# AIQ Opening Bell® Monthly

IN THIS ISSUE VOL. 7 ISSUE 1 JANUARY 1998


*Feature*



*Sections*

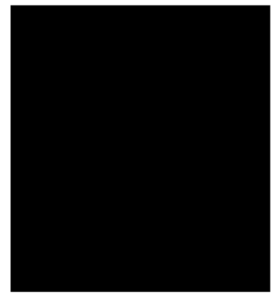



The *Opening Bell Monthly* is a publication of AIQ Systems
David Vomund, Chief Analyst
P.O. Box 7530
Incline Village, Nevada 89452


MARKET TIMING

## IMPRESSIVE 1997 GAINS! FOR MECHANICAL TRADING USING AIQ EXPERT RATINGS

**By David Vomund**



DAVID VOMUND

The year 1997 was another strong year for mechanical models using AIQ's Expert Rating signals. The market timing Expert Ratings were off the mark in some time periods but in the end trading results were impressive, especially when confirmation was applied.

**Market Timing - No Confirmation**

AIQ's market timing model was on a buy signal at the start of 1997. Looking only at Expert Ratings of 95 or greater with no confirmation, the model remained on a buy for most of the January through August advance. There was a one-day whipsaw in early January and traders were out of the market during one week in March. The timing model put traders back in the market in early September and then had them exit at the end of November. The last signal came at the end of December when the model turned bullish.

> ***"For traders who applied Phase confirmation, AIQ's market timing model was deadly accurate."***

Unfortunately, the market timing model gave a buy too early in March, so followers who did not use confirmation rode out the second half of the March/April correction. The model also missed the October market correction — it remained on a buy during the selloff. However, to its credit, AIQ's timing model didn't give a sell after the 550 point drop on October 27. Despite these setbacks, if you traded the S&P 500 index based on the Expert Rating signals you would have seen a 29.7% return in 1997.

Trade-by-trade details for the market timing model without confirmation are found in **Table 1**. This assumes you buy the S&P 500 at the close on the day of the first buy signal of 95 or greater, and then sell at the close on the day of the first sell signal of 95 or greater. No money market interest is factored in.


*Market Timing continued on page 2*

MARKET TIMING *continued . . .*

**Market Timing - Phase Confirmation**

Historical testing shows that applying a confirmation technique typically lowers the overall return. This wasn't the case in 1997.

For traders who applied Phase confirmation, AIQ's market timing model was deadly accurate. Using the Phase indicator for confirmation, a buy signal is not a buy until the Phase indicator increases in value from the prior day (it doesn't matter if the indicator is below zero, it only has to increase in value).

Along the same line, a sell signal is not a sell until the Phase indicator decreases in value. There is no time limit within which the confirmation must take place.

Using Phase as confirmation, the one-day whipsaw in January was avoided and traders were on the sideline for most of the March/April correction. By trading the S&P 500, traders saw a 38.2% return. Trade-by-trade details using Phase confirmation are found in **Table 2**.

**Market Timing - Weighted Action List Trading**

We next review the mechanical model that uses both the Expert Ratings on the overall market and on individual stocks. In the March 1997 issue of the *Opening Bell*, we discussed a mechanical trading technique which combines the market timing ratings with the Weighted Action List report.

In review, using a database of S&P 500 stocks, we ran a Weighted Action List report every time there was a market timing buy signal (an Expert Rating of 95 or greater). Only the first signal in a string of buy signals was used and no confirmation was applied. The top five stocks that appear on the Weighted Action List were purchased and held until a market sell signal was registered, at which time all positions were moved to cash. Only stocks over $10 were purchased and the Expert Rating buy signals on the stocks had to be 95 or greater.

To obtain percentage return figures, we made the following assumptions:

- All profits/losses were reinvested in the next block of trading with each of the five stocks receiving an equal amount of capital.
- The buy and sell points of the stocks were the opening price the day after the market Expert Rating.
- Commissions were factored in using a flat rate of $33 per trade.
- Slippage, dividends, and money market interest received were not factored in.

Results from this simple mechanical system show that the portfolio rose 37.7%, including commissions. The trade-by-trade details are found in **Table 3**. The entry and exit dates represent the day after a market timing Expert Rating was registered. The third column lists the percentage change in the S&P 500 index, while the fourth column shows the results of trading the five stocks listed in the far right column (top five stocks from the Weighted Action List).

We've been tracking this me-

**Table 1**

**No Confirmation**

| ER Buy Date | ER Sell Date | S&P 500 Buy Price | S&P 500 Sell Price | S&P 500 % Change |
|---|---|---|---|---|
| 12/31/96 | 01/06/97 | 740.74 | 747.65 | 0.93 |
| 01/07/97 | 03/13/97 | 753.23 | 789.56 | 4.82 |
| 03/21/97 | 08/08/97 | 784.10 | 933.54 | 19.06 |
| 09/02/97 | 11/18/97 | 927.58 | 938.22 | 1.15 |
| 12/29/27 | 12/31/97 | 953.36 | 970.42 | 1.79 |

**1997 Return = 29.69%**

**Table 2**

**Phase Confirmation**

| ER Buy Date | ER Sell Date | S&P 500 Buy Price | S&P 500 Sell Price | S&P 500 % Change |
|---|---|---|---|---|
| 12/31/96 | 01/06/97 | 740.74 | 747.65 | 0.93 |
| 12/31/96 | 03/13/97 | 740.74 | 789.56 | 6.59 |
| 04/08/97 | 08/08/97 | 766.12 | 933.54 | 21.85 |
| 09/02/97 | 12/10/97 | 927.58 | 969.78 | 4.55 |
| 12/29/97 | 12/31/97 | 953.36 | 970.42 | 1.79 |

**1997 Return = 38.22%**

MARKET TIMING *continued* . . .

chanical trading technique since 1992. It has an annual rate of return of 25% since 1992.

**Table 3**

**1997 Results**
**Weighted Action List**

| Buy Date | Sell Date | S&P 500 % Change | Stocks % Change | Portfolio Holdings (Stock Symbols) |
|---|---|---|---|---|
| 12/31/96 | 01/07/97 | 0.93 | 0.97 | TJX,BSX,HAL,CA,FITB |
| 01/08/97 | 03/14/97 | 4.82 | 19.62 | GM,LSI,MU,S,THC |
| 03/24/97 | 08/11/97 | -1.30 | 12.39 | RX,HFS,USBC,BSX,FNM |
| 09/03/97 | 11/19/97 | 1.15 | 1.74 | BAY,DH,WAMU,MER,FITB |
| 12/30/97 | 12/31/97 | 1.79 | 3.32 | EMC,UIS,ADSK,BAY,DELL |

**1997 Portfolio Return = 37.73%**

### Market Timing - Relative Strength Trading

Our final review of mechanical trading models uses the Relative Strength-Strong report. We came across this technique when we printed testing results of several stock screening reports in the April 1997 issue of the *Opening Bell*. The technique is the same as that used for the Weighted Action List except that we purchase the top five S&P 500 stocks on the Relative Strength-Strong report.

When a market timing signal of 95 or greater is generated, the Relative Strength-Strong report is generated and the top five stocks in the long term section are purchased and held until a market timing sell signal of 95 is registered, at which time all positions are sold and moved to cash.

Again, a commission of $33 per trade is applied and the buy and sell prices represent the opening price the day after the market timing signal.

The yearly return for this technique was 39.9%. Trade-by-trade details using the Relative Strength-Strong report are found in Table 4.

Unlike the Weighted Action List trading technique, we have not monitored this trading system back to 1992. Historical testing of the system shows a 39% annual rate of return.

**Table 4**

**1997 Results**
**Relative Strength Portfolio**

| Buy Date | Sell Date | S&P 500 % Change | Stocks % Change | Portfolio Holdings (Stock Symbols) |
|---|---|---|---|---|
| 12/31/96 | 01/07/97 | 0.93 | 0.97 | TJX,BSX,HAL,CA,FITB |
| 12/31/96 | 01/07/97 | 0.93 | -1.91 | NAE,CHRS,TJX,DELL,CA |
| 01/08/97 | 03/14/97 | 4.82 | 7.56 | GM,LSI,MU,S,THC |
| 03/24/97 | 08/11/97 | -1.30 | 35.48 | AMD,DELL,CNC,USB,WAMU |
| 09/03/97 | 11/19/97 | 1.15 | -6.87 | DELL,AMAT,NAV,NC,CPQ |
| 12/30/97 | 12/31/97 | 1.79 | 3.82 | CINF,U,NAV,TCOMA,USB |

**1997 Portfolio Return = 39.86%**

### In Summary

When we updated these statistics at the end of 1997, we were surprised at how good the results were. We were surprised at the good results because each technique had some bad time periods during the year.

It is human nature to remember the bad time periods. During our fall seminar at Lake Tahoe, the high relative strength stocks were under pressure and in November, when a sell signal was registered shortly after three buy signals, there were suggestions that the market timing model should be updated. As our 1997 results show, it can be detrimental to judge the effectiveness of a system on a daily or even a weekly basis.

We'll continue to monitor these trading models and will report trading results next year. As always, past performance does not guarantee future results. ■

*Visit Vomund's Web site at www.visalert.com.*

THE BEST OF 1997

# THESE 'WORDS OF WISDOM' ARE IMPORTANT TO REMEMBER

The Opening Bell Newsletter marked its five year anniversary in 1997. We believe that some of the best thoughts published were the insights from AIQ users who shared their trading techniques with us. These trading techniques are invaluable for those who are in the process of developing their own trading strategies as well as for trading veterans.

There were many different techniques presented. We began the year with Nicolas Williams who combines Candlestick analysis with a 10 day CCI, and we ended the year with Jim McConnell's asset allocation techniques.

In between were words of wisdom from other professionals and AIQ power users. Here are our favorite:

## John Bollinger - February 1997

*"People who don't understand how each indicator works won't know that they are duplicating their efforts. If they don't understand the indicators -- both how they work and how they are calculated — and they try to perform challenging tasks, they have no way of anticipating when or why their tools can fail them. By learning how to use the indicators, not only will you be able to employ them successfully but you will be able to anticipate when an indicator will turn on you and stab you in the back. This does not mean that you have to learn every indictor. Time and again I find people using more tools than they can process intelligently."*

There are several important points in this statement. First, when looking at the indicators, it is important to understand that some indicators have similar characteristics to other indicators. Someone who uses both the MACD and the Phase should know that these are the same indicators but with different settings. When one is bullish, in most cases so is the other.

Along the same line, some users may use both the Stochastic and the RSI. The problem with this is that both indicators measure overbought/oversold levels and both are based strictly off price action. It is hard to find a case where the RSI is oversold and the Stochastic is not. It is best to use indicators that work independent of each other.

***"There is no reason to understand all the indicators...Pick three or four indicators, some based on price and some based on volume...you'll quickly learn when they work well and when they don't."***

The second point is you should understand in what type of environment each indicator works best and in what type of environment each indicator fails to work. Some indicators work best in non-trending situations and some work best for securities that are in trends.

The final point here is that there is no reason to look at or understand all the indicators available in TradingExpert. Pick three or four indicators, some based on price and some based on volume, and learn them well.

By concentrating on a selected few indicators, you'll quickly learn when they work well and when they don't.

## James O'Shaughnessy - May 1997

*"The reason human forecasters fail is they are inconsistent. One time they use a bit of information that is highly relevant and another time they ignore it based on either their whims or the prejudice of the moment. ... Most money managers have a good strategy. The problem is they don't follow the strategy."*

The psychological side of trading is just as important as the analytical side of trading. The majority of our articles deal with the analysis. Yet, the analysis is useless if you don't keep emotions under control. Too many people make their decisions based on emotions and then look at the charts to justify their positions. Real-time quotes, CNBC, and other outside influences can be hazardous to your trading.

*"If you want to talk about being terrified, think of what it will be like to be 65 with little savings. You'll be going into retirement knowing that you were terrified out of the market because of a bad quarter in 1997. Do you remember the pain suffered in the third quarter of 1990? Probably not, but at that time people were white knuckled with fear. Look what you would have missed by getting out of the market back then."*

When we interviewed Mr. O'Shaughnessy, we were in the midst of the March correction. Remember the March correction? At the time it was very painful. Now it seems very minor. Market timing is critical if you need the money in one to three years, but in the long term markets go up. Security selection and asset allocation have a greater influence on profits than market timing.

## Lee Clayton - June 1997

*"It was hard at first to take losses, but I have come to realize that a small loss is much better than getting taken*

THE BEST OF 1997 *continued . . .*

*down into a 20-30% loss. Once you're down that much, it takes a tremendous move just to get back to even."*

The sell decision is always more difficult than the buy decision. That is because investors rarely if ever sell right at the top. The fact is, people rarely buy at the exact bottom, so why expect to sell at the top. It's critical to decide on the sell decision when a stock is purchased and then stick to it. Too many portfolios contain some stocks that "have gone down so far that it is too late to sell." This happens to almost everyone and in each case it takes a long time to make up for a big loss.

*"I try to stay away from stories about stocks, from listening to somebody hyping a particular stock. I try to just look at the technicals. I don't like hot tips. I use a discount broker and I trade over the Internet. I am not influenced by what brokers are hyping. I even turn off CNBC most of the time and concentrate on market timing and stock selection."*

Once again we see the importance of taking emotions out of decisions. Very often, your emotions say one thing and then a simple look at the charts say another.

### Linda Bradford Raschke - August

*"A lot of people get into scenario building. They might examine what they perceive to be fundamental data and then make evaluation judgments...On the other side of every trade is somebody who is equally convinced that it is going in the opposite direction. Who is right? The market is. The market is going to do what it wants regardless of your convictions."*

Trading can be very humbling. The good trader is the one who puts his ego aside and listens to the market. After all, the market is always right. To see what happens when you don't listen to the market, simply look at the market timers who have been bearish for years. We could have two bear markets and still be higher than when they turned bearish. Yet, they still think they are right.

*"Consistency speaks in reference to following a specific methodology. Unfortunately, most methods don't always work in all market conditions and market conditions never persist forever. What happens is that the minute you become discouraged with a particular methodology and abandon it, market conditions change and the system begins to work again. You end up exiting every methodology at its low draw down on its equity curve so you are always one step out of sync. If you are always switching strategies, you are probably just leaving the one that is ready to kick in."*

Your confidence in a system is tested during losing streaks. If you switch strategies every time a few losses are seen, you'll be one step behind the game. Very often, the best stock selections come right after losing streaks.

### James McConnell - November

*"Asset allocation is basically where you are going to make the most of your gain investments today. If you decided to allocate your assets into the Japanese stock market over the U.S. market for the last year, you would be underperforming. Likewise, if you invest in U.S. securities, the small-cap or large-cap decision is important."*

The rotation of industry groups is critically important in investments. Likewise, the rotation of large-cap versus small-cap stocks is important. These tell you where your money should be.

### Broker - March 1997

*"I suggest new users first load the S&P 500 data, add all the fundamentally recommended stocks, and then make the recommended stocks a separate group on which to run reports. They can then follow the S&P 500 along with the recommendations. Fundamentals and earnings are what drive stocks, but the technical picture tells you when to buy."*

For compliance reasons, this broker could not reveal his name or his firm. He is an AIQ power user and thoroughly understands the program. Most AIQ users run reports on all the stocks in their database and are unaware that reports can be run on selected lists. It works well to further narrow the stocks you want to follow by creating a list of fundamentally attractive stocks and then running reports just on this list of stocks. These may be Value Line, Standard & Poor's, or an investment newsletter's recommendations. Why have stocks that you wouldn't be willing to purchase clutter up the reports?

*"Learning is critical. Read the Investor's Business Daily, read the AIQ manual and the Opening Bell, and go to seminars — it's an ongoing learning process."*

We especially like the *Opening Bell* recommendation! Our learning process continues and we look forward to 1998.

*For a free index to 1997 Opening Bell articles, call your sales representative at (800) 332-2999.* ■

**PLEASE SEND CORRESPONDENCE TO:**

**Opening Bell Monthly**
**G.R. Barbor, Editor**
**P.O. Box 7530**
**Incline Village, NV 89452**

AIQ Opening Bell Monthly 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.

**For subscription information, phone 1-800-332-2999 or 1-702-831-2999.**

CHART PATTERN ANALYSIS

# Identifying Chart Patterns Can Be Very Helpful to Traders

**by David Vomund**

*"Charts are the working tools of the technical analyst."*

That is what Robert Edwards and John Magee wrote in their classic book, *Technical Analysis of Stock Trends.* The first edition of this book was published in 1948 and while there have been several updated versions, the chart patterns they discuss continue to work in today's market.

In this article, we'll present a review of the technical chart patterns. By viewing examples of these patterns, we hope that our readers will learn how to identify them as they are developing.

Chart patterns do not call market tops or bottoms. In each chart, the analyst waits for a sign, such as a trendline break, to indicate that the trend has actually reversed. Instead of calling tops or bottoms, pattern analysis gives an early indication as to when a new trend has emerged.

Stock prices tend to move in trends. When an existing trend is in the process of ending, a pattern typically develops which will become recognizable as a reversal formation. A "V" shaped top or bottom rarely occurs. Typically, there is some backing and filling. During this transition period, it may not be clear as to which of several patterns may emerge. Trendlines can often be drawn to fit the developing pattern.

## Rounded Tops and Bottoms

Edwards and Magee describe rounded tops or bottoms as "a gradual, progressive and fairly symmetrical change in the trend direction, produced by a gradual shift in the balance of power between buying and selling." A rounded top or a rounded bottom is commonly referred to as a "bowl" or a "saucer" pattern.

As a rounded bottom develops, the stock's initial trend is down since there is too much supply and not enough demand. As the price decreases, more buyers get interested so the stock begins to level out. Demand increases and the stock begins to move higher. As the stock makes its bottom and as it begins its advance, there is often good fundamental news such as positive earnings news or new product developments. The stock enters its uptrend.

An example of a rounded bottom is seen in Bob Evans Farms Inc. (BOBE). **In Figure 1**, we see that in late 1995 and 1996 the stock was in a steady downtrend and was fluctuating between the 28-week moving average and the lower AIQ Band. The supply and demand equation equalized in early 1997 and the stock spent several months moving sideways (the 28-week moving average was crossed often). By mid 1997, buyers came in and now BOBE is fluctuating between the 28-week moving average and the upper band.

Notice that the graph of BOBE uses the weekly chart format. This pattern typically takes place over a long time period so it is more easily spotted under the weekly chart format than from a daily chart. The rounded top or bottom pattern occurs infrequently, but when it is identified it can be very profitable.

## The Right Triangle

The right triangle is a pattern that exhibits a series of narrower price fluctuations. On one side of the fluctuation, the boundary of price action is horizontal. On the other side, prices fluctuate toward the horizontal boundary. An ascending triangle is a right triangle with a horizontal top and an ascending bottom. A descending triangle is the reverse.

To illustrate this formation, we'll look at Smith International (SII) in **Figure 2**. Early in 1997, SII began to form an ascending triangle. $49 acted as resistance and the stock sold off every time it reached this level.

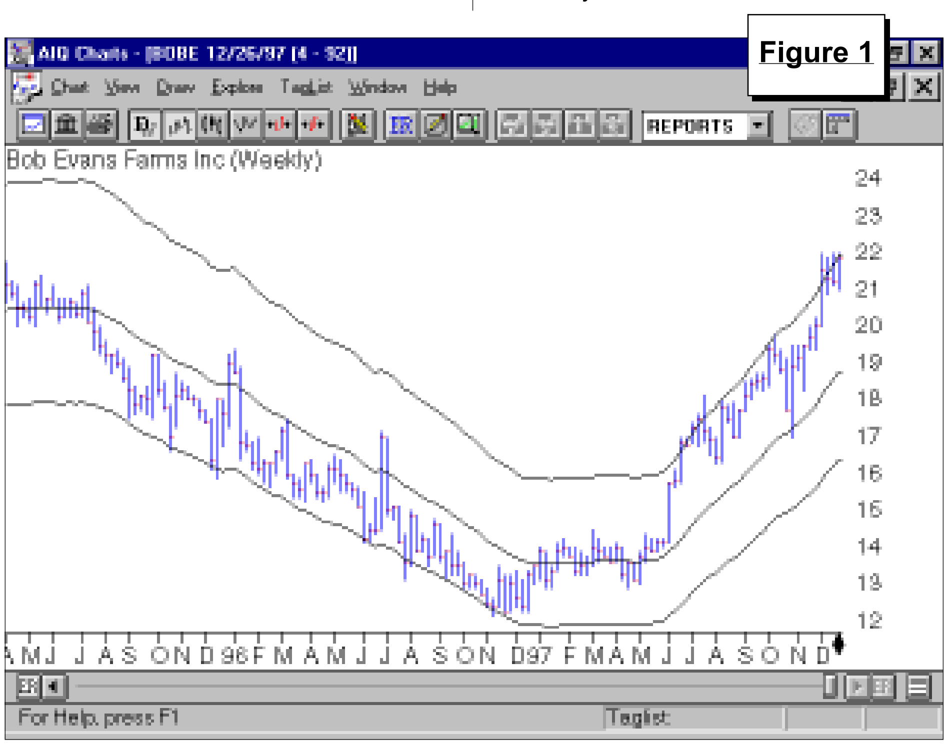


Figure 1

## CHART PATTERN ANALYSIS *continued* . . .

Yet each selloff was smaller than the previous one. A trendline was drawn at the extremes of the pattern. For each trendline, at least two price points must be connected before the stock breaks out of the pattern. We see in Early May that SII was able to clear resistance, which was the buy point for this pattern.

After the ascending triangle, SII staged an impressive advance. The stock rallied until October at which time it reversed direction. As the uptrend was ending, a descending triangle pattern developed (see **Figure 3**). $73 acted as support for the stock, but each rally from this level was less than the previous rally. In November, SII fell below its lower trendline. The uptrend was over.

As often happens with trendline breakouts, SII rallied and tested the level where the breakdown occurred. The horizontal trendline was support, but once the stock falls below this trendline it now became resistance. SII was unable to penetrate this level and the downtrend resumed.

We can see that the right triangle pattern does not call the exact bottom or top of the stock. We wait for the breakout and then act accordingly. We missed the exact bottom and the exact top but the move in between worked out nicely.

**Figure 2**


Edwards and Magee explain that in most cases it is the horizontal trendline that is broken in this pattern. Therefore, caution should be exercised when a descending triangle is developing.

Likewise, be ready to buy long when an ascending triangle is developing. If the security breaks the sloping trendline instead of the horizontal trendline, then the resulting move typically has less significance. If the upward sloping trendline on a descending triangle is broken, the stock may only rally to its previous reaction high.

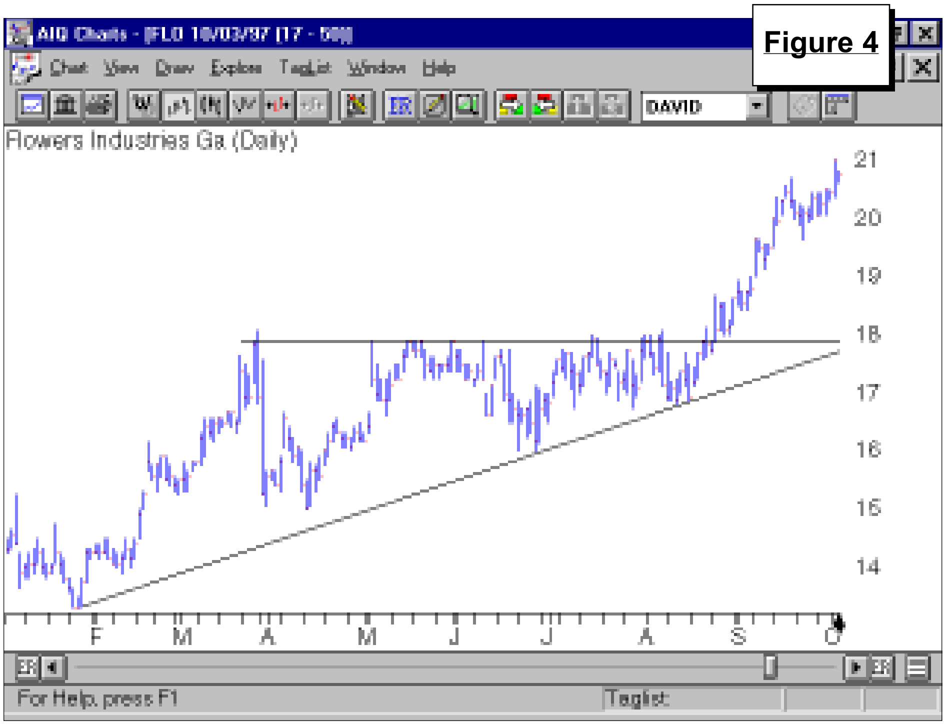
Trendlines must connect at least two points before the breakout. The more points touched without a breakout, the more significant the trendline. In **Figure 4** (next page) we see an ascending triangle pattern for Flowers Industries (FLO). Notice that FLO tested the upper trendline at least five times before it was penetrated. The lower trendline was tested three times.

Right triangles occur more frequently than do rounded bottoms. By browsing a database, users will spot several examples. Just recently, the Russell 2000 index developed a descending triangle pattern (best seen using closing prices only rather than plotting the highs and lows).

**Figure 3**


*Chart Pattern Analysis continued on page 8*

## CHART PATTERN ANALYSIS *continued* . . .




Instead of breaking below its horizontal support line, however, it broke above the downward sloping upper trendline.

Next month we'll cover the symmetrical triangle pattern. To purchase *Technical Analysis of Stock Trends*, visit Traders Library on the AIQ home page at www.aiq.com. ■

## MARKET REVIEW

The market began December on a sell signal and several additional sell signals were registered throughout the month. A 96 down rating was registered on December 10 and 11, and a 95 sell came on December 18. During this time, the market corrected and the Russell 2000 fell to its October 27 low before finding support.

The Stock Traders Almanac says that historically a Santa Claus Rally hits the market during the last week of December and first two trading days in January. As this time period came, the market rallied and there was good participation in the broader market averages. This turned enough indicators bullish and a 100 buy signal came on December 29. The Phase indicator was increasing at that time so the signal was immediately confirmed.

The market ended the month with the S&P 500 index just below its old highs and the Russell 2000 was in the middle of its fourth quarter trading range. ■

## STOCK DATA MAINTENANCE

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

| Stock | Ticker | Split/Div. | Approx. Date |
|---|---|---|---|
| McKesson Corp. | MCK | 2:1 | 01/05/98 |
| Computer Learning Ctr. | CLCX | 2:1 | 01/09/98 |
| Northern Telecom | NT | 2:1 | 01/12/98 |
| DPL Inc. | DPL | 3:2 | 01/13/98 |
| Semtech Corp. | SMTC | 2:1 | 01/13/98 |
| Donaldson Co. | DCI | 2:1 | 01/14/98 |
| Ecolab Inc. | ECL | 2:1 | 01/16/98 |
| First Amer. Finc'l | FAF | 3:2 | 01/16/98 |
| Franklin Res. | BEN | 2:1 | 01/16/98 |

| Stock | Ticker | Split/Div. | Approx. Date |
|---|---|---|---|
| Compaq Comp. | CPQ | 2:1 | 01/20/98 |
| Peoples Holding | PGL | 3:2 | 01/21/98 |
| CVB Fin'l | CVB | 3:2 | 01/21/98 |
| Patterson Evergy | PTEN | 2:1 | 01/26/98 |
| Ameritech Corp. | AIT | 2:1 | 01/27/98 |
| Analysis & Tech. | AATI | 3:2 | 01/30/98 |
| Fairfield Comm. | FFD | 2:1 | 02/02/98 |
| Staples Inc. | SPLS | 3:2 | 02/02/98 |

**Trading Suspended:**

Fieldcrest Cannon Inc. (FLD), Game Fin'l (GFIN), Guaranty National Corp (GNC), LA Gear (LA)
Mosinee Paper (MOSI), NHP Inc. (NHPI), Perkins Family Rest. (PFR), Rohr Inc. (RHR)

**Name/Ticker Changes:**

BEI Electronics (BEII) to BEI Medical Systems (BMCD), CUC Int'l (CU) to Cendant Corp (CD)
DSP Communications (DSPC) to DSP Communications (DSP), Mohawk Ind. (MOHK) to Mohawk Ind. (MHK)
Money Store Inc. (MONE) to Money Store Inc. (MON), Premier Parks (PARK) to Premier Parks (PKS)
Robbins & Myers (ROBN) to Robbins & Myers (RBN)