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The Opening Bell Newsletter is a publication of AIQ Systems P.O. Box 7530 Incline Village, Nevada 89452

## Planning and Preparation

# Not Easy! Here's What It Takes To Be A Successful Trader

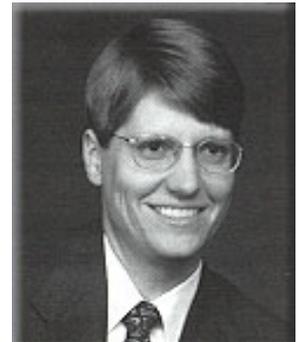
By David Vomund

**W**hile watching the Olympics, it is easy to see comparisons between winning athletes and successful traders. As difficult as it is for athletes to perform in their events, the really hard work came long before the Olympics. Swimmers, for example, do countless laps long before the Games begin. When we watch the Olympics, we are seeing the results of each athlete's planning and preparation.

Just as an Olympic athlete can't just show up for an event without any preparation, neither can a stock trader. For successful traders, the real work takes place before the trade is entered. Planning and preparing for a successful trade is hard work. Managing the actual trade is the easy part. In this article we'll describe the requirements needed to be a successful trader.

**Enthusiasm** – Those new to trading often think one can install the AIQ software and then begin profitable trading. Once they see the size of the

*User's Manual* they realize their mistake! All successful traders try various trading methods and test different trading strategies.



DAVID VOMUND

While there are thousands of AIQ users, no two use the program the same way. Developing a personal trading approach takes time and it's not easy. Enthusiastic traders get through this

*"While there are thousands of AIQ users, no two use the program the same way. Developing a personal trading approach takes time and it's not easy. Enthusiastic traders are willing to put in the effort to improve their performance."*

process and are willing to put in the effort to improve their performance. The "just show me the money" crowd doesn't last long in this industry.

### **Control Destructive Emotions**

In order to profit it is necessary to risk something. If you risk too much, then

emotions take over and you make decisions based on fear. Each trader learns his risk tolerance, whether greed or fear is dominant. Those dominated by greed better make sure that they have a solid stop mechanism. Those who are dominated by fear need to find a confident and positive attitude. Visualize successful trades. You often get what you believe.

Learning to tolerate the uncertainty in order to succeed is essential. Sometimes, this means riding down a drawdown. The more often you have a drawdown the more you'll be able to accept it. The same is true for selling stocks at a loss. If your ego is too big and it is hard to sell for a loss, then it might be good to have a lot of losses. The more often you sell for a loss, the easier it will be. The easier it is, the sooner you'll get out next time.

**Have a Trading Plan** – Do you buy stocks high or are you a bottom-fisher? What part of the chart do you like? Where in the cycle of the chart are you likely to buy and sell? Are there certain indicators that you most often use?

## AIQ Opening Bell Newsletter

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AIQ Opening Bell does not intend to make trading recommendations, nor do we publish, keep or claim any track records. It is designed as a serious tool to aid investors in their trading decisions through the use of AIQ software and an increased familiarity with technical indicators and trading strategies. AIQ reserves the right to use or edit submissions.

While the information in this newsletter is believed to be reliable, accuracy cannot be guaranteed. Past performance does not guarantee future results.

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**Figure 1.** Daily chart of Novell. In late May, stock fell below support completing the descending triangle pattern shown. On this day, a short-seller may have opted to take a short position.

These are the types of questions that need to be asked when developing a trading plan.

A trading plan describes your approach(es) to trading. It describes when you buy and when you sell. It describes the trading model(s) that are used in stock selection. It describes position size. Expert Design Studio backtests will help answer these questions. The plan should be in writing but it will change over time. Successful traders will agree that over time the changes become fewer and fewer.

**Have a Proper Position Size** – Even the best stock selection system will have losing trades. If you take too large a risk on too few trades, your plan may not have the ability to endure. Having a proper position size is important in managing risk. Most people should equal-

ize the risk on all trades by using an equal dollar amount for each trade. This may vary from 0.5% of their account to 10% of their trading

*“If your ego is too big and it is hard to sell for a loss, then it might be good to have a lot of losses. The more often you sell for a loss, the easier it will be. The easier it is, the sooner you'll get out next time.”*

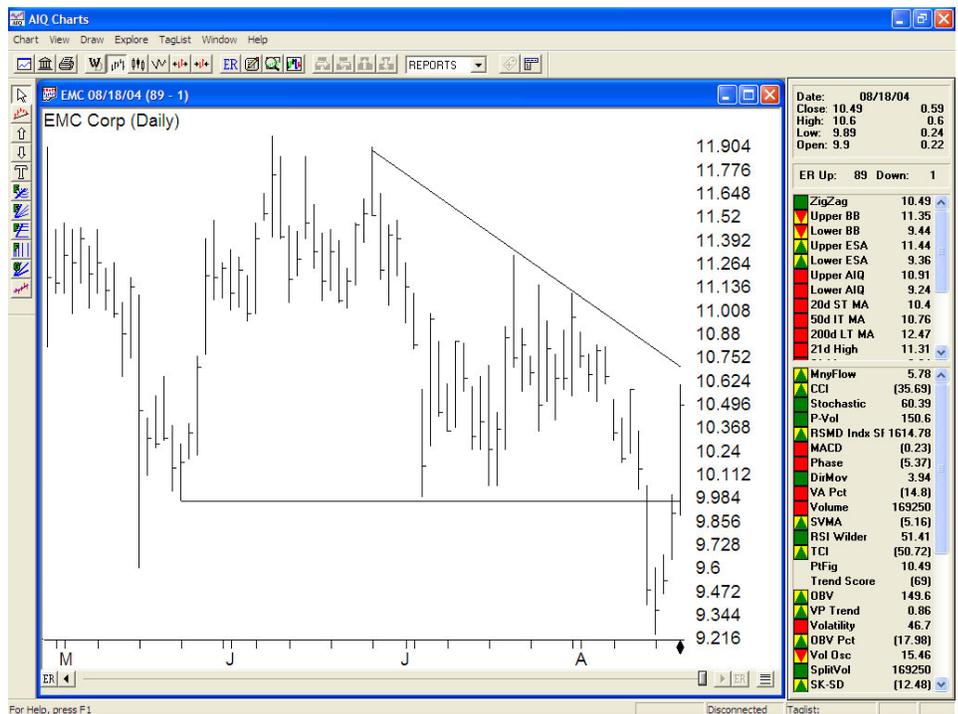
account. By equalizing the risk, you are eliminating the desire to “go big” based on your gut instinct.

**Manage the Trade** – Many times, managing a trade means sitting on your hands and doing nothing. Resist the urge to exit a trade before your trading plan's exit strategy tells you to. Follow your trading plan and let the stock hit your chosen target, time period, or stop level before exiting. If you exit early, it should be a result of a disciplined rule.

An example of a possible trade is shown in **Figure 1**. If you're using a breakout system, then Novell (NOVL) may have appeared on your bearish list. On May 25 NOVL fell below support, completing a descending triangle pattern. A short-term trader may have shorted on that day with a stop placed just above the horizontal trendline. One with a greater risk tolerance could place a stop just above the descending trendline.

In either case, the stop loss level should be chosen before entering the trade and it should be adhered to. In mid-June NOVL approached the horizontal trendline but did not trigger the stop. By following the system, the trader would close the trade due to a time or profit target trigger.

**Confidence** – Risk taking requires a certain amount of guts. Some traders gain confidence after successes and take on more risk. That's good. Confidence is gained from success, when you know what to do in all situations. When your trading portfolio has steady gains



**Figure 2.** Daily chart of EMC. Chart shows a descending triangle short-selling signal in mid-August. However, stock quickly reversed and stop loss was triggered just four days later.

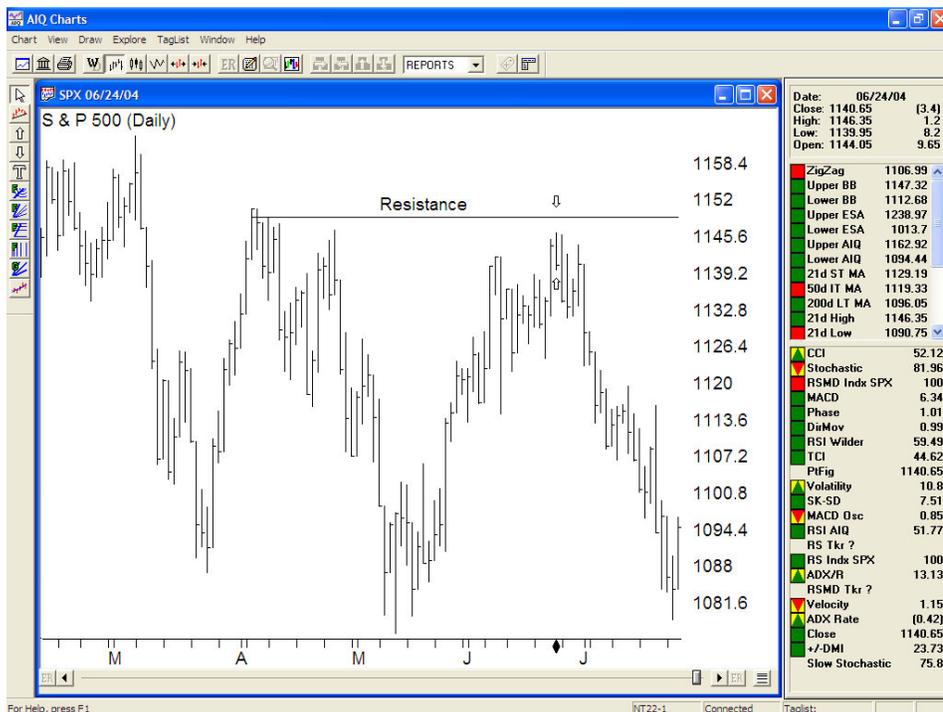
then you will want to play bigger.

Confidence can also be gained from thorough backtesting. If you don't have confidence in a system, then you might abandon your system after a few losing trades.

Suppose you employ the short-selling technique shown in Figure 1 but your first trade is in EMC Corp (EMC). **Figure 2** shows a similar descending triangle short-selling signal but in this case a stop loss is triggered four days after entering the trade. Without confidence that your system works, you might leave an effective system in search of better results.

**Compare the Reward to Risk** – Profit targets are hard to quantify but risk isn't. Where will a stop be placed and how much risk is involved. If the stock has more room to fall than to rise then it is not a good trade. In the descending triangle examples (Figures 1 and 2), the horizontal trendline stop represents a small loss while there is significant profit potential. The gains in Novell (Figure 1) more than offset the loss in EMC Corp (Figure 2).

**Figure 3** shows another example. On June 24 (see arrows) the S&P 500 was at the upper end of a trading range. To enter a long trade at this



**Figure 3.** Daily chart of S&P 500 Index. On 06/29 (arrow) index was near upper end of trading range, obviously a high-risk time to take a long position.

point makes no sense. The index is against resistance but can fall 70 points before reaching the lower end of the range. By going long, you are betting on a breakout. Until the

*“Having a proper position size is important in managing risk. Most people should equalize risk on all trades by using an equal dollar amount for each trade... By equalizing the risk, you are eliminating the desire to “go big” based on your gut instinct.”*

breakout happens, there is more room for the index to move lower than there is for the index to move higher.

**Review Your Trades** – Did you follow your trading plan on the buy and sell side? Did you get out too fast or should you have added to the position? If you followed your trading plan but the stock was sold for a loss then it was a good trade. If you made exceptions to your plan

then it was a bad trade, even if the trade was profitable.

By reviewing your trades, you'll develop a more disciplined approach. You will also see if your trading plan needs to be adjusted.

It is tempting to enter a trade without a proper plan or with little preparation. Building a trading plan takes time, and it's not fun. It is essential for long-term success, however. It helps improve the consistency of your decisions and the consistency of your results.

David Vomund publishes VIS Alert, a weekly investment newsletter. For a sample copy, go to [www.visalert.com](http://www.visalert.com).

## MARKET REVIEW

The S&P 500 had fractional gains in September but there was mid-month volatility. This index fell 3.5% in the first half of the month and then recovered those losses in the second half of the month.

Damage was worse for the Nasdaq Composite, which fell 2.6% during the month. Its mid-month correction was 7%.

Last month we ran an article on how the WAL Score and US Score (found on AIQ's Market Log report) can be used as a market timing tool. This month provided an excellent example.

Around the market low on August 16, 87% of the unconfirmed signals were on the buy side. At the same time, 92% of the confirmed signals were on the buy side. Good trading opportunities emerge when both the confirmed and unconfirmed signals are in agreement.

## STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split/Div.	Approx. Date	Stock	Ticker	Split/Div.	Approx. Date
Energy South Inc.	ENSI	3:2	09/02/04	Chevron Texaco	CVX	2:1	09/13/04
Gilead Sciences	GILD	2:1	09/07/04	Scripps EW	SSP	2:1	09/13/04
TCF Financial	TCB	2:1	09/07/04	Stifel Financial	SF	4:3	09/16/04
21st. Century Holding	TCHC	3:2	09/08/04	Hughes Supply	HUG	2:1	09/23/04
Chittenden Corp	CHZ	5:4	09/10/04	Legg Mason	LM	3:2	09/27/04
Gorman-Rupp	GRC	5:4	09/13/04	Cathay Gen'l Bancorp	CATY	2:1	09/29/04

### Trading Suspended:

Apogent Technologies (AOT), Cendant (JCD), Duane Reade Inc. (DRD), Huffey Corp. (HUF), Sonus Networks (SONSE), Trump Hotels & Casinos (DJT), Xicor Inc. (XICO)

### Name Changes:

California Amplifier (CAMP) to CalAmp Corp (CAMP)  
 Capital Environmental Resources (CERI) to Waste Services (WSII)  
 Chicago Pizza & Brewery (CHGO) to BJ's Restaurants (BJRI)  
 Childtime Learning Centers (CTIM) to Learning Care Group (LCGI)  
 R. J. Reynolds Tobacco (RJR) to Reynold American Inc. (RAI)  
 Willshire Financial Svs. (WFSG) to Beverly Hills Bancorp (BHBC)

## S&P 500 Changes

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

Fisher Scientific (FSH) replaces Thomas & Betts (TNB). FSH is added to the Health Care Equipment (HEALTHMP) group.

*Market Timing with Industry Sectors*

# Get a Better Feeling for Health of Market -- Add Sector Rotation to Your Market Timing Model

By David Vomund

**T**here are a lot of market timing methods. You can use moving average crossovers, chart pattern analysis, Expert Rating signals, relative strength indicators, etc. Nearly all these market timing models feature a direct analysis of a market index such as the S&P 500 or Dow Jones Industrial Average.

In this article we'll discuss a market timing technique that doesn't evaluate any of the market indexes. We'll perform an inter-market analysis on industry groups, revealing how industry group rotation can help you determine the health of the market.

Many people perform inter-market analysis. For example, by watching a commodity index you can predict inflation data, which in turn affects interest rate movement. Along the same lines, knowing which industry groups are leading or lagging the market gives an indication of the future strength or weakness of the market.

Most people know that the technology sector is highly correlated with the Nasdaq Composite. That's why the Nasdaq is often used as a measure of technology strength or weakness. But what about the S&P 500? Which sectors are the most highly correlated to that index (i.e. tend to move with the index)? The answer is very important.

The sectors showing the highest correlation to the S&P 500 depends on the industry group structure. No matter what structure you use, however, you will find Finance and Technology at or near the top of the

**Table 1. Correlation versus the S&P 500 Index  
8/20/99 to 8/20/04**

Correlation	Ticker	Sector
841	FINANCM	Finance
827	MISCMM	Miscellaneous
795	ELCTRCMM	Electronics
762	MEDIAMM	Media
755	RETAILMM	Retail
742	BUILDGMM	Building
733	TELECM	Telecommunications
713	BANKNGMM	Banking
709	INTNETMM	Internet
698	UTILTYMM	Utility
697	LEISREMM	Leisure
695	TRANSPMM	Transportation
690	AUTOMM	Automobile
673	CONSUMMM	Consumer
665	CHEMCLMM	Chemical
615	INSRNCMM	Insurance
580	MEDICLMM	Medical
575	CMPUTRMM	Computer
508	AERSPCMM	Aerospace/Defence
474	METALSMM	Metals
451	OILGASMM	Oil & Gas
418	FOODBVMM	Food Beverage

list. These are the two sectors that consistently rank as highly correlated to the S&P 500, no matter what structure or time period is used.

To demonstrate this, we used AIQ's MatchMaker program to run a five-year correlation test of all the sectors in the AIQ Pyramid structure versus the S&P 500. The results are found in **Table 1**. The sectors near the top of the list show the highest correlation to the S&P 500 while the sectors near the bottom have the lowest correlation. A correlation of 1000 signifies identical movement.

The sector with the highest correlation is Finance. Miscellaneous has the second highest correlation. That's not surprising because Miscellaneous contains a broad mix of stocks, just like the S&P 500 index. Electronics has the third highest correlation (a.k.a. Technology). The important point is the S&P 500 is highly correlated to Finance and Technology.

The sectors with the lowest correlation are Metals, Oil & Gas (a.k.a. Energy), and Food. If you are holding equities long in a bad

market, then metals, energy, and food typically are the best sectors to hold. That's because their movement is somewhat independent of the market.

With this information, we can begin to judge the market's health based on group/sector rotation. Since Finance and Technology show the highest correlation to the market, these sectors had better be advancing when the market is moving higher. If the S&P 500 moves up without them, watch out. A market rally won't last long without these sectors. Along the same lines, if these sectors begin to outperform in a bad market environment then a low is near.

Let's clarify this with some examples. First we'll look at the market top at the start of July. At that time, the market was near the upper end of its trading range so it was going to either break to the upside or enter a correction within the range. To identify group rotation, we created a structure based on the largest holdings in the Rydex sector funds. AIQ's pre-built Group Analysis report was used.

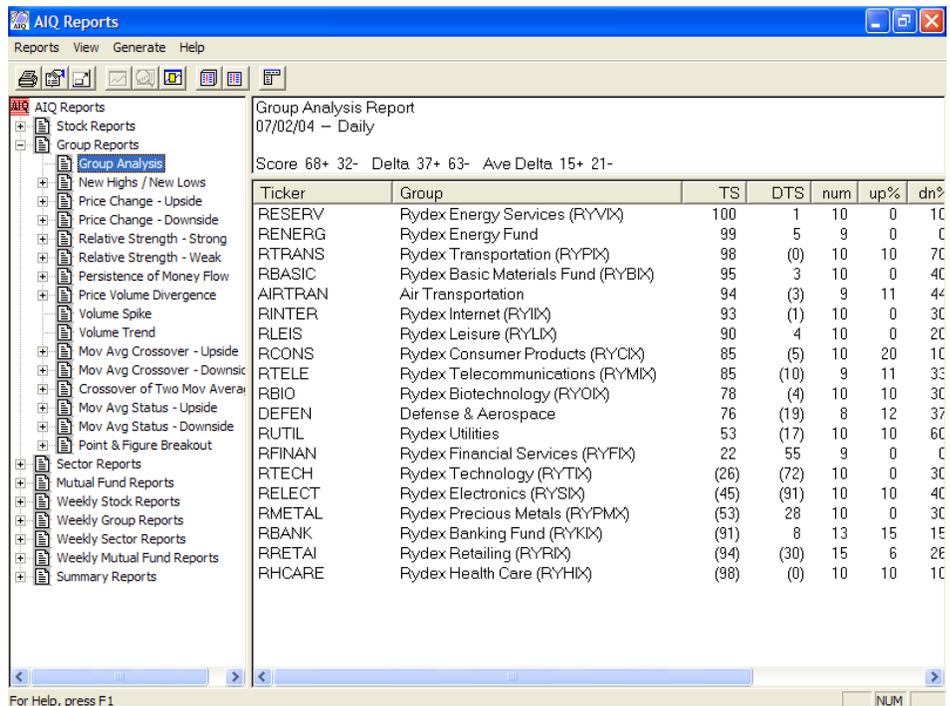


Figure 1. AIQ Group Analysis Report for 07/02/04 lists sector fund ranks at market top.

Figure 1 shows the Group Analysis report on July 2. It shows the defensive Energy groups at the top of the ranking but more importantly the lower end of the report is dominated by Financial and Technology groups. Four of the bottom seven groups are either financial or technology related. This industry

group report was one of the first signs of approaching market weakness.

Now let's look at the market bottom in May. At the time the S&P 500 was at the lower end of the range and would either break below the range or would begin to rally within the range. Figure 2 shows the Group Analysis report on May 21. Notice this time that Banking is the top group, and the top third of the report is dominated by financial and technology related groups. These groups moved toward the top of the ranking during a weak market, signaling the beginning of a month-long rally.

It is not advisable to only use group rotation in your market timing decisions but it does work well when used in conjunction with the more standard market timing models. That's because its readings work independent of the readings from standard index analysis. By following the strength or weakness of the finance and technology groups, you can get a better feel for the market environment.

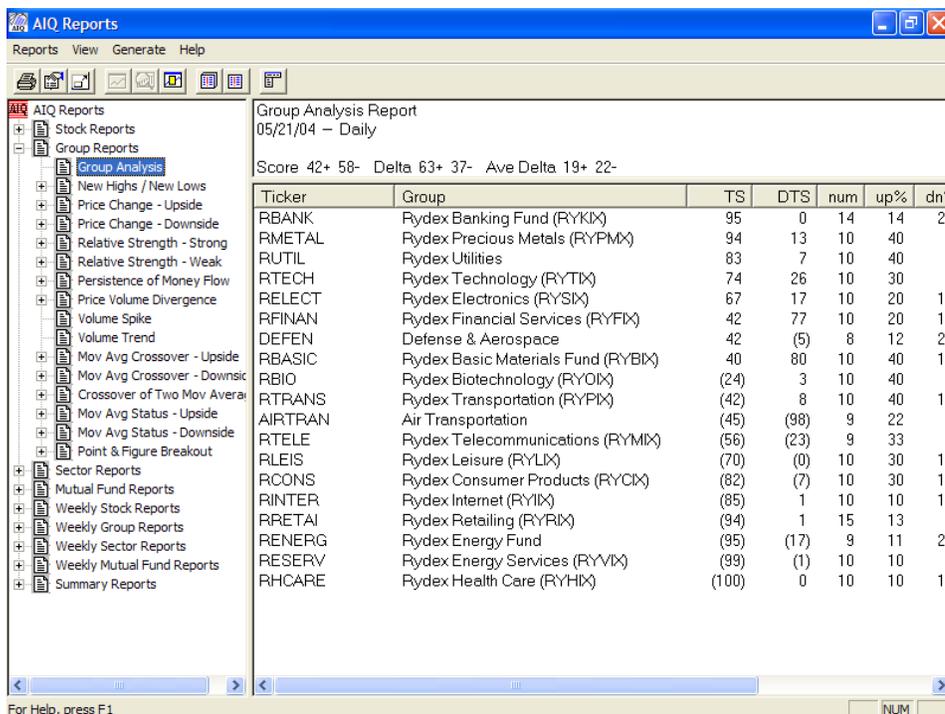


Figure 3. AIQ Group Analysis Report for 05/21/04 lists sector fund ranks at market low.

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**Two-track format to start**

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**Dan Zanger, [chartpattern.com](http://chartpattern.com)**

Dan Zanger is Founder and President of [chartpattern.com](http://chartpattern.com). Best known for his record breaking portfolio performance, Dan shares technical analysis education in his Understanding Chart Patterns section, and shows his international audience what setups he looks for in finding powerful movers in the market. Dan's stock recommendations which can be found in his four-night per week newsletter are little known, and often under institutionally-subscribed stocks that he brings to the attention of his readership BEFORE the institutions move them. Dan has been an AIQ user for 12 years.



**Jerry Klein, [investtalk.com](http://investtalk.com)**

Founder of Klein-Pavlis-Peasley. Jerry, as clients and listeners feel comfortable calling him, began his career in the investment industry in 1962. Before starting his own firm, Jerry has acted as a Registered Securities Representative, Investment Advisor and Money Manager with a number of registered securities broker-dealers. He also co-presents the Investtalk radio show every week night.



**David Vomund, Chief Analyst, AIQ Systems**

David Vomund is editor of AIQ's Opening Bell newsletter, and publisher of VISalert.com newsletter. David is an experienced Money Manager and Market Timer.



**Steve Palmquist, [daisydogger.com](http://daisydogger.com)**

Steve Palmquist is a full time trader with nearly 20 years of experience and is a speaker at trade shows and seminars. Steve's [daisydogger.com](http://daisydogger.com) site provides trading tips and techniques, and the Timely Trades Letter provides a Market Outlook, trading setups, and trading tips. Steve is an AIQ user.



**Dean Kasparian, President, AIQ Systems**

Dean Kasparian is President of AIQ Systems. An experienced analyst, Dean has been actively involved in all aspects of AIQ product development, AIQ seminars and workshops.



**Rich Denning, CPA Stock Investor**

Rich Denning, CPA, has been an AIQ user since 1985. A stock investor since 1973, Rich has concentrated on short-term trading using systems written in AIQ's EDS language.



**Steve Hill, Vice President, AIQ Systems**

Stephen Hill is Vice President of AIQ Systems. Steve has 12 years experience with AIQ products. He has been involved in all aspects of AIQ through support, sales and teaching seminars.



**DAY  
ONE****Monday October 11, 2004****7:30 - 8.30am Registration and AIQ Hosted Breakfast****Track 1 - Using AIQ Effectively**

8:30am - 10:00am

**Getting Started Right** *David Vomund*

David Vomund will discuss such areas as Market Timing, Stock Selection and Group/Sector Rotation. Both this session and the following session are perfect for a refresher or if you are new to TradingExpert Pro.

10:30am - 12:00noon

**Getting the Best Out of AIQ** *Dean Kasparian*

Dean Kasparian will discuss the primary elements of AIQ's TradingExpert Pro and will focus on how to get the best out of these tools.

**Track 2 - Trading and Exiting**

8:30am - 10:00am

**Real Time Trading Strategies** *Steve Hill*

Steve Hill will focus on real time trading systems in both RT Alerts and in the new AIQ Real Time Back Test feature. Exiting strategies in real time will also be discussed.

10:30am - 12:00noon

**Exit Trading Strategies** *Rich Denning*

Rich Denning will focus on the importance of exiting strategies and their place in your overall trading systems, including trailing stops, system exits and days held exits.

**12:00noon - 1:30pm AIQ Hosted Lunch****Track 1 and Track 2 combined for afternoon sessions**

1:30pm - 3:00pm

**Trading with the Market Part I** *Steve Palmquist*

Steve's sessions outline trading strategies and how to vary the trading style and exit strategies based on current Market conditions. Steve will be sharing EDS scans and stop loss strategies that he uses in his trading. He will also explain how he analyzes the Market to determine which set of tools to use.

3:30pm - 5:00pm

**Hidden Tools in AIQ** *David Vomund*

David Vomund will discuss some of the lesser known but very powerful tools within AIQ's TradingExpert Pro. Topics will include Hot Keys, Color Studies, Data Management, Custom Indicators, Breadth Builder, and much more.

**DAY  
TWO****Tuesday October 12, 2004****7:30 - 8.30am AIQ Hosted Breakfast**

8:30am - 10:00am

**Trading System Design** *Dean Kasparian*

In this session Dean kasparian will discuss the elements critical to forming a trading system strategy and discuss some of the pitfalls and traps to avoid in developing a system.

10:30am - 12:00noon

**ETF Trading** *David Vomund*

Exchange Traded Funds (ETFs) are the fastest growing financial product in the United States. In this session, David will discuss various ETF trading strategies. While day-trading strategies will be highlighted, most of the focus will be on longer-term rotational systems. David will discuss several mechanical trading systems, including the one that he uses for his managed account program, ETFportfolios.net.

**12:00noon - 1:30pm AIQ Hosted Lunch**

1:30pm - 3:00pm

**Trading with the Market Part II** *Steve Palmquist*

Part II of Steve's session from yesterday.

3:30pm - 5:00pm

**Lessons from a Money Manager and Radio Talk Show Personality** *Jerry Klein*

Radio personality, Money Manager, and AIQ user Jerry Klein will discuss his analysis techniques, including the use of chart patterns, indicator readings, and basic fundamental analysis. Common pitfalls investors make will also be highlighted as well as his own "Stink-O-Meter."

**6:00pm - 9:00pm AIQ Hosted Cocktail/Dinner Reception**

**DAY  
THREE**

**Wednesday October 13, 2004**

**7:30 - 8.30am AIQ Hosted Breakfast**

8:30am - 9:30am

**What's New in AIQ**

*Dean Kasparian*

Dean will cover the new features in AIQ's latest version of TradingExpert Pro including such power features as Real Time Back Testing, Custom Indicators, Custom Barometer in Quotes and Historical Real Time Data.

10:00am - 12:00noon

**Trading off Chart Patterns**

*Dan Zanger*

Over the last 15 years, Dan has spent over 10,000 hours studying every type of chart pattern formation imaginable. From Cup and Handle patterns to Falling Wedges, Ascending Triangles, Bull and Bear Flags. In this session Dan will highlight chart patterns and how they can lead you to the biggest movers in the market. Dan will focus on patterns and trendlines and how he uses them for timing his trades.

**Seminar concludes at noon**

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- AIQ hosted lunch Monday and Tuesday.
- AIQ hosted cocktail reception/dinner on Tuesday, October 12th at 6pm

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