose the diamond bottom shown in Figure 11.6. Scott first noticed the diamond in May, a few days before the breakout. He believed that the price would not decline below 69.88, 0.12 below the round number of 70 and at the same level as a couple of price peaks in January.

Risking just $0.75 with a possible reward of $3.75 gave him a risk to reward ratio of 1:5. If everything worked as planned, he would make a tidy sum, enough to buy the stereo.

The day after the stock broke out upward, he bought and received a fill at 71.75 (near point C in Figure 11.6). That was higher than he liked, but with the strength shown, he was sure the trade would work out. Scott dutifully placed his stop-loss order at 69.88 with his broker. Three days later the stock closed at 75, above the target price. He dropped by the music store just to fondle the knobs and flip the switches of his dream machine.

Then things began going wrong. The stock closed down nearly $3 to 72.13. It dropped to 71.38 the next day and made a lower low a day later. Suddenly, Scott was losing money and his stereo pipe dream was in danger of plugging. Should he sell the stock and put off the party for another time?

Luck was on his side and prices began climbing again. Soon, they were at 74, but the honeymoon did not last long. Prices completed a symmetrical triangle but Scott did not see it. They broke out downward through the support trend line (extend the lower right diamond diagonal toward the triangle). The stock even gave him another chance to get out at a profit when it attempted a pullback to the triangle boundary. Scott was busy making party plans and missed the signal. When he received a call from his broker in mid-June reporting that the stop took him out at 69.88, Scott scratched his head and wondered what went wrong. Do you know the answer?

The answer is greed. Since he needed money for a stereo, once prices cleared the top of the diamond, he should have put a limit order to sell at his target price. Although this technique limits the profit potential (because you get taken out even though the stock may double after that), it allows a trader to capture the turn near a high point. I have seen this behavior with event patterns. Prices shoot up, hit the target and then just as quickly decline. If you do not sell, you lose your profit. An example from my own trading: A few days ago, a stop-loss order sold my position in Rohm & Haas for a $113 profit in an earnings flag trade. If I used my profit target, I would have made $1,000.

Another factor is the psychological pressure of *having* to profit from a trade. If your trading profits determine whether you will eat or not, then there is a good chance your trading will suffer. You will feel pressured to remain in a bad trade longer than necessary or buy into risky situations that you normally would avoid.

Fortunately, Scott was smart enough to use a stop-loss order to protect himself. If he had noticed the downward breakout from the symmetrical triangle, that would have signaled a sell, too.

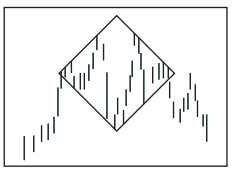
For Best Performance

The following list includes tips and observations to help select diamond bottoms that perform better after the breakout. Consult the associated table for more information.

- Review the identification characteristics for correct selection—Table 11.1.
- Trade with the trend. Select diamonds with upward breakouts in a bull market or downward breakouts in a bear market—Table 11.2.
- Diamonds with upward breakouts in a bull market have the lowest failure rates of the three columns with large samples—Table 11.3.
- Select diamonds with breakouts near the yearly low—Table 11.4.
- Throwbacks and pullbacks hurt performance—Table 11.4.
- Breakout day gaps improve performance—Table 11.4.
- Expect a trend reversal 5 to 6 weeks after the breakout—Table 11.5.
- Tall patterns perform better than short ones—Table 11.6.
- Select wide patterns—Table 11.6.
- Diamonds with a rising volume trend do best in bull markets; a falling volume trend, in bear markets—Table 11.7.
- Heavy breakout volume suggests better performance—Table 11.7.

12

Diamond Tops



RESULTS SNAPSHOT

Upward Breakouts

Appearance	Diamond pattern forms after an upward price trend. Breakout is upward.
Reversal or continuation	Short-term bullish continuation

	Bull Market	**Bear Market**
Performance rank	21 out of 23	2 out of 19
Break-even failure rate	10%	0%
Average rise	27%	33%
Change after trend ends	–29%	–34%
Volume trend	Downward	Downward
Throwbacks	59%	54%
Percentage meeting price target	69%	79%
Surprising findings	Throwbacks hurt performance but breakout day gaps help.	
See also	Diamond Bottoms	

Downward Breakouts

Appearance	Same, but breakout is downward.
Reversal or continuation	Short-term bearish reversal

	Bull Market	Bear Market
Performance rank	7 out of 21	10 out of 21
Break-even failure rate	6%	4%
Average decline	21%	24%
Change after trend ends	47%	47%
Volume trend	Downward	Downward
Pullbacks	57%	57%
Percentage meeting price target	76%	59%
Surprising findings	Pullbacks hurt performance but breakout day gaps help. Tall and narrow patterns perform better than other combinations. Patterns with light breakout volume perform better.	
See also	Same as for upward breakout.	

The Results Snapshot shows the important results of diamond tops. In appearance, the only difference between diamond top and bottom patterns is the price trend leading to the formation. For tops, the prior price trend is upward, whereas diamond bottoms have price trends that lead down to the formation.

A review of the numbers shows that the 0% break-even failure rate in a bear market (upward breakout) is deceptive as the sample count is too small to get an accurate measure. Still, the other failure rates are at or below 10% and that is quite good. An odd finding is that patterns in a bear market rise 33%, beating patterns in a bull market, which rise 27%. The low sample count (28 samples) is the reason.

Diamonds with downward breakouts do well as far as the average decline goes. The other numbers in the Results Snapshot are self-explanatory except for the "Percentage meeting price target." I used the height of the diamond added to or subtracted from the breakout price as the target. That method worked just over half the time, far less than the 80% success rate I like to see.

Tour

What does a diamond top look like? Figure 12.1 shows a good example. This diamond signals a reversal of the prevailing price trend and shows the typical behavior of a top: Prices return to the level before the diamond begins. In this regard, the reversal stands out like a sore thumb. Of course, not all tops act this way. Some signal a reversal of the primary trend and prices not only retrace their recent gains but continue moving down.

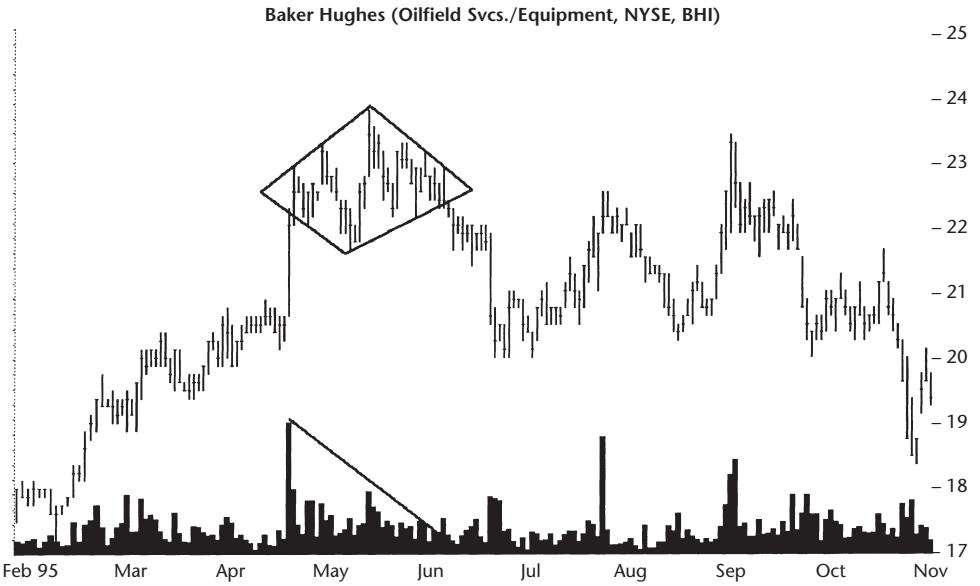


Figure 12.1 A good example of a diamond top. Notice that prices quickly return to the $20 level.

Identification Guidelines

Table 12.1 lists identification guidelines for diamond tops. Consider the diamond top pictured in Figure 12.2.

Prior price trend. The short-term price trend is up just before the formation, leading to the minor high on the left. Then prices decline and form a minor low before moving higher again. In late September, prices reach a new high before cascading downward to finish below the prior minor low. Again,

Table 12.1
Identification Characteristics

Characteristic	Discussion
Prior price trend	Prices trend up to the formation. With this definition, diamond tops need not form at the top of a price chart—they can form anywhere.
Diamond shape	Prices form higher highs and lower lows (widening appearance), then lower highs and higher lows (narrowing appearance). Trend lines surrounding the minor highs and lows resemble a diamond. The diamond need not appear symmetrical.
Volume trend	Diminishing over the length of the formation.
Breakout volume	Usually high and it can continue high for several days.
Support and resistance (SAR)	The formation creates a location for support or resistance. Diamond tops usually show SAR near the top of the formation. SAR duration can last up to a year or more.

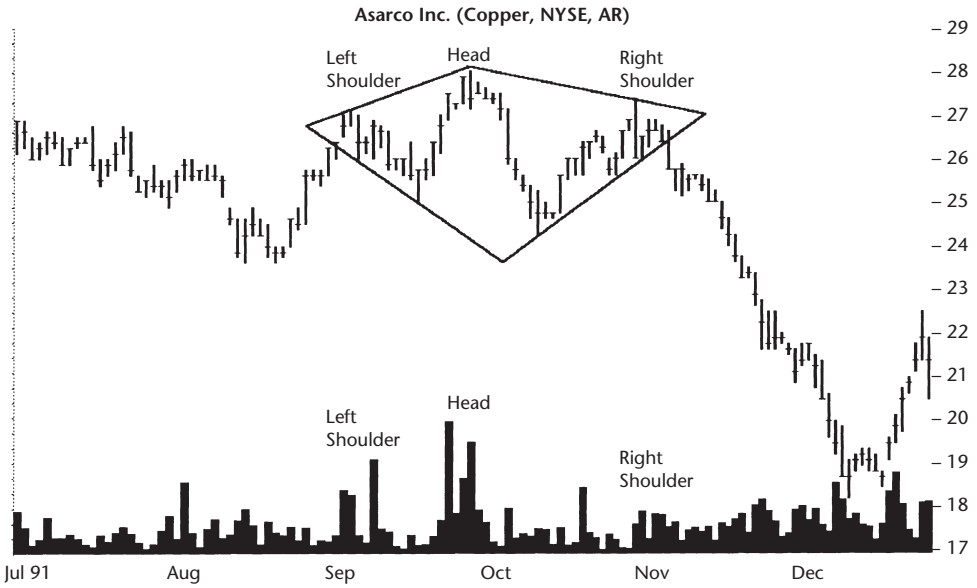


Figure 12.2 A diamond top masking a head-and-shoulders top. In either case, the bearish outlook is certain.

prices rise up and form another minor high before breaking down through the upward trend line on the right.

Diamond shape. The fluctuations of minor highs and lows form a diamond shape when the peaks and valleys connect such as that shown in Figure 12.2. Notice that the diamond is not symmetrical; irregular diamond shapes are common for diamonds.

Volume trend. The volume trend is receding, especially in the latter half of the formation when the price is narrowing (and the chart pattern resembles a symmetrical triangle).

Breakout volume. The breakout volume is usually high but is not a prerequisite to a properly behaved diamond. In Figure 12.2, the volume on the breakout day and succeeding days is tepid at best but trends upward as prices fall.

The pattern is a head-and-shoulders top, with the left shoulder, head, and right shoulder marked on Figure 12.2 The volume pattern is typical for a head-and-shoulders top, with the right shoulder volume vastly diminished when compared to the left shoulder or head volume.

Should you locate a diamond pattern and discover that it may be a head-and-shoulders top, do not worry. In both cases, the formation is bearish. When such a collision occurs, choose the formation that gives you the more conservative performance results (see the measure rule).

Support and resistance. Support and resistance for diamond tops commonly appear at the top of the formation, as seen in Figure 12.3. The diamond reversal forms a resistance level, repelling prices during the rise in March and April 1993, and is not pierced until a year later.

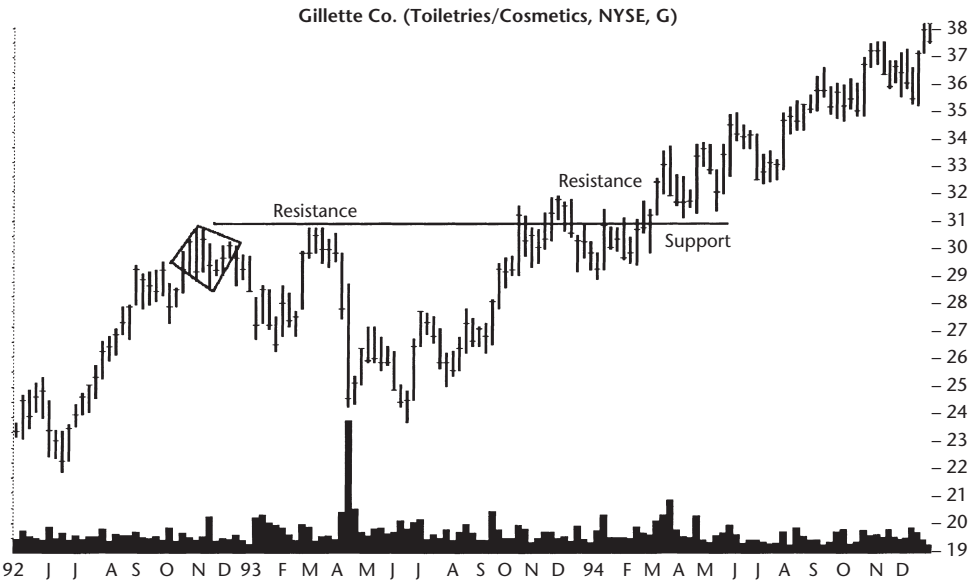


Figure 12.3 Support and resistance for the diamond appears at the top of the formation. A support and resistance zone at 31 created by the diamond lasts for a year and a half. Note the weekly time scale.

A congestion zone forms in October 1993 and lasts through March of the following year before prices climb convincingly above the resistance area. Even then, during April and May 1994, prices are buoyed by the support zone at 31 created a year and a half earlier.

Figure 12.4 shows another example of a diamond top. In the first edition of the *Encyclopedia*, I called this example a failure because prices broke out upward instead of downward. I no longer make that distinction: Breakouts can occur in any direction.

I would expect prices to breakout downward because of the quick rise leading to the pattern (late January) and drop until they found support around the 108 level, the price range of the January lows. As you can see, that did not happen. Price broke out upward instead.

Does this diamond obey the identification guidelines? Prices rise into the pattern from the bottom, so the prior price trend rule is intact. The diamond shape becomes clear after drawing trend lines along the minor highs and lows. Linear regression on the volume trend shows that it tilts downward, as expected. The breakout volume is high, but again, this is not a rule, just an observation. A breakout on low volume is fine. In short, the diamond top pictured in Figure 12.4 is valid. With an upward breakout, I would check for overhead resistance to the upward move but this figure does not show any. A look at the weekly chart would clarify the situation and allow a trader to estimate the likely rise (assuming price stops at overhead resistance).

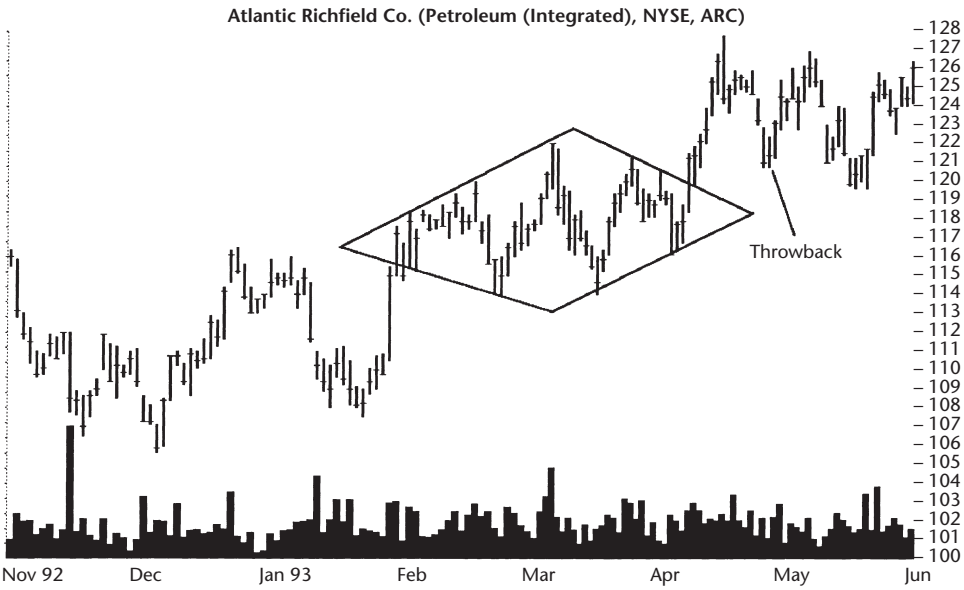


Figure 12.4 A failure of a diamond top to reverse direction.

Focus on Failures

Figure 12.5 shows a typical diamond top failure. The diamond may look odd by its unsymmetrical appearance, but does it qualify as a valid diamond? Yes. The price trend leading to the pattern is up, there are plenty of trend line touches in the pattern, and volume diminishes from being high on the left to low on the right—all are ingredients of a properly selected diamond top. Breakout volume, however, is timid, falling well short of the peaks posted during the prior three days.

Is low breakout volume the reason why prices failed to descend far (just 3%)? Maybe. A high volume breakout would have given more confidence to a bearish situation and perhaps prevented a pullback. I have noticed that high volume downward breakouts pull back less often than do low volume ones. This makes intuitive sense, as a high volume descent tends to push prices down farther than a low volume one.

Perhaps the key to this failure is like many others: Support below the pattern stops the decline. On the weekly chart (not shown), support appears in August 1996, February 1996, and May 1995, all with prices peaking near 17. Coupled with a bullish general market, the rising tide lifted all boats and prevented this one from sinking.

Based on this chart, if this were my trade, I would have seen the support in July (point A) as a warning sign. That would be my guess as to how far prices would drop. Indeed, they do stop at that level in April, but that is well after the pattern fails.

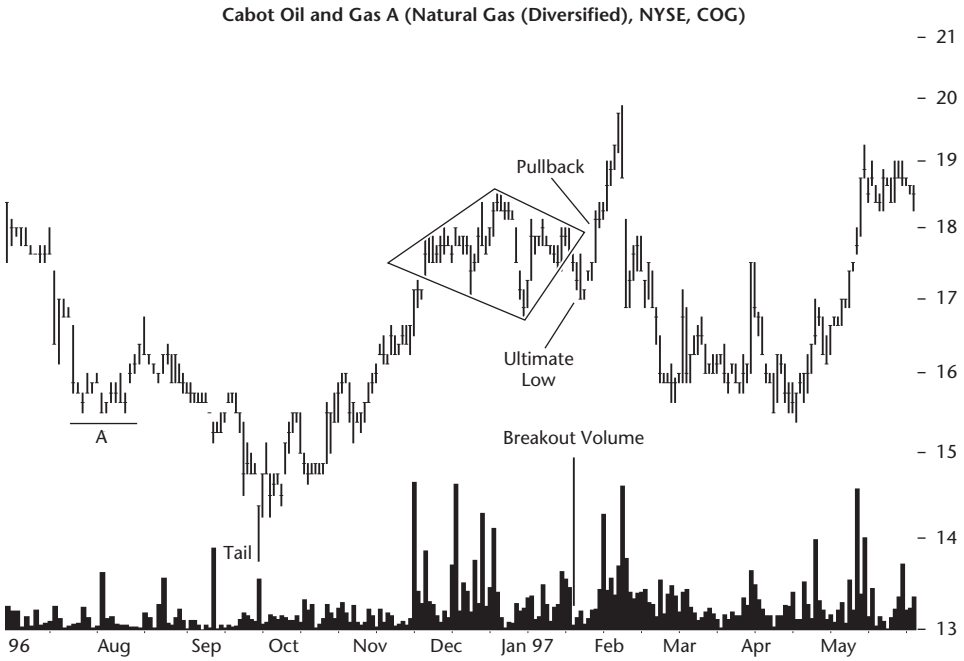


Figure 12.5 A valid diamond top breaks out downward but price fails to descend far because of underlying support.

If prices pierced the point A support zone at 15.50, I would expect a continued decline to the September low. To play it safe, perhaps a target of 14.50 (above the September tail because you do not want to place a target based on an outlier spike) would work.

A stop would have closed out my short position at the prior minor high (near the price level where the word "Pullback" points in Figure 12.5).

Why do chart patterns fail? Who knows? They just do. Use stops to protect your position and use conservative price targets.

Statistics

Table 12.2 shows general statistics for diamond tops.

Number of formations. I scoured my three databases to unearth enough diamonds to make the statistics tables worthwhile. Except for the bull market, downward breakout, I am not sure I succeeded. Still, my prospecting found 375 diamond tops. Most occur in a bull market (because that was the longest) and downward breakouts were more plentiful than upward ones. I used 500 stocks from mid-1991 to mid-1996 and another 200 stocks bracketing the bear market from 1999 to 2003. Additional samples came from periods between those two ranges.

Table 12.2
General Statistics

Description	Bull Market, Up Breakout	Bear Market, Up Breakout	Bull Market, Down Breakout	Bear Market, Down Breakout
Number of formations	88	28	203	56
Reversal (R), continuation (C)	88 C	28 C	203 R	56 R
Average rise or decline	27%	33%	–21%	–24%
Rises or declines over 45%	24 or 27%	6 or 21%	11 or 5%	3 or 5%
Change after trend ends	–29%	–34%	47%	47%
Busted pattern performance	26%[a]	28%[a]	–19%[a]	N/A
Standard & Poor's 500 change	7%	–1%	–1%	–9%
Days to ultimate high or low	81	66	52	43

Notes: Minus sign means decline. N/A means no samples available.

[a]Fewer than 30 samples.

Reversal or continuation. Since tops have prices entering the pattern from the bottom, most of the diamonds acted as reversals. These are the ones with downward breakouts. Diamonds with upward breakouts act as continuations of the prevailing price trend.

Average rise or decline. Diamonds with upward breakouts did not perform well, but downward breakouts held their own, meeting or beating the average decline for all chart pattern types.

Rises or declines over 45%. How well does the pattern do? Up breakouts show a reasonable number of large climbers but downward breakouts do not. Outsized declines are unusual, however, so do not be alarmed at the poor showing.

Change after trend ends. When prices reach the ultimate high or low, what happens? Here again, the showing is poor. After reaching the ultimate low, prices climb 47%. That figure may sound great but it falls short of some patterns that climb 60%. Once prices peak after an upward breakout, they drop between 29% and 34%. That is quite good.

Busted pattern performance. Since busted patterns are those in which price moves less than 5% after the breakout, diamonds with downward breakouts in a bear market had none that qualify. The others show poor performance and low sample counts, too.

Standard & Poor's 500 change. The numbers suggest how well you could have done if you bought the stocks in the index as opposed to trading the diamonds perfectly. The numbers also show the influence of the general market on the average rise or decline. A large up move (bull market) helps prices rise, while a downward move (bear market) pulls them lower.

Days to ultimate high or low. How long does it take price to reach the ultimate high or low? It ranges between 43 and 81 days, or about 6 to 11 weeks. Notice that prices in a bear market drop quicker than they rise in a bull market.

Table 12.3 shows failure rates for diamond tops under varying breakout directions and market conditions. I am sure your eye went first to the bear market, up breakout with a 0% failure rate. Look down at the bottom of the column. I found only 28 patterns. Of course, downward breakouts are more likely to happen in a bear market than upward breakouts, as the sample sizes attest (I found 56 patterns with downward breakouts in a bear market).

For small moves, diamonds with downward breakouts are the best bets. They have the lowest failure rates (if you exclude the low sample count, bear market, up breakout column). This changes for moves higher than 20%. For large moves, patterns in a bull market with an upward breakout show smaller failure rates.

How do you make sense of the numbers? Table 12.3 shows how likely it is that your pattern may fail to rise or drop a given amount. For example, in a bull market, 10% of the diamonds with upward breakouts will fail to rise more than 5%. Twenty-seven percent will fail to climb 10%. Similarly, 6% of the patterns in a bull market with a downward breakout will fail to drop more than 5%.

Table 12.4 shows breakout- and postbreakout-related statistics.

Formation end to breakout. The delay to the breakout is due to the way my software draws the diamonds. Ignore the numbers.

Yearly position. Where in the yearly price range do breakouts occur most often? The table shows that most diamonds have breakouts near the yearly high. After all, we are talking about diamond *tops*, not bottoms.

Table 12.3
Failure Rates

Maximum Price Rise or Decline (%)	Bull Market, Up Breakout	Bear Market, Up Breakout	Bull Market, Down Breakout	Bear Market, Down Breakout
5 (breakeven)	9 or 10%	0 or 0%	13 or 6%	2 or 4%
10	24 or 27%	3 or 11%	45 or 22%	8 or 14%
15	34 or 39%	5 or 18%	69 or 34%	14 or 25%
20	40 or 45%	10 or 36%	106 or 52%	24 or 43%
25	48 or 55%	12 or 43%	136 or 67%	38 or 68%
30	55 or 63%	16 or 57%	155 or 76%	43 or 77%
35	61 or 69%	18 or 64%	171 or 84%	49 or 88%
50	70 or 80%	23 or 82%	197 or 97%	56 or 100%
75	80 or 91%	26 or 93%	203 or 100%	56 or 100%
Over 75	88 or 100%	28 or 100%	203 or 100%	56 or 100%

Table 12.4
Breakout and Postbreakout Statistics

Description	Bull Market, Up Breakout	Bear Market, Up Breakout[a]	Bull Market, Down Breakout	Bear Market, Down Breakout
Formation end to breakout	3 days	2 days	3 days	3 days
Percentage of breakouts occurring near the 12-month low (L), center (C), or high (H)	L7%, C26%, H67%	L18%, C36%, H46%	L9%, C26%, H65%	L11%, C38%, H51%
Percentage rise/decline for each 12-month look back period	L25%[a], C31%[a], H22%	L54%, C21%, H36%	L22%[a], C22%, H20%	L19%[a], C16%[a], H29%[a]
Throwbacks/pullbacks	59%	54%	57%	57%
Average time to throwback/pullback ends	9 days	13 days	12 days	11 days
Average rise/decline for patterns with throwback/pullback	23%	30%	19%	18%
Average rise/decline for patterns without throwback/pullback	34%	35%	24%	30%[a]
Performance with breakout gap	16%[a]	32%	20%	19%[a]
Performance without breakout gap	29%	36%	22%	27%
Average gap size	$0.40	$0.91	$0.63	$0.53

Note: Minus sign means decline.

[a]Fewer than 30 samples.

Yearly position, performance. Mapping performance onto the yearly price range, we find mixed results. Bull markets do better when the breakout is in the middle of the yearly price range. Bear markets have too few samples to be usable. Upward breakouts do better near the yearly low, and downward breakouts do better near the yearly high.

Throwbacks and pullbacks. How often do prices throw back (upward breakouts) or pull back (downward breakouts) to the diamond trend line border or breakout price? Answer: about half the time.

The time to complete the throwback or pullback ranges between 9 and 13 days. When a throwback or pullback occurs, performance suffers, as Table 12.4 shows. Thus, the key to selecting better performing patterns is to search for underlying support or overhead resistance before investing. Nearby support or resistance may repel the downward or upward move, respectively.

Gaps. Across the board, gaps hurt performance. By gaps, I mean a price gap that occurs on the day price closes outside the pattern boundary (the breakout day). The average gap size varies from $0.40 to $0.91 depending on market conditions and breakout direction. Other chart patterns show larger gaps associated with downward breakouts, but the small sample size may explain the large gap size in diamonds with upward breakouts in a bear market.

Table 12.5 shows a frequency distribution of days to the ultimate high or low. Notice how many diamonds reach the ultimate move in the first few weeks. For example, in a bear market, 55% of those diamonds with downward breakouts top out in the first month. At the other end of the table, 13% are still searching for the ultimate low after 70 days (about 2.5 months).

Also notice the slight blip around a month into the trade. In a bear market, up breakout, 11% of the diamonds top out after 35 days. Skipping down, 14% of diamonds in a bear market with downward breakouts bottom around day 42. In fact, all patterns show a slight rise during days 35 or 42. This finding suggests

Table 12.5
Frequency Distribution of Days to Ultimate High or Low

Days:	7	14	21	28	35	42	49	56	63	70	>70
Bear market, up breakout	14%	11%	7%	7%	11%	7%	7%	4%	0%	0%	32%
Bull market, up breakout	18%	9%	10%	10%	3%	6%	2%	0%	2%	1%	38%
Bear market, down breakout	23%	11%	14%	7%	4%	14%	2%	4%	7%	2%	13%
Bull market, down breakout	18%	11%	6%	10%	6%	8%	5%	3%	2%	4%	27%

Table 12.6
Size Statistics

Description	Bull Market, Up Breakout	Bear Market, Up Breakout[a]	Bull Market, Down Breakout	Bear Market, Down Breakout[a]
Tall pattern performance	27%	37%	–26%	–28%
Short pattern performance	27%	29%	–18%	–18%
Median height as a percentage of breakout price	12.43%	17.18%	10.70%	16.33%
Narrow pattern performance	29%	29%	–22%	–24%
Wide pattern performance	26%	36%	–21%	–23%
Median length	37 days	40 days	36 days	32 days
Average formation length	46 days	54 days	48 days	47 days
Short and narrow performance	31%	33%	–18%	–21%
Short and wide performance	22%[a]	18%	–17%	–13%
Tall and wide performance	29%	42%	–25%	–27%
Tall and narrow performance	24%[a]	16%	–28%	–28%

Note: Minus sign means decline.

[a]Fewer than 30 samples.

price weakness (upward breakouts) or strength (downward breakouts) a month after the breakout. Keep that in mind, as you may need to exit your trade then.

Table 12.6 shows size-related statistics.

Height. Although the bear market columns have few samples, the trend is clear: Most tall patterns perform better than short ones. To determine if the pattern is short or tall, measure the diamond height from the highest high to the lowest low in the pattern and then divide by the breakout price (where price pierces the diamond boundary). If the result is larger than the median shown in the table, they you have a tall pattern; less than the median, the pattern is short.

Width. Most of the time, narrow patterns perform better than wide ones except for diamonds with upward breakouts in a bear market. In all cases, I used the median length as the separator between narrow and wide.

Average formation length. How long is the average diamond? It varies from 46 days to 54 days. That is just shy of 2 months. Since this is an average, your results will vary.

Height and width combinations. No one combination performs better than the others do, as Table 12.6 shows. However, most of the time, patterns that are both short and wide perform worse than the other combinations.

Table 12.7 shows volume-related statistics for diamonds.

Table 12.7
Volume Statistics

Description	Bull Market, Up Breakout	Bear Market, Up Breakout[a]	Bull Market, Down Breakout	Bear Market, Down Breakout
Rising volume trend performance	30%[a]	31%	–21%	–23%[a]
Falling volume trend performance	25%	33%	–21%	–24%
U-shaped volume pattern performance	25%[a]	43%	–22%	–22%[a]
Dome-shaped volume pattern performance	27%	30%	–22%	–27%[a]
Neither U-shaped nor dome-shaped volume pattern performance	30%[a]	19%	–19%	–19%[a]
Heavy breakout volume performance	27%	28%	–21%	–23%
Light breakout volume performance	27%	48%	–22%	–24%[a]

Note: Minus sign means decline.

[a]Fewer than 30 samples.

Volume trend. Diamonds in bear markets do best with a falling volume trend. Bull markets are either unchanged or do better with a rising volume trend.

Volume shapes. Diamonds show no consistent performance trends among the various shapes. That may be due to the small sample size. However, diamonds with a random volume shape (neither U nor domed) perform worse than three of four columns, so select diamonds with U- or dome-shaped volume.

Breakout volume. Oddly, diamonds with light breakout volume perform better than do those with heavy breakout volume most of the time (the exception is for diamonds with upward breakouts in a bull market). Many of the numbers are close or the samples few, so do not depend on the result.

Trading Tactics

Table 12.8 shows trading tactics for diamond tops.

Measure rule. Use the measure rule to predict a price target. Consider Figure 12.6, a chart of a diamond top. Compute the formation height by taking

Table 12.8
Trading Tactics

Trading Tactic	Explanation
Measure rule	Compute the formation height by subtracting the lowest low from the highest high in the formation. For downward breakouts, subtract the difference from the location where prices pierce the diamond boundary. For upward breakouts, add the difference to the breakout price. The result is the minimum price move to expect. Alternatively, formations often return to price levels from which they begin. The base serves as a minimum price move.
Wait for breakout	For best results, wait for price to close outside the diamond trend line before placing a trade.
Risk/reward	Look for support (risk) and resistance (reward) zones before placing a trade. These zones are where the trend is likely to pause or even stop. From the current closing price (before the breakout), compute the difference between the zones and the current price. The ratio of the two must be compelling enough to risk a trade.

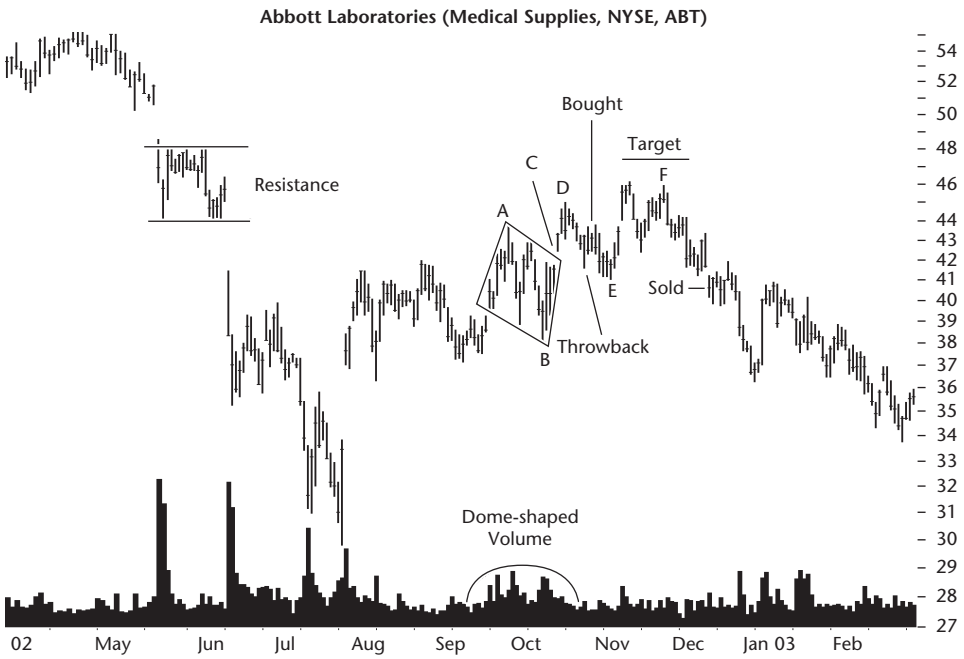


Figure 12.6 Shown is a diamond top with dome-shaped volume. To get a price target, compute the formation height (A – B) and add it to C, the breakout price. The result is the target price.

the difference between the high in the pattern (point A at 43.85 in this example) and the low (B at 38.08). Add the difference (5.77) to the breakout price (C at 41.85, the point at which price pierces the diamond boundary) to get the target (47.62). Price reaches the target between 69% and 79% of the time. See the Results Snapshot ("Percentage meeting price target") for the numbers. In this example, the diamond missed the target by falling short.

However, there is an alternative method that sometimes yields more accurate results. The method involves looking at the price chart and seeing if there is something to reverse. By this I mean diamonds sometimes form after a quick run-up in prices. The reversal will usually erase these gains and return prices to where they were before the run-up.

Wait for breakout. When trading technical formations like diamond tops, it is always safest to wait for the breakout. If you do not wait for the breakout, you may face a situation similar to that shown in Figure 12.4. Instead of reversing, prices resume their original trend and the investor, shorting before the breakout, takes a loss.

Risk/reward. Before placing a trade, consider the risk/reward ratio. In essence, you first identify the support and resistance levels and calculate the difference between those levels and the current price. Trades that result in risk/reward ratios of one to two or higher are worth making. With smaller ratios, the risk may be too high to warrant a trade.

Sample Trade

Figure 12.6 shows a diamond top Lorenzo traded. He first noticed the diamond well after it formed—during the throwback to be exact. The throwback's hooking pattern caught his attention, and he searched for a nearby chart pattern. In this case, he saw a diamond top, but was it a valid diamond or just cubic zirconia?

Lorenzo reviewed the identification guidelines and found that prices were rising into the pattern, verifying a top. The diamond shape, although pushed to one side, had an adequate number of touches of each diamond boundary (the trend lines). Volume receded from the middle of the pattern to the end, so it had a downward trend. In fact, the entire volume shape appeared domed. Dome-shaped volume for diamonds in a bull market with an upward breakout was a decent choice (not the best or worst; see Table 12.7).

Breakout volume was high but nothing to write home about and well below the peaks of a few days earlier. Prices also gapped upward, suggesting buying enthusiasm. However, he knew that breakout day gaps resulted in performance that was not as good as those diamonds without gaps. That made him nervous.

Since the breakout was upward, he checked for overhead resistance and saw the long island in May. Prices tested the region at point D, leading to the

throwback. Still, he knew that prices would eventually pierce such resistance zones, perhaps after multiple attempts to break through.

He computed the predicted price target using the diamond height projected upward from the breakout price and saw that the target was at the high end of the resistance zone. Thus, it looked likely that prices would throw back there. That meant watching the stock closely and selling when it neared the target to maximize profits. On the down side, if prices dropped, he would close out his position just below the diamond bottom (point B).

Two days after prices closed the gap in the throwback, he bought and received a fill at 43. In the days that followed, the stock dropped, and he knew from experience that many of his trades either did well immediately or fell apart. This looked as if it were going to result in a loss. He placed a stop-loss order to sell at 37.93. That was below the round number support at 38 and just below the diamond bottom.

Prices climbed. When they closed above the prior minor high, point D, he raised his stop to just below point E, a nearby minor low. Prices continued higher for two more days then retraced their gains, attempted another high (point F) and then started a long slide.

From experience, Lorenzo knew that a failure of price to make a higher high (at point F) was a bearish sign, but he hoped price would rebound. It did not. Instead, price gapped down and tripped his stop. The stock sold at 40.98, for a 5% loss.

What did he do wrong? I would not have taken this trade because of the overhead resistance. Since there are plenty of chart patterns in other stocks under more promising circumstances, why take one with high risk and limited profit potential? On the plus side, he used a stop-loss order and raised it as prices climbed. Eventually, the order took him out for a small loss. That is the way it should work when a trade goes bad. Let your profits run and cut your losses short.

For Best Performance

The following list includes tips and observations to help you select better performing diamonds. Refer to the associated table for more information.

- Correctly identify the pattern using the guidelines—Table 12.1.
- Downward breakouts occur most often and perform well—Table 12.2.
- Downward breakouts have the lowest failure rates for small declines, but upward breakouts have fewer failures for larger moves—Table 12.3.
- Throwbacks and pullbacks hurt performance. Avoid trades with nearby support and resistance zones—Table 12.4.

- Breakout day gaps suggest poor performance—Table 12.4.
- Expect a trend change about a month after the breakout—Table 12.5.
- Tall patterns usually perform better than short ones—Table 12.6.
- Avoid short and wide diamonds—Table 12.6.
- Select patterns with light breakout volume—Table 12.7.