AIQ Opening Bell® Monthly

IN THIS ISSUE | VOL. 10 | ISSUE 4 | APRIL 2001

Feature

Sections

The *Opening Bell Monthly* is a publication of
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INDUSTRY GROUP ANALYSIS

AIQ'S UNIQUE GROUP ANALYSIS MODULE OFFERS VALUABLE INFORMATION

DAVID VOMUND

By David Vomund

One of the distinguishing features in TradingExpert is its industry group analysis capabilities. No other program enables users to better identify group rotation. How to use AIQ's Group/Sector Analysis report to identify the rotation will be covered in next month's *Opening Bell* newsletter.

In this month's article, we'll examine lesser-known analysis techniques which utilize AIQ's unique group analysis module.

Growth Versus Value

An important aspect of today's market is the constant rotation between growth and value stocks. Rather than the entire market of growth and value stocks advancing or declining together, we've entered a pattern where value stocks do well when growth stocks decline and growth stocks do well when value stocks decline.

"An important aspect of today's market is the constant rotation between growth and value stocks....people who correctly switched would have seen their portfolios constantly move higher. AIQ's industry group feature can help identify this rotation."

In other words, when the "new economy" growth stocks do well then the "old economy" value stocks move lower and vice versa.

While the market has experienced a significant correction, people who correctly switched between growth and value stocks would have seen their portfolios

Industry Group Analysis continued on page 2

INDUSTRY GROUP ANALYSIS *continued* . . .

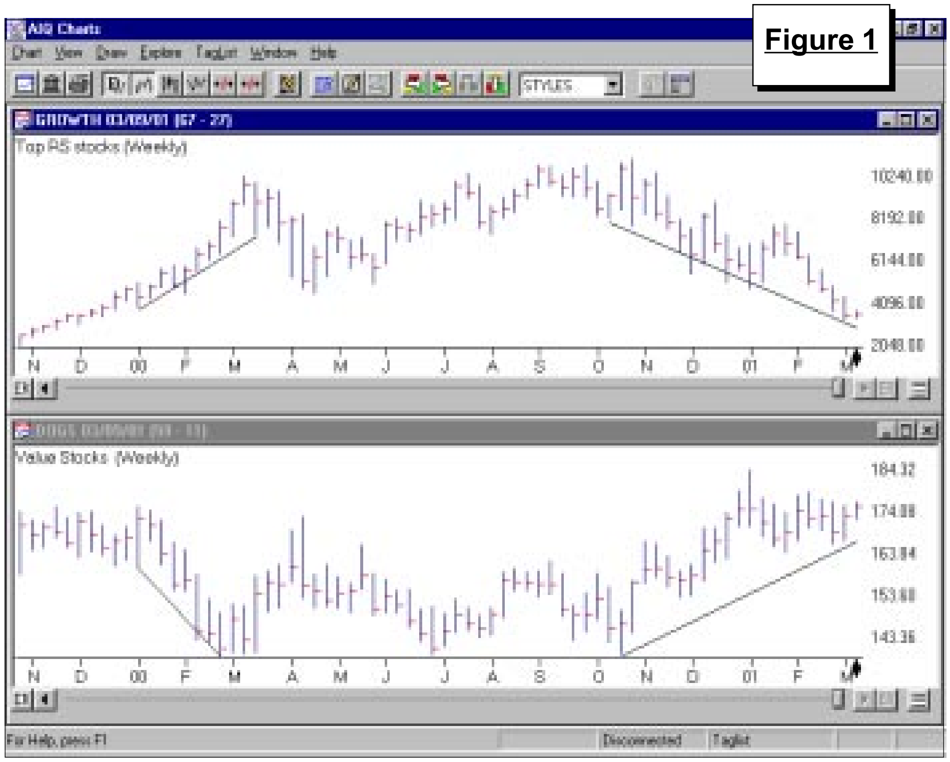

Figure 1

constantly move higher. AIQ's industry group feature can help identify this rotation.

Most people use the industry group structures that come with the TradingExpert software but it is very easy to create your own groups as well. To identify the rotation between growth and value stocks, we created an industry group to represent each style.

To get a good list of growth stocks we ran the Relative Strength report on March 10, 2000. This was the day of the Nasdaq top. An industry group was made of the stocks that appeared at the top of the report. This group includes names such as Broadcom Corp. (BRCM), LSI Logic (LSI), Network Appliance (NTAP), and JDS Uniphase (JDSU).

To get a list of value stocks we used the Dogs of the Dow strategy. With this strategy, we made a group of the 10 highest yielding Dow stocks. This group includes names such as Caterpillar (CAT), International Paper (IP), JP Morgan (JPM), and Philip Morris (MO).

In **Figure 1** we see a chart of both industry groups. Notice that when the high Relative Strength growth stocks are doing well, such as in the first quarter of 2000, then value stocks were sold. Conversely, when the value stocks did well in November 2000 through February 2001, then growth stocks were sold. You can deduce a lot about the market environment by simply monitoring the performance of these two groups.

Unweighted Indexes

AIQ industry groups are calculated on an unweighted basis, which means that each stock is given the same weight in the calculation of the group index. That differs from what is used at Standard & Poor's where the industry groups are capitalization weighted.

For instance, IBM is a much larger company than Palm so in Standard & Poor's Computer-Hardware group IBM has a larger weighting in the group's calculation.

Standard & Poor's uses the same capitalization weighting when it comes to calculating the S&P 500 index. The largest-cap stocks influence the index much more than do the mid-sized companies.

"The ability to compare an unweighted index to the actual index is extremely valuable information....This type of information is only available to AIQ users."

An interesting study is to see how the S&P 500 index would look if each stock was equally weighted. Using AIQ's industry group feature, we created an industry group which contains the 500 stocks in the S&P 500. TradingExpert then calculated the group on an unweighted basis.

The fascinating result is found in **Figure 2**. The top graph displays the AIQ-created unweighted index of the S&P 500 stocks and the bottom one shows the actual

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INDUSTRY GROUP ANALYSIS *continued* . . .

S&P 500 index. Notice that for most of the time the two indexes moved together but then started to diverge in September. The actual S&P 500 index underwent a severe correction but the unweighted index rose in value.

By the end of February, the actual S&P 500 had corrected about 20% off its all-time high but the unweighted index was near its all-time high!

The ability to compare an unweighted index to the actual index is extremely valuable information. Figure 2 tells us that the largest S&P 500 stocks were the ones that were driving the index lower but the rest of the S&P 500 stocks were performing well. This isn't always the case. By performing this same analysis in 1998-1999, we found the unweighted index underperformed the actual S&P 500 index. This type of information is only available to AIQ users.

MatchMaker

One of the lesser used tools within TradingExpert is MatchMaker. MatchMaker uses a statistical method called Spearman Rank Correlation to compare the price activity of different tickers over a specific period of time. The result is a ranking where those tickers with the highest correlation (i.e., prices tend to move together) appear at the top and those with the lowest correlation (i.e., prices tend to move independent of one another) appear at the bottom.

The most common use of MatchMaker is to improve industry group structures by running correlation tests on each industry group compared to the stocks that comprise that industry group.

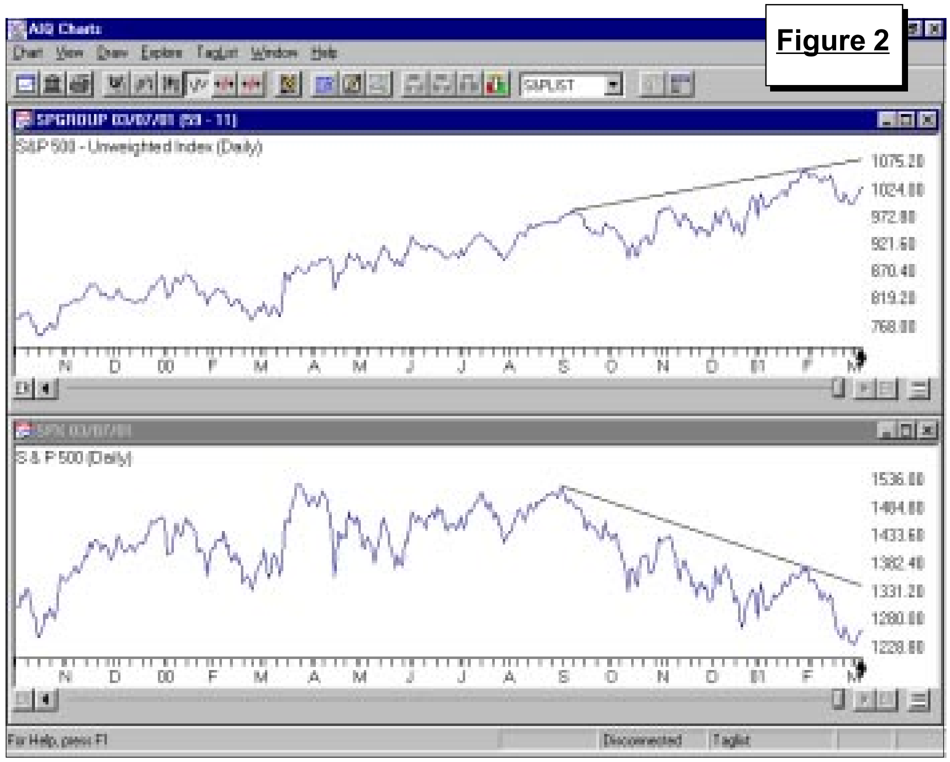


Figure 2

Those stocks that are highly correlated to their industry group index are kept while those stocks with low correlations are removed from the group. This technique was last covered in the June 1999 *Opening Bell*.

> ***"We used MatchMaker to see which industry groups move with the market and which groups move independent of the market... If you don't like the market but want to be invested, then you should be in the groups that move independent of the market."***

For this article, we used MatchMaker to see which industry groups move with the market and which groups move independent of the market.

For our first test, we ran a correlation comparing the S&P 500 to all the industry groups in the AIQALL industry group structure. The time period covers both bull and bear markets.

Here are the industry groups that show the highest correlation to the S&P 500:

- Finance (Public TD Inv. Fund)
- Telecommunications (Equipment)
- Finance (Investment Brokers)
- Electrical (Misc. Components)
- Media (Radio & Television)

It is important to follow these groups because they can give an indication of the market's health. When finance groups are strong performers and rise to the top of AIQ's reports, that implies that the market is bullish.

Not too surprisingly, the stocks with the highest correlation to the S&P 500 are finance related. The four highest correlated stocks to the S&P 500 are Morgan Stanley Dean Witter (MWD), Lehman

Industry Group Analysis continued on page 4

INDUSTRY GROUP ANALYSIS *continued*

Brothers (LEH), Citigroup (C), and Merrill Lynch (MER).

If you don't like the market but want to be invested, then you should be in the groups that move independent of the market.

Here are the groups that show the lowest correlation to the S&P 500 index:

Metal Ores (Gold)

Oil & Gas (Canadian Export & Production)

Food (Meat Products)

Food (Canned)

Food (Confectionery)

If the food groups are more attractive than most other groups, then the market is in an unstable environment.

The Nasdaq Composite is heavily weighted with technology issues so it is most highly correlated to technology groups. The groups with the highest correlation are:

Telecommunications (Equipment)

Computer (Software)

Computer (Local Networks)

Electrical (Semiconductors)

Internet (Services)

As you can see in the above examples, AIQ's industry group feature allows users to perform analysis that is not available to the general public or to most institutions.

In next month's *Opening Bell* newsletter, we'll discuss how the program is used to identify group rotation. ■

David Vomund publishes VIS Alert, a weekly investment newsletter. For a sample copy of the newsletter, call (775) 831-1544 or go to ***www.visalert.com****.*

BOOK REVIEWS

TECHNOLOGY BUBBLE IN YEAR 2000 SPARKS INTERESTING READING

We are living in an extraordinary time. When the history of Wall Street is written, it will talk about the 1929 Great Depression and it will talk about the 2000 technology bubble. In the last three years, we've seen a record one-year advance in the Nasdaq and then we've seen a record decline in the Nasdaq.

Irrational Exuberence
by Robert J. Shiller

During the bubble, two books were written: *Dow 36,000* and *Irrational Exuberance.* History will remember *Dow 36,000* as a sign of the bubble and *Irrational Exuberance* as the book that correctly predicted the market outcome.

> ***"History will remember 'Irrational Exuberance' as the book that correctly predicted the market outcome."***

Irrational Exuberance was written by Robert J. Shiller, a Professor of Economics at Yale University. The book serves as a warning that poorer performance is in the offing and he tells us how to respond.

The timeliness of the book is no longer important as the bubble has already burst, but Shiller's analysis is interesting and is convincingly documented. For example, he demonstrates that earnings growth does not drive the market. Examining the three biggest bull markets, he found that earnings growth and price growth don't correspond well at all.

While *Irrational Exuberance* is written for popular as well professional readership, it often reads like a text book and is not recommended for casual reading.

The Fortune Tellers
by Howard Kurtz

One indication of the bubble is the growth of financial journalism. CNBC has become part of popular culture and has often overtaken CNN in ratings. Fifteen years ago there were few financial journalists. Today, CNBC is viewed in bars and gyms and the CNBC anchors are as famous as movie stars.

In his book, *The Fortune Tellers*, Howard Kurtz discusses the influence that the financial commentators and analysts have. They not only report the news, they move markets in ways that provide huge windfalls for some investors while causing losses for others.

Sometimes this book reads like a marketing piece for CNBC. It provides a fascinating look at the pressures and dealings behind the scenes.

The Fortune Tellers provides fun reading for anyone who has witnessed the progression from FNN to CNN's Moneyline to the live coverage at CNBC. If you like Mark Haines, Ron Insana, David Faber, Maria Bartiromo, and Jim Cramer — then you will love this book. ■

MARKET TIMING USING RSMD

TESTING CONFIRMS THAT AIQ'S RSMD INDICATOR IS SIGNIFICANT MARKET TIMING TOOL

By David Vomund

The RSMD indicator plays an important role in my analysis. In past articles, we've discussed how this relative strength indicator can be used to help decide whether to concentrate on Nasdaq or S&P 500 stocks. This indicator can also be used as a market timing tool.

When the RSMD indicator favors the Nasdaq over the S&P 500, then people are willing to take more aggressive positions and the market is generally more favorable. When the indicator favors the S&P 500 over the Nasdaq, then money has moved to more conservative stocks and the market is generally unfavorable. In this article, we'll put this market timing technique to the test.

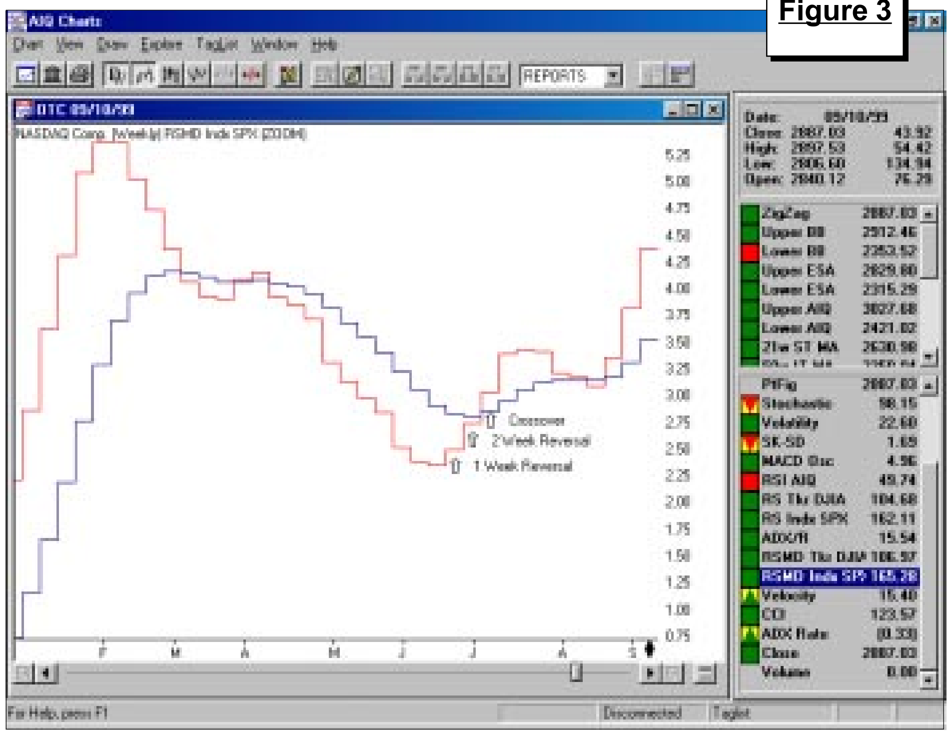
RSMD is a relative strength indicator that is exclusive to AIQ's TradingExpert. It takes the commonly used relative strength indicator and plugs it into the MACD formula. In effect, RSMD is a momentum of relative strength indicator.

When plotting the Nasdaq Composite (OTC), you plot the RSMD SPX indicator to get the relative strength of the Nasdaq versus the S&P 500. When this indicator is rising then the Nasdaq is outperforming the S&P 500. When the indicator is falling then the S&P 500 is outperforming the Nasdaq.

Although this indicator is designed to tell which of two markets is outperforming, it can also be used for market timing.

> ***"RSMD is a relative strength indicator that is exclusive to AIQ's TradingExpert. Although this indicator is designed to tell which of two markets is outperforming, it can also be used for market timing."***

Figure 3



We've noticed that the market environment is much more friendly when the Nasdaq outperforms the S&P 500. This is especially true for growth investors but it is also true if you buy non-Nasdaq stocks as well. When the Nasdaq is outperforming then people are willing to aggressively invest their portfolios, implying confidence in the market. The opposite is true when the S&P 500 outperforms.

We've found that using the RSMD SPX indicator with daily charts gives too many whipsaws but using crossovers on weekly charts is too slow. Rather than changing the settings, we use the indicator in the weekly format and look for a trend reversal of two straight weeks rather than waiting for a crossover.

Until now, we have never tested to see if the two-week reversal is the best use of the indicator. For our test we used a one-week reversal, a two-week reversal, and the crossover of the two lines. Let me explain this with the aid of a graph.

In **Figure 3** we are plotting the Nasdaq Composite's weekly RSMD SPX indicator.

Market Timing Using RSMD continued on page 6

MARKET TIMING USING RSMD *continued* . . .

Table1

Trade Details During Times When OTC Outperforms S&P 500

RSMD SPX 1 Week Reversal Buy Date	Sell Date	S&P 500 % Ch.
2/16/96	6/7/96	3.91
8/30/96	10/18/96	9.02
12/6/96	12/20/96	1.25
1/3/97	2/7/97	5.55
4/11/97	4/18/97	3.89
5/2/97	6/13/97	9.88
6/20/97	7/4/97	1.50
7/11/97	10/17/97	3.00
1/23/98	3/20/98	14.78
3/27/98	4/10/98	1.30
4/17/98	5/22/98	-1.09
6/26/98	8/21/98	-4.59
9/25/98	10/2/98	-4.03
10/30/98	2/19/99	12.79
4/2/99	4/16/99	1.95
6/25/99	8/6/99	-1.14
8/27/99	10/22/99	-3.46
11/5/99	3/17/00	6.88
6/9/00	7/28/00	-2.54
8/25/00	9/8/00	-0.79
1/12/01	2/9/01	-0.27

RSMD SPX 2 Week Reversal Buy Date	Sell Date	S&P 500 % Ch.
2/23/96	6/14/96	1.03
9/6/96	10/25/96	6.90
12/13/96	12/27/96	3.86
1/10/97	2/14/97	6.45
5/9/97	10/24/97	14.17
1/30/98	5/29/98	11.29
7/3/98	8/28/98	-10.40
11/6/98	2/26/99	8.53
4/9/99	4/23/99	22.16
7/2/99	8/13/99	-4.57
9/3/99	10/29/99	0.42
11/12/99	3/24/00	9.41
6/16/00	8/4/00	-0.10
9/1/00	9/15/00	-3.61
1/19/01	2/16/01	-3.05

RSMD SPX Crossover Buy Date	Sell Date	S&P 500 % Ch.
3/15/96	6/28/96	4.5
9/20/96	11/1/96	2.44
1/10/97	2/14/97	6.45
5/23/97	11/7/97	9.50
2/13/98	5/29/98	6.93
7/10/98	8/28/98	-11.78
11/13/98	3/12/99	15.00
4/2/99	4/16/99	-0.16
7/9/99	8/20/99	-4.75
8/27/99	3/31/00	11.15
9/1/00	9/15/00	-3.61

TradingExpert's Zoom feature was used to make the indicator cover the entire screen. This helps us to more clearly see the movement in the indicator. When the indicator's fast line is rising then the Nasdaq Composite is outperforming the S&P 500, making for a more bullish market.

Tip: To expand an indicator plot to fill the entire chart window, position your mouse cursor on the indicator plot and press the ***Z*** *key. Pressing the* ***Z*** *key again restores the indicator plot to its original size.*

A buy signal using the RSMD SPX indicator is when the fast line crosses above the slower signal line. A quicker interpretation is to simply look for direction changes instead of crossovers. For example, in Figure 3 the indicator was moving lower in April and May but began to reverse direction in June. Using a one-week reversal method, we buy when the indicator rises for the first time (see first arrow). Using a two-week reversal method, we wait for the indicator to rise for two consecutive weeks (see second arrow). Finally, we tested the indicator using a crossover of its signal line (see third arrow).

Since we are testing the indicator's market timing effectiveness, in our testing we purchase the S&P 500 index during time periods when the Nasdaq Composite outperforms and then move to cash during time periods when the S&P 500 outperforms. The reason we purchase the S&P 500 instead of the Nasdaq Composite is because we are testing for market timing and the S&P 500 is a better measure of the entire market.

MARKET TIMING USING RSMD *continued* . . .

Table 2

Summary Statistics (1/1/96 - 03/23/01)

	S&P 500 % Return when the SPX Outperforms	S&P 500 % Return when the OTC Outperforms	Trades Per Year	% of Time in the Market
1 Week Reversal	9.72%	72.00%	4.0	52%
2 Week Reversal	28.60%	76.39%	2.8	54%
Crossover	33.64%	38.00%	2.1	48%

Past performance does not guarantee future results

The trade-by-trade results for the one-week and two-week reversals are found in **Table 1**. We see that using a one-week reversal technique, the Nasdaq Composite's RSMD SPX indicator was moving lower until February 16, 1996, the week the indicator first rose in value. We purchased the S&P 500 on the following day's opening price and held it until June 7, 1996. June 7 represents the day that the indicator had its first decrease in value. Funds were moved to the money market on the following day's opening price.

Table 2 shows the all-important summary statistics. The time period of our testing is from January 1996 through March 23, 2001. This time period includes both bull and bear markets.

Previous to the study, we believed that the market was more favorable when the Nasdaq outperformed the S&P 500. Our study confirmed this is the case. Looking at the one-week reversal method, the five year return was only 9.72% when you bought the S&P 500 during time periods when the RSMD indicator favored the S&P 500 over the Nasdaq. However, by buying the S&P 500 when the Nasdaq Composite was outperforming, the return dramatically increased to 72%. This demonstrates the most critical point of this article: *the overall market is more bullish when the Nasdaq outperforms the S&P 500.*

Further examining Table 2, we see that the highest return was realized by waiting for the RSMD SPX indicator to rise or fall on two consecutive weeks before making a market timing move. The return using this technique was 76.4%. Waiting for a crossover of the two lines is too slow a technique as its overall return fell to 38.0%.

To use this two-week reversal strategy, plot the Nasdaq Composite (OTC) and display its RSMD SPX indicator. Once this indicator rises for two consecutive weeks, then buy the S&P 500 index. Hold the S&P 500 until the indicator falls for two consecutive weeks, at which time move to cash and wait for the next signal.

By using the two-week reversal method, the 1995 to March 2001 return was 76% with an average of only 2.8 trades per year. Although this return is about 10% less than buying-and-holding the S&P 500 over the same time period, the results are exceptional since you are in the market only about 54% of the time.

"By buying the S&P 500 when the Nasdaq Composite was outperforming, the return dramatically increased to 72%. This demonstrates the most critical point of this article: the overall market is more bullish when the Nasdaq outperforms the S&P 500."

Before applying this market timing technique, verify the two-week reversal trade dates in Table 1. Once you can duplicate the trade dates on your system, then you understand the technique.

When viewing the weekly RSMD SPX indicator, you should plot as little data as possible and use the Zoom feature to more closely see the indicator. To detect the buy and sell signals, you must look at the movement of the indicator lines on the chart rather than the RSMD indicator value, which is meaningless.

In next month's *Opening Bell*, we'll perform the same study using the S&P 500's MACD indicator. ■

Market Review

March was an ugly month for the market, capping off a terrible quarter. For the month, the S&P 500 fell 6.4% and the Nasdaq Composite fell 15.5%. For the quarter, the S&P 500 fell 12.1% and the Nasdaq fell 25.5%. From its high, the Nasdaq has plunged 64%. This represents the Nasdaq's largest drop ever.

The AIQ timing model registered a 95 sell signal on March 9. This signal was confirmed by a falling Phase indicator the following day. Users should check their system to verify that they received this signal. If you use Dial/Data or myTrack and you don't show this signal, then you should perform a *Reload history* on selected ticker DJIA and go back to the start of this year.

The timing model remained on a sell signal until March 26, when a 97 buy signal was registered. This signal was confirmed on the same day.

Using the analysis from the RSMD indicator (see page 5), the Nasdaq Composite's weekly RSMD SPX indicator favored the S&P 500 over the Nasdaq the entire month. The indicator did rise in value the week of March 23 but it then fell the following week. There wasn't a two-week reversal. The market is generally unfavorable when the S&P 500 outperforms the Nasdaq Composite.

While the market was generally unfavorable in March, there were groups that performed well. The Homebuilding group increased 12% and Construction Materials rose 11%. On the downside, the Wireless Communications group fell 32%, the Internet Software & Services group fell 29%, and the Computers Storage & Peripherals group lost 27%. ■

S&P 500 Changes

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

Cintas Corp. (CTAS) replaces Summit Bancorp (SUB). CTAS is added to the Diversified Commercial Services (SERVICED) group.

Concord EFS (CEFT) replaces CeridianCorp (CEN). CEFT is added to the Data Processing Services (SERVICEP) group.

Fiserv Inc. (FISV) replaces Old Kent Financial (OK). FISV is added to the Data Processing Services (SERVICEP) group.

Standard & Poor's has created a new group structure that AIQ is now adopting. To update your structure, go to www.pewd.com/downloads. Click on **newsp500 install ins** for instructions.

STOCK DATA MAINTENANCE

The following table shows past and future stock splits and large dividends:

Stock	Ticker	Split	Approx. Date
Federal Screw	FSCR	5:4	04/03/01
Right Mgmt. Consult'nt	RMCI	3:2	04/09/01
Jefferson Pilot	JP	3:2	04/10/01
UCBH Holdings	UCBH	2:1	04/11/01
Granite Construction	GVA	3:2	04/16/01
Symbol Tech.	SBL	2:1	04/17/01
Cardinal Health	CAH	3:2	04/17/01
MBIA Inc.	MBI	3:2	04/23/01
Starbucks Corp.	SBUX	2:1	04/30/01

Trading Suspended:
Allaire Corp. (ALLR), Atlantic Financial Corp. (AFIC), b2bstores.com (BTBC), BMC Software (BMCS), Disney Co. Internet Group (DIG), eToys Inc. (ETYS), Firstar Corp. (FSR), Guest Supply Inc. (GSY), Johns Manville Corp. (JM), Rollins Truck Leasing (RLC), Summit Bancorp. (SVB), Xircom Inc. (XIRC)

Name/Ticker Changes:
Alcan Aluminum Ltd. (AL) to Alcan Inc. (AL)
Nhancement Tech. (NHAN) to Appiant Technologies Inc. (APPS)
Ogden Corp (OG) to Covanta Energy (COV)
Polyphase Corp. (PLY) to Overhill Corp. (OHV)
United Security Bancorp (USBN) to American West Bancorp (AWBC)