AIQ Opening Bell Newsletter

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Interview with Jay Kaeppel

Professional Trader/Author Shares His Own Effective Trading Strategies

By David Vomund

Opening Bell: Jay, you've developed some systems for trading sector funds. How have they held up during the recent bear market?

Kaeppel: Well the good news is that they have held up pretty well relative to the overall market, but the bad news is they are still down in 2001-2002. The Relative Strength System was up 23% in 2000, down 14% in 2001, and unchanged for the year through the end of August 2002. It went completely to cash after June 28th so it was able to sidestep the July decline.

The Pure Momentum System was up 18% in 2000, down 6% in 2001, and down 6% through the end of August 2002. I still trade both systems and as yet have made no modifications from the original rules.

Jay Kaeppel is Director of Research at Essex Trading Co., Ltd. and an active commodity trading advisor (CTA). Jay is the author of "The Option Traders Guide to Probability, Volatility and Timing" (Wiley, August 2002) as well as "The Four Biggest Mistakes in Option Trading" and "The Four Biggest Mistakes in Futures Trading." He can be contacted at hftwp@aol.com.

Place Kaeppel Photo Here

Jay Kaeppel

Opening Bell: Can you recap the rules for these systems?

Kaeppel: Yes. The Relative Strength System (RS) buys and holds the five Fidelity Select funds at the top of the Relative Strength Long-Term Report (with the caveat that the low for the most recent week must be above the 28-week EMA). A fund is held until it registers a weekly low that is below the 28-week EMA at the end of the previous week. Then it is sold and replaced with a new fund from the Relative Strength

> *"Using Fidelity for trading sector funds still shows the best results… Fidelity offers by far the greatest number of sector choices. You have a better chance of catching a strong sector."*

Report. I ignore gold funds and will look only at the top eight funds in the Report. If no fund qualifies as a buy, then the money goes into cash. This system went completely into cash on 06/28/02.

The Pure Momentum System simply buys and holds the five Fidelity Select funds at the top of the Price Change – Upside Long-Term Report at the end of each month. At the end of the following month, the report is run again and if one or more funds in the current portfolio have fallen out of the top five, then they are replaced by new funds.

Editor's note: The Relative Strength System was covered in the July 2000 Opening Bell.

Opening Bell: Have you tested these systems with Rydex, Profunds, and/or Exchange-Traded Funds (ETFs)?

Kaeppel: Yes, and so far using Fidelity funds still shows the best results. I think this is primarily a function of the fact that Fidelity offers by far the greatest number of sector choices. You just have a better chance of catching a strong sector. For example, in the last year Select

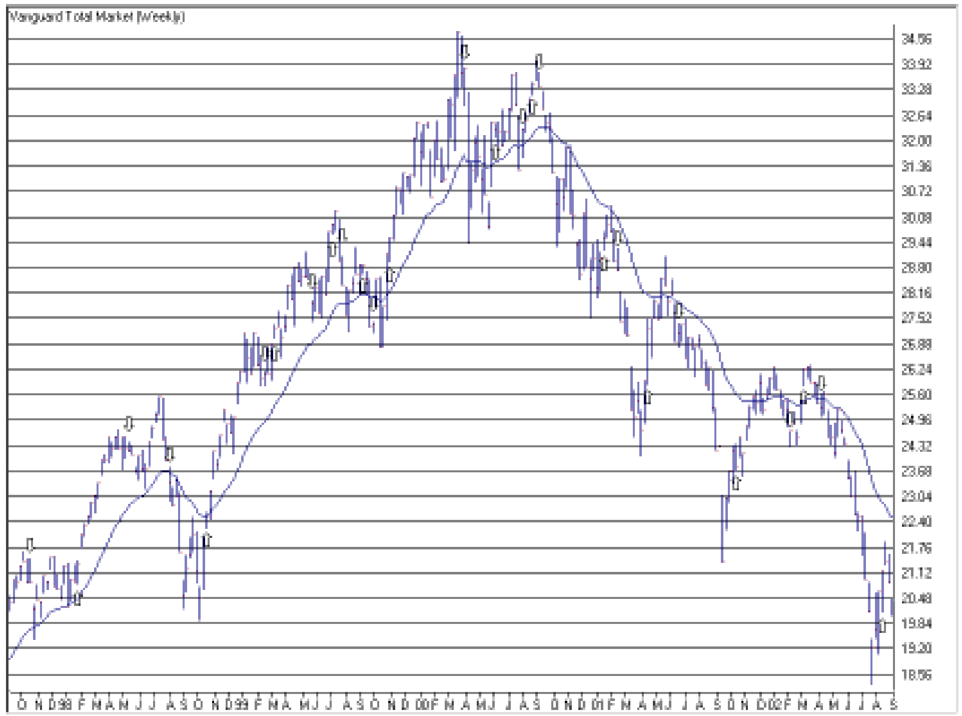

Figure 1. Five year chart with signals from Kaeppel's RSMD mechanical market timing strategy

Construction (FSHOX) enjoyed a strong run. However, no Rydex, Profunds, or ETF funds offered a pure play in construction stocks.

The downside is that Fidelity has more fees, loads, and switching restrictions than these other avenues. One alternative for more active investors is to use "folios," whereby an investor can put for instance 10K into a basket of stocks in a given industry. For example, let's say Select Construction is a buy. Instead of going through Fidelity, an investor could use MatchMaker and find the 10 stocks most highly correlated with FSHOX. He can then buy $1000 worth of each stock through Foliofn.com (or some other brokerage offering stock baskets).

To take it a step further, the investor could run the Relative Strength report on those 10 stocks and overweight the top performers.

Opening Bell: Market timing fell out of favor in the bull market of the 90's — do you see new interest in that area now?

Kaeppel: Oh yes. There are a lot of people who wish they had gotten out of the stock market — or at least lightened up somewhat — before the recent collapse. Lots of things go in cycles in the market. When I started out in the early 1980's, market timing was a big deal. By the end of the 90's you were considered a fool if you tried to time the market. By then the question was not "should I be in the market,"

> ***" I'm a fan of mechanical approaches because they take the emotion out of the decision making process. One of the most useful techniques is your own use of the RSMD indicator, whereby a 2-week change in the trend of RSMD signals a switch between two indexes or funds being compared."***

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but "how do I make the most money?" Now market timing is enjoying renewed interest.

Opening Bell: Any useful timing techniques?

Kaeppel: I'm a fan of mechanical approaches because they take the emotion out of the decision making process. One of the most useful techniques is your own use of the RSMD indicator, whereby a 2-week change in the trend of RSMD signals a switch between two indexes or funds being compared. Originally you used it to switch between OTC and SPX, but it also has a lot of other good uses.

I look at VTSMX vs. VBMFX (Vanguard Total Stock Market versus Vanguard Total Bond Market) and also FOCPX vs. VFITX (Fidelity OTC versus Vanguard Intermediate-Term Bond). If either of these comparisons favors stocks, then it's a buy signal for stocks. If both of these comparisons favor bonds, then that's a sell signal for stocks. I don't use this strategy to go from 100% in stocks to 100% cash but I do lighten up when a red light is flashed.

"I generally try to use options to do things that you can't do simply by going long or short a given security – for instance, buying straddles, calendar spreads, selling premium, etc."

This strategy isn't perfect – in 1999 you would have lightened up or been on the sidelines during a couple of good runs, but in the long run you can avoid a lot of pain. This strategy has been out of stocks for large portions of the 2000-2002 bear market, including the fourth quarter of 2000, September of 2001 and July of 2002.

Figure 1 shows the buy and sell signals since 1998.

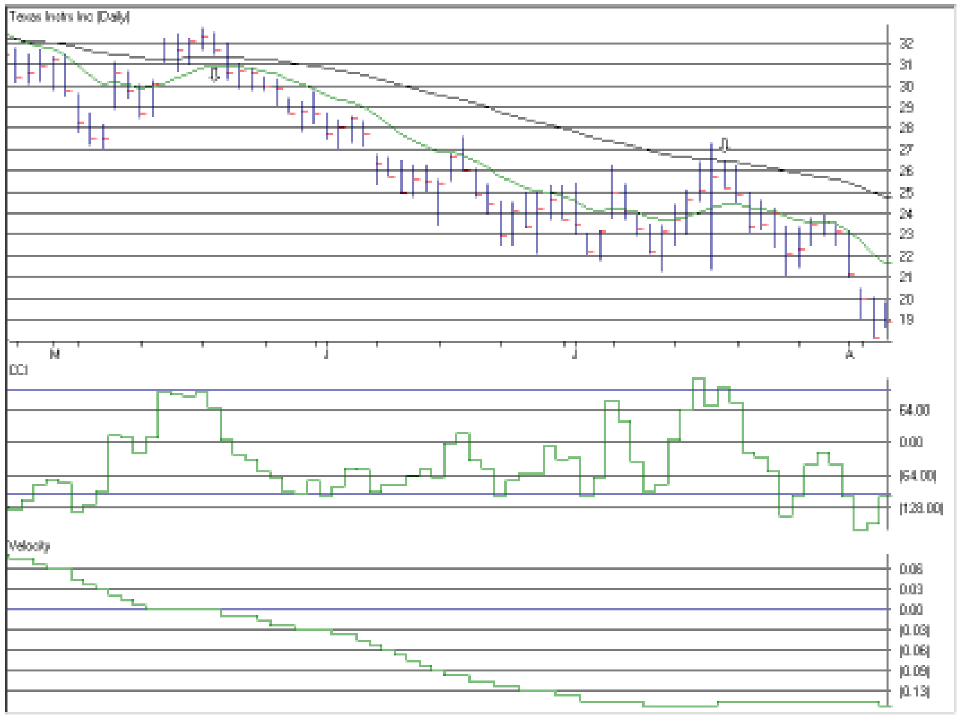

Figure 2. Daily chart of Texas Intruments with CCI and Velocity indicators. The arrows show buy puts signals given by Kaeppel's options tecnique that is based on these two indicators.

Opening Bell: Any other good uses for this strategy?

Kaeppel: Plenty. I switch between large-cap and small-cap by comparing FSMKX to NAESX (Fidelity Spartan 500 Index to Vanguard Small-Cap Index). You can also take it a step further. Once you've determined that, say, large-cap is outperforming, you can then compare a large-cap growth index or fund to a large-cap value index or fund and zero in even more on the top-performing area. The advent of ETFs makes it much easier to use this type of strategy nowadays. For example, if RSMD is favoring FSMKX over NAESX you can compare the RSMD of IWF (iShares Russell 1000 Growth) to that of IWD (iShares Russell 1000 Value) to decide whether to be in large-cap growth or large-cap value.

Likewise, if RSMD favors NAESX over FSMKX you can compare the RSMD of IJT (iShares Small Cap 600 Growth) to that of IWN (iShares Russell 2000 Value) to decide whether to be in small-cap growth or small-cap value.

Opening Bell: You recently wrote a book on option trading. Are there any timing techniques you use there?

"One technique (for trading futures) that is surprisingly effective is trading reversals after a failure to penetrate support or resistance. There is a touch of subjectivity involved but the basic pattern is simple."

Kaeppel: I generally try to use options to do things that you can't do simply by going long or short a given security – for instance, buying straddles, calendar spreads, selling premium, etc. However, for simply buying calls and puts there is one fairly useful technique I have found. For a buy calls signal, look for the following setup:

The 13-day EMA > 55-day EMA

10-Day CCI <= -90

75-day Velocity rising or flat on the day the CCI reaches -90

The trigger comes when the stock registers its next up close.

For buying puts, look for the following setup:

The 13-day EMA < 55-day EMA

10-Day CCI >= +90

75-day Velocity declining or flat on the day the CCI reaches +90

The trigger comes when the stock registers its next down close. See Figure 2. This technique works pretty well with futures also.

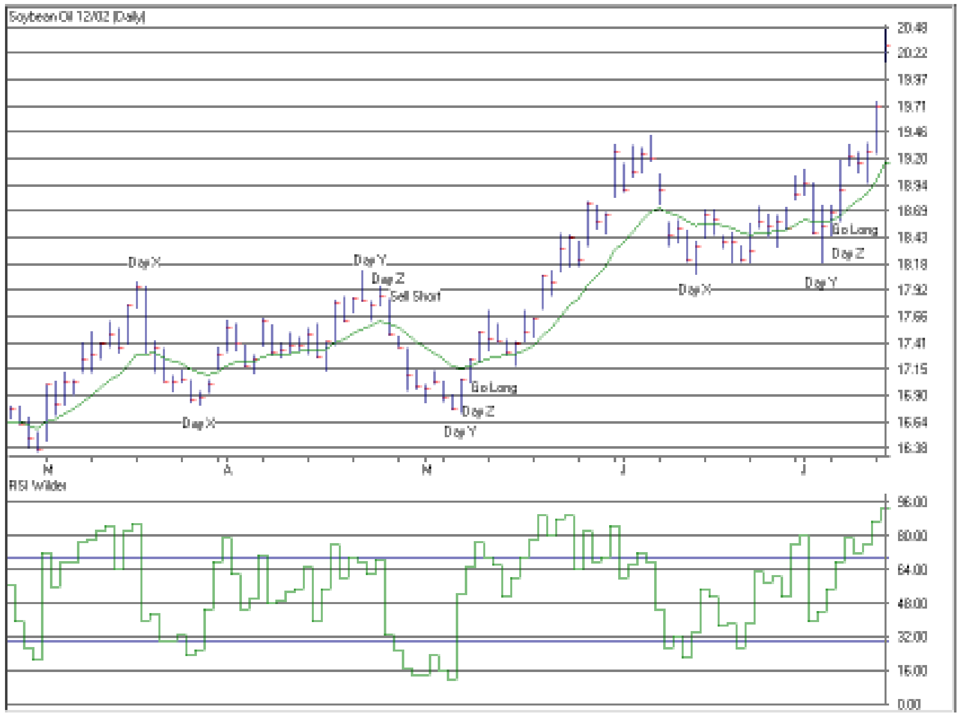

Figure 3. Soybean Oil daily chart illustrating a commodities trading technique that involves trading reversals after a failure to penetrate support or resistance. RSI is used to exit position.

Opening Bell: You are primarily a futures trader. Any other techniques for trading futures?

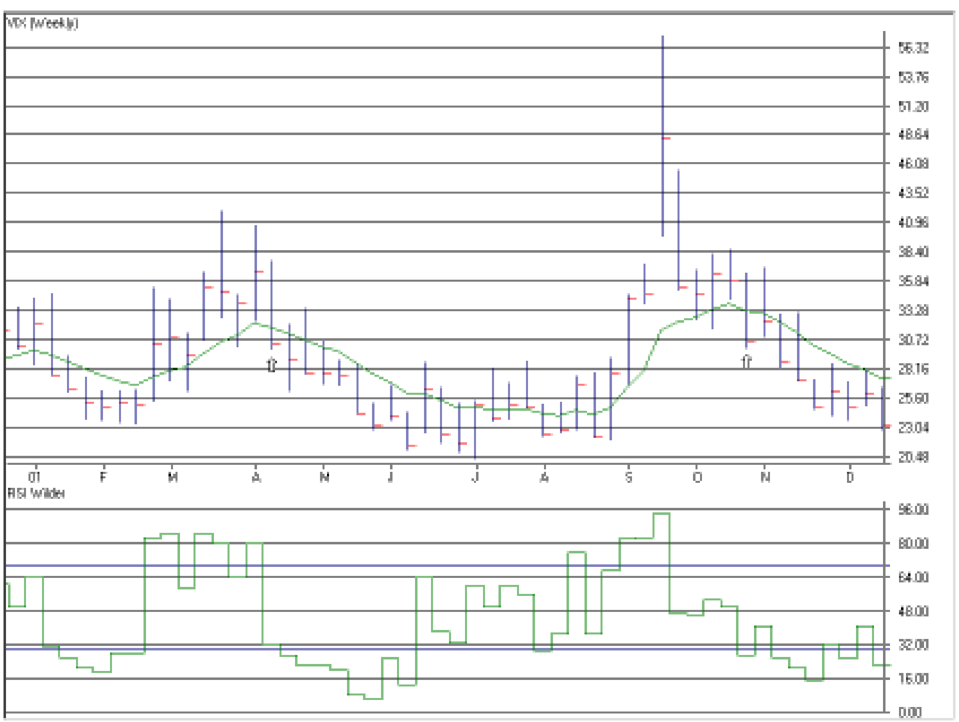

Figure 4. Weekly chart of VIX index with two intermediate term buy signals. Signals are given by Kaeppel's timing technique that is based on the 4-week RSI of the VIX index.

Kaeppel: One technique that is surprisingly effective is trading reversals after a failure to penetrate support or resistance. There is a touch of subjectivity involved but the basic pattern is simple.

A market makes a 10-day low — which is Day X — then reverses to the upside. Not less than 8 trading days later it retests that previous low, possibly even breaking down through the initial low. After making a low for the retest — this is Day Y — the market then reverses and closes back above the low of Day X — this is Day Z.

In other words the market bottomed, rallied, fell back to or below the initial low, and then closed back above the initial low. The bears tried twice to take the market down and couldn't. This is a logical setup for a rally.

Figure 3 visually demonstrates this strategy.

The idea is to buy above the high on Day Z, with a stop below the lowest low established from Day X to Day Z. I'll sell some of the position when the 4-day RSI exceeds 70% and use a trailing stop on the rest.

Opening Bell: Getting back to the stock market, a lot of traders focus on the VIX index to help them time their trades. Have you found any uses for the VIX?

Kaeppel: The good news is that despite the fact that so many people are now looking at it, the VIX remains a pretty good tool. The correlation between the SPX and the VIX in MatchMaker is about –790, which is about as extreme of an inverse correlation as you're going to find.

Most traders use the VIX as a short-term tool, but I have found one way to use it as an intermediate-term tool. The setup, which uses the weekly VIX rather than the daily version, is as follows:

The 4-week RSI of the weekly VIX Index exceeds 70%

The weekly VIX subsequently closes below its own 10-week moving average

Then buy stocks and hold for 13 weeks

Since 1986 there have been 22 such buy signals. The most recent was a buy signal on 8/16/02. Of the 21 closed out trades, 18 of those showed a profit with an average 13-week gain of +6.3%. That works out to about a 28% annualized rate of return. To take it a step further, returns can be increased by focusing on the top performing sectors and stocks rather than just buying the S&P 500 index.

Figure 4 displays the 04/13/01 and 10/26/01 buy signals.

Opening Bell: Thank you for sharing some very useful information with us.

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Market Review

Murky corporate profit outlooks, doubts about the economy's strength, corporate scandals, and talk of war with Iraq continued to put pressure on the market. In September, the S&P 500 and the Nasdaq Composite fell about 11%. In the third quarter, the S&P 500 fell an amazing 17%.

There was a lot of damage in September. Airline stocks took the brunt of the selling, falling 30%. Most of the other underperforming groups were technology related. Computer-Local Networks fell 27%, Semiconductors fell 25% and Telecommunications-Cellular fell 24%. The best performing group was Building- Recreational Vehicles, which rose 12%.

Looking at stocks in September, seven stocks in the S&P 500 were cut in half. These include Electronic Data Systems (EDS), AMR Corp. (AMR), Lucent Technologies (LU), El Paso Corp (EP), and Sprint PCS (PCS). The best performing S&P 500 stock was Forest Labs (FRX), which gained 12%. Amazingly, only two S&P 500 stocks, Moody's Corp and ConAgra (CAG), appear on the Persistence of Money Flow report.

Looking at AIQ's timing model, a 95 buy came on 09/04, a 98 buy came on 09/06, a 99 buy came on 09/09, a 98 sell appeared on 09/17, and a 99 buy was issued on 09/26.

At month's end the S&P 500 was near its July lows. With earnings season approaching in mid-October, there will be plenty of reason for the market to either form a double-bottom or to move to new multi-year lows.

S&P 500 Changes

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

El Paso (EP) moves from Gas Utilities (NATURALG) to Multi-Utilities & Unregulated Power (UTILMULT)

Crane Co. (CR) moves from Building Products (BUILDPRD) to Industrial Machinery (INDSMACH).

Molex (MOLX) moves from Electrical Components & Equipment (ELECTRIE) to Electronic Equipment & Instruments (ELCTRONI).

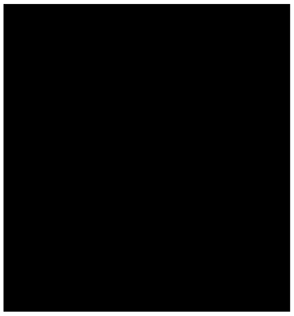
STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date
Enginred Support Sys.	EASI	3:2	10/31/02

Trading Suspended:
Allied Devices (ALDV), Bouygues Offshore (BWG), Conoco Inc. (COC), iGo Corp (IGOC), Jefferson Smurfit Group (JS), McAfee.com Corp (MCAF)

Name Changes:
Philips Pete (P) to ConocoPhilips (COP)
Elcor Corp (ELK) to Elk Corp (ELK)
Learn2 Corp (LTWC) to LTWC Corp (LTWC)
Intervoice-Brite (INTV) to Intervoice Inc. (INTV)



DAVID VOMUND

Testing Determines the Best Performers

Which Pre-Built EDS Rules Are the Most Effective?

By David Vomund

When we created the Expert Design Studio (EDS) module, we wanted to enable people to create their own screening models but we also understood that many people don't want to do their own programming. In that regard, about 200 pre-built screening techniques were created, allowing users to simply copy and paste these rules as they build their own models.

Most of the pre-built rules are based on the action of a specific indicator. For each indicator, several rules were created to represent most of the indicator's technically significant actions.

With 200 pre-built screening rules shipped with every TradingExpert Pro system, the question that most users ask is which of the pre-built rules are the most effective? In the June 1999 *Opening Bell* we tested all of the pre-built screening rules, identifying those that were the most effective and those that were the least effective. Those tests were run on a bull market.

"Congratulations to AIQ power user Richard Denning, creator of the sixth best strategy. His EDS model was designed as a quick two-day trading model but it obviously works for longer time periods as well."

One of the few advantages of the current bear market is that we can now run tests on both bull and bear markets. For this article, we tested all of the pre-built screening rules on a time period that includes both bull and bear markets. We'll identify the best performers.

Running 200 tests is obviously time consuming and we expect few, if any, users have actually completed similar tests. If you use EDS, then you may want to refer to this article often.

"One of the few advantages of the current bear market is that we can now run tests on both bull and bear markets. We tested all of the Expert Design Studio pre-built screening rules on a time period that includes both bull and bear markets."

Our tests were run on a database of the AIQ Pyramid stocks, which includes about 1700 issues. The tests were run on the period 01/01/98 to 07/31/02. A fixed holding period of 22 business days (approximately one month) was used. This is a longer time period than what most of the pre-built rules were designed for. For that reason, most of the trading results were very similar and represent simple market activity. For example, a Stochastic buy signal may be significant for a few days after the buy but it is insignificant for the next month. The rules that performed the best were ones that were designed for longer time periods.

Due to space limitations, we are not able to list the results of all the rules. Because of the importance of this time-consuming test, we are listing as many results as possible. **Table 1** is a listing of the 40 best performing rules, sorted by their annual return on investment (ROI).

To help identify the pre-built rules listed in Table 1, we indicate which folders they reside in and what the rule names are. The first column of the table displays the name of the directory (or directories) followed by the file name. The second column shows the name of the rule that was tested.

To find a pre-built rule, open the Expert Design Studio and select *File*, *Open*, and double-click the *EDS Strategies* folder. This accesses the directory list found in Table 1. Double-click the appropriate directory name and then highlight and open the file name. With the file open, the rule will be displayed in the *Rule Library* page of the EDS window.

The most effective rule is the TriStarDoji. This is a candlestick rule that looks for stocks with three straight Doji patterns. A Doji appears when a stock's opening price equals its closing price. In addition,

Table 1 - Highest ROI Trades

The following lists the results of testing the pre-built EDS rules using a stock database of the 1700 AIQ Pryamid stocks. A fixed 22-business day holding period was used. The testing time period was 01/01/98 to 07/31/02.

	Directory\file	Rule Name	Annual ROI
1	basic indicator strategies\candlesticks\Tri Start Doji	TriStarDoji	100.15
2	obm\april-2000	BestofKane	74.84
3	obm\december	Allworks	63.96
4	obm\dec99	buy	62.14
5	OBM\November	Allworks	61.65
6	obm\denningVCR	GoLong	60.53
7	hit and run\boomer buy	BoomerBuy	51.98
8	chart pattern strategies\cup and handle	CupHandle	47.83
9	basic indicator strategies\MF RSI\MFRSI crosses from above to below 90	MFRSIcross90	47.07
10	basic indicator strategies\candlesticks\Four Price Doji	FourPrice	45.25
11	basic indicator strategies\candlesticks\Long Leg Doji	LongLegDoji	39.99
12	barometer\red down\RSIAIQreddown	RSIAIQreddown	39.82
13	basic indicator strategies\AIQ TradingBands\price crosses from above to below Upper Band	AIQupperDN	38.47
14	barometer\green up\RSIAIQgreenup	RSIAIQgreenup	36.91
15	basic indicator strategies\ESA\Price crosses from above to below the Upper ESA	ESAupperDN	36.63
16	basic indicator strategies\candlesticks\tweezer bottom	TweezerBottom	35.21
17	basic indicator strategies\candlesticks\3Crows	ThreeCrows	34.74
18	obm\april-2000	CitizenKane	34.11
19	basic indicator strategies\candlesticks\DragonFly	DragonFly	34.04
20	street smarts\Holy Grail strategy	HolyGrail	33.91
21	hit and run\boomer short	BoomerShort	32.37
22	obm\april-2000	Bottomfishing	32.34
23	obm\jun99obm	Allworks	32.33
24	basic indicator strategies\candlesticks\GraveStone Doji	Gravestone	32.02
25	barometer\green\CCIingreen	CCIingreen	31.81
26	basic indicator strategies\ADX\ADX trend	GoodAdx	31.66
27	hit and run\stepping in front of size	SteppinginFrontofSize	31.02
28	hit and run\Gilligans Island Shorts	GilligansIslandShortBuy	31
29	basic indicator strategies\OBV\OBV has reached a new high	OBVnewHI	30.95
30	basic indicator strategies\candlesticks\Tweezer Top	Tweezertop	30.86
31	basic indicator strategies\ADX\ADX trend in place and Dir. Movement up	ADXupDIRMOVup	30.13
32	basic indicator strategies\OBV\OBV has reached a new low	OBVnewLO	29.91
33	barometer\red\VOLUMEinred	VOLUMEinred	28.6
34	obm\Mar99obm	allworks	28.3
35	basic indicator strategies\CCI\CCI cuts from above to below 100	CCIdn	27.93
36	basic indicator strategies\CCI\CCI cuts from below to above 100	CCIup	27.65
37	basic indicator strategies\MoneyFlow\moneyflow has reached new low	MFnewLo	27.64
38	barometer\red\Velocityinred	Velocityinred	27.6
39	barometer\red down\MACDreddown	MACDreddown	26.28
40	basic indicator strategies\Bollinger Bands\Price crosses from above to below Upper BB	UPPERBBcrossDOWN	26.20

the stock must have fallen in value for the first two Dojis. This rule had by far the highest return but there were only 77 trades. Only two of those trades were S&P 500 stocks. With so few trades, this return can easily be overstated by just a few good trades. It would be worth loosening the criteria in an attempt to get more trades and thereby making the return more valid.

We were extremely pleased to see that the next five most effective rules were all based on models that were created for the *Opening Bell*. The most effective of those models is the Best of Kane, which was introduced in the April 2000 *Opening Bell*. This model looks for stocks that have corrected by at least 30% but have attractive Volume Accumulation Percent and On Balance Volume indicators.

Congratulations to AIQ power user Richard Denning, creator of the sixth best strategy. His EDS model, which was covered in the September 2001 *Opening Bell*, was designed as a quick two-day trading model but it obviously works for longer time periods as well.

The seventh best rule used a model that was created from Jeff Cooper's *Hit and Run Trading* book. It screens for uptrending stocks by requiring a positive Directional Movement Indicator and an ADX/R to be above 30. The stock must also have two consecutive inside days (high less than previous day's high and low greater than yesterday's low) and on the third day the stock must rise above the previous inside day's high. An example of this model is found in **Figure 1**. There were 1639 trades so the results are valid. We've programmed a lot of Jeff Cooper's strategies. It's good to know that this one has been the most effective.

"The rules from this test will be extremely beneficial in creating future EDS models. In upcoming articles, we'll use these results to build new highly effective models."

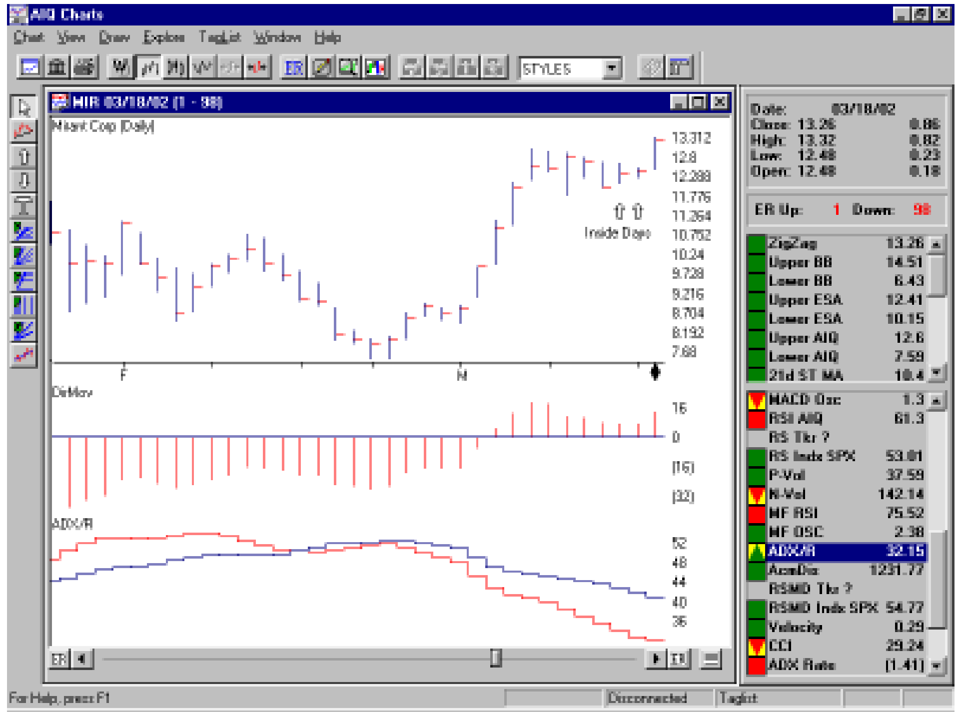


Figure 1. Daily chart of Mirant Corp. Stock met Jeff Cooper's uptrending screen criteria on 03/10/02. Criteria is based on Dir Mov and ADXR indicators plus recent price action.

The next strategy (8) searches for stocks with cup-and-handle chart patterns. This strategy only had 290 trades so it may be worth making its selection criteria less restrictive.

It is the next set of rules (9 to 17) that will be the most useful in creating new EDS models. These rules tested well and show thousands of trades in their backtests. Two of the screenings, Four Price Doji and Long Leg Doji, involve candlestick chart patterns. The Long Leg Doji doesn't search for the exact candlestick pattern but it tests well with 8100 trades. This rule requires the stock's opening price to be equal to its closing price and the low price to equal the previous day's low.

It is interesting to see that two of the top performing rules deal with buying strong stocks on a pullback (13 and 15). One rule looks for stocks that have fallen below their Upper AIQ Trading Band (13) and the other rule looks for stocks that have fallen below the Upper ESA (15). These rules work well in bull markets because you are buying strong stocks that have pulled back. In bear markets, there are fewer signals since most stocks fail to even rise above their upper bands.

The rules from this test will be extremely beneficial in creating future EDS models. In upcoming articles, we'll use these results to build new highly effective models. We'll also continue to report results of our testing.

In the next issue of the *Opening Bell* we'll reveal the most ineffective rules. These rules can be used to develop short selling models.

David Vomund publishes VIS Alert, a weekly investment newsletter. For a sample copy, call 775-831-1544 or go to **www.visalert.com.**