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Feature

Sections

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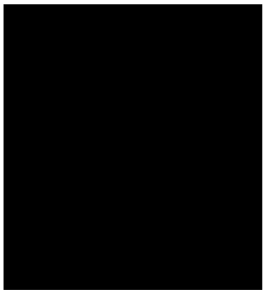
STOCK ANALYSIS

Stock Selection Process Is Simplified With Windows Version of TradingExpert



DAVID VOMUND

By David Vomund

Every few years in this newsletter, I write about the process I use to select stocks. In preparation for this article, I reread the two previous articles in which I discussed my selection process. The first article was in December 1992 and the second multi-part article went from October 1993 to February 1994.

In reading these articles I was struck by two things: One, how little my criteria for selecting stocks has changed. Two, how greatly simplified selecting the stocks is with the Windows version of TradingExpert compared to the old DOS version. The criteria used in selecting stocks may now be pre-built into reports in the Windows version.

Long time *Opening Bell* readers know that my investment horizon tends to be longer term than most AIQ users. My average stock holding period is just over six months. Except for a few new elements, the criteria that must be satisfied before selecting a stock is unchanged from four years ago. That's reassuring. There have been some losing streaks but the process has served me well and has stood the test of time (the losing streaks are more a function of poor market timing rather than stock selection).

The Process

I'm a growth/momentum investor. Picking bottoms is not my goal. As a growth investor, I make sure the overall trend is in my favor. To see the long-term trend, I use weekly charts which plot several years of data. A stock in a nice uptrending pattern will fluctuate between the upper AIQ Band on the weekly chart and the 28-Week Moving Average.

In other words, the 28-Week Moving Average tends to act as support as the stock moves higher. Before purchasing a stock, the price must be above its 28-Week Moving Average and ideally the stock will show a pattern of fluctuating between the 28-Week Moving Average and the upper AIQ Band.

Moving to the daily charts, my favorite indicators are Money Flow, On Balance Volume (OBV), and Volume Accumulation Percent (VA Pct). These are good indicators because they don't necessarily move up when a stock moves up and visa versa (i.e., they are leading rather than coincident indicators). The

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STOCK ANALYSIS *continued . . .*

three indicators attempt to measure the degree that money is flowing into or out of a stock. Since volume is the fuel that can sustain a rally, the indicators use both price and volume activity. Ideally, a stock rises on heavy volume and falls on light volume.

Money Flow and VA Pct also factor in where the stock closes relative to its daily range. It is considered most bullish when a stock rises on heavy volume and closes near or at its high price for the day. A stock that rallies during the day but closes near its low is said to be under distribution and this type of price activity causes the indicators to fall.

Both Money Flow and VA Pct are based on the same formula, so you can choose to use one or the other. If VA Pct is very bullish, Money Flow will be the same.

There are two things to watch for with these indicators:

- Positive VA Pct
- Positive divergence with OBV or Money Flow

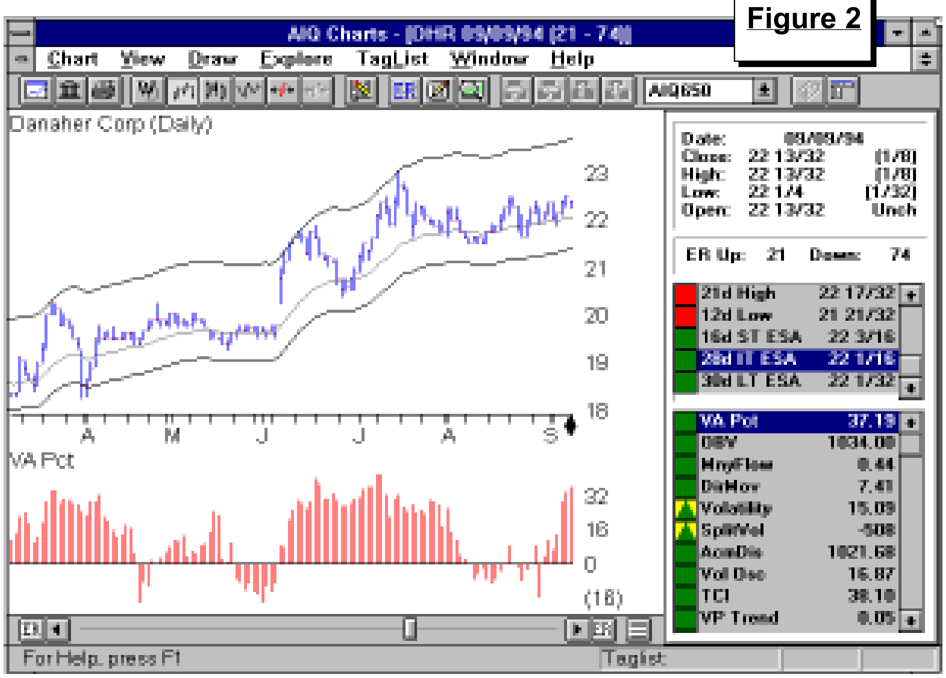
We want the VA Pct indicator to be positive (above zero) and the longer it's been positive the better. Ideally, we want it to be above zero for most of the period that can be plotted on an AIQ daily chart (six to eight months). This type of VA Pct activity is of little value for short-term forecasting, but works well in picking stocks that will outperform over a one year or longer time horizon.

The second thing to look for is whether the OBV or Money Flow line is stronger or weaker than price action. Since these are leading indicators, we want them to be performing better than price. If the stock is near its highs, we want one or both of these indicators to be in new high territory. If the stock just made a new near-term low, we want these indicators to be above their lows. These are called "positive divergences." Positive divergences are also useful for short-term forecasting.

Another indicator that I am now using is the RSMD SPX indicator, which is relative strength plugged into a MACD formula. In effect, this indicator measures the momentum of relative strength. The daily RSMD SPX should be above its signal line and moving higher.

Figure 1

Figure 2



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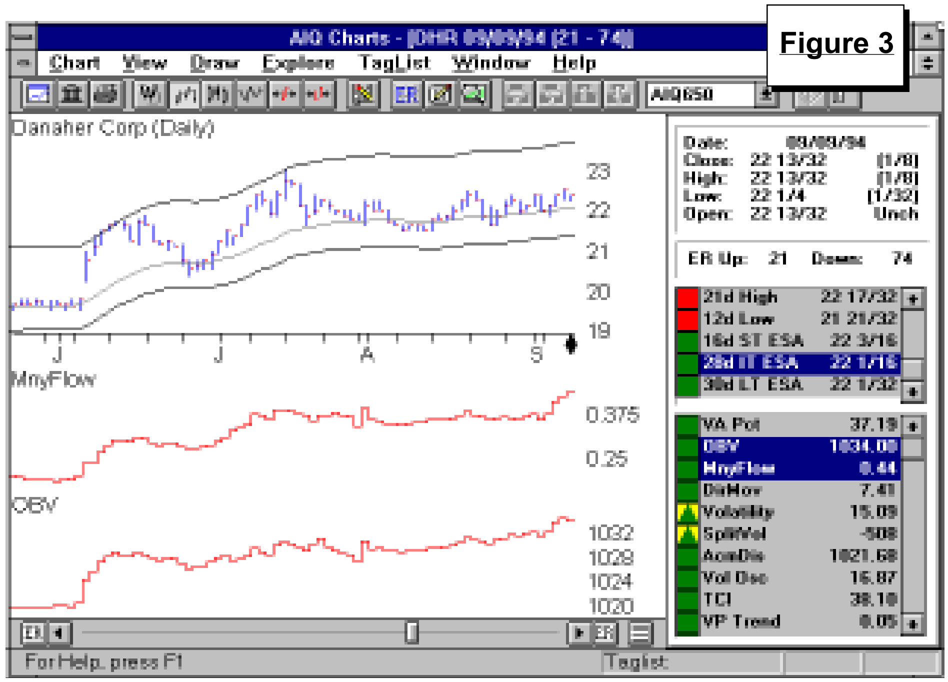
STOCK ANALYSIS *continued . . .*

Figure 3



The Expert Ratings issued for stocks are designed for short-term investors and are countertrend. Because I am a trend follower and usually hold a stock for several months, I loosen the Expert Rating requirement. For my selection process, it is not required to have an Expert Rating buy signal in the last 10 days. Expert Ratings, however, should not be ignored because they reflect the reading of all the indicators.

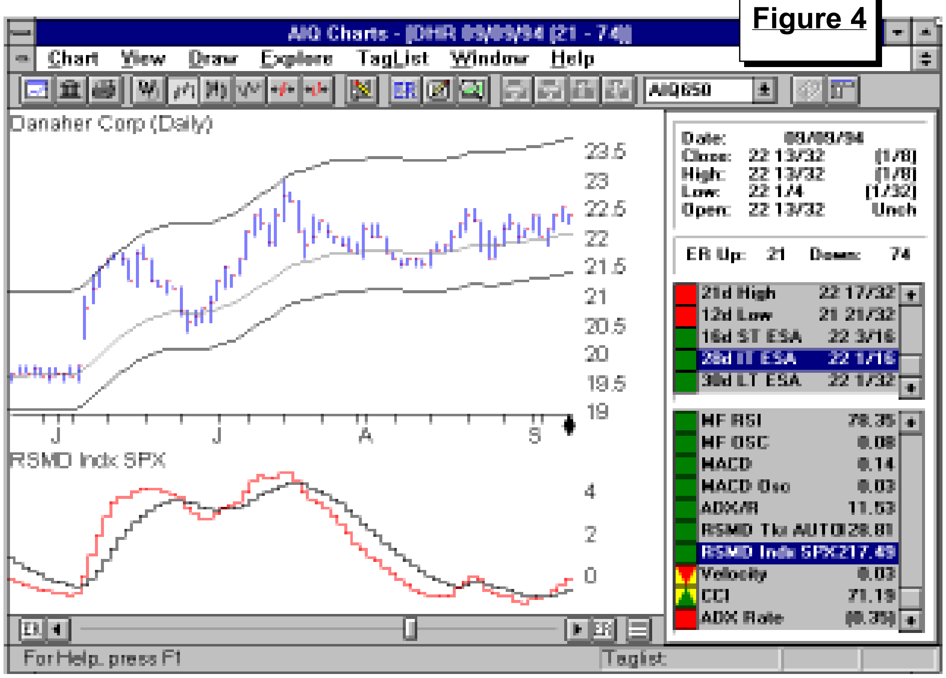
Since I only focus on a few indicators, I let the Expert Ratings tell me if the other indictors are negative. Before a stock is purchased, it must be on an Expert Rating buy signal that is confirmed by the Directional Movement Index (DMI). The stock is on a confirmed buy signal if it has an Expert Rating signal of 95 or greater and the DMI moves above zero. When the DMI is positive, all sell signals are ignored.

A final element in my stock selection process deals with fundamentals rather than technicals. When you buy a stock, you become part owner in a company. If you are becoming part owner, why buy a company that is losing money?

I'm a believer in limiting the stocks you are examining to those that have passed a fundamental screening. There are several ways to do this without having to become a fundamental expert. Two good sources are the Value Line rankings which can be found in most libraries and "Your Weekend Review" section of Friday's *Investor's Business Daily.*

For those who want to build their own screening model, the AIQ Fundamentals Module works well. This module will also import Telescan ProSearch scan files.

Figure 4



Putting It All Together

Let's look at an example of a stock that has all of the criteria that I have discussed. In searching for an example, I examined all the stocks recommended in my Stock Alert Newsletter that returned more than 50%. The best example is Danaher (DHR), a stock that I recommended three times in the last two years. In the following example, we will examine Danaher on the date it was first recommended. At that time, I was using the DOS version of TradingExpert. Later, I'll show how the new Windows version of TradingExpert can be used to more quickly identify winning stocks.

Danaher (DHR) was first recommended on September 9, 1994. Looking at Danaher's weekly chart shown in **Figure 1**, we see that the stock is in a nice uptrend and is fluctuating between its upper AIQ Band and its 28-Week Moving Average. The stock shows low volatility while it slowly and steadily moves higher. It would have been nice to buy the stock in early 1993 when it first began this "stairstep" pattern, but I'm a believer that what is high can go higher. In this case, the stock was again recommended in

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Stock Analysis *continued . . .*

October 1994 and in February 1996.

Figure 2 is a daily chart of DHR, with the VA Pct indicator plotted. Notice that this indicator is above the zero line for most of the prior six months. This is a sign of accumulation and indicates that the long-term prospects of the stock are attractive.

Figure 3 shows both the Money Flow and On Balance Volume indicators. We see a positive divergence in both indicators. While the stock is just below its recent high price, both Money Flow and On Balance Volume are at new highs. While the stock has moved sideways during the last two months on the chart, volume was heavier on the days when it advanced and the stock tended to close in the upper half of its daily range. This is another sign of accumulation and points toward a bullish situation over the short term.

Figure 4 shows the RSMD SPX indicator. The indicator is rising, which tells us the momentum of the DHR's relative strength is increasing. On the daily chart, this indicator gives short-term readings and is subject to whipsaws. But, despite its drawbacks, it helps to increase the odds that the stock will go up shortly after it is purchased. For a longer-term reading, the weekly chart can be used.

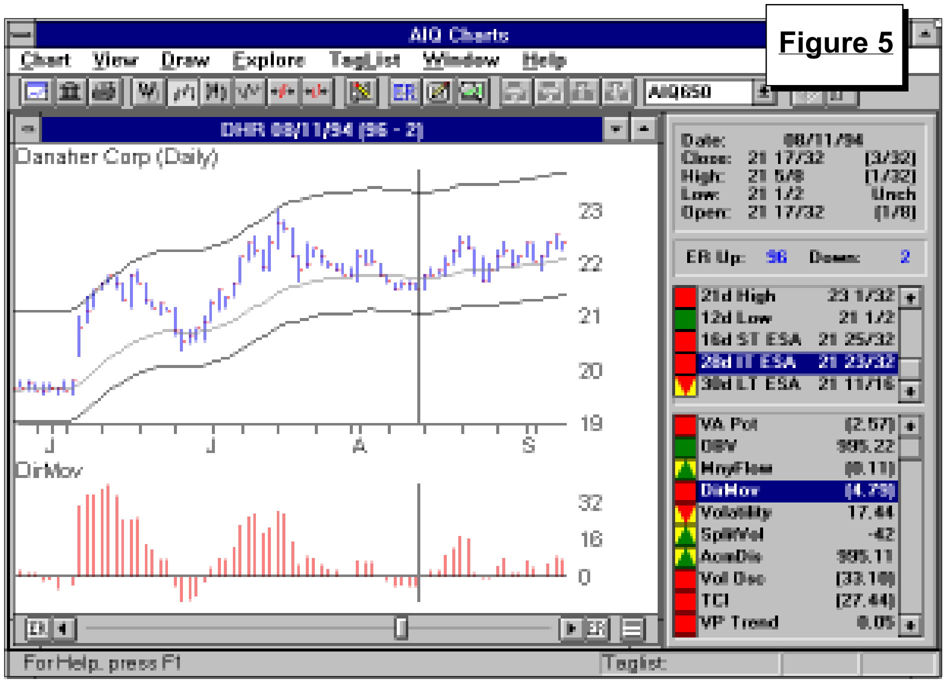


Figure 5

Figure 5 verifies that the stock is on an AIQ buy signal. A 96 up reading was registered on August 11, 1994. Initially, the signal was not confirmed - the Directional Movement Index was negative. But once the Directional Movement Index moved positive, the signal was confirmed.

Danaher continued its steady upward march and it wasn't until July of this year that the stock experienced a 15% correction, after reaching a high price of $43 1/2.

The Windows Advantage

Danaher was selected using the DOS version of TradingExpert. At that time, I made a tag list of fundamentally attractive stocks and then scrolled through the tag list looking for attractive situations.

The built-in reports of the DOS version were not used because I was only interested in those stocks that were on my fundamental list. When reports were run, the system looked at all the stocks in my database. Also, there were no reports that screened for my established criteria.

With the new Windows version of TradingExpert, the entire stock selection process is simplified and improved. I can now run reports only on the stocks that are in my fundamental tag list. The other "noise" is filtered out.

The second major advantage is that the Windows version incorporates built-in reports which screen for most of my selected criteria. For example, the Persistence of Money Flow report in TradingExpert for Windows can be used to screen for stocks that have a positive VA Pct indicator at least 90% of the time in the last six months (as

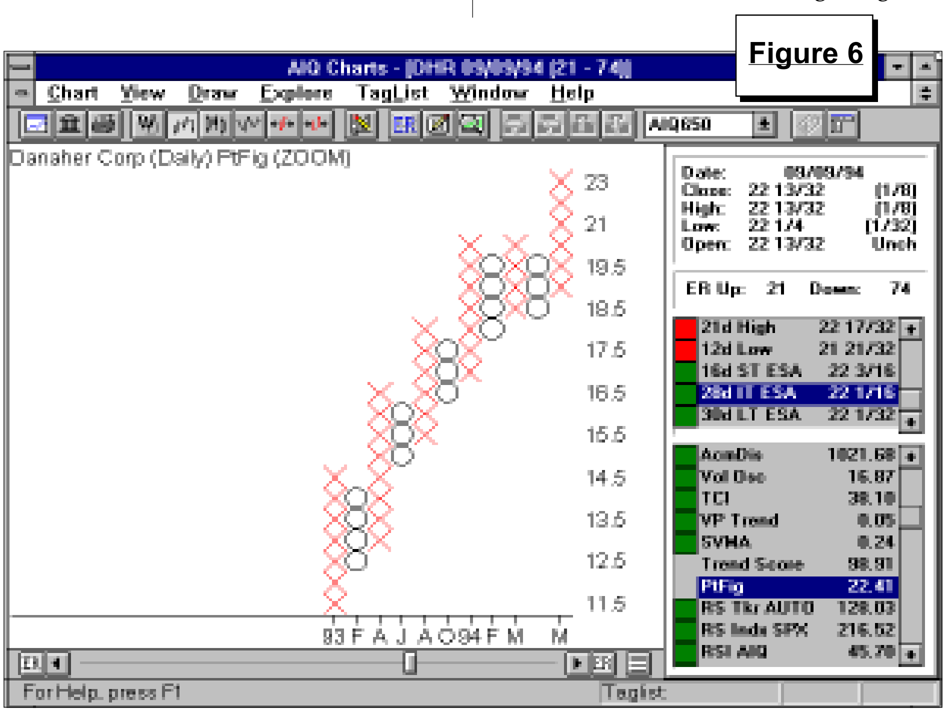


Figure 6

STOCK ANALYSIS *continued . . .*

was the case with Danaher as seen in chart in Figure 2). Using a database of 1500 stocks, I conducted a study that ran from 1994 to the beginning of 1996 and found that the top 10 stocks on this report gained an average of 34% the following year. (This story was reported in the May, 1996 *Opening Bell*.)

The Price Volume Divergence report will also list stocks that show a positive divergence by one or both of the On Balance Volume and Money Flow indicators. Using a database of the 500 stocks in the S&P 500, I performed a study from 1991 through 1995 and found that the top five stocks on this list rose an average of 2.4% over the following month. (See *Opening Bell*, December, 1995.)

A new report in the latest version of TradingExpert for Windows that plays an integral part in my selection process is the Point & Figure Breakout report. You don't have to understand Point & Figure charting to benefit from this report. It lists stocks that have broken out of a sideways consolidation pattern.

This report and Point & Figure charting were not available at the time that Danaher was first purchased, but if they were, Danaher would have appeared on the report.

Figure 6 displays a Point & Figure chart for Danaher. The X's represent stock rallies and the O's represents stock declines. Notice that the stock rallied to about $20 on two occasions and then fell in price. It's not until the last column that Danaher broke above the resistance level. The Point & Figure Breakout report screens for stocks which display this pattern.

Other Elements

My stock selection process assumes that other elements are in place. Obviously, picking winning stocks is easier during bullish market environments. It is best to limit your purchases to times that the AIQ market timing system is on a buy signal.

Picking winning stocks is also easier when there is broad participation in market moves. The Russell 2000 or the Nasdaq Composite should be rallying along with the Dow and the S&P 500.

Industry group analysis also plays an important role in stock selection. Very often, a bad stock in a good group will outperform a good stock in a bad group. Before purchasing a stock, make sure its industry group is in an uptrend and that the group is in the upper half of AIQ's Group Analysis report.

Each individual has to develop his own investment process. By combining some of the methodology discussed in this article with strategies you have found effective, we hope you will be able to better select winning stocks while requiring less time to do so. ■

In addition to managed accounts, David Vomund publishes the Stock Alert Newsletter, an advisory for stock investing. To receive a free sample of Stock Alert, phone 702-831-1544.

CORRECTION

In the September 1996 issue of the *Opening Bell*, typographical errors occurred in the two formulae for the CCI and TCI indicators in Dr. J D. Smith's article *The Many Talents of the Trading Channel Index.* The correct formulae are printed here.

Four Steps to Compute CCI

1)	$X_t = (H+L+C) \div 3$	compute typical price
2)	$\overline{X}_t = \frac{1}{n} \Sigma X_t$	compute moving average
3)	$MD = \frac{1}{n} \Sigma (X_t - \overline{X}_t)$	compute mean deviation
4)	$CI_t = (X_t - \overline{X}_t) \div 0.15\ MD$	compute Channel Index

Five Steps to Compute TCI

1)	$X_t = (H+L+C) \div 3$	compute typical price
2)	$E_t = \alpha X_t + (1 - \alpha)\ E_{t-1}$	compute exponential average
3)	$D_t = \alpha\ (E_t - X_t) + (1 - \alpha)\ D_{t-1}$	compute average deviation
4)	$CI_t = (X_t - E_t) \div 0.15\ D_t$	compute Channel Index
5)	$TCI_t = \beta CI_t + (1 - \beta)\ TCI_{t-1}$	compute TCI

MARKET REVIEW

There was one market timing Expert Rating this month — a 98 buy signal on September 9. At that time, about 80% of the stocks giving confirmed and unconfirmed buy and sell signals were on the buy side (using a database of the AIQ Pyramid stocks). The sell signal that was registered two weeks prior turned out to be a whipsaw signal. The market rallied strongly after the Sept. 9 buy signal, demonstrating how important it is to be willing to change your market stance and follow the system.

The large cap stocks as measured by the Dow and the S&P 500 have rallied into new high ground. Recent strength in the technology issues propelled the Nasdaq Composite to its old highs. Most small company stocks have not yet participated in the rally, however, as the Russell 2000 is still almost 5% off its highs. ■

D.V.

TRADING COMMENTARY

TEN COMMON MISTAKES
OR, WHAT SEPARATES THE SUCCESSFUL AIQ USER FROM THE UNSUCCESSFUL USER

There are both successful and unsuccessful AIQ TradingExpert users. What separates the two often deals with the psychological side of trading rather than the interpretation of the system and its indicators. After listening to both successful and unsuccessful users, we've assembled what we consider to be the ten most common mistakes that new AIQ users make. We present the list in no particular order.

Mistake 1. Falling in Love with a Market Outlook.

Wall Street is always right. When the market goes against you, it is important to re-evaluate your position. This does not mean that you should change your opinion but that you must be willing to admit when you are wrong. We all know of examples of people in the newsletter industry who have been bearish for years and have missed one of the most spectacular bull advances. They don't want to admit they are wrong. The same holds true for stock analysis. When a stock that you are holding keeps falling, your reason why the stock should go up may be wrong.

Mistake 2. Betting Against the Market Timer.

There are no perfect market timing systems but AIQ's is very good. It is subject to whipsaws but it can keep you out of trouble. Whether you choose to raise cash or curtail new investments after a sell signal, it is not wise to bet against the market timer. Many times, users call saying their stock selection technique is not working. It turns out that their selection process is sound but it is hard to make money in a falling market. It is much easier to pick winning stocks when AIQ's market model is on a buy signal rather than a sell signal.

Mistake 3. Over Optimizing.

With technical analysis, we rely on history to tell us the future. Unfortunately, this can be taken too far. When you over optimize a system, what works in the past does not work in the future. We've all seen new trading models that produce incredible historical results but fail to match the results in the real world. It does not pay to design a system or test indicator constants on only a few securities. That's why when we perform our tests on the stock reports, we look at a database that contains at least 500 stocks and we test over different market time periods.

Mistake 4. Not Having a Sell Discipline.

It is important to determine the parameters of when to sell before you buy a stock. This takes the emotional element out of the sell decision. Many people buy a stock and then evaluate it every day. As the stock begins to fall, emotional factors rather that a true evaluation of the stock with the AIQ system becomes the primary decision role. It is best to use a trendline stop or a trailing stop. Expert Ratings on the individual securities should not be the deciding factor.

Mistake 5. Unrealistic Expectations

Fishermen always catch big fish. Gamblers walk away from the slots richer than when they arrived. At least that is how the story goes. In the world of stock trading, sometimes it seems you failed if you don't double your money each year. Yet, the all-time greatest money managers average a 50% gain per year. The majority of money managers average a 12% return. Truth be told, most people don't beat the market for an extended period of time. Those who can consistently beat the market by a few percentage points each year usually end up with more money than those who try to "get rich quick."

Mistake 6. Sell the Winners and Hold the Losers.

When people have to sell some stock, they usually sell the winners and hold the losers. That's because it is against human nature to admit you are wrong. After all, by selling a loser you move from a simple paper loss to an actual loss. The problem is that you end up holding losers for long periods of time because they fail to turn around. This money can be better used elsewhere. It is best to sell the losers and let those with profits run.

Mistake 7. Limiting Stock Selections to Those on the Nasdaq

Because of a very successful marketing campaign, many believe the only way to buy small company growth stocks is to limit selections to Nasdaq stocks. Truth is, there are many small growth stocks on the NYSE and it costs less to buy these stocks. If two stocks trade with similar volume, in almost every case the bid-to-ask spread will be smaller for stocks listed on the NYSE than is the case for stocks on the Nasdaq. Some of the volume on the Nasdaq is also fabricated (market makers trading to market makers). Misleading volume and high bid-to-ask spreads reduces the quality of the analysis that can be performed on these stocks. A "must read" article for anyone trading Nasdaq stocks is *One day soon the music's going to stop* from the July 29, 1996 issue of Forbes.

Trading Commentary continued on page 8

AIQ REPORTS

POINT & FIGURE BREAKOUT REPORT

By David Vomund

In the past, we've had several requests for a report that lists stocks that have broken above resistance or stocks that have fallen below support. The new Point & Figure Breakout report accomplishes this and it is one of the most powerful new features in TradingExpert's 3.11 version. This report is available for stocks, groups, sectors, and mutual funds.

In its screening process, the report looks at the activity of the Point & Figure charts for securities rather than the normal bar charts. In Point & Figure terms, it searches for triple-top buy and sell signals. To appear on the bullish section, the stock must break above a level that acted as resistance on at least two prior occasions. The opposite is true on the sell side.

To show what the pattern looks like, **Figure 7** is a chart of a surrogate group that represents the Fidelity Select Home Finance fund. The "X"s represent rallies while the "O"s represent declines. Notice that the group rallies, enters a tight consolidation, and then rallies once again (see circles). With each consolidation the group, in effect, "catches its breath." Within the consolidation, the group rallies to the same level twice before breaking above the consolidation. The Point & Figure breakout report looks for securities that have broken out of this type of consolidation pattern.

Figure 8 shows the Point & Figure Breakout report for September 23. The stocks are sorted by Percent, which by default is the percent change of each security over the last five trading days.

The pattern that the report screens for is most easily seen on Point & Figure charts, but it can also be seen on regular bar charts. **Figure 9** shows Travelers Inc., the second stock that appears on the September 23 breakout

AIQ Reports continued on page 8

Figure 7

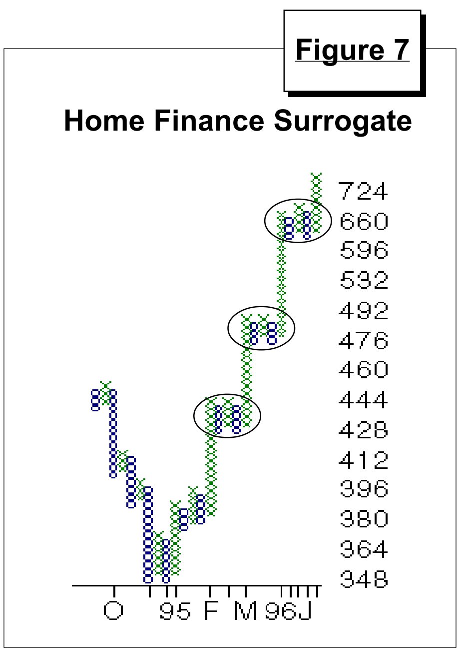


Figure 8

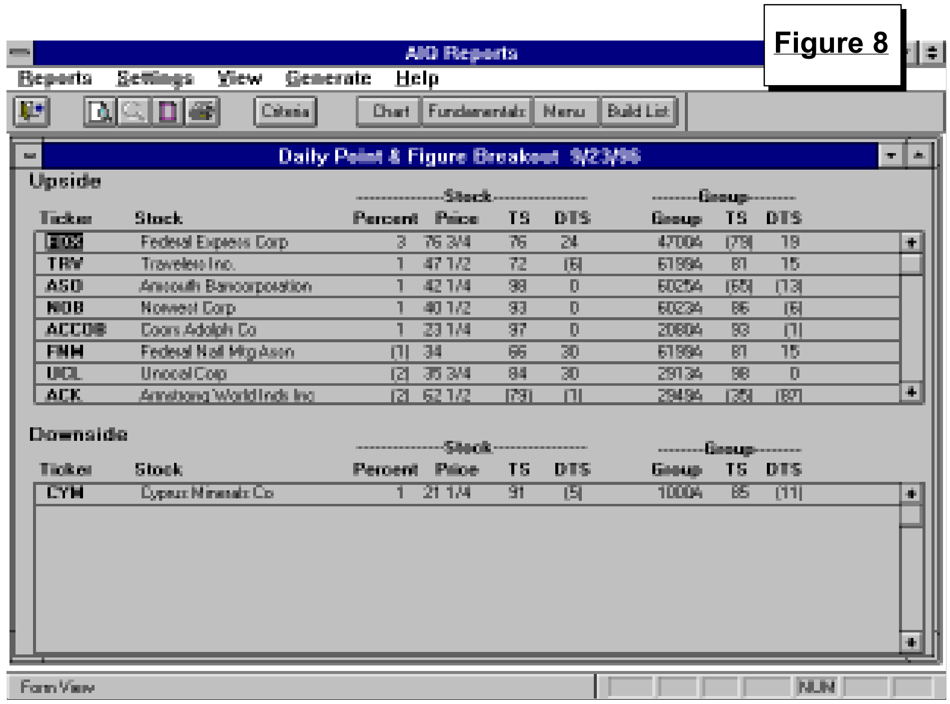
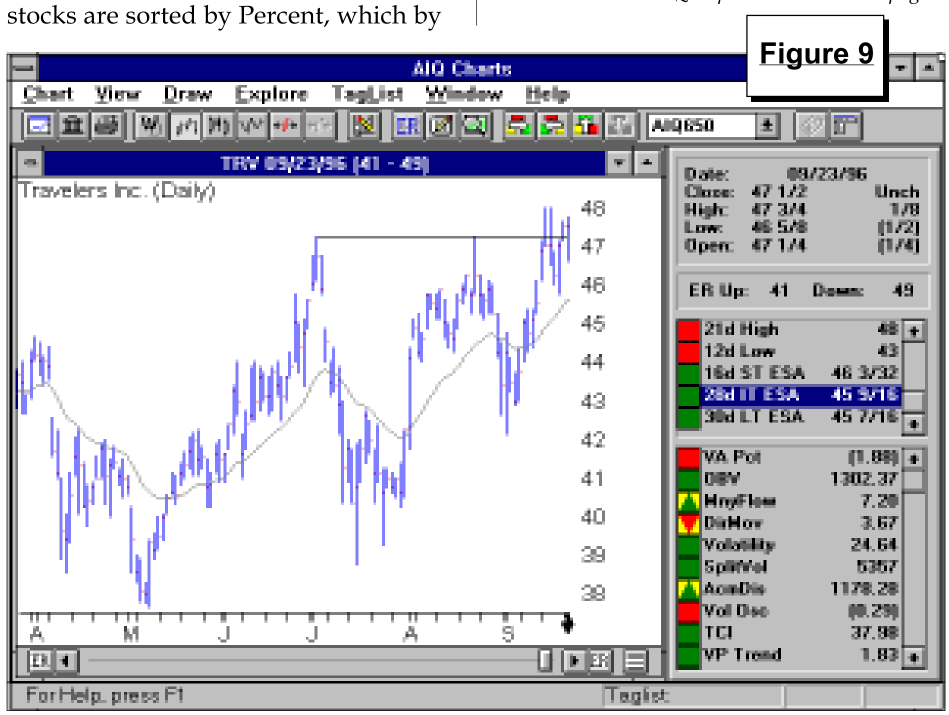


Figure 9



TRADING COMMENTARY *continued . . .*

Mistake 8.
Trying to Pick the Bottoms of Past Stars.

Wall Street is driven by mass psychology. In one month, people will pay any price for a stock and next month there will be no buyers. When "fad" stocks lose public favor, they can give up all that was gained and then some. People were falling over themselves trying to buy Micron Technology and Iomega. This summer, there were no buyers. People who bought these stocks on the way down when they had a 20% correction now have a 60% loss. Don't try to catch a falling star. Wait until the downtrend is over.

Mistake 9.
Measuring Results on Too Short a Time Period.

Because most AIQ users are short term traders, portfolio performance is typically measured on a very short term basis. As a result, people often panic too early. For many AIQ users, it is a tragedy when the market goes against the market timing model for a week. A week seems important at the time, but overall it is usually insignificant. By measuring performance every week, you end up following the herd instead of anticipating it.

Mistake 10.
Information Overload.

TradingExpert is a huge program. Anyone who uses all of its features won't have time to ever place a trade. And if you look at too many variables, you'll never buy a stock because there will always be something wrong with it. People should pick three or four indicators to become familiar with. Look at only those indicators so that you get a feel for how they work. Also, use the parts of the program that fit your investment style. A stock selection process does not have to be complicated in order to be effective. ■

AIQ REPORTS *continued . . .*

report. Notice that the stock reached $47 1/4 in early July and mid-August. It wasn't until mid-September that the stock rose above this level. The consolidation and breakout levels are based on the high and low prices for the securities rather than the close.

Since Point & Figure charts are based on price only, the time spent in the consolidation phase is irrelevant. For Travelers Inc., the pattern covered three months. The pattern for Federal Express, on the other hand, covered only one month and the pattern for Amsouth Bancorp covered one year.

When a stock rises too far above the breakout level, it will no longer appear on the report. By default, when the stock rises by more than five box sizes (five Xs above the breakout), it will no longer appear on the report. This value is called the "search box number" under Daily Report Criteria.

Preliminary tests of this report show that the breakout is not enough reason to buy the stock. Since the report is based solely on a stock's price, indicator readings must be incorporated in the analysis. I am finding, however, that the Point & Figure Breakout report is helping to spot the stocks that, after more analysis, end up as my final selections. ■

STOCK DATA MAINTENANCE

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

Stock	Ticker	Split/Div.	Approx. Date
First Liberty Fin'l	FLFC	3:2	10/02/96
Jones Apparel	JNY	2:1	10/03/96
Equity Corp.	ECII	3:2	10/03/96
Hilton Hotels	HLT	4:1	10/07/96
Conso Products	CNSO	3:2	10/07/96
Pomeroy Computer	PMRY	3:2	10/07/96
Heartland Express	HTLD	3:2	10/07/96
Oakley Inc.	OO	2:1	10/11/96
Newbridge Networks	NN	2:1	10/14/96
Clarify Inc.	CLFY	2:1	10/14/96

Stock	Ticker	Split/Div.	Approx. Date
Parkvale Financial	PVSA	5:4	10/15/96
Vantive Corp	VNTV	2:1	10/15/96
Just For Feet	FEET	3:2	10/16/96
Thermo Ecotek	TCK	3:2	10/17/96
Pacific Sunwear	PSUN	3:2	10/18/96
McAfee Assoc.	MCAF	3:2	10/22/96
Nike Inc.	NKE	2:1	10/24/96
Nat'l Beverage Corp	FIZ	2:1	10/28/96
ADC Telecom	ADCT	2:1	11/01/96

Trading Suspended:

Varity Corp (VAT),Sanifill Inc. (FIL), Caremark Int'l (CK)

Name/Ticker Changes:

Station Casinos (STCI) to Station Casinos (STN), Betz Labs (BTL) to Betz Dearborn (BTL)
Celex Group (CLXG) to Successories Inc. (SCES), JLG Industries (JLGI) to JLG Industries (JLG)
Sonat Offshore Drilling (RIG) to Transocean Offshore (RIG), America Online (AMER) to America Online (AOL)
Mark Twain Bancshares (MTWN) to Mark Twain Bancshares (MTB)