AIQ Opening Bell Newsletter

March 2002 Vol. 11 Issue 3

In This Issue

This 10th Anniversary Issue includes timeless articles from earlier editions. These articles pertain to concepts for successful trading that are as valuable today as when first published.

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From June 1994 Opening Bell

Learn To Enjoy Your Losses

By Dr. J.D. Smith, AIQ Systems Founder

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.

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

10th Anniversary Issue
March 1992 to March 2002

Editor's Note: See page 3 for an explanation of Dr. Smith's DOFPIC attitude.

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 1. On January 10, the AIQ expert

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JD Smith Photo
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Dr. J.D. Smith founded AIQ in 1985 to develop stock market software specifically for use on desktop personal computers, utilizing the same expert system methodology used for mainframes. In 1986, he introduced AIQ's first stock market system, the world's first Artificial Intelligence-based expert system for stock market trading available for personal computers. The first version of AIQ TradingExpert was released in 1992.

Dr. Smith sold AIQ Systems to Track Data Corporation, New York City, in 1994.

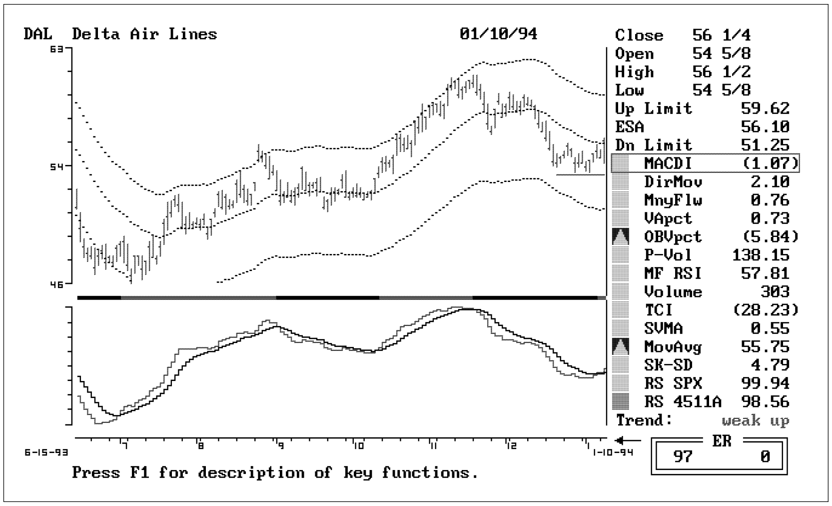

Figure 1. Delta Airlines chart on 01/10/94 with MACDI

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 2). 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 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 3.

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,

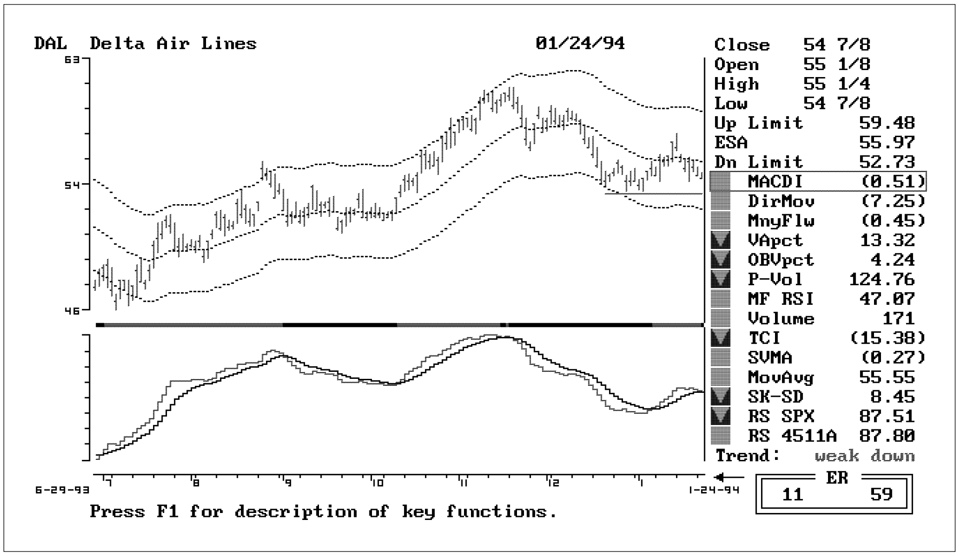

Figure 2. Delta Airlines chart on 01/24/94 with MACDI

DOFPIC: The Winning Attitude

What is it about our best users that causes them to be successful traders month after month, year after year? The answer is not how they use our systems, because there are almost as many ways of using them as there are successful traders. The answer lies in personal trading habits.

I have found that the successful trader has a detailed personal trading process that is executed in exactly the same way all the time. Without such a trading process, the chance of consistent success is severely reduced. The question now becomes — how does one develop a trading process?

Developing a trading process can be an interesting challenge because, to be useful, it must be personal. This is important because in order for our trading process to be effective it must match our personality; it must take advantage of our strengths and it must compensate for our weaknesses.

Thankfully, there exists a body of knowledge to assist in developing such a plan. The general theory of command systems offers useful concepts of planning and control. The literature on trading techniques and trading discipline offers numerous personal qualities which have an impact on trading success. Combining planning and control concepts with the qualities of good trading practice provides us with a suitable framework upon which to build our own trading process.

None of these personal qualities are particularly new. They are heavily discussed in the literature on personal behavior as well as trading. None of the planning concepts are new. They have been developed over many years of study of command and control theory. What is new is the handle I have given to this combined approach. I call it DOFPIC, which stands for the qualities necessary for successful trading: Discipline, Organization, Focus, Patience, Independence, and Confidence.

The qualities represented by DOFPIC transcend trading the stock market, but they have special significance here because adroit application of these qualities will allow us to meet some of our personal objectives.

Discipline is the ability to follow our trading plan, which allows us to control the fear and greed that are the prime motivations moving the market.

Organization is the specific process — the daily logs, the money management rules and the risk management stops we use to execute the plan.

Focus is the quality that allows us to be specific on which market instruments we trade and our role in the trading process.

Patience is a constant reminder to trade carefully and to wait until our market has a shape that offers a very good chance of success.

Independence is the ability to ignore advice and tips from people outside of the AIQ world, people who most certainty know less about what is going on than we do.

Confidence in our self and in our trading process follows from the other qualities, and is absolutely required for successful trading. – *Dr. J. D. Smith*

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 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. 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.

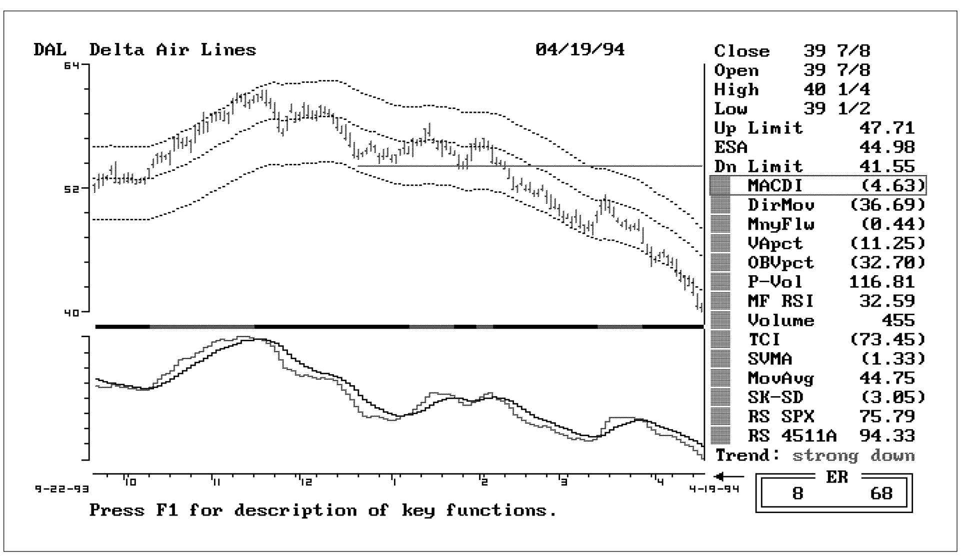

Figure 3. Delta Airlines chart on 04/19/94 with MACDI

From August 1997 Opening Bell

Linda Bradford Raschke On Short Term Trading Strategies

By David Vomund

This month we are pleased to present an interview with Linda Bradford Raschke. Linda is President of LBRGroup, a firm specializing in trading and commercial hedging. She is featured in Jack Schwager's book *The New Market Wizards* and coauthored the best selling book *Street Smarts - High Probability Short Term Trading Strategies.*

> *"The worst thing you can do in terms of market timing is to buy in the middle of a trading range. Either buy new highs, or buy pullbacks, but don't put your capital to work in the middle of a trading range."*

DV: *Thanks for joining us for this interview. In your book 'Street Smarts' you give several strategies for short term traders. Do you think that anyone can trade short term or are certain personality traits required to be a successful short term trader?*

LBR: Anybody who wants to can be a successful short term trader. In terms of personality, you either want to trade or you don't. People who like to trade tend to be more active traders. These are the people who do well in the markets. Several studies of FCM (Futures Commission Merchant) accounts have shown that the most successful traders are those with the highest activity levels.

Even the best intermediate term investors who use trend following systems constantly massage and adjust their positions. All the people I know who are able to support themselves by trading tend to be very active. But in the most recent stock market environment, one has obviously been able to do well by good old fashioned investing!

DV: *How much is your own judgment a factor in your trading?*

LBR: I have found that I do better using discretion as opposed to trading a system. There are a few select systems that I trade because they force me to place a trade that I might otherwise feel far too uncomfortable with using my own discretion. These systems serve as the trigger. Many of the patterns discussed in *Street Smarts* actually have a mechanical entry or trigger to make it easier for people to trade. The system keeps them from failing to pull the trigger.

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Linda Bradford Raschke

For example, it is helpful to have buy stops resting in the market which will automatically take you into the trade, but then you must manage the trade in terms of how the market responds.

DV: *In 'Street Smarts' you say that the single most important secret is this: 'Listen to the markets and do not impose your will upon them.' Can you expand on this?*

LBR: It simply means not letting your positions speak for you. A lot of people get into scenario building. They might examine what they perceive to be fundamental data and then make evaluation judgments. For example, they may think the market is too high so they go short. On the other side of every

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Holy Grail Pattern

Buy rules (sells are reversed)

1. The 14-period ADX must initially be greater than 30 and rising. This is the value to the right of TradingExpert's ADX/R indicator.
2. Look for a retracement in price to the 20 period exponential moving average. This will usually be accompanied by a turndown in the ADX.
3. When the price touches the 20 period moving average, put a buy stop above the high of the previous bar.
4. Once filled, enter a protective sell stop at the newly formed swing low. Trail stops as profits grow.

trade is somebody who is equally convinced that it is going in the opposite direction. Who is right? The market is. The market is going to do what it wants regardless of your convictions.

If you pay attention to what the market is saying rather than forcing your will on the market, it will give you subtle clues as to what it is going to do. For example, moves often start in either direction with an impulse and a thrust. It may be a range expansion, an increase in standard deviation, a breakaway gap, or even a failure to make a lower low. There is always a message but you are not going to pick it up unless you have an open mind.

DV: *You say consistency is a necessity for successful trading, but every trader has losing steaks. How do you treat these losing streaks and do you ever get the urge to change your strategy when they occur?*

LBR: Consistency speaks in reference to following a specific methodology. Unfortunately, most methods don't always work in all market conditions and market conditions never persist forever. What happens is that the minute you become discouraged with a particular methodology and abandon it, market conditions change and the system begins to work again. You end up exiting every methodology at its low draw down on its equity curve so you are always one step out of sync. If you are always switching strategies, you are probably just leaving the one that is ready to kick in.

Figure 1. Cincinnati Milicron chart showing Holy Grail Pattern buy signal 6/23/97 & 6/24/97

As for losing streaks - a losing streak for most professionals is more than likely to be characterized by a flat period instead of huge losses. There is absolutely no reason in this business for small losses to become big losses. Unless you are following a trend following system which gets whipsawed during consolidations, losing streaks come from sloppy habits, trader error, or stubbornness.

I have never been tempted to change my style because I feel that my patterns and strategies don't change. The market is very basic - you buy pullbacks in a trending issue, you buy divergences, or you buy breakouts from congestion areas. Likewise on the sell side. These things don't change over time.

DV: *How important is market timing in your analysis?*

LBR: Very important. It helps determine how much you want to risk and it helps determine the degree of follow through. If your timing is such that you are hopping on board right when there is an increase in momentum, then you have greatly increased the probability of follow through in your direction. Likewise, if you are not in a period of high momentum, then you may want to buy on a pullback or at the lower end of a trading range to minimize your risk.

The worst thing you can do in terms of market timing is to buy in the middle of a trading range. Either buy new highs, or buy pullbacks, but don't put your capital to work in the middle of a trading range.

DV: *AIQ users are primarily equity traders rather than futures or commodities*

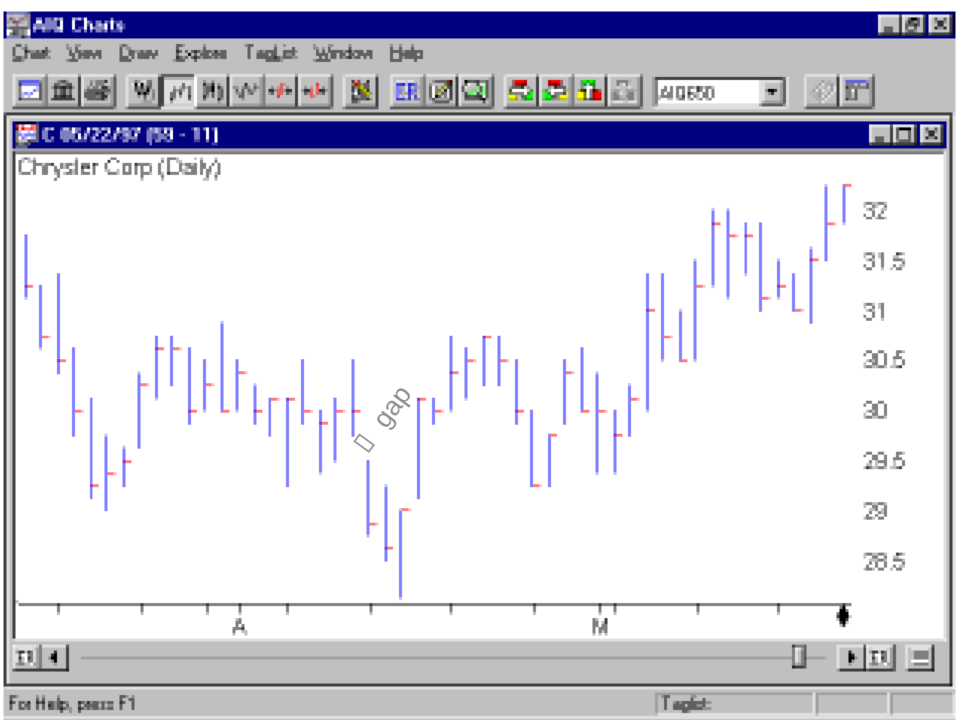

Figure 2. Chrysler chart showing Unfilled Gap buy signal on 04/11/97 followed by immediate price reversal

traders. Do you trade stocks or are you primarily a futures trader?

LBR: I trade stocks as well. People don't appreciate that small investors have much more flexibility, especially in stocks, than institutional investors. Small investors don't have to move as much size, they don't have to justify their decision making process to stockholders, and they don't have to show that they are 95% invested long at the end of the quarter. Institutional investors always have a different type of psychological gun to their heads.

DV: *One of the easiest patterns to find that is listed in your book is the Holy Grail (see page 4). Can you explain this pattern and give us a few examples?*

LBR: This pattern uses Welles Wilder's ADX (Average Directional Index), which measures the strength of a trend over a period of time. The stronger the trend, the higher the ADX reading. This pattern takes advantage of the fact that the odds are very high that when a security makes a new momentum high and pulls back, it will retest its recent high. Therefore, any pullback from a new momentum high can be bought.

Most people hesitate to buy pullbacks because a top may be in place. With this pattern, the odds that a top is in place is probably only 5% to 10%. If you look at stocks that have participated in the market's advance in the last two or three months, you'll see the majority of them have had Holy Grail patterns.

Three-Day Unfilled Gap Reversals

1. Today the security gaps lower and does not fill the gap.
2. Over the next three trading sessions, have in place a buy stop one tick above the high of the gap-down day.
3. If filled, place a protective sell stop at the low of the gap-down day.
4. Protect any accrued profits with a trailing stop.
5. If not filled after three trading sessions, cancel the initial buy stop.

Wolfe Wave Construction

1. Wave 2 is the top of a bar chart.
2. Wave 3 is the bottom of the first decline after wave 2.
3. Wave 1 is then the bottom prior to the wave 2 top. Point 3 must be lower than point 1.
4. Wave 4 is the top of wave 3. Wave 4 should be higher than the wave 1 bottom.
5. A trend line is drawn from point 1 to point 3. The extension of this line projects to the anticipated reversal point which we call wave 5. This is the entry point for a ride to the target line (1 to 4).
6. The price objective of this pattern is from a trendline drawn from points 1 to 4. The initial stop is placed just beneath the newly formed reversal at point 5. It can then be quickly moved to break-even.

Note: You cannot begin looking for the Wolfe Wave until points 1, 2, 3, and 4 have been formed.

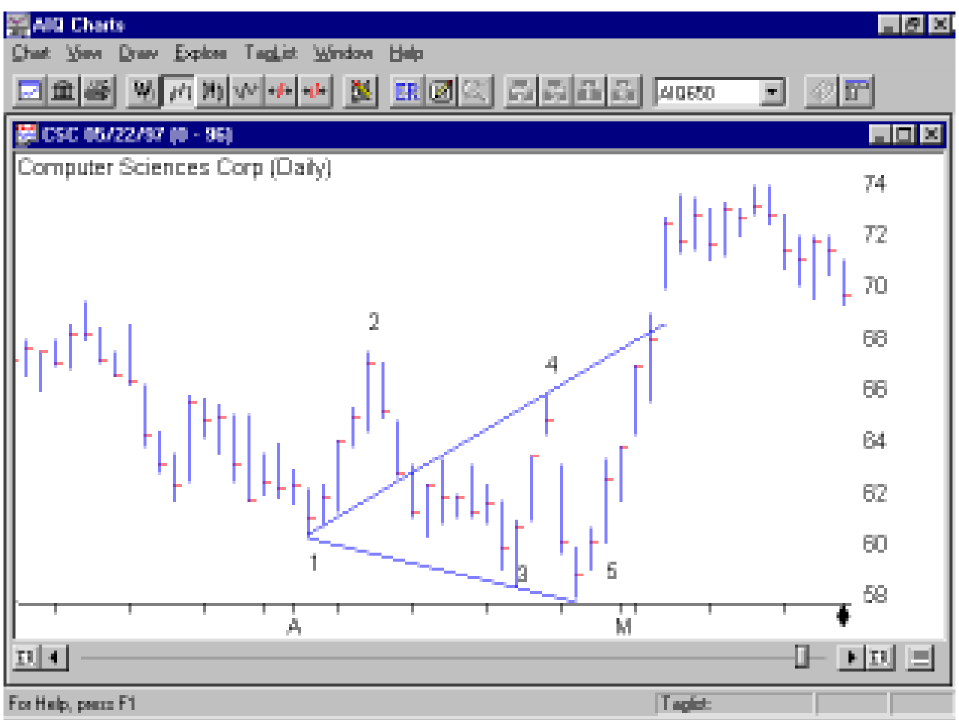

Figure 3. Computer Sciences chart with Wolfe Wave pattern buy signal on 04/28/97

The 20 period exponential moving average often acts as support for stocks. Recently, Chevron (CHV) provided a good example. With the Holy Grail pattern, we want the stock to fall back to a 20 day moving average after its ADX indicator has moved to a value above 30.

A good example of a Holy Grail buy is Cincinnati Milacron (CMZ) on June 23 and 24 (Figure 1, page 5). CMZ touched the moving average and then continued to rally to a new high. Another example can be seen in American Express (AXP). AXP touched the moving average on July 1, rose the next day, and then jumped 7 points the following day.

DV: *TradingExpert has a Price Gap report which makes it easier to spot the Three-Day Unfilled Gap Reversal pattern. Can you give us some examples of this pattern?*

LBR: Gaps are a classic tool in technical analysis. There are different types of gaps such as breakaway gaps or exhaustion gaps which come at the extremes. The Three-Day Unfilled Gap Reversal signals periods where the security has exhausted itself and a reversal is close at hand. A lot of stocks had beautiful buy setups in April of this year. If you look at Chrysler (C) you will see a perfect example (Figure 2, page 5). On April 11, Chrysler gapped down (see arrow). Two trading days later, the April 11 high point was surpassed. Other examples can be seen in Sears (S) and General Motors (GM).

DV: *Another strategy that only uses price analysis is a pattern you call the Wolfe Wave. Can you give us some examples?*

LBR: I'll give you several examples because once you study this chart pattern you will automatically get a magically trained eye and will be able to immediately recognize the pattern. Keep in mind that when you look at this pattern you are seeing accumulation or distribution. In the last two months, we've been in a very strong upward move. There are many examples of Wolfe Wave buys in April and May and now fewer are appearing as the market moves higher.

A good example is Computer Sciences Corp (CSC) during April (see Figure 3). Wave 1 was on April 2, wave 2 on April 8, wave 3 on April 22, and wave 4 on April 24. The buy came on April 28. Interestingly, there was also a Wolfe Wave buy on July 1 but that is more readily seen using hourly data.

Another example is Bristol Myers Squibb (BMY) which gave a buy on April 14 (see Figure 4). Yet another example is Disney (DIS) which also gave a buy on April 14. Since the overall market is so strong, the stocks have rallied past their target prices.

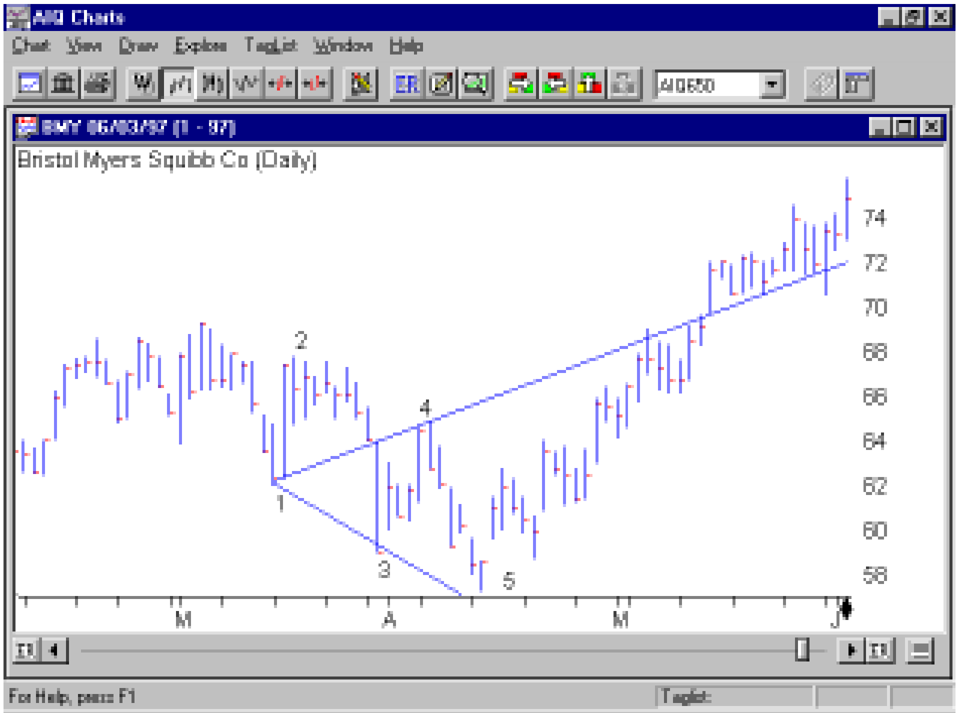

Figure 4. Bristol Myers Squibb chart with Wolfe Wave pattern buy signal on 04/14/97 (see position 5 on chart)

You have to train your eye for sell signals as well. An example on the sell side is Ralston Purina (RAL). In Figure 5, the pattern on the sell side is simply a reverse of the buy side. RAL gave a sell on June 13 and the stock fell right to its target.

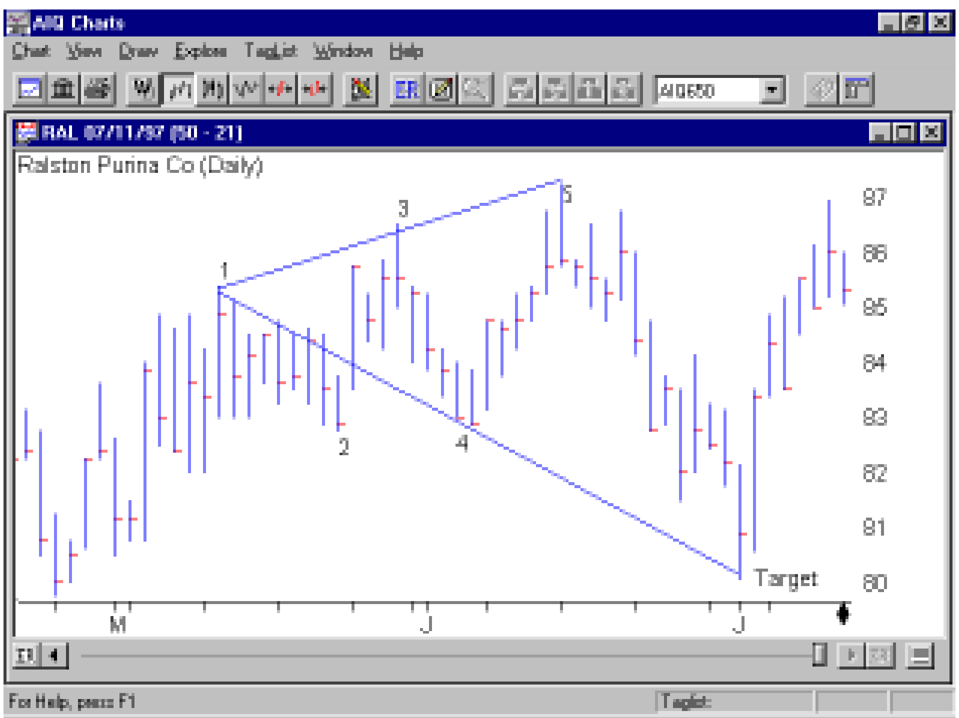

Figure 5. Ralston Purina chart with Wolfe Wave pattern sell signal on 06/13/97 (see position 5 on chart)

DV: *Let's talk a little about stop strategies. Obviously you keep them pretty tight.*

LBR: Different patterns have different stops. Most often, I'll get out if the market fails to do what I thought it would do. The best patterns give you instant feedback. How tight a stop you use depends on how aggressive or conservative you are. If a trade feels uncomfortable, I sometimes find it easiest to place an order to exit the market on close. This takes away the psychological anguish of trying to time the exit.

DV: *It is nice to be able to sleep at night! Thanks for the interview and we look forward to seeing you at our AIQ seminar in September.*

Please Note

The information in this newsletter is believed to be reliable but accuracy cannot be guaranteed. Past performance does not guarantee future results.

From March 1992 Opening Bell

Welcome to the Machine

By David Vomund

Technical analysis can be intimidating. Many investors would like to use technical analysis in their investment selections but do not feel comfortable with their own interpretation of technical indicators. A simple way around this dilemma is just to buy on a confirmed up signal and sell on a confirmed down signal. The other analysis that we talk about, such as looking at divergences in the MACD or examining a stochastic, is used to give added confidence to your trading decisions and increase profits beyond that which you would receive by using a strictly mechanical system. This month we'll test a simple mechanical system on TradingExpert and take a look at the results.

AIQ's Mechanical Trading System is introduced by David Vomund in this article that appeared in the first issue of the Opening Bell Newsletter (March 1992).

We conducted a study testing TradingExpert signals back to 1986. When a market buy signal occurred, a Weighted Action List report was run and the top 15 stocks from a database consisting of the S&P 500 were bought and held until a market sell signal was given, at which time we moved to cash. Confirmation techniques were ignored and only signals of 95 or greater were used.

There are two main assumptions in this study. First, the S&P 500 database that we used consists of the current S&P 500 stocks. When we knew a stock was not in the S&P 500 at the time of a buy signal, the stock was ignored. However, there are probably several instances when a stock was purchased that was not in the S&P 500 index at the time of the buy signal. Second, trading commissions are not factored in. You will want to look at your commission rate and the number of stocks you buy on a given signal to see if the net return remains above the return on the S&P 500.

The results are shown in **Table 1**. Without the use of an Expert System, simply buying and holding the S&P 500 during this six year time period produced a return of 92%. If you were to buy the S&P 500 only during time periods of TradingExpert buy signals and moved to cash during sell signals, you would increase your return to 282%. By running a Weighted Action List report and buying the top 15 ranked stocks on market buy signal and selling the stocks on a market sell signal, your return would increase to 531%, excluding commissions. Not bad for a strictly mechanical system.

When this article was published in 1992, AIQ didn't have group analysis and only a few screening reports were available. This was a test of AIQ's original technology, the Expert Ratings.

After the article was published we began tracking the portfolio using five stocks as a fully invested portfolio. In addition, we began factoring in a commission of $33 per trade. In 1998 the commission rate was lowered to $20 per trade. These were the only changes made to the original system. Dividends and interest were never factored in.

Table 1

S&P 500 Gains 1/7/86 to 2/24/92 Backtest

Buy and Hold	92%
AIQ Market Timing	282%
AIQ Mechanical System Portfolio	531%

As before, only S&P 500 stocks were purchased and the stocks had to be priced over $10.

*Each quarter, we updated the strategy's results and since 1995 we have published its yearly results in the Opening Bell. The results have been outstanding. **Table 2** shows the yearly results and overall return. Since 1992 the AIQ Mechanical Portfolio is up 438% with only one losing year! The trading system developed in 1992 has withstood the test of time.*

Table 2

AIQ Mechanical System Portfolio

1992	13.53%
1993	17.26%
1994	35.75%
1995	18.90%
1996	27.88%
1997	37.73%
1998	76.23%
1999	2.32%
2000	4.94%
2001	-24.78%

AIQ Trading Return = 438%

S&P 500 Buy and Hold = 175%

Past performance does not guarantee future results.