AIQ Opening Bell Newsletter

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Market Timing in 2002

Our RSMD Timing Model Wins Best Performance Honor!

By David Vomund

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DAVID VOMUND

Looking at the three-year bear market, most people would agree that year 2002 was the worst. Most of the damage came in March through mid-July, when the S&P 500 lost 31%. In the third quarter of 2002, which possibly may also be the market's low point, all areas of the market succumbed to selling pressure. Large-cap and small-cap went down. Growth and value went down.

> *"In this article, we'll examine three market timing systems that have been discussed in previous* Opening Bell *issues... the AIQ Market Timing Model, Nasdaq 100 Timing Model, and RSMD Timing Model."*

The latter half of the year was constructive, however, as the S&P 500 entered a five-month consolidation period. By the end of the year, the S&P 500 was in a narrow trading range where 866 represented the lower end of the range and 965 represented the upper end of the trading range (see **Figure 1** on page 2).

If you used a market timing model and shorted during the sell signals, you likely did well in 2002. If you moved to cash during sell signals, then the system limited your losses but you were probably in the red for the year. There were very few rallies to play.

How bad was 2002? If you bought and held the S&P 500 only when it was above its 200-day moving average you would have been invested for only 19 days! For the year, the S&P 500 lost 23.4%.

In this article, we'll examine three market timing systems that have been discussed in several previous *Opening Bell* issues. Our analysis of these systems assumes you enter the market after a buy signal and move to cash after a sell signal. Obviously, results would improve by going short.

AIQ Market Timing Model

AIQ's market timing model has been out of sync for the last few years. In 2002 it slightly outperformed a buy-and-hold approach, but its signals offered little value.

For our testing we used Expert Rating signals of 95 or greater without confirmation. The S&P 500 was bought the day of the Expert Rating buy signal and was held until an Expert Rating sell signal of 95 or greater was registered. Money market interest was not factored in.

A list of the trades appears in **Table 1**. The most damaging trade was the June 5 to August 28 trade, which resulted in a 12.6% loss. Applying a confirmation technique, such as waiting for an increasing Phase indicator, would have somewhat limited the loss but it still would have been the largest losing trade. Some of these losses were recouped when the model gave a buy on September 26 and remained on a buy until December 9.

For the year, trading the AIQ market timing model lost 19.2% while the S&P 500 lost 23.4%.

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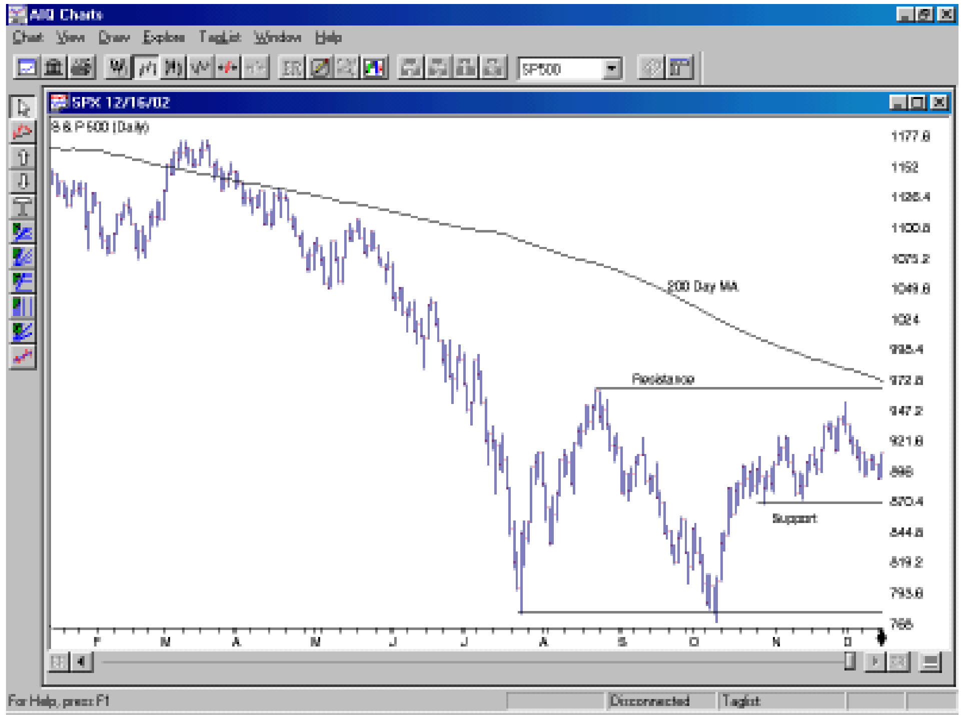

Figure 1. Daily chart of S&P 500 Index displaying last 11 months of year 2002. After a major decline that ended in July, the S&P 500 entered a five-month consolidation period. By the end of the year, the S&P 500 was in a narrow trading range

Nasdaq 100 Timing Model

In the May 1999 *Opening Bell* we introduced a timing model which uses AIQ's Breadth Builder function. With the Breadth Builder, TradingExpert Pro has the unique capability to calculate breadth and volume figures based on a list of stocks. On December 31 of each year, we created a list of the Nasdaq 100 stocks and used the Breadth Builder to calculate market breadth and volume based on these stocks.

With breadth and volume indicators calculated, we can apply indicators such as On Balance Volume and Money Flow to the Nasdaq 100 index. The ability to plot a Money Flow indicator based on the Nasdaq 100 index and volume from the Nasdaq 100 stocks is a unique feature of AIQ's TradingExpert Pro.

> *"Part of the benefit in creating a Nasdaq 100 model is the capability to chart and analyze volume indicators. Another benefit is that you can apply AIQ's timing model to the created market... This Nasdaq 100 Timing Model has outperformed the Nasdaq Composite in four of the last six years."*

Part of the benefit in creating a Nasdaq 100 model is the capability to chart and analyze volume indicators. Another benefit is that you can apply AIQ's timing model to the created market. The same rules that are applied to ticker DJIA can be used on the Nasdaq 100 market.

Using AIQ's market timing model on the Nasdaq 100 index produced a lot of trades in 2002. **Table 2** shows the individual trades along with the return of the Nasdaq

Composite. By buying the Nasdaq Composite on the day of an Expert Rating buy signal and selling the day of an Expert Rating sell signal, the 2002 return was –19.91%. Although down, the return is better than the 31.5% loss in the Nasdaq Composite.

This timing model has outperformed the Nasdaq Composite in four of the last six years. The timing results are good but I'd caution against relying exclusively on this model for your market timing. Nevertheless, I do examine its signals on a daily basis.

For more information on this model and how to create it, please refer to page 6, May 1999 *Opening Bell*. This issue is posted on AIQ's web page at www.aiqsystems.com. You can also refer to instructions on using the Breadth Builder feature in the TradingExpert Pro User Reference Manual, page 49.

Table 1. Expert Rating Results

Buy Date	Expert Rating	Sell Date	Expert Rating	S&P 500 % Change
12/31/01	N/A	01/02/02	1000	0.57
01/17/02	98	02/19/02	98	-4.88
02/25/02	98	05/21/02	100	-2.67
06/05/02	98	08/28/02	99	-12.58
09/04/02	95	09/17/02	98	-2.23
09/26/02	99	12/09/02	98	4.33
12/10/02	99	12/31/02	N/A	-2.73

2002 Results:
Expert Ratings = -19.23%
S&P 500 Index = -23.37%

RSMD Timing Model

In the April 2002 *Opening Bell* we ran what I consider to be one of our most important and timely articles. This article covers a simple but effective market timing technique that uses the Nasdaq's RSMD SPX indicator as a market timing tool.

Table 2. Nasdaq 100 Market Model

Buy Date	Expert Rating	Sell Date	Expert Rating	Nasdaq Comp. % Change
1/3/2002	98	1/9/2002	99	0.03
2/11/2002	99	3/20/2002	99	-0.75
5/8/2002	96	5/21/2002	95	-1.89
6/17/2002	97	6/19/2002	99	-3.63
6/27/2002	99	7/1/2002	97	-3.80
7/5/2002	99	7/9/2002	98	-4.64
7/11/2002	100	7/19/2002	100	-4.03
7/24/2002	100	7/25/2002	98	-3.89
7/29/2002	95	8/27/2002	99	0.94
9/9/2002	98	9/27/2002	97	-8.08
10/1/2002	99	11/11/2002	97	8.69

2002 Results:
Expert Ratings = -19.91%
Nasdaq Composite = -31.53%

RSMD is a relative strength indicator that is exclusive to AIQ's TradingExpert Pro. 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, click the RSMD SPX indicator to get the relative strength of the Nasdaq versus the S&P 500. When the fast line is rising then the Nasdaq is outperforming. When the fast line is falling then the S&P 500 is outperforming. To eliminate most of the whipsaws, I use the weekly version of the indicator.

Here is how the timing model works. When the fast line on the Nasdaq's weekly RSMD SPX indicator is rising, then the overall market environment is bullish. When this indicator begins to fall, then the market environment has turned bearish.

Here is why the timing model works. When the RSMD SPX indicator favors the Nasdaq over the S&P 500, then people are willing to take more aggressive positions and the market is generally favorable.

When the indicator begins to favor the S&P 500 over the Nasdaq, then money is moving to more conservative stocks and the market is generally unfavorable.

To see the movement in the RSMD SPX indicator, it is best to use TradingExpert Pro's Zoom feature. Figure 2 shows a recent chart of the RSMD indicator. Rather than waiting for the Phase line (the fast line) to cross the Signal line (the slow line), I recommend looking for a change in direction of the Phase line. You can either use a one-week change in direction or eliminate some of the whipsaws and use a two-week change in direction.

In Figure 2 we placed arrows to represent the buy and sell signals. A buy signal occurs when the RSMD indicator rises for two straight weeks. After moving higher, a sell signal occurs when the RSMD falls for two straight weeks.

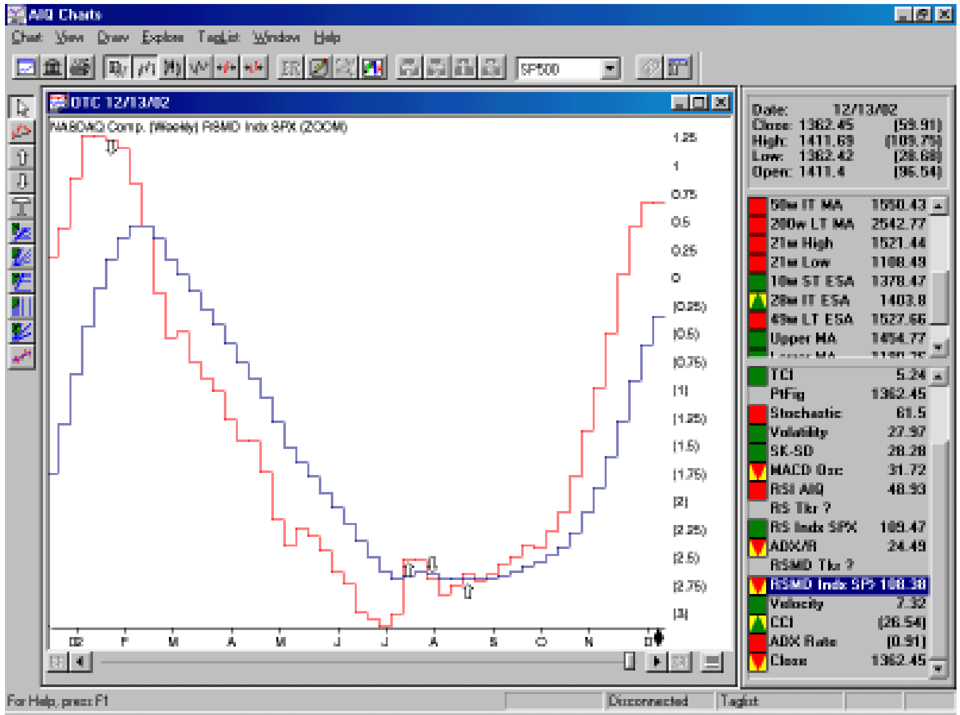

Figure 2. Weekly chart of NASDAQ Comp. Zoom feature was used to display RSMD Indx SPX iindicator in the main chart window. Arrows show timing of RSMD buy and sell signals.

> *"For the year, the RSMD Timing Model lost 6.8%, far better than the 23.4% loss in the S&P 500...the RSMD system performed well during the bull market, keeping people invested during the strong advances."*

Table 3 shows the trading signals for 2002 using a two-week change in the RSMD indicator. Even though the indicator is run on the Nasdaq, this is an overall market timing model so the percentage return figures assume you trade the S&P 500 index. For the year, this system lost 6.8%, far better than the 23.4% loss in the S&P 500.

Several timing systems could be created which would lose 6% this year, but unlike most of those systems the RSMD indicator performed well during the bull market, keeping people invested during the strong advances.

A year ago, I adopted the RSMD indicator as my main market timing tool. That was a well-timed move as many of the previously used models broke down. Like every model, the RSMD model needs to be constantly evaluated for its effectiveness but so far it has worked very well in the recent bull and bear markets.

As we move into the New Year, let me remind you that the market has never experienced four straight down years. Let's hope that record remains intact!

David Vomund publishes VIS Alert, a weekly investment newsletter. For free trial issues, call 775-831-1544 or go to ***www.visalert.com.***

Table 3. Two Week Change in RSMD

Buy Date	Sell Date	% Ch. S&P 500
12/31/01	02/01/02	-2.26
07/19/02	08/02/02	1.95
08/23/02	N/A	-6.49

2002 Results

RSMD SPX = -6.82%

S&P 500 Index = -23.37%

What Every AIQ User Should Know, Part II

Ability to Create Industry Groups for Your Special Trading Needs Is Valuable AIQ Tool

In addition to standard tools, AIQ TradingExpert Pro has some unique features that nearly every user would find beneficial. This is the second of a three-part series of articles covering features that every TradingExpert user should know how to use.

The first article in the series (December 2002) covered list management and its many benefits. In this article, we'll demonstrate the benefits of creating industry groups specific to your trading needs.

TradingExpert comes with two industry group structures, the Standard & Poor's structure and the AIQALL structure. The software also has the ability to create new industry group structures. Those who use standard analysis tools may think creating industry groups is unimportant, but we'll show that almost every user can benefit from AIQ's industry group tools.

People who perform a top-down analysis obviously find AIQ's group analysis capabilities very important. These people first analyze industry sectors and groups and then pick stocks within the attractive groups. Most people, however, are bottom-up traders. They screen a broad database of stocks trying to find attractive trades. The group analysis feature in TradingExpert Pro is important for bottom-up traders as well.

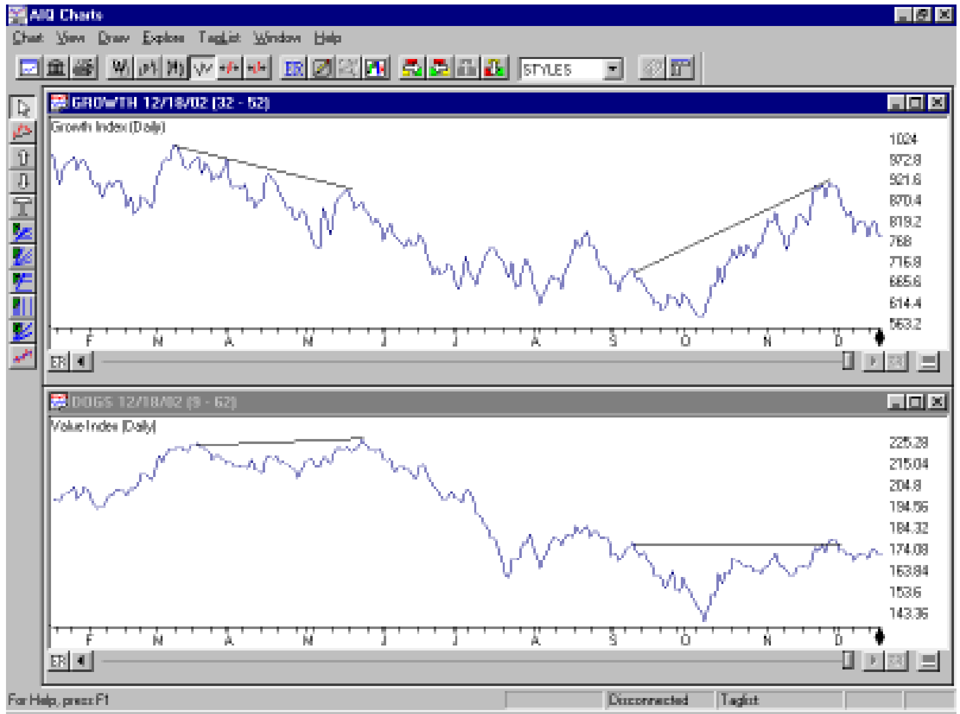

Figure 1. Daily charts of two indexes (Growth and Value) showing comparison of price activity during 2002. Trendlines indicate periods when performance of two groups differed significantly.

Let's look at an example that demonstrates the usefulness of AIQ's group analysis capability. When analyzing the market's health, almost everyone graphs the Dow, S&P 500, and the Nasdaq Composite. To get a better feel of the market environment, one could further break down the market to growth and value components.

Figure 1 shows a Growth industry group and a Value industry group. Notice in March to May that the Growth group lost value while at the same time the Value group moved slightly higher. In September to December, however, the Value group moved sideways but the Growth group moved sharply higher.

This Growth/Value group analysis can play an important role when evaluating the market's health. When value stocks outperform, then that implies that your analysis should emphasize low PE or high yielding securities. When growth stocks outperform, then that implies that high relative strength or technology stocks are in favor. Then again, when both groups head

> *"People who perform a top-down analysis (sector to group to stock) find AIQ's group analysis capabilities very important...Most people, however, are bottom-up traders. The group analysis feature in TradingExpert Pro is important for bottom-up traders as well."*

lower, as they did in May to October, then the market's health is at its worst.

Some may say that you can do the same analysis by following market indexes that track growth and value stocks. That's true but by creating AIQ groups you can control which stocks comprise the index and you can see volume data calculated from the stocks in the index.

A similar analysis can be done on the stocks in your portfolio. By creating a group of the stocks your trading system selects, you can see when the system outperforms the market indexes and when the system struggles. It helps tell you when you want to be active in your trading and when you should sit on the sidelines.

Groups can also be created to track mutual funds. By creating industry groups based on the 10 largest stock holdings of the mutual funds, one can analyze these surrogate groups using both price and volume-based indicators. To create a surrogate mutual fund group, first build a list of the 10 stocks and then create an index for this group of tickers. (For detailed instructions on creating an industry group, see below.) Let's look at an example. The top graph in **Figure 2** is a surrogate group calculated from the 10 largest stock holdings for the Rydex Health Care mutual fund. The bottom graph shows the actual fund. Notice how similar the price movement of the actual fund is compared to the surrogate group.

> *"Groups can also be created to track mutual funds. By creating industry groups based on the 10 largest stock holdings of the mutual funds, one can analyze these surrogate groups using both price and volume-based indicators."*

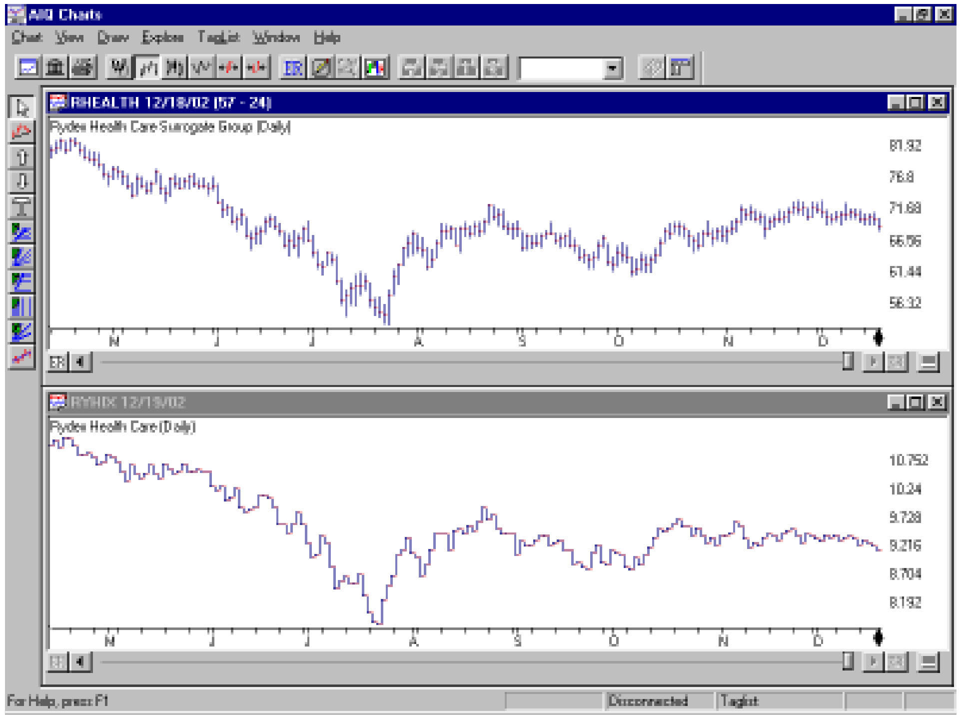

Figure 2. Daily charts of Rydex Health Care Fund (bottom) and a surrogate group created from the fund's 10 largest stock holdings (top). Comparison shows how closely the surrogate group tracks the actual fund.

With the surrogate group created, we have more tools to help analyze the Health Care fund. Whereas mutual funds only have closing prices, surrogate groups have high, low, and closing prices. They also have volume data. With volume data, we have access to volume-based indicators such as Money Flow, On Balance Volume, and the Positive Volume Index.

Learning how to create a group structure is a useful process for all AIQ users. If you can successfully create a structure, then you have mastered the Data Manager. Building an industry group is done with three easy steps.

Step 1. Create a list name. In the Data Manager, click *List* and then *New*. Enter a list name and click *OK*. For this exercise, we created a group structure that has a growth and value group as shown in Figure 1. We called our list "Styles."

Step 2. Create a group ticker. In Data Manager, click *Ticker* and *New*. Enter a ticker for the new group. Make sure the ticker symbol isn't the same as an existing stock's symbol. Click *Group* and then *OK*. Drag the group name to the left side of the Data Manager and drop it on the list name.

Step 3. Enter the stock symbols that comprise the group. In the panel on left side of the Data Manager window, single-click on the group ticker symbol which appears just below the list name. With the ticker highlighted, click *List* and *Insert Tickers*. Enter the ticker symbols that you want in the group separated by semicolons.

For our value group, we chose to use the highest yielding stocks in the S&P 100 index. For our growth group, we chose to use only the technology stocks in the Nasdaq 100 that have an index weighting of at least 1%.

With the group structure created, your Data Manager should resemble **Figure 3**. In the panel on the left side of Figure 3, our list name is Styles, the groups are Dogs and Growth, and the stock ticker symbols appear below their groups.

The next time you download data, indices for the groups will automatically be calculated. You can also calculate the groups by going to the Data Manager and clicking *Utilities* and *Compute Group/Sector Indices*. Highlight the list name and click *OK*.

I repeat, having the ability to create industry groups or an industry group structure for your specific needs is a valuable tool for AIQ users. Whether you use the group feature to spot the rotation of industry groups or whether you use the feature to track the performance of a set of stocks, performing group analysis helps you to better understand the market environment.

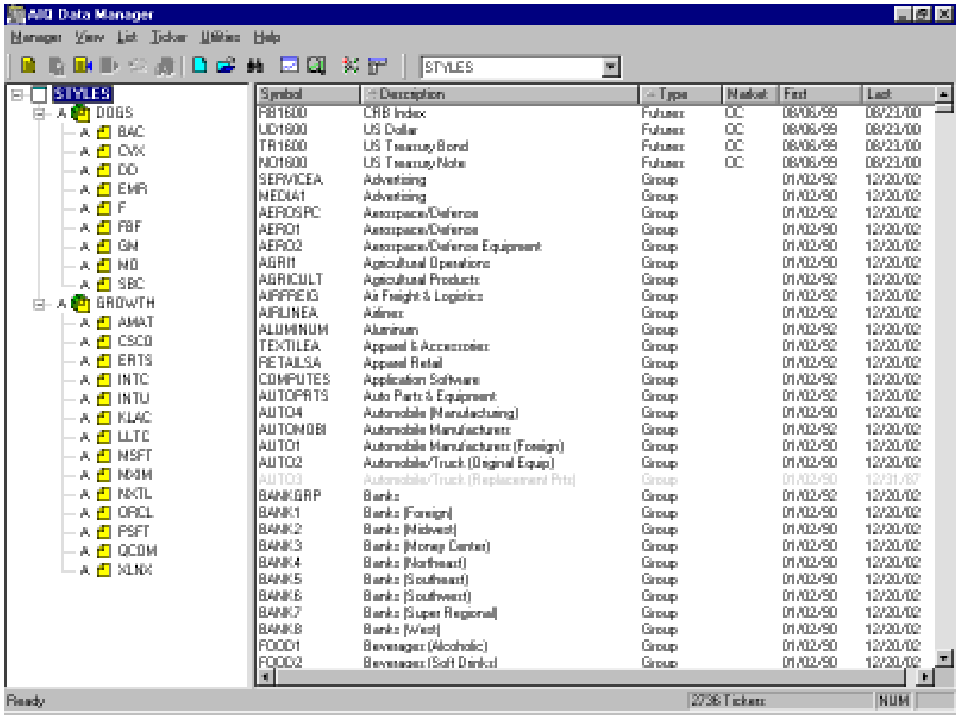

Figure 3. Left panel of Data Manager window is shown with list *Styles* selected. List is opened to display the two underlying groups, *DOGS* and *GROWTH*, and the stocks that comprise each of the groups.

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date
Aceto Corp.	ACET	3:2	01/03/03
Forest Labs	FRX	2:1	01/09/03
Raven Inds.	RAVN	2:1	01/16/03
Hi-Tech Pharm.	HITK	3:2	01/20/03

Trading Suspended:

Dot Hill Systems (HIL), EEX Corp. (EEX), Howell Corp. (HWL), Hunt Corp. (HUN), Kmart Corp. (KM), Leap Wireless Int'l (LWIN), Owens Corning (OWC), TRW Inc. (TRW)

Name Changes:

Alliance Gaming (ALLY) to Alliance Gaming Corp. (AGI)
Interactive Data Corp. (IDCO) to Interactive Data Corp. (IDC)
Micronetics Wireless (NOIZ) to Micronetics Inc. (NOIZ)

S&P 500 Changes

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

Quest Diagnostics (DGX) replaces TRW Inc. (TRW). DGX is added to the Health Care Distributors & Services (HEALTHSS) group.

Year-End Index of 2002 Articles

Opening Bell subscribers may obtain a free Index of 2002 Opening Bell articles by calling AIQ at 1-800-332-2999.

AIQ wishes you a Happy and Prosperous New Year

Market Review

The year 2002 will be looked back upon as a period of massive corporate accounting scandals, bankruptcies, and federal indictments. These events sent stocks into a tailspin.

After suffering sharp losses in both 2000 and 2001, the major market indexes fared even worse in 2002. For the year the S&P 500 lost 23.4%, its worst performance since 1974 and its fifth-biggest annual decline. The Nasdaq Composite fell 31.5%.

Still, 2002 will also be known as a time of sweeping regulatory reform. After the collapses of WorldCom, Adelphia, and Global Crossing, the government signed into law the Sarbanes-Oxley Act, which compels executives to certify their financial results and bars companies from making personal loans to executives and directors. The new law also mandates that corporate insiders report their trades within two days instead of 10.

Looking at the activity in December, the S&P 500 lost 6%. While the majority of industry groups lost value, Precious Metals experienced a strong rally, gaining 18%. The worst group was Semiconductors, which fell 25%. Air Transportation and Telecommunications lost about 14%.

The AIQ timing model registered a timely sell on December 9 with a 98 down signal. Unfortunately, that was followed the next day by a 99 up signal. Additional buy signals were registered on December 13 and December 16. Both of these signals were 98 up signals.

Looking to next year, we can hope tax cuts and aggressive cost cutting by companies leads to an improved market environment.