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Feature

Sections

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AIQ USER INTERVIEW

PRICE PATTERN ANALYSIS PAYS OFF FOR PROFESSIONAL TRADER DAN ZANGER

This month we are pleased to present an interview with Daniel Zanger. Dan has been an AIQ user since 1992 and publishes Chartpattern.com, an online newsletter. His newsletter, which has a margin portfolio, increased an amazing 1833% from January 1999 to mid-May 2000. Dan will be a guest speaker at AIQ's Lake Tahoe seminar in October. He can be reached at Dan@Chartpattern.com.

OBM: Please tell me about your background. How did you get started in stock trading?

Zanger: When I was about 20 years old, I watched the Business Channel in Los Angeles. It had a similar format to that of today's CNBC except many of the guests talked about stocks from a technical perspective rather than from a fundamental perspective.

By watching the ticker tape I saw which stocks were moving up and which were moving down and I noticed a direct correlation with volume. At that time, I purchased my first stock at $1.00 and sold it seven weeks later for $4.00. The stock was a spin-off from Rockwell Corp. This was back in the mid-70s.

OBM: How much experimenting did you do before you came up with your current stock selection system?

Zanger: I did a tremendous amount of experimenting, which cost me a lot of money in losses. I had to constantly go back to the drawing board and figure out where I went wrong. I found that I was buying stocks that were below their descending trendlines or that had just broken down below their support trendlines. I spent over 10 years and probably 20 to 30 hours a week constantly plotting my mistakes on a chart. I was buying based on emotion. Over time, I learned how to buy stocks at the correct time rather than relying on emotions.

OBM: Your most important buy criteria is price pattern analysis. Can you give us some examples of the patterns you look for?

Zanger: Many years ago, one of the best bullish patterns was a Cup-and-Handle formation. These days, the Cup-and-Handle is so well known that the stock runs away before the pattern is completed. One of the best bullish patterns today occurs when a strong relative strength/high growth stock corrects by 20% or so.

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INTERVIEW *continued . . .*

More often than not, a descending trendline will be in place as a result of this downside action. A break above the descending triangle signals some of the biggest gains in the stock market today. This is known as a continuation pattern.

One of these continuation patterns is the Flag pattern. After a big quick price advance, a bullish flag is characterized by lower tops and lower bottoms. A good example of a Flag pattern that we acted on is Ask Jeeves Inc. (ASKJ) in **Figure 1**. During the pattern, volume dried up. Once the upper trendline is broken the stock typically takes off, especially if the break comes on heavy volume.

Another powerful continuation pattern is the Ascending Triangle. Ascending Triangles are generally considered bullish and are most reliable when found in an up-trend. The top part of the triangle appears flat, while the bottom part of the triangle has an upward slant. Buyers enter the stock, but each time the stock hits its old highs sellers emerge and the stock retreats. Buying at that time resurfaces but each sell-off is less than the previous sell-off.

Prices eventually break above the old highs and are propelled higher as new buyers emerge. A good example is shown in **Figure 2**. Human Genome Science (HGSI) signaled its buy on 08/02/99.

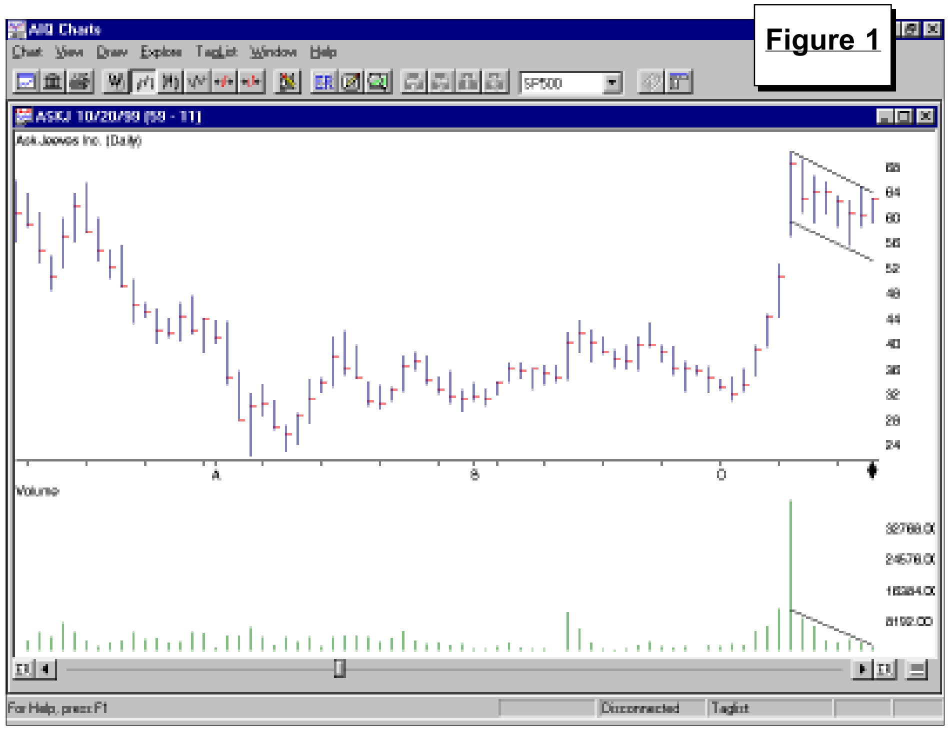

Figure 1

Another triangle pattern is the Symmetrical Triangle. With this pattern each new top and bottom becomes more shallow than the last, taking on the shape of a sideways triangle. It's interesting to note that there is a tendency for volume to diminish during this period. Eventually, this indecision is met with resolve and the stock usually explodes out of this formation, often on heavy volume. A good example is VISX Inc. (VISX) shown in **Figure 3.**

There are several other powerful patterns that are covered on my web site at *www.chartpattern.com*

OBM: How do you find the stocks with these patterns?

Zanger: Using the AIQ Tag List feature, I insert about 400 stocks that I believe have the best potential in the market today. Every single day, including Sunday, I scroll through my Tag List searching for the patterns. On many days, I'll even scroll through the Tag List two times.

"The trend of a stock is determined by supply and demand and the struggle between supply and demand can best be seen and interpreted by simply looking at a stock's price activity."

OBM: Do you use technical indicators in your analysis and, if so, which ones?

Zanger: I use almost no technical indicators in my analysis. Once in a while I may use the MACD, but that would be the only one. The trend of a stock is determined by supply and demand and the struggle between supply and demand can best be seen and interpreted by simply looking at a stock's price activity.

OBM: You recommend a lot of stocks in your newsletter. How do you filter out the ones that are actually purchased in your newsletter portfolio or your hedge fund?

Zanger: It is hard to explain how I go about picking my stocks for pur-

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INTERVIEW *continued . . .*

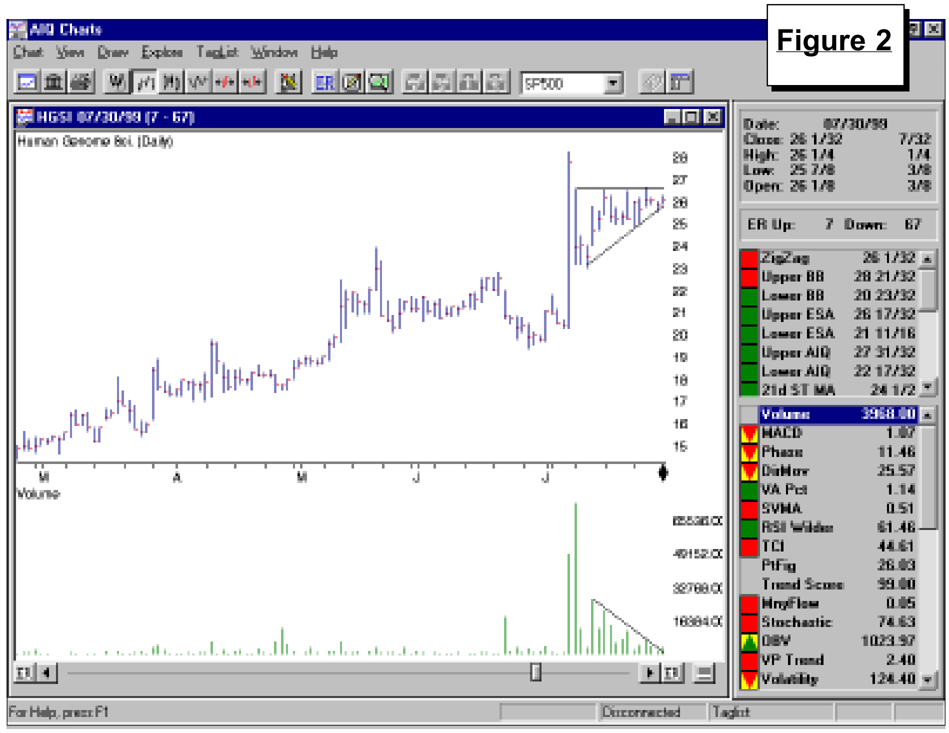
chase for the fund. Basically, I let the market dictate to me during market hours which stocks are acting best. I become "friends" with my stocks and get to know their personalities during market hours. I know when they are feeling good by the way they act, and I know when they are feeling bad. I get a feel for their personality changes from good to bad or bad to good.

I use this personality test on each stock almost like a psychological test. This, combined with the patterns that these stocks have made over a three to five week chart span, helps me identify bullish situations. If the stock is feeling good and the chart is saying it is time to buy based on various formations, then I will definitely step in and buy at that point

OBM: Many of the stocks you recommend have a price history of less than a year. Is there any significance to this?

Zanger: Basically, many of the new issues come from hot new areas of our economy. We currently see a technological revolution in internet stocks, ready to fill the public's appetite. These stocks are very trendy and sexy right now and these companies offer many new technologies that are in great demand. These stocks have a tendency to greatly outperform the market, mainly due to the fact that they have little or no institutional ownership.

Figure 2



This was the case with the cellular phone stocks and the early networking stocks in the mid-80's. In the early 90's, the HMO stocks went public. These stocks soared in price very rapidly. Institutions eventually purchase the stocks, which pushes prices up.

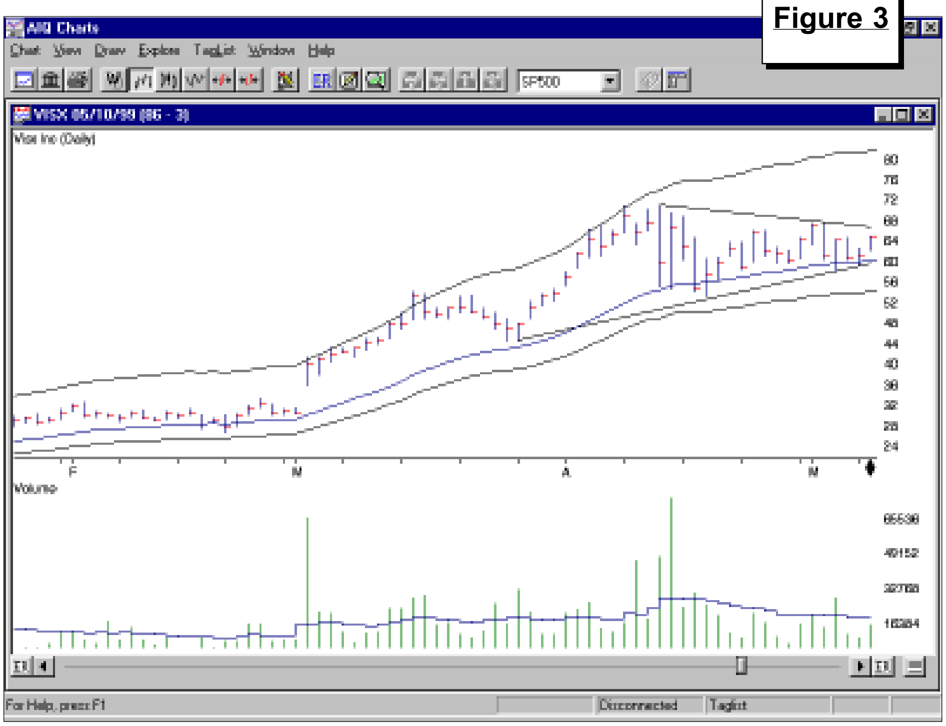
OBM: Last year, most of your recommended stocks were lesser known Nasdaq issues. Is that typically the case?

Zanger: It is typically true that I recommend Nasdaq stocks that are relatively new and have large increases in revenue growth, most at a rate of 40% per quarter. In fact, many of these stocks have revenue growth of 200-400% per quarter.

OBM: The Nasdaq market is notoriously unkind in trade executions. Do you run into problems when you execute Nasdaq trades for your hedge fund? Are limit orders necessary?

Zanger: Yes, I run into trade execution problems all the time. We have a machine that tracks each trade with a time stamp attached to each trade. We clearly know when we have been taken for a ride or not. We can present our case to the market makers

Figure 3



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INTERVIEW *continued* . . .

and more often than not they will go back and rectify the problem.

The average person can get unfair fills and there is not much you can do about it other than ask for a time stamp on the fill. If you are going to buy a stock at $80.00 and then five to ten weeks later the stock is at $100.00, much of that is forgotten. Paying an extra quarter for a stock that is going to run $100-$200 is completely meaningless.

I almost never put limit orders in unless I am trying to work a large order and the stock is in an area of good support. It is important to know the market. If you are in a fast market to the downside, then don't use limits.

OBM: You have used AIQ software for a number of years. Why do you like TradingExpert?

Zanger: I have used AIQ software for about 10 years and I find it very user friendly. I don't get fancy with the software because chart patterns are all that I find necessary. I plot price and volume and browse through charts, looking for patterns. Looking through the charts in rapid succession with a click of a button is the best way to learn chart pattern recognition.

OBM: Let's talk about risk control. How do you know when you should sell a stock?

Zanger: Selling securities is by far the hardest thing to do in the stock market. You can sell too early and miss a $40-$50 move in a matter of weeks, or you can sell too late and miss $30 to $40 points of profit. Knowing when to sell took me longer to learn than anything else in the market. An important thing I have learned is that if I sell a stock too early I may miss a $30-$50 advance. Yet, there is always another of my stocks close by that may advance $30-$50.

"When the break occurs, I am a seller. No questions asked. I have lost too much money by not obeying my trendlines and I won't let it happen again."

When I'm in a stock, I look at its support trendline in order to know when to sell. When the break occurs, I am a seller. No questions asked. I have lost too much money by not obeying my trendlines and I won't let it happen again. If the stock turns around and revalidates itself, I can always buy it back.

OBM: Market timing plays into your analysis. How do you determine when the market is bullish and when the market is bearish?

Zanger: I find the market is bullish when I can't easily buy a stock and I find the market is bearish when I can't give my stocks away at their current market prices. This probably is the easiest way to know what kind of market you are in. When stocks take a dip and buyers don't emerge, then sellers must take an additional discount to find buyers. That's when I know that I'm in a bearish situation. Conversely, if the stock runs up $15 in price and I am having trouble filling 10,000 shares, then I know there are few sellers. That is basically how I determine if the market is bullish or bearish.

Market timing is key to making large returns in the stock market. Buying stocks when the market is near the top after a lengthy run will cost you dearly, say 50% or so of your portfolio, if you don't implement a 7-10% selling rule.

Typically, after the Nasdaq has corrected 12 to 18%, stocks are at their cheapest and their basing patterns have been built for a significant duration of time. During the decline, fear is prevalent everywhere and buyers sit on the sidelines with large sums of cash ready to buy once the market begins to move up. There is a tremendous amount of buying pressure after a corrective phase. People realize they are missing a good run in the stock market so they put their sideline cash to work.

OBM: Thanks for sharing your thoughts with us. We look forward to your presentation at AIQ's October seminar. ■

S&P 500 Changes

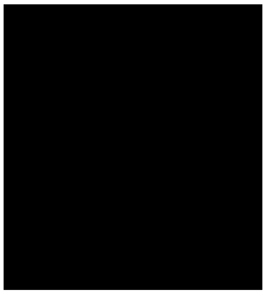
The following are changes to the S&P 500 Index and Industry Groups:

American Power Conversion (APCC) replaces Mirage Resorts (MIR). APCC is added to the Electrical Equipment (ELECTRIE) group.

Agilent Technologies Inc. (A) replaces NACCO Ind. (NC). Agilent is added to the Electronics-Instrumentation (ELCTRONI) group.

OPTION TRADING

Exploring Simplest Form of Option Trading — Buying Puts and Calls



DAVID VOMUND

By David Vomund

In the January 2000 *Opening Bell* we reviewed how options work and explained their terminology. We are now ready to explore the simplest form of option trading — buying puts and calls. While it is the easiest strategy to understand, it is also one of the most speculative.

AIQ's OptionExpert can be used to value either index or equity options. Index options were introduced in 1983 and have become increasingly popular. They give investors the right to buy a "basket" of stocks that make up an index, such as the Standard & Poor's 100 index (OEX). Although index options are based on a basket of stocks, cash, not stock, is delivered upon exercise.

While an equity option trader needs to consider the outlook for the market as a whole as well as the outlook of a particular stock, an index option trader need only consider the direction of the overall market. If you have been right about the market but wrong on the stock, you can appreciate this feature. Index options are also more liquid than equity options. The increased liquidity of index options, especially OEX options, provides for more trading opportunities with less slippage (loss due to the difference in the bid/ask spreads).

"AIQ's OptionExpert can be used to value either index or equity options...while an equity option trader needs to consider the outlook for the overall market as well as a particular stock, an index option trader need only consider the overall market."

On the other hand, if you're a skilled stock picker, equity options can produce higher returns than index options. While call option buyers lost money on the market in April, traders holding call options on Champion International (CHA) or Reebok Int'l (RBK) saw impressive results.

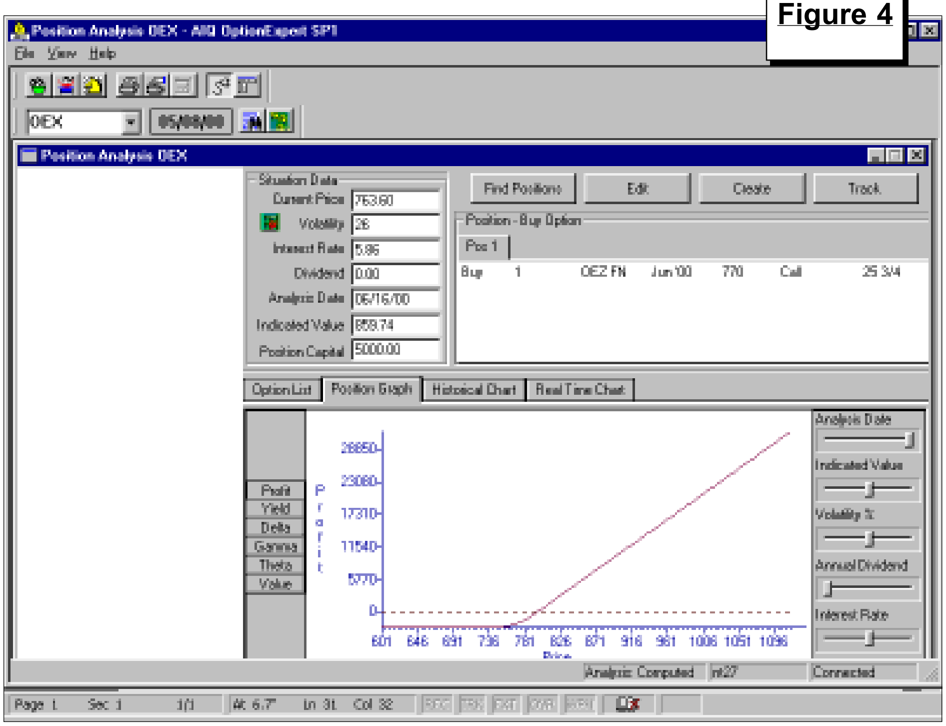
Since stocks have their own personalities, equity option players can find a good trade when an index option trader is forced to sit on the sideline. If the market is midway though a strong advance, it is likely that it is too late to buy index call options. An equity option investor can scan stocks to see which stocks have not yet participated in the market move.

Let's study the OEX June 770 call options as of the close on May 8. The option premium was $25 ¾ and the OEX was at 763.6. Assuming nothing changes but the OEX index itself, your break-even point at expiration requires the OEX to move to 795.75, a 32.15 point increase from the current level. This is calculated by taking the difference between the option's strike price and the current OEX value (770 – 763.6 = 6.40). Add to this the price of the options (6.4 + 25.75 = 32.15).

A graphical representation of this analysis is displayed in **Figure 4**. If the index is below the strike price of 770, the option expires worthless. As the OEX rises in value above the strike price, the option increases in value. Notice how the profit line passes through zero at approximately 796, just as we calculated above. The profit

Option Trading continued on page 6

Figure 4



OPTION TRADING *continued . . .*

curve increases as the OEX rises above 796 but losses are seen if the OEX fails to rise above that level.

As you can see, call and put options have unlimited profit potential with a limited loss. A limited loss sounds comforting until you consider that it means that you lost your entire option investment. Figure 4 can be reproduced for time periods between the current date and the expiration date by simply changing the *Analysis Date* in OptionExpert's Position Analysis window.

Proper input in the *Situation Data* box in the Position Analysis window is the key to successful option valuation. The three most important inputs are *Analysis Date*, *Indicated Value*, and *Volatility*.

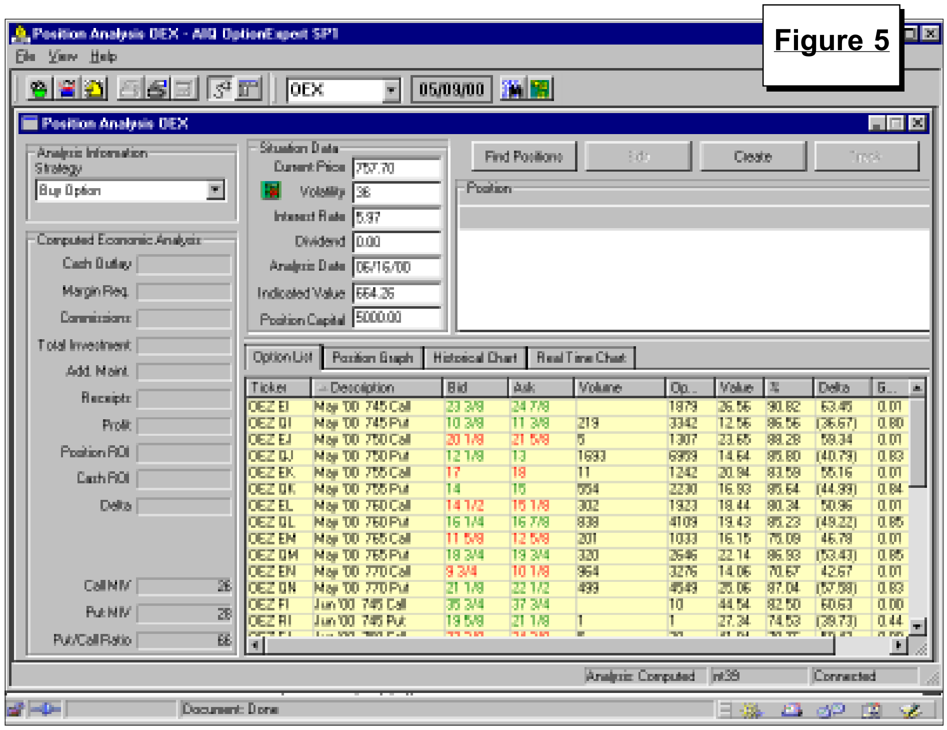
The *Indicated Value* is the value that you think the underlying security will move to during the time period that you hold the option. To determine indicated value, OptionExpert uses a mathematical formula based on recent price action. This value should not be taken as gospel however. Users may want to change the value to reflect their own idea of where the security will move. For call options, the indicated value should represent the minimum value that you expect the security to reach in the short-term.

Now that we have decided how far the security will likely move, we need to specify when it will reach our expected level. The *Analysis Date* field in the Situation Data box shows the nearest option expiration date, unless the current month's options are very close to expiration. This is usually sufficient unless your typical option holding period is significantly different from the default date.

Try changing the *Analysis Date* for several scenarios and see how the OptionExpert program will change the option or option strategy it recommends.

Volatility is a critical input in option valuation. The default value in the Situation Data box is computed

Figure 5



from historical price information downloaded from your data service via the internet.

Many option players prefer to use a "market implied volatility" (MIV) when evaluating option pricing. The historic volatility that is found in the Situation Data box looks at how volatile the security has been in the past while MIV is an estimate of how volatile the security will be in the future.

"Proper input in the Situation Data box in the Position Analysis window is the key to successful option valuation."

To determine MIV, you first assume that options with relatively large trading volume are fairly priced. If this is the case, prices can be plugged into the Black-Scholes option equation and the unknown variable, volatility, can then be solved for.

In other words, for each option that is traded on a security, implied volatility figures are computed so that each option is fairly priced. An average of the implied volatilities, weighted by volume traded, is computed to get the overall MIV of the security. This volatility figure can then be used to see which options are expensive or cheap relative to the other options on the same security.

If this sounds complicated, have no fear — the computer will do it for you. Near the bottom of the Computed Economic Analysis on the Position Analysis window box are the MIV figures for call options and for put options. In **Figure 5** we see that the MIV for call options is 26 and the MIV for put options is 28. The historical volatility is 36, which is found in the Situation Data box.

In general, if MIV is less than historical volatility then the options are cheap. If MIV is greater than historic volatility then the options are expensive. By entering the MIV value into the volatility slot in the Situation Data box you can see how the recommended positions change.

Recommendations

Only buy options with money that you hope to get rich with

OPTION TRADING *continued . . .*

but can afford to lose.

It is estimated that 80% of option buyers lose money. If you can't stomach a 50% loss in a day, option buying is not for you. Options should constitute no more than 10% of your portfolio.

Keep in mind -- you are limited by the time element of options.

Good investments often take time. Time premium is lost if the investment doesn't quickly move in your favor. Unless your investment time horizon is less than a few days, only buy options with over a month remaining until expiration.

Set goals for yourself.

A common mistake is not closing a position if premiums fall, hoping instead for an improvement before expiration. This can often lead to a 100% loss. It is best to exit a position when you have a loss of between 30% to 50% on your initial investment.

Also, avoid riding a successful position too long, hoping for yet more profits before expiration. If your option doubles, consider selling half your position, thereby giving you a "free trade" for the balance of the options.

Use limit orders for low volume options.

Be patient if your order is not initially filled and resist the urge to chase the market (some brokers do not accept limit orders). ■

MARKET REVIEW

May was an active month for the market and for the AIQ timing model. The model switched to a sell mode early in the month. On May 3, the model registered a confirmed 100 sell signal. This signal was short-lived as the model gave a 98 buy on May 5, a 97 buy on May 11, and a 98 buy on May 12. These signals were not confirmed until May 12 when the Phase indicator increased in value.

Mid-month the market remained in a choppy trading range and the system registered a confirmed 99 sell signal on May 19. The market fell near month's end and the timing model registered a series of buy signals. A 98 buy signal on May 26 (confirmed on May 30) was followed by a 100 buy on May 30 and a 99 buy on May 31. ■

STOCK DATA MAINTENANCE

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

Stock	Ticker	Split/Div.	Approx. Date
AES Corp	AES	2:1	06/02/00
AVX Corp	AVX	2:1	06/02/00
Kemet Corp.	KEM	2:1	06/02/00
Medimmune Inc.	MEDI	3:1	06/05/00
EMC Corp	EMC	2:1	06/05/00
Power One Inc.	PWER	3:2	06/05/00
Calpine Corp.	CPN	2:1	06/09/00
Anaren Microwave	ANEN	3:2	06/12/00
Vishay Intertech	VSH	3:2	06/12/00
Private Media	PRVT	2:1	06/12/00
Int'l Bancshares	IBOC	5:4	06/13/00
Robert Half	RHI	2:1	06/13/00

Stock	Ticker	Split/Div.	Approx. Date
Hanover Compressor	HC	2:1	06/14/00
Nextlink Comm.	NXLK	2:1	06/16/00
Juniper Networks	JNPR	2:1	06/16/00
Inter Parfums	IPAR	3:2	06/16/00
Cyber Optics	CYBE	3:2	06/16/00
Dow Chemical	DOW	3:1	06/19/00
C&D Techs	CHP	2:1	06/19/00
Virata Corp	VRTA	2:1	06/20/00
Meade Inst.	MEAD	2:1	06/20/00
SCP Pool Corp.	POOL	3:2	06/20/00
SEI Investment	SEIC	2:1	06/20/00
Dollar Tree Stores	DLTR	3:2	06/20/00

Trading Suspended:
Cordant Technology (CDD), Fruit of the Loom (FTL), Johnson Industries (JII), Jostens Ind. (JOS), Newbridge Networks (NN), Reynolds Metals (RLM), TCBY Ent. (TCBY), U.S. Home Corp. (UH), uBid Inc. (UBID), United American Healthcare (UAH), Wicor Inc. (WIC)

Name/Ticker Changes:
Armstrong World Inds. (ACK) to Armstrong Holdings Inc. (ACK)
Borg Warner Auto (BWA) to Borg Warner Inc. (BWA)
China.com Corp (CHINA) to Chinadotcom Corp (CHINA)
MCI Worldcom Inc. (WCOM) to WorldCom Inc. (WCOM)
United Healthcare Corp. (UNH) to UnitedHealth Group Inc. (UNH)

PARABOLIC SAR

Short-Term Swing Traders — This New TradingExpert Indicator Is for You

By David Vomund

A new indicator called the Parabolic SAR has been added to AIQ's TradingExpert Pro. The "SAR" in this indicator stands for "stop and reverse." That means that with this indicator you are always in the market. You simply reverse the position when the stop level is reached. When you are on a buy mode and the stop is reached, then you switch to a sell (or short) mode. If you are on a sell mode and the indicator turns bullish, then you switch to a buy mode.

To see the Parabolic SAR indicator in the TradingExpert system, open a stock chart and click the ParaSAR indicator in the Control Panel. Since this indicator overlays the stock price chart, it is found in the upper half of the Control Panel.

The Parabolic SAR indicator is shown in **Figure 6**. The indicator gets its name from the shape assumed by the trailing stops that tend to curve like a parabola. Dots below prices indicate a long position while dots above the prices indicate a short position. The dots represent the stop and reverse points.

Figure 6

As the prices move higher, the rising dots below the price action tend to start out slow and then accelerate with the trend. The slow start in the indicator allows a trend to take place. As the stock moves higher, there is an acceleration factor and the indicator moves faster until it catches up to price action. The same is true for stocks that are falling.

This is a trend following indicator so it obviously works best on volatile stocks that are in trends. Even on trending stocks, there will be whipsaws. In Figure 6, the indicator kept traders in Conexant's early year rally and kept traders out of the March and May drop. It only took small signs of strength in late March and early April to get Parabolic SAR whipsaw signals. This indicator is designed for short-term traders.

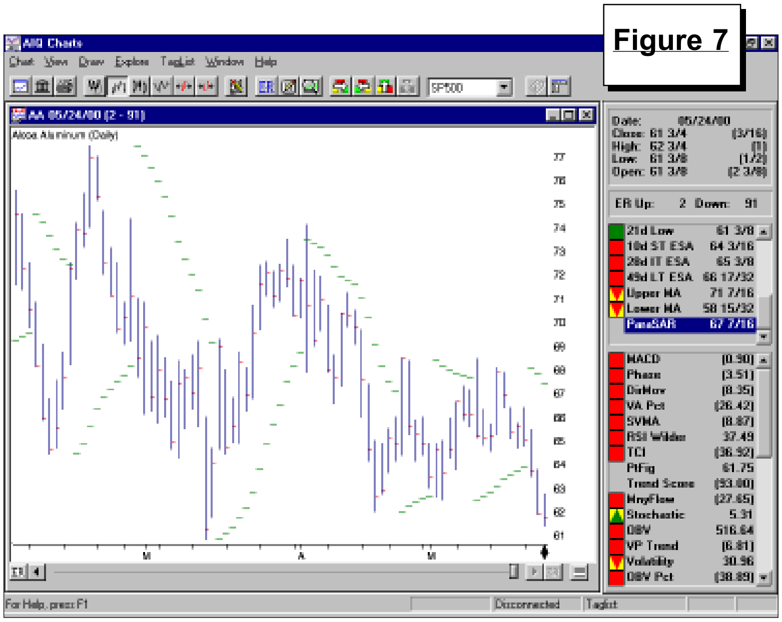


Figure 7

It is important to apply the Parabolic SAR to stocks with a lot of volatility and stocks that typically move in strong trends. The Conexant example in Figure 6 is a case where the stock exhibited strong trends and the indicator worked well. In **Figure 7** we see a more conservative trendless stock. In this example, the indicator is ineffective and simply gives whipsaw signals.

For short-term swing traders who deal with volatile stocks such as those found on the Nasdaq, the Parabolic SAR indicator may help improve entry and exit points. ■