AIQ Opening Bell®

Monthly

IN THIS ISSUE — VOL. 3 ISSUE 6 — JUNE 1994

Feature

Sections

The *Opening Bell Monthly* is a publication of AIQ Incorporated
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MUTUAL FUND ANALYSIS

MUTUAL FUND INVESTING PART III
SURROGATE GROUPS

By David Vomund

DAVID VOMUND

Beating the market is tough. A theory called "random walk" says that equity pricing is completely efficient and all information is taken into account. In a completely efficient market, dart throwing is as good a stock selection method as in depth fundamental and technical analysis. I don't believe the market is completely efficient but it is very efficient. There are no "sure thing" stock investments. In order to take advantage of the inefficiency that exists, you need an approach that is better than what other people are using. To give you the edge, AIQ always tries to provide what other software packages don't (Expert Ratings, Market Logs, group Trend Scores, etc.). Outlined in this and the next issue (July) is an approach to mutual fund trading that is uniquely available to AIQ Trading-Expert users and, I believe, is the best way to consistently outperform the market without enduring significant volatility.

"To improve our mutual fund analysis, we must have volume figures. To get these figures, we will develop "surrogate groups," which are industry groups that represent actual mutual funds."

People who trade mutual funds have very little information to work with. Mutual funds do not have open, high, or low prices. They also do not have volume figures. The only thing a technician has to work with is closing price. This means that the thousands of mutual fund traders are only looking at indicators that work off price (Stochastics, RSI, etc.). Most are momentum investors who buy the strongest funds. However, with Trading-Expert, we can go beyond this simple approach by taking advantage of the system's industry group capability to see if money is flowing into or out of the mutual fund's stock holdings.

To improve our mutual fund analysis, we must have volume figures. To get these figures, we will develop "surrogate groups," which are industry groups that represent actual mutual funds. Building a surrogate industry group to represent an actual mutual fund allows us to analyze

Mutual Fund Analysis continued on page 2

MUTUAL FUND ANALYSIS *continued . . .*

Table 1

FDCPX Fidelity Computers
AIQ MatchMaker Weekly Analysis
05/11/93 to 05/11/94

Coef.	Tic	Stock
620	NVLS	Novellus Systems
601	SYBS	Sybase
579	LRCX	Lam Research
568	TXN	Texas Instruments
562	AMAT	Applied Materials
546	XLNX	Xilinx
534	IDTI	Integrated Device Tech.
528	ALTR	Altera Corp
526	LOTS	Lotus Development
514	CPQ	Compaq Corp
509	SERA	Sierra Semiconductor
508	WFLT	Wellfleet Comm.
507	LSCC	Lattice Semiconductor

the surrogate group instead of the mutual fund. In this way, we can use both price and volume indicators. TradingExpert's Group Analysis Report can be utilized to see which surrogate groups are the strongest and which are gaining strength. All the information that TradingExpert has to offer can be utilized.

How do we build surrogate groups? There are two methods. The first method is to build surrogate groups using the largest stock holdings of the mutual funds. Some fund families are kind enough to tell you the 10 largest holdings of their funds for the prior month. I'm told that Morningstar's monthly CD-ROM service also gives this information. If you are interested in Fidelity's mutual funds, Fidelity publishes a *Mutual Fund Guide* (800-825-0061), a monthly publication that lists the 10 largest holdings of most of the Fidelity funds. All mutual funds report their largest holdings on a quarterly basis, but this information can be out of date by the time it is received.

The second method of building surrogate groups is to use AIQ's MatchMaker program. MatchMaker will create a list of the stocks in your database whose price movement is highly correlated to an actual mutual fund. For an example, I compared the Fidelity Select Computer fund to all the stocks in my database (approx. 1800 stocks) to see which stocks are highly correlated with the fund. The results from examining a one year weekly correlation are shown in **Table 1.** (**Table 2** shows results from a two month daily calculation.) Scores with a coefficient greater than 500 are highly correlated. Not surprisingly, the stocks that are highly correlated in both tables are technology stocks.

We now build a Fidelity Computers surrogate group based on the stocks in these tables. The result is shown in **Figure 1.** The actual Fidelity Computer fund is in **Figure 2**. We can immediately notice the similarity of chart patterns. With the surrogate group completed, we have the ability to perform a buy/sell analysis with

Table 2

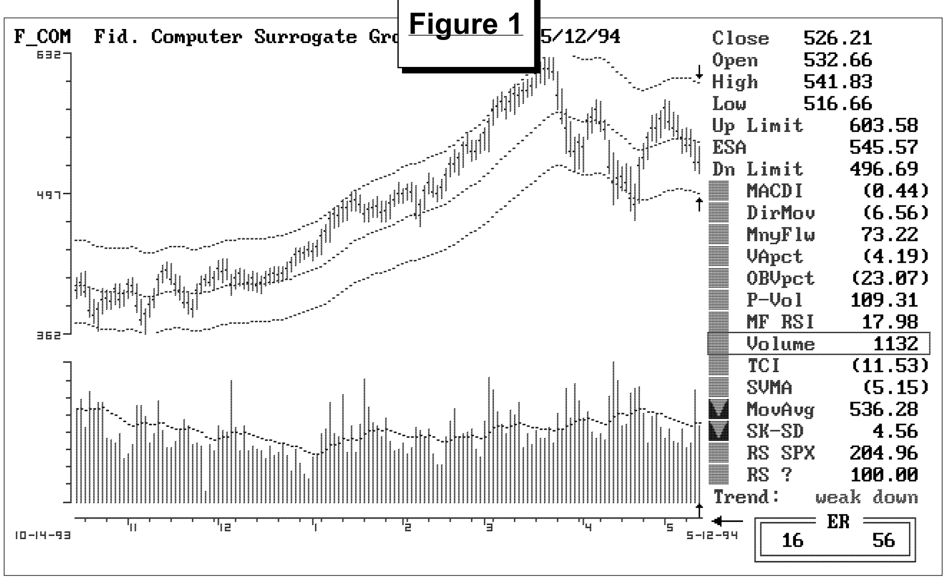
FDCPX Fidelity Computers
AIQ MatchMaker Daily Analysis
03/06/93 to 05/06/94

Coef.	Tic	Stock
735	TXN	Texas Instruments
700	MU	Micron Technology
616	WDC	Western Digital
607	QNTM	Quantum Corp
560	SGAT	Seagate Technology
550	AMD	Advanced Micro Dev.
546	LSI	LSI Logic
535	NSM	Nat'l Semiconductor
520	INTC	Intel Corp

indicators such as Volume Accumulation %, Money Flow, and On Balance Volume. The ability to apply these indicators to our analysis gives us the edge over other traders. Building the surrogate groups in this manner should be performed monthly.

The group we built was a surrogate for a sector fund but this same technique can also be applied to regular equity funds. The advantage of using this approach with sector funds is that the funds always hold stocks in the same sector, which increases the chance that the surrogate group will move in line with the fund even as the fund's stock holdings change (e.g., technology stocks tend to be in favor or out of favor as a group). In our surrogate computer group, MatchMaker shows a

Figure 1



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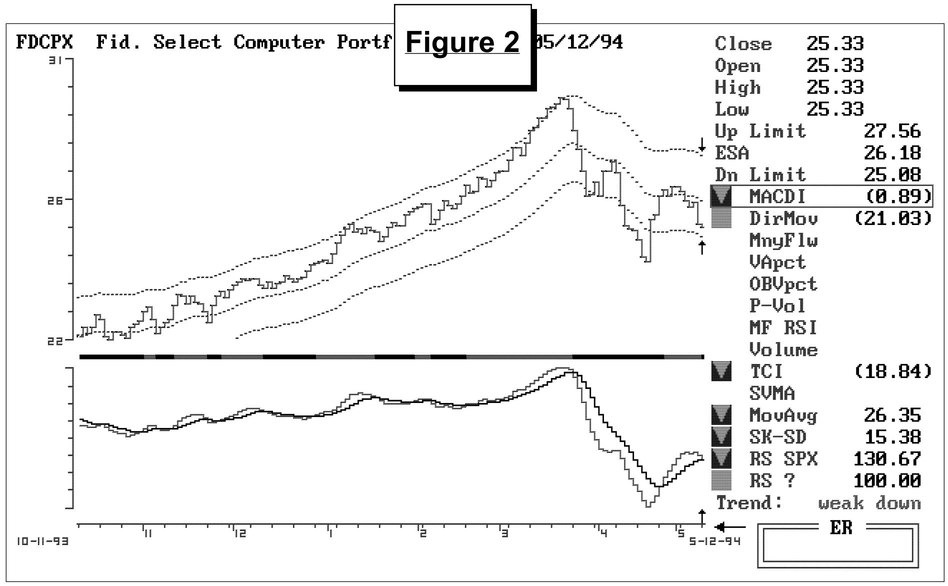
MUTUAL FUND ANALYSIS *continued . . .*

high correlation between the actual fund and our surrogate group for the last year. That is not surprising since we built our surrogate group using data for that time period. However, MatchMaker shows a high correlation between the actual fund and our newly created surrogate group in 1991 and 1992 also. The fund's stock holdings may have changed over time but computer/technology stocks tend to move together.

Next month, we'll cover the most interesting part of mutual fund trading—how to perform analysis on our created surrogate groups. ■

Figure 2



GROUP OF THE MONTH

THE NEW GROUP/SECTOR PYRAMID

BY DAVID VOMUND

As announced last month, we have revised the AIQ Group/Sector Pyramid, our industry group and sector structure. To briefly review what the Pyramid is, AIQ wanted to develop the ultimate industry group structure for investors who use a top-down approach to investing. To do this, we wanted a rational industry group structure—one that is classified on a fundamental and technical basis. Most industry groups, including the Investor's Business Daily and Standard & Poor's industry groups, are classified on a fundamental basis (e.g., companies that earn money by selling computer software are placed into a computer-software industry group). While the prices of these stocks tend to move together (highly correlated), there are some software stocks that move independent of the others. A technical test can be used to flag those stocks whose movement is independent of the group.

We use AIQ's MatchMaker program to test the correlations of the stocks within an industry group to see which stocks are highly correlated to the industry group index and which are not. Stocks that show a low correlation are taken out of the index. That way, the industry group index becomes a better representation of the underlying stocks. When this process is completed, the industry group structure is classified on a fundamental basis (where earnings are coming from) and a technical basis (high correlation between the stock and the industry group).

All correlations are reviewed and updated every six months. The current structure has 81 fully rational groups which contain an average of 4.5 stocks. The stocks are mostly mid and large capitalization stocks. The industry groups are classified into 15 rational sectors.

Let's look at an example, the Retail-Specialty group. The Dow Jones industry group structure classifies 9 stocks into a Retail-Specialty group. AIQ's MatchMaker shows that some of these stocks, including Toys R Us, Tandy Corp., Circuit City Stores, and Melville Corp., show a low correlation to the industry group index. An index of the remaining stocks is then calculated.

Table 3

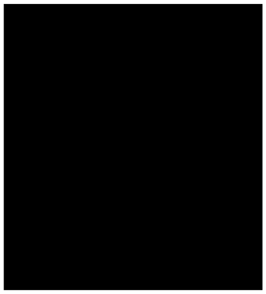
5999A Retailers, Specialty
AIQ MatchMaker Weekly Analysis
05/11/93 to 05/11/94

Coef.	Tic	Stock
782	CHRS	Charming Shoppes Inc.
661	PBY	Pep Boys Mny Mo & Jck
652	VEN	Venture Stores
609	LOW	Lowes Cos. Inc.
601	HD	Home Depot Inc.

The final step in our group creation is to compare the Retail-Specialty group against each of the stocks in our database. Matchmaker may point to a retail stock that has a high correlation to the Retail-Specialty index that was not originally classified in the Dow Jones structure. This analysis pointed to Venture Stores and this stock was added to the Retail-Specialty group index. Our final group consists of five stocks that show a high correlation to the group index (see **Table 3**). ■

The AIQ Group/Sector Pyramid has been updated as of April 15,1994. The Pyramid can be purchased for $188, and updates for $44. To order, call AIQ at 1-800-332-2999.

PUTTING IT ALL TOGETHER



DR. J.D. SMITH

Learn to Enjoy Your Losses

By Dr. J.D. Smith

I recently met a long-term AIQ user at one of our seminars. Not only is he a longtime user, he is a power user. He has purchased all the software and all the upgrades, attends two seminars a year, and subscribes to the Opening Bell Monthly. Clearly, he is a power user.

By way of conversation, I asked him how he was doing. He told me he had become an investor, with a longer term horizon. I glumly translated that to myself as meaning that he was a trader who did not exit his positions when his stops were hit. He did not exit when the market told him to exit. After some discussion, I was able to determine why.

First, he had listened to a friend who had listened to a broker about a hot new group that was going to move sometime in the future. Right there, he gave up his independence. Next, he had placed too much of his portfolio into this single group. He lost his diversification. When the trade went against him, he did not obey his exit rules and he lost his discipline. Then, finally, he lost his confidence.

My diagnosis is that not only did he not like to lose on a trade, he did not know *how* to lose. He thought that he avoided losing by not exiting his losing positions. The result is that this trader is now an investor who will wait until the stocks come back to their entry points before he sells. Because his capital is tied up, he cannot trade and will probably miss the next few market moves, which in turn compounds the current loss.

"... a good losing trade increases my dependence on my trading process with the result that I am able to continue to trade well and profitably."

I really dislike hearing these kinds of stories. Because they are completely unnecessary. Our DOFPIC attitude and our trading process makes them unnecessary.

Let's examine what I consider a good trade which, in fact, was a losing trade. Let's go back to January 10, 1994. The world was bullish. The market was at historic highs and the Transport Sector was very bullish. The Airline Group had completed a consolidation and was now breaking to the upside. Both the Directional Movement Index (DMI) and MACDI were bullish for the Airline Group. Now let's zero in on Delta Air Lines, **Figure 3**.

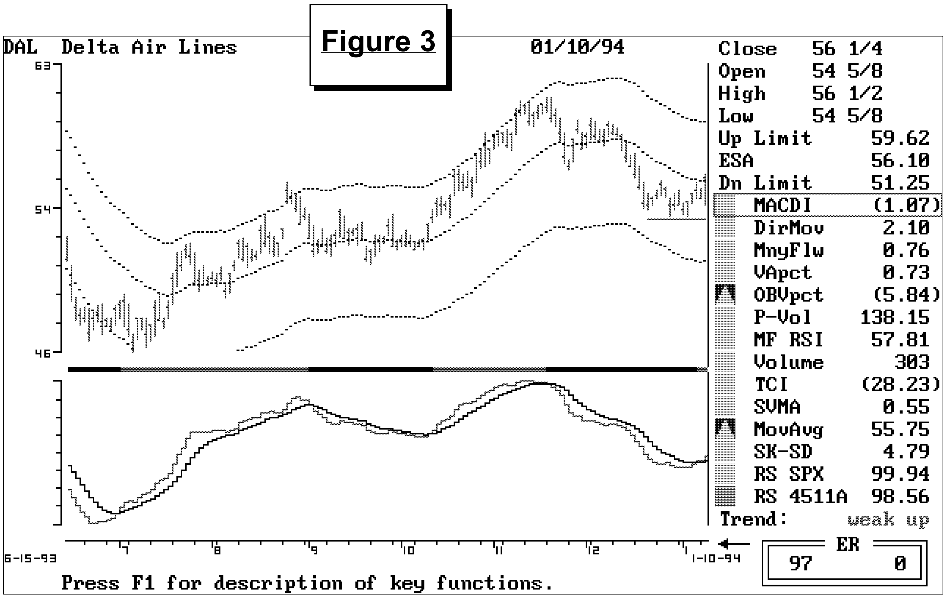
On January 10, the AIQ expert system issued a 97 Expert Rating to the upside for Delta. MACDI and Directional Movement were showing a same-day confirmation of this Expert Rating. The Delta stock had the highest Positive Volume value on my entry list of stocks to consider for trading. Delta Air Lines was a definite buy: at 56 1/4 on January 10. I was able to place an initial stop just below recent lows, which should get me out at a maximum 4.2% loss if the trade should go against me.

On January 19, Directional Movement turned negative for the Delta Air Lines stock. But that is not unusual. DMI will often whipsaw early in a new position. This is why for one of my exit rules I require both DMI and MACDI to turn negative (for long positions). I will exit on this indicator rule even though none of my price stops have triggered.

By January 24, the trade had degraded (see **Figure 4**). On that day, the *Difference Line* of MACDI crossed the *Signal Line* to the downside. This in conjunction with a negative Directional Movement Index activated my exit rule, and I was out.

This was a "good trade." It was a good trade because I was disciplined

Figure 3



PUTTING IT ALL TOGETHER *continued . . .*

enough to follow my rules. Equally important, I exited with only a 2.4% loss on the trade. What makes that loss look even better is illustrated in **Figure 5**.

If I had not exited when my rules told me to and I had become an *investor* in Delta Air Lines, the result would eventually have been a 29% loss within three months. A 2.4% loss is good. A 29% loss is clearly bad.

I feel that it is just as important to lose as it is to win. This is not a concept that is widely taught, but when actively trading the market it is a good concept to keep in mind.

It is important to lose for three reasons.

First, if we all put on only winning trades, who would there be to take the other side? But let's be realistic. My trading process and my trading systems are not perfect. AIQ's Expert Rating is not always right. Confirmation techniques help, but not completely. If I want to trade, then I am going to lose some of the time. As long as I can lose well — by that I mean quick and small — then I can build losses into my trading process and deal with them.

Second, losing teaches us discipline. If all our experience in the market occurred during a long, bullish trend where it is easy to pick winners, we would begin to believe that this is an easy game to play. We would be totally unprepared to react to the inevitable correction. We would be totally unprepared to deal with a down market. We would not have the discipline to practice market timing, group analysis, and stock selection. And we would not have the discipline to exit when the market, and our rules, tell us to exit.

Third, a losing trade gives us the incentive to evaluate and improve our trading process. During the review phase of our trading process, it is our task to evaluate our methods for determining market direction, to test our rules for sector rotation and group analysis, and to check in detail our

Figure 4

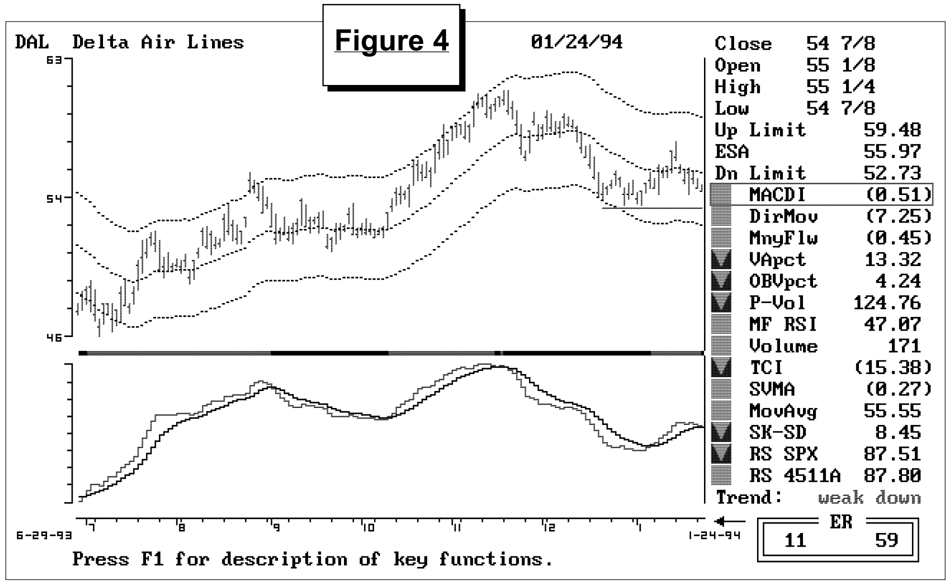
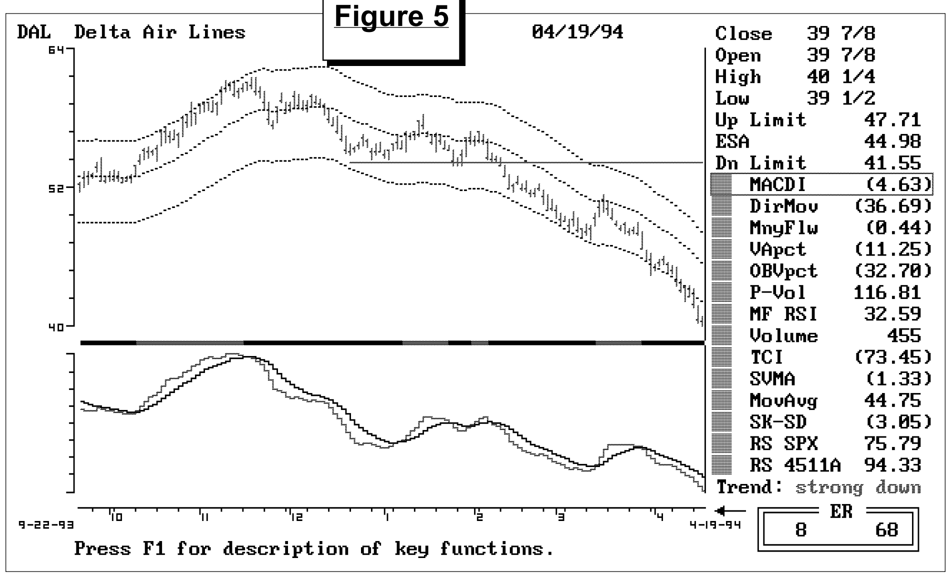


Figure 5



methods for stock selection. And, of course, we must examine our exit rules.

These are the reasons that I enjoy a good losing trade like the Delta trade. By reminding me that I am not infallible and that my system is not infallible, a good losing trade increases my dependence on my trading process with the result that I am able to continue to trade well and profitably. Also, I can feel good about myself. I had the discipline to not deviate from my rules and to take my loss when the market told me to exit. As a result, I only lost a little bit on the Delta trade.

I particularly enjoy a good losing trade when the exit improves my trading performance. Then, to me the loss is really a bonus. How can a loss be a bonus? If the percentage loss from the trade is less than my prior average percentage loss from trading in general, then my new average after this losing trade will decrease. By taking a quick, small loss, I improve my trading performance. In the case of the Delta Air Lines trade, I lost 2.4% compared to my average loss of 3.8%. (And, I avoided the 29% loss had I ridden it all the way down.)

This explains why I can say that losing is good. And losing well works for me. ■

TOOLS OF THE TRADE

REVERSAL DAY CHART PATTERNS

By David Vomund

An important chart formation is the reversal day. By itself, it is not of major significance. But in the context of other information (Expert Ratings, volume, support/ resistance levels), the reversal day can give an early indication of when a stock has reached a near-term top or bottom. We'll examine two reversal day patterns which are closely related: the two-day reversal and the inside/ outside day.

Two-Day Reversal

The bearish two-day reversal is a situation where a stock is in a trend and it closes at a new high. The following day, the stock opens near its previous close but then closes near the previous day's low. The opposite is true for the bullish two-day reversal. The wider the price swing, the more significant the reversal.

An example is shown for Lands End (LE) in **Figure 6**. The chart displays data through May 10 but the reversal came on March 29 (see arrows). On March 28, LE was rising nicely and closed on its high for the day and in new high ground. The next day, however, sellers entered. The stock opened at its previous close but moved lower. On the second day, it closed near the previous day's low.

As explained earlier, the reversal day itself is not enough reason to sell or sell short. Given other circumstances, however, the reversal day can become more significant. One important indication is when the reversal occurs with above average volume. If volume is well above average on the second day, then the two-day reversal is more significant.

In the LE example, we see that volume on the day that the stock reversed direction was well above average and higher than the previous day's volume figure. The 95 sell signal also increases our confidence in deciding that this stock will move lower.

Inside and Outside Days

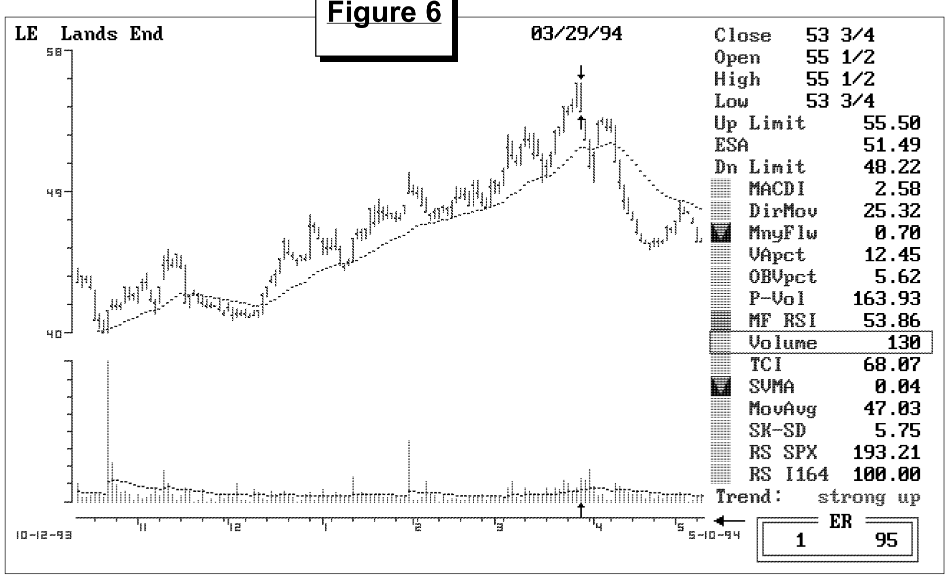
The inside and outside reversal days are similar to the two-day reversal but are more powerful. An outside reversal day is a bearish formation while the inside reversal day is a bullish formation. The outside reversal day begins with a stock that is reaching a new high in an uptrend. The reversal comes when the intra-day high for the stock is higher than the previous day's high but the stock closes below its previous day's low price. With an inside reversal day, the stock falls lower than its previous day's low but closes above its previous day's high.

An example of an outside reversal is shown in **Figure 7**. Texas Instruments (TXN) fell in mid-March and began to retrace its losses in late March. Just over half the value was retraced when the outside day occurred on April 8 (see arrows). On that day, the stock moved just above its previous day's high but closed well below its previous day's low.

An example of an inside day is found in **Figure 8**, a chart of Logicon (LGN). In late March, LGN was undergoing a correction and was nearing its February low. The inside day came on April 4 when the stock moved lower than its previous day's low but closed above its previous day's high. With this example, there are two factors that increase our confidence that this inside day signals a change of direction. First, the volume, as seen in the lower part of Figure 3, is well above average on the day of the reversal.

"...in the context of other information..., the reversal day can give an early indication of when a stock has reached a near-term top or bottom."

Figure 6



TOOLS OF THE TRADE *continued . . .*

Second, the reversal occurs when the stock is testing an important support trendline that connects February's low prices.

Weekly Chart Pattern Analysis

As with most charting formations, the theory applies to both daily and weekly chart analysis. An example from a weekly chart is seen in **Figure 9**. On this chart, Carpenter Technology (CRS) had an outside reversal week on February 25. The stock made a new weekly high but closed below the prior week's low price.

Weekly chart pattern analysis works well with TradingExpert since we chart the high for the week, the low for the week, and Friday's closing price. However, some other software programs have weekly charting that plots only one day out of each week. These programs should not be used to spot reversal patterns on weekly charts—the analysis is invalid.

Reversal patterns are an important part of technical analysis. Taken together with other technical factors (Expert Ratings, volume, support/resistance), reversal patterns help to identify when a trend may be ending and help you to take profits or enter new positions earlier in the game. ■

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, or write Vomund Investment Services, P.O. Box 6253, Incline Village, NV 89450.

Figure 7

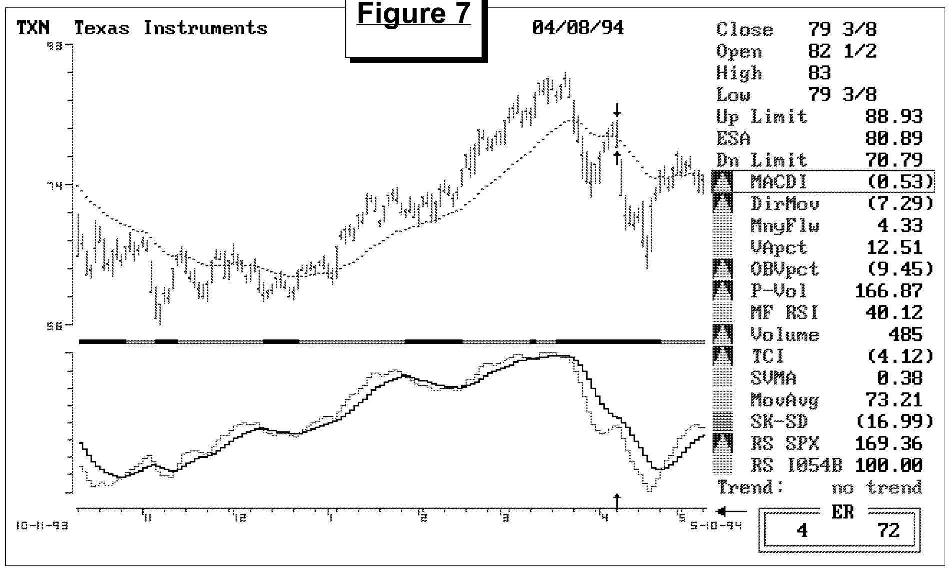


Figure 8

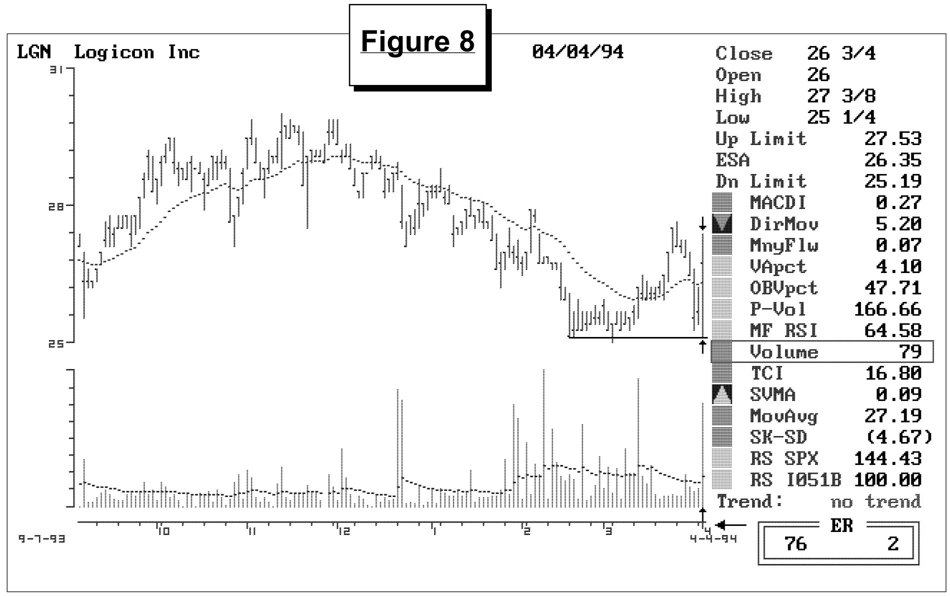
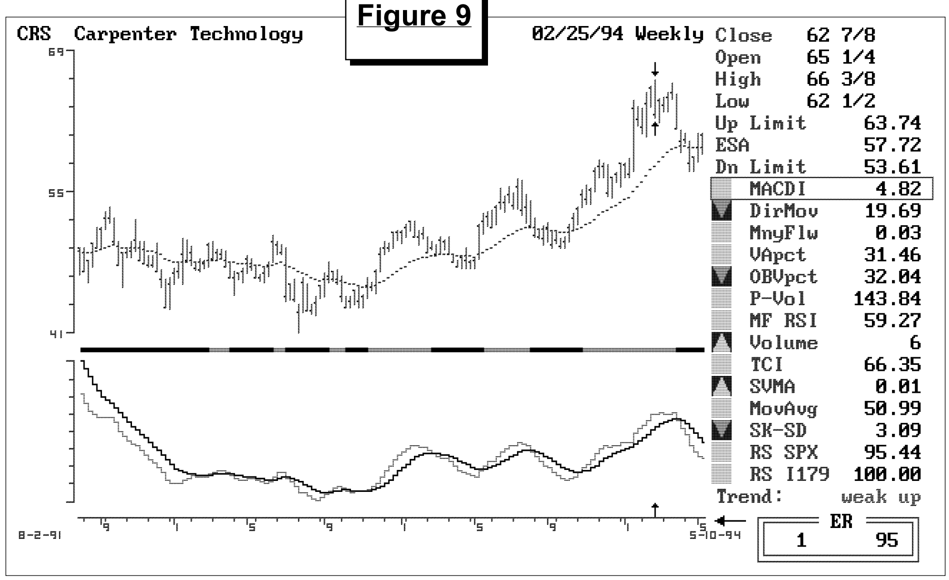


Figure 9



AIQ 1994 EDUCATIONAL SEMINARS

5th Annual Lake Tahoe Seminar

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Incline Village, Nevada
Thursday, Friday, and Saturday
September 29, 30, and October 1

READERS FORUM

Q. Why has the default for the SK-SD indicator changed in TradingExpert 3.0?

A. On our Market and Ticker Plots, AIQ tries to maintain the default parameters for technical indicators at those settings recommended by the developer of each indicator. The user is then allowed to modify those settings based on individual trading processes.

The SK-SD Stochastics indicator was developed primarily for the futures market, which needs a quick reacting indicator. This caused, in turn, the recommended value by the developer to be 3 days. We found this to be too fast for trading stocks. An indicator was wanted that smoothed out more the random, chaotic price behavior, so we traded off a slower responding indicator for a reduced number of whipsaws.

Therefore, during the development of TradingExpert 3.0, 10 days became the default for the SK-SD indicator.

The individual user can change the SK-SD to whatever time period is suitable. If you want a faster responding indicator, then you should set the time period smaller than 10 days. If you want it even slower than the 10-day indicator, then you can set it higher, up to 21 days.

Q. My Access Plot quit computing. When I try to recompute it using Compute Access Index under File Maintenance, an older date still shows up on the Access Plot. Why?

A. Since the Access Plot is computed from all the active stocks in your Master Ticker List, you probably have data missing in one or several stocks. This is not uncommon, especially if you are not reviewing your System Messages file. There are three messages to look for on the System Messages report:

1. Communications: {stock ticker}, 00/00/00, no data available - Ignored.

2. Reports: {stock ticker}, 00/00/00, last data - Ignored

3. DB Update: {stock ticker} has not been updated since 00/00/00.

These things can occur when there is a ticker symbol change, when a company has merged with another company, or when a company is no longer traded. The ticker symbol should be changed or the stock deleted. Then, the Compute Access Index function will work.

Readers Forum is compiled by our Product Support staff from questions frequently asked by our users.

MARKET REVIEW

The market has focused on interest rates in the last month. An interest rate hike was factored into the market, and as a result when the Fed increased rates shortly after the May 17 FOMC meeting, the bond and stock markets rallied. Sometimes anticipation is worse than the actual event.

AIQ registered several buy signals since our last review. A 99 up signal came on April 21, a 97 up signal on April 25, and a 95 up signal on May 17. The market was under a consolidation mode until the May 17 buy signal was registered, at which time the market averages rose on heavy volume. The increase in volume helped improve the On Balance Volume indicator which, until this time, was one of the weakest indicators.

The Accumulation/Distribution indicator, which also attempts to measure whether money is flowing into or out of the market, is showing strength. As of this writing, the market is rallying but is nearing a resistance trendline drawn from the January 31 and March 21 highs.

Surprisingly, one of the strongest sectors, despite the interest rate increase, is Banking. Oil and select Chemical stocks are also showing strength. ■ D.V.

STOCK DATA MAINTENANCE

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

Stock	Tic	Split/Div.	Date
First Georgia Holding	FGHC	3:2	05/10/94
Cellular Comm.	COMMA	3:2	05/16/94
Jason Inc.	JASN	5:4	05/19/94
Microsoft Corp	MSFT	2:1	05/23/94
Tellabs Inc	TLAB	2:1	05/23/94
DSC Communications	DIGI	2:1	05/26/94
Pamrapo Bancorp	PBCI	2:1	05/27/94
Healthwise of Amer	HOAM	3:2	05/27/94
High Plains Corp	HIPC	5:4	05/31/94
Home Svs Bank Fl	HOFL	2:1	06/06/94

Stock	Tic	Split/Div.	Date
Magna Bancorp	MGNL	2:1	06/07/94
St. Paul Co.	SPC	2:1	06/07/94
Owens & Minor	OMI	3:2	06/09/94
PPG Industries	PPG	2:1	06/13/94
Viking Ofc Prod	VKNG	2:1	06/15/94
Hanna (MA)	MAH	3:2	06/16/94
Patterson Dental	PDCO	3:2	06/20/94
Enron Oil & Gas	EOG	2:1	06/21/94
Barry (RG)	RGB	4:3	06/23/94

Name Changes:	Snap-On Tools (SNA)	to	Snap-On Inc (SNA)
	First Alabama Bancshares (FABC)	to	Regions Financial Corp (RGBK)
	Air Express Int'l (AEX)	to	Air Express Int'l (AEIC)
	Capital Holding Corp. (CPH)	to	Providian Corp. (PVN)