AIQ Opening Bell® Monthly

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INTERVIEW

KAEPPEL'S SECTOR FUND SWITCHING STRATEGY — WHAT MAKES IT WORK

By David Vomund

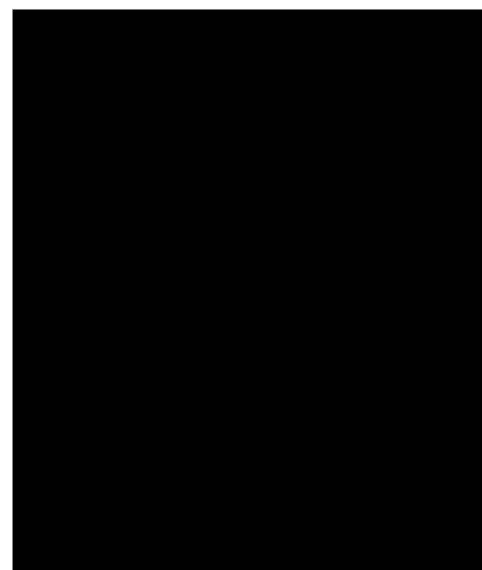
This month we are pleased to present an interview with Jay Kaeppel. Jay used TradingExpert to create a sector fund switching strategy, which was published in the July 1999 issue of Stocks & Commodities magazine.

Jay Kaeppel is the director of research at Essex Trading Co. He is a registered CTA and is the author of The Four Biggest Mistakes in Option Trading and The Four Biggest Mistakes in Futures Trading. He may be reached at 630-682-5780 or via e-mail at hftwp@aol.com or essextr@aol.com.

OBM: Jay, you are best known as a futures and options trader. What made you decide to do work with sector funds?

Kaeppel: Greed, I guess. Actually, I started out in mutual funds. I wrote a mutual fund newsletter called *Mutual Fund Switch Service* from 1985 to 1990. I started looking at sector funds back then.

OBM: Can you tell us the advantages and disadvantages of trading sector funds?



Jay Kaeppel

Kaeppel: Sector funds allow investors to hold an industry with a single purchase rather than having to buy a basket of stocks. With a diversified fund, the primary determinant of performance is the fund manager's ability to pick the right stocks. With a sector fund, the primary determinant of performance is the outlook for the fundamentals of the underlying industry. When the fundamentals for a given sector change significantly for the better

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you can see some astounding advances in price. So the good news is that because of their concentration in one industry, sector funds offer above-average profit potential. The bad news is that sector fund investing also entails above average risk. When a sector falls out of favor, the decline in prices can be swift and severe. It is important not to get stuck in a bad sector as it plummets.

OBM: What type of trading account is your sector fund switching system designed for?

Kaeppel: The system is ideal for retirement accounts, which allow you to compound profits as you go without paying taxes on them. The portfolio holds up to five funds at any given time. It may switch partially or entirely into cash if no funds qualify for purchase. To me this is a key component of the system. My main concern is, OK it has performed fine during a great bull market but what if the future is not so great? I am hopeful that being able to go to cash will save me some pain the next time there is a drawn out bear market.

OBM: Please describe the system that appeared in the original *Stocks & Commodities* article.

Kaeppel: The philosophy behind the strategy is to buy and hold the best-performing sector funds as long as they are trending higher. This is a weekly system so it really only takes a few minutes each weekend to update. I purposely designed it as a weekly system because I feared that if I had to watch it every day I would get "itchy" and start operating outside the system. There will be times when the system will go for months without generating a transaction. At other times, however, portfolio changes occur frequently.

To start, each weekend run AIQ's Relative Strength-Long Term report on a list of Fidelity Select Sector Funds. The first eight funds on the list are considered for purchase. When you get the list of eight buy candidates you eliminate from the list any funds that you already hold. Do not add more money to the funds that are already held. Also, if the Gold or Precious Metals funds are within the top eight ranking, then ignore these funds and consider the other six funds for purchase.

Looking at the individual funds, if the low for the week just ended was not more than two cents below this week's 28-week ESA, then the fund qualifies for purchase. Proceed down the list of the top eight funds until you have five which qualify for purchase. If you go through the top eight funds and have fewer than five buys, then hold any uninvested cash in a money market account until the following week. Repeat the process each week until there are five funds in the portfolio.

After that, this process only needs to be repeated after a sell signal is generated for one or more of the funds in the existing portfolio.

OBM: Can you give us an example of a fund that would be purchased?

> ***"People are averse to holding a portfolio of highly correlated funds. However, although the risk is increased, the ability to heavily weight certain sectors is one of the reasons the overall system works."***

Ticker	Mutual Fund	RSR	%Chg	Price
FDCPX	Fidelity Select Computers	5	5	40.32
FSPHX	Fidelity Select Health Care	5	1	105.40
FSPTX	Fidelity Select Technology	3	5	43.68
FDFAX	Fidelity Select Food & Agriculture	3	1	41.16
FBIOX	Fidelity Select Biotech	2	4	28.50
FBMPX	Fidelity Select Multimedia	2	5	29.24
FSPCX	Fidelity Select Insurance	2	1	29.41
FSRPX	Fidelity Select Retailing	2	0	39.96
FSCPX	Fidelity Select Consumer Industries	2	3	25.65
FSELX	Fidelity Select Electronics	1	8	27.15
FDLSX	Fidelity Select Leisure	1	4	43.92
FDPMX	Fidelity Select Precious Metals	0	(6)	9.11

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INTERVIEW *continued . . .*

Kaeppel: Sure. **Figure 1** shows the Relative Strength report for 10/23/98. The top ranked fund was Computers. **Figure 2** shows the Computers fund plotted with its 28-week ESA. Since the low for this week was not more than two cents below this week's 28-week ESA, it meets our buy criteria.

OBM: When do you sell?

Kaeppel: A sell signal occurs when the lowest daily closing price during the week just ended is more than two cents below the *previous* week's 28-week ESA. The sell signals are generated at the end of the week. The shares are sold on the following Monday and a new fund is purchased with the proceeds. The new fund is selected using the same buy rules described earlier.

In Figure 2 we see that a sell signal was generated for Computers during the week ending 10/22/99. So I sold it the following Monday. In hindsight it is easy to say I should not have sold Computers because it immediately began another sharp rally the day after I got out. But I look at it as though following a mechanical system — either you follow the rules or you don't. And if you don't, then what's the point of following a mechanical system?

OBM: Why are the gold funds eliminated from the system?

Kaeppel: They tend to take on a life of their own and can be much more volatile than the other sector funds. They should be traded using a system designed for gold shares rather than using an overall equity-based system. However, the purpose of leaving them in the master list is that they can "take up space" at the top of the list and will sometimes push a lesser performing fund out of the top eight, thus eliminating it as a buy candidate.

OBM: Since you don't add to existing positions does this mean that your portfolio holds five funds that are in different industries?

Kaeppel: The system won't buy two positions of one fund but the portfolio can still overweigh certain sectors. For example, at the end of May 2000 I was holding Energy, Energy Services, and Natural Gas. In 1999 the portfolio was heavily weighted in tech funds. Now intuitively a lot of people are averse to holding a portfolio of highly correlated funds. However, although the risk is increased, the ability to heavily weight certain sectors is one of the reasons the overall system works. In the early 90's the system made a lot of money in Health Care and Medical Delivery. In the mid-90's it was Home Finance, Financial Services, and Regional Banks. In 1999 it was Technology, Electronics, Computers, and Biotechnology.

> *"Gold funds tend to take on a life of their own and can be much more volatile... They should be traded using a system designed for gold shares rather than using an overall equity-based system."*

Remember, the idea is to be in whatever is performing well, regardless of any correlations. The trick is to not overcommit in terms of capital. For example, the system is only about 20% of my overall portfolio. As a result, I get diversification in other ways so I don't have any problem with holding a concentrated portfolio of sector funds.

OBM: In your *Stocks & Commodities* interview you showed a 10-year backtest starting in 1989. The annual rate of return was 26.8%.

Kaeppel: Through the end of 1999 that number was up to 29.7%, thanks to the huge runup in tech stocks in 1999. The original system made 64.6% in 1999 and as of 6/2/00 is up 3.8% for the year. The testing results do not include the effect of taxes but the initial 3% load fee was deducted. There were about 10 trades per year and about 60% of the trades were winners. The most notable

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statistic is that the average winning trade made a little over 30% while the average losing trade lost a little under 5%. That's a pretty compelling ratio.

Several fund families have added sector funds in recent years and the AMEX is now offering some Industry Average tracking stocks. For the record, I have never tested anything other than Fidelity's Select Sector Funds.

OBM: In your backtest you used the closing prices for the sector funds. Since Fidelity has hourly prices on their sector funds, do you expect results would be higher if you traded on the first hour price instead of the end-of-day price?

Kaeppel: There is no way to answer that definitively without obtaining hourly data and testing it out. For my own purposes, because the system was tested using end-of-day prices, when I make a trade on a Monday I try to do it towards the end of the trading day in order to stay true to the original system.

OBM: Since the time the article was published have you made any modifications to the system?

Kaeppel: I personally am still trading the system just as it appeared in the article. I make no claim that the way I am doing it is the best way. That is why I simply trade it and wrote an article to put the idea out there rather than trying to market and sell the system itself. I have gotten a great deal of feedback from readers of the article and certainly there are a lot of possibilities for enhancing the system.

One obvious area for testing is to use a quicker exit, i.e., getting out the day after the actual sell signal rather than updating only on a weekly basis and trading on the following Monday. Other possibilities include updating the portfolio just once at the end of each month and/or including more funds in the portfolio.

OBM: After a long bull run, funds can be well above their 28-week moving averages. For people who don't mind trading more often, would you suggest using a faster moving average?

Kaeppel: Not really. The original idea behind the system was to find strong-performing funds and ride them as long as possible. So the problem I see with more frequent trading is this: you sell a fund because it drops below, let's say, its 10-week moving average. You then run the Relative Strength report to find a new fund to buy and find the one you just sold still at they very top of the list. By using too short of a moving average you run the risk of stopping yourself out of the best funds.

OBM: This is a purely mechanical system. As you trade the system are you acting on each signal or do you incorporate some judgment?

Kaeppel: I just follow the system. I realized a long time ago that I'm a lousy "gut" trader. In the long run this has worked to my benefit. I try to do my best thinking "up front" and build that into a system. Once I develop a system that I have confidence in, then I have no problem just following the signals.

OBM: Your books talk about the mistakes people make when trading options or futures. Do any of these mistakes apply to sector fund trading as well?

Kaeppel: Yes. Probably the most relevant one regarding the use of any trading system is a lack of discipline. At the point where you have developed a system and are ready to start trading it everything looks great. The problems come when you hit a rough patch in real-time trading. Do you stick with the system or not? In the futures trading book I stated that "second guessing a trading decision is the single most simple act in all of trading".

It is simply human nature to second guess any decision which, if wrong, is going to cause you to lose money. However, if you have developed a system which is conceptually sound and also includes contingency plans for a worst case scenario, then second guessing signals is always a mistake.

I am hopeful that this system will continue to work well in the long run because I think it is conceptually sound (objective measures are used to go with the trend, let profits run and cut losses) and it also has a mechanism (going to cash) for avoiding a worst case scenario (a drawn out 1973-74 type bear market). As always, time will tell.

OBM: Thanks. We look forward to hearing you at our fall seminar. ■

S&P 500 Changes

The following are changes to the S&P 500 Index and Industry Groups:

Starbucks Corp. (SBUX) replaces Shared Medical Systems (SMED). SBUX is added to the Restaurants (GESTAURA) group.

Novellus Systems (NVLS) replaces Champion International (CHA). NVLS is added to the Equipment-Semiconductor (EQUIPSEM) group.

Tiffany & Co. (TIF) replaces Silicon Graphics (SGI). TIF is added to the Retail-Specialty (RETAILSP) group.

Broadcom Corp. (BRCM) replaces GTE Corp. (GTE). BRCM is added to Equipment-Semicoductors (EQUIPSEM) group.

Charter One Financial (CF) replaces MediaOne Group Inc. (UMG). CF is added to Savings & Loan Companies (SAVINGSL) group.

Visteon Corp. (VC) replaces IKON Office Solutions (IKN). VC is added to the Computers-Software & Service (COMPUTES) group.

THE EMOTIONAL SIDE OF TRADING

Proper Trading Psychology During Turbulent Times Is Very Important

By David Vomund

DAVID VOMUND

The founder of AIQ, Dr. J.D. Smith, believed that having a disciplined and systematic approach to trading was just as important as having a good trading system. He was right. You can give the "crystal ball" to someone but if he doesn't have the proper emotional qualities necessary to follow the system, he will lose money.

In recent years, we've ignored the subject of trading psychology and focused on creating effective systems. Being emotionally unfit to trade was fine during the raging bull market because even bad decisions were very profitable. But one shouldn't confuse a bull market with brains. Now that we have seen a Nasdaq bear market, proper trading psychology is once again very important.

In bad times, the market exposes those with poor trading habits. They no longer think clearly and bad decisions are made. It happens like clockwork with each market drawdown and I expect every reader can identify a time in the past when he/she made poor decisions because emotions took over.

Whether it be the 1990 bear market, the dull market of 1994, the swift correction in the fall of 1998, or this year's Nasdaq bear market, you now look back at the decisions that were made and wonder — what were you thinking?

Making good decisions in turbulent times is something we all struggle with because it is human nature to let emotions drive decisions. Those who have a good trading psychology weren't born that way; they developed it through experience. Those with a poor trading attitude are easy to identify but they are usually in no condition to take advice. We all learn from the school of hard knocks.

Having just experienced the second worst drop in Nasdaq history, many people are struggling with their trading psychology. This is a great time to learn from mistakes. Here is the advice I give to people to speed up their learning curves.

1) Evaluate your profile.

First, evaluate your risk tolerance and investment time horizon. If you are very risk averse and can't stomach drawdowns, then your trading system should be designed to take only small losses. Similarly, if you may need the money in less than a few years, then your system should incorporate market timing and should not have large drawdowns.

"Having just experienced the second worst drop in Nasdaq history, many people are struggling with their trading psychology. This is a great time to learn from mistakes."

If, however, you have a long time horizon, then your trading strategy should be geared toward high returns with risk considerations of secondary importance. After all, if you have a long-term time horizon, then a drawdown is only a problem if you lock in the loss by selling into the weakness.

It's important to know your profile and match your investment program to your profile. Conservative investors who are uncomfortable with the volatility of very aggressive, high growth portfolios should avoid such programs. A conservative investor will exit a risky strategy on the first round of weakness, usually locking in significant losses. If you are a conservative investor or have a short time horizon, stick with low risk strategies.

2) Stick with a system.

All successful traders have a personal trading system. For AIQ users, that system may incorporate Expert Ratings, it may use an Expert Design Studio model, or it may employ simple chart evaluation. Each person develops his own system to match his personality and beliefs.

One of the most common mistakes investors make after developing a system is to not stick with it. They find a strategy that works well but then exit the strategy during bad times and switch to a new strategy. They are constantly one step too late and end up exiting at the low point of each system's drawdown.

This happens when one doesn't have confidence in one's system. There is no substitute for live trading but I find that performing thorough backtests can often help build confidence in a system.

The problem with exiting a trading system during bad periods is that you lock in losses. Near the end of May the market looked terrible and many people gave up hope of recovery. Without warning, the Nasdaq

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THE EMOTIONAL SIDE OF TRADING *continued* . . .

rose about 18% in one week.

Those who exited their systems prematurely locked in the losses and missed the advance. It is hard to recover from those mistakes.

I spoke with a gentleman who began to use an AIQ mechanical model near the market's peak in March. After the market corrected, he called complaining that his performance was better before he followed the AIQ model. I asked if the market environment had anything to do with it but that didn't register with him. He is no longer using the software and I expect he'll try other systems and will exit them at their lowest drawdowns as well.

3) Make decisions on sound analysis.

AIQ users have a very powerful analysis tool. Last year when the Nasdaq rose 85%, a great analysis tool was not required. This year, it is. Unfortunately, it is human nature to make decisions based on pure emotion rather than relying on a system.

Trying to eliminate emotion from the decision making process is something everyone struggles with. When television anchors yell from the noisy floor of the NYSE and proclaim how important that day's trading is, you immediately want to call a broker. The reporters stir your emotions. Often a simple glance at an AIQ chart puts things back in perspective. That's why I prefer to make buy and sell decisions when the market is closed.

Are you making decisions based on analysis or emotion? If you perform your analysis but then change your decision based on overnight futures activity, then there is a problem. If you become bullish on days when the market advances and then turn bearish on days when the market declines, then there is a problem.

Making decisions based on emotion can be a problem for people who are not active traders as well. If you ignore the system because of an overall bullish or bearish belief, then you are relying on emotion. People who ignore bullish technical evidence because they feel stocks are in an overall bear market are making decisions based on emotion instead of analysis.

Along the same line, people who ignore a system's sell discipline because they are convinced that "things are different this time" are relying on emotion.

Following a trading strategy can be especially hard on the sell side because people often fall in love with their holdings. They form an emotional attachment to their stocks and decide to stay invested even after the system says to sell. This often ends poorly.

"One of the most common mistakes investors make after developing a system is to not stick with it. They find a strategy that works well but exit during bad times and switch to a new strategy... They end up exiting at the low point of each system's drawdown."

4) Do the analysis.

During poor market periods people often decide to stop performing the analysis. They rationalize that once the market improves, then they'll start investing again. This is a recipe for disaster. When the market recovers, these people are caught flatfooted and miss the move.

In 1994, we had a very dull market and after several months of drifting many people lost interest. Without warning, the market sprinted upward in 1995, gaining 34% without even a 5% pullback.

5) Remain independent.

The market does its best to make most people wrong. Consensus opinions rarely work. Many analysts have been saying that the market will drift sideways until October and then stage a rally. These opinions should not influence your decision making process. Stick with your personal trading approach.

6) Accept responsibility.

Those with big egos make poor traders. If you can't admit to being wrong, you won't last long in this business. Remember those perennial bears that missed the huge bull run? They refused to listen to the market and missed the spectacular advance.

It is human nature to give yourself credit when things go well and then blame others when things go poorly. The success or failure of an investor rides solely on the person who places the trade. This is true when things go well and it is true when things go poorly. When the AIQ software works great and you hit a winning steak, give yourself credit because you actually followed the system and pulled the trigger. When things go poorly you have to accept responsibility as well, especially if you didn't follow your system.

In my *VISalert.com* newsletter I don't accept praise when things go well because I'm simply giving information. If a subscriber does well it is because of his own action. Nor do I offer sympathy during bad periods. The responsibility of a portfolio lies solely on the one who places the trades.

7) Learn from mistakes.

Everybody makes mistakes. The important point is to learn from the mistakes so that they aren't repeated. It is a good practice to review your trading decisions, especially during turbulent market periods. Sometimes

THE EMOTIONAL SIDE OF TRADING *continued . . .*

good decisions result in losses. That's fine.

There may be other cases where bad decisions were made. That's when you evaluate why a bad decision was made and how it can be avoided in the future.

I've had several embarrassing moments in the past that I vow never to repeat. Selling the day of a significant market bottom because of pre-market futures activity was part of my "agony of defeat." Because of that early mistake, I no longer sell into climactic sell-offs. While others focus on when to sell, I'm looking for entry points.

8) You need to be realistic.

Investing is not a game of perfection. You can and will be wrong. There is no crystal ball. Every good system has a downside. For people who seek high returns, the downside is risk. For people who time the market, the downside is whipsaws.

Too many good systems are ruined because people seek perfection. In my managed account program, we have seen spectacular returns although one of the downsides is we may take large losses in selected stocks. If we were seeking perfection, we'd add a rule that would limit losses on individual issues. Unfortunately, when you fix one part of a strategy it can adversely affect other areas of the strategy. By avoiding large individual losses we found that our overall performance was reduced.

If you have a good system, then use it. By constantly tinkering with the system you'll usually reduce its performance or you will over-optimize the system, rendering it completely useless.

To be successful, it is up to each one of us to design our own personal trading process that matches our personality. Each of us needs to gain confidence in our strategy and understand that each system goes through bad periods. By sticking with our own personal systems and applying the proper trading attitudes, we can reach our personal objectives. ■

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

MARKET REVIEW

Heading into the month, the AIQ timing model was on a May 26 buy signal. This signal remained in effect until mid-June. The market rallied for the first few days after the May 26 signal but in June all major indexes began to move sideways. The 1480 to 1490 level on the S&P 500, which had acted as resistance in early January and again in April, acted as support in late May. The market was unable to penetrate this level.

On June 16, a 98 sell signal was registered and immediately confirmed by the decreasing Phase indicator . Looking at the market log, we see that this signal was less than ideal since there was a high percentage of stocks giving unconfirmed buy signals. Of the stocks in the S&P 500 giving unconfirmed signals, 72% were on the buy side. Despite the signal, the market continued its sideways path

On June 30, the system registered a 97 buy signal. This signal was unconfirmed but about 78% of the stocks giving unconfirmed signals were on the buy side.

For the first half of the year, the S&P 500 was down 1% and the Nasdaq Composite was down 2.5%. ■

STOCK DATA MAINTENANCE

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

Stock	Ticker	Split/Div.	Approx. Date
TriQuint Semiconductor	TQNT	2:1	07/12/00
Braun's Fashions	BFCI	3:2	07/12/00
Interwoven Inc.	IWOV	2:1	07/14/00
Patterson Dental	PDCO	2:1	07/17/00
Fifth Third Bancorp	FITB	3:2	07/17/00
Xeta Corp.	XETA	2:1	07/18/00
Timberland Co.	TBL	2:1	07/18/00
Tiffany & Co.	TIF	2:1	07/21/00
American Int'l Group	AIG	3:2	07/31/00

Trading Suspended:
MediaOne Group (UMG), Safety-Kleen Corp. (SK), Times Mirror Co. (TMC)

Name/Ticker Changes:
Outback Steakhouse (OSSI) to Outback Steakhouse (OSI)
In Focus Systems (INFS) to InFocus Corp. (INFS)
PharChem Laboratories (PCHM) to Pharm Chem Inc. (PCHM)

MARKET MEASUREMENTS

Which Market Index Best Represents Your Investments?

By David Vomund

What is the market doing? A few years ago the answer usually involved the point change in the Dow Jones Industrial Average (DJIA). Now the answer usually involves the Nasdaq Composite as well.

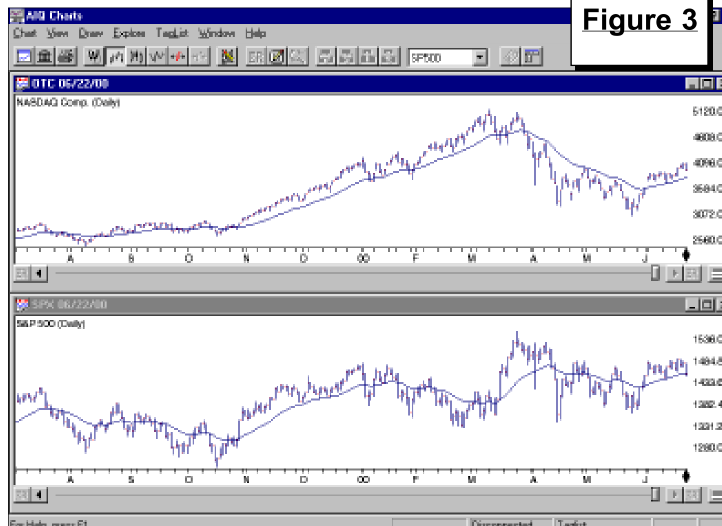
If these two indexes measure the market, why are there other indexes such as the Standard & Poor's 500 (S&P 500) and New York Composite (NY Comp)? What is the best market index for small company stocks? These are important questions since market indexes are the yardstick against which all investment performance is measured. It is important to know which "market" the indexes represent and what their performance means for our investments.

Dow, S&P 500, & NYSE Composite

The DJIA is a composite of 30 large company U.S. stocks. Dow Jones & Co. periodically changes the components of the average to reflect current economic trends. In the 1970s, airline stocks replaced rail stocks. More recently, Intel and Microsoft were added to reflect the increasing importance of technology on our economy. The DJIA is a price based average. That means that a high priced stock has a greater influence on the DJIA than does a lower priced stock.

The S&P 500 and NY Comp are both capitalization weighted indexes. That means stocks with high market values (price per share times the number of shares) have greater influence on index performance than smaller company stocks. The theory is that more investors hold large company stocks so they have a larger index weighting.

Over the last 10 years, Standard & Poor's has been making changes to the index components on a more frequent basis. Currently, about 50 changes are made per year. We report these changes each month in this newsletter. For a complete listing of S&P 500 stocks and a listing of component changes, visit *www.spglobal.com.*



The New York Composite contains all the stocks listed on the New York Stock Exchange. Since both the NY Comp and the S&P 500 are capitalization weighted, these indexes move closely together. In fact, AIQ MatchMaker shows a correlation of 968 over the past year (1000 is perfect correlation). The S&P 500 and NY Comp are good measurements of large company stock performance. The DJIA also measures large company stock performance but its narrow focus makes it an inferior yardstick.

This leads to the question of why AIQ's market timing model relies on the DJIA instead of the S&P 500. Actually, the AIQ model also uses data that is calculated from all the stocks on the NYSE. This data includes advancing issues, declining issues, up volume, down volume, total volume, and new highs/new lows. If you are looking for divergences, it makes sense to compare a narrow index such as the DJIA with a measure of broad market activity, such as the Advance/Decline Line.

Although the AIQ timing model uses the DJIA, one can easily trade the S&P 500 based on the signals. The Dow and the S&P 500 are highly correlated.

Nasdaq Composite & Russell 2000

A few years ago, many people used the Nasdaq Composite (symbol OTC) to measure small company stock performance. Investors have since become more sophisticated and realize that the Nasdaq Composite reflects the activity of growth stocks, mostly large company technology stocks. The Nasdaq Composite is capitalization weighted so stocks like Intel, Microsoft, Dell Computers, and Oracle play a major role in its performance.

What is the best benchmark for small company stocks? Most analysts cast their votes for the Russell 2000 index (symbol RUT). If you take the 3000 largest-cap U.S. stocks and then take away the largest 1000 stocks from that list, the remaining 2000 stocks comprise the Russell 2000 index.

Figure 3 shows the Nasdaq Composite (top) and the S&P 500 (bottom). Notice that last year growth stocks, as represented by the Nasdaq, made a low in August and experienced an exceptional rally from November through February. Large company stocks, as measured by the S&P 500, hit their low in October and then rallied for only two months. This year, the S&P 500 has moved sideways while the Nasdaq experienced a sharp correction in April and May.

Next month, we'll show how the Relative Strength indicator can help determine in which market your investments should be concentrated. ■