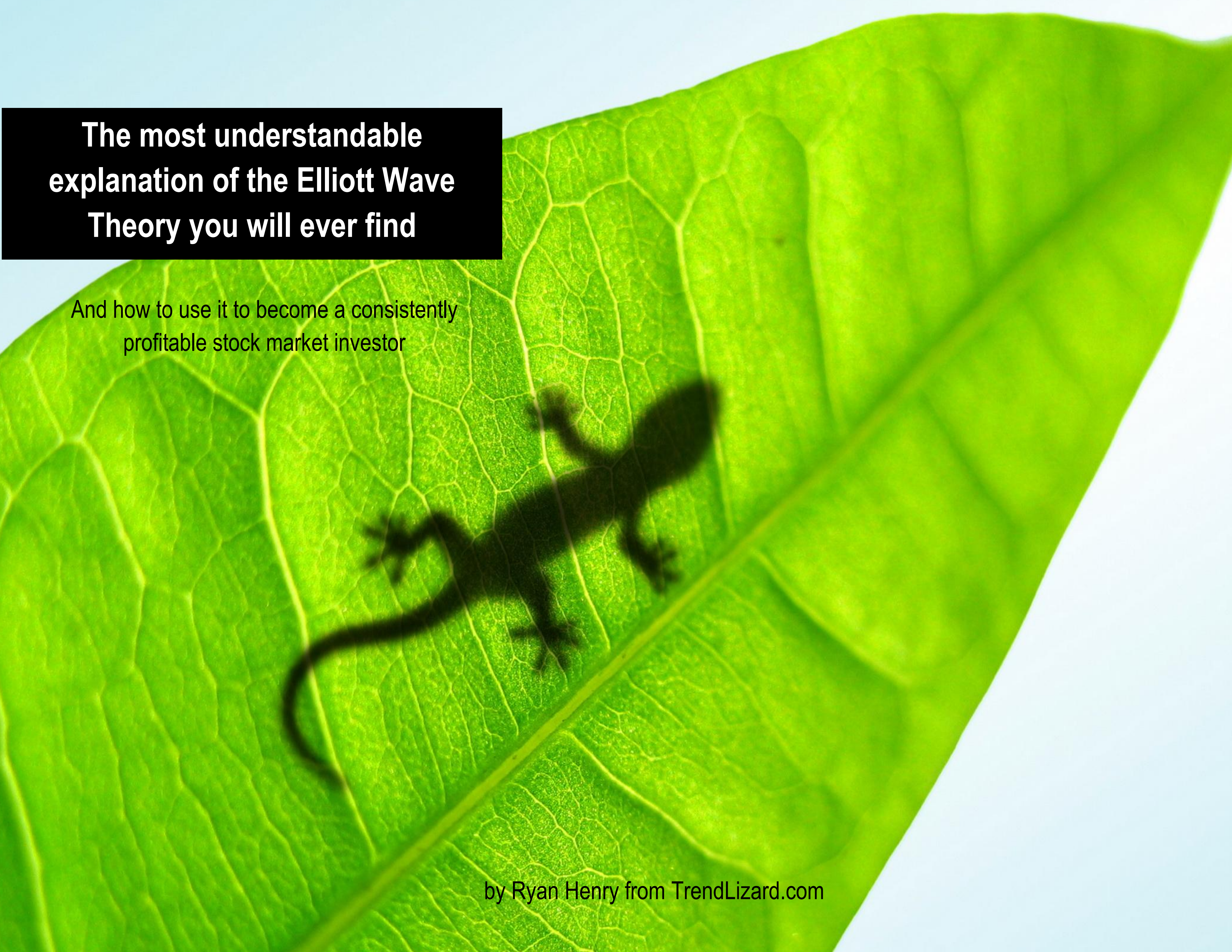


The most understandable explanation of the Elliott Wave Theory you will ever find

And how to use it to become a consistently profitable stock market investor

by Ryan Henry from TrendLizard.com

What is the Elliott Wave Theory?

The Elliott Wave Theory is a stock market investment strategy that determines if a potential investment is in a sustainable (and therefore tradable) trend. The theory is based on the fact that when you get a bunch of people together (the stock market is, after all, just a bunch of people), they take on a mob or herd mentality.

A herd mentality is when people in a group tendto act similarly to one another. It's been proven thatherd behavioris real, repetitive, and predictable.

The predictable and repetitive nature of herd mentality can be found in trends in birth rates, changes in fashion, or the types of movies that are most popular at any given point in time. The Elliott Wave Theory applies this concept to the stock market. It tries to identify where the stock market is in the predictable, repetitive pattern that is created by herd mentality.

Everyone who ever analyzed a stock or any other potential investment wants to know only one thing. They want to know where the price of the investment – stock, real estate, whatever - is going to go. If they can consistently find a way to identify the investments that are going to increase in value, then they will be a successful investor.

There are a lot of different strategies investors useto try to identify investments that will go up. For example, a lot ofinvestors look at the financial statements of a company to determine if that company is making an increasing amount of money every quarter (among hundreds of other financial health statistics).

Income Statement

Revenues*	$2,000,000
Less: Cost of goods sold	1,000,000
Profit before tax	1,000,000
Less: Provision for taxes	250,000
Net income	$750,000

Sometimes, the stocks of companies who are making an increasing amount of money go up. Sometimes, the stock price has already accounted for the growth in earnings so the stock price doesn't go up. Short of having information that others don't already have, it's difficult to look at companies financial statistics and consistently find winning investments.

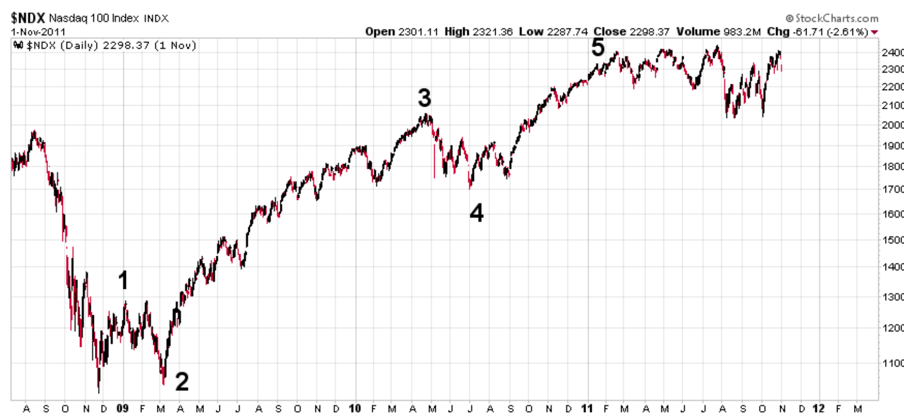
Finding investments that will go up

The Elliott Wave Theory uses a different approach. Using what it knows about the unavoidable behavior of a large group of people, it looks at the price movement of a potential investment to determine where that investment is in the predictable pattern that is created by herd mentality. If that can be determined, then it can be determined if it is a good investment that will increase in value. That's the basis of the Elliott Wave Theory, and it works. Let's get into how this theory works in the real world so that you can use it to consistently find investments that will go up.

Elliott Wave in real time

We talked about the predictable, repetitive pattern that is created by a herd mentality. So what is this pattern? Great question.When a stock or other potential investment is in a trend, its price moves in a five-phase pattern. Someone who is familiar with Elliott Wave will call this five-phase pattern a five-wave move, a trendy move or an impulse wave. These are the moves that we want to find and invest in because they are the moves that are going to continue.Investing early in five-wave moveswill yield us massive returns on our investment and therefore make us successful investors.

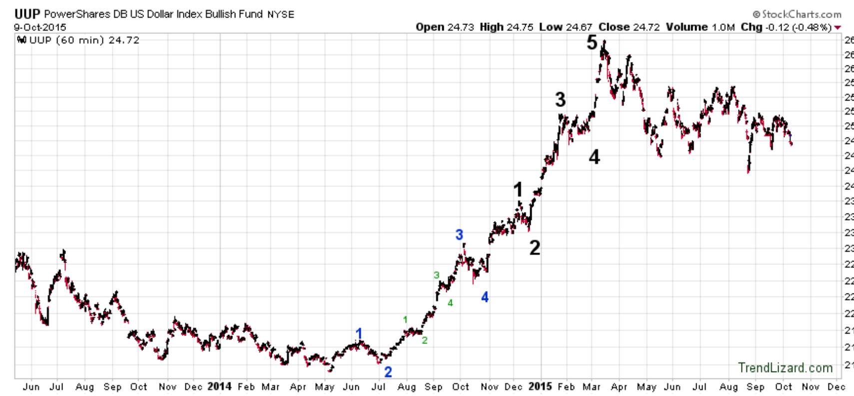
Let's look at an example of a five-wave move. This is a chart that tracks the price movement of the Nasdaq-100, which is a market index just like the S&P 500 or Dow. Market indexes give us a very good gauge of the direction of the overall stock market, as well as the market's herd mentality. Can you see the five-wave move on this chart?



The same price chart is now labeled to show all five phases of this big advance. The first phase or "wave" moves in the direction of the new uptrend and is labeled with a black one. This is the infancy of a new trend.At this point, not many investors buy into the idea that a new trend has begun. The second wave moves in the opposite direction of the new trend and often gives the impression that a new trend has *not* begun; it throws a lot of investors off the scent of the new trend. Next comes the third wave of the advance. This is when the advance really finds its groove, and more and more investors become interested in this dynamic price move. The fourth wave moves against the dominant trend; it essentially provides a chance to refuel and get ready for the next move. By this time, most investors are aware of the trend and are excited about partaking in the festivities – everyone else is. The final move is the fifth wave. Everyone who is going to invest in this trend is now invested. And that is precisely when the trend ends.

Every big advance that was ever worth investing in played out in five waves like this one. If we can identify investments that are in trendy moves, then we can buy the investment early and ride the trend to its completion. That's the best part; price action will constantly tell us if we're on the right track with our investment so that we can stick with a trend until its end. Here's why:

Look again at this chart and note that the first, third, and fifth moves of this five-wave pattern move with the uptrend, and the second and fourth waves move against the uptrend. What keeps us on the right track is that the moves that go with the trend (the first, third and fifth moves) are smaller five-wave patterns themselves. Now look again and note the small blue numbers. They show that each move in the direction of the trend has five waves itself. So any time the price of an investment is moving in the direction of its trend, it will give us five-wave patterns. This tells us every step of the way if we are trading with the trend or against it, and that is incredibly valuable information.

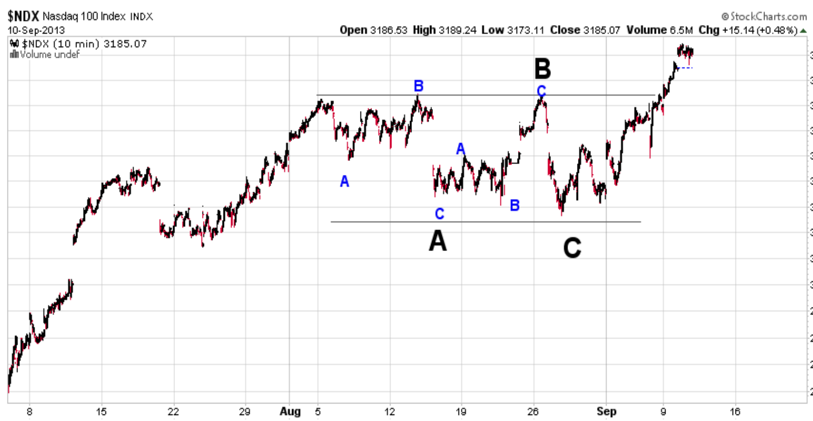


I could spend the next week showing youdifferent examples of trendy five-wave moves; they are everywhere. Instead, look for yourself. Look at some price charts (I recommend using stockcharts.com for price charts – no affiliation), find some big moves, and look for five-wave patterns. Note that downtrends play out in five waves too.

It’s not always rainbows and butterflies

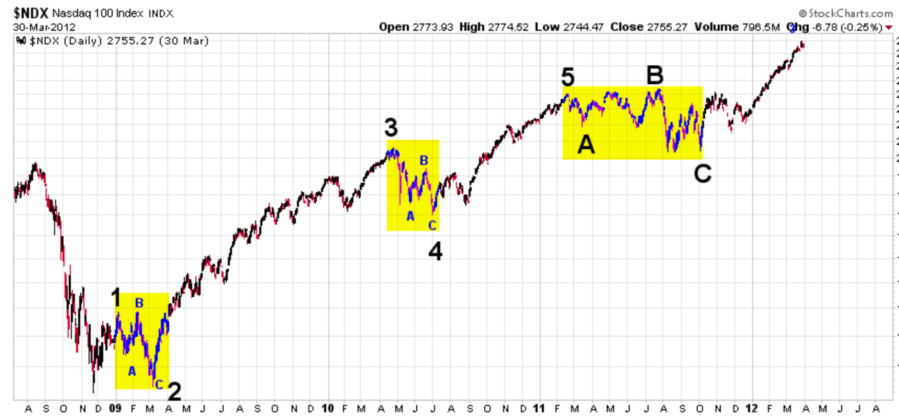
Of course if the price of every investment was always moving in a trendy way, investing would be easy.When an investment is not in a trend, it is in a countertrend or corrective price move. No one likes these moves; price doesn’t move in any meaningful way so it is really hard to make any money during corrective moves. But these price moves are just as important as trendy moves because they tell us which direction the trend is*not* headed.

Unlike trendy moves that play out in five phases, corrective moves play out in three phases. And while trends are purposeful and directional price moves, corrections are lesspurposeful and more indecisive.



Here is a good example of a corrective move. The trend was up before this corrective price move started. And the uptrend continued once the corrective price move ended. That is what happens with every corrective price move; it simply puts the trend on hold. You can see that it would have been difficult to make any money during this corrective move; price moved sideways in spastic fashion. Still, a corrective move gives us really good information. It tells us that the trend is still up. If you can find an investment that had previously been in an uptrend and is now about to complete a corrective pullback, the odds are very much in your favor that the uptrend is about to continue.

Corrective moves don’t happen just anywhere.

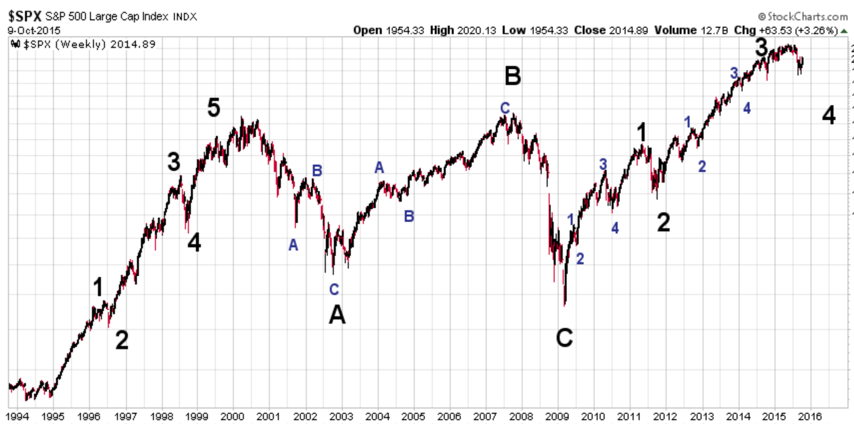


Recall that in a five-wave trend, the second and fourth waves move against the direction of the trend. These are corrective moves. You can see on the chart that the highlighted second and fourth waves of a five-wave advance play out in three waves. The other time you will see a corrective price move is when the entire trendy five-wave move completes. Look again at the chart and note that once the five-wave advance completed, a corrective three-wave pullbackplayed out.

On a side note, you might notice that corrective waves are labeled ABC instead of 123. Corrective price moves are always labeled with letters while trendy moves are labeled with numbers.

Together in perfect harmony

These trendy and corrective price moves don't just pop up on occasion like the price patterns other investors try to identify (such as a head and shoulders pattern). Instead, every piece of price action on a price chart is either in a trendy move or a corrective move – we just have to figure out which one. Here's a good way to think about it;if we recorded and charted price action from the very first day the stock market opened to the day it shut its doors and ultimately closed, the price pattern would be one massive five-wave trend. All price action in between would either be part of a trend or part of a corrective move. Massive bear markets that last years are just really big corrective three-wave moves.



Remember the devastating bear markets that played out from 2000 to 2002 and from 2007 to 2009? It didn't feel like the market was in some uneventful corrective pattern at the time, but that's exactly what it was – just on a really large scale. The trend was up going into that nearly decade-long correction, and the trend is up again now that the correction completed. As you can see, the market (or anything else you are analyzing) is always somewhere in the Elliott Wave pattern.

So let's circle back to the beginning.

The Nasdaq-100 just gave us a big trendy advance. It was followed by a corrective pullback. What's next? This five-wave advance told us the trend was up because only trends play out in five waves. The corrective three-wave pullback confirmed that the trend was still up. Let's see what happened from there:

The uptrend continued with purpose. The five-wave pattern we've been looking at is only the first wave of an even larger five-wave pattern (see the red labeling). This is how all trends unfold.

Keep it simple

There are other rules that provide some framework for how to properly identify five-wave moves. The big one is that a second wave (a countertrend move) can never move below the starting point of the first wave and similarly a fourth wave can't move below the starting point of the third wave. Learning some of the other nuances of the Elliott Wave Theory is likely in your best interest, and it's not hard to find information out there on the subject. But just as important is to keep your application of the theory really simple. Too many users of this theory try to turn it into a science. They might watch the minute-by-minute price movement of an investment, expecting to find clean, useful Elliott Wave patterns. I hate to break it to you, but it's not going to be perfect on a really small time frame; there are humans involved, after all.

Another problem I've seen is that people try to use this theory to predict the future. At the sight of a strong move, they confidently announce that the next great bull market (aka the next big five-wave move) is at hand. Then they fight tooth and nail to support that claim, even when it becomes long beyond obvious that things have changed and their claim is wrong. You can't fall victim. This theory provides us constant feedback; constantly listen to it. If you are trying to invest in a stock's uptrend and it falls into a corrective pullback, this is a great indication that you are on the right side of that investment. If instead the stock unexpectedly reverses its uptrend and suddenly gives you trendy down moves, exit the investment. Never get married to what you think is going on; instead simply let price action and the search for trendy vs. corrective price moveskeep you on the right side of the trend.

The best advice I can give you is to find stocks that have been in a strong and well-established trend. Look for trendy (five-wave) price movement that is occurring in the same direction as the well-established trend. If you find it, buy the investment and allow price action to guide you from there.

Cash money

Believe what you want about the reasoning behind it, but plain and simple, the Elliott Wave Theory works. Go look at the price charts of some of the stocks in the S&P 500, on any time frame over a few months, and you'll see the "waves" at work. Not only is this the simplest, it's also the most effective way I have found to consistently and accurately identify a trend while gaining some concept of how long that trend might continue. And at the end of the day, the whole purpose of any trading strategy is to identify and trade the trend.

Ryan Henry is the co-founder and lead analyst at TrendLizard.com. Every day they apply the Elliott Wave Theory to 37 Exchange-Traded Funds (ETFs) to identify the strongest and most tradable trends. Then they tell you exactly how to trade those trends, from start to finish.