AIQ Opening Bell Newsletter

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Risk Management Works

Focus on 'Not Losing' versus 'Making a Wad'

This interview with hedge fund manager Henry Brookins was conducted by *Opening Bell* publisher David Vomund.

Opening Bell: How did you become involved in the investment field?

Brookins: I attended graduate school in Monterey, California, and met a fellow with a large profitable portfolio. As a Naval Officer making 32k a year, I was interested in how he was making so much extra money. He told me to read William O'Neil's "How to Make Money in Stocks." After successfully paper trading O'Neils method for four months, I entered the market with a credit card cash advance and I have been trading ever since. However, I did modify O'Neil's method quite a bit after attending the "School of Hard Knocks" for a year or so.

Henry Brookins is a hedge fund manager and publisher of *runStockrun*, a daily newsletter. Mr. Brookins has been an AIQ user since 1997 and has lectured at several AIQ seminars. He can be contacted by visiting his web site at *www.runstockrun.com.*

Opening Bell: Can you tell me more about your *runStockrun* daily newsletter?

Place Brookins Photo Here

Henry Brookins

Brookins: After successfully trading for a couple of years and periodically posting stock picks on a Prodigy bulletin board between 1991 and 1993, a lot of people started asking me to start a stock newsletter so that they could receive regular stock updates. During those years, I was still in the military and didn't have time to devote to a newsletter. I caved in to pressure in 1995 and started a weekly letter called *Brookins' Buys.* When I left the military in 1997, I became a full-time trader and later changed the name of my newsletter to *runStockrun*.

> *"If you can find a "consistent" money manager, one with low drawdowns, then you're better off than with someone who is making a killing one year and losing a lot the next."*

In short, the newsletter is designed to help stock investors and traders to make money. The letter gives a market forecast and identifies potential winning

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stocks, both long and short, with specific entry and exit points.

Opening Bell: In your newsletter you follow a growth strategy but you also keep a close watch on drawdowns. Your focus on risk management seemed unnecessary in the 1990s but times have changed. Why do you place so much emphasis on limiting losses?

Brookins: Mathematically, it is prudent to focus on not losing versus focusing on making a wad. The best way to show why what I do works well is to take a real life example of the money I manage for others.

The Mathematics of Losing

From the data shown in **Table 1**, it looks like I am barely outperforming the markets. But, looking at real dollars (**Table 2**) instead of percentages, the picture changes.

So mathematics proves that if you can find a "consistent" money manager, one with low drawdowns, then you're better off than with someone who is making a killing one year and losing a lot the next. People should ask a manager what his max drawdown is versus the average yearly return. Unfortunately, the latter is the way marketing works at the big firms.

Opening Bell: How has your stock selection style changed in the current market compared to the bull market of the 1990s?

Brookins: From 1990 to 1995, the CANSLIM method, which focuses heavily on fundamentals, worked very well. However, in 1995 things changed with the introduction of trading in the internet stocks. Wall Street no longer cared about fundamentals, and the best performers for the next four to five years were stocks that were losing money—the Dot.Com types. Momentum trading became a way of life. You either joined the crowd, or underperformed by a long shot. About this time the CNBC Gurus began talking about "a new paradigm and the need to find a new way to value a company."

During this time, I drastically altered my method and played the momentum game with the big guys. I started trading the market instead of investing. I no longer felt comfortable holding a stock overnight. I started trading using a lot more Technical Analysis (trends) and I paid a lot more attention to drawdowns. Very little attention was paid to fundamentals. Big Money doesn't care about fundamentals and Big Money is what moves stocks. These days, I go long and short and primarily focus on technical analysis and limiting drawdowns.

"Big Money doesn't care about fundamentals and Big Money is what moves stocks. These days, I go long and short and primarily focus on technical analysis and limiting drawdowns."

Table 1.
HB Fund vs. Market Indexes
Percentage Gain/Loss

	DJIA	NASD	SP500	HBFund
1998	9.2	25.2	18.4	16.5
1999	25.2	85.6	19.5	48.8
2000	(6.2)	(39.3)	(10.1)	(18.5)
2001	(7.1)	(21.1)	(13.0)	2.2
4-year avg.	5.3	12.6	3.7	12.3

Table 2.
HB Fund vs. Market Indexes
Year-end $ Value

	DJIA	NASD	SP500	HBFUND
Start Balance	$100,000.00	$100,000.00	$100,000.00	$100,000.00
1998	$109,200.00	$125,200.00	$118,400.00	$116,500.00
1999	$136,718.00	$232,371.00	$141,488.00	$173,352.00
2000	$128,241.00	$141,049.00	$127,197.00	$141,281.00
2001	$119,135.00	$111,287.00	$110,661.00	$146,265.57
Actual gain	19.1%	11.3%	10.7%	46.2%

Opening Bell: Market timing plays a large role in your analysis. What tools do you use to tell you when to be in the market and when to be out of the market?

Brookins: My primary tool is Technical Analysis and, of course, I use the software from AIQ. I use it every day and won't change to anything else. Moving averages are among my favorite tools. I like the 21-day ESA, 50-day ESA, and 200-day MA. Anytime these moving averages converge like they did at the end of last year on the S&P 500 and the Nasdaq, you know a big move is coming.

I also follow investment advisor sentiment, put/call ratios, stochastics, your proprietary AIQ

Bands, and, of course, price/volume relationships to determine when to enter and exit the market.

The overall trend of the market is the most critical item. In **Figure 1** we see that the S&P 500 is in an overall downtrend and remains so as long as it is below the 1180 price level. Once it breaks above 1180 (which is a long way from now!), it will have risen above the trendline drawn from the January and March high points. It will also have risen above the 50-week moving average. Notice also how the market tends to rally once it falls below the lower AIQ Band.

These AIQ tools have worked very well for me for years, and I've evaluated a lot of software and systems. I have devised a relatively simple system over the years with my own money invested, and the system has hardly changed in 10 years (except for the near abolishment of fundamental analysis, for now).

Opening Bell: What is your average holding period?

Brookins: Over the last three years, the average holding period is about four days with an average gain of over 4% per trade. The majority were short positions.

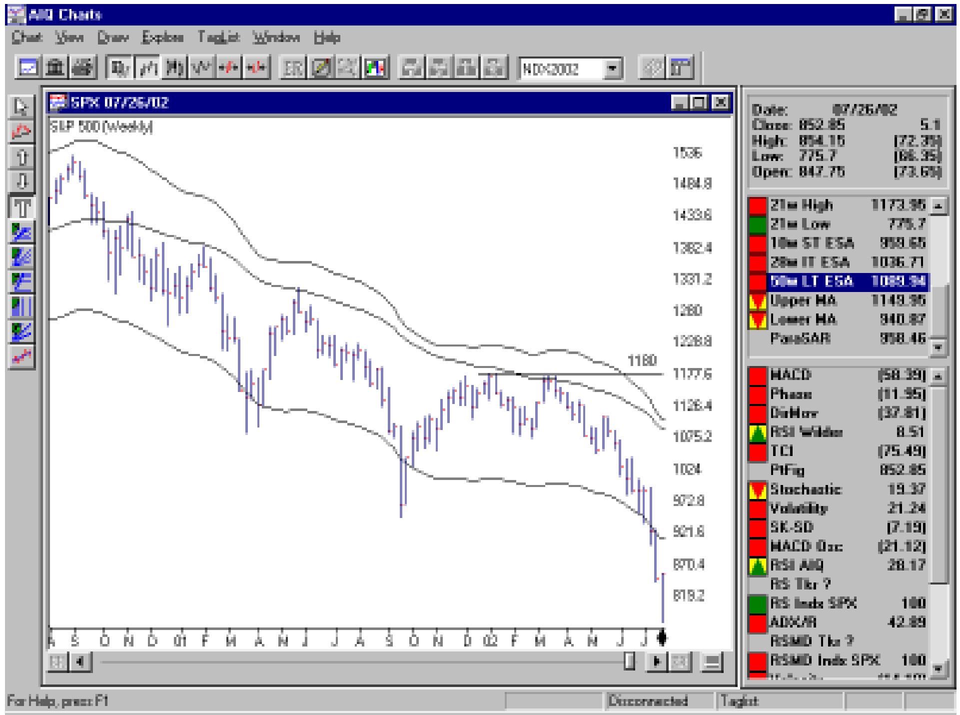

Figure 1. Weekly chart of S&P 500 showing downtrend and the 1180 resistance level. Notice that market can not rise above 50 wk MA but tends to rally once lower trading band is penetrated.

Opening Bell: Please give us some examples of your short selling strategy.

Brookins: I mostly combine chart pattern analysis with moving average and volume readings. The stocks I short typically have fallen below their 50-day moving averages. In some cases, the 21-day moving average recently moved below the 50-day moving average.

Let me give you a few examples. I shorted Enzon Inc. (ENZN) in January of this year. In **Figure 2** we see ENZN's poor technical picture. It broke below all of its moving averages and did so with heavier than average volume. The short was confirmed once it broke to the downside of the Wedge pattern on heavy volume. During this time the market was in a downtrend, which gave me further reassurance.

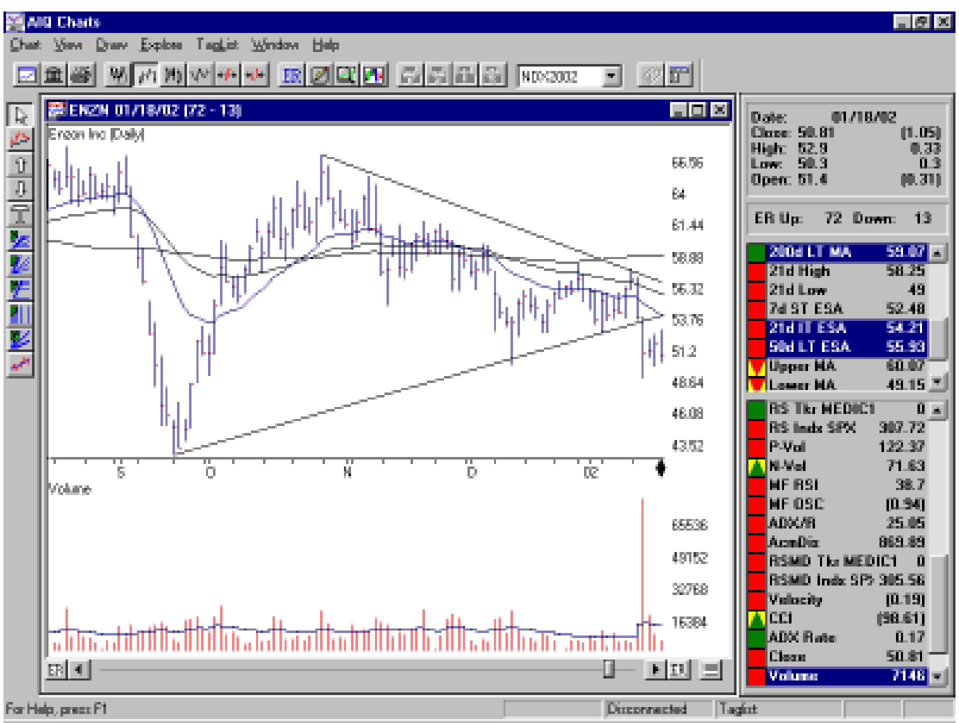

Figure 2. Daily chart of ENZN with wedge pattern indicated by support and resistance trendlines. Downside break of support trendline on heavy volume considered bearish signal.

Figure 3 shows a longer-term short trade. This weekly chart of Merrill Lynch (MER) has similar characteristics to the Enzon example. MER first broke below its moving averages and then broke below its support trendlines with above average volume.

MER rallied enough to test its

breakdown but the overall downtrend prevailed. Another example that users can plot on their screens is BGEN. Its breakdown came at $50.

A common pattern in bear markets is the Rising Wedge (**Figure 4**). Although the pattern slopes higher, it is typically resolved to the downside. Explosive moves follow the breakdown, as was the case with NVIDIA (NVDA).

You can see the exact same formation during the same time period on Veritas Software (VRTS). Using a weekly chart, Forest Labs (FRX) broke below a Rising Wedge in early May.

Opening Bell: In your newsletter, you trade mostly Nasdaq stocks and also trade the Nasdaq Tracking Stock (QQQ). Is there an advantage to trading Nasdaq stocks over NYSE stocks?

Brookins: I do mainly trade the NASDAQ, but that varies. Over the past two months, I've traded the Dow Jones Industrial Average stocks because those were the last stocks to break down. I'll go wherever the action is.

Opening Bell: How do you know when to sell a security?

Brookins: There are so many techniques that I can't give a firm rule unless I'm given a specific market condition. Selling depends on market, price volume action, short or long, whether I'm trading against the major trend or not, and whether I am in profit or not. I typically use a short-term moving average to guide me out.

Opening Bell: What advice would you give to new TradingExpert users?

Brookins: Don't rely on AIQ's buy and sell signals. Learn chart patterns. There are repeating patterns that are profitable a high percentage of the time. Study the past price/volume action of a stock once it breaks below or above the 9-day moving average, particularly if the 9-day crosses above the 21-day moving average. And definitely use the AIQ Trading Bands as a guide to an overbought or oversold condition.

You can contact Henry Brookins by visiting his web site at **www.runstockrun.com.**

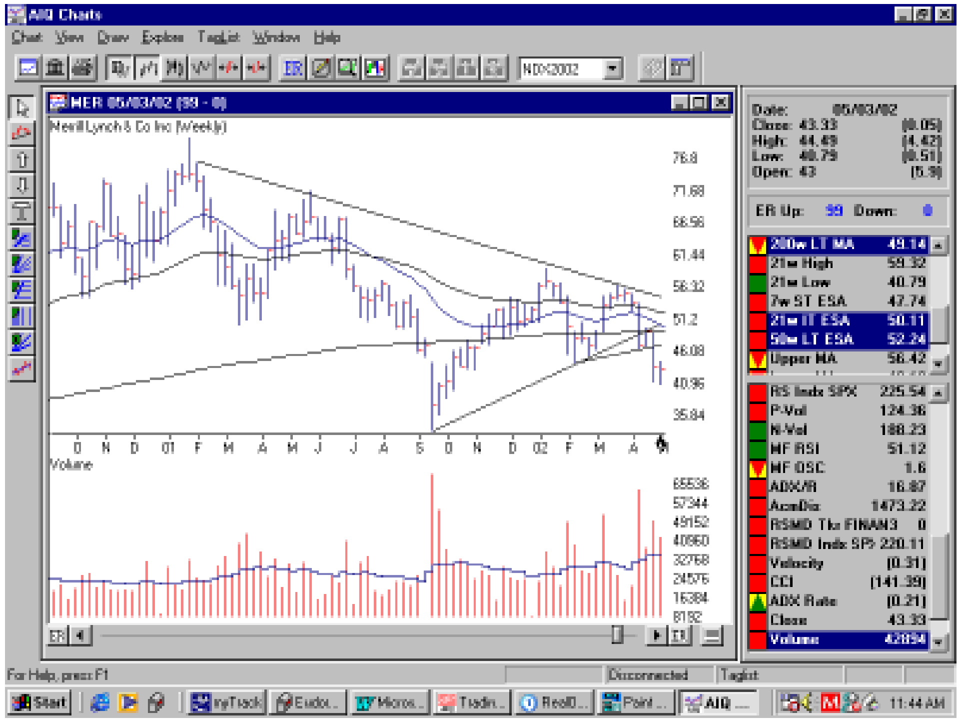

Figure 3. Weekly chart of Merrill Lynch with wedge pattern drawn and bearish break below support trendline on above average volume.

Figure 4. Daily chart of NVIDIA showing rising wedge pattern which ended in January 2002 when price broke below support trendline.

Want to Avoid Choppy Market Whipsaws? Commodity Channel Index Helps

Some indicators work well in trending markets while others work in consolidating markets. The Commodity Channel Index (CCI) works best in strong trending markets. Unlike other trend following indicators, the CCI is designed to limit whipsaws during choppy markets.

Created by Donald Lambert, the CCI is a price momentum indicator that measures the degree of variance of a security's price from its statistical mean. Although originally developed for trading commodities, the CCI can be used for equities or indexes as well.

AIQ has a default time period of 90-days in the calculation of the CCI. Time periods that are too short can lead to whipsaws while time periods that are too long result in missed signals. The 90-day time period seems to be a good compromise.

In general, the CCI looks at prices relative to the average price. If the CCI is high, then prices for that security are higher relative to its average price. Conversely, if the CCI of a security is low, then prices are lower than the average price.

In consolidating or sideways markets, the CCI tends to fall within the +/-100 range (the two horizontal lines on an AIQ chart). Whenever the CCI moves above or below this range, then it suggests a strong trend is in place. Therefore, when the CCI rises above +100 it suggests a strong uptrend is underway and that long positions can be established. Long positions are closed once the CCI falls below +100. Conversely, when the CCI falls below –100 it means a downtrend is in place and short positions can be established. Short positions can be covered once the CCI rises above –100.

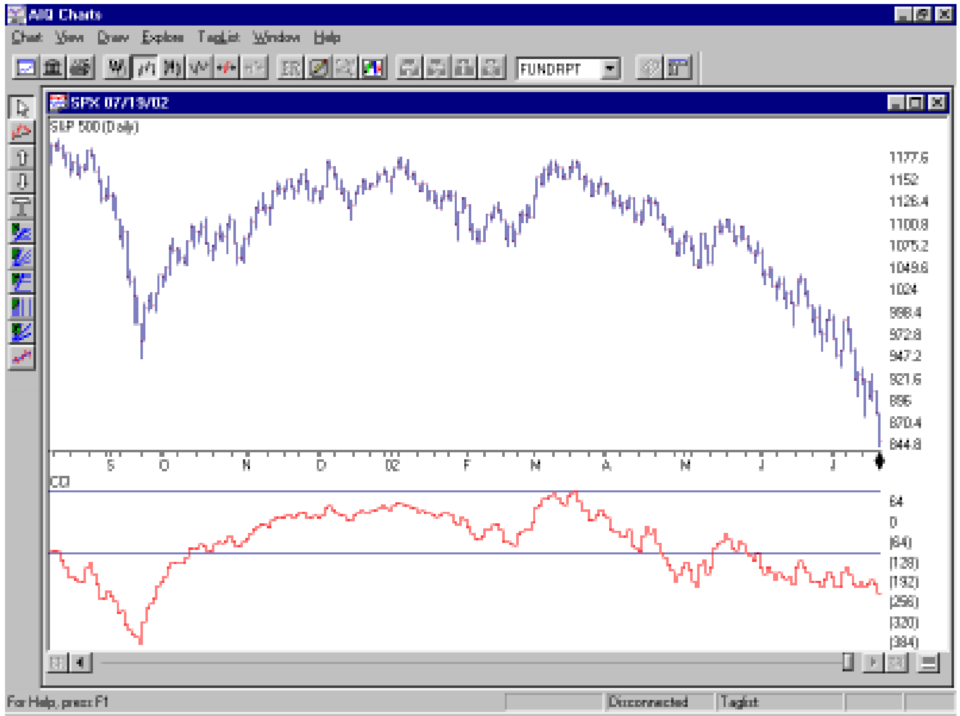

Figure 1. Chart of S&P 500 with CCI indicator plotted in lower panel

Figure 1 shows the S&P 500 along with its CCI indicator. Notice how this indicator was on a sell signal during the September 2001 sell-off. When the S&P 500 drifted sideways from November 2001 through April 2002, the CCI was within the +100/-100 range so no signals were fired. This helped to avoid whipsaws.

There was a brief sell signal when the CCI fell below –100 in late April and then another sell in late May. As of this writing, the late May sell signal is still in place.

Like other indicators, it is best to use the CCI in conjunction with other technical tools. Modifications to the simple buy/sell rules can be made as well. For instance, if the CCI has fallen to –170 and you have large profits on short positions, then it may be best to lock in some of the profits rather than waiting for the indicator to rise above –100. Money management rules are important. Still, it is easy to see the value of the Commodity Channel Index indicator.

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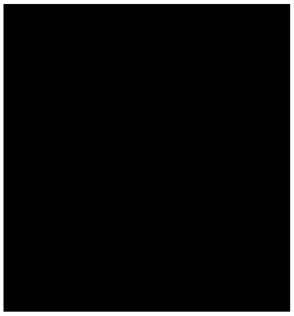

DAVID VOMUND

Creating a Reduced-Risk Trading System

Consider Exchange Traded Funds During 'Tortuous' Bear Markets

By David Vomund

After a tortuous bear market, many people want to participate in the market but don't want to take the risk of holding individual stocks. For these investors, Exchange Traded Funds (ETFs) are worthy of consideration. ETFs are like index mutual funds, except they can be bought or sold at any time of the day, just like a stock. ETFs serve as great trading vehicles.

First launched in the early 1990s, Exchange Traded Funds have become the fastest-growing financial product in the United States. ETFs are securities that combine essential elements of individual stocks and index funds. Like stocks, ETFs are traded on the major U.S. stock exchanges and can be bought and sold at any time during normal trading hours. You can even short them on a downtick. Like index funds, ETFs are pools of securities that track specific markets.

> *"ETFs eliminate individual stock risk. Since ETFs hold a broad portfolio, one bad stock has only a limited affect on price."*

ETFs give investors the opportunity to buy or sell an interest in an entire portfolio in a single transaction. They do have risk. There is the risk that the market will fall. But ETFs eliminate individual stock risk. Nearly every day, there is an example of a stock that loses a quarter of its value because of a profit warning. With ETFs, the risk of holding one of these securities is diminished. Since they hold a broad portfolio, one bad stock only has a limited affect on price.

There are some very well known ETFs. The Spyder (SPY) tracks the S&P 500, the Nasdaq 100 Tracking Stock (QQQ) tracks the Nasdaq 100 index, and the Dow Diamond (DIA) tracks the Dow Jones Industrial Average. There are lesser-known ETFs available in many other investment categories, including:

- Industry Sectors
- Small Cap, Mid Cap, and Large Cap
- Growth and Value Orientation
- Domestic and International
- Fixed Income

For a complete listing of ETFs, visit **www.amex.com**.

ETFs trade just like stocks and AIQ's screening reports and Expert Design Studio models can be utilized. Backtesting is a problem, however, because most ETFs began trading in 2000 or later.

Table 1. Exchange Traded Funds

Ticker	Name
DIA	Dow Diamond
IJH	iShares S&P MidCap 400
IJK	iShares S&P MidCap 400 Growth
IJR	iShares S&P SmallCap 600
IVE	iShares S&P 500/Barra Value
IVW	iShares S&P 500/Barra Growth
IWM	iShares Russell 2000
QQQ	Nasdaq 100 Tracking Stock
SPY	Spyder

My goal for this article was to create a trading system utilizing ETFs. I also wanted to learn the functions of the new Portfolio Manager. Therefore, I chose to backtest a trading system that couldn't be automatically backtested using AIQ's Portfolio Simulator. Instead, the backtested trades were manually entered into the Portfolio Manager.

Here is the trading system. I first created a Tag List of the nine broad-based ETFs, found in **Table 1**. The Relative Strength-Short Term report was run on this list of ETFs every other Friday (i.e., there is only one day in a two-week time span when you need to re-evaluate). At the start of the test, the two highest rated ETFs were purchased making a fully invested portfolio.

Two weeks later, the report was run again. If the current holdings were rated in the top five ETFs then there were no trades. If a holding had fallen in the Relative Strength report to where it was no longer in the top five, then it was sold and the highest rated ETF was purchased.

The portfolio was always fully invested in two ETFs. During times when no ETFs appeared on the Relative Strength-Short Term Strong report, then the best performing ETFs were purchased from the Relative Strength-Short Term Weak report. We assumed that the ETFs were bought and sold on Friday's closing price instead of Monday's opening price. This assumption is reasonable because you can download price data and run the report a few minutes before the close. The backtest doesn't include slippage, however. The lesser-known ETFs trade on light volume so it may be hard to follow this model with a lot of money.

The backtest began on September 1, 2000. The two highest rated ETFs that were purchased were S&P MidCap Growth and Russell 2000. The Portfolio Simulator is unable to backtest a model that screens and trades only one day every other week so you need to manually enter each trade in the Portfolio Manager.

To do this, you first need to create an account. Open the Portfolio Manager and click *Account* and then *New/Simulation*. Be sure to use a commission schedule that matches your brokerage commission fees. Once the account is created, then make a money deposit on the first day of the backtest. Click *Transaction* and then *New*. Be sure to highlight *Deposit* from the set of *Transaction Type* choices. For my test, I deposited $100,000 on August 31, 2000. To enter a trade, click *Transaction* and then *New*. For this test you will be selecting either *Buy* or *Sell.*

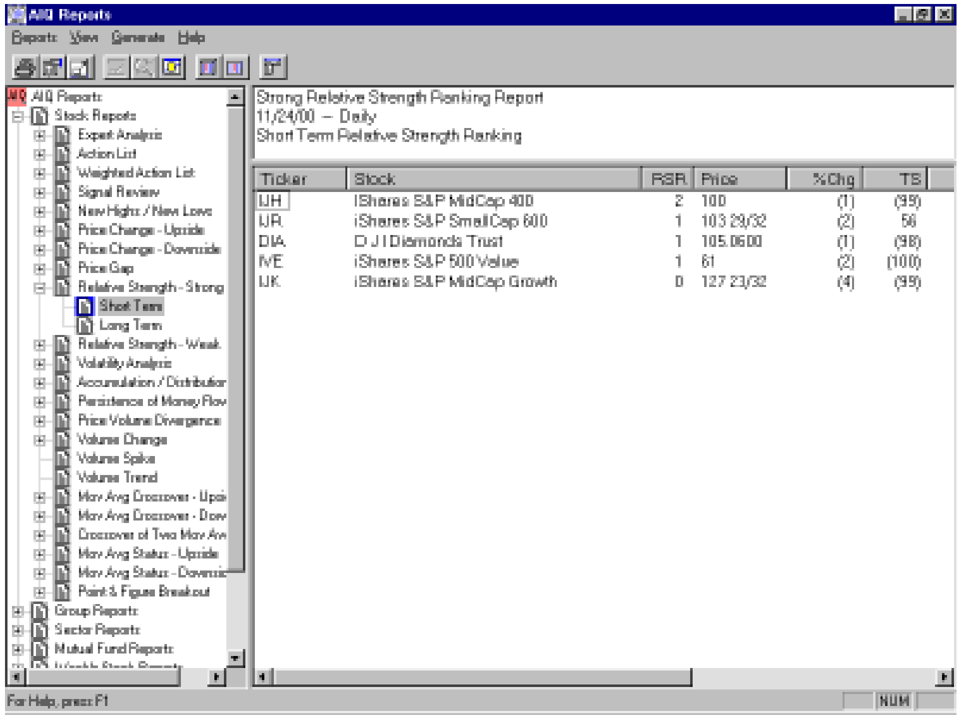

Figure 1. Relative Strength-Strong Report for ETFs on 11/24/00.

There were two trades in the first three months of our backtest. On Nov. 24, 2000, the Relative Strength report had us in S&P MidCap 400 (IJH) and S&P SmallCap 600 (IJR), as shown in **Figure 1**. These two securities continually outperformed the other market measurements and were held for 11 months!

There were about two trades per month in the fourth quarter of 2001 and on December 21, 2001 the same two securities, S&P MidCap 400 (IJH) and S&P SmallCap 600 (IJR), were purchased. Once again, they turned into long-term positions as they were still being held in August 2002.

During this bear market, our trading strategy lost money but it consistently outperformed the market. Over the last two years, this trading strategy lost 20.75%. That compares to a 37.7% loss in the S&P 500 and 66.9% loss in the Nasdaq Composite. There were nine trades and the average holding period was 157 calendar days (**Figure 2**). The yearly breakdown is seen in **Table 2**.

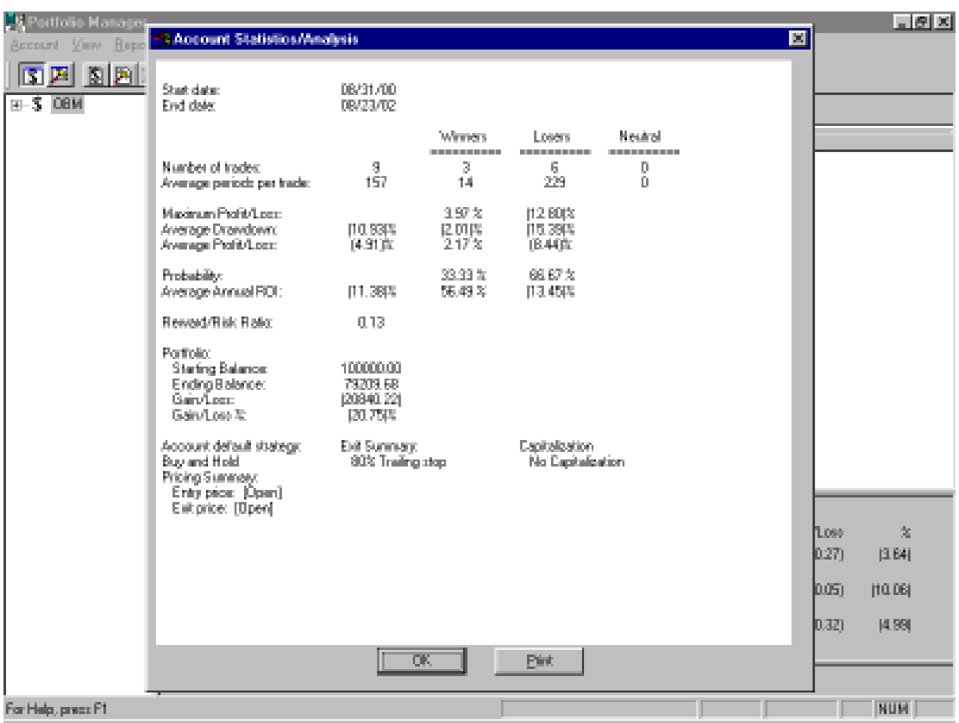

Figure 2. Statistics/Analysis Report with results of two year bear market test of ETF trading strategy.

With an average holding period

Table 2. Percentage Returns

	ETF Strategy	S&P 500	Nasdaq Comp.
08/31/00 - 12/29/00	-9.13	-13.00	-41.27
12/29/00 - 12/31/01	-2.66	-13.04	-21.03
12/31/01 - 08/16/02	-11.32	-19.11	-30.24

of 157 days, this is a long-term trading system. To make it more active, either run the report every week (as opposed to every other week) or sell the ETF if it drops from one of the top three position spots on the Relative Strength report.

The ETF trading strategy outperformed in the bear market, but how would it have performed in the 1990s bull market? I don't know that answer because the iShares ETFs began trading in mid-2000.

I am confident the strategy would test well, however, because the Nasdaq 100 Tracking Stock (QQQ) was available for purchase. Over the last two years, QQQ was only held for four weeks but in the 1990s, especially in 1999, it would certainly have played a major role in boosting portfolio returns.

One way of backtesting this strategy in the 1990s is to run the Relative Strength report on a set of mutual funds that includes a large-cap fund, a small-cap fund, a growth fund, and a value fund. Hand entering the backtest into the Portfolio Manager was time consuming but I found it a beneficial exercise. First, it allowed me to learn the functions of the new Portfolio Manager. It also gave me a better feel for how the ETF trading system worked, seeing how many trades were worth executing and how many turned into whipsaws.

Even if you choose not to employ an ETF strategy in your own account, it is useful to know that these securities exist. When you want to enter the market but are unwilling to take the risk of owning individual stocks, then buying an ETF such as the Spyder (SPY) makes a lot of sense.

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

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date
Bay State Bancorp	BYS	3:1	09/04/02
Novitron Int'l	NOVI	5:4	09/11/02
Delta Apparel Co.	DLA	2:1	09/23/02

Trading Suspended:

CAE Inc. (CGT), Chiles Offshore Inc. (COD), Conseco Inc. (CNC), Cott Corp (COTT), Engage Inc. (ENGA), HNC Software (HNCS), Panavision Inc. (PVI), SLI Inc. (SLI), US Airways (U)

Name Changes:

Cache Flow Inc. (CFLO) to Blue Coat Systems (BCSI)
Life Financial Group (LFCD) to Pacific Premier Bancorp (PPBI)
MeriStar Hotels & Resorts (MMH) to Interstate Hotels & Resorts (IHR)

Market Review

The market was flat in August but it did have a substantial rally from its July low. From the July 23 low to the August 22 high, the S&P 500 rose 20% and the Nasdaq Composite rose 16%.

The mid-month rally brought the market to overbought levels. Looking at AIQ's Market Log report on August 23, there were a lot of stocks giving sell signals. Of the S&P 500 stocks giving unconfirmed AIQ signals, 99% were on the sell side. Of the stocks giving confirmed signals, 92% were on the sell side. The AIQ market timing model, which had been on a buy since mid-May, finally switched to a sell signal when it gave a 99 sell on August 28.

S&P 500 Changes

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

Travelers Property Casualty Corp (TAP.B) replaces Vitesse Semiconductor (VTSS). TAP.B is added to the Property & Casualty Insurance (INSURAPC) group.

Monsanto Co. (MON) replaces Palm Inc. (PALM). MON is added to the Fertilizers & Agricultural Chemicals (CHEMICAF) group.

RJ Reynolds Tobacco (RJR) replaces Conoco Inc. (COC). RJR is added to the Tobacco (TOBACCOA) group.

A new Fertilizers & Agricultural Chemicals (CHEMICAF) group is added under the Materials (MATERIAL) sector.