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Industry Group Trading System

The 'Best of Times, Worst of Times' Trading Strategy

By Jay Kaeppel

Jay Kaeppel

There has been much debate about whether it is better to buy weak stocks or strong stocks. The theory behind buying weak stocks is that you have the opportunity to "buy low and (hopefully) sell high." The theory behind buying strong stocks is one of momentum – an object in motion is most likely to continue in that motion (at least for a while). Most research strongly suggests that if you had to choose, when buying individual stocks you are better off buying stocks making new highs rather than new lows.

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This is also true with industry groups – however, not to the same degree. While a given company may go out of business for any number of reasons, it is a much more rare occurrence for an entire industry group to decline in price and never rebound (although it can happen – the horse and buggy industry has yet to recover from the Model T). Thus, it makes sense to buy an industry group that has experienced a sharp decline. The problem with this approach is, how do you know if you are "buying low" or simply trying to "catch a falling safe?"

Weak Industry Groups

Generally speaking, there is a pattern which is not uncommon for industry group price performance. At some point, the fundamentals for a given industry go south and eventually so do the stocks in that industry group. This can go on for any period of time, but usually does not last much longer than about two years. Once the majority of the decline is over, the group may then experience a period of basing action for up to a year (actually, the longer the better). Once this long decline and basing period is over, it is not uncommon for a group to then reemerge as a leading performer.

In other words, once the industry has been "wrung out" and the fundamentals (which usually change over a long period of time) swing back to the upside, the industry group as a whole is ripe for an advance in price. In a moment, we will look at a simple method that attempts to take advantage of this phenomenon.

"So which is better? Buying "weak" industry groups or "strong" industry groups? My research indicates that the best approach might be to utilize both strategies rather than attempting to choose one or the other."

Strong Industry Groups

Regarding strong industry groups, a number of studies indicate that simply buying the strongest performers and holding on as long as they are trending higher is a crude but highly effective (although at times frightening) strategy in and of itself. My sector fund trading system published in the July 2000 *Opening Bell*, along with David Vomund's work from last October and December, shows that the returns from buying into strength can be quite high.

Combining the Two Methods

So which is better? Buying "weak" industry groups or "strong" industry groups? My research indicates that the best approach might be to utilize both strategies rather than attempting to choose one or the other.

As in almost all cases involving investment "styles" (large-cap vs. small-cap, growth vs. value, stocks vs. bonds, etc.) the one thing we can count on is that one style will outperform for a while and then the other style will take over as the leader. In this case, rather than trying to determine which "style" is performing better at any point in time, we simply utilize both styles at all times. We will give details next.

The "Best of Times, Worst of Times" System

The overall portfolio involves buying and holding 10 industry groups at a time - 5 weak and 5 strong. For the purposes of testing, the reports are run after the close on the last day of trading each quarter and the portfolio is readjusted at the close on the next trading day (i.e., the first trading day of each quarter). The ideal way to trade these groups is through the use of "folios," also known as "stock baskets" (information on folios can be found in the Editor's Notes at the end of this article).

The starting point was the AIQ Industry Group Pyramid which I named ListMM. Because I want to trade 10 industry groups in a single folio and because the broker that I use (FolioFN) limits a given folio to 50 stocks, I stripped down AIQ ListMM so that each group contains no more than five stocks. I called this revised list "ListJK."

ListJK is not better or worse than ListMM; it is simply a little easier to trade all of the stocks in a given group at one time. The primary considerations in selecting the stocks to keep in each group were: 1) the stock could be traded as part of a folio at *www.foliofn.com*, and 2) the correlation of the stock to the original AIQ Industry Group.

"To buy "weak" groups, look for the worst performing groups over a 500-day period – then wait 12 months before buying those groups…To buy "strong" groups, look for the best performing groups over the latest 240-day period and then buy those groups."

Rules for Buying Weak Industry Groups

What we are looking for are groups that have experienced prolonged declines and have also had some time to consolidate and build a base for an upswing in price. To buy "weak" groups, look for the worst performing groups over a 500-day period – then wait 12 months before buying those groups.

The mechanics for buying weak industry groups are as follows:

After the last trading day of each quarter:

1. In AIQ Reports – click on *Group Reports*

2. On the menu at top select *Reports – Global Properties*

3. Set the *Group/Sector Report* list

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as the list you want to use

4. Select the *Price Change - Downside – Long-Term Report*

5. Right click on that report, and set the *Price Change – Long-Term Constant* to 500 days

6. On the menu select *Generate – Selected Reports* and set the date to the last trading day of the quarter ended one year ago (i.e., on 12/31/03 set the date to 12/31/02).

Buy the stocks in the top five groups, giving equal weight to each group, and then repeat this process at the end of the next quarter.

Rules for Buying Strong Industry Groups

What we are looking for here are the groups that are performing the best right now. To buy "strong" groups, look for the best performing groups over the latest 240-day period and then buy those groups.

The mechanics for buying strong industry groups are as follows:

After the last trading day of each quarter:

1. In AIQ Reports – click on *Group Reports*

2. On the menu at top select *Reports – Global Properties*

3. Set the *Group/Sector Report* list as the list you want to use

4. Select the *Price Change - Upside – Long-Term Report*

5. Right click on that report, and set the *Price Change – Long-Term Constant* to 240 days

6. On the menu select *Generate – Selected Reports* and set the date to the last trading day of the quarter just ended (i.e., on 12/31/03 set the date to 12/31/03).

Buy the stocks in the top five groups, giving equal weight to each group, and then repeat this process at the end of the next quarter.

Results

I have run this test with several different industry group structures including the AIQ Industry Group Pyramid, my own stripped down version of the AIQ Industry Group Pyramid, surrogate groups for each of the Fidelity Select Sector funds, industry groups set up for trading as single-stock futures by OneChicago, and the Fidelity Select Sector funds themselves using the AIQ Mutual Fund Reports rather than the Group Reports. Several patterns clearly emerge.

In every case, the "strong" groups outperformed the "weak" groups between 1993 and 2003. However, on a year-by-year basis there was no predictable pattern (looking at rolling 12-month returns for all of these tests, "strong" groups outperformed 57% of the time, "weak" groups outperformed about 43% of the time). Additionally, the standard deviation of annual returns for "weak" groups was significantly less (generally 40 to 50% lower) than that of "strong" groups.

"While the "strong" groups generated the higher gross returns, the "weak" groups generated higher risk-adjusted returns. This trade-off in performance is another reason why it makes more sense to combine these two strategies…"

In other words, while the "strong" groups generated the higher gross returns, the "weak" groups generated higher risk-adjusted returns. This trade-off in performance is another reason why it makes more sense to combine these two strategies and thus get the best of both worlds – high long-term returns from strong groups and dependable annual returns from weak groups.

Table 1 shows the yearly returns

Table 1 - Annual Returns

Year	Weak % +/-	Strong % +/-	Both % +/-	SPX % +/-	Both vsSPX
1993	71.4	90.9	83.3	7.6	75.7
1994	13.9	31.8	22.8	(1.4)	24.2
1995	86.5	119.6	102.9	35.2	67.7
1996	19.4	61.2	39.6	18.7	20.8
1997	30.3	37.0	33.6	32.3	1.3
1998	18.3	134.0	71.5	26.0	45.5
1999	88.0	272.6	173.3	18.5	154.8
2000	32.4	32.9	34.2	(11.8)	46.0
2001	49.1	83.9	67.6	(10.0)	77.6
2002	40.6	(4.0)	18.4	(21.3)	39.7
2003	104.0	45.8	73.3	17.0	56.3

Updated through 12/9/03.

Table 2 – Quarterly and Rolling 12-Month Returns

		Qrtly Weak	Qrtly Strong	Qrtly Both	Qrtly SPX	Weak $1,000	Strong $1,000	Both $1,000	SPX $1,000	Rolling 12 mo. %+/- Weak	Rolling 12 mo. %+/- Strong	Rolling 12 mo. %+/- Both	Rolling 12 mo. %+/- SPX
12/31/92	3/31/93	25.4	10.5	18.0	3.4	1254	1105	1180	1034				
3/31/93	6/30/93	7.6	27.7	17.7	(0.3)	1350	1412	1388	1031				
6/30/93	9/30/93	19.8	46.7	33.3	2.7	1617	2071	1850	1059				
9/30/93	12/31/93	6.0	(7.8)	(0.9)	0.9	1714	1909	1833	1069	71.4	90.9	83.3	6.9
12/31/93	3/31/94	3.6	(2.3)	0.7	(5.7)	1776	1865	1845	1008	41.6	68.7	56.4	(2.5)
3/31/94	6/30/94	(1.0)	1.1	0.1	1.7	1758	1885	1846	1025	30.3	33.6	33.0	(0.6)
6/30/94	9/30/94	19.5	30.9	25.2	3.5	2102	2468	2311	1061	30.0	19.2	25.0	0.1
9/30/94	12/31/94	(7.1)	1.9	(2.6)	(0.6)	1952	2515	2251	1055	13.9	31.8	22.8	(1.4)
12/31/94	3/31/95	9.8	16.1	13.0	9.3	2143	2921	2543	1153	20.7	56.7	37.9	14.3
3/31/95	6/30/95	14.7	30.0	22.4	9.0	2459	3798	3112	1257	39.8	101.4	68.6	22.6
6/30/95	9/30/95	35.9	35.6	35.8	6.3	3342	5149	4225	1336	59.0	108.6	82.8	26.0
9/30/95	12/31/95	8.9	7.3	8.1	6.7	3641	5524	4567	1426	86.5	119.6	102.9	35.2
12/31/95	3/31/96	5.5	19.7	12.6	5.3	3841	6610	5142	1502	79.2	126.3	102.2	30.3
3/31/96	6/30/96	1.2	20.7	10.9	3.4	3886	7978	5704	1552	58.1	110.1	83.3	23.5
6/30/96	9/30/96	4.9	2.4	3.6	2.0	4076	8166	5910	1583	22.0	58.6	39.9	18.5
9/30/96	12/31/96	6.6	9.1	7.8	7.0	4347	8905	6374	1693	19.4	61.2	39.6	18.7
12/31/96	3/31/97	(0.5)	(0.3)	(0.4)	3.1	4327	8876	6349	1745	12.7	34.3	23.5	16.2
3/31/97	6/30/97	24.7	23.1	23.9	17.3	5394	10927	7866	2047	38.8	37.0	37.9	31.8
6/30/97	9/30/97	20.0	22.4	21.2	7.2	6474	13375	9534	2194	58.8	63.8	61.3	38.7
9/30/97	12/31/97	(12.5)	(8.8)	(10.7)	2.1	5664	12196	8517	2240	30.3	37.0	33.6	32.3
12/31/97	3/31/98	21.1	19.9	20.5	13.7	6858	14621	10262	2545	58.5	64.7	61.6	45.9
3/31/98	6/30/98	2.2	15.8	9.0	3.6	7010	16934	11187	2638	30.0	55.0	42.2	28.9
6/30/98	9/30/98	(23.3)	(15.0)	(19.2)	(14.1)	5374	14390	9042	2266	(17.0)	7.6	(5.2)	3.2
9/30/98	12/31/98	24.7	98.3	61.5	24.5	6704	28539	14605	2821	18.3	134.0	71.5	26.0
12/31/98	3/31/99	11.9	61.3	36.6	5.3	7501	46029	19949	2971	9.4	214.8	94.4	16.7
3/31/99	6/30/99	30.2	32.9	31.6	6.7	9770	61155	26244	3172	39.4	261.1	134.6	20.2
6/30/99	9/30/99	10.7	5.5	8.1	(7.1)	10816	64514	28370	2946	101.3	348.3	213.8	30.1
9/30/99	12/31/99	16.5	64.8	40.7	13.4	12604	106334	39910	3342	88.0	272.6	173.3	18.5
12/31/99	3/31/00	41.0	21.9	31.4	3.5	17772	129581	52454	3459	136.9	181.5	162.9	16.4
3/31/00	6/30/00	(0.2)	26.4	13.1	(2.4)	17731	163801	59320	3375	81.5	167.8	126.0	6.4
6/30/00	9/30/00	(2.1)	1.3	(0.4)	(2.3)	17353	165891	59067	3299	60.4	157.1	108.2	12.0
9/30/00	12/31/00	(3.8)	(14.8)	(9.3)	(10.7)	16693	141268	53560	2947	32.4	32.9	34.2	(11.8)
12/31/00	3/31/01	3.3	(14.7)	(5.7)	(10.7)	17240	120561	50512	2632	(3.0)	(7.0)	(3.7)	(23.9)
3/31/01	6/30/01	17.9	40.9	29.4	7.9	20329	169863	65365	2841	14.7	3.7	10.2	(15.8)
6/30/01	9/30/01	(7.9)	5.9	(1.0)	(16.0)	18728	179881	64719	2385	7.9	8.4	9.6	(27.7)
9/30/01	12/31/01	32.9	44.5	38.7	11.2	24894	259848	89759	2652	49.1	83.9	67.6	(10.0)
12/31/01	3/31/02	16.6	16.6	16.6	(0.7)	29026	302892	104641	2633	68.4	151.2	107.2	0.1
3/31/02	6/30/02	(13.6)	(18.2)	(15.9)	(15.5)	25066	247784	87984	2225	23.3	45.9	34.6	(21.7)
6/30/02	9/30/02	(9.7)	(4.4)	(7.1)	(12.5)	22638	236808	81773	1948	20.9	31.6	26.4	(18.4)
9/30/02	12/31/02	54.6	5.3	30.0	7.2	35003	249350	106273	2088	40.6	(4.0)	18.4	(21.3)
12/31/02	3/31/03	(1.3)	(13.7)	(7.5)	(5.6)	34550	215114	98289	1972	19.0	(29.0)	(6.1)	(25.1)
3/31/03	6/30/03	36.3	19.8	28.1	14.4	47107	257803	125903	2256	87.9	4.0	43.1	1.4
6/30/03	9/30/03	30.9	22.7	26.8	4.0	61670	316344	159660	2347	172.4	33.6	95.2	20.5
9/30/03	12/9/03	15.8	15.0	15.4	4.1	71414	363748	184248	2443	104.0	45.8	73.3	17.0
	% P/L	10.7	16.3	13.5	2.3				% P/L	43.1	85.8	63.0	9.2
	Stdev	16.2	23.9	17.7	8.9				Stdev	31.9	83.9	50.7	19.9
	PL/SD	66.3	68.2	76.5	26.3				PL/SD	135.0	102.2	124.5	46.4

Updated through 12/9/03.

for the strong groups, the weak groups, and the overall portfolio. Notice in Table 1 that the portfolio outperformed the market each year. Notice also that the strong groups performed best when the market was very strong such as in 1998 and 1999. The weak groups performed well once the market weakened. In 2001, the weak groups gained 49% and in 2002 they gained 40%. Year 2003 represents the weak groups' best year. **Table 2** details the quarterly and rolling 12-month percentage returns.

Editor's Notes:

Folios, also known as stock baskets, are recent vehicles that offer many benefits to traders, particularly those who want to tailor a portfolio to benchmark a certain industry or sector. Buying a stock basket allows a trader to invest the same amount of money in each of a number of different stocks by purchasing fractional shares of each.

For example, if a trader wanted to invest $10,000 in domestic automakers, buying a stock basket would allow him to invest exactly $3,333.33 in Delphi Automotive, Ford, and GM. With Delphi Automotive, Ford, and GM trading at $9, $12.11 and $42.88 a share respectively, a trader would buy 370.37 shares of Delphi, 275.254 shares of Ford and 77.736 shares of GM. For more information, visit *www.foliofn.com*.

If you would like to download Jay Kaeppel's revised group structure or would like to see trade-by-trade details in an Excel spreadsheet, go to *www.aiqsystems.com*. Click *Educational Products* and then *Opening Bell*.

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date
Pulte Homes	PHM	2:1	01/05/04
River Valley Bancorp	RIVR	2:1	01/12/04
Inergy LP	NRGY	2:1	01/13/04
Pacificare Health	PHS	2:1	01/15/04
Hudson River Bancorp	HRBT	2:1	01/16/04
Florida Rock	FRK	3:2	01/19/04
Evertrust Financial	EVRT	3:2	01/19/04
Thor Industries	THO	2:1	01/27/04
Yak Communications	YAKC	2:1	01/30/04
Provident Financial	PROV	3:2	01/30/04
Paccar Homes	PHM	3:2	02/06/04

Trading Suspended:

FAO Inc. (FAOO)
OfficeMax Inc. (OMX)
Protection One (POI)
Ziegler Cos. (ZCO)

Name Changes:

Neighbor Care Inc (NCRX) to Genesis Health Ventures (GHVI)
Proton Energy Systems (PRTN) to Distributed Energy Systems (DESC)
Royce Micro-Cap Trust (OTCM) to Royce Micro-Cap Trust (RMT)
Yellow Corp (YELL) to Yellow Roadway (YELL)

S&P 500 Changes

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

There are no changes this month.

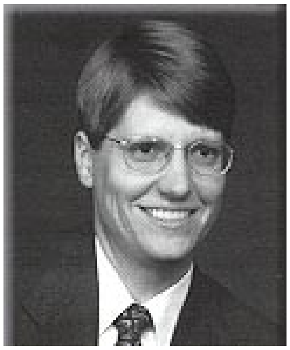
MARKET REVIEW

Eight-Month Market Rally Continues Through End of Year

The market continued its eight-month long rally in December but there was a shift in participation. From April through most of November, all major market averages rose in value but the broader market averages were the best performers. During that time, the S&P 500 and the Dow underperformed. That tide turned in December.

In December, money moved from the broader market and technology stocks to the more cyclical large-cap stocks represented in the S&P 500 and the Dow. In December, the S&P 500 rose 5.1% and the Dow rose 6.9%. That beat the Nasdaq's return of 2.2% and the Russell 2000's return of 1.9%. The yearly leaders lagged in December.

The best performing sectors in December were commodity related. Energy Rose 12%, Natural Gas rose 11%, Paper rose 11%, and Chemicals rose 10%. One commodity sector fared poorly, however. Gold fell 2%.



DAVID VOMUND

Analysis of Market Timing Systems

US Score Market Timing System Proves To Be Very Effective in 2003

By David Vomund

After three years of a brutal bear market, prices rebounded strongly in 2003. Whereas market timing was critical in 2000 to 2002, market timing was not needed in 2003. The only market timing opportunity came in the first quarter when the S&P 500 corrected 14%.

Although history may say the bear market ended in October, the market tested the low in March and many people's portfolios will show that March was the actual bear market bottom. In the second, third, and fourth quarters of 2003, there were no significant corrections so market timing signals offered no value.

The best market timing model was short until March 12 and then long after that. From late March to the end of the year, there was never even a 5% correction. When there are so few corrections, market timing models are unnecessary and will almost always underperform. For the year, the S&P 500 gained 26.4%.

In this article, we'll examine market timing systems that have been discussed in 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.

AIQ Market Timing Model

AIQ's market timing model has been out of sync for the last few years. Its signals currently offer little value in market timing decisions.

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.

Table 1 lists the trades. The most damaging time was when the model remained on the sidelines from March to July. Trading the S&P 500 using this approach would have resulted in a 2.8% gain for the year.

RSMD Timing Model

In the April 2002 *Opening Bell,* we ran an article on a timing system that has become an important factor in my own market timing. The article covered a simple but effective market timing technique that uses the Nasdaq's weekly RSMD SPX indicator as a market timing tool.

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 this timing method works. When the fast line (the Phase 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. I recommend looking for a change in the direction of the Phase line instead of waiting for a crossover of the Signal 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.

Here is why the RSMD 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.

Table 2 shows the trading signals for 2003 using a two-week change in the RSMD indicator. Even though the indicator is run on the Nasdaq, this is an overall market

Table 1. Expert Rating Results

Buy Date	Expert Rating	Sell Date	Expert Rating	S&P 500 % Change
12/31/2002	N/A	1/17/2003	98	-0.84
1/29/2003	97	3/10/2003	98	-6.58
7/02/2003	95	7/03/2003	97	-0.81
8/08/2003	97	9/22/2003	97	4.62
9/30/2003	98	10/22/2003	96	3.45

timing model so the percentage return figures assume that the S&P 500 index is traded. For the year, this trading system gained 9.9%. If you were to trade the Nasdaq instead of the S&P 500, the return would have been 20.4%.

US Score Timing System

In the December 2002 *Opening Bell*, we covered a market timing technique that we use to keep our emotions in check. It is a counter-trend system so when stocks are hot and our emotions tell us to buy more, this technique often turns bearish. Conversely, it only switches to a buy when stocks sell off.

The technique looks at the percentage of stocks giving unconfirmed AIQ buy or sell signals. This percentage can be found on the Market Log report under the US Score. A US Score of 20 – 80 means 20% of the stocks with unconfirmed signals are on the buy side while 80% of the stocks with unconfirmed signals are on the sell side. To get the ratio, we ran the Market Log report on a database of the S&P 500 stocks. Generally, any reading greater than 85% is significant.

This technique can be thought of as an overbought/oversold indicator. When the market rises too far too fast, then a high percentage of stocks will give unconfirmed AIQ sell signals. Conversely, when the market falls too far then a high percentage of stocks will give unconfirmed buy signals. This technique works well because most of the time the market is not in a strong trend.

Table 2. Two Week Change in RSMD

Buy Date	Sell Date	% Change S&P 500
12/31/2002	2/07/2003	-5.69
2/21/2003	4/04/2003	3.62
4/25/2003	8/15/2003	10.22
8/29/2003	10/24/2003	2.07

2003 Trading Resuls:
S&P 500 Trading = 9.94%
Nasdaq Composite Trading = 20.40%

Figure 1 shows this year's S&P 500 with the US Score at most of the swing points. Notice at nearly every short-term high there was a high percentage of stocks with sell signals and at nearly every short-term low there was a high percentage of stocks with buy signals. There are exceptions. At the mid-March high, 98% of the stocks were giving unconfirmed sell signals. Sure enough, the market sold off for the remainder of the month. At the late March low, however, there was not a high percentage of stocks with buy signals.

Even though the market never experienced a five percent correction in the second half of the year, there were enough mini-corrections to make this technique effective. Instead of buying at the high, this technique helped traders to wait for a pullback. Along the same lines, rather than selling at the low this technique warned investors that it was too late to sell and that a rally was near.

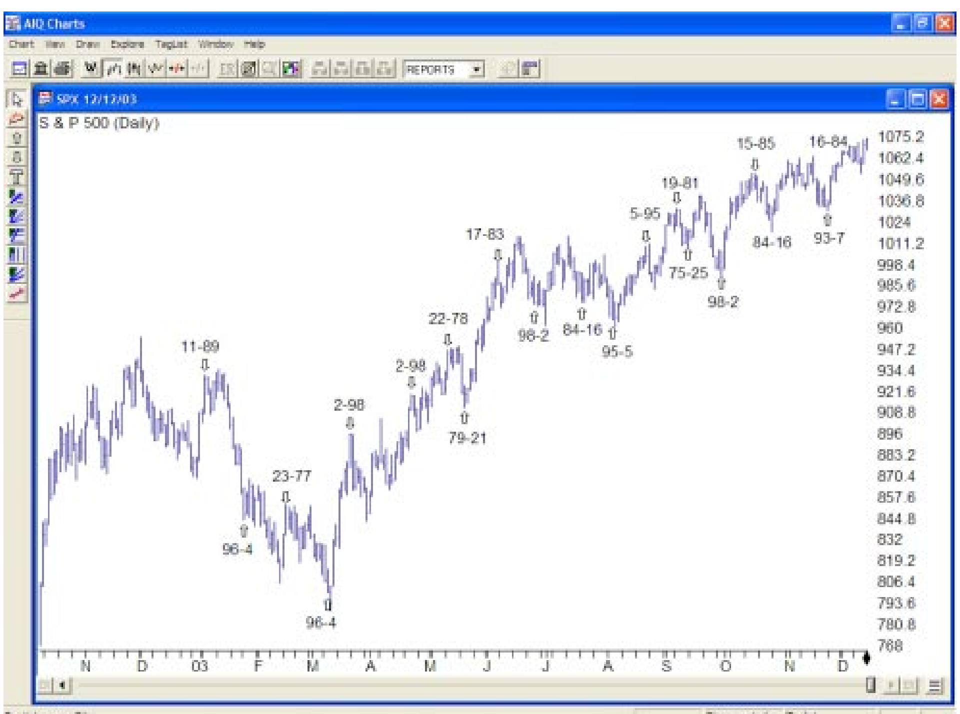


Figure 1. S&P 500 chart with US Score shown at most inflection points (arrows) during 2003.

Conclusion

The market has never experienced four consecutive declining years. With the strong performance of 2003, that record is still intact. Market timing was not critical in 2003 as it was in the previous three years but incorporating the techniques listed in this article allowed traders to reduce portfolio risk.

In this article I only briefly covered each technique. For more information on the individual techniques, please read the referenced *Opening Bell* articles. These articles can be found at *www.aiqsystems.com* under *Educational Products.*

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