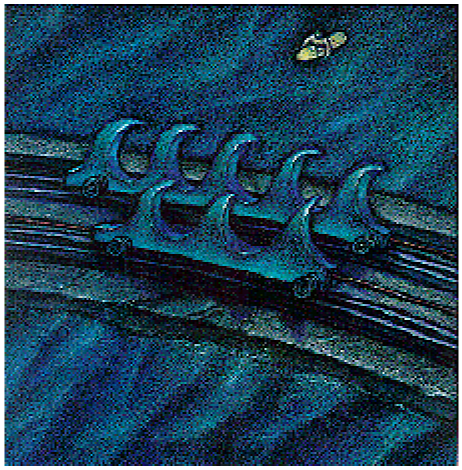
Elliott wave: Fact or fiction?

by F. David Minbashian



Using concepts from the elegant new science of chaotic dynamics, I was writing an essay to show as simply as I could arguing how commodity and stock prices follow a path of motion without any patterns. As I arrived at my conclusion, I could almost hear the hue and cry of disagreement from avid followers of R. N. Elliott only too eager to show me the vast profits they have amassed using his theory, for the Elliott wave principle is nothing if not a grand pattern by which prices are supposed to unfold. If you are one of those followers, don't stop reading yet. I do have something positive to say about your theory.

A few years ago I embarked on the task of learning the theory. There was no denying the fact that you could see and count the waves in chart after chart. I was so taken by the idea that I went around saying, "How do I love thee? Let me count the waves."

When it came to applying my newly acquired skills, things did not turn out as well. At first, I thought it was my lack of experience. Wrong or right, though, it was a lot of fun trying. I looked forward to following prices to see what kind of count would emerge. Was a 3 of 3 beginning or was it the "x" in an abc-x-abc formation? It got so bad that I had to warn myself and others against "the disease of the wave count" where nothing matters but to carry a count to its conclusion.

After a while it dawned on me. Prices will go up until they stop going up, in which case they will go sideways or turn down. There was no denying it. Chart after historical chart can be labeled with the correct Elliott wave count (Figure 1). The key is not the ability to label charts after the fact (although labeling historical charts, like solving a puzzle, can be a lot of fun). The key is whether such action will provide information about the future development of prices. The issue was resolved for me when I thought up a simple exercise — an exercise you can easily join me in performing.

Chart maneuvers

Take an actual up-to-date price chart where you are reasonably sure of a good wave count. Make three or more copies of this chart. On the first copy, extend the chart into the future so prices advance sharply in the usual zig-zag manner (Figure 2). Take the second copy and extend the chart so prices decline sharply.

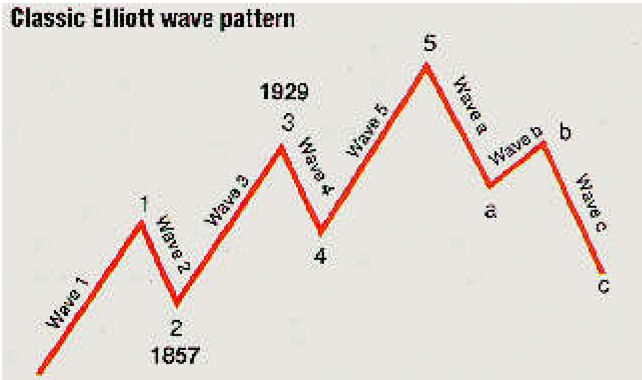


FIGURE 1: *The classic Elliott wave is 5 waves and three waves down.*

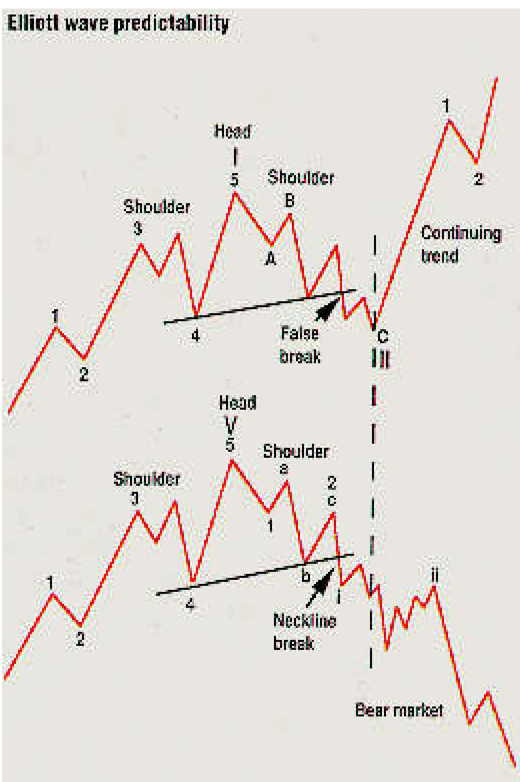


FIGURE 2: *Perfectly acceptable Elliott wave counts do not exclude any subsequent market movements and, therefore, have no predictive power.*

Extend the third chart in a sideways fashion. The disappointing surprise is that all three charts have perfectly acceptable Elliott wave counts, which means the count does not exclude anything and, therefore, has no value in predicting future prices. The Elliott wave count is only an excellent device for classifying the past, describing what has already happened.

Alternate counts

Maybe, deep down, Elliott wave theorists know the possibility of ambiguity exists, for they have cleverly devised the notion of the alternate count. With an alternate wave count, they may totally contradict the analysis that precedes it so the theory is never wrong. It is the count or, oops, it is the alternate count.

The idea that the Elliott wave principle has no value in predicting the future and is, at best, an amusing way to categorize the past finds ample support in a recent development. When it comes to the principle, you could say that A. J. Frost and Robert Prechter wrote the book on it (*Elliott Wave Principle*, 1978). As the bull market of the early 1980s was unfolding, Prechter made a name for himself by counting it as wave 5. The party came to a sudden end with the crash of 1987. I will not get into how badly some Elliott wave followers got caught in the crash. Suffice it to say that trends in nature are real, but they disappear as quickly as they appear.

Prechter took the crash to be wave a. This meant the rally that began right after the crash was wave b, that it would not go very far and that after it was over, devastation would result in the form of a wave c decline that would put the crash to shame, just the way it happened after the 1929 crash. Indeed, the crash of 1987 started out as a carbon copy of the one in 1929. The papers were full of comparison charts.

What is not commonly known is that it was not the 1929 crash itself but what happened in the ensuing three years that decimated the Dow Jones Industrial Average. So Prechter's idea was not that far-fetched. The trouble was that by year-end 1988, similarities with the 1929 chart started to disappear. By mid-1989, the Dow was well on its way to all-time new highs. The rally did not seem to want to end.

If the theory is no good, how come so many people use it successfully and so many satisfied traders believe in it?

To make matters worse, Frost, the senior co-author who up to now had been silent, was reported to have another alternate count that put the end of the current rally above 3000 on the Dow. This was no small scholars' disagreement that could be glossed over easily. Here you had the two people in the best position to know the workings of the theory inside and out, taking diametrically opposing positions on the present count.

It is not as if one of the authors is lacking in his knowledge or interpretation of the theory. It is further evidence that the theory lends itself to every interpretation and thereby has no value in predicting the future. Before the market moves, both counts are correct. After the market makes its move, only one correct count remains so we can properly label the move. The irony is that the market, by its action, picks the correct market-picker and not the other way around, as we are time and again led to believe.

Believers, arise

The only question remaining here is: If the theory is no good, how come so many people use it successfully and so many satisfied traders believe in it? To answer this question is to provide the positive comments on the theory I promised you at the outset, but it also puts the final nail in the coffin of the Elliott wave principle.

Follow me as I analyze a hypothetical trade made according to the theory. Every Elliott analyst must dream of being part of a wave 3 move, but how do you go about doing that? One way is to successfully identify wave 1, the first move up. Next, try to get in somewhere near the end of wave 2, which is the correction to the first wave. If you are right and wave 3 materializes after you get in, do not get out too quickly. Stay for the duration, because you will have ample opportunity to get out. There will be a wave 5 after any setbacks caused by a corrective wave 4.

Now, let's walk through the same trade again without any mention of Elliott, but using some well-known trading principles. Let us be trend followers and cut our losses short and let our profits run — that's all. Initially, when I see the first move up, it's an indication that trends may have turned up. Then, when I see a modest pullback, it is a place where I can go in because it allows me a natural place to put my stop to cut my losses short.

If the up move resumes and my position is profitable, I will stay with it because I am a trend follower and, in addition, I believe in letting my profits run. As you see, I am participating in the same move without any preconceived notions about where the move will take me and without knowing anything about the Elliott wave principle. When it works, the theory is nothing more than a trend-following method that allows you to cut your losses short and let your profits run.

On a more esoteric note, another important feature of the theory is the equal treatment the hourly chart gets with the monthly chart. This is correct because of the fractal nature of price movements — namely, what happens on a small scale is repeated on larger and larger scales. Before re-embracing the theory, however, let me remind myself that when it lays claim to predicting the future, it gets deeply into hot water and, when it is successful, it is engaging in no more than the time honored practices of trend-following and money management. So who needs it?

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