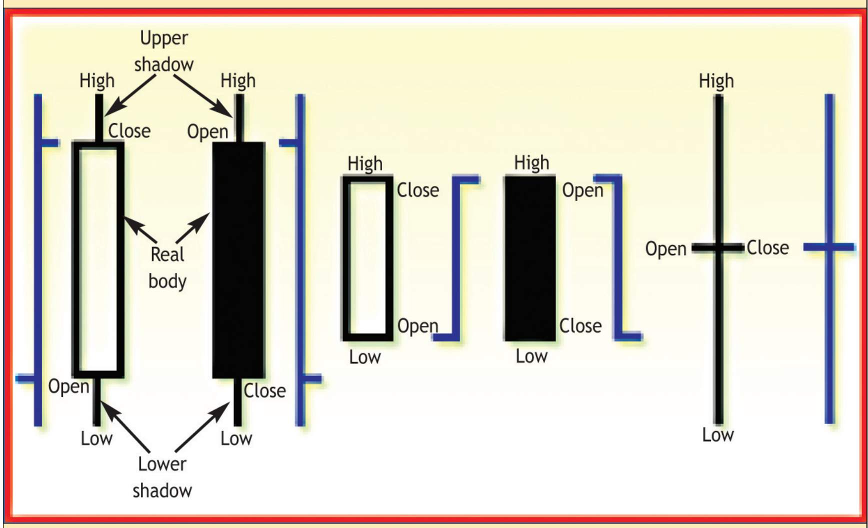
Heikin Ashi charts

This variation on the Japanese candlestick chart emphasizes trend moves.

BY TIM RACETTE

Traders have many chart types to choose from, one of the most popular of which is the Japanese candlestick chart. Traditional Japanese candles use the same price information as standard price bars, but display that information to highlight bullish and bearish activity. A trading session's high and low are represented by the highest and lowest points of the candlestick, while the session's open and close are represented by the top and bottom of the wider part of the candle (Figure 1). The thin lines at the tops and bottoms are called shadows (or "wicks"), and the wider parts are called "real bodies." The candle is typically white (or green) if the close is above the open and black (or red) if the close is below the open.

FIGURE 1: CANDLES VS. STANDARD PRICE BARS



Japanese candle charts use the same price information as standard price bars, but display that information to visually emphasize bullish and bearish activity.

A lesser-known but very useful candlestick variation is the Heikin Ashi chart. While a traditional candlestick chart plots the open, high, low, and close of each price bar for a given time period, a Heikin Ashi candlestick uses the midpoint of the most recent candle as the opening price of the next candle (Figure 2).

The major difference between these two candlestick types is the way up candles form vs. down candles. In order for an up candle to form on a traditional candlestick chart, the closing price must be above the opening price; a down candle forms when the closing price is below the opening price. In a Heikin Ashi chart, an up candle forms when price closes above the midpoint of the prior candle and a down candle forms when price closes below the midpoint of the prior candle. This subtle, but important difference is why Heikin Ashi charts make it easier to pick out the current trend.

Figure 3 compares another Heikin Ashi chart (left) to a traditional candlestick chart (right). Both charts use the same data and the same time frame. Notice how the Heikin Ashi candles more consistently remain the same color while a trend persists, only changing color when the trend changes. By remaining shaded throughout the trend, the Heikin Ashi chart reduces the odds of signaling a false trend change. The traditional chart in Figure 3 includes three up candles that might cause a trader to prematurely exit the downtrend.

While the Heikin Ashi chart helps reduce the likelihood for exiting a trend too soon, it is also an effective tool for determining when a market is in a range. Non-trending, or range-bound markets are characterized by repeated changes in color, instead of a smooth series of same-colored candles. Because a series of consecutive same-color candles indicates a trending market, a lack of this behavior helps identify a range-bound market.

Using Heikin Ashi charts

One basic technique a trend trader can use is to wait for a color change before entering a trade. This ensures you are entering at the earliest point in a potential trend change. If

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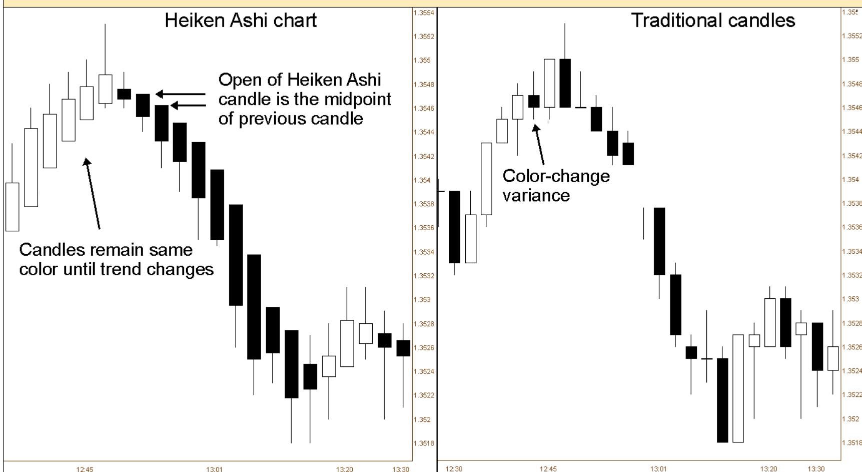
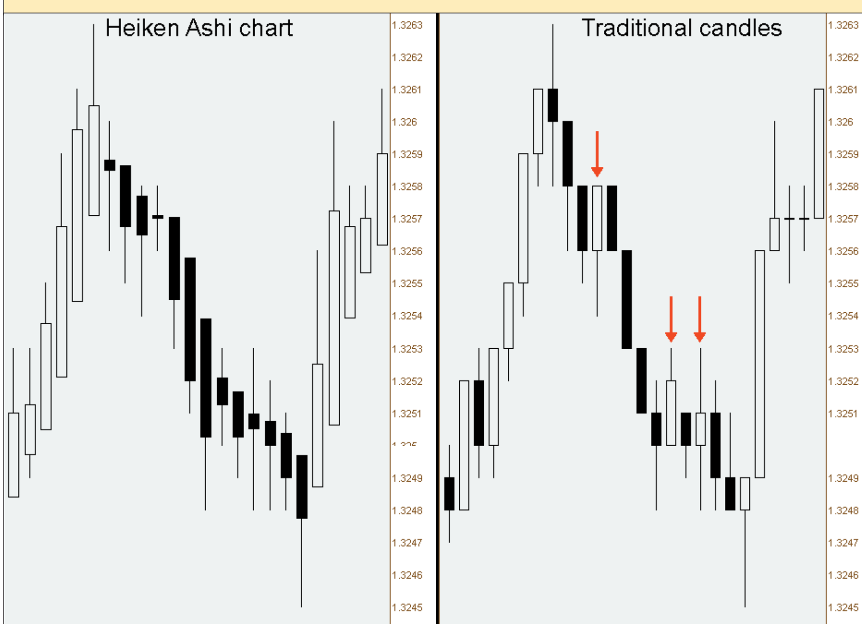
FIGURE 2: HEIKIN ASHI VS. TRADITIONAL CANDLE



The Heikin Ashi candle (left) uses the midpoint of the most recent candle as the opening price of the next candle.

FIGURE 3: HIGHLIGHTING TREND



The candles in the Heikin Ashi chart (left) are more consistent during trend moves.

FIGURE 4: CATCHING PULLBACKS

The first candle to change color after a pullback signals the possible resumption of the uptrend.

the larger trend is up and price is ascending in a series of higher highs and higher lows, the first candle to change color after a pullback signals the possible resumption of the uptrend. Figure 4 is a Heikin Ashi chart that highlights a series of pullbacks within a larger uptrend. In all cases, the first candles to change back to white signaled new legs of the uptrend.

Identifying the prevailing trend is the first step in this process. It's easy to become engrossed in shorter-term time frames and lose sight of the bigger picture. To avoid the trap of buying high and selling low, you can consult a Heikin Ashi chart for reference. Although there is no such a thing as "too high" or "too low," the further the market moves from the first trend-change candle, the less likely the trend is to continue. Entering a trade in the direction of the trend after a substantial move has occurred significantly reduces your odds by increasing the likelihood you will buy near highs or sell near lows. When searching for an entry point you want to enter as close to a trend-change candle as possible.

Entering on a pullback in the direction of the larger trend is inherently a high-probability trade because you are trading in the direction of the current price momentum. Using the Heikin Ashi candlesticks you can identify the first sign of the larger trend resuming after a correction. ◆

For information on the author, see p. 6.

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