TRADING TECHNIQUES

Trading With The Cup-With-Handle

Here are some more nuances for trading stocks based on the charting pattern called the cup-with-handle pattern introduced by William O'Neil.

by Gregory Kuhn

How much would you pay for a trading system that accurately identified the buying trend of the smart money early enough to profit? Would you spend no more than the annual subscription to a chartbook service? The biggest problem in searching for chart formations is that if you look hard enough at a stock's one-year graph, you're bound to find any formation you want to conform to your bias. But the smart money has a way of leaving subtle footprints in the way some chart patterns form.

The cup-with-handle pattern, when combined with price and volume action, is often the result of such footprints. The volume surges that typically accompany the rally days in a sound cup-with-handle base - clues that investors are building a position - don't occur because there are more buyers than sellers; they occur because the buyers are much bigger. The mystique behind the cup-with-handle's basic structure, however, is nothing more than understanding a simple technique - the 1-2-3 change of trend as explained by Victor Sperandeo in *Trader Vic: Methods of a Wall Street Master.* Sperandeo points out that fortunes are often made by simply identifying a change of trend. Of all the technical indicators and rules I have studied over the years, this single rule is by far the most important I've learned.

The 1-2-3 change of trend - hidden within the cup-with-handle - gives a trader the opportunity to get on board a new uptrend at its earliest emerging point. Let's look at the 1-2-3 change of trend as part of the development of the cup-with-handle pattern.

IDENTIFYING A TREND CHANGE

A security that is trending higher is recognized by a series of higher highs preceded by higher lows. Following a stock's strong advance over many months (actually, any tradable can be substituted), a corrective process eventually ensues, resulting in a downtrend as traders take profits. The downtrend will consist of lower lows preceded by lower highs. This downtrend forms the left side of the cup. Soon, the stock begins its bottoming process as selling pressure subsides. If a trader recognizes that the downtrend has ended, then there is an opportunity to buy the stock. The following steps are the process to identifying the end of the corrective downtrend.

Step 1 of the trend change (Figure 1) is marked when the stock's downtrend line is breached as eager buyers exchange trades with reluctant sellers, lifting the price of the stock higher. As the stock advances off its bottom, those who bought on the cup's declining left side sell into the stock's rally. This initial line of overhead resistance is typically strong enough to stall the advance temporarily.

Step 2 of the change of trend is the retest of the lows. In many cases, though, the stock never actually comes close to its lows. Instead, it enters a short-term consolidation over a period of weeks.

Step 3 - the trend change signal - occurs when the stock breaches its minor (or reaction) high created during the downtrend identified in step 1. This step represents the earliest emerging point of a new uptrend - the first higher high preceded by a higher low. In recognizing this stage, the trader may be able to take a position before the cup-with-handle is completed (Figure 1). Taking this position after the completion of the 1-2-3 change of trend but before completion of the cup-with-handle pattern is similar to starting the race before the gun goes off.

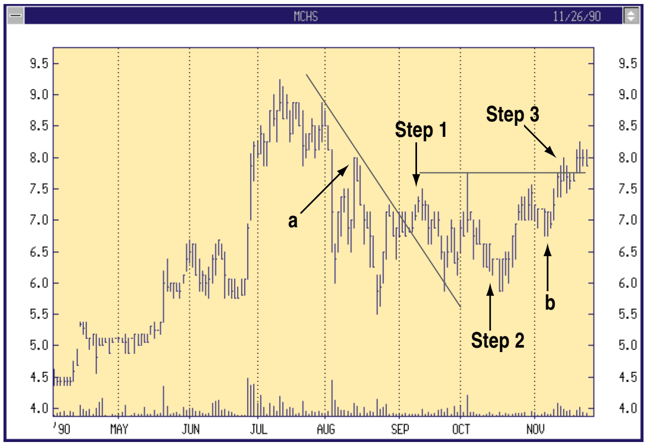

FIGURE 1: MICRO HEALTHSYSTEMS, 4/90-11/90. For a trendline to be valid in a downtrend, it must touch the last lower high preceding the lowest low (a). The downtrend line is broken at step 1; successful test of the lowest low forms step 2; the earliest emerging point of a new uptrend occurs at step 3. A higher low precedes a higher high at step 3 (b).

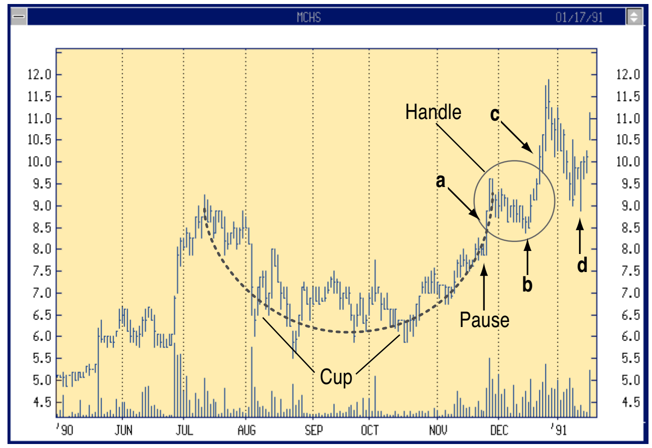

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FIGURE 2: MICRO HEALTHSYSTEMS, 5/90-1/91. The cup-completion cheat breakout (a) is a good place to buy because you can use the handle low (b) for your risk point if the market trends higher. If you had bought during the handle breakout to new highs (c), you may have been forced to sell out during a normal retest (d).

CUP-COMPLETION CHEAT

The cup-completion cheat rule means that we are buying the stock just after step 3 of the 1-2-3 change of trend signal instead of waiting for a handle to form at higher prices, which is the recommended entry point for the cup-with-handle pattern method. Not only will buying the stock early provide more profit potential if the stock successfully forms a handle and breaks to new highs, it allows the trader to set a more effective stop-loss, one based on money management and technical support.

The cup-completion cheat rule can be traded when the following conditions are met:

1. The bottom of the cup is formed on low volume, while rising volume accompanies the rallies completing step 1 and step 3, and the consolidation following step 3 is also accompanied by low volume. One way to check this condition effectively is by identifying the accumulation/distribution rating in *Investor's Business Daily* (IBD). An "A" rating is preferred showing strong demand at this point, but a "B" rating is also acceptable.
2. The IBD relative strength ranking is 90 or higher. This would indicate the stock is a leader, even as it forms a new base.
3. As the stock breaks out from its consolidation area following step 3, volume should increase by at least 40% over its 50-day average.

Once the stock breaks out from this point, it will normally succumb to profit taking at its final resistance point near the old highs, completing the right side of the cup to form the handle portion of the cup-with-handle. You should sit tight, holding your position, because the evidence indicates the price of the stock will ultimately move higher.

FIGURE 3: MICRO HEALTHSYSTEMS, 5/90-4/91. The stock advanced more than 200% during the next four months as a new bull market sprang to life in 1991.

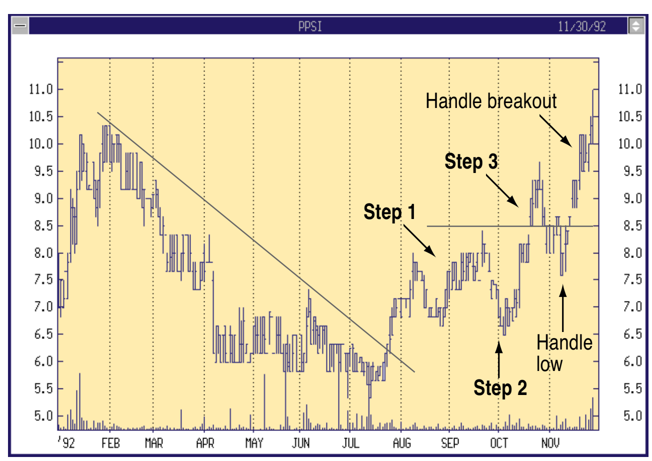

FIGURE 4: PACIFIC PHYSICIAN SERVICES, 1992. The cup-completion buy point was simultaneous with a trend change signal on Pacific Physician Services (PPSI).

SETTING A MORE EFFECTIVE STOP-LOSS

In *Reminiscences of a Stock Operator*, the narrator comments that it's never the thinking that makes big money, it's the sitting. In other words, winning trades tend to take care of themselves — it's the losses that must be controlled. Before potential profit can be considered, the trader's first question should always be, "How much money can I lose on this trade?"

Although setting the most effective stop-loss is often elusive, the answer should always have something to do with money management. Unfortunately, buying on a breakout from a cup-with-handle pattern while waiting for volume confirmation and dealing with slippage doesn't always provide the trader with a very good spot to decide when the trade is in jeopardy. To help in this regard, an experienced trader can buy in increments in anticipation of a breakout, but it's tricky.

Following a cup-with-handle breakout, a temporary pullback into the base formation is normal in some cases. But there's probably nothing more frustrating than being stopped out on a *normal* pullback, only to have the trade return to its original direction and proceed much higher.

Buying half of an allocated position on the cup-completion cheat breakout and adding the remaining half on the handle breakout or just taking a full position at this point lowers the trader's average cost. This allows a stop-loss to be set at a point where a pullback can be considered *abnormal* — a point where the trade may be in jeopardy — but still within the confines of good money management. Let me illustrate this technique.

Micro Healthsystems (MCHS) emerged from a perfect cup-with-handle pattern in late 1990. But once a 1-2-3 change of trend was complete, MCHS paused on the right side of the cup for a few days, giving traders an opportunity to buy in before the formation of a handle at higher prices (Figure 2). Even if the trader managed to buy MCHS at the day's high at $8\frac{7}{8}$ as it emerged from its pause on November 27 (see point a), a reasonable stop-loss would never have been hit.

Using an 8% stop-loss† (money management) would give the trader an $8\frac{1}{8}$ exit price. After a successful breakout from a cup-with-handle pattern, the stock is already well into a confirmed uptrend. To negate the trend either temporarily or permanently, the stock would have to decline below the last higher low — the bottom of the handle area. With the handle low at $8\frac{3}{8}$ (point b), the trader now has a stop-loss based on money management and at a point where the rising trend can be considered in jeopardy — a move below the handle.

Shortly after its breakout, MCHS failed abruptly as the market soured over Persian Gulf War concerns in January 1991. If the trader waited and bought instead on the handle breakout around 10 in late December (point c), an 8% stop-loss set at $9\frac{1}{4}$ would have forced the trader to sell as the stock temporarily broke below 9 in January (point d). This was the disciplined thing to do, but since the rising trend was still intact, the pullback proved to be a test of support. The trader who cheated was still on board and avoided a whipsaw that would have left too much money on the table (Figure 3).

Of course, it doesn't always work out this wonderfully. Pacific Physician Services (PPSI) broke out of a simultaneous 1-2-3 change of trend and cup-completion cheat on October 21, 1992, at $8\frac{1}{2}$ (Figure 4). However, a stop-loss set at 8% below the purchase price would have been triggered when the stock quickly pulled back to $7\frac{1}{2}$ to form a handle bottom. But since the cup-with-handle is still forming, the trader can re-enter a position on the handle breakout at higher prices. The result? A 65% gain in two months.

In two recent cases, US Delivery Systems (DLV) and Grist Mill (GRST) both set up cup-completion cheat breakouts. Following a perfectly shaped left side of a cup and bottom, DLV surged off its lows on expanding volume in late January 1995 to form the right side, then paused for a week as it bumped into overhead resistance from the left side of the cup (Figure 5). Since DLV's relative strength ranking was 92 at this point, the stock could have been purchased as it broke above $16\frac{3}{8}$ cheat on expanding volume. Purchased at $16\frac{1}{2}$, an 8% stop-loss can now be placed at $15\frac{1}{8}$, which turned out to be more than a point below the handle low at $16\frac{3}{8}$ (Figure 6).

Once DLV failed and broke below the handle low in early March, the string of higher highs and higher lows was then broken and the rising trend was in question. Using the handle low as a stop-loss point, the trader can exit the trade with a smaller loss rather than waiting for the initial stop to be hit.

Although DLV soon returned to its original direction — an *apparent* whipsaw† — the poor price-and-volume characteristics that accompanied the move implies a weakening situation in which the trader would not be likely to forfeit a huge gain. The whole intent in buying off of a constructive cup-with-handle pattern is to identify a stock with a strong capability of doubling in three to nine months. And studies performed by *Investor's Business Daily* founder William O'Neil, who is credited with coining the cup-with-handle name, of history's greatest winning stocks showed that winning stocks seldom dropped 8% below their correct buy spots before their huge moves.

Let's use two traders to illustrate the Grist Mill (GRST) trade. GRST maintained a relative strength rank of 93 and an accumulation/distribution rating of A as it broke out on heavy volume from its cheat area on March 21 (Figure 7). Trader A cheated and purchased the stock at $11\frac{1}{8}$ on March 21, then set an 8% stop-loss at $10\frac{1}{4}$. Trader B waited and bought on the handle breakout at 12 on April 3, setting an 8% stop-loss at 11. When GRST pulled back into the handle area and hit $10\frac{3}{4}$ on April 20, Trader B was stopped, while Trader A was still in the position. As this was being written, GRST has held above the

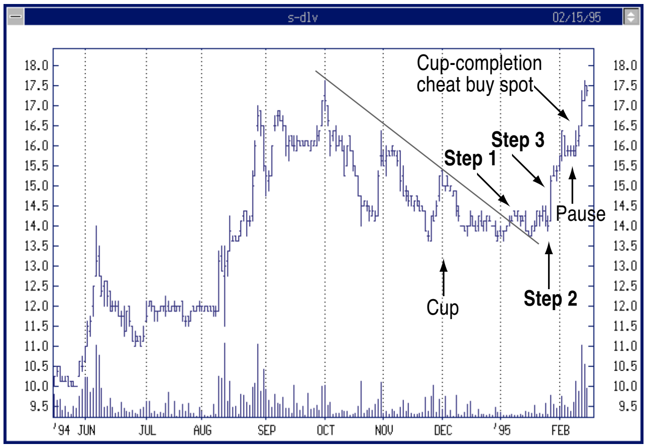

FIGURE 5: US DELIVERY SYSTEMS, 5/94-2/95. The early buy spot occurred before the right side of the cup was complete.

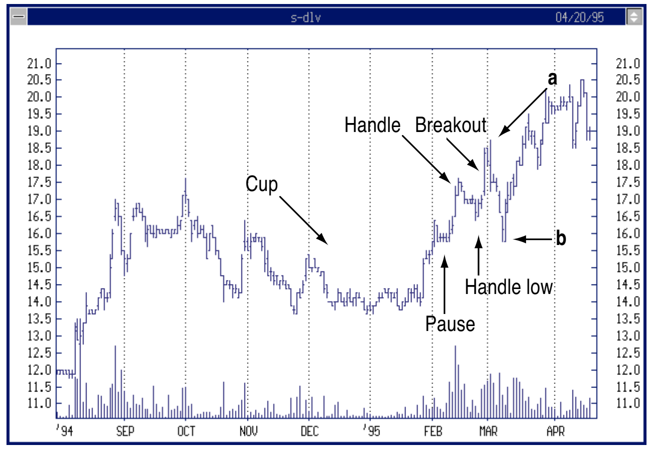

FIGURE 6: US DELIVERY SYSTEMS, 8/94-4/95. In (a), higher high followed by a lower low at (b) puts the rising trend in jeopardy.

handle low, keeping the intermediate-term rising trend intact. For now, the pullback appears to be normal, but Trader B won't be around to find out unless he blindly jumps back on the trade.

MORE NUANCES

Aside from the cup-with-handle's basic structure, many set up with various quirks or subtle nuances typically because of market conditions. One is a base-breakout failure that resets itself into a small cup-with-handle.

- ***Failed-breakout reset*** — The activity of Gendex stock (XRAY) in 1992 is a good example of this rare pattern (Figure 8). I walked away from this after it failed following its breakout in late May that year. Just like the example of PPSI where it pulled into the cheat area to form a handle, XRAY pulled all the way into the initial base structure, only to re-emerge from a small cup-with-handle. The subsequent move led to a 160% gain in six months (Figure 9). The obvious lesson: always watch for a stock to reset a new base, even if the initial breakout fails.
- ***Double handle*** — Another subtlety is the double handle. Like the failed-breakout reset, when a handle breakout fails, watch for a possible new handle to form as long as the stock is within the overall cup-with-handle base structure and not extended into new highs (Figures 10 and 11).
- ***High handle*** — Normally, the handle forms at a level slightly lower or in line with the left side of the cup. In some cases, though, the formation of the cup's right side overshoots the left side, setting up a possible high handle. The high on the cup's right side can be as much as 7-8% above the left side's high. Recently, Tencor Instruments (TNCR) formed a high handle about 3½% above the left side of its cup, while Three Com (COMS) got as high as 8½% before its handle formed

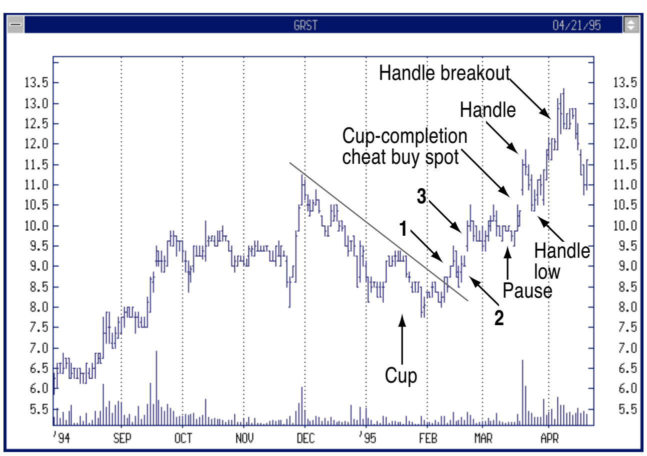

FIGURE 7: GRIST MILL, 8/94-4/95. Note how the handle low is a retest of support at the cup-completion cheat buy spot.

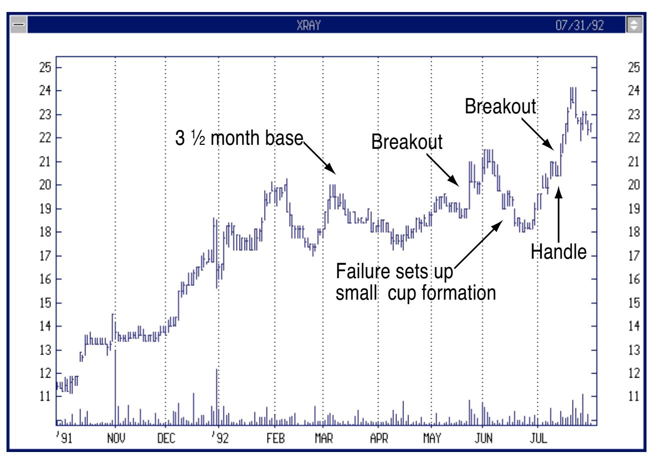

FIGURE 8: GENDEX, 10/91-7/92. Another cup-with-handle formation occurred after the failure.

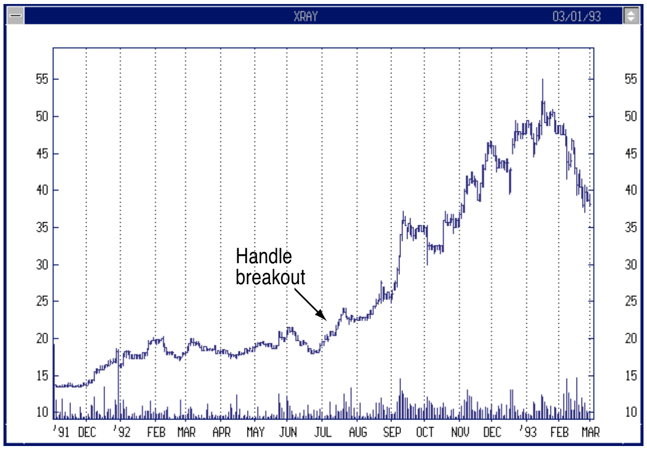

FIGURE 9: GENDEX, 11/91-3/93. There was a substantial gain after the breakout.

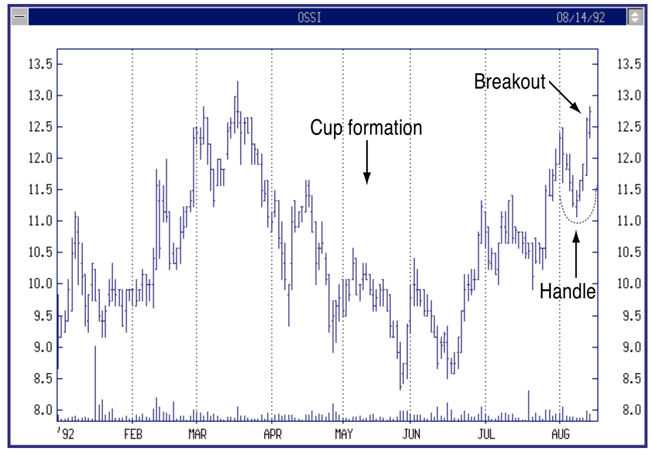

FIGURE 10: OUTBACK STEAK HOUSE, 1-8/92. The first handle appeared in August.

(Figures 12 and 13). Both were sound base structures.

- ***Spike-and-roll*** — The spike-and-roll (and double spike-and-roll) is what I call the appearance that many constructive cup-with-handle patterns form (Figure 14). In addition, note that some of the other examples included in this article have this characteristic. Micro Healthsystems, US Delivery Systems and Tencor Instruments each have a double spike-and-roll pattern.

THE FINAL WORD

Once a trend becomes widely recognized and accepted by the crowd, it's late and very close to reversing course. Whether buying on step 3, the cup-completion cheat or just waiting for a handle breakout, the cup-with-handle gives the trader an opportunity to catch a potentially powerful, new trend in its early stages. Although the opportunity isn't always obvious, the cup-completion cheat rule is an effective way to avoid a costly whipsaw in many cases.

Gregory J. Kuhn manages individual stock accounts and produces a fax service called as The LeaderBoard that recommends CANSLIM stocks.

REFERENCES, RESOURCES, READING

Kuhn, Gregory J. [1995]. "The cup-with-handle pattern," *Technical Analysis of* STOCKS & COMMODITIES, Volume 13: March.

FIGURE 11: OUTBACK STEAK HOUSE, 1-9/92. The second handle ended in early September.

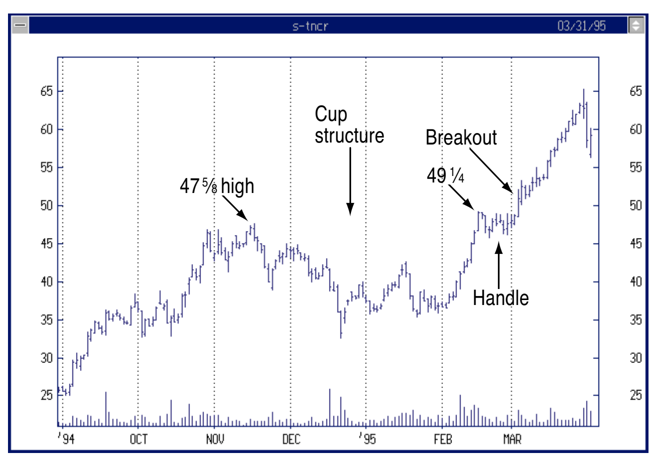

FIGURE 12: TENCOR INSTRUMENTS, 9/94-4/95. The right side of Tencor's cup was completed at 49-1/4, exceeding the left-side high of 47-5/8 by 3-1/2%.

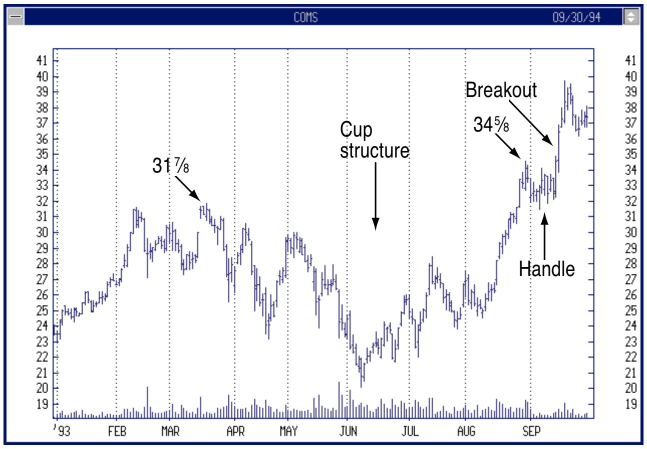

FIGURE 13: THREE COMS, 1-9/93. The high on the Three Coms cup peaked at 34-5/8, 8.6% higher than the 31-7/8 high on the left side.

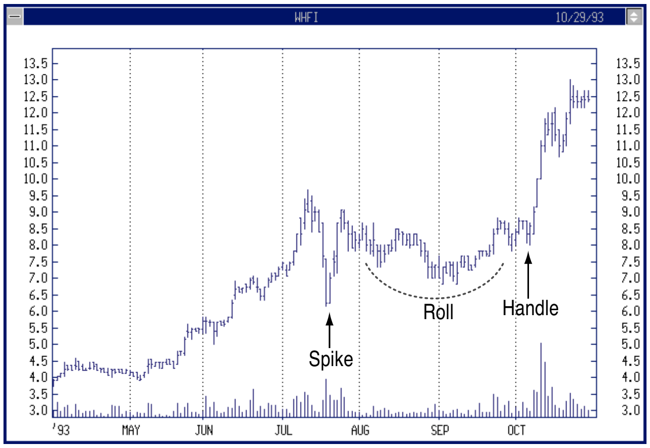

FIGURE 14: WHOLESOME AND HEARTY FOODS, 4-10/93. The spike typically occurs following an extended advance. The roll is the base of the cup that holds above the spike low.

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