AIQ Opening Bell® Monthly

IN THIS ISSUE VOL. 4 ISSUE 5 MAY 1995

Feature

Sections

The *Opening Bell Monthly* is a publication of AIQ Incorporated
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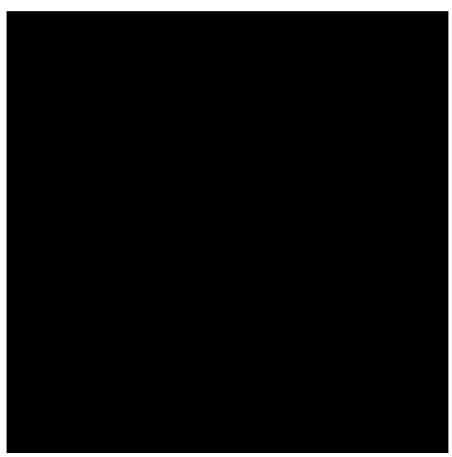
Incline Village, Nevada 89452

AIQ USERS SHARE THEIR TECHNIQUES

INTERVIEW WITH MONEY MANAGER RICHARD SCHMIDT

By Carol Tong

Richard Schmidt (see biography next page) believes in the necessity of seeing a predominance of factors converging together as essential in picking winning stocks. His success in the market has evolved through time, as he has developed as a trader. He stresses that it is important to be flexible to change. Indeed, of his early days he said, "...every time I'd adhere to a rule, every time I followed somebody else's (rule), I ended up losing. You cannot have hard and fast trading rules. The rules change in different markets at different times with different companies and industries. So, what we are looking for is a predominance of factors."



RICHARD SCHMIDT
PRESIDENT STELLAR MANAGEMENT, NAPLES, FL

Mr. Schmidt incorporates market timing and industry group analysis in his consideration of a specific stock. A favorite confirmation of market direction is the Up-Down Signal Ratio. This ratio measures the percent of stocks in the database that are registering confirmed buy/sell signals. The ratio is found at the top of the Weighted Action List report or at the top left of the Market Log. Mr. Schmidt notes, "...in different markets, this ratio has worked differently." A few years back he looked for a ratio greater than 90% on the buy or the sell side. In today's market environment, he looks for the movement in the ratio rather than a specific value.

Mr. Schmidt also looks for movement in the Unconfirmed Signal Ratio (labeled US in the Market Log). He says, "An Unconfirmed Signal Ratio of 40 in my evaluation could be a much stronger signal than a ratio of 90, if the unconfirmed signals went from 10 to 40."

Likewise, when focusing on industry

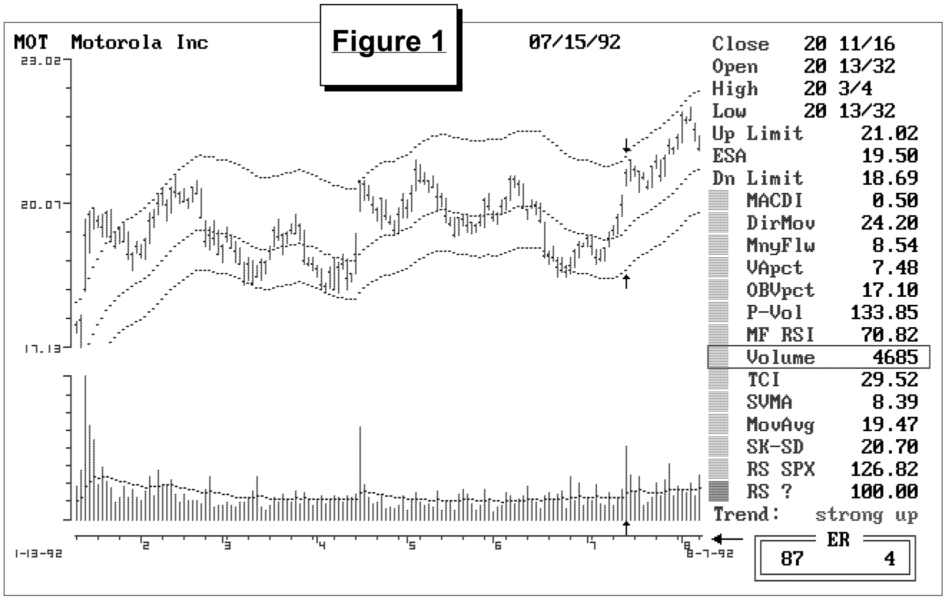
AIQ Users Share Their Techniques continued on page 2

AIQ USERS SHARE THEIR TECHNIQUES *continued . . .*

groups, Mr. Schmidt emphasizes the movement of groups and reacting to change. He carefully monitors the Delta Trend Score readings of groups (found on the daily Group Report), stating, "If we see groups starting to move up, we attempt to get to them before they get too high. In this market, we very quickly, particularly in groups, seem to be getting to overbought and oversold levels. So, ...I have to wait for just a change. By the time I have a Trend Score of 100 in a group, it is almost too late." Using the browse feature, he will tag those groups with the highest Delta Trend Score readings.

This top-down approach led him to Motorola in 1992. Motorola was on a confirmed buy signal and had registered several unconfirmed sell signals by early August. Mr. Schmidt says, "...when you have a breakout to the upside, you frequently see down signals." He explains that this is a characteristic of a counter-trend system. The breakout in Motorola came on a gap up move in July 1992 on heavy volume (see **Figure 1**). He uses a real-time trading package which screens for gap moves explaining, "Gap moves often signal us to major breakouts to the upside."

Figure 1



Editors Note: TradingExpert for Windows will have a report that lists stocks that have gapped.

Reflecting on his past experience, Mr. Schmidt is well suited to assessing the fundamental strength of the companies he tracks. He credits his business background for his fundamental approach to the market and says he "perceives the market from the outside looking in, not from the inside looking out." In evaluating stocks fundamentally, accelerating earnings, low debt and institutional participation are paramount. In addition, he looks at the degree of capitalization and prefers companies with a minimum of 100 million shares for his growth positions.

Rather than relying on set stop limits, Mr. Schmidt uses a broad approach. Just as he requires a confluence of positive technical indicators to enter a position, he requires a number of negatives to exit. He explains, "Too often we have seen things break through stops only to see them bounce back up again. The stops tend to guarantee a loss and prevent a gain." Rather, he likes to take a strategic outlook. "I look at the big picture and I absolutely, positively never use stops. If I see a market where the Trading Channel Index (TCI) is giving good signals and then it turns down at the same time that other key indicators turn down, then I am out. Especially if share prices are still going up. If I see a negative TCI only, I'm not gone. If I see a price break 7% I'm not gone. If I see a price break 15% I'm not gone. But if I see a price break 3% and a lot of other negatives are out there, then I'll become very concerned. Or, if I see earnings have decelerated, a couple of gap down openings, and a price that moves below the 21- day smoothed average, then I become alert and say, 'Wait a minute, we have a predominance of negatives here.'"

Richard Schmidt

Richard Schmidt is president and founder of Stellar Management, Inc., in Naples, Florida. A relative newcomer to the market, Mr. Schmidt developed an interest in stocks and options after retiring from a successful career in business. He currently manages $30 million and attributes his record as a money manager to a synergism of fundamental study, based on sound business principles, with technical analysis to pinpoint market timing. A remarkable 80% of his trades are profitable. He is an active TradingExpert user and member of the AIQ user group in Naples. He can be reached at (813) 263-7100.

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AIQ USERS SHARE THEIR TECHNIQUES *continued . . .*

Among his key indicators are TCI, Stochastic, Money Flow, On Balance Volume, 21- day moving average, and 5- week moving average.

Diversification and asset allocation are also crucial to Mr. Schmidt. In 1994, Stellar Management's portfolio was, at times, as much as 50% in the money market. When fully invested, the portfolio may contain between 16 to 20 positions. Despite the careful analysis, it is anticipated that some percentage of the positions will not work out, and careful monitoring allows a quick response. In bearish market environments, the holdings gravitate toward large cap stocks and protective put options are sometimes used. When negative indicators appear, a quicker exit is taken to preserve assets.

Mr. Schmidt turned bullish in December and remains bullish, anticipating greater acceleration in growth stocks due to changes in the tax structure as well as new companies moving into the growth categories due to international ventures. Shorter term, he cautions that we are beginning to see a lower percentage of stocks with unconfirmed buy signals. ■

STOCK DATA MAINTENANCE

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

Stock	Ticker	Split/Div.	Approx. Date
Health South	HRC	2:10	4/18/95
America On Line	AMER	2:1	04/28/95
Second Bancorp OH	SECD	3:2	05/02/95
Odwalla Inc.	ODWA	3:2	05/02/95
Petsmart Inc.	PETM	3:2	05/02/95
Washington G & L	WGL	2:1	05/03/95
Optical Data Sys.	ODSI	2:1	05/08/95
WLR Foods	WLRF	3:2	05/15/95
Met-Pro	MPR	3:2	05/15/95
Dimark Inc.	DMK	5:4	05/16/95
Pier 1 Imports	PIR	5%	05/18/95
Micron Tech.	MU	2:1	05/23/95
Thermo Elect.	TMO	3:2	05/25/95
Paychex Inc.	PAYX	3:2	05/26/95

Name/Ticker Changes:

ZEOS Int'l (ZEOS) to Micron Electronics (MUEI)

Trading Suspended:

Dibrell Bros. (DBRL)

MARKET REVIEW

By David Vomund

No market timing buy or sell signals were registered in the last month so we'll use this column to review the market activity of the first quarter of this year, a quarter that saw the largest stock price increase in the past two years.

Most of the gain came in the large-cap stock arena as the S&P 500 rose almost 10%. With such a narrow rally, it has been hard for investors to keep pace with the Dow and S&P 500.

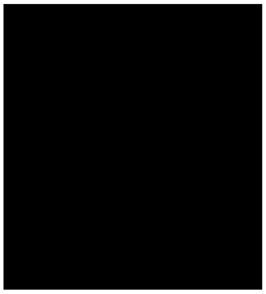
Vanguard's S&P 500 index fund amazingly outperformed 91% of all other domestic stock funds. The S&P 500 rallied more than most of the sector funds as well.

While it was a great quarter for domestic stock investors, those who like the international markets have been disappointed. The average international fund fell 2% on the quarter. Emerging market funds fell more than 11%. Even worse, the Latin America funds fell more than 30%, on average.

As of this writing, the market is within points of its all-time highs. The jump in Chrysler gave the large-cap indexes a boost as they continue to outperform the broader market averages. The Russell 2000 is still 2.6% below its '94 peak.

The NASDAQ Composite is showing great strength as technology stocks like Intel, which play a major role in the capitalization-weighted composite, have been very strong. ■

MARKET ANALYSIS



DAVID VOMUND

MARKET TIMING SIGNAL CONIRMATION TESTING

By David Vomund

Confirmation of Expert Ratings has always played a large role in the use of AIQ's software. In AIQ's early days, we recommended using the Price Phase indicator as a confirmation. Not long after, we realized that different types of traders preferred different confirmation techniques. The Price Phase was not the best confirmation tool for everyone. Some users preferred no confirmation while others wanted a slower confirmation indicator. In two subsequent articles, we are going to quantify the benefits and costs of using various confirmation techniques and answer the questions:

Does confirmation really lower risk? Does it increase returns?

This month's article will test the Price Phase confirmation compared to using no confirmation. Next month, we'll test the MACDI crossover and the Directional Movement Index for confirmation.

Our testing time period is 1985 through the first quarter of 1995. The test is applied to the AIQ market timing model using data from *The Wall Street Journal*. Traders who use Telescan as a data vendor will have slightly different results since Telescan reports the actual high and low price of the Dow rather than the theoretical value that is reported by the other data vendors. While the buy and sell dates may differ, the conclusions should remain the same.

In our test, only signals greater than 95 are used. In the "no confirmation" study, we assume that you buy the S&P 500 index the day of the buy signal (only the first buy signal in a string of buy signals is used) and hold the index until a market sell signal.

In the "Price Phase" confirmation study, the signal is not confirmed until the Price Phase indicator moves in the direction of the signal. To briefly review the Price Phase, this indicator is the MACDI set to 10 and 49 days. With these settings, the Price Phase Line is the faster MACDI line (the green line on most computers). The value for the Price Phase indicator is to the right of the MACDI when the MACDI is set to 10 and 49 days (a more detailed explanation is found in the TradingExpert manual page X-28).

An Expert Rating buy signal is confirmed the day the value of the Price Phase increases over its previous day's value. The opposite is true for the sell side.

In our study, there is no time limit as to when the Price Phase indicator needs to confirm the Expert Rating. In general, the Price Phase confirmation is a fast confirmation technique (i.e., it takes little movement in the direction of the signal before a confirmation is seen).

The study details are found in **Table 1**. The first three columns show the entry date, exit date, and the percent change in the S&P 500 if no confirmation technique is used. The last three columns show the results from applying the Price Phase confirmation to the market timing.

Table 2 displays summary statistics. We immediately see that the overall return is slightly lower when the Price Phase confirmation technique is applied to the Expert Rating signals. If you began with $10,000 and invested $10,000 in every signal (no benefits of compounding), the return using no confirmation was 187% while the return using the Price Phase confirmation was 163%. It is a tribute to the accuracy of our market timing expert system that a confirmation technique lowers the overall return.

Does this mean that a confirmation technique should not be used? Not

Table 2

Summary Statistics

(1985 through 1st Quarter 1995)

No Confirmation	
% Ch. w/o Compounding	187%
Avg. % Ch. per Trade	3.82%
Number of Trades	49
Largest Loss	9.96%
Phase Confirmation	
% Ch. w/o Compounding	163%
Avg. % Ch. per Trade	3.40%
Number of Trades	48
Largest Loss	5.08%

MARKET ANALYSIS *continued . . .*

Table 1

— — No Confirmation — —			— — Phase Confirmation — —		
ENTRY DATE	EXIT DATE	S&P 500 % Ch.	ENTRY DATE	EXIT DATE	S&P 500 % Ch.
03/19/85	04/03/85	-0.24	03/19/85	04/03/85	-0.24
05/09/85	09/03/85	3.29	05/09/85	09/05/85	2.94
09/13/85	04/29/86	31.49	09/23/85	04/29/86	30.50
05/20/86	06/06/86	4.05	05/22/86	06/09/86	-0.07
07/14/86	09/08/86	4.21	07/22/86	09/08/86	4.18
09/22/86	03/27/87	26.05	09/22/86	03/27/87	26.05
05/26/87	07/01/87	4.78	05/26/87	07/01/87	4.78
07/29/87	08/27/87	4.98	07/29/87	08/27/87	4.98
09/22/87	10/06/87	-0.09	09/22/87	10/06/87	-0.09
12/07/87	12/28/87	7.35	12/07/87	12/28/87	7.35
01/20/88	04/14/88	7.06	01/25/88	04/14/88	3.01
05/03/88	05/05/88	-1.60	05/03/88	05/05/88	-1.60
05/13/88	07/18/88	5.35	05/16/88	07/18/88	4.56
07/28/88	10/27/88	4.23	07/29/88	10/27/88	1.94
11/09/88	01/03/89	0.72	11/22/88	01/03/89	3.03
03/03/89	03/17/89	0.52	03/06/89	03/17/89	-0.72
03/29/89	06/29/89	9.35	03/29/89	06/29/89	9.35
06/30/89	10/11/89	12.27	07/07/89	10/12/89	9.38
11/15/89	01/10/90	1.99	11/15/89	01/10/90	1.99
01/31/90	02/20/90	-0.33	01/31/90	02/20/90	-0.33
02/27/90	03/22/90	1.64	02/27/90	03/22/90	1.64
05/01/90	07/05/90	7.05	05/02/90	07/05/90	6.34
08/13/90	10/09/90	-9.96	08/27/90	10/09/90	-5.08
10/15/90	12/21/90	9.41	10/15/90	12/24/90	8.80
01/16/91	04/22/91	20.49	01/17/91	04/22/91	16.15
05/01/91	06/17/91	-0.04	05/01/91	06/18/91	-0.45
06/28/91	07/24/91	2.02	07/01/91	07/24/91	0.19
08/21/91	09/04/91	-0.16	08/21/91	09/04/91	-0.16
09/11/91	10/24/91	-0.01	09/16/91	10/24/91	-0.18
10/29/91	11/15/91	-2.26	10/29/91	11/15/91	-2.26
11/29/91	02/24/92	9.87	12/02/91	02/25/92	7.62
04/10/92	05/15/92	1.43	04/10/92	05/15/92	1.43
05/29/92	06/05/92	-0.45	05/29/92	06/05/92	-0.45
06/22/92	07/20/92	2.57	06/29/92	07/20/92	1.18
07/27/92	08/06/92	2.20	07/28/92	08/06/92	0.74
08/14/92	09/08/92	-1.30	08/28/92	09/08/92	-0.10
09/10/92	09/22/92	-0.67	09/10/92	09/22/92	-0.67
09/28/92	12/14/92	3.89	10/13/92	12/14/92	5.75
12/18/92	01/07/93	-2.39	12/18/92	01/07/93	-2.39
01/12/93	02/16/93	0.67	01/25/93	02/16/93	-1.39
07/06/93	10/22/93	4.95	07/08/93	11/03/93	3.21
12/17/93	02/04/94	0.74	12/17/93	02/04/94	0.74
02/28/94	03/24/94	-0.60	03/07/94	03/24/94	-0.55
03/28/94	06/20/94	-0.98	04/07/94	06/20/94	1.02
06/27/94	08/05/94	2.19	07/06/94	08/05/94	2.46
08/23/94	09/19/94	1.36	08/23/94	09/20/94	-0.25
09/26/94	09/29/94	0.31	No Confir	N/A	
10/10/94	10/20/94	1.70	10/10/94	10/21/94	1.27
11/07/94	03/31/95	8.14	11/14/94	03/31/95	7.45

necessarily. These numbers do not reveal the drawdowns during holding periods, nor do they reflect the anguish of being on the wrong side of the market.

A good example is found on September 28, 1992. Table 1 shows that a 3.89% return is achieved by acting on this signal. Sound good? It turns out that shortly after the signal, the market fell and was, at one point, down over 3% from the buy date. That's no fun. Using the Price Phase confirmation, one would have been in cash during that market drop.

The greatest benefit of using the confirmation method comes from the August 13, 1990 buy signal. We are in the midst of a small bear market. At the time of the buy signal, the market was falling and falling fast. The Price Phase did confirm the signal too early but it kept investors out of a nearly 5% drop in the market.

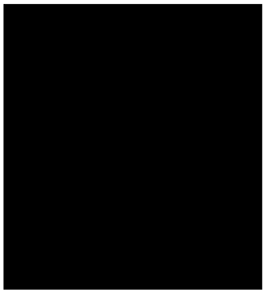
Other examples of how the Price Phase helped avoid down moves are illustrated in the 11/9/88, 08/14/92, and 3/28/94 buy signals.

Many AIQ users employ confirmation techniques to help reduce the number of signals. The Price Phase confirmation is a fast confirmation and we see that over this ten year time study, only one buy signal was not confirmed before the corresponding sell signal was registered. If you are a user who is interested in reducing the number of signals, a slower confirmation technique should be used.

In next month's *Opening Bell,* we'll perform the same analysis to two slower confirmation techniques. We'll expand our conclusions after this further study is completed. ■

David Vomund is publisher of two advisories for stock and sector fund investing available by mail or fax. For a free sample of the advisories, phone 702-831-1544.

TOOLS OF THE TRADE



CAROL TONG

CANDLESTICK CHARTING VERSUS CANDLESTICK READING

By Carol Tong

Candlestick charts, developed by the Japanese centuries ago, require the same data used to draw a Western style bar chart. So why all the hype over candlesticks? As Seiki Shimizu stressed in his book, *The Japanese Chart of Charts*, the chart is just a chart, nothing more. However, candlestick pattern recognition is another story - learning to read the chart often illuminates a market not revealed by Western technicals.

For me, candlestick charts are my preferred method of price plotting. In fact, I rarely look at a standard bar chart anymore. I think the candles are more visual and, more importantly, with candlesticks I "see" the underlying psychology of the market. As a former psychology student, reading market sentiment combined with Western technical analysis is the preferred method. For a review of candlestick construction and basic patterns, see the December and January issues of the *Opening Bell.*

The candlestick chart originated at a time when Japan was not yet a nation, but a number of warring states. Later, when the chart was further developed as an analysis tool applied to trading rice futures, the patterns were often described and named alluding to warlike or military terms. Indeed, the markets are often perceived as a war between bulls and bears. Each trading session is a battle in which the bulls try to move the stock up while the bears try to drive it down, with the above charted as a white or black candle, respectively.

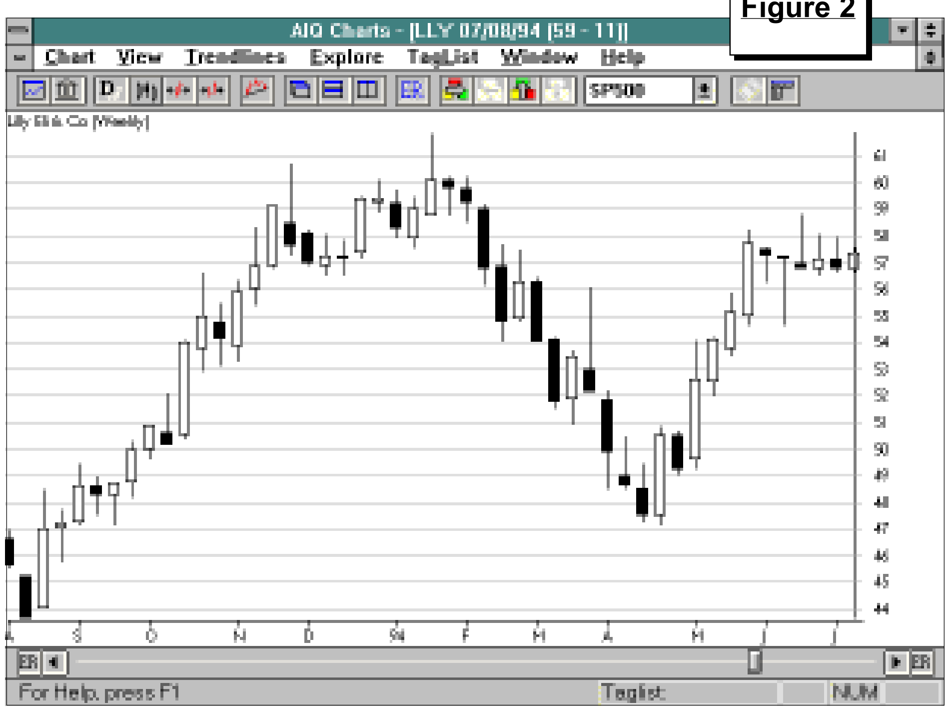
In Western analysis, the focus is day to day change in price, with the most emphasis on the close. If I hear the Dow is up 47, I know it means today's closing price has risen that much higher than yesterday's close. The Japanese method emphasizes the relationship between the open and close of the current trading session above all else. That is, who won the battle?

In Western analysis, the focus is day to day change in price, with the most emphasis on the close. . . The Japanese method emphasizes the relationship between the open and close of the current trading session above all else. That is, who won the battle?

Perhaps 90% of candlestick patterns are defined by the open and close range, referred to as the real body of the candle. As we know, if the close is above the open, meaning the bulls have succeeded in pushing the stock upward, the candle is white (bullish). If the close is lower than the open, meaning the bears triumphed in sending the stock lower, then the candle is black (bearish).

Let's look at a weekly candlestick chart of Eli Lilly in **Figure 2.** (TradingExpert's candlestick charting is much improved in the Windows version due to be released this June, so we are using charts from our beta version of the Windows

Figure 2



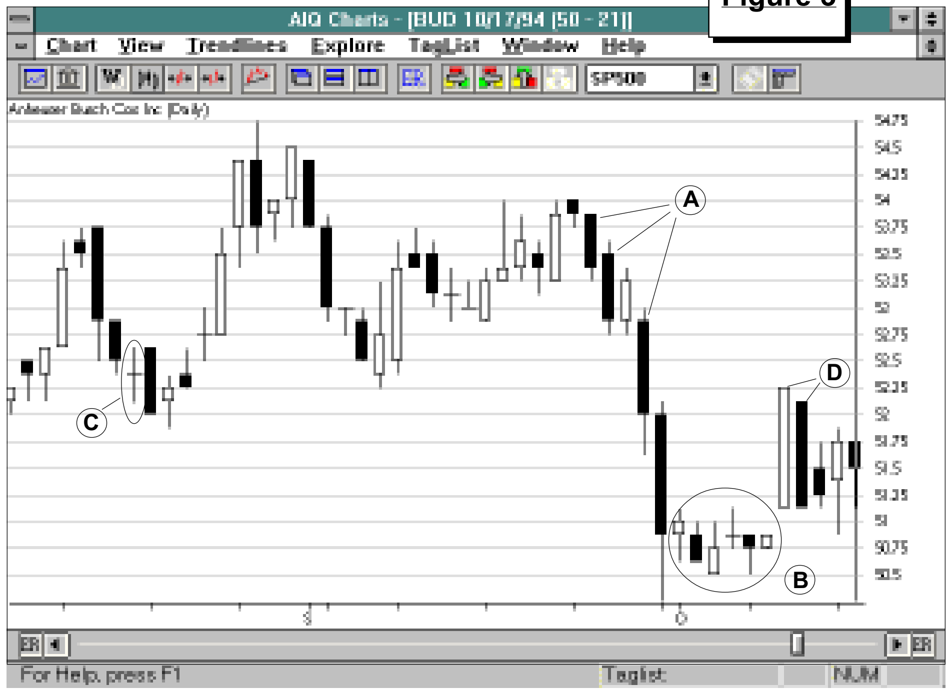
TOOLS OF THE TRADE *continued . . .*

program for this article).

In Figure 2, notice that in uptrending time periods, the candle bodies are predominately white, defining the uptrend as a series of sessions with progressively higher closes above opens. Conversely, a downtrend shows a series of black candles with closes progressively lower than opens. The color of the real body, then, allows the chart reader to quickly recognize which army controls the market.

Another key is strength of the trend as determined by the length of the candle's real body (see **Figure 3**). The length of the real body can be likened to an advance into bullish or bearish territory. Thus, a longer real body is interpreted as a stronger move. In a steady prolonged trend, the real bodies are long, showing one side or the other has firm power over market direction (A). As the struggle nears equilibrium at consolidation points, the real body is small, showing neither side succeeded in moving the stock during the session - it has closed near its open (B). The candle may have a shadow, indicating a push into upside or downside territory (or both), a failure to hold ground, and a retreat back to neutral.

Figure 3



A Doji candlestick, which has no real body at all, shows a balance of power (C). The opposite is a Marubozu candlestick, an exceptionally long real body candle with no shadow at all (D). In Japanese, "bozu" means monk. Because Buddhist monks shave their heads, this candle is so named, meaning it's bald on both ends. A white Marubozu shows total bullish control: the stock opened at its low and the bulls pinned the close at the high. A black Marubozu shows total bearish control: the stock opened at its high, was pummelled by the bears, and closed at its low.

Aside from reading bullishness or bearishness of each individual candlestick, what can we infer from the patterns? Candlestick pattern recognition is unique as a leading indicator. Convergence of a number of patterns or technical signals together increases the probability of accurately foretelling the market direction.

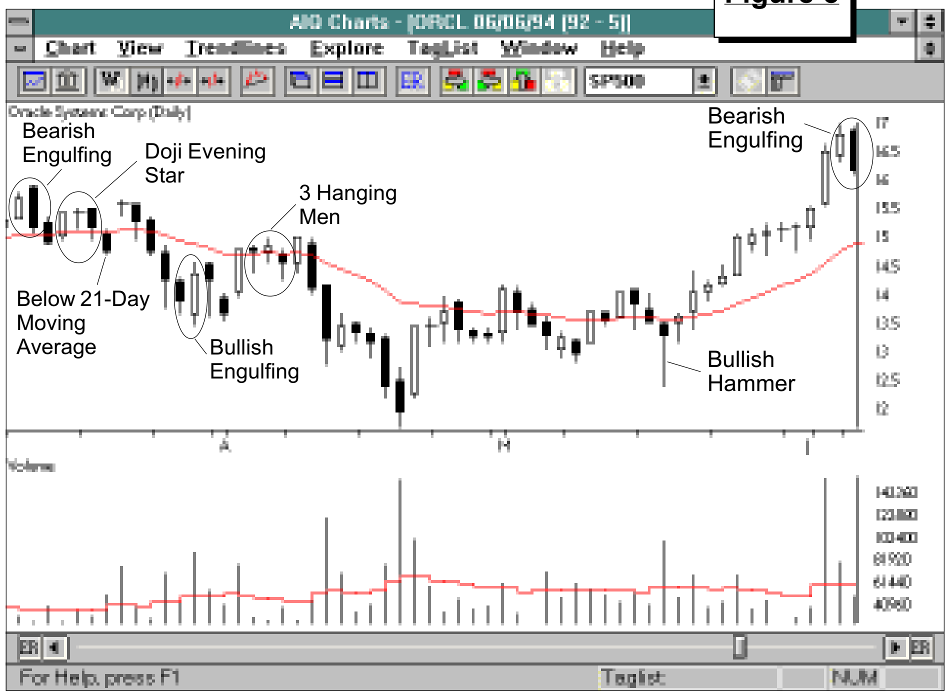
Let's look at Alcoa Aluminum (AA) as an example (**Figure 4**). The stock was in a steady downtrend when, on October 21, a Karakasa, or umbrella line appeared. This line in a downtrend can also be called an inverted Hammer and often signals a reversal. In this case, the Karakasa is followed by two more black candles, each gapping down from the one prior. This is recognized as "San ku", or Three Gaps*, which is interpreted as a weakening in the current trend.

Figure 4

Tools of the Trade continued on page 8

TOOLS OF THE TRADE *continued . . .*

Figure 5



In early November, a bullish Three River Morning Star appears. The star candle is a bullish hammer line, and reinforces the support level between 76 3/4 and 77 1/4 tested earlier by the third gapping candle. After the formation of the Morning Star, the downtrend is over and Alcoa takes off.

Note in early January that a Karakasa line appears again, this time as a bearish Hanging Man. It is immediately followed by a bearish Engulfing Pattern, confirmed by a black candle on the following day.

Accuracy Increases with Western Technicals as Confirmation

Using candlesticks with Western technicals as confirmation also increases probability of accuracy. Like any indicator, candlestick pattern recognition alone is not foolproof. Candlesticks tend to give early signs and are especially good at pinpointing trend reversals. However, waiting for confirmation may result in more profitable, albeit fewer, trades.

In Spring of 1994, Oracle (ORCL) entered a downtrend after a bearish engulfing pattern on March 15 was followed by a Three River Doji Evening Star (**Figure 5**). The Evening Star pattern was further confirmed the next day when the stock dropped below its 21-day moving average.

In late March, the bulls tried to wrest control and created a bullish Engulfing Pattern, but the subsequent appearance of three consecutive Hanging Men and a failure to break above the 21-day moving average quashed their effort.

The Oracle stock continued to decline, bottoming at 26 1/4 on heavy volume. Finally, on May 17 a very bullish Hammer appears with volume almost twice the average. Note the Hammer's long lower shadow depicting the bears' failure to gain ground. The AIQ system gives a 95 Expert Rating to the upside on the 18th, confirmed by the small white candle the next day, which gaps up on the open and breaks above the moving average. Oracle then proceeds to climb until halted by the bearish Engulfing Pattern in late June.

Candlesticks, while easy to read, are not without drawbacks. They are a good charting method and can anticipate pivot points before they happen, but should not be used alone. Most are reversal patterns which identify tops and bottoms and are meaningful when a defined trend is present.

Some candle patterns are formed over as many as 40 or 45 sessions, but the majority of recognized patterns are fewer - commonly two or three sessions and the practical effect is short term.

Another limitation of candlesticks is that patterns do not predict magnitude of a move. As always, a good stop strategy is essential.

As is the case with any technical indicator, the basic data for candlesticks must be reliable. Open prices, in particular, may differ depending on the data source, and some data vendors have only recently recorded opening prices.

Finally, pattern analysis is subjective, so expect the candlesticks to work as well as their reader.

*San Ku, or Three Gaps is a pattern which belongs to a group of patterns and a trading philosophy known as Sakata's Method. Briefly, the rule advises if, in a trend, three consecutive candles gap in the direction of the trend, this signals a winding down or loss of power - expect change. The color of the three candles must be white in an uptrend or black in a downtrend. ■