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Testing Expert Design Studio Rules

Interested in a Short-Selling Model? Here Are the Most Effective EDS Rules

By David Vomund

In the April 2007 issue we reported on the most effective Expert Design Studio (EDS) rules for going long. Now, for the first time, we can report on the most effective rules for short-selling. That is, we'll show the most effective rules for picking bearish stocks.

In past issues we reported on the least effective EDS rules, assuming that the least effective rules for going long may be the most effective rules for going short. Now we'll eliminate that assumption by testing all of the 250 pre-built rules by going short.

“Now, for the first time, we can report on the most effective EDS rules for short-selling... If you use EDS, then you may want to refer to this article often.”

Running 250 tests is obviously time consuming and we expect few, if any, users have actually completed similar tests. If you use EDS, then you may want to refer to this article often.

Our stock database used in the test is the S&P 1500 stocks. The tests were run from January 3, 2001 through

December 29, 2006. This is a good period because it includes both bull and bear markets.



DAVID VOMUND

For the sell strategy, we used a 97% capital protect with an 85% profit protect once a 10% profit is reached. The 97% capital protect means that if a stock rises (yes, rises because we are going short) 3% from the point of purchase then it is sold on the next day's open.

The 85% profit protect after a 10% profit means that once the stock hits a 10% profit, we are only willing to give up 15% of that profit before selling. The 10% profit goal may be wider than what many short-sellers would use. Some short-sellers prefer to take quick profits.

Due to space limitations, we are not able to list the results of all the rules. Because of the importance of this time consuming test, we are listing as many results as possible. **Table 1**, which covers two pages, shows the 74 most

(continued on page 4 following Table 1)

Table 1 - Highest ROI Trades

The following lists the results of testing the pre-built EDS rules using the S&P 1500 stock database. A 97% capital protect combined with an 85% profit protect above a 10% profit was used. The test is from 2001 through 2006.

FOLDER/SUBFOLDER	FILE NAME	RULE NAME	ROI	# TRADES
1 Miscellaneous/OpeningBellStrategies	denningvr	goshort	20.33	78
2 Technical indicator strategies/Strategies using Candlesticks	meeting lines	meetinglines	13.14	22
3 Technical indicator strategies/Strategies using Candlesticks	dark cloud	darkcloud	5.56	662
4 Market timing indicators and strategies	mktndirmovdn	mktndirmovdn	0.12	48
5 Market timing indicators and strategies	MktupMACDup	MktupMACDup	-0.57	23
6 Expert System Based Strategies/Expert Rating Strategies	market er down	downmarket	-1.23	73
7 Market timing indicators and strategies	MktdnPhasedn	MktdnPhasedn	-1.82	67
8 Miscellaneous/OpeningBellStrategies	minoconf	buymt	-3.56	84
9 Miscellaneous/OpeningBellStrategies	nov99obm	allworks	-4.32	815
10 Shorter term strategies/Hit and Run Trading - Jeff Cooper	lizards buy	lizardbuy	-5.25	3923
11 Market timing indicators and strategies	mktuperphaseup	mktuperphaseup	-5.45	72
12 Expert System Based Strategies/Expert Rating Strategies	1656 debate	er16and16	-5.83	1204
13 Expert System Based Strategies/Expert Rating Strategies	market er up	goodermarket	-6.49	82
14 Miscellaneous/OpeningBellStrategies	congesti	breakout	-9.30	14412
15 Intermediate Term Strategies/Steve Palmquist	newly above 200ma	new200	-9.83	6082
16 Market timing indicators and strategies	mktupdirmovup	mktupdirmovup	-10.77	32
17 Miscellaneous/OpeningBellStrategies	basing scan	downandbase	-10.83	440
18 Technical indicator strategies/Strategies using Candlesticks	harami	harami	-11.66	15185
19 Swing trading strategies/Street Smarts - Rasche, Connors	st macdi buy	macdcover	-11.85	6262
20 Shorter term strategies/Hit and Run Trading - Jeff Cooper	180s buy	buy180	-12.34	19133
21 Miscellaneous/OpeningBellStrategies	mar99obm	allworks	-12.42	802
22 Swing trading strategies/Street Smarts - Rasche, Connors	turtle soup	isgoodturtle	-12.47	31056
23 Shorter term strategies/Hit and Run Trading - Jeff Cooper	expansion pivot buys	expansionpivotbuy	-12.85	15099
24 Swing trading strategies/Street Smarts - Rasche, Connors	volatile history	buy	-13.06	21768
25 Technical indicator strategies/strategies based on one indicator/Volatility	volatility cuts above mov'g avg after 21 days below	VOLTYbo	-13.07	22571
26 Technical indicator strategies/strategies based on one indicator/SK-SD	sk crosses from below to above sd	SKSDcrossUP	-13.24	60206
27 Technical indicator strategies/strategies based on one indicator/MACD	macd crossover to upside	MACDxUP	-13.31	57719
28 Technical indicator strategies/Strategies using Candlesticks	harami cross	harami	-13.37	850
29 Market timing indicators and strategies	MktdnMACDdn	MktdnMACDdn	-13.53	28
30 Shorter term strategies/Hit and Run Trading - Jeff Cooper	gilligansislandbuy	gilligansislandbuy	-13.80	2515
31 Technical indicator strategies/strategies based on one indicator/parasar	parasar	ParaSarGoLong	-13.81	41183
32 Shorter term strategies/Hit and Run Trading - Jeff Cooper	5 day momentum buy	buylong	-13.85	3621
33 Technical indicator strategies/strategies based on one indicator/Volatility	volatility reaches a 21 day low	VOLTY21lo	-13.99	69690
34 Technical indicator strategies/strategies based on one indicator/CCI	CCI cuts from below to above 100	CClup	-14.01	32258
35 Longer Term Strategies/Strategies based on AIQ Reports	wal report upside	iswactstockup	-14.03	20971
36 Miscellaneous/OpeningBellStrategies	obmdec98	allworks	-14.09	725

Table 1 - Highest ROI Trades (Continued)

FOLDER/SUBFOLDER	FILE NAME	RULE NAME	ROI	# TRADES
37 Miscellaneous/OpeningBellStrategies	basing scan	upandbase	-14.10	4392
38 Technical indicator strategies/strategies based on one indicator/Simple Mov'g Avgs	price cross up the it ma	ITMApriceUP	-14.10	40016
39 Technical indicator strategies/Strategies using Candlesticks	hammer	hammer	-14.12	45928
40 Technical indicator strategies/strategies based on one indicator/ESA	st esa crossover it esa to the upside	EsaCrossUp	-14.37	30368
41 Technical indicator strategies/strategies based on one indicator/RSIWildier	rsi wildier in overbought territory	RSIWildierover70	-14.42	37247
42 Technical indicator strategies/Strategies using multiple indicators	bollinger bands squeeze and low volatility	bbandsqueeze	-14.43	42705
43 Technical indicator strategies/strategies based on one indicator/Bollinger Bands	Bollinger Bands Squeeze and low volatility	Bbandsqueeze	-14.43	42705
44 Technical indicator strategies/strategies based on one indicator/VAPct	va pct is above zero 90% of the last 120 days	BuyPervisMF	-14.44	10380
45 Charts Patterns Strategies	double top strategy	doubletop	-14.45	20360
46 Technical indicator strategies/strategies based on one indicator/OBVPct	price new high not confirmed by high in obv pct	OBVPctHlon	-14.45	52767
47 Technical indicator strategies/strategies based on one indicator/Stochastic	stochastic buy	Stochasticbuy	-14.51	50119
48 Technical indicator strategies/strategies based on one indicator/OBVPct	obv pct slope is dn while price slope is up	OBVPctDIVdn	-14.54	55882
49 Chart Pattern Strategies	short term horizontal trading ranges	trading range	-14.57	112734
50 Technical indicator strategies/strategies based on one indicator/Simple Mov'g Avgs	price cross up it ma	LTMApriceUP	-14.62	29487
51 Chart Paittern Strategies	double bottom strategy	low	-14.84	7927
52 Chart Pattern Strategies	expansion breakout strategy	expansionbreak	-14.89	33915
53 Price and volume based strategies	price new high not confirmed by high in vp trend	vpinonhi	-14.90	52539
54 Technical indicator strategies/strategies based on one indicator/VP Trend	price new high not confirmed by high in vp trend	VPTnonHI	-14.90	52539
55 Technical indicator strategies/strategies based on one indicator/OBV	price reaches new high not confirmed by high in obv	OBVhiNON	-14.92	37460
56 Technical indicator strategies/strategies based on one indicator/MoneyFlow	moneyflow slope is down while price slope is up	MFdnPRICEup	-14.94	27765
57 Swing trading strategies/Street Smarts - Rasche, Connors	range contraction	narrowrange	-14.98	112777
58 Technical indicator strategies/strategies based on one indicator/VAPct	price new high not confirmed by high in vapct	VAPCThiNON	-14.98	54176
59 Technical indicator strategies/strategies based on one indicator/OBV	obv has reached a new high	OBVnewHI	-15.01	38182
60 Technical indicator strategies/strategies based on one indicator/OBVPct	obv pct crossed from positive to negative	OBVPctSELL	-15.01	61105
61 Technical indicator strategies/strategies based on one indicator/VAPct	va pct slope is down while price slope is up	VAPCTdivDN	-15.11	57446
62 Technical indicator strategies/Strategies using Candlesticks	hanging man	hangingman	-15.18	29940
63 Technical indicator strategies/strategies based on one indicator/phase	positive phase with 3 day slope up	GoodPhaseup	-15.18	95392
64 Shorter term strategies/Hit and Run Trading - Jeff Cooper	expansionpivot shorts	expansionpivotshort	-15.27	6972
65 Price and volume based strategies	price reaches a new 21 day high	price21hi	-15.35	81445
66 Price and volume based strategies	volume and volatility filter	tradeok	-15.36	138238
67 Technical indicator strategies/strategies based on one indicator/phase	phase was going down then turns up	Phaseup	-15.41	89091
68 Intermediate Term Strategies/Steve Palmquist	strong money flow stocks	strongmoneyflow	-15.44	59097
69 Technical indicator strategies/strategies based on one indicator/accum. distribution	price new high not confirmed by high in accum dist	AcmDisHlon	-15.52	40478
70 Technical indicator strategies/strategies based on one indicator/OBV	obv slope descending while price slope is ascending	OBVdnPRICEup	-15.52	47521
71 Technical indicator strategies/strategies based on one indicator/VP Trend	vp trend slope down while price slop is up	VPT dnPRICEup	-15.54	64123
72 Technical indicator strategies/strategies based on one indicator/Simple Mov'g Avgs	price cross up the st ma	STMApriceUP	-15.70	62215
73 Technical indicator strategies/strategies based on one indicator/Stochastic	stochastic is in overbought territory	STOCHover80	-15.71	98154
74 Expert System Based Strategies/Expert Rating Strategies	er down and decreasing trendscore	confirmeddown	-15.78	24427

effective short-selling rules, sorted by their annual return on investment (ROI). Notice that few ROI values are positive. That is a reflection of the market, where there hasn't even been a 10% market correction in 4 ½ years.

To help identify the pre-built rules listed in Table 1, we indicate which folders they reside in and what the rule names are. The first column in the table displays the name of the folder (or folders) followed by the file name. The next column shows the name of the rule that was tested.

To find a pre-built rule, open the Expert Design Studio and select *File, Open*, and double-click the *EDS Strategies* folder. This accesses the list of folders in which the rule files reside. Double-click the appropriate folder name and then highlight and open a file. With the file open, the rule will be displayed in the *Rule Library* page of the EDS window.

For a description on how to use EDS, please refer to the March 2006 *Opening Bell*. For more advanced rule manipulation, please refer to the May 2006 issue.

The most effective rule was created by AIQ power-user Richard

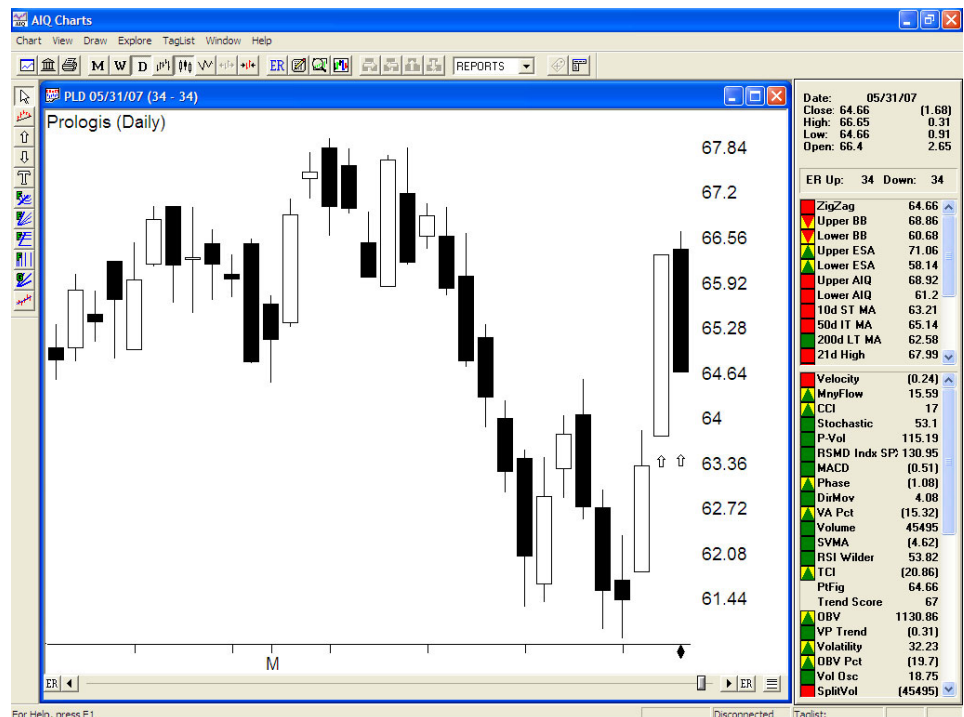


Figure 1. Candlestick Chart of Prologis on 5/31/07. Arrows point to Dark Cloud Cover pattern, which is the basis for the number three performing EDS screening rule.

Denning. His VCR model was featured in the September 2001 *Opening Bell*. It is impressive to see how well it is working, especially since the model was created before our testing period. Unfortunately, there were only 78 trades in our back test so this isn't an active model.

The second rule, Meeting Lines, is a Candlestick Charting pattern. Meeting Lines are formed when opposite colored Candlesticks have the same closing price. Unfortunately, this rule only provided 78 trades. This is an effective short-selling rule when you back-test using earlier time periods as well so I believe the rule has merit, but it may be worth loosening the criteria for the rule in order to increase the number of trades.

The third rule is the most interesting because it provided 662 trades. The Dark Cloud is a bearish Candlestick Chart pattern. This pattern takes place over two days. On the first day there is a strong White Real Body. That means the stock is heading higher and the close is greater than the open. On the

second day the price gaps higher but by the end of the session the stock closes near the low of the day and is within the prior day's White Body.

Figure 1 shows an example of a Dark Cloud Cover. Prologis (PLD) had a very strong day on May 30, represented by the large white candle (see first arrow). On the second day of the pattern (see second arrow), the stock gapped higher but sellers emerged. The stock fell back to the lower half of the previous day's candle and, in this case, closed on its low. This can be seen because there isn't a tail on the lower portion of the pattern.

We'll jump to the ninth rule because it also has a lot of trades. This model was featured in the November 1999 *Opening Bell*. Luckily, it was a short-selling model! The model featured a Harami Candlestick Chart pattern, which previously tested as bearish. The Harami pattern is somewhat comparable to an Inside Day pattern in bar charts. It occurs when a Small Real Body follows a Long Real Body. The second and final rule in the model

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uses the RSI AIQ indicator. The rule states that the RSI AIQ indicator must rise from below to above 30 anytime in the last two days.

Figure 2 shows an example of a stock that passes the screening. On May 11, Forest Laboratories (FRX) formed the Harami pattern when the high price was below the previous day's high and the low price was above the previous day's low. On the same day, the RSI AIQ indicator rose above 30.

The tenth rule is based on Hit and Run Trading, by Jeff Cooper. The entry and exit points of this rule are designed to be used on real-time charts; hence it is designed as a day-trading rule and Mr. Cooper notes there is often little follow-through. The AIQ back test shows he is right. By the time the end-of-day traders buy the setup, it is too late and the stock typically underperforms.

The twelfth rule dates back to the 1990s when many AIQ users noted that an Expert Rating (ER) of 16-56 was bearish for stocks. This issue was addressed in the December 1998 *Opening Bell* when we

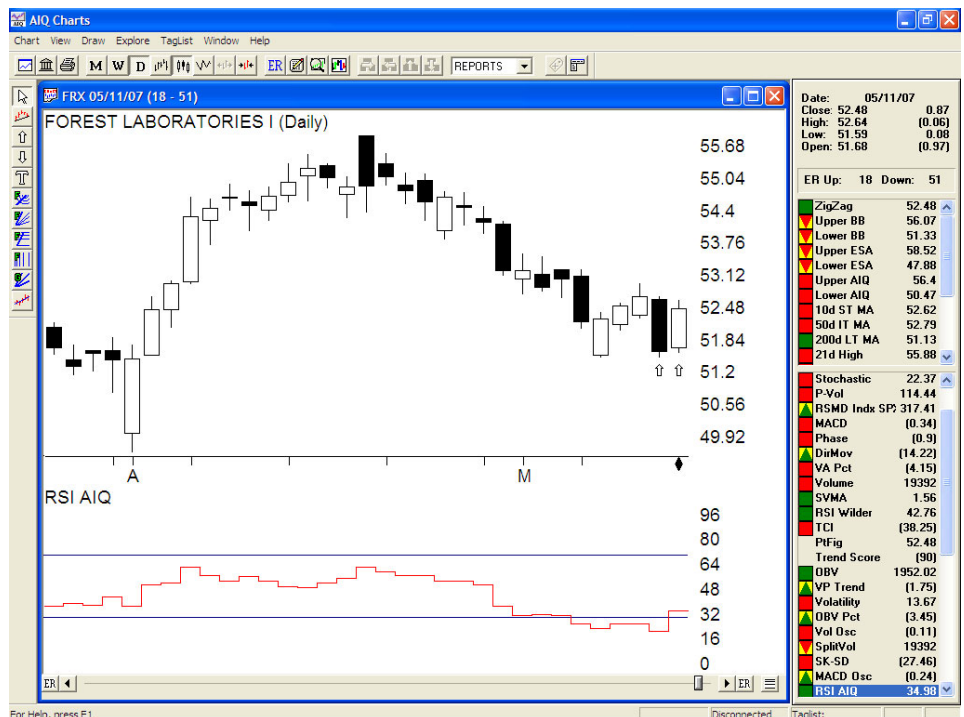


Figure 2. Candlestick Chart of Forrest Labs. Last two Candlesticks (arrows) form a Harami which, combined with rising RSI AIQ, is the basis for the ninth best performing EDS shorting rule.

developed a short-selling model that combined the 16-56 ER reading with a CCI move above negative 100 and a Stochastic move above 20. In that article we recommended different settings for the indicators but current testing reveals the default setting

should be used.

Figure 3 shows a stock that passes this screening. Notice its 16-56 Expert Rating, shown just below the prices. At the same time, its CCI rose above negative 100 and the Stochastic rose above 20.

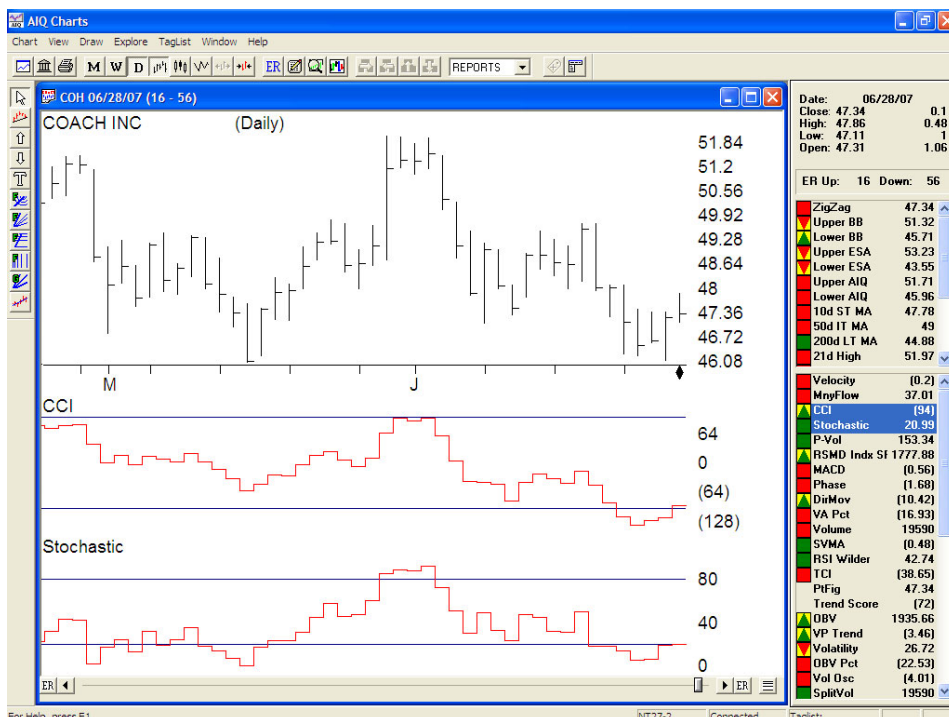


Figure 3. Daily chart of Coach for 6/28/07. On this date, the 16-56 ER coupled with CCI move above -100 and Stochastic move above 20 triggered the 12th best performing EDS shorting rule.

Conclusion Using back tests from AIQ's Expert Design Studio is a great way to see which rules warrant further research and which rules offer no value. Highly effective models can be created when multiple effective rules are combined.

There are several assumptions, however, in an EDS back test that may make a rule appear more effective than it is. For this reason, our next step will be to test these short-selling rules along with the most effective long rules from the April 2007 issue, using AIQ's Portfolio Simulator. This way, the important rules are tested with real-life capitalization rules. This information will be extremely valuable.

David Vomund publishes VIS Alert, a weekly investment newsletter. For a sample copy, go to www.visalert.com.

Market Review

Good Start--but by Month's End Market Sheds 5%

Times continue to be interesting for traders, to put it mildly. July started out well but near the end of the month the market shed a fast 5%, nearly all of it in two days.

We've seen similar profit taking before (recall February's sell-off) and we'll see it again. Volatility has returned.

Reasons are always given for selling. The housing recession is deep and will remain with us for the foreseeable future with effects being felt far and wide. Rising energy prices are another problem. At the top of the list of problems, however, are concerns about credit quality fueled by troubled sub-prime mortgage lenders.

July's month-end weakness was greater than its early strength. For the month, the S&P 500 fell 3.2% and the Nasdaq Composite fell 2.2%. Small-cap stocks were the weakest, however, with the Russell 2000 plunging 6.9%.

As **Figure 1** shows, 1490 is an important level for the S&P 500. This level acted as support in May and June, and turned into resistance in July. From a charting perspective, it is hard to get excited about this index as long as it is below this level.

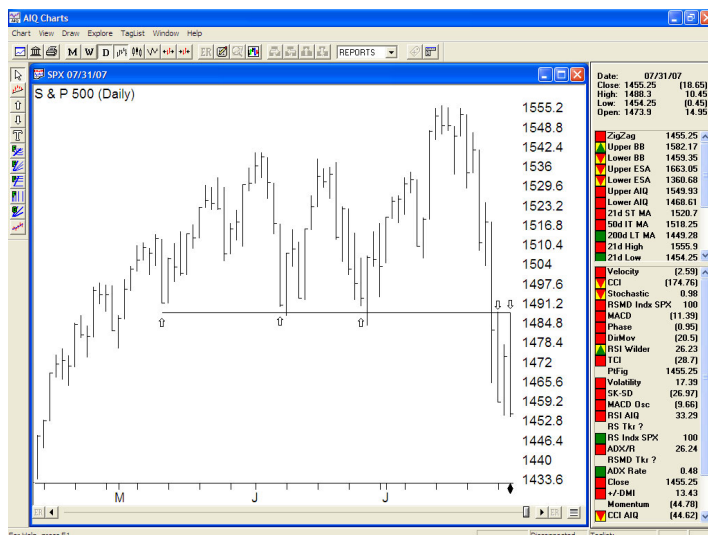


Figure 1. Chart of S&P 500 with support/resistance line at 1490 level.

There were few places to hide as the market fell. The best sector in July was Precious Metals, which gained 8%. Energy also had moderate gains. Most groups fell, however, with Banking leading the way. This sector fell 10%. Real Estate fell 7% and Financial Services fell 6%.

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date
Shenandoah Telecom.	SHEN	3:01	08/03/07
AAON Inc.	AAON	3:2	08/06/07
Aeropostale Inc.	ARO	3:2	08/07/07
Research in Motion	RIMM	3:1	08/20/07
FMC Technologies	FTI	2:1	08/20/07

Trading Suspended:

Bombay Co. (BBA), Dollar General (DG), Imperial Chemical (ICI), Interpool (IPX), Mellon Financial (MEL), Paxar (PXR), Winston Hotels (WXH)

Name Changes:

Abington Community Bancorp (ABBC) to Abington Bancorp (ABBCD)
 Advancis Pharm (AVNC) to MiddleBrook Pharm. (MBRK)
 Bank of New York (BK) to Bank of New York Mellon (BK)
 Chicago Merc. Exchange Holdings (CME) to CME Group Cl A (CME)
 Collegiate Pacific (BOO) to Sport Supply Group (RBI)
 Diversa (DVSA) to Verenum (VRNM)
 Grupo TMM S.A. (TMM) to Grupo TMM S.A.B. (TMM)
 United Auto Group (UAG) to Penske Automotive Group (PAG)

S&P 500 Changes

Changes to the S&P 500 Index and Industry Groups:

Discover Financial Services (DFS) replaces ADC Telecomm. (ADCT). DFS is added to the Consumer Finance (CONSUMEF) group.

General Growth Properties (GGP) replaces Mellon Financial (MEL). GGP is added to the Retail REITs (REITRET) group.

Tyco Electronics (TEL) replaces PMC Sierra (PMCS). TEL is added to the Electronic Manufacturing Services (ELECTMFG) group.

Covidien Ltd. (COV) replaces Sanmina (SANM). COV is added to the Health Care Equipment (HEALTHMP) group.

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This year's keynote speaker Nelson Freeburg Founder Formula Research

Nelson Freeburg is editor of FORMULA RESEARCH, a financial letter that develops systematic investment models for stocks and bonds. When he first came to the financial markets, Nelson was pursuing a Ph.D. in world politics at Columbia University. Wholly taken by the excitement and promise of trading, Nelson said good-bye to the academic life. Nelson began researching the markets full-time. Eventually he would build a financial database that reaches back to the last century--and from this, a library of advanced trading strategies. Today Nelson uses these timing models to advise institutional clients and manage his own investments.

Many investment professionals rely on Formula Research. Gerald Appel, John Bollinger, Paul Tudor Jones, John Murphy, Martin Pring, Linda Raschke, Larry Williams--all of these and other industry leaders employ his proprietary research.

Every morning begins with an AIQ-hosted breakfast. Sessions begin at 8:30 each day and run through to 5:00 pm (12:00 on last day). Regular breaks during the day include an AIQ-hosted lunch on the first two days. Tuesday evening all attendees are invited to an AIQ catered buffet dinner.

Including meals, cost for all three days is only \$895 per person.

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BONUS live webinar session with Linda Bradford Raschke. Linda is President of LBRGroup, Inc., a registered CTA and money management

firm and president of LBR Asset Management, a CPO. She began her professional trading career in 1981 as a market maker in equity options.

Also joining us this year will be **Martha Sipe**, CFA, a veteran of Wall St and president of mindingmatter.com, and **Bob Debnam**, founder of the ChartProfit service. We are also pleased to welcome back **Dale Wheatley**, founder of The Options Hunter service and **Steve Palmquist**, trader and founder of daisydogger.com. Our regular AIQ speakers **Steve Hill**, CEO and **David Vomund**, Chief Analyst round out the speaker line-up.

There will no Getting Started with AIQ track this year; instead we will be offering **one-on-one hands-on clinics** with senior AIQ staff. Appointment times will be accepted throughout the first two days of the seminar



Here's what last year's attendees had to say

"Tremendously valuable - the content and clarity of the presentations moved my trading education forward"

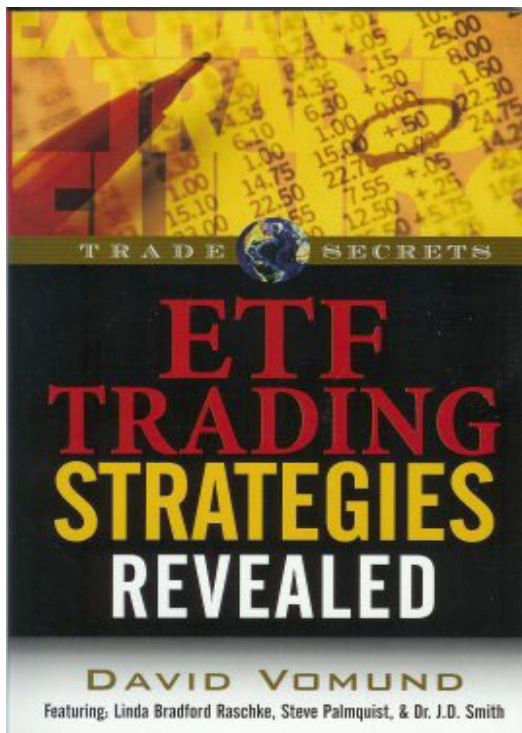
"This was an extremely useful session, advancing my understanding of several important chart patterns"

"Steve (Palmquist) actually told the group what works for him and what makes him a successful trader, outstanding."

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- Discover the way to apply classic techniques to leverage your ETF investments for both the short-term and long-term.
- Study simple but highly effective mechanical ETF rotation techniques (style, sector, and international) that are now available to the individual investor.

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