AIQ Opening Bell Newsletter

March 2004 Vol. 13 Issue 3

In This Issue

The Opening Bell Newsletter is a publication of AIQ Systems P.O. Box 7530 Incline Village, Nevada 89452

Trading With The Market

Analyze Market Conditions -- Then Decide Which 'Trading Tool' Is Right for the Job

By Steve Palmquist

STEVE PALMQUIST

Steve Palmquist is a full-time trader with nearly 20 years of experience. He is the founder of www.daisydogger.com, which provides free market analysis, trading tips, and educational material. Steve is also the publisher of the "Timely Trades Letter" available through the web site.

As a full time trader I am often asked, "What is the key to successful trading?" That is a bit like asking which is the most important part of the body, the heart or the liver? You can't live without either one. Just as the body needs more than one key part to survive, the trader needs to master more than one "key to success."

It is the mastery of several different aspects of trading that leads to success. It takes time, and it will cost you something to learn. Mastering the trading profession, like many other professions, is well worth the tuition you invest.

Analyzing Market Conditions

Learning to trade with the market is one of the keys to taking results to the next level. Looking at **Figure 1** (page 2), it's clear that long strategies with holding periods measured in months were not trading with the market during the 2000-2002 period. However, there are some long strategies with short holding periods that worked during this period. There are also a number of short strategies that worked during this period.

Trading with the market requires a variety of strategies that are known to work in different market environments, and a method for determining which strategy to use at any particular time – or in a particular market condition. TradingExpert Pro is an excellent tool for developing and testing these strategies.

I have a dozen different scans that I

run every evening. These scans look for long and short pullback setups, volume accumulation, volume distribution, and patterns. I have tested these scans in bullish, bearish, and sideways trading market periods, so I know which ones to use in a given market environment. These scans constitute my Trading Toolbox. Prior to trading, I analyze the market to determine which tool is right for the job.

Analyzing market conditions is so important that I write down my observations each evening as I prepare for the next trading day. I started sharing these observations with my friends, which encouraged me to focus on an objective look at the market. It is this process which eventually led to publishing the *Timely Trades Letter*. Whether you ever publish a letter or not, I encourage you to write down your analysis on the current market conditions every evening. Write a newsletter for yourself. This process will improve your trading.

Try not to be bullish or bearish — just focus on where key support and resistance levels are and what these levels imply for trading. When you decide you're bullish or bearish, there is a tendency to then find reasons to justify your position, especially if you follow the news. Instead, determine what type of market environment it is and which of the tools in your toolbox should be used.

I have found NASDAQ trendlines and moving averages to be effective instruments for determining which trading tools should be used. During backtesting, I have found that several of my trading systems respond well to limiting long entries to periods when the QQQ is above its 30-day simple average. I also use trendlines on the NASDAQ to determine whether to focus on long or short scans, as shown in **Figure 2**.

Figure 1. NASDAQ three-year weekly chart.

Figure 2 shows a one-year period where the NASDAQ was basically unchanged. A long-term trader may have broken even for the year. When the NASDAQ was below the descending trendline, I would focus on short setups for swing trades. When the NASDAQ broke the descending trendline, I would begin to focus more on long setups for swing trades. This is part of the process of selecting the best tool for the job.

"Trading with the market requires a variety of strategies that are known to work in different market environments and a method for determining which strategy to use at any particular time…TradingExpert Pro is an excellent tool for developing and testing these strategies."

AIQ Opening Bell Newsletter

David Vomund, Publisher
G.R. Barbor, Editor
P.O. Box 7530
Incline Village, NV 89452

Figure 2 is a close up of the breakout of the descending 50-week moving average shown in Figure 1. The first ascending trendline after the break was drawn through the lows in early April and late May. As long as the NASDAQ was above this trendline, I continued to focus on long setups. The break of this trendline in early August caused me to stop placing long trades. A trendline break implies a change, which could be a basing period or the beginning of a retracement. I do not begin taking short swing trades unless there is a lower low formed after a trendline break.

The retracement of early August in Figure 2 did not form a lower low, so I redrew the upward sloping trendline through the new low as shown on the chart. This new trendline then became one of the filters for determining whether or not to continue taking new long entries.

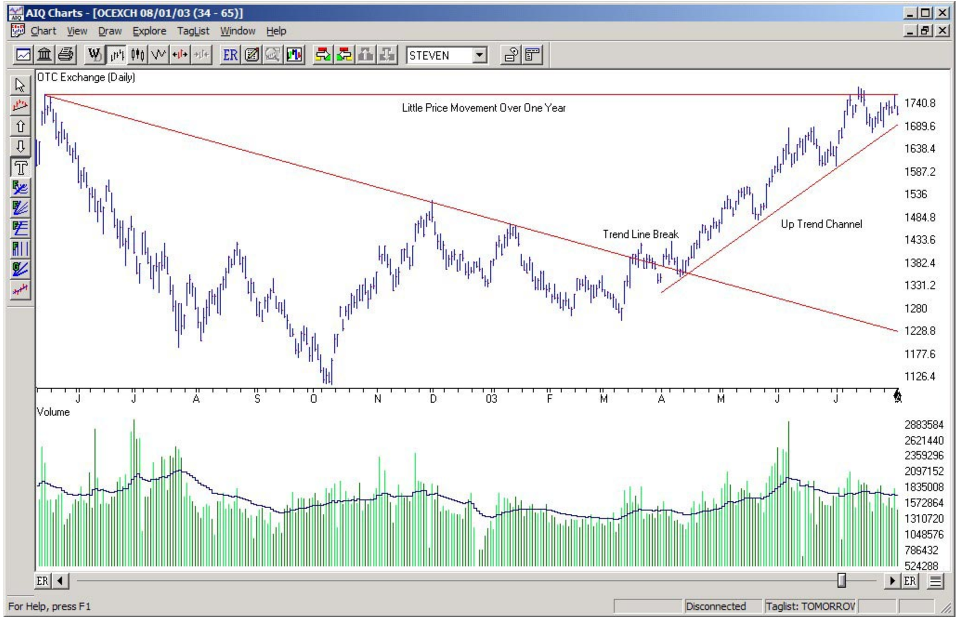


Figure 2. NASDAQ daily chart for 15-month period 05/02 through 07/03. Trendlines are used to determine condition of market and trading strategy that should be employed.

When the market is in a clear trend as shown in Figure 2, I generally use my tools for swing or intermediate-term trades. When the market is range bound as shown in **Figure 3**, I generally focus on short-term or swing trades. The pattern setups for all three types of trading are similar. The market conditions tell me which type of trading to do, and the type of trading determines the stop strategy.

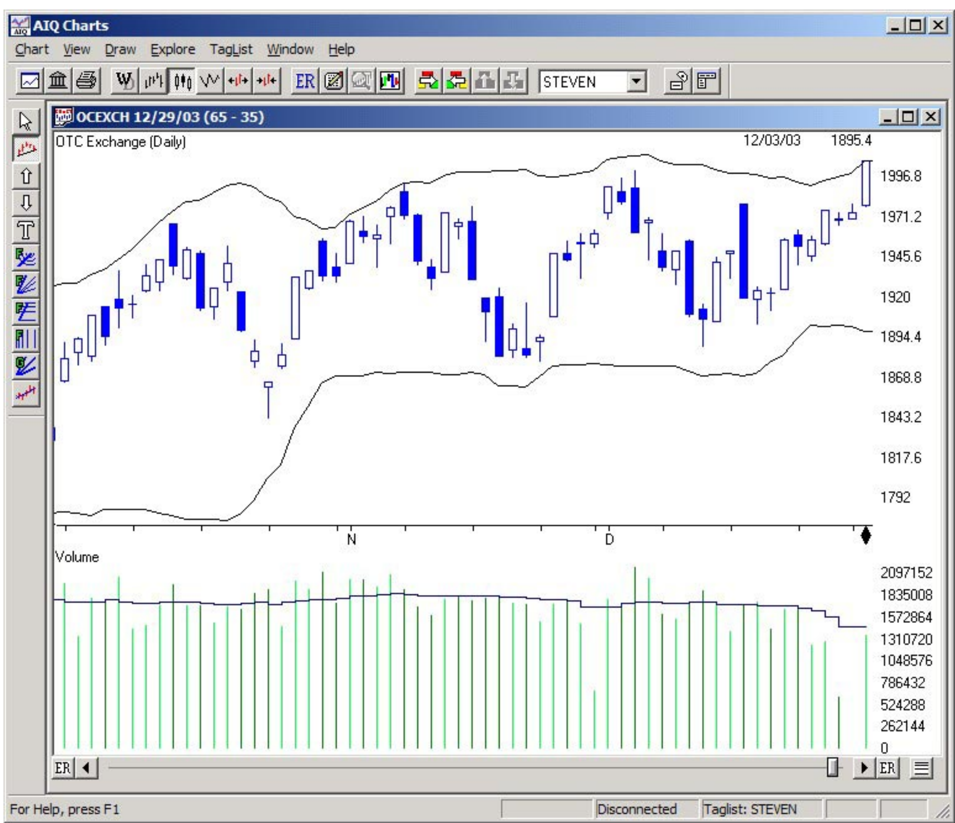


Figure 3. Candlestick chart of NASDAQ for period 10/03 through 12/03. During these three months, the NASDAQ remained within a narrow trading range.

Matching Trading Techniques to Market Conditions

Short-term trading involves just playing the breakout. Period. I typically sell after 1-3 days, or a profit of $1.50 or 4%. This approach can be profitable in range bound markets like the one shown in Figure 3 where longer-term trading just churns the account.

Swing trading involves placing an initial stop under the low of the setup pattern and trailing the stop as the trade moves up. This tends to be more profitable than short-term trading when the market is trending. More information on swing trade setups and stop loss techniques may be found at: daisydogger.com/Trading_Techniques.htm.

Intermediate-term trading starts with an initial stop under the low of the setup pattern and typically remains as long as market conditions remain favorable. I will sell when the stock or the market breaks a key trendline or shows signs of topping.

A range bound market such as shown in Figure 3 is a good place to use short-term or swing trading techniques. In the third week of November, the market was retesting the recent low set in late October. This type of situation can provide a reasonable risk entry for new long setups if the market shows a clear bounce off the lows, as it did with the large white candle the fourth week of November.

The reason for reduced risk is that if the bounce fails and the market were to drop below the support level of the previous four bars, it would be a signal the market was not ready to move to the top of the range and the longs could be quickly exited. It is usually best to trade with the market trend.

As the market approached the recent high (early November, Figure 3) short-term traders would consider exiting long positions in case the market retraces from the retest of recent highs. The short-term trader locks in profits as a range bound market approaches resistance, and then prepares to trade the short side if the market bounces off the resistance level or the long side again if the market breaks through the resistance level. When the market is in an extended basing period, this can be an effective technique.

"The market is a strong force that influences the outcome of most trades…Having different systems that test well for bull, bear, and sideways markets and selecting the right tool for the current market conditions can improve your results."

Eventually the market will break out of a basing area, which provides another reasonable risk entry in the direction of the break. The reason for reduced risk is that if the market should retrace and re-enter the basing area, a false breakout may be assumed and trades can be quickly closed. A breakout from a basing area is often a time to move from short-term trading to swing or intermediate-term trading.

Intermediate term trading techniques are best used when the market is in a clear trend. New trends often start with the break of an intermediate or long-term trendline, or a successful retest of a base breakout. In cases like this, consider swing trading until the market has established a higher low. After a higher low is established, use it to draw a trendline and consider intermediate-term trading techniques until the trendline is broken.

"Whether you ever publish a letter or not, I encourage you to write down your analysis on the current market conditions every evening. Write a newsletter for yourself. This process will improve your trading."

The break of the descending trendline in Figure 2 took a few weeks for the market to sort out. This is one reason why I don't immediately start intermediate-term trading when a trendline is broken by a point or two. To use intermediate-term trading rules the trend must be clear, which is usually not the case until a higher low has been established. From the time of the trendline break until a higher low is formed, consider using short or swing-trading techniques. Once a higher low has been formed (mid May of Figure 2) a trendline can be drawn and used to determine when to close intermediate-term trades.

These techniques are not exclusive. Uptrends will frequently be channels where both intermediate and short-term trading techniques may be used.

Short-term trading in a channel involves entering longs as the market bounces off the bottom of the channel, and closing them as the market approaches the upper channel boundary. Short-term short positions may be established as the market bounces off the top of the channel and returns to the lower channel boundary. Counter-trend shorting is for the experienced trader, and should be very short term.

Summary

The market is a strong force that influences the outcome of most trades. Taking all trades generated by a system regardless of market conditions will likely give you lots of practice at taking draw-downs and stop losses. Having different systems that test well for bull, bear, and sideways markets and selecting the right tool for the current market conditions can improve your results.

Rather than focusing on short, intermediate, or long-term trading, consider developing expertise in all three and letting market conditions determine which set of rules to use. In upcoming issues, I'll describe effective stock trading techniques for the different market environments.

Steve Palmquist can be reached through his *www.Daisydogger.com* web site.

Market Review

It's been a year since the S&P 500 corrected 5%. The market's advance since the bear ended last March has been stunning but that advance turned parabolic in December and early January. It wasn't until mid-January that the S&P 500 fell below an upward sloping trendline connecting the lows from the parabolic advance. Since that break, the S&P 500 has drifted sideways.

By the end of March, the S&P 500 was in a narrow trading range where 1160 represents the upper end of the range and 1120 represents the lower end of the range. While this index is in a trading range, overbought/oversold indicators such as the Stochastic are very effective.

During the period of consolidation, there has been a rotation from growth to value. The S&P 500 is in a trading range, but the Nasdaq Composite has underperformed and is in a pattern of lower highs and lower lows.

In March, commodity stocks did well while technology stocks faltered. Energy Services rose 6% and Basic Materials rose 5%. Defensive sectors like Leisure, Consumer Products, and Utilities also performed well.

The worst performing sector was Defense & Aerospace, which lost 7%. Electronics, Internet, and Biotechnology all lost 2%.

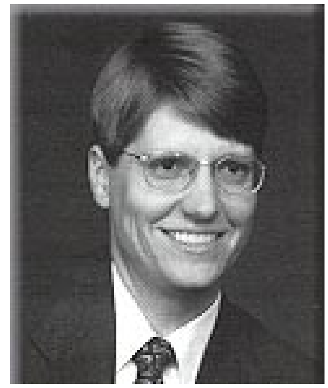
S&P 500 CHANGES

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

There are no changes this month.

Timer Digest National Ranking

AIQ's David Vomund Is Ranked As Top Ten Market Timer

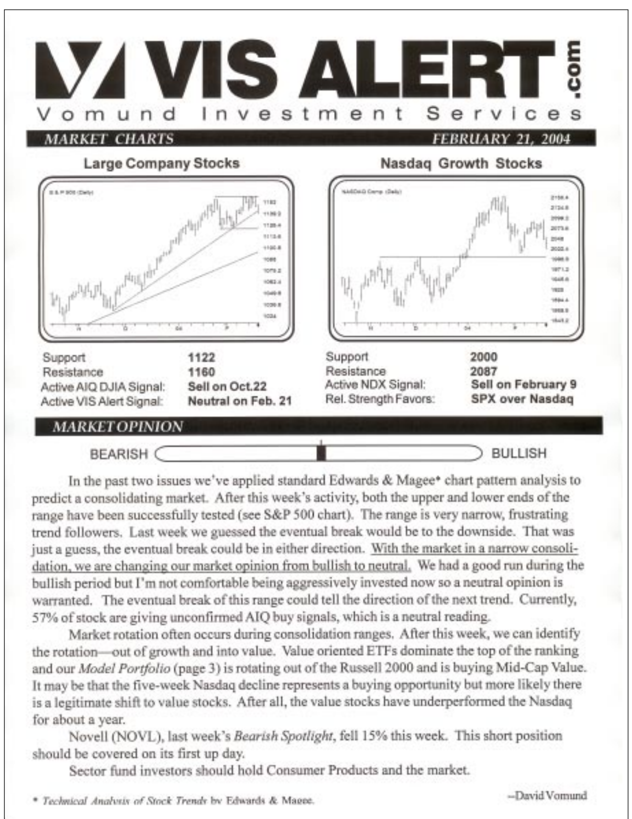


David Vomund

AIQ analyst David Vomund's advisory newsletter *VIS Alert* is ranked as one of the 10 best market timing newsletters in the nation by *Timer Digest* (*www.timerdigest.com*), an independent tracking service of newsletter market timing performance. Vomund uses unique tools found in AIQ's TradingExpert Pro to achieve this high ranking.

In addition to his work as senior analyst for AIQ and his contributions to AIQ's *Opening Bell* newsletter, David is president of Vomund Investment Services, publisher of the *VIS Alert* advisory newsletter. His market timing performance in *VIS Alert* ranks seventh best in the country by *Timer Digest* for the 10-year time period ending December 31, 2003. Vomund relies exclusively on TradingExpert Pro for his market timing decisions. As the market has changed over the last 10 years, his market timing techniques have evolved. He currently relies heavily on the unconfirmed signal ratio (US) found on the Market Log report and also on the reading of the Nasdaq's RSMD SPX indicator, an indicator unique to AIQ's TradingExpert Pro.

While others have temporarily held the top timer slot, Vomund takes pride in the consistency of his results. He explains, "an AIQ user once told me that the key to investment success is to understand that you can be wrong, but you can't be wrong for a long period of time. I've been on the wrong side of the market on plenty of occasions, but I don't stay there long."



VIS ALERT .com
Vomund Investment Services

MARKET CHARTS — FEBRUARY 21, 2004

Large Company Stocks | **Nasdaq Growth Stocks**

Support	1122	Support	2000
Resistance	1160	Resistance	2087
Active AIQ DJIA Signal:	Sell on Oct.22	Active NDX Signal:	Sell on February 9
Active VIS Alert Signal:	Neutral on Feb. 21	Rel. Strength Favors:	SPX over Nasdaq

MARKET OPINION

BEARISH — BULLISH

In the past two issues we've applied standard Edwards & Magee* chart pattern analysis to predict a consolidating market. After this week's activity, both the upper and lower ends of the range have been successfully tested (see S&P 500 chart). The range is very narrow, frustrating trend followers. Last week we guessed the eventual break would be to the downside. That was just a guess, the eventual break could be in either direction. With the market in a narrow consolidation, we are changing our market opinion from bullish to neutral. We had a good run during the bullish period but I'm not comfortable being aggressively invested now so a neutral opinion is warranted. The eventual break of this range could tell the direction of the next trend. Currently, 57% of stock are giving unconfirmed AIQ buy signals, which is a neutral reading.

Market rotation often occurs during consolidation ranges. After this week, we can identify the rotation—out of growth and into value. Value oriented ETFs dominate the top of the ranking and our *Model Portfolio* (page 3) is rotating out of the Russell 2000 and is buying Mid-Cap Value. It may be that the five-week Nasdaq decline represents a buying opportunity but more likely there is a legitimate shift to value stocks. After all, the value stocks have underperformed the Nasdaq for about a year.

Novell (NOVL), last week's *Bearish Spotlight*, fell 15% this week. This short position should be covered on its first up day.

Sector fund investors should hold Consumer Products and the market.

—David Vomund

* *Technical Analysis of Stock Trends* by Edwards & Magee.

For information on David Vomund's VIS Alert Newsletter, visit *www.visalert.com.*

Updated Performance: Market Sector Strategies

Our 'Relative Strength Report Strategies' Outperform S&P 500 by Wide Margin

By David Vomund

In the October and December 2003 *Opening Bell* newsletters, we focused on mechanical trading systems that took advantage of AIQ's Relative Strength report to trade market sectors. One strategy trades ETFs (Exchange Traded funds) that track various market segments while the other strategy trades the Fidelity sector funds. In this article, we'll update their performance.

Style Index Strategy (ETFs)

AIQ is known for spotting sector rotation. Our Style Index strategy applies the concepts of sector rotation but instead of buying individual sectors, the strategy rotates to the best performing market segments. These market segments include large-cap growth, large-cap value, small-cap growth, small-cap value, and a mid-cap index.

> ***"The Style Index strategy is designed to rotate to the segments of the market that have the best performance. During the bullish years, returns will often be led by the strength of the Nasdaq 100 (QQQ) holding. During the bearish years, the portfolio is designed to rotate to less volatile value-based securities."***

Exchange Traded Funds (ETFs) are the trading vehicles used in this strategy. ETFs combine elements of index funds in that they track specific market indexes, but they trade on stock exchanges just like a stock. **Table 1** lists the ETFs used in this strategy. More ETFs can be added to this list.

Table 1. Style Index Trading Vehicles

Ticker	ETF	Market Segment
DIA	Dow Diamond	Large-Cap Value
QQQ	Nasdaq 100 Tracking Stock	Large-Cap Growth
SPY	S&P 500 SPDR	Large-Cap Index
MDY	MidCap SPDR	Mid-Cap Index
IJS	iShares Small-Cap Value	Small-Cap Value
IJT	iShares Small-Cap Growth	Small-Cap Growth
IWM	iShares Small-Cap Index	Small-Cap Index

For my *VIS Alert.com* newsletter portfolio, I also include a mid-cap growth, a mid-cap value, and a large-cap value ETF. While ETFs are used as the trading vehicle, mutual funds from ProFunds *(www.profunds.com)* will work as well.

This Style Index Strategy utilizes AIQ's Relative Strength report. The Short-Term Relative Strength Strong report is run every other Friday on the ETFs listed in Table 1. This report looks at the last 120 trading days (approx. six months) and breaks them into quarters. A percentage return figure is calculated for each quarter. These returns are then averaged with twice the weight placed on the most recent quarter's worth of data.

To begin the strategy, the Relative Strength report is run on the ETFs after Friday's close. The top two in the ranking are purchased, making a fully invested portfolio. Two weeks later, the Relative Strength report is run again. If the current holdings are rated as one of the three best in the report (or the top half if you include more ETFs), then there are no trades. If a holding falls in the Relative Strength report to where it is no longer in the top three, then it is sold and the highest rated ETF is purchased.

The strategy is designed to rotate to the segments of the market that have the best performance. During the bullish years, returns will often be led by the strength of the Nasdaq 100 (QQQ) holding. During the bearish years, the portfolio is designed to rotate to less volatile value-based securities.

Since price history on ETFs is

limited, it is not possible to run a backtest that covers both bull and bear markets. Most of the ETFs began trading in 2000. Therefore, a backtest of a trading system cannot be run using ETF trades but must instead be run on the benchmark indices that the ETFs track.

For example, before the Nasdaq 100 ETF (QQQ) was traded, our backtest purchased the Nasdaq 100 index. Before the Dow Diamond was traded, the backtest bought the Dow Jones Industrial Average.

Our backtest on this strategy covered 1998 through 2002. For the test, the ETF trade prices were based on the close the day after the signal (i.e. Monday's close). In 2003 an actual account was employed and some discretion was used to determine when to act on a trade.

The strategy gained 37.94% in 2003. A backtest from 1998 through end of 2003 shows a gain of 133%. The S&P 500 gained 25% over the same time period. **Table 2** lists all the individual trades. The average holding period was 94 calendar days.

Fidelity Sector Fund Strategy

The Sector Fund strategy uses the same concept as the Style Index strategy. To begin the strategy, the Short Term Relative Strength report is run on the 40 Fidelity sector funds. The top two are purchased. Two weeks later, the Relative Strength report is run again. If the current holdings are in the top half of the report (i.e. the top 20), then there are no trades.

If, however, a holding falls to the bottom half of the report, then it is sold and the top-rated sector fund is purchased. We do not double into funds and the account is always fully invested in two funds.

For our backtest, buy and sell prices were the closing prices at the end of the week (i.e. the day the reports were run). With real money, people would place the trades on

Table 2. Individual Trade Details

Ticker	Buy Date	Sell Date	% Change
CVK	1/5/1998	2/17/1998	3.39
MDY	1/5/1998	1/20/1998	-0.93
RUT	1/20/1998	2/2/1998	0.72
SPY	2/2/1998	5/11/1998	10.82
NDX	2/17/1998	3/16/1998	4.57
MDY	3/16/1998	3/30/1998	0.13
DIA	3/30/1998	7/6/1998	3.52
NDX	5/11/1998	3/10/1999	64.66
SPY	7/6/1998	5/10/1999	15.78
NDX	3/10/1999	5/22/2000	60.21
DIA	5/10/1999	8/2/1999	-3.13
CVK	8/2/1999	9/13/1999	-2.51
DIA	9/13/1999	9/27/1999	-6.55
CVK	9/27/1999	10/25/1999	-3.17
CKG	10/25/1999	11/8/1999	6.2
MDY	11/8/1999	12/20/1999	-2.03
CKG	12/20/1999	4/24/2000	4.24
DIA	4/24/2000	5/8/2000	-2.7
CKG	5/8/2000	7/31/2000	-2.07
MDY	5/22/2000	7/3/2000	6.11
QQQ	7/3/2000	7/31/2000	-6.04
IJS	7/31/2000	8/12/2002	11.34
MDY	7/31/2000	3/26/2001	-5.56
IWM	3/26/2001	5/7/2001	9
DIA	5/7/2001	5/21/2001	3.74
IWM	5/21/2001	7/30/2001	-6.37
IJT	7/30/2001	12/17/2001	-1.5
MDY	12/17/2001	12/31/2001	1.53
IJT	12/31/2001	2/25/2002	-3.42
DIA	2/25/2002	3/11/2002	4.43
MDY	3/11/2002	4/8/2002	0.1
IJT	4/8/2002	4/22/2002	2.03
IWM	4/22/2002	5/20/2002	-1.4
IJT	5/20/2002	6/17/2002	-5.73
MDY	6/17/2002	7/15/2002	-13.96
DIA	7/15/2002	9/9/2002	-1.86
MDY	8/12/2002	10/21/2002	-1.66
IJT	9/9/2002	10/21/2002	-1.12
DIA	10/21/2002	12/2/2002	4.04
QQQ	10/21/2002	5/8/2003	14.33
IWM	12/2/2002	12/16/2002	-3.68
IJT	12/16/2002	4/7/2003	-3.88
IWM	4/7/2003	12/31/2003	48.57
IJS	5/9/2003	6/2/2003	5.57
QQQ	6/4/2003	8/8/2003	-1.15
IJS	8/12/2003	12/31/2003	18.25

Monday morning. Also, the portfolio was rebalanced at the end of each year to create equal positions in the two holdings.

From 1998 through 2003, the portfolio gained an amazing 277%. The S&P 500 gained 25% over the same time period. The portfolio was partially insulated from the bear market because it rotated to Gold but it also took advantage of bullish periods by concentrating on technology holdings. A Portfolio Manager Summary Statistics sheet is found in **Figure 1**.

Summary

A comparison of the two Relative Strength strategies is found in **Table 3**. We see that both strategies outperformed the S&P 500 by a wide margin. The return from the Sector Fund strategy is well above the Style Index strategy but that is due to the 1999-00 performance. The return on the two portfolios is fairly similar when you exclude those two years.

The risk associated with the Sector Fund strategy is well above the Style Index strategy. For example, as of this writing the Sector Fund portfolio is holding Developing Communications and Wireless. Needless to say, this is a high-risk non-diversified portfolio. For that reason, only a small portion of your portfolio should be placed into the Sector Fund strategy. As with any strategy, past performance does not guarantee future results.

For more detailed information on these strategies, please refer to the October and December 2003 *Opening Bells*. This article supplements the previous articles. For example, the Style Index trade details in this issue did not appear in the October issue. Similarly, the Portfolio Manager Summary Statistics page for the Sector Fund did not appear in the December issue.

At the start of next year, we'll update this year's returns for both strategies.

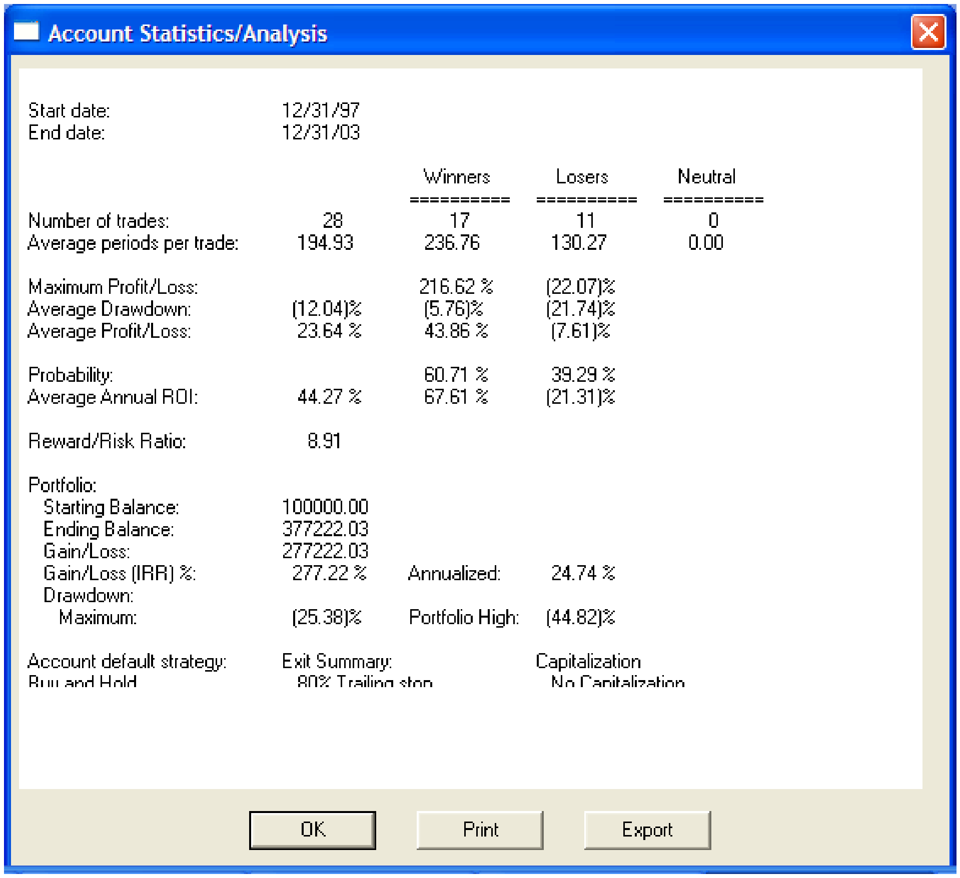


Figure 1. Portfolio Manager's Account Statistics/Analysis window displaying backtest results for the Fidelity Sector Fund Strategy.

"From 1998 through 2003, the Fidelity Sector Fund portfolio gained an amazing 277%. The S&P 500 gained 25% over the same time period."

Table 3. Yearly Returns (%)

Year	Style Index	Sector Fund	S&P 500
1998	39.28	30.25	28.58
1999	50.01	93.77	21.04
2000	-3.10	41.22	-9.10
2001	2.10	-7.65	-11.89
2002	-18.11	-14.10	-22.10
2003	37.94	39.48	28.69
Avg.=	18.02	30.50	5.87

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split/Div.	Approx. Date	Stock	Ticker	Split/Div.	Approx. Date
Health Care Prop.	HCP	2:1	03/02/04	Fair Isaac Corp.	FIC	3:2	03/11/04
STW Corp.	SJW	3:1	03/02/04	Centex Corp.	CTX	2:1	03/15/04
Healthcare Svs. Gp.	HCSG	3:2	03/02/04	Activision Inc.	ATVI	3:2	03/16/04
First WA Financial	FWFC	5:4	03/02/04	Barr Pharmas Inc.	BRL	3:2	03/16/04
Bemis Co.	BMS	2:1	03/02/04	CEC Ent.	CEC	3:2	03/16/04
Patina Oil & Gas	POG	2:1	03/04/04	Candela Corp	CLZR	2:1	03/17/04
Trimble Navigation	TRMB	3:2	03/05/04	XTO Energy	XTO	5:4	03/18/04
SS&C Technology	SSNC	3:2	03/08/04	Donaldson Co.	DCI	2:1	03/22/04
Winnebego Ind.	WGO	2:1	03/08/04	Corinthian College	COCO	2:1	03/23/04
Center Fin'l Corp.	CLFC	2:1	03/08/04	Raymond James Financl	RJF	3:2	03/25/04
Polaris Indus.	PII	2:1	03/09/04	Schnitzer Steel	SCHN	3:2	03/26/04
Lifeway Foods	LWAY	2:1	03/09/04	Amphenol Corp.	APH	2:1	03/30/04
Marine Prod.	MPX	3:2	03/11/04	Affiliated Mgrs.	AMG	3:2	03/30/04

Trading Suspended:

Dan River Inc. (DRF), Elder Trust (ETT), Gadzooks Inc. (GADZQ), Media Arts Group (MDA), Mid Atlantic Medical Svs. (MME)

Name Changes:

Pumatech Inc. (PUMA) to Intellisync Corp (SYNC)