AIQ Opening Bell® Monthly

IN THIS ISSUE VOL. 10 ISSUE 7 JULY 2001

The *Opening Bell Monthly* is a publication of AIQ Systems
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INTERVIEW

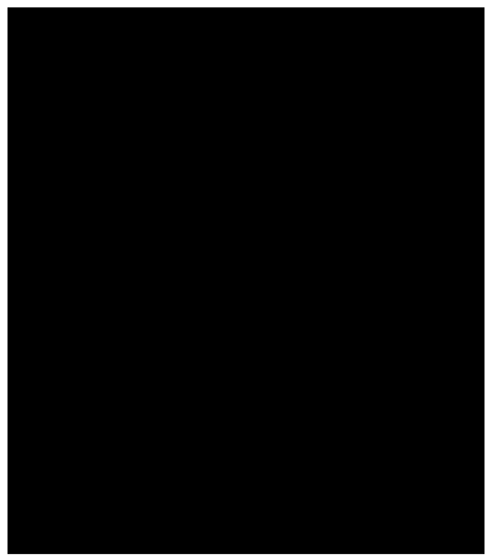
Author/Lecturer Dr. Van K. Tharp On Maximizing Your Trading Potential

By David Vomund

This month we are pleased to present an interview with Dr. Van K. Tharp. Dr. Tharp was featured in the original Market Wizards book, writing on the subject of trading psychology. Worldwide, he has helped traders to improve on maximizing their trading potential. Dr. Tharp is a keynote speaker at AIQ's Annual Fall Seminar, which will take place October 4 to 6 at Lake Tahoe.

Vomund: *In The Opening Bell we present a variety of trading strategies. These serve as ideas for people to help assist them in creating their own trading systems. We've learned, however, that it is important for each individual to design his or her own trading process. Can you explain why this is so?*

Dr. Tharp: Probably the most important part of developing a system is to know yourself and your mission in life. You then need a set of objectives to fit you and your mission. In my opinion, these are steps that a lot of people skip, but they are at least fifty percent of a good trading system. Once you have these things, especially the objectives, then you can design a system to meet those objectives, according to your specific needs. As soon as your objectives change, then the whole system may need to be changed.



DR. VAN K. THARP

In my experience, if you don't go through this process of getting to know yourself and your objectives first, you

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INTERVIEW *continued . . .*

won't have a system that you are willing to follow. That's why the process is so important.

Vomund: *If you could give one suggestion to traders who are trying to develop a new system, what would it be?*

Dr. Tharp: Do NOT skip the most important sections. Know yourself first. We recently did a newsletter on knowing yourself and what that means. And we'd be happy to send that to any Opening Bell readers who request it by calling our toll free number at 800-385-4486.

Vomund: *In your newest book, "Financial Freedom Through Electronic Day Trading," that you co-authored with Brian June, you spend significant time encouraging traders to develop business and trading plans. How important is this for an individual trader?*

Dr. Tharp: Individual traders are trying to make a profit trading in the markets. That goal is no different from any other business. So we teach traders to approach their trading activities as a business. Brian draws an excellent analogy in our book about the importance of business planning. People trying to start a corner grocery store would never expect to get a loan from a bank with a vague idea of what they wanted to do. They'll be competing against major grocery store chains and need to have a clear understanding of what their edge in the market will be.

Similarly, a trader is competing against Goldman Sachs, Morgan Stanley, and top professional traders. How can a trader expect to win consistently against such competition without a plan?

"Individual traders are trying to make a profit trading in the markets. That goal is no different from any other business. So we teach traders to approach their trading activities as a business."

I've coached some of the world's top traders, and they think their business planning is a huge edge. We've come to think that it's so important, that the business planning chapter is the longest one in the new book. Not only that, but we've developed a workshop that teaches the critical aspects of business planning to traders.

A trading plan is intimately tied into a trader's business plan. The business plans tells "why" a trader trades and outlines the utilization of key resources. A trading plan describes the "how" — what a trader will do day-in and day-out to meet the goals set forth in the business plan.

The trading plan provides a daily road map for traders so that they can trade with discipline. And the activities involved in creating a trading plan provide invaluable insight for your trading preparation. These activities — thinking in detail about each individual aspect of a trading system, deciding when to use which trading strategy, and outlining contingency plans for when things go wrong — provide the foundation for building supreme confidence in what you do. And with that confidence, you can execute without hesitation.

Vomund: *How do you know your trading style? That is, what time horizon, drawdown, and system accuracy applies to you?*

Dr. Tharp: I think it comes from knowing yourself. For example, day trading takes a lot of time. And we believe that you should spend at least an hour in preparation for every hour you spend day trading. If you have a full time job and cannot make that commitment, then don't day trade.

However, for people with full time jobs, there are systems that require you to check the markets at the end of the day or even at the end of the week. What do you have time for? What can you tolerate in terms of risk? How right do you need to be — knowing that being right has nothing to do with making money. These are all significant questions you must answer if you want to develop a system that is right for you — a system that you can trade and that will make money for you.

Vomund: *Many people think that short term trading is just for "gun slingers." Why should someone consider short term swing trading or intraday trading?*

Dr. Tharp: If you look back at our discussion on developing business and trading plans, you'll see that traders can bring a disciplined approach to any trading time frame. Given a disciplined approach, a short term trader has the advantage of high trading frequency, what I refer to as opportunity.

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INTERVIEW *continued . . .*

But a high degree of trading opportunity is a double-edged sword. A haphazard approach combined with a high level of trading opportunities leads only to faster losses. But a disciplined approach that uses a positive expectancy system (one that makes money over time) combined with a high level of trading opportunities can lead to explosive equity growth.

Because short term trading is so powerful (when done properly) Brian June and I have worked with other key people to found a company called One Minute Trader. This company provides training and services that teach the tools necessary to survive and thrive in the fast paced world of short term trading. Let me give an example of how powerful a role opportunity plays in your trading.

Suppose that you only make money on half of your trades, but that your average winning trade is three times bigger than your average losing trade. If you risk $250 per trade (½ a point on 500 shares, for example) and take only eight trades per week, you would make $100,000 per year — which is incredible! And, if you can do that with enough opportunity, you can really grow your equity in the markets without taking much risk.

"A good franchise like McDonalds, has numerous systems for greeting the customer...All of these systems work well because they are simple. Anyone who buys a McDonalds franchise is likely to make a lot of money because that person has to go to Hamburger University and learn how to apply the systems."

Vomund: *Would you please explain the importance of understanding the concept behind a system? Also, in "Trade Your Way to Financial Freedom" you write: "The more you understand the real nature of your concept, the less historical testing you will have to do." Can you explain why this is true?*

Dr. Tharp: Before I get into that topic, let me explain something very important that Robert Kiyosaki has introduced to the world. It's part of his <u>Cashflow Quadrant</u>™. Most people who trade are either employees or they are self employed. In either case, people in those categories work for money as opposed to having money work for them. Now let's take a look at how both those people approach systems.

"...we believe that you should spend at least an hour in preparation for every hour you spend day trading. If you have a full time job and cannot make that commitment, then don't day trade."

First, the employee basically works for a system. He's motivated by fear and needs the security of having a system around him controlled by others. He doesn't really understand the system. He just works for it. He needs to be told what to do. Being <u>right</u> is important to him as that's what he's been taught in school for years.

Now if you work for the system (and you don't really understand the system), what kind of questions do you ask about the market? Typically the questions are something like: What stocks should I buy? What's the market going to do? You have no idea how to trade or no system to generate that information for yourself, so you ask questions that are typical of people who work for the system.

The self employed person is the second type of person who works for money. The self employed person tends to be a perfectionist. He is the system and he does everything — partially because he thinks no one else can do it better. And when these people become traders, they tend to become discretionary traders or they have trouble finding a system because nothing is quite good enough. They are always asking — how do I improve my system? How can I be right more? How can I do better?

Let's contrast that by looking at people who have money work for them (i.e., as opposed to people who work for money). The businessman is the type of person who develops systems. His goal is to get everything so automated that he could leave the business for a year and it would run itself (and perhaps be better because he is not there). What kind of systems do these people develop? They develop simple systems that the average high school student could follow.

For example, a good franchise like McDonalds, has numerous systems for greeting the customer, serving the food within 30 seconds, preparing the food, advertising, cleaning, etc. etc. All of these systems are very simple and they work well because they are simple. Anyone who buys a McDonalds franchise is likely to make a lot of money because that person has to go to Hamburger University and learn

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INTERVIEW *continued*

how to apply the systems.

Most people don't have this mentality because they are employees (who have no idea what a system is) or self employed people (who are the system). What you want is something that is very simple so that anyone with some intelligence could follow it. And in order to develop something like that, you have to understand it really well.

I used to do seminars with Tom Basso, who contributed to both "Trade Your Way to Financial Freedom" and "Financial Freedom Through Electronic Day Trading." Tom always said he was a businessman first and a trader second. He always spent his time looking for anything about the business that he could automate and systematize.

And if you understand what I've just said about Tom as a businessman (who develops systems), then you can understand why you really need to understand what it is you are trying to accomplish and how it works. And the more you understand this, the less you have to test it.

Vomund: *When creating a system, the user changes the variables in order to achieve better historical results. Eventually this leads to over-optimization. Can you explain the dangers of optimizing and explain how one knows when a system is over-optimized?*

Dr. Tharp: This really is about understanding some statistical terms, such as degrees of freedom. The more variables you have in your system (i.e., the more complex it is and thus the more degrees of freedom it has), the more you can get it to perfectly match what happened in the past. And the better it predicts what happened in the past, the less reliable it will be in the future.

> *"When people try to optimize, they are looking to be right and that's the real danger. Making money has nothing to do with being right."*

Basically, you can divide your historical data into two sections. Use one section to optimize your system, but keep it simple. Use the second section to test it as if you have some future data. Do you get the same sort of results? If the optimized sample is a lot better, then it is too optimized.

When people try to optimize, they are looking to be right and that's the real danger. Making money has nothing to do with being right. It has to do with having profits that are many times your initial risk when you are right and very small losses when you are wrong.

Here's an example. Suppose you buy a stock at 50 that's breaking out of a base on high volume. If it falls back into the base, you know you are wrong. As a result, your initial stop loss is only $1. Suppose you are wrong 4 times in a row. You've now lost $4 (times the number of shares you've purchased). However, on the fifth trade when you are right you make 20% on the stock or $10 per share. You've now been right 20% of the time, but you got a total profit on the stock of $6 per share. And if each trade represents 1% of your equity, you're up 6%. When you take on that perspective, being right is no longer so important. And thus optimization is no longer important.

However, I recommend something even more interesting than optimizing. Trade your system in real time with very small positions — like 1 share of stock or 10 shares. Note what your risk is in each position when you enter. This is what I call a 1-R risk. Then record your final profit or loss in a spreadsheet next to the risk. Divide that final profit or loss by your initial risk, and you'll have your profit expressed as a multiple of the initial risk. I call this the R-multiple of the trade. When you've done 100 or so trades, you'll have the R-multiple distribution of your system.

You can then plug that R-multiple distribution into a simulator and try various position-sizing algorithms to see what you can live with. You'll see the worst and the best when you randomly simulate an R-multiple distribution. ■

Dr. Tharp's interview will be continued in next month's issue of the Opening Bell.

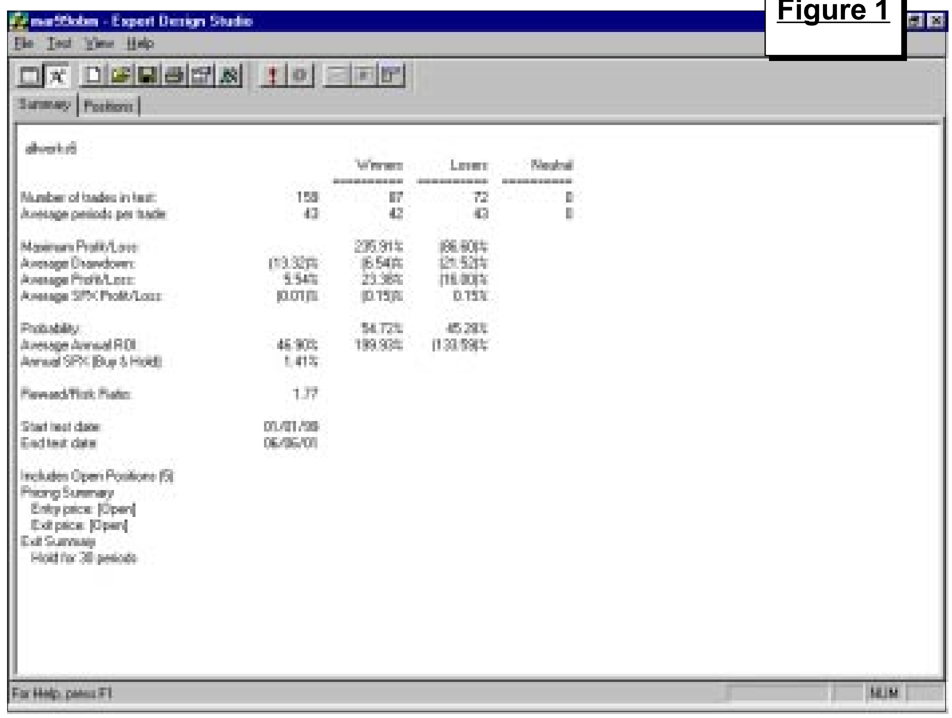
Dr. Van K. Tharp is President of the International Institute of Trading Mastery, Inc., 519 Keisler Drive, Suite 204, Cary, NC 27511. 919-852-3994. He has written a five-volume course for traders, The Peak Performance Course for Traders and Investors, and he is the author of "Trade Your Way to Financial Freedom" and co-author of "Financial Freedom Through Electronic Day Trading."

EXPERT DESIGN STUDIO AT WORK

A Valuable and Unique AIQ Tool — Capability To Incorporate Market Timing Rules In EDS Models

By David Vomund

Figure 1



We've covered many Expert Design Studio (EDS) models in previous issues of the *Opening Bell*. In our earlier work, we backtested models over various time periods without incorporating market timing. That is, stocks were purchased once they passed the screening rules even if the overall market environment was bearish.

TradingExpert Pro's EDS has the capability to incorporate market timing rules as well. In this month's article, we'll explain how to incorporate market timing rules with a mechanical EDS stock selection system.

Using Indicators for Market Timing

In the March 1999 issue of the *Opening Bell*, we introduced a growth investing model. This model picks volatile stocks that do very well during bullish times but can quickly head south when the market turns. Incorporating a market timing rule with this model may be appropriate.

The growth model has several components. To make sure the selected stocks are in a strong uptrend, there is a rule that says the stock must be above its 28-day moving average for all of the last 60 days.

To make sure the stock isn't too extended, a rule was added requiring the stock to be below its upper AIQ Band. Finally, the stock's Volume Accumulation Percent indicator must have a value above 30.

This model can be downloaded from AIQ's web page at *www.aiqsystems.com*. Click on ***Educational Products*** and then ***Opening Bell***. At the bottom right, click on the ***March 1999*** file.

We tested several market timing rules to use in conjunction with the 1999 growth model and we found that the S&P 500's Stochastic indicator added value to the model. Since our growth investing model requires a strong uptrending market, we added a rule that requires the S&P 500's Stochastic indicator to be above 80. Therefore, when the S&P 500 is strong enough to move its Stochastic above 80, then stocks that pass the growth model are selected for purchase.

Once the market weakens enough to bring the S&P 500's Stochastic indicator below 80, stocks are not screened for selection. When this condition occurs, no stock, including any that qualify based on our stock screening rules, can be selected.

Here is the EDS code for the market timing portion of the model:

rule1 if [stochastic]>80.

rule2 if tickerrule("spx", rule1).

In this simple code, the first rule defines the market timing indicator and the second rule allows the indicator to be run on the S&P 500 (ticker SPX). If you want the market timing model to use a different indicator, then you would modify rule1.

For example, if you only wanted to run EDS systems when the S&P 500's Velocity indicator is above

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EXPERT DESIGN STUDIO AT WORK *continued . . .*

zero, then the rule would be:

rule1 if [velocity]>0.

If you want to run an EDS system when the S&P 500's Phase indicator is increasing, then you would change the code to:

rule1 if [phase]>val([phase],1).

How does adding a market timing rule affect our growth model? In **Figure 1**, we show the results of running the growth model without adding market timing rules. The model was run on a database of about 1200 stocks from January 1999 to June 6, 2001. A fixed 30-day holding period was used.

We see that the average stock trade made 5.5% compared to an unchanged S&P 500. The average annual return on investment was 47%.

In **Figure 2** we incorporated the market timing rule that specified that stocks could only be purchased during times when the S&P 500's Stochastic was above 80. By combining the market timing rule with the growth stock selection model, we see that the number of trades was reduced in half but the stock selections performed better.

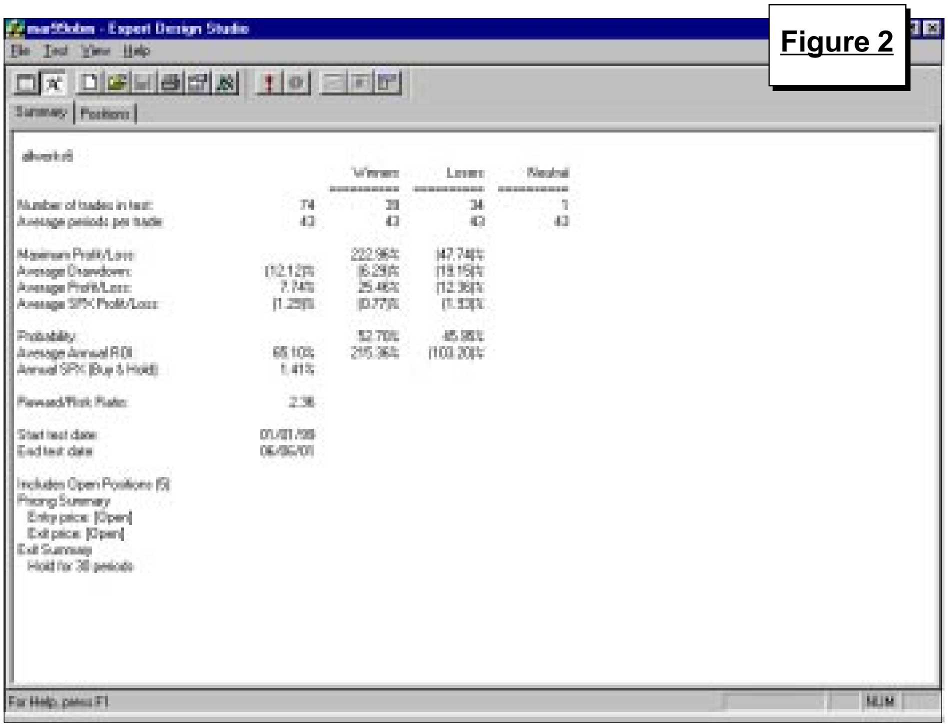


Figure 2

The average gain per trade rose to 7.7% compared to an equivalent –1.3% loss in the S&P 500. The average annual return on investment was 65%.

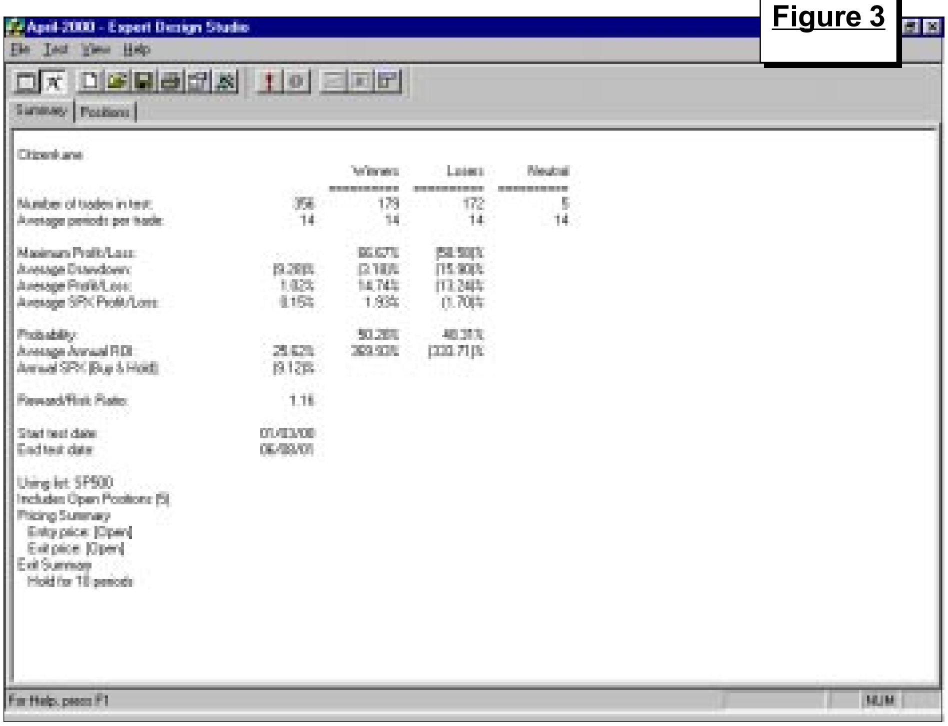


Figure 3

Using AIQ's DJIA Market Timing Model

We've seen how indicators can be used in EDS to create market timing rules. EDS has the capability to incorporate AIQ's market timing Expert Ratings (ticker DJIA) in a stock screening model as well. That is, you can have EDS run a stock screening model only during times when the AIQ market timing model is on a buy signal. When the timing model is on a sell signal, then no stocks are purchased.

The EDS code for checking to see if AIQ's market timing model is somewhat involved.

Here is the code:

!Search for ERs in the last 220 days

define scandays 220.

! rule for up ER's of 95 and greater

erup if [er up] >=95.

erdown if [er down] >=95.

UpSignal is ScanAny(erup,scandays).

DownSignal is ScanAny(erdown,scandays).

EXPERT DESIGN STUDIO AT WORK *continued . . .*

!If ScanUps date is greater than ScanDowns, then the LAST signal given was a BUY

LastWasBuy if UpSignal > DownSignal.

LastWasSell if DownSignal > UpSignal.

marketrule if tickerrule("djia", LastWasBuy).

To briefly explain this code, the model looks at all the Expert Rating signals of 95 or greater for ticker DJIA in the last 220 days. Of those signals, it finds the latest one and then sees whether it was a buy or a sell signal. If the last signal was a buy then the final "marketrule" passes the screening.

This EDS file can also be downloaded from the internet at *www.aiqsystems.com*. Click on ***Educational Products*** and then ***Opening Bell***. At the lower right click on ***July 2001***.

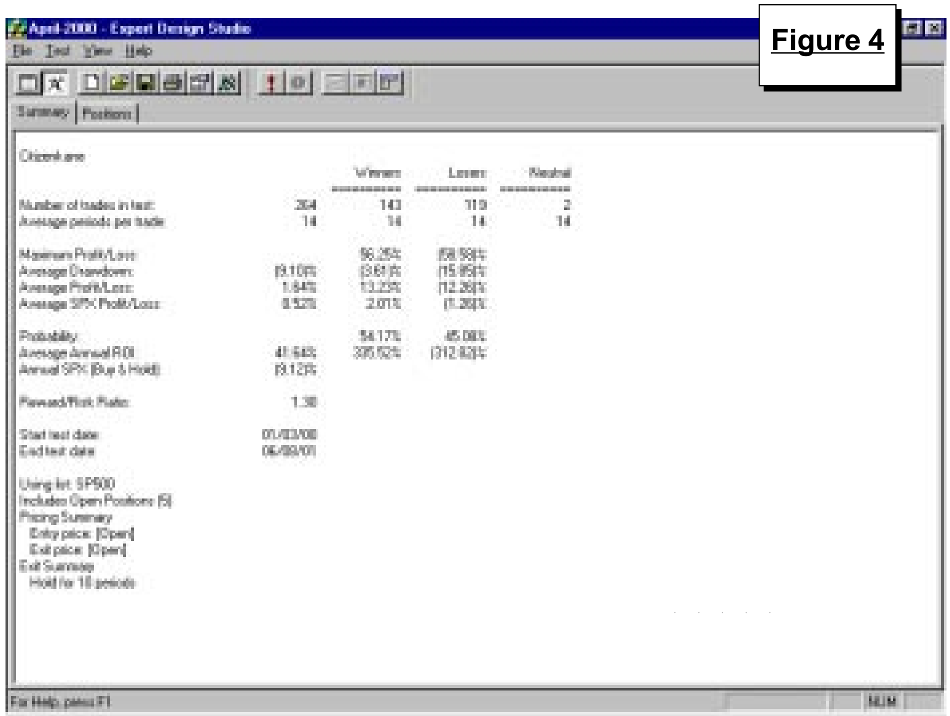
To combine this market timing model with any stock selection model, simply copy and paste it into the stock model and add the "marketrule" to the final stock rule. By doing this, your stock selection systems will only buy stocks when the AIQ market timing model is on a buy signal.

How does combining market timing Expert Ratings change a stock selection model? We'll look at our Citizen Kane model that was featured in the April 2000 *Opening Bell*. This bottom-fishing model buys stocks that have corrected by at least 30% sometime between 10 and 50 days ago. In addition, each stock's Volume Accumulation Percent indicator must be above zero and trending higher.

This model is run on an S&P 500 database with a fixed 10 business day holding period. The time period used was January 2000 to June 8, 2001.

Figure 3 shows the backtesting results for the Citizen Kane bottom-fishing model without incorporating market timing. There are 356 trades with an average gain per trade of 1.02% over the fixed 10 business day holding period.

Figure 4



After combining the market timing code with the Citizen Kane file, we ran the model over the same time period. By requiring the AIQ market timing model to be on a buy signal, the number of trades was reduced to 264 (**Figure 4**). The average gain per trade rose from 1.02% to 1.64%. Buying stocks only when the AIQ market timing model was on a buy improved the results.

The capability to combine market timing rules with stock selection rules is a valuable and unique tool in the AIQ software.

It is interesting to see how certain market timing rules help some EDS screening models but can hurt others. Market timing rules that help growth models can be very different than market timing rules that help bottom-fishing systems.

We encourage you to use the information from this article to test various market timing techniques on your EDS stock screening models. ■

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

S&P 500 Changes

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

Pepsi Bottling Group (PBG) replaces Adaptek Inc. (ADPT). PBG is added to the Soft Drinks (SODAGRP) group.

TMP Worldwide (TMPW) replaces CIT Group (CIT). TMPW is added to the Advertising (SERVICEA) group.

John Hancock Financial Services (JHF) replaces Harcourt General Inc. (H). JHF is added to the Life & Insurance (INSURALI) group.

Zions Bancorp (ZION) replaces Alza Corp. (AZA). ZION is added to the Banks (BANKGRP) group.

MARKET REVIEW

Heading into June, the AIQ market timing model was on a March 26 buy signal. Several additional buy signals were registered in June. On June 4 there was a 98 buy signal followed by another 98 buy on June 19. During the last week of the month three consecutive buy signals were registered: a 98 buy on June 26, a 99 buy on June 27, and a 97 buy on June 28.

Two of these signals occurred because the Dow hit a 21-day low at the same time that the Advance Decline Oscillator was above its 21-day low. The last signal occurred because the Stochastic indicator gave a buy signal at the same time that Volume Accumulation Percentage was increasing.

Carefully check your system on June 21. There should not be a buy signal for ticker DJIA on this date. If you see a buy on your system, then reload history for ticker DJIA going back to May 1.

The S&P 500 chart shown in the figure displays a good example of support and resistance levels. A horizontal support trendline was drawn at the mid-May low (see upward arrow). The S&P 500 re-tested this area in late May and then rallied. In June, however, the S&P 500 fell below the support level. What was support then became resistance.

We see at the end of June that the S&P 500 twice rallied to this resistance level but was unable to penetrate it (see downward arrows). By the end of the month, the S&P 500 was locked in a narrow trading range between 1203 and 1241.

During June, several of the previously devastated groups led the way with marginal gains. The Internet Retailers and Software groups increased by about 6%. There were some groups with large losses, however. Both Energy and Energy Services fell about 20% and Aluminum fell 10%. ■

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date	Stock	Ticker	Split	Approx. Date
Exxon Mobil Corp.	XOM	2:1	07/12/01	King Pharma.	KG	4:3	07/23/01
TransAtlantic	TRH	3:2	07/23/01				

Trading Suspended:

Catalina Lighting (LTG), CIT Group Inc. (CIT), Coventry Health (CVTY), CVB Financial (CVB), Litton Ind. (LIT), MCN Energy Group (MCN), Oshman's Sporting Goods (OSH), SunSource Inc. (SDP), TandyCrafts Inc. (TAC), Voicestream Wireless (VSTR), Warnaco Group (WAC)

Name/Ticker Changes:

Bell & Howell Co (BHW) to ProQuest Co. (PQE)
BF Goodrich (GR) to Goodrich Corp. (GR)
Consolidated Stores (CNS) to Big Lots Inc. (BLI)
Coventry Health Care (CVTY) to Coventry Health Care (CVH)
Cross Timbers Oil (XTO) to XTO Energy Inc. (XTO)
Data Broadcasting Inc. (DBCC) to Interactive Data Corp. (IDCO)
Krispy Kreme Doughnuts (KREM) to Krispy Kreme Doughnuts (KKD)
Meditrust Corp. (MT) to La Quinta Prop. (LQI)
Sybase Inc. (SYBS) to Sybase Inc. (SY)
Unitrin Inc. (UNIT) to Unitrin Inc. (UTR)