Chapter III.

Confirming Expert Rating Signals

In This Chapter

A variety of confirmation rules are discussed in this chapter. These rules vary in complexity, in responsiveness, and in risk/reward levels.

AIQ Expert Rating signals are designed to anticipate changes in the direction of price movement. Some are accurate and some are not. However, more often than not, the Expert Rating signals are accurate. Of the signals that are accurate, some are early, some are late, and some are timed perfectly.

Since traders cannot portend next week's market prices, they must decide whether to make a trade or to stand aside based on the information available. In order to help the prudent trader increase the number of profitable trades, AIQ TradingExpert Pro provides a wide array of information that can be used for signal validation. The process of using other information to validate signals is called signal confirmation.

Signal confirmation is accomplished in a variety of ways. Inherent in each method is a certain risk vs. reward characteristic; the specific method must be decided by each trader. As the level of confirmation increases, the level of risk is reduced. As risk is reduced, the level of potential reward is also reduced. Traders must balance their personal levels of risk tolerance against their reward objectives.

Note
More information about any of the technical indicators discussed in the Confirmation Guide can be found in Chapter I of this Reference Manual, *Technical Indicators Explained.*

Signal Confirmation Rules

Each trader must develop his or her own confirmation rules for deciding market direction and for each trading instrument. A variety of signal confirmation rules will be discussed on the following pages. These rules vary in complexity, in responsiveness, and in risk/reward levels. The final choice is left to the user.

The Signal Confirmation rules are:

1. No Confirmation
2. Price Confirmation
3. Price/Volume Confirmation
4. Independent Corroboration by Separate TradingExpert Components

> **Important**
> The first three rules apply to both the market timing and the equity Expert Rating signals found on AIQ Charts. However, the fourth rule concerning independent corroboration applies only to market timing signals.

Rule 1. No Confirmation

The lowest level confirmation rule is simply no confirmation at all. With this rule, Expert Ratings are accepted at face value and trades are entered without reliance on other information. This rule has the highest level of associated risk, but it is a valid trading strategy and one that is used by some AIQ users.

Since the “no confirmation” strategy results in a greater number of trades than the more selective confirmation strategies, traders must rely on good money management techniques to minimize losses from trades that go against them. At the same time, they must not exit too early from trades that are working. This type of trading is only for the experienced, nimble trader.

Trading on unconfirmed Expert Ratings is common with traders of both index and equity options. These traders have found that, if they wait for signal confirmation, the option premium has already jumped.

Rule 2. Price Confirmation

The next level confirmation involves the use of trend-following indicators to verify a signal. This rule mandates waiting for price action to move in the direction of the Expert Rating signal. For this purpose, price action is derived from the MACD technical indicator (Moving Average Convergence-Divergence Indicator).

This indicator is comprised of two parts. The first part is the difference between two moving averages of daily closing prices and is called the Price Phase Line. The second part is a moving average of the Price Phase Line and is called the Signal Line. The Price Phase Line is by itself a price indicator and, when used as such, is called the Price Phase Indicator.

In addition, another indicator called the MACD Oscillator is computed from the difference between the Price Phase Line and Signal Line. Although the MACD Oscillator is derived from MACD, it is a separate indicator.

The fastest confirmation rule and the most risky is to wait only for the MACD Oscillator to turn in the direction of the signal. The next fastest is to delay until the Price Phase Indicator turns in the direction of the signal. The third and slowest rule is to wait for the Price Phase Line to cross the Signal Line. While it usually takes a little longer, this last validation rule can sometimes avoid an unprofitable trade.

Of the three rules involving MACD, AIQ considers the second rule, the change in direction of the Price Phase Indicator, to be the rule of choice. This is because the Price Phase is fairly fast in turning, usually confirming several periods before the Signal Line is crossed. Price Phase direction change, therefore, provides a good compromise between safety and speed, or risk and reward.

The turn of the Price Phase Indicator in the direction of the signal is used for signal confirmation in all of the TradingExpert reports.

Note
The Price Phase Indicator is computed for a specific combination of moving averages. The averages that AIQ has established for this indicator were determined by extensive testing. For further information, see the section on the Price Phase Indicator in Chapter I of this Reference Manual.

Rule 3. Price/Volume Confirmation

Higher still on the confirmation scale are rules that involve joint confirmation by two or more technical indicators. The indicators chosen should include the strength of the trend as well as the direction and level of volume. The AIQ charts include a special Indicator Barometer which uses color to show the direction and strength of an indicator's movement. With the Barometer, users can develop their own confirmation rules for any set of indicators.

The more indicators used, the longer it will take for confirmation and the lower the percentage of signals that are validated. However, the benefit is that the risk of trading on a premature signal is reduced.

Including both a price-based indicator and a volume-based indicator in your signal confirmation process is beneficial because these type indicators are not looking at the same data — one often filters the other, reducing whipsaws.

A good volume-based indicator to use in conjunction with price-based indicators is the Positive Volume Index. Since the Positive volume Index is not included in the knowledge base of the expert system, its analysis is independent of the Expert Rating.

In addition to the price-based indicators discussed in Rule 2, another good price-based indicator to use for multi-indicator analysis is the Directional Movement Index.

For a signal to be confirmed using multi-indicator analysis, both the price-based indicator(s) and volume-based indicator(s) should conform to a set of rules. For example, if using the Price Phase Indicator and the Directional Movement Index together with the Positive Volume Index, the signal is confirmed when these three rules are met:

1. The Price Phase Indicator has changed direction and has turned in the direction of the signal.
2. The Positive Volume Index is above its Signal Line for a buy signal, or below its Signal Line for a sell signal.
3. The Directional Movement Index is positive (above the zero line) for a buy signal, or negative (below the zero line) for a sell signal.

Rule 4. Independent Corroboration by Separate TradingExpert Components

Important
Rule 4 applies only to market timing signals.

The strongest level of confirmation for market timing signals is to require that one or more of the system's other independent components provide an indication of the market's future price movement in concert with the market timing signal.

This type of confirmation is best illustrated by an example. One of many possible rules that could be established is a rule that market timing signals (Expert Ratings of 95 or greater) must be confirmed by the Up/Down Signal Ratio, which is found on the Weighted Action List, an AIQ report. For example, the trader might require a Signal Ratio of 85 or greater in the direction of the signal.

In this example, the signal given by TradingExpert's market timing system is confirmed by a signal from TradingExpert's stock timing system. The two are completely separate in terms of expert system knowledge base and data, and share no information or expert rules. Thus, two independent components of TradingExpert are in agreement in that they are both calling for the market to move in the same direction.

This is a very powerful type of validation and does not necessarily require waiting for market price to confirm the signal. In this special case, both the equity and market timing systems have signaled a change in market direction at the same time.

Another possibility of independent corroboration is the Score found on the Group and Sector Analysis reports and generated by the system's group/sector component. The Score provides trend-following information which is based on the movement of groups within the data base.

Confirmation Level vs. Risk Level

Your specific confirmation rule will depend upon your trading strategy and your tolerance for risk. Specific confirmation rules must also be developed for each financial instrument traded, but all will involve only two types of confirmations — confirmation of market timing signals and confirmation of equity signals.

The more complex the confirmation rule and the more validation that is required from other components within the TradingExpert system, the lower the risk of the trading signal. Risk is never zero but, with a high level of confirmation, risk is far lower than trading Expert Rating signals without any confirmation at all.