AIQ Opening Bell Newsletter

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Best-Selling Author Analyzes 2006

Is a Pre-January Effect Possible This Year?

By Lawrence McMillan

For much of the last 20 or 30 years, there were distinct year-end broad market patterns that were tradable — between the small-cap and the large-cap indexes. In the last few years, however, those patterns have been distorted or have disappeared completely, due mainly to the strong performance of the small caps over the large caps at nearly all times of those years. In this article, we'll provide some background on the "systems" and an analysis of the current situation.

Lawrence McMillan

Professional trader Lawrence G. McMillan is perhaps best known as the author of *Options As a Strategic Investment*, which has sold over 200,000 copies. An active trader of his own account, he also manages option-oriented accounts for certain individuals and in addition is the Portfolio Manager of The Hardel Volatility Arbitrage Fund (a hedge fund).

In essence, the January Effect describes the phenomenon whereby small cap stocks outperform large cap stocks in January. This used to occur because tax loss selling at the end of the previous year had depressed the small caps on a relative basis, and they then bounced back once that tax loss selling abated. In addition, there was a clear *Pre*-January Effect as well: in November and December (when tax selling was heaviest), the large cap stocks outperformed the small caps. These two very tradeable patterns worked quite well through most of the 1980's and 1990's.

But, since 2000 the patterns have eroded to a great extent. The Pre-January Effect has nearly disappeared because small caps have been so strong. Moreover, while the January Effect itself is still visible in most years, it has shortened and advanced. That is, it occurs earlier now — usually beginning in mid-to-late December and ending just shortly after the new trading year has begun.

It's not too surprising to see the change in the January Effect itself, since the success of the system in the '80's and '90's generated a lot of publicity. So, traders looking to get the jump on their competition began establishing trades earlier — hence the movement of the system's yearly origin from early January to mid-December. Moreover, traders began taking profits earlier, rather than letting the effect "run" as they previously had. So, the system terminates more quickly — in early January.

Figure 1 and **Figure 2** show the composite graph of the Value Line Index (representative of small caps) minus the S&P 500 Index (representative of large caps). Figure 1 is how things used to be — prior to the small-cap resurgence in 2000. Note both the Pre-January Effect and the January Effect are clearly visible. Figure 2 shows how things look now. The tremendous performance of the small caps in the last six years has erased the Pre-January Effect and made the January Effect only an acceleration of the existing positive trend.

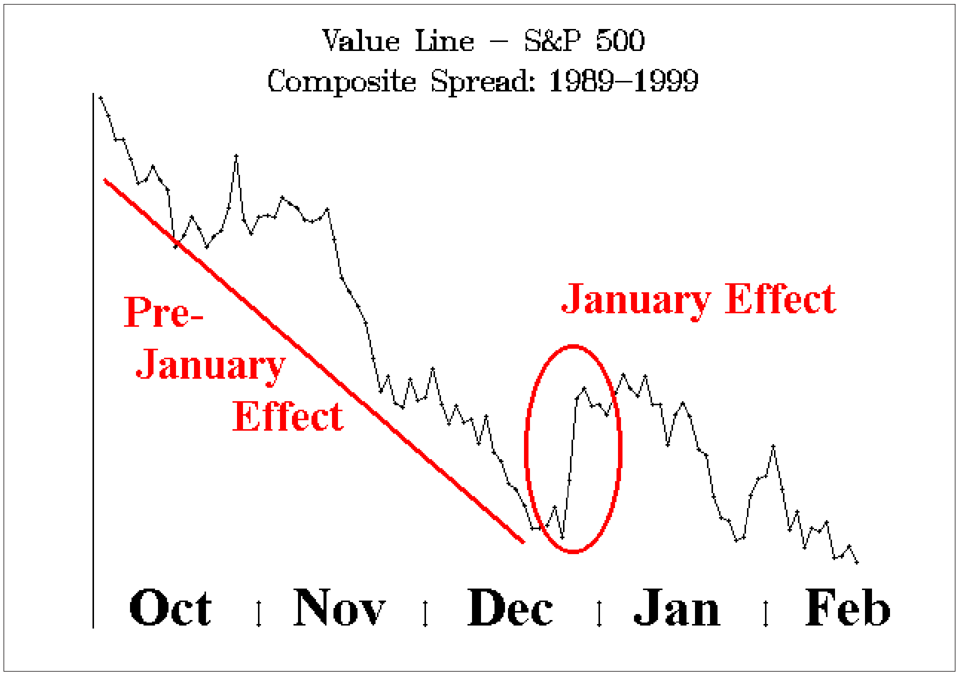

Figure 1. Composite graph of Value Line Index minus S&P 500 Index for 10 year period 1989 to 1999. Difference represents the spread between small-cap and large-cap stocks.

Delving into what causes these effects, one is led to the conclusion that it is still year-end tax selling which depresses a segment of stocks (usually those that have been doing worse during the year) and then they bounce back after the end of the year. In recent years, it has been the big caps that have been doing worse. In fact, in January 2005 the entire spectrum was inverted as big caps had a brief period of outperformance before once again succumbing to the superiority of the small caps.

A year ago, we postulated that the group which had been doing the best would be the underperformer

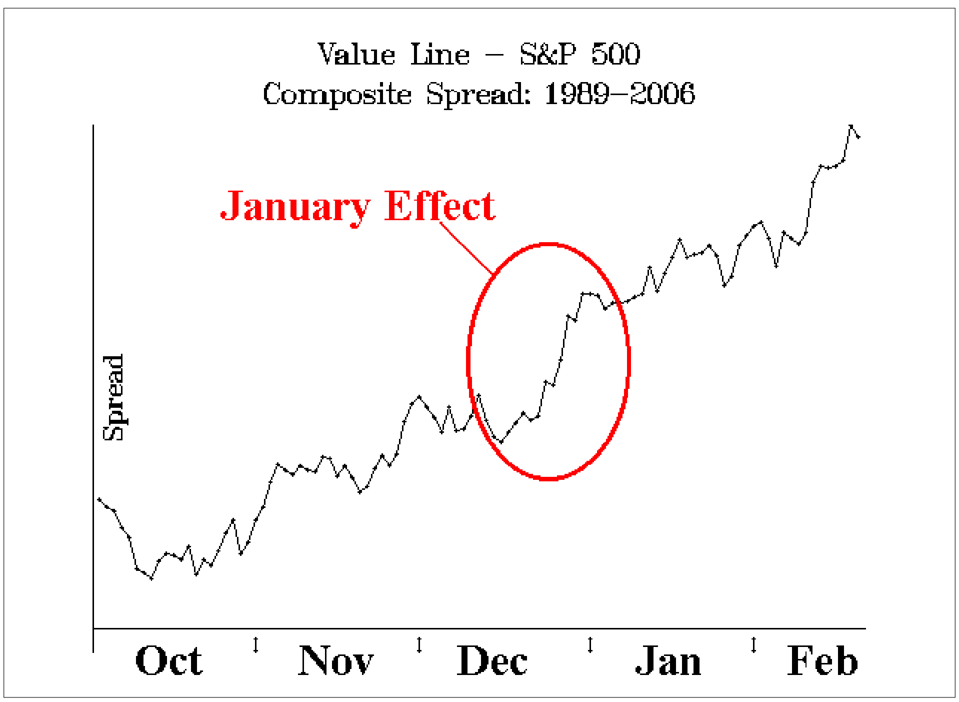

Figure 2. Composite graph of small cap/large cap spread for 18 year period 1989 to 2006.

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for a brief period as the year ended and the next year began — a more generalized interpretation of the January Effect. If you are trading individual stocks, you can often take advantage of this just by buying those stocks near the end of the year that you feel have been "oversold" due to tax loss selling.

This year, it seems that big caps have finally come back into their own, with the Dow at all-time highs, while the NASDAQ struggles comparatively. But perceptions and reality often differ. **Figure 3** shows $VLE minus $SPX over the past 12 months. Yes, there *was* a period (from April through August) in which the big caps were superior. That corresponded to the mild correction that we had this year. But, since the bull market resumed in July, the small caps have been superior once again.

As a result, we are not convinced that the "old" patterns will re-emerge. It's unlikely that the small caps will be the subject of tax loss selling across the board, for they have performed well this year, not poorly. Conversely, plenty of big caps have still struggled, so they might be the more likely candidates for selling as a group. We'll continue to monitor this situation as December unfolds, but a traditional Pre-January Effect seems unlikely.

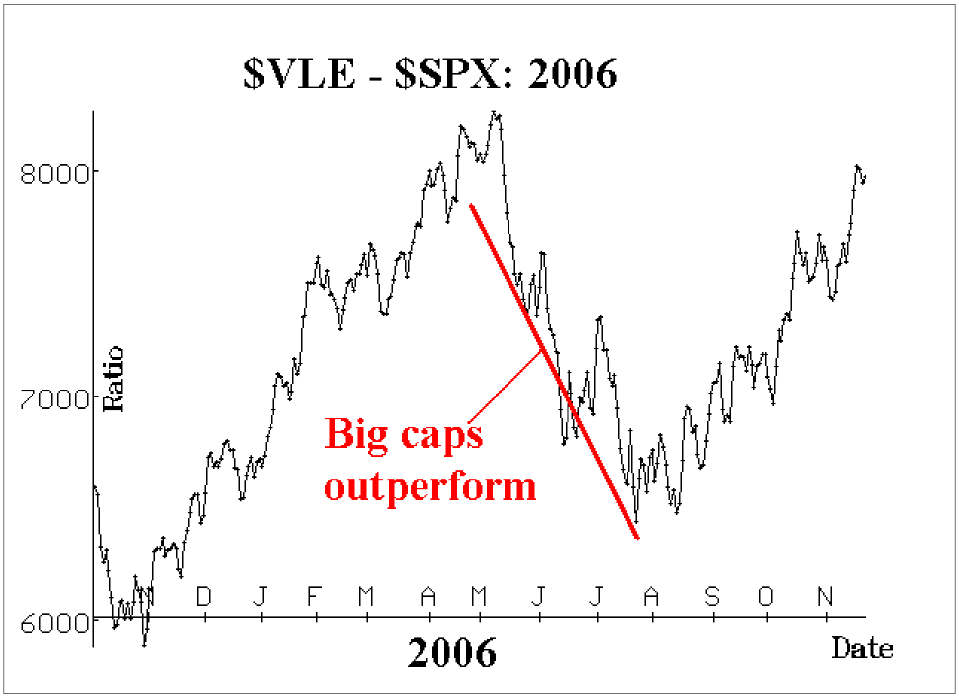

Figure 3. Graph of small cap/large cap spread for 12 month period ending mid Nov. 2006.

Lawrence McMillan edits and contributes to his firm's publications: *Daily Volume Alerts, The Option Strategist* and *The Daily Strategist* – derivative products newsletters covering equity, index, and futures options. His web page is *www.OptionStrategist.com*.

S&P 500 Changes

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

CB Richard Ellis Group (CBG) replaces Fisher Scientific (FSH). CBG is added to the Real Estate Management & Development (REALMGT) group.

Fidelity National Info Services (FIS) replaces Louisiana Pacific (LPX). FIS is added to the Services - Data Processing (SERVICEP) group.

Celgene Corp. (CELG) replaces AmSouth Bancorp (ASO). CELG is added to the Biotechnology (BIOTECHN) group.

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date
Sterling Bancshares	SBIB	3:2%	12/04/06
Commerce Bancshares	CBSH	5%	12/04/06
Walter Industries	WLT	2:1%	12/07/06
Perry Ellis Int'l	PERY	3:2	12/13/06
Sigma Adrich	SIAL	2:1	12/18/06

Trading Suspended:
Alberto Culver (ACV)
Fedders Corp. (RJC)
HCA Inc. (HCA)
Inco Ltd. (N)
Michaels Stores Inc.(MIK)
PETCO Animal Supplies Inc. (PETC)
Reynolds & Reynolds (REY)
Ryan's Restaurant Group (RYAN)

Name Changes:
Britesmile Inc. (BSML) to BSML Inc. (BSML)
Covalent Group Inc. (CVGR) to Encorium Group (ENCO)
Interchange Corp (INCX) to Local.com Corp (LOCM)
Thermo Electron (TMO) to Thermo Fisher Scientific (TMO)

Market Truths Continued

Trendlimes, Relative Strength, Moving Averages —'Market Truths' You Can Rely On

By David Vomund

This is the second in a series of articles based on Vomund's time-proven "Market Truths," concepts based on years of testing. The first of this series appeared in the November issue of the Opening Bell.

The Market Truths that I'm presenting are concepts that I have learned from my experience as a technical analyst for 20 years. People with a lot of trading experience will agree with most of the truths. Many of us have learned these truths by losing money in the market. The goal of these articles is to teach the truths to new investors so that they won't fall into the same pitfalls.

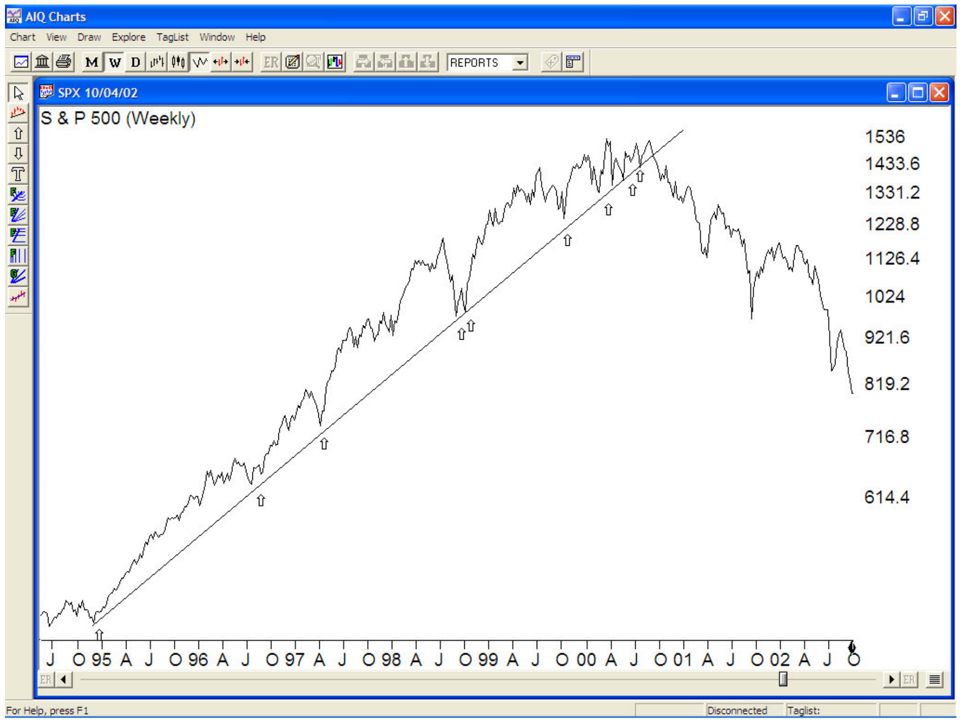

Figure 1. Daily chart of the S&P 500. Trendline shown conforms with 1995-2000 bull-run. Mid-2000 trendline break signaled start of new bear market.

Market Truth - Trendlines Work

The concept of drawing trendlines on a chart is very simple and anyone that has access to a chart can do it. It is basic, and it works. As you scroll through charts, draw any trendline that connects at least three high points or low points. The more the security touches the trendline without breaking it, the more confidence you can place in the trendline.

> ***"Figure 1 shows what may have been the most important trendline in our lifetime so far."***

Figure 1 shows what may have been the most important trendline in our lifetime so far. This trendline connects the lows from the 1995 to 2000 bull-run. Notice how many times the market corrected back to this trendline during the advance, only to find support. It wasn't until mid-2000 that the trendline was eventually broken, leading to the brutal 2000-02 bear market.

Figure 1 shows an exceptional trendline but more often trendlines look more like **Figure 2**. Notice each time PMC Sierra (PMCS) hits $7, sellers emerged (see down arrows). The buy signal came on the break above resistance in early November. It is ideal if the technical indicators are confirming the move but a trader can do well by simply buying trendline breaks.

Market Truth – You Don't Have to Trade All the Time

Every trader has a preferred style of trading. Growth investors struggle when value is in favor. Breakout traders struggle when the market is consolidating. The key is to trade aggressively when the market favors your style and cut back when the environment changes. Don't force trades.

Those who trade for a living can't sit on the sideline for very long so they need several tools that work in different market environments. These traders still have a preferred approach, however, so they have to maximize their profits when the market favors their approach.

Market Truth – The Relative Strength Report Favors Low-Priced Securities

Those, like myself, who run rotation systems using the Relative Strength report should be aware that this report favors low-priced securities. So if you run a strategy that rotates to the highest ranked security and one of the security choices has a low price, then you will constantly rotate into and out of that security.

One reason the report favors low-priced securities is because these securities often make larger percentage moves. Stocks below $10 tend to double in price more often than do stocks over $50.

The second and more important reason that the report favors low-priced securities is the way the report is calculated. AIQ's Long-Term Relative Strength report takes the last 240 days and breaks that period into quarters. It then calculates a percentage return on each quarter and averages the percentage returns, with twice the weight applied to the most recent quarter.

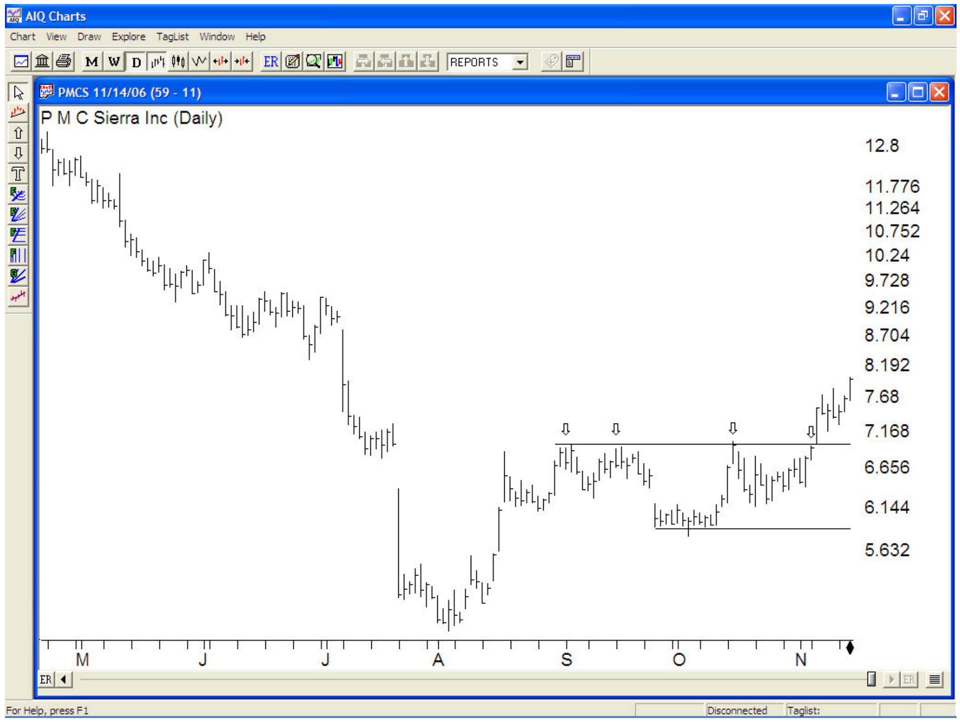

Figure 2. Daily chart of PMC Sierra. Upper horizontal trendline drawn at the $7 level acted as resistance during late 2006. Buy signal occurred when price broke above trendline in Nov.

There is an upside bias when you average percentage change numbers. Take for example a stock that starts at $10, moves to $20 (a 100% return), and then falls back to $10 (a 50% drop). After the move, the stock is unchanged but when you average the percentage changes you get a positive number (25% return).

Because of this, rotation strategies using this report won't work well if the report is run on a list of securities where most securities are over $50 but a couple are less than $10. Luckily, few mutual funds and ETFs have a price under $10 so the rotation models work on these issues.

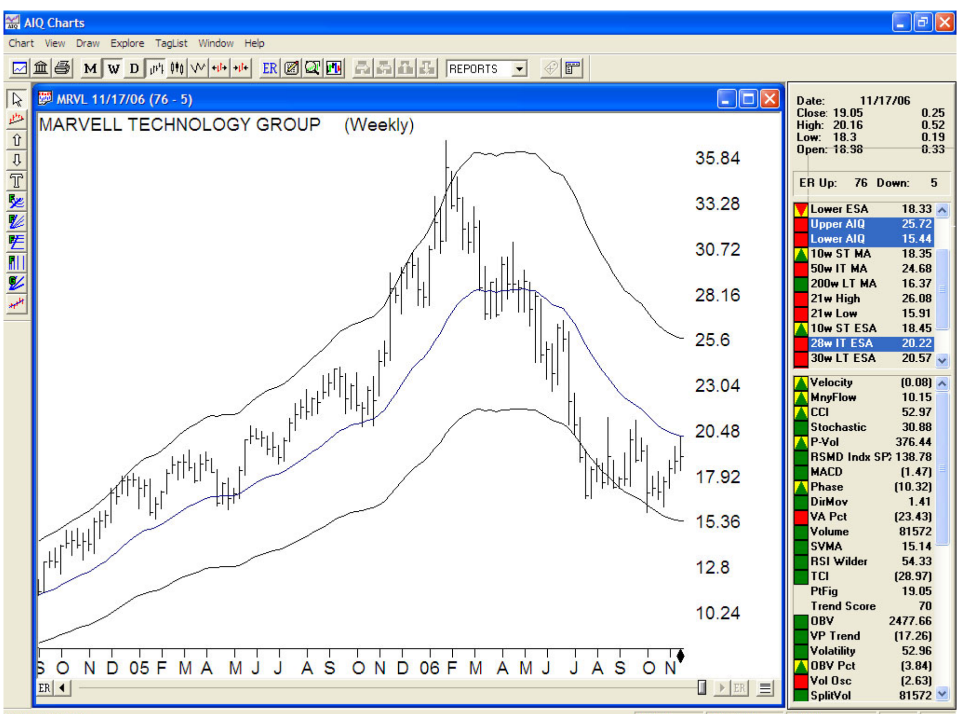

Figure 3. Weekly chart of Marvell Tech. with AIQ Trading Bands above and below 28-day Moving Avg. MA acted as support until early 2006 when drop below MA led to substantial decline.

Market Truth – Buy Stocks That Are Above Their 28-Week Moving Averages

Good things tend to happen to stocks that are above their 28-week moving average and bad things tend to happen to stocks that are below it. For that reason, most AIQ users should limit their long selections to stocks that are above this moving average.

The 28-week moving average tends to act as long-term support for uptrending stocks. These stocks tend to move higher in a stair-step pattern, where the upper AIQ Trading Band acts as resistance and the 28-week moving average acts as support.

An example of this pattern is found in **Figure 3**. Notice in late 2004 and all of 2005 that the 28-week moving average acted as support. It wasn't until the first quarter of 2006 that support was broken. The stock clearly broke down in May when it made its first pattern of lower lows. Another example is Patterson Dental (PDCO) shown in **Figure 4**.

More Market Truths next month.

A 90-minute Market Truths CD narrated by David Vomund can be purchased from AIQ's web page. Visit www.aiqsystems.com, click *Educational Products* and *Educational CDs.*

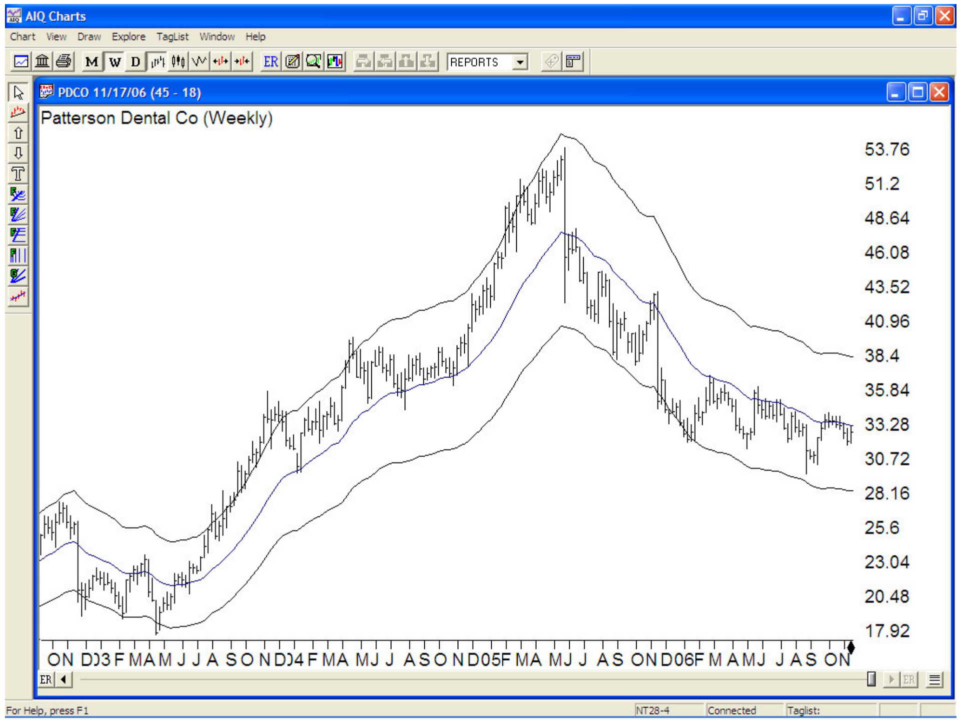

Figure 4. Weekly chart of Patterson Dental with AIQ Trading Bands shown above and below 28-day moving average. The MA acts as support until mid 2005 when drop below MA leads to major decline and MA now acts as resistance.

MARKET REVIEW

November was much like October – a good month for stocks. Why the continued advance? There was a lot of cash around (more than $2 trillion in money market funds) and, with low bond rates and falling real estate, for many investors stocks were the only choice. Stock buybacks and heavy merger and acquisition activity also played a part.

For the month, the S&P 500 rose 1.6%, the Nasdaq Composite rose 2.7%, and the Russell 2000 rose 2.5%. It wasn't a steady rally, however. Near month end the market experienced a day of heavy selling. On November 27, the Dow fell 158 points and the Nasdaq fell 54 points. That brought the market averages back to the support trendlines.

Figure 1 shows a chart of the Nasdaq Composite. Notice at the end of the month that this composite fell right to its support trendline, drawn from its August low. Support held and the Nasdaq rallied. The Nasdaq is short-term uptrending as long as it remains above its trendline.

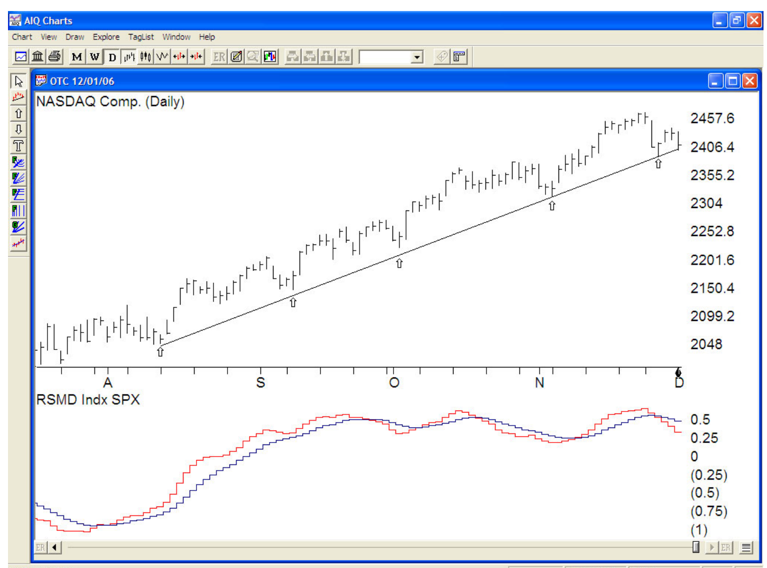

Figure 1. Daily chart of NASDAQ Comp. with upward sloping trendline.

After November 27, the market rebounded. The S&P 500 rallied back to its high whereas the Nasdaq Composite only recovered half of its November 27 loss. The Nasdaq underperformed, as can be seen from its falling Relative Strength indicator. Typically, when this indicator enters a strong downtrend, the market environment is difficult.

Precious Metals and Energy were the winning sectors in November, each gaining about 10%. Retail was the worst performer, losing 2%.