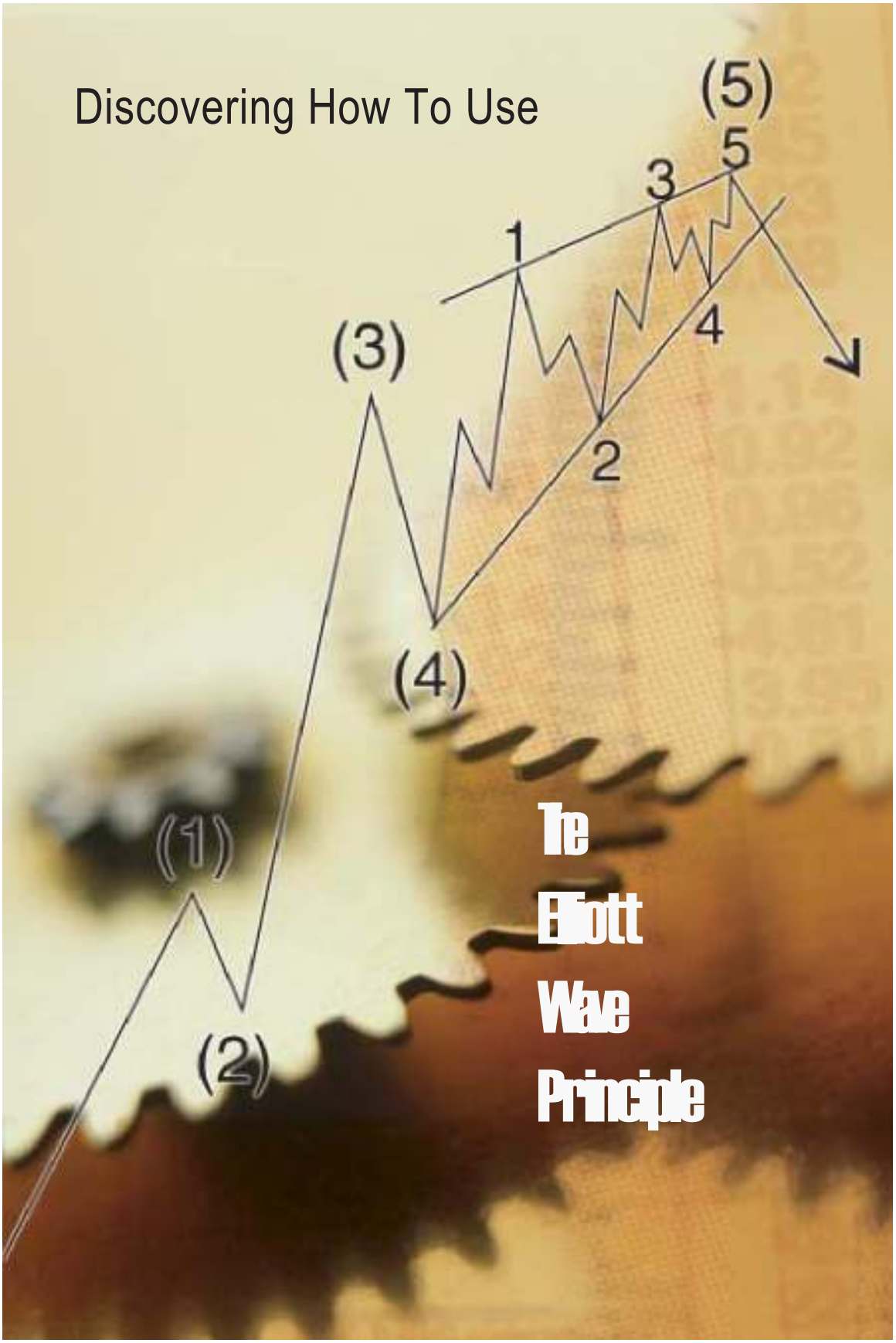
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The
Elliott
Wave
Principle

# Discovering How To Use
# The Elliott Wave Principle

## The Concept

When investors first discover the Wave Principle, they're often most impressed by its ability to predict where a market will head next.

And it *is* impressive. But its real power doesn't end there.

The Wave Principle also gives you a method for identifying at what points a market is *most likely to turn*. And that, in turn, gives you guidance as to where you might enter and exit positions for the highest probability of success.

## Step 1: Pattern Analysis

At its most basic level, wave analysis is simply the identification of patterns in market prices.

The idea that market prices are patterned was intensely controversial just a few years ago. But no longer. Recent discoveries have confirmed that patterns exist in many natural systems even systems that previously appeared to be random.

Examples include the weather, botany, geography and even human physiology.

Generally, these systems unfold in patterns of "punctuated growth" that is, periods of alternating growth and non-growth, or even decline. The patterns then build on themselves to form similar designs at a larger size, and then the next size up, and so on.

This emerging science is called "fractal geometry." It is one of the most exciting branches of Chaos Theory. And it is precisely the model identified by R.N. Elliott some 60 years ago in the financial markets.

## The Basic Pattern

Elliott's pattern consists of "impulsive waves" and "corrective waves." An *impulsive wave* is composed of *five subwaves*. It moves in the *same* direction as the trend of the next larger size. A *corrective wave* is divided into *three subwaves*. It moves *against* the trend of the next larger size.

As Figure 1 shows, these basic patterns build to form five- and three-wave structures of increasingly larger size (larger "degree," as Elliott said).

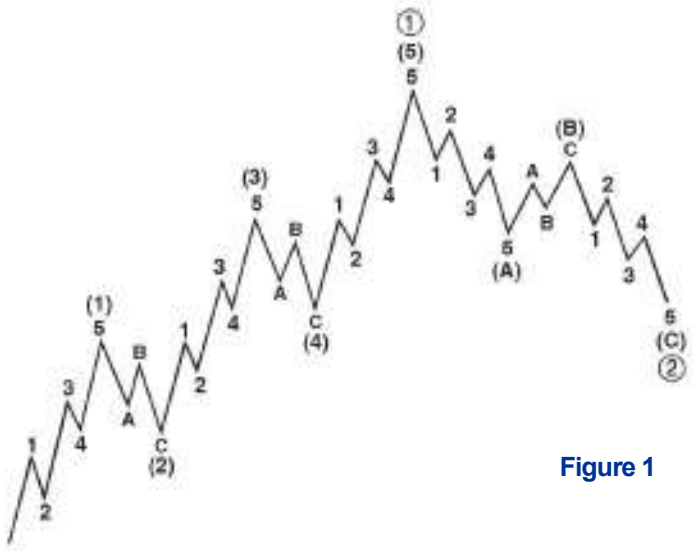



**Figure 1**

In the above illustration, waves 1, 2, 3, 4 and 5 together complete a larger impulsive sequence, labeled wave (1). The impulsive structure of wave (1) tells us that the movement at

the next larger degree of trend is also upward. It also warns us to expect a three-wave correction — in this case, a downtrend. That correction, wave (2), is followed by waves (3), (4) and (5) to complete an impulsive sequence of the next larger degree, labeled as wave 1. At that point, again, a three-wave correction of the same degree occurs, labeled as wave 2.

Note that regardless of the size of the wave, each wave one peak leads to the same result a wave two correction.

Within a corrective wave, subwaves A and C are usually *smaller-degree impulsive waves*. This means they too move in the *same* direction as the next larger trend. (In Figure 2 below, waves A and C are in the same direction as the larger wave (2).) Note that because they are impulsive, they themselves are made up of *five subwaves*. Waves labeled with a B, however, are *corrective* waves; they move in *opposition* to the trend of the next larger degree (in this case, they move *upward* against the *downtrend*). These corrective waves are themselves made up of *three* subwaves.

## Step 2: Trends and Turns

The analyst's first task is to look at charts of market action and identify any completed five-wave and three-wave structures. Only then can he interpret where the market is and where it's likely to go.

Say we're studying a market that has reached the point shown in Figure 2. So far we've seen a five-wave move up, followed by a three-wave move down.

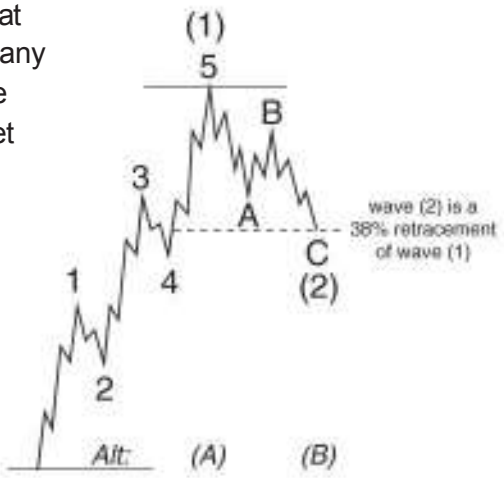



**Figure 2**

But this is not the only possible interpretation. It is also possible that wave (2) hasn't ended yet; it could develop into a more complex three-wave structure before wave (3) gets underway. Another possibility is that the waves labeled (1) and (2) are actually waves (A) and (B) of a developing three-wave *upward* correction within a larger impulsive *downtrend*, as shown in the "Alternate" interpretation at the bottom of the chart. According to each of these interpretations though, the next imminent movement is likely to be upward.

This illustrates an important point concerning the Wave Principle. It does not provide *certainty* about any one market outcome. Instead, it gives you an objective means of determining the *probability* of a future direction for the market. At any time, two or more valid wave interpretations usually exist. So it's important for the investor to carefully assess the probability of each interpretation.

View the Wave Principle as your road map to the market and your investment idea as a trip. You start the trip with a specific plan in mind, but conditions along the way may force you to alter your course. Alternate counts are simply side roads that sometimes end up being the best path.

Elliott's highly specific rules keep the number of valid interpretations to a minimum. The analyst usually considers as "preferred" the one that satisfies the largest number of guide-lines. The top "alternate" is the one that satisfies the next largest number of guidelines, and so on.

Alternates are an essential part of using the Wave Principle. They are not "bad" or "rejected" wave interpretations. Rather, they are valid interpretations that are given lower *probability* while the count works itself out. If the market doesn't follow the original preferred scenario, the top alternate usually becomes the preferred.

Elliott's rules give specific "make-or-break" levels for a given interpretation. In Figure 2, for example, if the move labeled wave (2) *continues below the level of the beginning of wave* (1),

then the originally preferred interpretation would be instantly invalidated.

By eliminating subjectivity, the rules help you firm up your investment strategy and reduce your risk.

## Fibonacci Relationships

Fibonacci ratios are named for the famous 13th-century mathematician Leonardo Fibonacci of Pisa, the most important mathematician of the Middle Ages. Fibonacci popularized the current decimal and Hindu-Arabic numbering systems. He also discovered (actually rediscoered) the numeric sequence that bears his name, the Fibonacci sequence which begins with the number 1 and in which each subsequent number is the sum of the previous two: 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89 and so on. The sequence in turn gives rise to several unique ratios, including .618, .382 and 1.618 — the Golden Ratio. These ratios exist throughout nature, in everything from population growth to the physical structure within the human brain, the DNA helix, many plants and even the cosmos itself.

Many investors today know that Fibonacci ratios are used for market forecasting. But few realize that Fibonacci analysis of the markets was pioneered by R.N. Elliott. The use of Fibonacci ratios requires a valid Elliott wave interpretation as a starting point. Unfortunately, many non-Elliott analysts try to find Fibonacci proportions between market moves that are not related to each other in any way. This has made the approach appear far less valuable than it is.

Elliott had two chief insights concerning Fibonacci relationships within waves. First, corrective waves tend to retrace prior impulse waves of the same degree in Fibonacci proportion. For example, wave (2) in Figure 2 retraces 38% of wave (1). That's a common relationship. Other frequent wave relationships are 50% and 62%. Second, impulse waves of the same degree within a larger impulse sequence tend to be related to one another in Fibonacci proportion. (See Figure 3.)

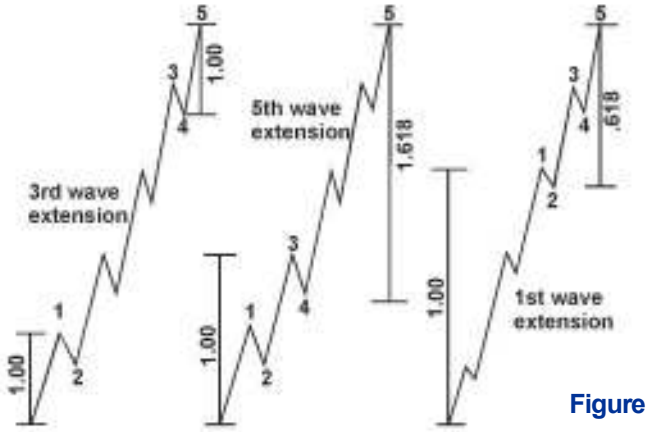



**Figure 3**

## Establishing Investment Strategy and Reducing Risk

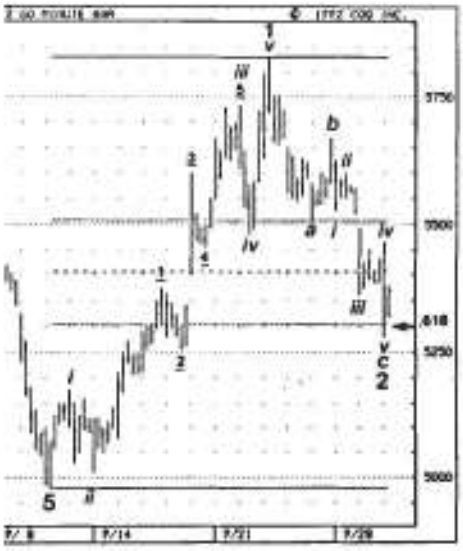
Wave interpretation rules and Fibonacci relationships together are powerful tools for establishing investment strategies and reducing risk exposure. Investors use them to help decide where to get in, where to get out and at what point to give up on a strategy. Thus, the Wave Principle lets you identify the highest-probability direction for the market, plus adopt an optimum position to take advantage of it all while protecting yourself against lower-probability outcomes.

Figure 4 shows a real-life example of a market that has reached a point like that shown in Figure 2. The lowest point on the chart is the end of a fairly large-degree decline. Thus, the investor would look for at least a three-wave move to the upside at the same degree.

In this case, the market has moved up in five waves in about two weeks, with a three-wave downward correction afterward, as in the movement shown in Figure 2.

Once wave 1 to the upside is complete, the investor can set price targets for wave 2. In a given five-wave impulse sequence, wave 2 most often retraces 62% of the preceding wave 1; next

Figure 4



most common are 38% or 50% retracements. These relationships generate targets of approximately 5300, 5500 and 5400 for the bottom of wave 2, in order of probability.

So if prices drop substantially below the 62% retracement point at about 5300, probability shifts away from the preferred interpretation. And if prices fall all the way beyond the low just under 5000, this development will violate the rule that second waves may not retrace more than 100% of first waves. This will require the investor to shift to an alternate interpretation, if he or she has not already done so.

The investor can take advantage of these rules and relationships in various ways. For example, a longer-term investor might see an opportunity near 5000. He would look to benefit from the entire expected upmove, ignoring interim corrections. Also, knowing that wave 2 cannot more than fully retrace wave 1, he could determine that his interpretation would be wrong if the market were to dip below the low. He could choose to limit his risk there. Or, because he knows that it is unusual for wave 2 to significantly exceed a 62% retracement of wave 1, he might limit his risk at *that* level and thus ahead of

other sellers.

A shorter-term investor has a different opportunity. He might look to take advantage of each of the subwaves in the impulsive move up. For example, after noting the end of wave 1, he'd view a 38% retracement as the most likely *minimum* downside potential for wave 2. He would invest accordingly. Then he would watch for an acceptable a-b-c pattern to signal a reversal. When he saw it, he would look to catch the expected wave 3 uptrend, and so on.

As Figure 4 shows, wave 2 displays a three-wave, a-b-c structure. That structure can be interpreted as complete at about 5275, fractionally below the ideal 5300 retracement level. This outcome increases confidence in the preferred interpretation.

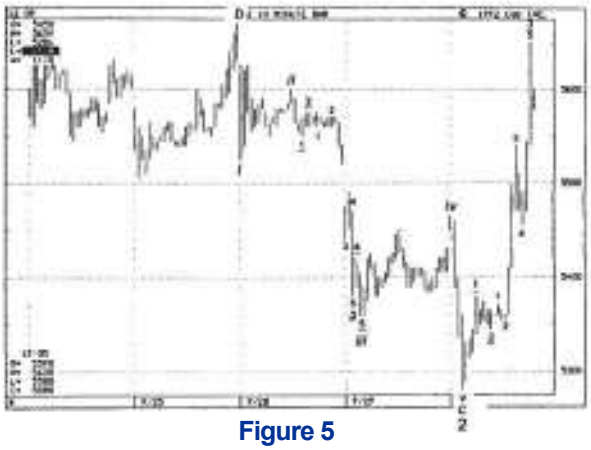


**Figure 5**

Figure 5 shows subsequent market action on a zoomed-in, shorter-term chart. The market reversed sharply higher from the wave 2 low, displaying clear impulsive action. Thus, the investor can look forward with confidence to a move well above the top of wave 1 at about 5800. He will check his strategy again at that point and watch for signs of a reversal. He is of course continually monitoring the market for signs that his road map is keeping him on the right path.

By the way, we've chosen an exotic market as our example to prove a point. Elliott counts work not only in commonly traded indexes and stocks, but also in *any* freely traded market.

## State-of-the-Art Forecasting

The basics of the Wave Principle remain as Elliott formulated them. Those basics are fully described in the standard textbook of wave analysis, *Elliott Wave Principle Key to Market Behavior*, by A.J. Frost and Robert R. Prechter, Jr. (Prechter is founder and president of Elliott Wave International.) That book, and the real-time performance record of EWI's market forecasting services, rescued the Wave Principle from obscurity and propelled it to worldwide acceptance as perhaps the most sophisticated form of technical analysis.

Today, Elliott Wave International's analysts cover every major market in the world, including currencies, equities, interest rates, metals, energy and commodities. When you subscribe to the services of Elliott Wave International, you're receiving more than just an opinion about a market. You're receiving the expertise of the world's foremost Elliott wave research and forecasting organization, staffed by seasoned financial professionals with years of front-line experience in the markets they cover. And you're receiving forecasts based on the most sophisticated, most objective, most advanced analytical method known: the Elliott Wave Principle.

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