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Industry Sector Rotation Using EDS

Perform Relative Strength Analysis With Your Own Screening Criteria

By David Vomund

In the November issue of the *Opening Bell* we discussed how AIQ's pre-built Relative Strength report could be used to take advantage of sector rotation. By rotating to those sectors at the top of the report one can significantly outperform the market. This simple report provides the necessary tools to trade well. Still, having the flexibility to run additional screening criteria is helpful. AIQ's Expert Design Studio (EDS) program gives users flexibility to create their individual screening techniques.

I've used AIQ's Relative Strength report to rotate to various exchange-traded funds (ETFs) for several years. Over the past year, I've used EDS to identify both sector ETF and country ETF rotation. It has worked well. In fact, I'm so confident in the technique that I'm beginning a new managed account program, *Tactical Allocation Portfolios*, that trades sector, country, and long/short ETFs (www.ETFportfolios.net).

The technique for identifying rotation is covered in this article.

Buying sectors at the top of the short-term Relative Strength report works (see February 2006 issue of the *Opening Bell*). Therefore we want to use an EDS model that searches



DAVID VOMUND

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for high relative strength. Because of the way EDS and AIQ Reports use holidays, we can't get EDS to match exactly with the Relative Strength report, but that isn't essential for our technique.

If you recall, the short-term Relative Strength report looks at the last 120 trading days, breaks that period into quarters, and then averages the percent change for each quarter with twice the weight on the most recent quarter. Here is the EDS code that I use:

Period1 is $\text{[close]}/\text{val}(\text{[close]},30)$.

Period2 is $\text{val}(\text{[close]},30)/\text{val}(\text{[close]},60)$.

Period3 is $\text{val}(\text{[close]},60)/\text{val}(\text{[close]},90)$.

Period4 is $\text{val}(\text{[close]},90)/\text{val}(\text{[close]},120)$.

RelativeStrength if $0.4*\text{Period1} + 0.2*\text{Period2} + 0.2*\text{Period3} + 0.2*\text{Period4}$.

Using this code, an EDS report can be built that sorts ETF sectors from strongest to weakest. Although buying high relative strength sectors is effective, some people are uncomfortable with this approach because of buying high. Nearly every time they chart a high RS sector, they immediately think that they should have bought earlier.

For those people who want to buy earlier into a trend, a new

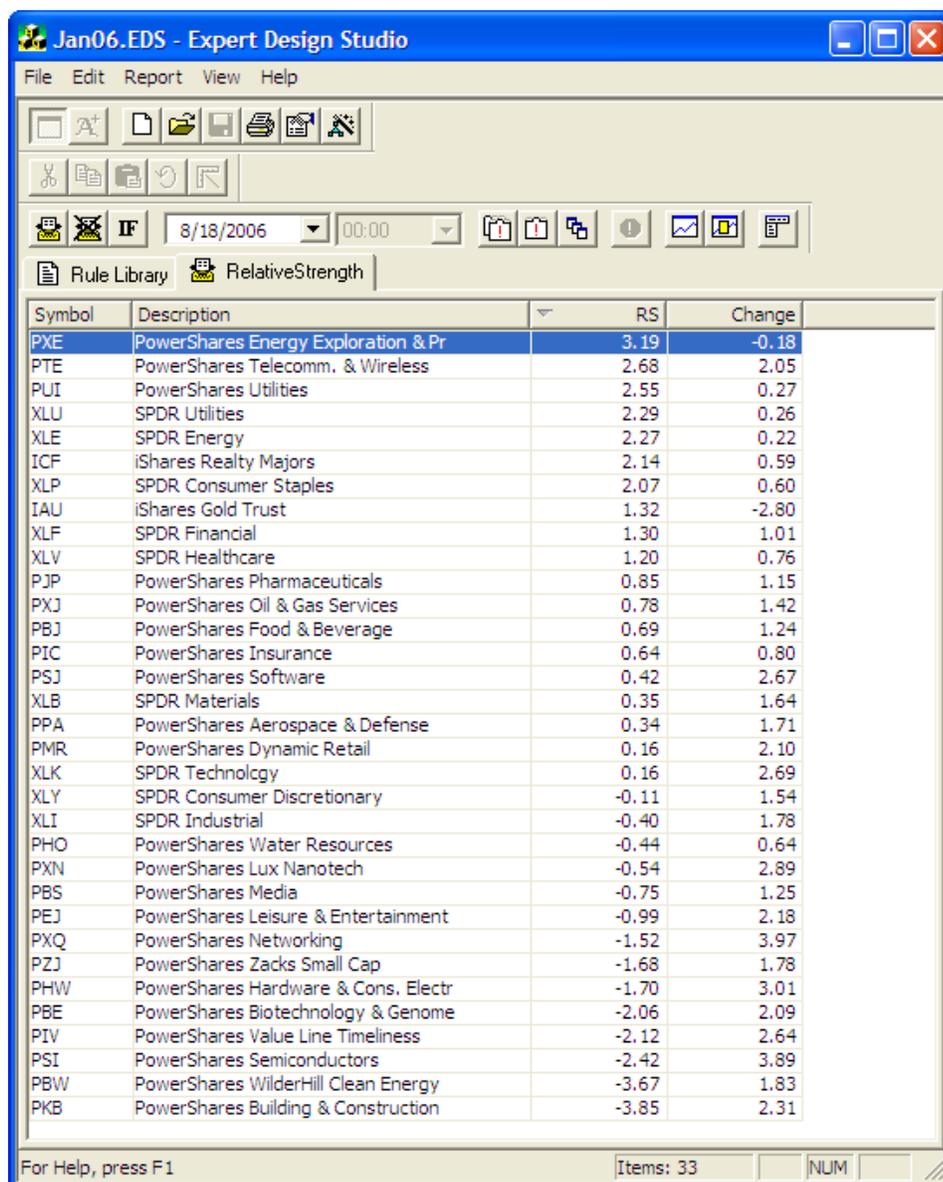


Figure 1. Expert Design Studio report for 8/18/06 listing sector ETF's. Report shows results of screen designed to find high Relative Strength tickers. ETF tickers are sorted by RS value.

screening can be added to our EDS report. I've found that tracking the weekly change in the RS ranking is useful in establishing whether a sector is gaining or losing momentum.

Let me explain this with an example.

Figure 1 shows our EDS relative strength screening on August 18. This report is run on a list of the PowerShares and SPDR sector ETFs. This report is sorted on the relative strength column, where the strongest sectors appear at the

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top of the report and the weakest appear at the bottom.

The last column, titled “Change,” is the change in the relative strength value from one week to the next. For example, the PowerShares Telecomm & Wireless

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sector has an RS value of 2.68 and a Change value of 2.05. That means that a week earlier this sector had an RS value of 0.63 (2.68 minus 2.05).

Relative Strength is the key screening, where a trader's goal is to own what appears at the top of the report. Rather than buying something when it appears at the top of the report, however, some traders may choose to use the Change column to identify which sectors are showing the strongest upward momentum. By entering those sectors with the highest Change numbers, you are buying sectors with the strongest momentum in relative strength.

Users can sort the sectors by the Change column by simply clicking on that column title (**Figure 2**). The sector with the largest Change number is Networking, with a score of 3.97. The next highest reading is Semiconductors (3.89) followed by Hardware & Consumer Electronics (3.01). Do we see a common theme here? The Change column shows that technology-related sectors had the strongest upward momentum. Those who like to enter earlier into a trend could buy a technology sector, hoping that it will rise toward the top of the Relative Strength column at some point in the future.

The advantage of entering sectors with a high Change score is

Symbol	Description	RS	Change
PXQ	PowerShares Networking	-1.52	3.97
PSI	PowerShares Semiconductors	-2.42	3.89
PHW	PowerShares Hardware & Cons. Electr	-1.70	3.01
PXN	PowerShares Lux Nanotech	-0.54	2.89
XLK	SPDR Technology	0.16	2.69
PSJ	PowerShares Software	0.42	2.67
PIV	PowerShares Value Line Timeliness	-2.12	2.64
PKB	PowerShares Building & Construction	-3.85	2.31
PEJ	PowerShares Leisure & Entertainment	-0.99	2.18
PMR	PowerShares Dynamic Retail	0.16	2.10
PBE	PowerShares Biotechnology & Genome	-2.06	2.09
PTE	PowerShares Telecomm. & Wireless	2.68	2.05
PBW	PowerShares WilderHill Clean Energy	-3.67	1.83
PZJ	PowerShares Zacks Small Cap	-1.68	1.78
XLI	SPDR Industrial	-0.40	1.78
PPA	PowerShares Aerospace & Defense	0.34	1.71
XLB	SPDR Materials	0.35	1.64
XLY	SPDR Consumer Discretionary	-0.11	1.54
PXJ	PowerShares Oil & Gas Services	0.78	1.42
PBS	PowerShares Media	-0.75	1.25
PBJ	PowerShares Food & Beverage	0.69	1.24
PJP	PowerShares Pharmaceuticals	0.85	1.15
XLF	SPDR Financial	1.30	1.01
PIC	PowerShares Insurance	0.64	0.80
XLV	SPDR Healthcare	1.20	0.76
PHO	PowerShares Water Resources	-0.44	0.64
XLP	SPDR Consumer Staples	2.07	0.60
ICF	iShares Realty Majors	2.14	0.59
PUT	PowerShares Utilities	2.55	0.27
XLU	SPDR Utilities	2.29	0.26
XLE	SPDR Energy	2.27	0.22
PXE	PowerShares Energy Exploration & Pr	3.19	-0.18
IAU	iShares Gold Trust	1.32	-2.80

Figure 2. Expert Design Studio report for 8/18/06 with results of screen designed to find high Relative Strength tickers. In this report, ETF tickers are sorted by Change (in RS value).

“Rather than buying something when it appears at the top of the (Relative Strength) report, however, some traders may choose to use the Change column to identify which sectors are showing the strongest upward momentum...The advantage of entering sectors with a high Change score is that you enter earlier into a trend.”

that you enter earlier into a trend. The disadvantage is that there are many false readings. That is, a trend

numbers is a good option for entering industry sectors. These two methodologies can be combined to

fails to emerge so the sector doesn't rise in the relative strength ranking.

Buying high relative strength sectors or buying sectors with improving relative strength

form a more dynamic strategy. With the combination strategy, you look for high Relative Strength readings combined with a high Change reading. That means the sectors are strong and getting stronger.

When you employ the combination strategy, you typically limit your selections to those at or near the top of the Relative Strength column and also have a positive Change reading. Using Figure 1, you would not be interested in the top ranked sector, Energy, because its Change reading shows no upward momentum. A better selection is the second choice, Telecommuni-

cations. Telecommunications has a high Relative Strength reading but also has a large Change reading. Its Change score of 2.05 is well above the other sectors that surround it.

In **Figure 3** we see the ideal situation, where sector with the highest Relative Strength reading also has the highest Change reading. PowerShares Energy sits at the top of the Relative Strength ranking but the high value of the Change column implies that the sector is still gaining strength relative to the other sectors. For many years we've applied relative strength analysis to rotate to those areas of the market doing the best. This article shows that this type of analysis can also be performed in EDS, and that there are advantages to doing so. Additional screening columns can be created and, unlike in the Reports module, each column can be sorted.

Editor's Note: You can download Vomund's EDS file at www.aiqsystems.com. Click *Opening Bell Monthly*.

For information on David Vomund's new *Tactical Allocation Portfolios* managed account program, which trades sector, country and long/short ETFs, visit www.ETFportfolios.net.

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PXE	PowerShares Energy Exploration & Pr	6.78	3.54
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XLE	SPDR Energy	6.07	3.34
IAU	iShares Gold Trust	4.49	1.97
PXJ	PowerShares Oil & Gas Services	4.43	2.83
XLB	SPDR Materials	4.40	0.58
PXQ	PowerShares Networking	4.35	-0.11
XLK	SPDR Technology	4.22	0.08
PHW	PowerShares Hardware & Cons. Electr	4.15	-0.24
PSJ	PowerShares Software	3.95	-0.00
PTE	PowerShares Telecomm. & Wireless	3.93	0.27
PUI	PowerShares Utilities	3.75	0.08
XLY	SPDR Consumer Discretionary	3.73	0.26
PPA	PowerShares Aerospace & Defense	3.63	0.79
PBE	PowerShares Biotechnology & Genome	3.59	-0.74
XLU	SPDR Utilities	3.47	0.11
PMR	PowerShares Dynamic Retail	3.25	-0.19
PZJ	PowerShares Zacks Small Cap	3.24	0.48
PEJ	PowerShares Leisure & Entertainment	3.17	-0.23
PKB	PowerShares Building & Construction	3.17	0.87
PHO	PowerShares Water Resources	3.13	0.56
PBS	PowerShares Media	3.12	-0.15
PJP	PowerShares Pharmaceuticals	3.10	-0.23
XLF	SPDR Financial	2.46	0.05
PBJ	PowerShares Food & Beverage	2.07	-0.05
XLI	SPDR Industrial	1.88	0.17
XLV	SPDR Healthcare	1.85	0.33
PIC	PowerShares Insurance	1.83	-0.22
XLP	SPDR Consumer Staples	1.70	-0.28
PTV	PowerShares Value Line Timeliness	1.42	0.84
PSI	PowerShares Semiconductors	1.39	0.83
PXN	PowerShares Lux Nanotech	0.82	-0.85
PBW	PowerShares Wilderhill Clean Energy	0.27	2.11

Figure 3. Expert Design Studio report for 12/01/06 with results of screen designed to find high Relative Strength tickers. In this report, sort is based on a combination of RS and Change values.

Web Seminars

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ETFs and NTFs – Perfect Fit for Active Traders

Check Out the New Securities! Traders Can Now Make Money In Any Market Environment

By David Vomund

There was a time when mutual funds were good trading vehicles for market technicians. The Rydex and ProShares mutual fund families welcomed active traders. Whereas Fidelity charged investors a fee for sector fund traders who sold within 30 days of the buy point, Rydex offered sector funds with unlimited trading. ProShares went directly after market timers by offering leveraged long and short funds.

Still, mutual funds have flaws for active traders. First, you can only buy or sell at the end of the day. Second, after the mutual fund “market timing” scandal, many funds no longer allow for active trading. In fact, effective January 1 Rydex funds are even charging redemption fees for three of their funds (Commodities, Sector Rotation, and Multi-Cap Core Equity) if they are held less than 30 days.

Luckily, there are new securities that are perfectly designed for active traders and market technicians. These securities are so attractive that stock traders may even switch to these new securities.

ProShares Leveraged Long and Short ETFs

ProShares has introduced a line of exchange-traded funds (ETFs) that are a market timer’s dream. They have ETFs that are both long and short the Dow Jones Industrial Average or the S&P 500. But the two ETFs that are becoming very popular are the ProShares Ultra QQQ (QLD) and the ProShares Ultra Short QQQ (QID). The QLD tracks the Nasdaq

100 index but with leverage—it moves twice as fast as the index—while the QID, which also uses leverage, moves inverse to the Nasdaq 100 index.

With the QID, you can be short the market without going short. By buying the QID you can either hedge other long positions or bring an account, even an IRA account, to a net short position.

Figure 1 shows the QID. If you compare this chart to the Nasdaq 100, you’ll see a nearly perfect inverse correlation. Also notice the steady uptrend in its volume. This reflects the increased popularity in this investment. When analyzing QID and QLD, I suggest performing your regular market timing analysis on the market charts (S&P 500, Nasdaq, etc.) and then trading these securities based on the analysis.

For myself, I’m much more comfortable and confident in turning bearish on the market instead of an individual stock. When I don’t like the market, I’m much more comfortable buying the QID rather than shorting an individual stock.

Sector ETFs

Sector fund traders are no longer limited to trading at end-of-day pricing. Between the three ETF families that offer sector choices, there are close to 60 ETF sector funds. The iShares family and the PowerShares family offer the most choices. The Rydex family recently introduced unweighted sector options but thus far their securities are fairly illiquid.

An AIQ list file containing the sector ETFs can be downloaded at www.aiqsystems.com. On the left

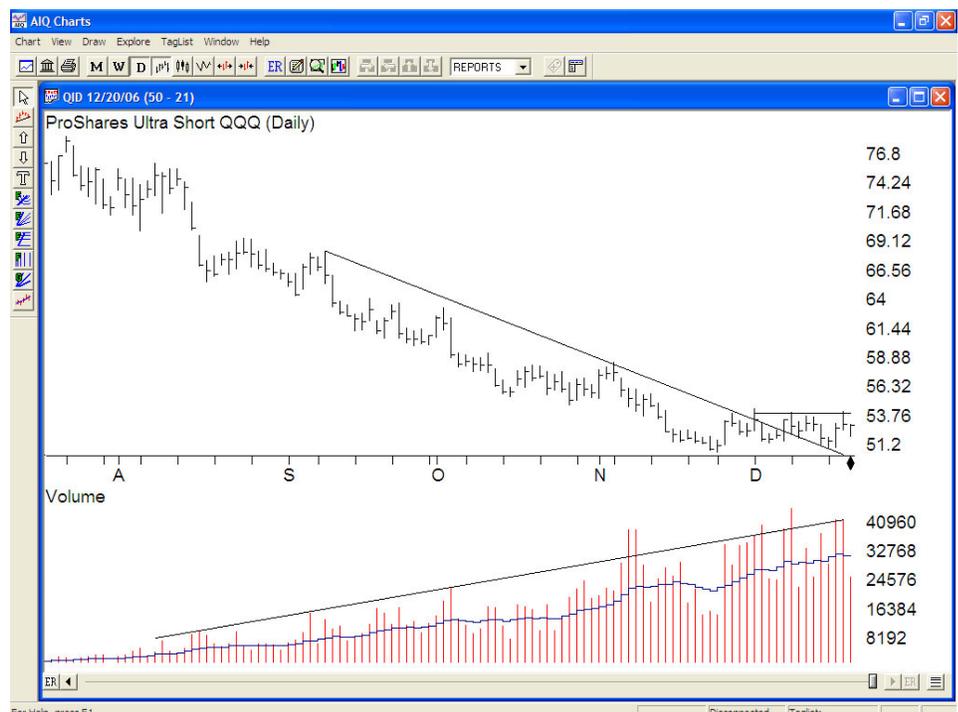


Figure 1. Daily chart of ProShares Ultra Short QQQ (QID), a leveraged fund that inversely tracks the Nasdaq 100 index.

side, click *Data*, and then *AIQ List Files*. Download the ETF-SECT choice to your Wintes32 folder.

With this list file, you can run the screening technique highlighted in this issue's cover article on the broad lists of ETF sector funds.

Country ETFs

There was a time when investors had to buy multi-national companies in order to have international exposure. That has changed. The iShares family offers close to 30 international ETFs. Now it is easy for someone to enter individual countries such as Mexico, Singapore, and Sweden. In 2006, traders were well rewarded. iShares China (FXI) rose 85% and iShares Spain (EWP) rose 50%.

Commodities

You no longer have to be a futures trader to trade a commodity index. The iPath family, the same family as iShares, offers three commodity choices. The iPath GSCI Total Return Index (GSP) and the iPath Dow Jones – AIG Commodities Index (DJP) track overall commodity

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indexes. Finally, the iPath Goldman Sachs Crude Oil (OIL) tracks oil.

These securities are exchange-traded notes (ETNs). Unlike ETFs, ETNs are unsecured notes issued by Barclays Bank. These obligations are rated AA by Standard & Poor's. Other than being backed by notes, ETNs are similar to ETFs. They can be bought, sold or shorted anytime throughout the trading day.

Since their inception last June,

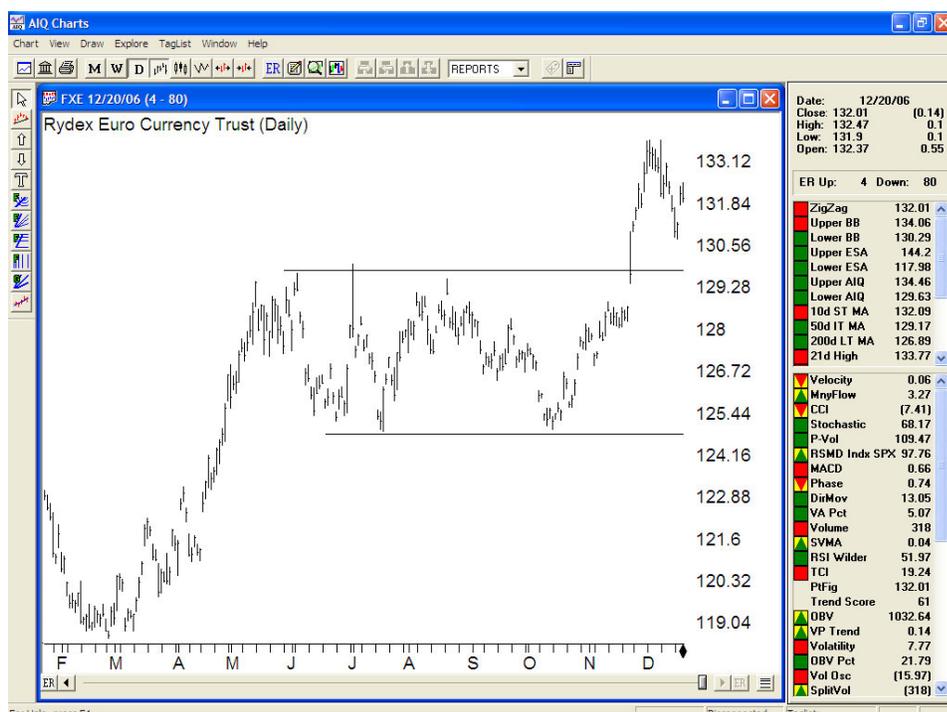


Figure 2. Daily chart of Rydex Euro Currency Trust (FXE). This currency ETF tracks the Euro.

AIQ's MatchMaker shows no correlation between these securities and the S&P 500 index. That is important as these securities may become very timely when the equity market enters a bear market.

Currencies

At the end of November the S&P 500 experienced a large one-day selloff, blamed on a falling dollar. In the past, equity traders didn't watch the dollar—that was a currency trader's game. Now, Rydex is offering several currency ETF choices. The first currency ETF, and the one with the best liquidity, is the Rydex Euro Currency Trust (FXE). This ETF tracks the Euro and is shown in **Figure 2**. By performing a chart analysis, most technicians would label November's activity as a break above a consolidation.

Other security choices are the Rydex British Sterling (FXB), Rydex Australian Dollar (FXA), Rydex Canadian Dollar (FXC), Rydex Mexican Peso (FXM), Rydex Swedish

Krona (FXS), and Rydex Swiss Franc (FXF).

Rather than sitting in the U.S. money market, you can now look to overseas money market instruments.

Summary

This is a good time to be a technician. There are many new trading vehicles available to anyone with a brokerage account. Several of these new vehicles are great options in an equity bull market, some will work great in a bear market, and others are independent the market.

The benefits of these new securities are great and will be incorporated into my trading approach. My new managed account program, *Tactical Allocation Portfolios*, will take advantage of these new securities. Through these securities, traders now have many options to make money no matter what environment our equity market is in.

For information on Vomund's new managed account program that trades sector, country, and long/short ETFs, visit the web site www.ETFportfolios.net.

S&P 500 Changes

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

DirecTV Group Inc. (DTV) replaces Freescale Semiconductor (FSLB). DTV is added to the Broadcast & Cable TV (BROADCAST) group.

Questar Corp. (STR) replaces North Fork Bancorp (NFB). STR is added to the Gas Utilities (NATURALG) group.

IAC/Interactive Corp. (IACI) replaces Lucent Technologies (LU). IACI is added to the Retail-Internet (RETAILIN) group.

Peabody Energy (BTU) replaces HCA Inc. (HCA). BTU is added to the Coal & Consumer Fuels (COALFUEL) group.

Cognizant Technology Solutions (CTSH) replaces Alberto-Culver (ACV). CTSH is added to the IT Consulting & Services (INFOTECH) group.

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date
Buckle Inc.	BKE	3:2	01/04/07

Trading Suspended:

- Freescale Semiconductor (FSLB)
- Lucent Technologies (LU)
- North Fork Bancorp (NFB)
- Red Hat (RHAT)

Name Changes:

- Alcatel S.A. (ALA) to Alcatel-Lucent (ALU)
- Lindsay Manuf. (LNN) to Lindsay (LNN)
- RAIT Investment Trust (RAS) to RAIT Financial Trust (RAS)
- SAFECO Corp. (SAFC) to Safeco Corp. (SAF)

MARKET REVIEW



Year 2006 was a strong one for the market, exceeding most people's expectations. The S&P 500 rose

13.62% and the Nasdaq Composite rose 9.52%. Much of that gain came in the second half of the year when the S&P 500 rallied from July through December without so much as a 2% correction (see 2% ZigZag indicator in **Figure 1**). Volatility fell to a 12-year low.

As good as our market was, international markets were stronger. The Morgan Stanley EAFE Index rose 23%.

In 2006 the strongest industry groups were REITS, Telecommunications, and Aerospace & Defense. These groups gained 20% to 30%. The worst performing group was Home Construction, falling 15%. Several of the energy groups, along with Electronics, fell 5%.



Figure 1. Chart of S&P 500 for 2006. ZigZag indicator (red) shows strong trend in 2nd half.

At the end of 2006, the S&P 500 was just above a steep trendline connecting its lows dating back to July. The Nasdaq had already broken below its similar trendline.

The technical picture was deteriorating and it seems risk will once again be factored into market decisions.