

Head and Shoulder Patterns

As suggested by its name, the head and shoulders reversal pattern is made up of a left shoulder, head, and a right shoulder.

This pattern is formed when there is a rally to a new high followed by weakness and a fall to intermediate support (this forms the left shoulder).

Then there is a 2nd rally to a higher high followed by another drop to support (this forms the head).

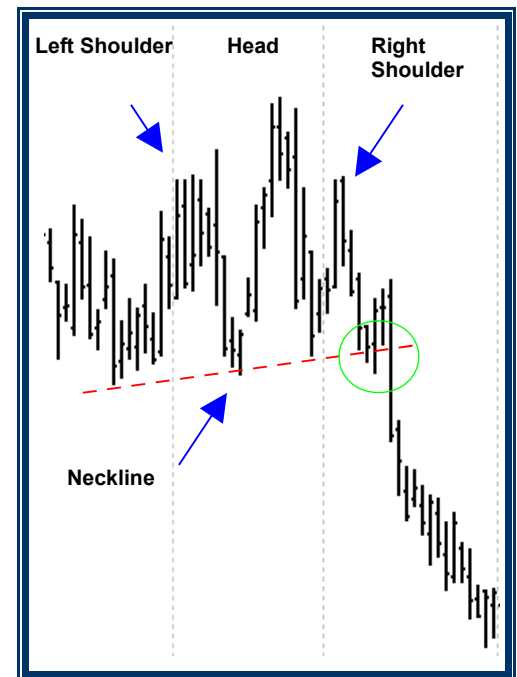
This is then followed by a 3rd and typically weaker rally, which forms the right shoulder.

As the chart on the right shows, the primary breakpoint for this pattern is a breach of the neckline. Ideally, this should be supported by an increase in volume as one of the primary confirmations that a trend reversal has occurred.

The neckline is determined by connecting the low of the left shoulder, the low of the head and the low of the right shoulder.

Depending on how the patterns forms, the neckline can slope up or down or be horizontal. Some analysts argue that the neckline's slope can determine the pattern's degree of bearishness, with a downward slope being more bearish than an upward slope, but I have not found this to be significantly consistent with market realities.

Studies by Savin, Weller and Zvingelis (Oxford Journal 2006) found "...strong evidence that the pattern had power to predict excess returns. Risk-adjusted excess returns to a trading strategy conditioned on "head-and-shoulders" price patterns are 5-7% per year."



The above chart of Coffee shows the key point of reversal on the Head and Shoulders pattern is a break below the "neckline".