AIQ Opening Bell® Monthly

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Feature

Sections

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PUTTING IT ALL TOGETHER

EXIT ON EXPERT RATINGS? NOT ME.

By Dr. J.D. Smith

DR. J.D. SMITH

At a recent AIQ seminar I was asked how to best avoid closing a long position early, an especially important question as AIQ typically generates several Expert Rating sell signals during a runup in stock prices. This is a common question relating to a problem that has bedeviled us all.

The answer has several aspects:

- How Expert Rating signals are generated by the AIQ expert system.
- The various signal confirmation techniques used in the trading process.
- Specific exit rules in the trading process.
- Use of indicator constants to fine tune the trading process.

"I will exit a long position from a trendline stop or when MACDI and DMI are both bearish."

An example of the situation in question is shown in **Figure 1**, a chart of Brunswick. The figure shows a very common price pattern - a six to eight week consolidation followed by a drop to the lower Trading Band, then an early upside Expert Rating followed by a long runup in prices. (This was not one of my positions since I was fully invested during this period of time, but it is a good example of what we are talking about.)

An Expert Rating buy signal (98 1) for Brunswick was issued on September 30. By October 12, my required indicator confirmations had occurred - a MACDI crossover showing positive price momentum and the Directional Movement Index (DMI) turning positive, showing a bullish trend in place.

The Recreation group that Brunswick is a part of also had a positive DMI and a MACDI crossover to the upside. In addition, the barometer for the Recreation group was very green. This is not required by my entry rules, but it certainly doesn't hurt my confidence level when taking a long position.

My entry, then, would have been at

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the open on October 13, at 14 3/4. The long runup in prices followed.

First Down Signal

The first down signal occurred a month later on November 12. The signal is shown in **Figure 2**, along with a list of specific rules that fired on that day. Four rules out of the several hundred evaluated were true, and thus were synthesized by the inference engine into the Expert Rating of 92 to the downside. Although it is not necessary to refer to the rules that fire on a given day, it does increase our understanding of the kind of situations that the Expert Ratings are pointing to.

Rule A is a mathematical rule and involves the second derivative of average closing prices. The rule says that the increasing rate of change is starting to decrease. The fact that the rate of increase is decreasing would not be an unusual situation after a month-long upward trend.

Rule B informs us that On Balance Volume is not keeping up with prices in the short-term. On Balance Volume is one attempt to measure supply and demand and we know that it is difficult for prices to continue to advance without demand for the stock. The rule indicates that demand is weakening. This could be a sign of profit taking by very nimble traders. After all, prices have increased 15% in a month's time, a good trading profit.

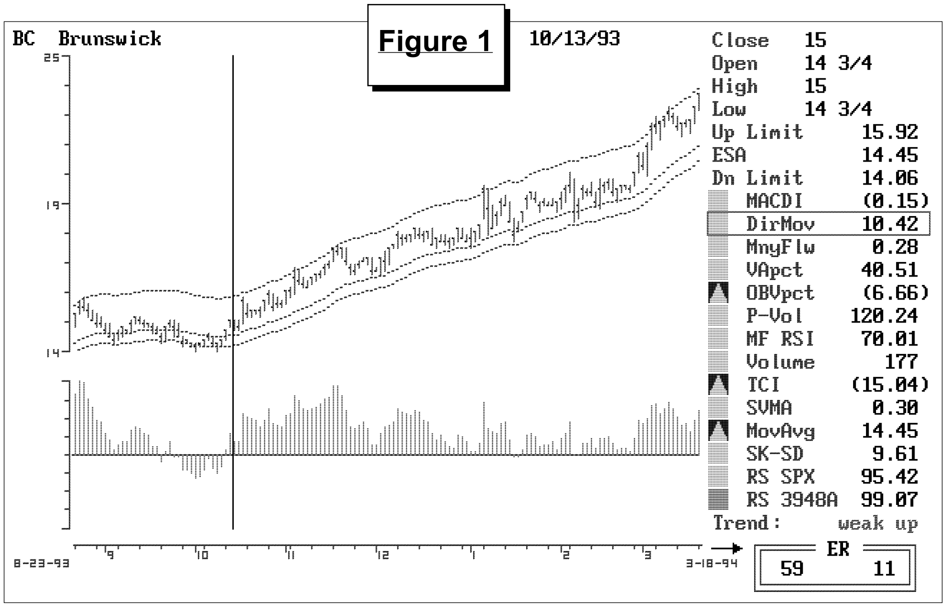

Figure 1

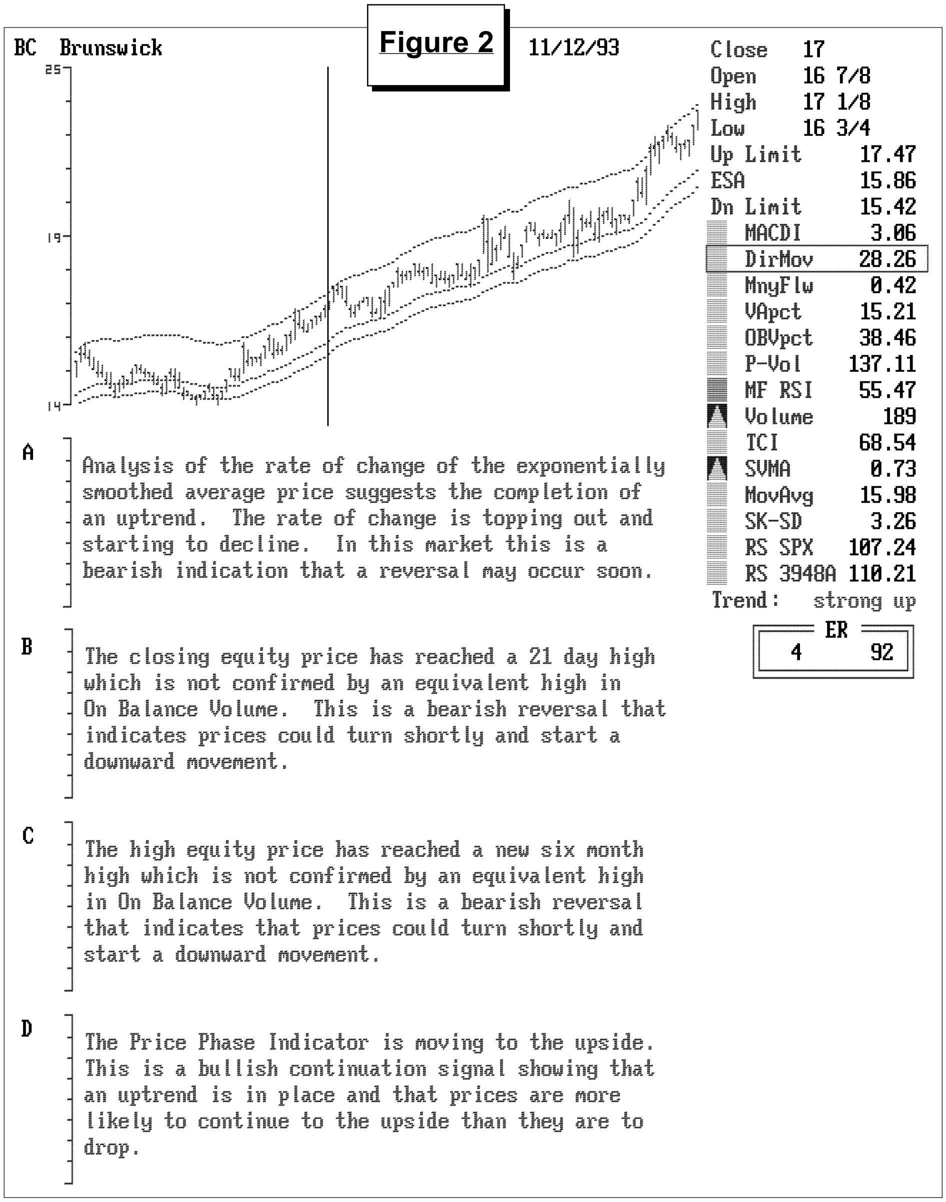

Figure 2

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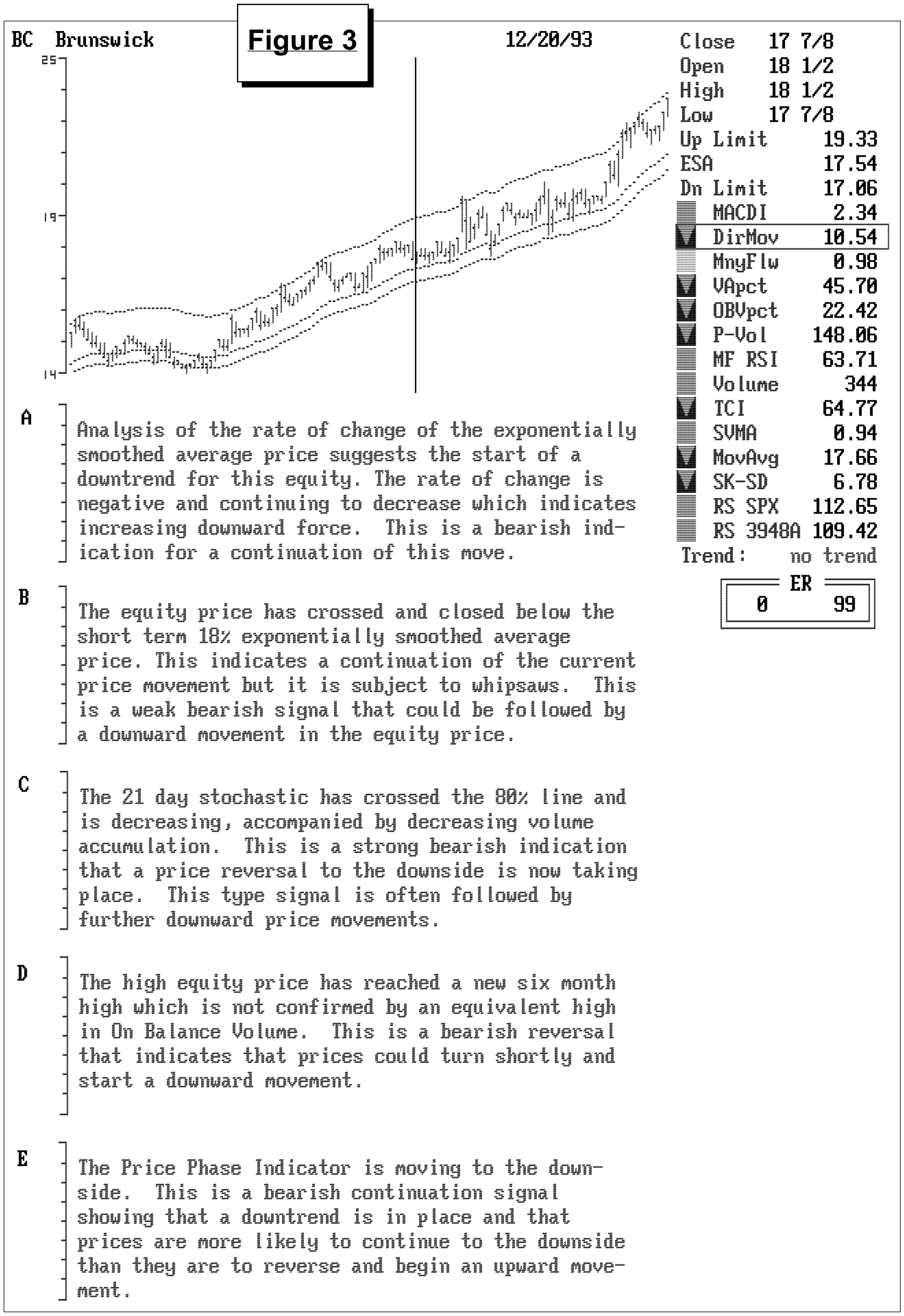
PUTTING IT ALL TOGETHER *continued* .

Figure 3



Rule C tells us that demand is not keeping up with prices in the medium-term (and here we define medium term as six months). It seems that attraction for the stock has slowed, and there is no great groundswell of interest.

The appearance of Rule D keeps our life interesting. It's a bullish rule. It says that short-term price momentum is moving to the upside, a bullish continuation signal. It is the purpose of the inference engine to now synthesize these rules, both the bullish and bearish ones, into a single Expert Rating. The result of that synthesis is a 92 down Expert Rating.

Is now the time to exit the position? Not me. Despite the 15% gain in a month's time. My exit rules require a MACDI crossover to the downside showing downward price momentum, and a negative Directional Movement Index showing that the trend has also turned downward.

The reason that I do not use Expert Ratings to exit is because Expert Ratings are based on an extensive analysis of not only prices but evaluation of supply and demand for the stock. MACDI and DMI are both based strictly on prices. Prices are reality based. Expert Ratings are anticipatory. When my money is on the line, I vote for reality.

I like the 92 down signal. It is a very effective Expert Rating when used with my confirmation indicators, MACDI and DMI. This signal would have sparked my attention, and I would place a trendline parallel to the ESA line as a precautionary measure.

As you can see in Figure 2, the Brunswick stock continues to advance for a few more fractions and then spends two weeks in a consolidation phase, with support at 16 3/4. Price momentum slowed but DMI stayed on the upside. This lack of DMI confirmation would have kept me in this stock, albeit a bit more cautiously.

Another Down Signal

The next down signal occurred five weeks later on December 20. This time, a 99 to the downside was generated by the expert system. The price chart and rules that fired on that day are displayed in **Figure 3**. The first rule tells us that average prices were starting to fall. This is not an unusual rule because prices tend to move in waves and often will roll over to the downside even in overall bullish price movement. This rule by itself was not enough to give the 99 down. It takes several bearish rules to generate that kind of Expert Rating.

But we know that prices are indeed falling. Closing price has crossed the 18% ESA (Rule B), the Stochastic dropped below the 80% line (Rule C), and price momentum is moving to the downside (Rule E). We also know from the rules that have fired that demand for the stock is weakening - accumulation is decreasing (Rule C) and On Balance Volume is not keeping up with

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PUTTING IT ALL TOGETHER *continued . . .*

the six-month price movement (Rule D).

Note that this is a completely different situation than the prior down signal in November. On November 12, prices were thrusting upward with momentum while on December 20, prices are rolling over with downward momentum. Sell now? Not me. Although MACDI is bearish, the overall trend measured by DMI is still bullish. I would hold this position, although there is now an opportunity for a new trendline stop based on the lows of October 8 and December 2.

My Specific Exit Rules

I would have held this position until January 18, 1994 (**Figure 4**). To repeat my rules, I will exit a long position from a trendline stop or when MACDI and DMI are both bearish. On January 17, both the trendline and the indicator stops called for an exit. I would have closed the position at the open on January 18, at 18 3/8.

This would have been a "perfect" trade. I would have followed my entry and exit rules exactly and I would have made a profit. A 25% profit in three months - I would have been delighted.

But one of you is going to write and say: "just a minute, this was just an 'okay trade' because you left 19% profit on the table. By waiting until March 29 and exiting at 21 7/8, the profit would have been 44%, not just 25%." My response is that the missed 19% does not concern me. What concerns me is that I follow my trading process and my rules. On January 18, I would have entered another trade and perhaps made even more than 19%. Who knows. What I do know is that my trading process works for me.

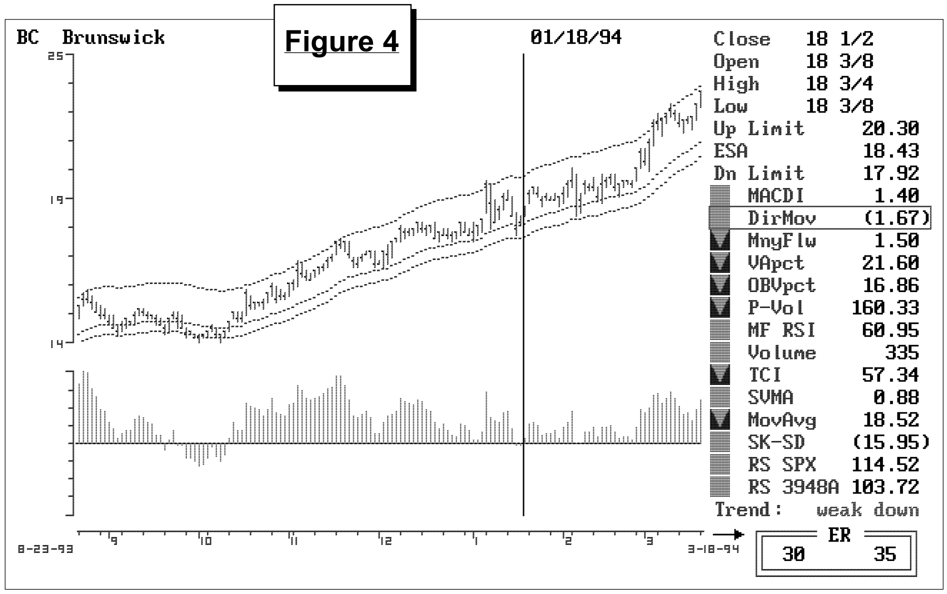


Figure 4

Fine Tuning the Trading Process

During the monthly review phase of my trading process, I evaluate all the closing trades in my log. If I saw several charts like Figure 4, where I repeatedly left significant profits on the table, I would consider increasing the DMI constant from 14 days to 21 days. The result of this is shown in **Figure 5**.

There is no DMI exit signal on January 17 and therefore I would not have exited on January 18. The DMI with a 21-day smoothing constant would have kept me in the trade until the morning of March 29, with a profit of 44%.

I would backtest this new constant on my prior trades over the last year and sum up the net results. If the results were good, I would then include this new constant for DMI in my trading process.

The first purpose of my trading process is to increase my trading confidence and my trading profits. If I can change an indicator constant and improve my confidence and my profits, I will do it - quick. ■

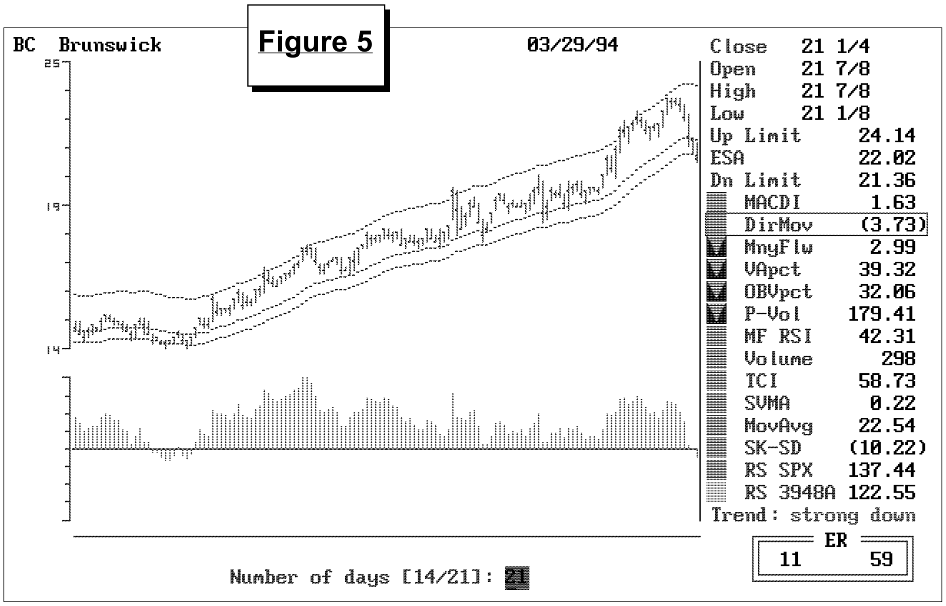


Figure 5

STOCK DATA MAINTENANCE

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

Stock	Ticker	Split/Div.	Date
Computer Marketplace	MKPL	2:1	06/07/94
Hong Kong Tele	HKT	3:1	06/14/94
Vishay Intertech	VSH	5%	06/14/94
Lands End	LE	2:1	06/16/94
Health Mgmt Assoc.	HMA	3:2	06/20/94
Office Depot	ODP	3:2	06/20/94
Apple South	APSO	3:2	06/20/94
Capital Cities ABC	CCB	10:1	06/20/94
Frontier Insur.	FTR	3:2	06/20/94
Energy West	EWST	2:1	06/27/94
McDonalds	MCD	2:1	06/27/94
Express Scripts	ESRX	2:1	06/27/94
Del Labs	DLI	4:3	06/30/94
Inbrand Corp.	INBR	3:2	06/30/94
Green Tree Financial	GNT	2:1	07/01/94
Premier Finc'l Svs.	PREM	3:1	07/05/94
Dial Corp	DL	2:1	07/05/94
Wiscons Control Trans	WCLX	2:1	07/06/94
EA Engine Science	EACO	3:2	07/06/94
LCI Int'l	LCII	2:1	07/07/94
American Biltrite	ABL	2:1	07/12/94
Recoton Corp	RCOT	3:2	07/12/94
Fidelity Fed'l Banc	FFED	6:5	07/18/94
Regional Acceptance	REGA	5:4	07/19/94
Lancaster Colony	LANC	4:3	07/21/94
Altal Inc.	ALTI	5:4	07/21/94
Athey Prod.	ATPC	5%	07/25/94
Simpson Ind.	SMPC	3:2	07/29/94
Wabash Nat'l	WNC	3:2	07/29/94
Huntington Bancshares	HBAN	5:4	08/01/94

Name Changes:

Bally Manufacturing (BLY)	to	Bally Entertainment (BLY)
Northrup (NOC)	to	Northrop Grumman (NOC)
Dime Savings Bank (DME)	to	Dime Bancorp (DME)
BEI Holdings (BEIH)	to	AMRESCO Inc. (AMMB)
Arkla (ALG)	to	Noram Energy (NAE)
Capital Holding Corp (CPH)	to	Providian Corp (PVN)
Illinois Power (IPC)	to	Illinova Corp (ILN)
National Health Labs (NH)	to	National Health Lab Holdings (NH)

MARKET REVIEW

By David Vomund

AIQ was on a market buy signal for most of the last month but very little happened to the market. In fact, there was so little volatility that in the early part of June AIQ registered a 33-33 Expert Rating in 11 of 14 days. This rating signifies that no indicator fired a buy or sell signal.

The strength in the market has been strictly in large company stocks. The Dow has shown a nice uptrend since prices hit bottom at the end of March. The Russell 2000 index, on the other hand, reached a new low in mid-April and then retested the low in early May. This index has failed to move above its late April highs.

More recently, the S&P 500 stalled when it reached a resistance level of 463. The 463 level acted as support for the S&P 500 in late February and early March. A horizontal trendline drawn from that point now becomes a resistance level.

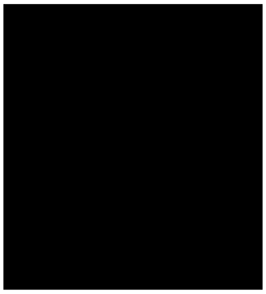
AIQ registered a 100 sell signal on June 20. On that day, the Dow fell 35 points. One indication before this weakness that the technical picture of the market was weakening came on Friday, June 17. On that day, 70% of the stocks with confirmed buy/sell signals were on the sell side. This figure increased to 82% on June 20. At the time of the sell, the Stochastic had just moved below the 80 line, the Advance Decline Oscillator moved into negative territory, and Volume Accumulation Percent was decreasing.

Before the market turned weak, Wall Street was becoming more defensive as the gold and energy groups were at the top of the Daily Group Report and some of the more aggressive issues, including technology and brokerages, sat at the bottom of the report. ■

MUTUAL FUND ANALYSIS

MUTUAL FUND INVESTING PART IV
THE PROCESS

By David Vomund



DAVID VOMUND

Last month I wrote that the best way to consistently outperform the market without enduring significant volatility is to use TradingExpert to trade mutual funds, especially sector funds. There are several reasons why I believe this is the case.

First, there are two analysts working for your portfolio—the fund analyst and yourself. The fund analyst is picking the top stocks in the sector, and you are picking the attractive sectors. Second, the approach to analyzing industry groups and sector rotation is unique to TradingExpert. Other software packages don't identify sector rotation the way TradingExpert does, so very few people are able to analyze sector funds the way we can. Third, in today's market environment it is often better to simply buy the sector rather than buying the most attractive stock in the sector. The increased diversification that the fund gives you decreases the chance of one of your major holdings being one of Wall Street's daily casualties.

But aren't funds slow and boring? Yes, you give up the 50%, 100%, or even 200% gains that are seen in some stock positions, but handsome returns can be seen in sector funds. In the last year, the strategy outlined in this article has allowed me to outperform the market by 11%. Boring, yes. But I'll take it.

To review what I covered last month, I am forming industry groups that represent actual mutual funds and buy and sell analysis is based on these industry groups rather than the funds themselves. This way, I can use both price and volume indicators and all the analysis tools that TradingExpert has to offer. I build these groups by either using each fund's largest stock holdings or by using AIQ's MatchMaker to see which stocks tend to move with the fund (see OBM June 1994). I prefer to trade sector funds because of their diversity relative to individual stocks. However, they are much less diversified than balanced funds that almost always move with the market.

The Daily Group Report

Before I go into detail on how sector funds are analyzed, I will first discuss elements of TradingExpert's Daily Group Analysis Report. This report plays a critical role in the fund selection process. The report is ranked by Trend Score, which is a measure of selected price and volume indicators. This is important. Most mutual fund traders rank funds simply on price or price-based indicators. By building surrogate groups, you can utilize the Daily Group Report that ranks groups by the strength of each group's price and volume indicators. Since these indicators tend to lead price action, you will often see a strong performing group move lower in the ranking just before its performance weakens. As the group was moving higher in price, there was underlying distribution among the stocks that form the group.

There are several cases where one of the strongest performing groups is actually in the lower half of the Daily Group Report. Let's look at an example. I ran the Daily Group Report on my surrogate groups for January 27. The third highest ranked group was Defense & Aerospace, which had a Trend Score reading of 99. The third lowest ranked group was Software & Computer Services, which had a Trend Score of negative 80. Graphs of each surrogate group

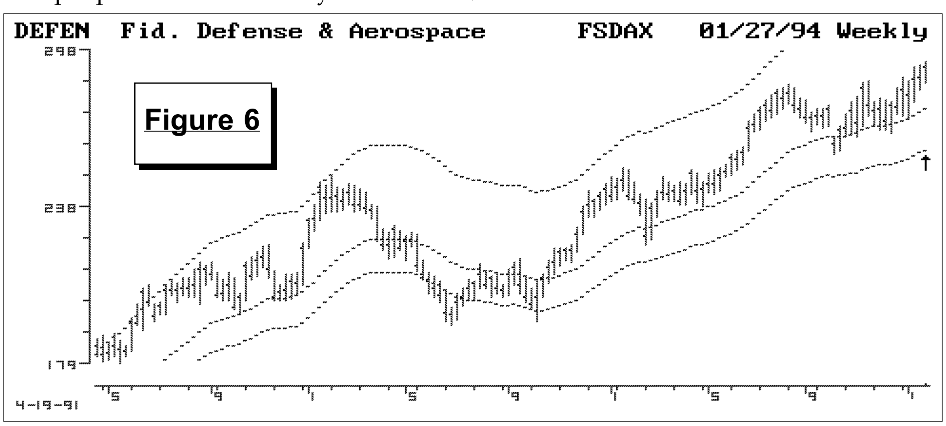


Figure 6

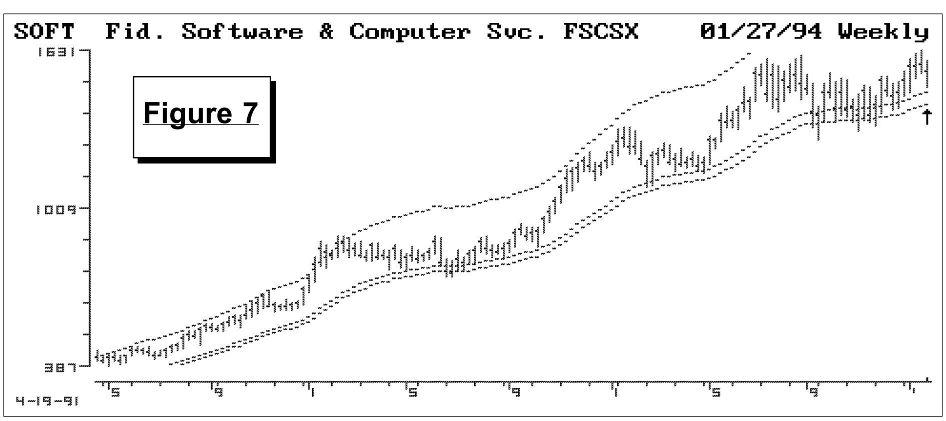


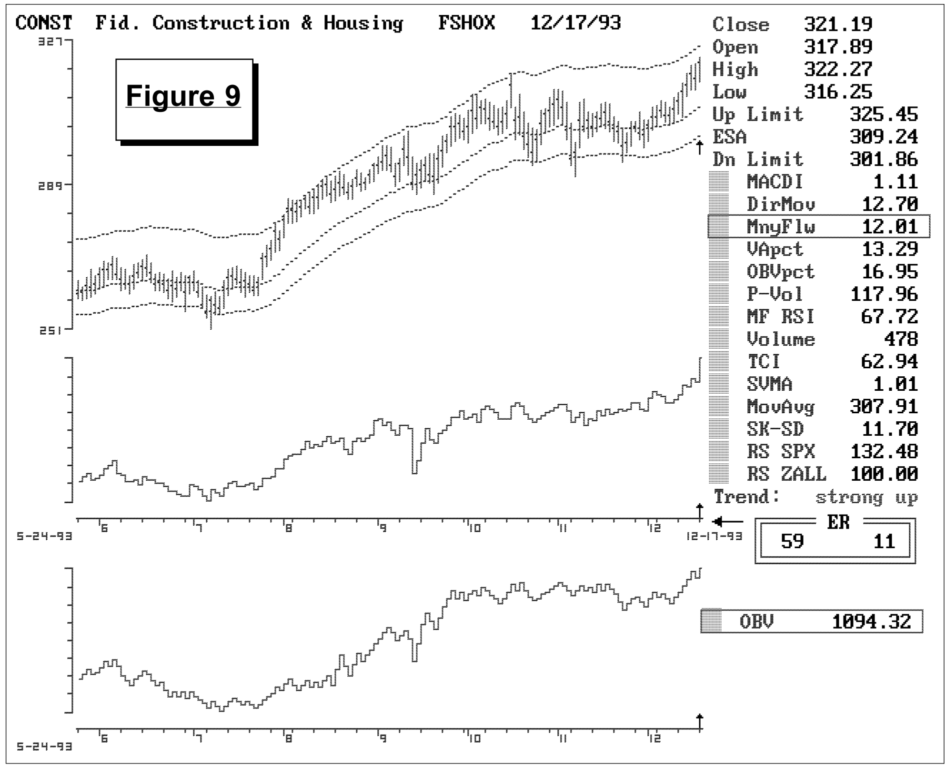
Figure 7

MUTUAL FUND ANALYSIS *continued . . .*

are shown in **Figure 6** and **Figure 7**. You can see that both are strong performers. If you ranked the groups strictly on return, both would be near the top of the list. Yet one group is near the top of AIQ's ranking and the other is near the bottom. That is because one group is under accumulation and the other is under distribution. If you looked at the stocks that make up the software group, you would see that they tended to close near their daily lows and when they did close lower, they had heavier volume than when they closed higher. These stocks were going up but they were under distribution.

In my analysis, Trend Score is the most important column on the Daily Group Report. The second most important is Delta Trend Score, which is a measure of the Trend Score's momentum. A high Trend Score reading with a positive Delta Trend Score reading means the group's indicators are not only strong but they are still gaining momentum.

Another column to examine is the Up %, the percentage of stocks within the group that have recent buy signals. The series of events that typically takes place when a group makes a major bottom and begins a strong uptrend is as follows: As the group moves lower and nears its low point, the stocks begin to give AIQ buy signals and the Up % figure increases to a high value (remember, Expert Ratings are counter-trend so buy signals are typically registered when the stock reaches a new low). As the group makes a bottom and begins to advance, its price and volume indicators turn positive and show accumulation. Therefore, the Delta Trend Score will show a large positive value relative to the other groups. When the group has clearly bottomed and has established an uptrend, it will show a high Trend Score. The opposite occurs when the group is topping out.

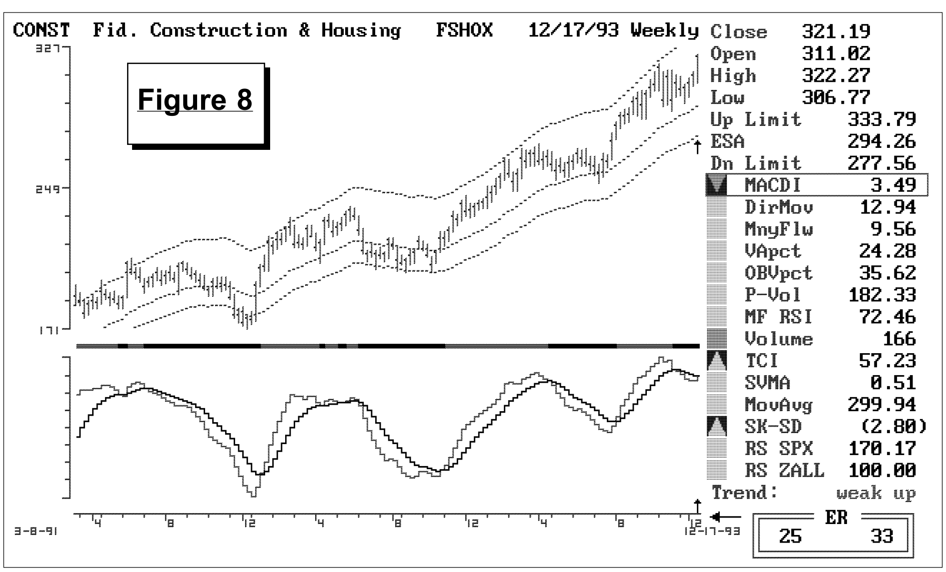


It becomes obvious that people looking to buy at or near the low should concentrate on Up % and Delta Trend Score readings. People who are interested in buying into a trend and riding the trend higher should concentrate more on the Trend Score and Delta Trend Score readings.

The Process

Readers of my articles know that I'm not so much interested in calling bottoms but want to buy into a trend and ride that trend higher. Since trends last longer for sector funds than most other securities, my premise is that the surrogate groups at the top of the Daily Group Report are the most attractive for purchase.

I tested my theory using surrogate groups that represent Fidelity Select Mutual Funds. I ran a Daily Group Report for these funds after every confirmed market buy signal from 1/10/90 to 12/8/92. The funds corresponding to the top five groups on the report were bought and held until a confirmed market sell signal. The results are impressive. The S&P 500 increased 26% over this time period. By buying the S&P 500 when AIQ was



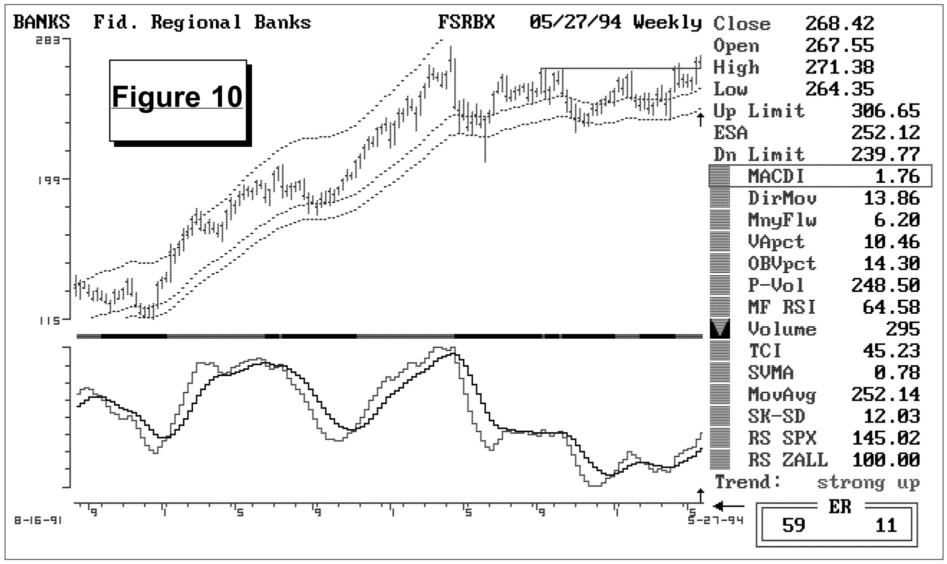
Mutual Fund Analysis continued on page 8

MUTUAL FUND ANALYSIS *continued* . .

a sell signal, the return increases to 40%. However, buying the top five sector funds on a market buy signal jumps the return to 71%. This demonstrates to me that my fund purchases should be limited to those near the top of the report. (Note: I'll expand this study in a future OBM article.)

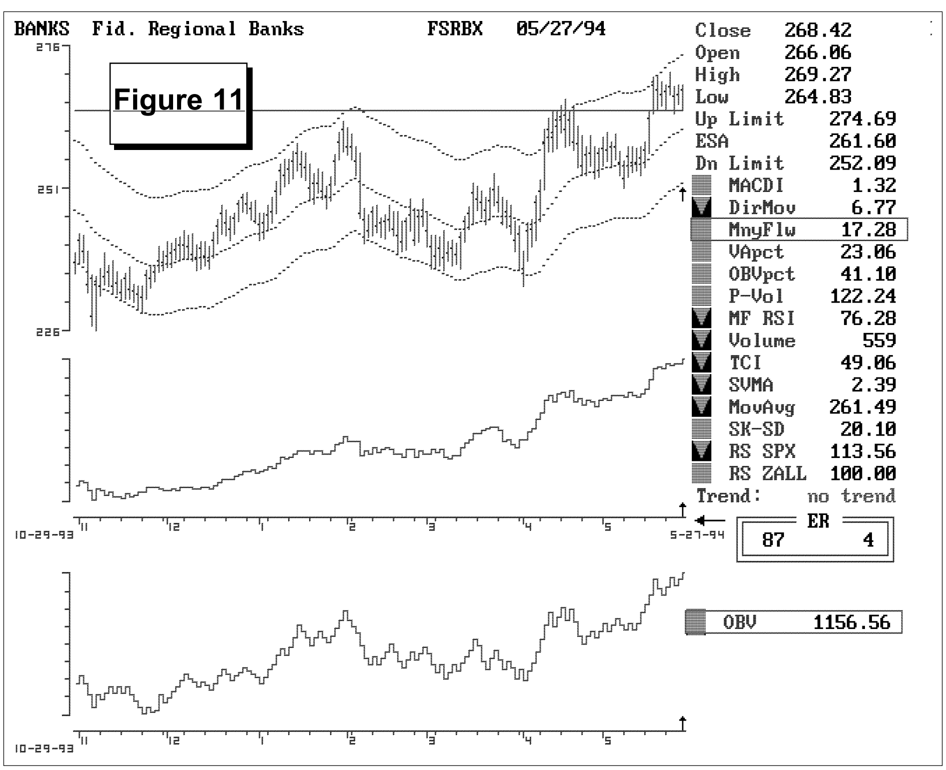
My fund selection process is not 100% mechanical, however. I want to see a fund that is in a nice uptrend with strong indicators. I'll demonstrate this with a few examples. The first example is December 17, 1993 when AIQ registered a (strong) market buy signal. The Daily Group Report run for the Fidelity and Invesco sector funds showed Construction & Housing at the top of the list. Its Trend Score was 100 and its Delta Trend Score was 0 (funds with a negative Delta Trend Score are not purchased).

I don't necessarily always buy the fund at the top of the list but Construction & Housing looked good so there was no reason to move down the list. Since I'm interested in purchasing a fund in an uptrend, I'll look at the weekly chart of the fund's surrogate group to make sure its long-term trend is up. Figure 8 is Construction & Housing's weekly chart and there is indeed a well established uptrend. Next, I'll move to the daily chart to make sure the surrogate group's daily indicators are attractive. Figure 9 shows the daily chart along with Money Flow and On Balance Volume. These two indicators are in new high ground, so accumulation continues as the fund is moving higher. This fund was sold two months later for a 4.3% profit.



This example occurred before the recent correction, when finding funds in an uptrend was easy. Lately, uptrends aren't as well defined but there are funds that have moved above post-correction resistance and are trending higher once again. A more recent purchase was Regional Banks, selected on May 27. AIQ had given several market buy signals a few weeks back and my portfolio was mostly invested. Buying Regional Banks made it 100% invested. On May 27, Regional Banks was not the highest ranked fund on the Daily Group Report but with a Trend Score of 99, it was close.

Figure 10 shows the weekly chart of the Regional Banks surrogate group. You can see that it consolidated below a resistance trendline for almost a year. I was not willing to buy this fund until this line was penetrated. The daily chart in Figure 11 shows that the fund experienced heavy accumulation once the trendline was broken. Both On Balance Volume and Money Flow were moving into new high ground.



To close my positions, I will typically sell from my portfolio the two lowest ranked funds on the Daily Group Report when a market sell signal is registered. ■

David Vomund is publisher of two advisories for stock and sector fund investing available by fax or mail. For a free sample of the advisories, phone 702-831-1544 .