Brainy's Articles on

Technical Analysis

Dow Theory

Introduction

The term *Dow Theory* refers to a body of knowledge (or collection of ideas) which underpins key aspects of contemporary technical analysis. It was first observed by Charles Dow, and then expanded in numerous writings by others including: William P. Hamilton, Robert Rhea and E. George Schaefer. Dow Theory is very relevant today as a lot of what we know as Technical Analysis is based on the principles of Dow Theory.

Dow Theory is mostly to do with interpreting underlying market mood and emotion by looking at the presence or absence of trends and the nature of any trend, by looking at the performance of key market sectors, and by studying volume on the price charts. It is very interesting that the original proponent of these ideas was the editor of what became a major newspaper.

It is very important for Technical Analysts to have some knowledge of Dow Theory as the basic principles are very sound, and of great value when they are understood. This cannot be over-stated.

This article in Brainy's series on Technical Analysis (number TA-2200) provides an introduction to the topic of Dow Theory. Some of the ideas discussed here are covered in more detail in other articles in Brainy's series on Share Trading, or Technical Analysis. Readers are encouraged to see the latest list of Articles in the ***Share Market Toolbox***[1].

Who was Charles Dow?

Charles H. Dow (1851–1902) was the founder and first editor of the *Wall Street Journal*, and co-founder of *Dow Jones and Company*. He was the person who devised the stock market index which is known today as the Dow Jones Industrial Average (DJIA).

Charles Dow did not actually write down what we now refer to as Dow Theory. He talked about it extensively and in his editorial writings in the newspaper. Compiling, interpreting and extending the Dow Theory body of knowledge was done later by his associates. There are written records of Dow's ideas in the editorials of many editions of the Wall Street Journal in 1901 and 1902.

Because he didn't actually write out and publish the “Dow Theory”, we can today read various interpretations of the theory, and different wording about the theory. Nonetheless, there are six basic principles of Dow Theory, as explained below.

Dow talks about the “averages”

Throughout Dow's writings, and the subsequent materials on this topic, there is constant reference to the “averages”. This is a reference to the stock market indexes — the Dow Jones Industrial Average DJIA (an index of the industrial or manufacturing companies), and the Transport Average (an index of rail companies, formerly known as the Dow Jones Rail Index, as rail was the major method of shipping goods around the country). This is a clear reference to key indexes on the US market, but the principle also applies in other markets in other countries.

Basic principles of Dow Theory

The six basic principles of Dow Theory can be summarised as follows, with more detail in the pages that follow.

- The averages (ie. the market indexes) discount everything
- The market has three main movements (market trends)
- Primary movements (or market trends) have three phases
- Determining the trend
- Both averages must confirm
- Volume provides additional evidence.

1 www.robertbrain.com/articles

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