AIQ Opening Bell Newsletter

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AIQ Opening Bell Interview

Successful Investment Newsletter Publisher Shares His Stock Trading Techniques

By David Vomund

Henry Brookins, a native of Mobile, Alabama, attended the U.S. Naval Academy at Annapolis. After graduating, he served as an engineering officer and ship driver. In 1993 he graduated with an M.S. degree from the Naval Postgraduate School in Monterey, CA, and served an additional four years in the US Navy as an oceanographer.

While in graduate school, he learned to trade stocks and in the early 90's started his own successful stock newsletter. In 1998, he started the Stock Hedge Fund. At present, he trades stocks and writes an investment newsletter called Brookinsbuys.com (www.brookinsbuys.com).

Mr. Brookins was a featured speaker at AIQ's Tahoe Seminars in 1997 and 1999.

Henry Brookins

Vomund: Can you tell us how you became involved in the investment business?

Brookins: I took one look at a friend's brokerage account in graduate school, and decided that I would learn to trade stocks. My friend was using William O'Neil's CANSLIM method and gave me O'Neil's book to read. I started paper trading based on the book's methodologies and after a period of successful paper trading, I decided to put in my own money. I soon discovered the thrill of making money in stocks.

Vomund: When you were a guest speaker at AIQ seminars in the late 1990s, you were a modified CANSLIM trader. The market has changed since then. Has your approach changed?

"It is my experience that if you can protect the downside, the upside will take care of itself. It's a mathematically proven fact that going from $100 to $50 is ONLY a 50% loss. But it takes a 100% gain to just break even."

Brookins: Back in the late 90's, it really didn't matter what method a person used to pick a stock. Dart throwing would have produced great results for most since we were in the latter stages of a bull market. But I found that holding stocks with solid earnings AND bullish chart patterns made me sleep a little better at night.

As you may recall, during my lecture at the AIQ seminar in Tahoe I warned of a significant market top in the making. I presented a 30-year uptrend channel and indicated that the markets were hovering near the top of the channel and we were due for a significant rest. Less than a year later the markets peaked.

After the seminar in Tahoe, I started moving away from using my "modified CANSLIM" method because I couldn't find but a handful of stocks with "value." The majority of stocks were very overbought relative to their earnings. So in order to make money, I started trading internet stocks, and I played momentum stocks up until the end of the bull market.

For the past few years, I have either been in defensive issues (metals, oil, medical, etc.), or mostly in cash. Also over the past few years, I have discovered a method to take advantage of extreme moves in a stock or market, so this has supplemented my income while waiting for the markets to bottom.

Value has returned. And now I am back to searching for stocks with large projected earnings and with bullish charts. And, of course, I always keep "risk" money aside to play stocks like Google Inc. (GOOG) or Travelzoo Inc. (TZOO) that run ahead of themselves into oblivion.

Vomund: Our first *Opening Bell* interview took place in September 2002, just before the market low. At that time you said people's focus should be on minimizing drawdowns instead of making a "wad." Now that the market has moved higher, is this still the case?

Brookins: My theory regarding drawdowns remains the same. It is my experience that if you can protect the downside, the upside will take care of itself. It's a mathematically proven fact that going from $100 to $50 is ONLY a 50% loss. But it takes a 100% gain to just break even.

It is also a mathematical certainty that over a period of time a person returning 10-15% a year with minimum drawdowns will beat a trader making huge returns and having large drawdowns. The market should not vary a person's drawdown or protection philosophy.

Vomund: You handled the bear market well. What are the lessons of the bear market that investors should come away with?

Brookins: There are several lessons. First, history repeats itself. The sun rises and sets, only to rise again. When the talking heads are saying "it's different this time," go ahead and dial 1-800-RUN. I'm talking about buying stocks without earnings. Near the end of the bull market, they changed the way they valued stocks because they had to justify to mom and pop why they were buying YHOO at $400 in their "Value Fund." That was one of the first warning signs.

"Quit thinking that you have the guts to ride a bear market out. You don't. Statistical data shows people tend to give up near the bottom and bail out. Why go through the stress that takes a toll on your life, and your account? "

Don't listen to the "talking heads" on TV, other than for entertainment. Their news is usually late, and they only serve as

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voices for "Big Money" — those who manipulate the markets. The markets are manipulated — always have been, always will be. It's a fact we must live with and accept. Golden Rule — He who has the gold makes the rules.

Finally, quit thinking that you have the guts to ride a bear market out. You don't. Statistical data shows people tend to give up near the bottom and bail out. Why go through the stress that takes a toll on your life, and your account? Sit in cash and remember the math of losing and recovery (above). Be patient and wait for both market and stocks to be on the same trend.

Vomund: You've published an investment newsletter for a long time. Can you tell me how it has evolved over time and describe its current emphasis?

Brookins: The newsletter has evolved more in format than anything else, and not much even there. I still have a section that discusses the big picture in the markets (i.e. trends). I have a HOT STOCK section that introduces stocks that are getting ready to move. Usually these stocks have good fundamentals and excellent chart patterns, but sometimes the section is based on chart patterns that indicate a move is imminent. I also reveal my buy points.

"In general, (to sell) I watch for the stock to break below a key moving average. For long-term investors, this would be the 50 and/or 200-day moving average. Traders would use shorter moving averages."

In addition, I include a Hot Watch section that reveals stocks that I am actively tracking and that show promise of appreciating. We actively track the buys in another section based on chart patterns (i.e. resting, basing, etc.), and I indicate when to take profit and sell the stock. I recently started a section for Short Sellers, and also just started a 100k Model Portfolio that is currently in cash.

Our emphasis for the past few months has been in some Oil stocks, Utility stocks, select Metals, Specialty Chemicals, some Communications issues, and select Internet stocks. IPOs are doing relatively well (see GOOG, OSTK, VLTR). But Oils and Utilities are overbought here. We're starting to see more techs show up – like Communications.

Vomund: In order to limit drawdowns, you incorporate market timing. What techniques do you use to time the market?

Brookins: This part of my trading method has not changed since I started using it in 1992, and my subscribers and I have never been caught in more than a 5% correction. This method also gets us back into the market near the bottom. Our purpose is to take advantage of the middle 70% of the uptrend. This is the one area of my trading that is proprietary but I use:

1) Moving Averages

2) Investor Sentiment

3) Stochastics and RSI

4) Proven Price/Volume Patterns

Vomund: As a growth investor, do you think there can be a long period where the market increases without growth stocks participating? If so, what will your approach be?

Brookins: I'm not sure about the "long period" part — but I believe it can happen for several months! During the last market run from October 2000 to March 2001, the top 100 NASDAQ stocks led the charge from NASDAQ 2600 to 5000, but the broad market advance-decline line was already falling.

"My approach is this: I have developed some software scans that scan for stocks that are bullish, regardless of the market trend. I will move to where the money is flowing, period."

My approach is this: I have developed some software scans that scan for stocks that are bullish, regardless of the market trend. I will move to where the money is flowing, period.

This year I might be a growth investor, next year I might buy metals. I really don't care what stocks are moving, as long as my money and my subscribers' money are in the stocks moving higher.

Vomund: Can you please describe your stock selection approach?

Brookins: I first check next year's projected earnings; I then look for sales and earnings growth on a quarterly basis, paying particular attention to the trend. These should be ramping up. I then do a quick calculation to make sure the stock is not fully priced. I want stocks that can at least double, based on earnings. I check for insider buying, and also average daily volume (I try to stay over 50k daily average so I can get in and out if news hits). I then place these stocks on a watch list, and check their chart patterns nightly.

When the chart patterns become bullish and I feel the stock is about to make a move, I place it in the newsletter. I don't want investors sitting in a stock a year waiting for it to move. I want them to be up in profit as early as possible. This builds confidence to hold the position longer and reduces stress.

I have narrowed bullish patterns down to about five dependable patterns, with the chart of choice being a flat base. We try to buy the stock as it emerges from the base on heavier than average volume. An example is Verisign Inc. (VRSN) in **Figure 1**.

An example of a recent selection is Vasco Data Security (VDSI). Its last quarter earnings change was up 123%, and the last quarter in sales was up 32%. I calculate its value to be $4.50. In **Figure 2** we see it broke out of its base and volume picked up as the stock has advanced.

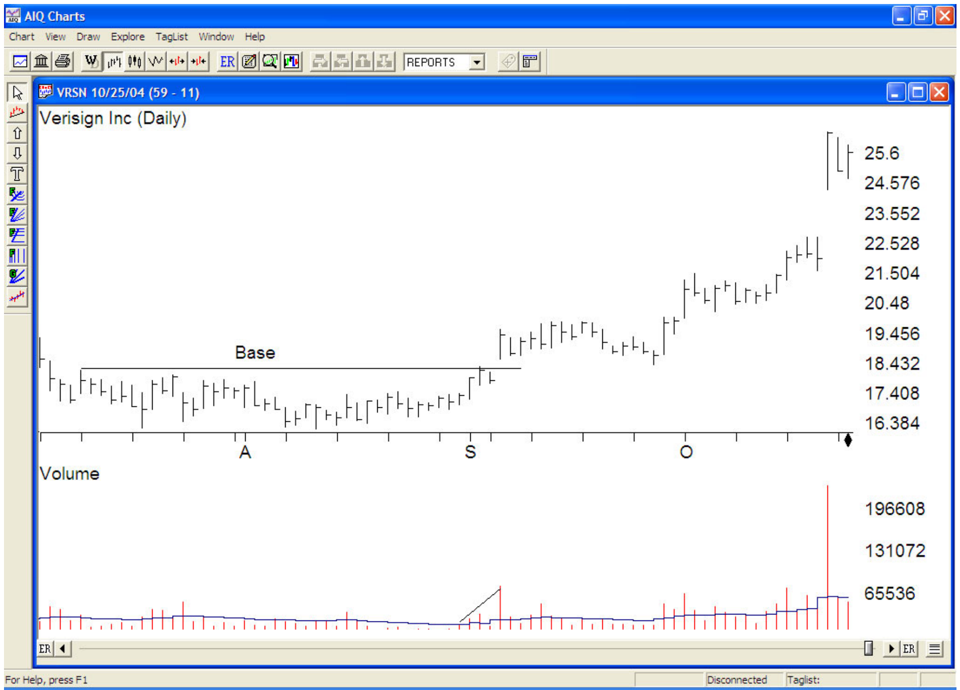

Figure 1. Daily chart of Verisign Inc. Bullish chart pattern formed early in September when VRSN moved above base on above average volume.

"I look for chart pattern primarily (for shorting stocks). When coupled with sudden bad news, the two provide a deadly combination. But usually, chart pattern is enough. I especially like flat base breakdowns on heavy volume."

Figure 2. Daily chart of Vasco Data Security. Buying opportunity occurred early in September when VDSI broke out of base. Following breakout, stock continued to advance with increased volume.

Vomund: How do you know when to sell?

Brookins: I never "know" per say, but I have rules that have worked well most of the time. Often I get stopped out of a stock, only to see it rise a zillion percent — an example is Shanda Interactive (SNDA), recommended in my newsletter at $17 in July 2004. We were stopped out; now it sits at $31.

But in general, I watch for the stock to break below a key moving average. For long-term investors, this would be the 50 and/or 200-day moving average. Traders would use shorter moving averages.

There are other situations also. If I have a big profit, sometimes I take some profit and set a loose stop. In general, if it is rising on heavy volume, I hold. If it stalls on heavy volume, I sell.

Vomund: Do you short stocks?

Brookins: Yes. I look for chart

pattern primarily. When coupled with sudden bad news, the two provide a deadly combination. But usually, chart pattern is enough. I especially like flat base breakdowns on heavy volume.

An example is LKQ Corp (LKQX). It was shorted at $16 as it dropped out of its base (**Figure 3**). I use sell stops to enter the trade, which allows me to catch the downside momentum while not having to sit by the computer waiting for the entry point.

Vomund: Thanks for sharing your thoughts with us.

Information on Henry Brookins' letter can be found at www.brookinsbuys.com.

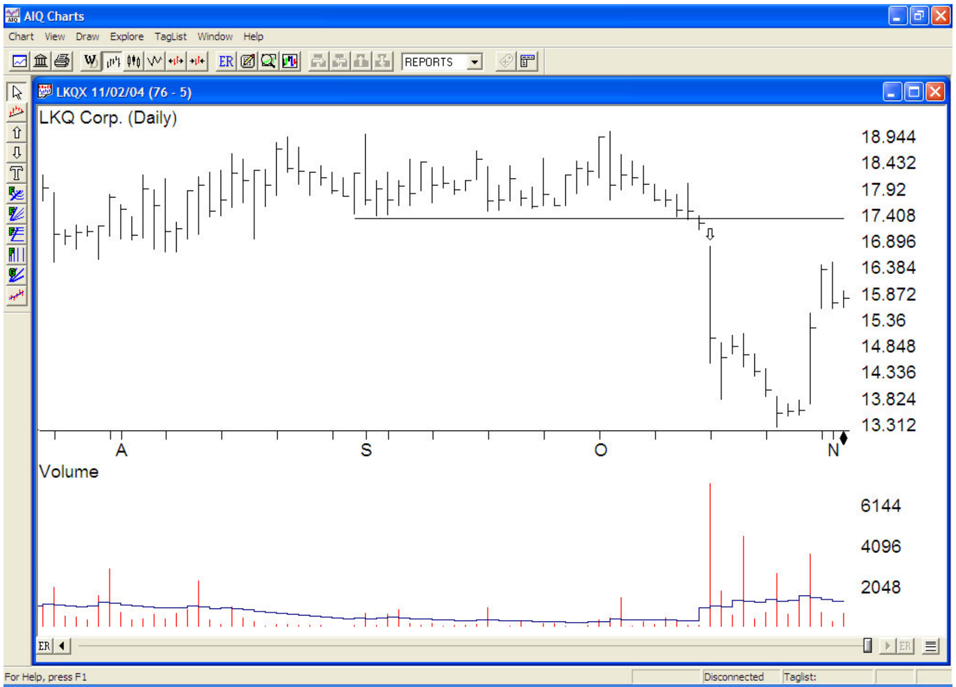

Figure 3. Daily chart of LKQ Corp. Bearish chart pattern formed in mid-October when flat base breakdown took place with heavy volume.

MARKET REVIEW

The first week of November may have been the most important week for the market this year. During that week, the S&P 500 rallied above its previous swing high. That ended the year-long pattern of lower highs. It also ended the eight-month trading range. A weekly chart of the S&P 500 shows the completion of a head-and-shoulders bottom pattern that took place in 2004.

While the news was good for the S&P 500, the best performers were small-cap stocks. The Russell 2000 was hitting new all-time highs for most of November.

S&P 500 CHANGES

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

Laboratories Corp of America (LH) replaces South Trust Corp (SOTR). LH is added to the Health Care Distributors & Services (HEALTHSS) group.

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date
Cheesecake Factory	CAKE	3:2	12/09/04
Badger Meter	BMI	2:1	12/13/04
Immucor Inc.	BLUD	3:2	12/14/04
Wilshire Bancorp	WIBC	2:1	12/15/04
LCA-Vision	LCAV	3:2	12/16/04
Centene Corp	CNC	2:1	12/20/04
Applied Industrial Tech	AIT	3:2	12/20/04
Savannah Bancorp	SAVB	5:4	12/20/04
Autodesk Inc.	ADSK	2:1	12/21/04
First Service Corp	FSRV	2:1	12/23/04
Bebe Stores Inc.	BEBE	3:2	12/30/04
Cleveland Cliffs	CLF	2:1	01/03/05
Brady Corp	BRC	2:1	01/03/05

Trading Suspended:

AT&T Wireless Services (AWE), IMC Global Inc. (IGL), SouthTrust Corp (SOTR), Rouse Co. (RSE), Atrix Laboratories (ATRX), NetSolve Inc. (NTSL)

Name Changes:

Boise Cascade Corp. (BCC) to OfficeMax Inc. (OMX)
Tesoro Petroleum (TSO) to Tesoro Corp. (TSO)
ASA Ltd. (ASA) to ASA (Bermuda) Ltd. (ASA)

Modifying Indicator Readings

Stay Out of Trouble -- Know Which Indicators Work Well and Which Don't In Given Market Conditions

By David Vomund

The market, as measured by the S&P 500 index, was in a trading range for eight months this year. In November, the S&P 500 broke above this range, possibly starting an uptrending pattern. Knowing the trend is important because it affects what technical indicators should be used to judge the market and it affects how the technical indicators should be interpreted.

"In strong uptrending markets, some indicators work very well while others fail to give good results. In consolidating or trading markets, those indicators that failed during trending market environments often work best."

In strong uptrending markets, some indicators work very well while others fail to give good results. In consolidating or trading markets, those indicators that failed during trending market environments often work best. Before analyzing a security with a set of indicators, it is essential to determine the trend of the security and then apply the appropriate indicators in the analysis.

Some indicators work best in trending markets and some indicators work best in non-trending (i.e., consolidating markets). In **Table 1** we've classified some well-known indicators into these two categories.

Generally, indicators that work well in non-trending market environments are those that give overbought/oversold readings. The theory is that when a security rises too far too fast it becomes "overbought" and therefore retreats.

The opposite is true for oversold conditions. These indicators work well in non-trending environments because an overbought reading is registered whenever the security rallies to the upper end of its trading range. Conversely, the security becomes oversold when it nears the lower end of its trading range.

Indicators that work well in trending environments are generally those that tend to remain positive as long as the security continues to rise or those that remain negative as long as the security decreases. A common element in many of these types of indicators is the use of moving averages.

Note: Some indicators such as On Balance Volume and Money Flow are not listed since they do not give strict buy and sell signals.

Table 1.
Indicator Classification

Trending	Non-Trending
AD OSC.	RSI
Dir Mov	Stoc
MACD	MF RSI
MACD Osc	
Mov Avg	
P-Vol	
SK-SD	

Non-Trending Indicators

To demonstrate the effectiveness of a non-trending indicator, we'll look at the S&P 500 during its trading range. **Figure 1** shows the S&P 500 with a 7-day RSI Wilder indicator, an indicator that works well for non-trending securities. An RSI buy signal is registered when the indicator moves out of oversold territory by rising above the lower horizontal line (corresponding to a value of 30). A sell is registered when the indicator falls below the upper horizontal line (corresponding to a value of 70).

"In a non-trending market, the RSI indicator works very well. However, the RSI indicator loses its effectiveness when a strong trend develops."

Notice that as the S&P 500 nears

the top of its range the RSI moves above 70, indicating an overbought reading. Shortly after reaching overbought, the market falls and the RSI registers its sell signal. Conversely, when the S&P 500 falls to the bottom of the range, the RSI reaches oversold and a low is near (the market briefly fell below the range in August). In a non-trending market, the RSI indicator works very well.

However, the RSI indicator loses its effectiveness when a strong trend develops. In **Figure 2** we show the S&P 500 during 2003, a year of a strong uptrend. During the entire advance, the indicator only gave one buy signal, which was a well timed one in early August. Unfortunately, it registered sell signals even as the market moved higher (see down arrows).

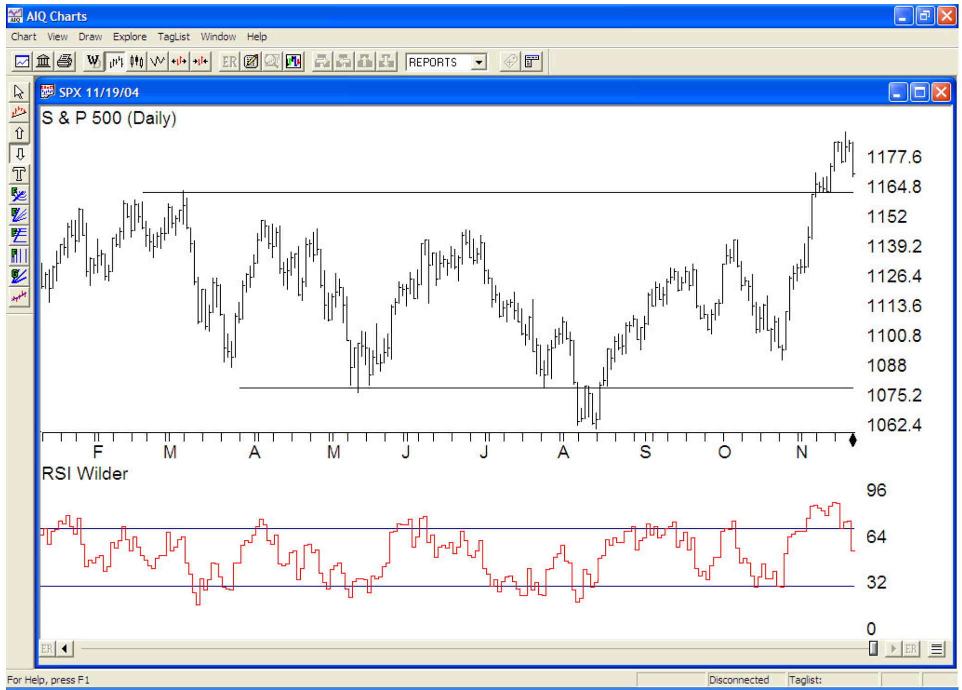

Figure 1. S&P 500 Index with horizontal trendlines drawn to depict 8-month trading range through most of 2004. RSI (shown in lower window) signaled reversals as price neared range boundaries.

"The Directional Movement Index (DMI) works well for the uptrending market, but it loses its effectiveness in non-trending environments. Most of the trades turn out to be whipsaws..."

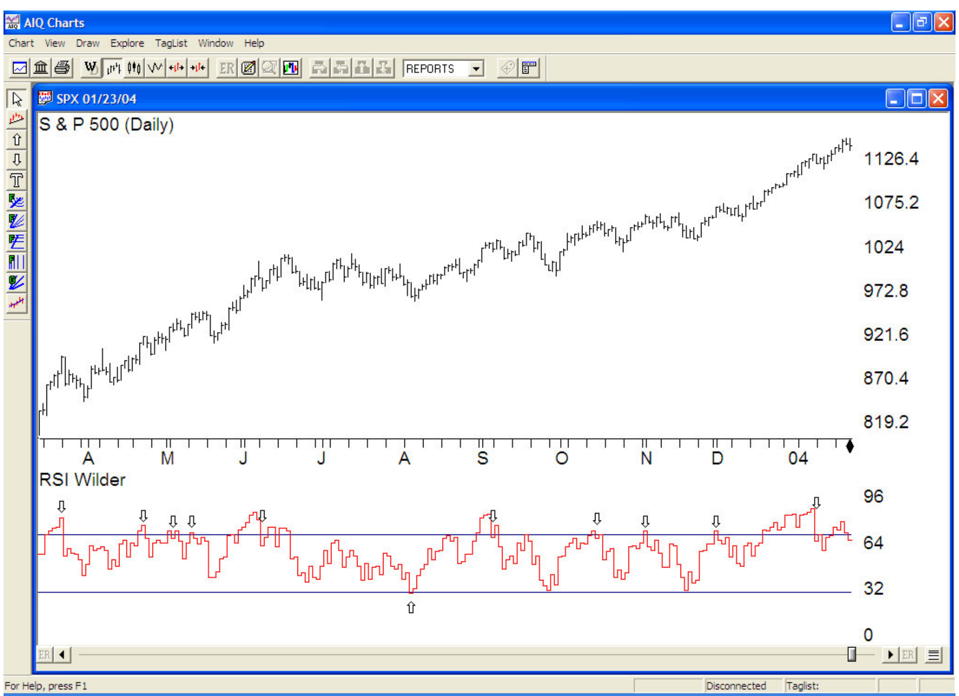

Figure 2. S&P 500 Index showing market's strong uptrend in 2003. Frequent RSI sell signals (down arrows) demonstrate indicator's ineffectiveness in a trending market.

The RSI, as well as the other non-trending indicators, will almost always have you exit from strong trending markets too early.

Trending Indicators

Now we'll examine the effectiveness of an indicator that works well in a trending market environment. In **Figure 3**, an uptrending S&P 500 is displayed along with its Directional Movement Index (DMI). Using the DMI, a buy is registered when the indicator moves above zero and a sell is registered when it falls below zero. In the uptrending S&P 500 chart, the DMI remained positive for the majority of the market advance. Sure there were some brief sell periods but the indicator kept traders in the market for the majority of the advance.

The DMI works well for the uptrending market, but it loses its effectiveness in non-trending environments. Most of the trades turn out to be whipsaws, and the trades come in the middle of the range rather than at the upper and lower ends of the range.

Modifying Indicator Readings

We've seen in our analysis that when an indicator that works well in a non-trending market is applied to a trending security, it tends to give bad signals against the trend. Does this mean the indicator should be ignored? Not so fast. By making adjustments to an indicator's interpretation, we can effectively apply a non-trending indicator to a trending market.

The first adjustment is to simply ignore all signals against the trend of the security. We've seen these indicators give frequent sell signals during a strong advance. These signals should be ignored. This doesn't mean you shouldn't have an exit system in place. It means that the exit system should not involve the use of non-trending indicators.

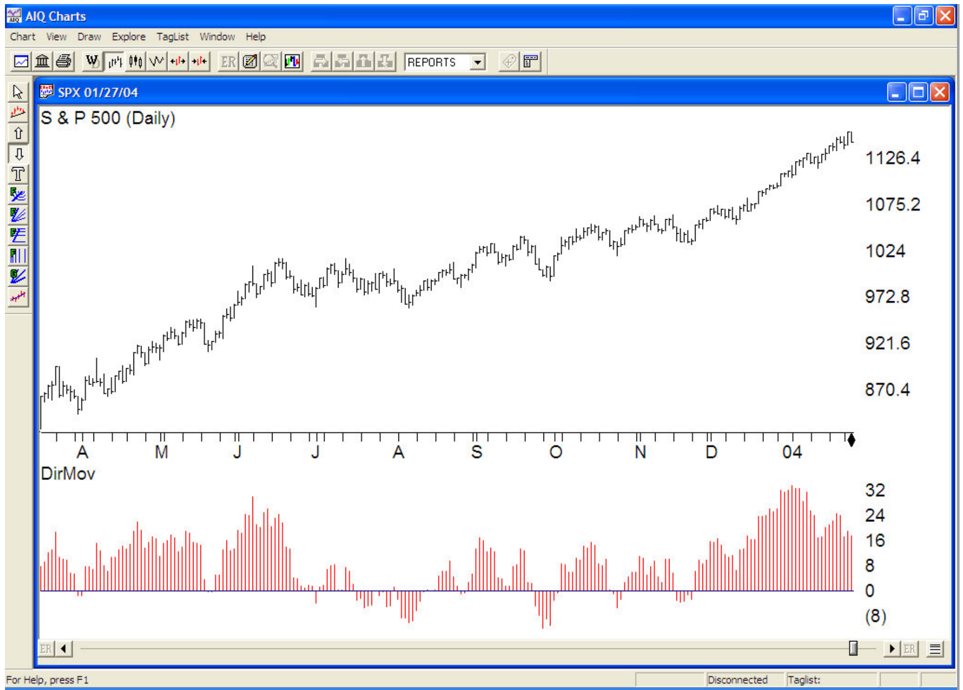

Figure 3. S&P 500 Index during period of strong uptrend in 2003. For majority of advance, the DMI (lower window) remained in positive territory, showing this indicator is effective in a trending market.

The second adjustment is to change the requirements for buy and sell signals so that the indicator gives more signals in the direction of the overall trend. The Stochastic or RSI will rarely give buy signals in an uptrending market. As a result, the "oversold" levels should be adjusted upward so the indicator will give buy signals. For these two indicators, a level below 50 may represent an oversold buy point.

Applying this method to the S&P 500 in Figure 2, overbought sell signals are ignored because the market is uptrending. Using 50 as an oversold level, most of the minor pullbacks in the market result in an RSI buy signal. When using a non-trending indicator in a trending market, be sure to only use the signals in the direction of the overall trend.

"By making adjustments to an indicator's interpretation, we can effectively apply a non-trending indicator to a trending market…Unless adjustments are made to an indicator's interpretation, you can get into trouble using the wrong type of indicator in a given market environment."

Conclusion

Indicators can be classified into two categories: those that work in trending markets and those that work in non-trending markets. Unless adjustments are made to an indicator's interpretation, you can get into trouble using the wrong type of indicator in a given market environment.

If the market ended its non-trending environment in November, then the indicators that worked so well for most of this year will no longer work. Those of you who understand this and make the appropriate adjustments will profit the most.

David Vomund publishes VIS Alert, a weekly investment newsletter. For a sample copy, go to *www.visalert.com*.

Your Questions Are Welcome!

Let us answer your questions about any of our articles, about using TradingExpert Pro, or about anything pertaining to AIQ products.

Also, let us know if there is a topic you would like to see covered in the *Opening Bell*.

We welcome your questions. Send them to openingbell@aiqsystems.com.

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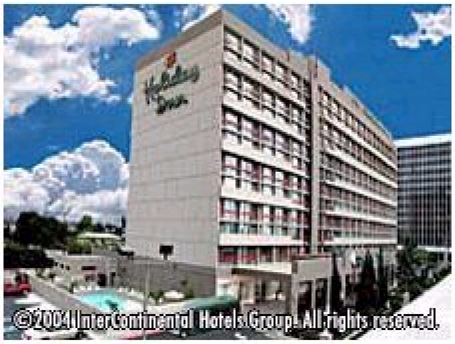

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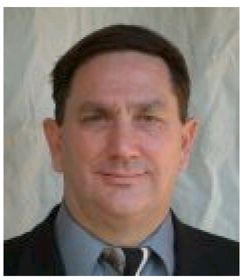
Speaker Biographies

Over 70 attendees participated in AIQ user Steve Palmquist's seminar at the 2nd Annual Las Vegas Traders Expo Sunday November 21, 2004

Steve's session on learning proven methods for improving your results in current market conditions from a full time trader was a big success at the Las Vegas Traders Expo. Attendees learned how to use Market Adaptive Techniques (MAT) for dealing with specific trading environments, and how to use that information to select setups and adjust holding timeframes.

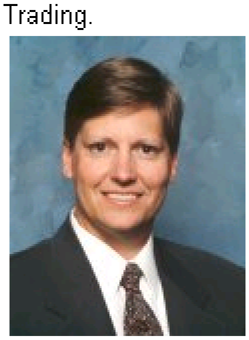


Steve Palmquist

Steve Palmquist is a full-time trader with nearly 20 years of experience. He is the founder of www.daisydogger.com, which provides free market analysis, trading tips, and educational material. Steve is also publisher of the Timely Trades Letter available through the web site. Steve was a featured speaker at AIQ's October Lake Tahoe Seminar.

David Vomund is AIQ's Chief Analyst, AIQ Opening Bell monthly editor, VISalert.com publisher and experienced money manager and market timer

David has earned a reputation as one of the country's top market timers. He teaches his analysis techniques to hundreds of individual and professional investors each year. David has been published in Stocks & Commodities and Active Trader magazines, and was a contributing author to Computerized Trading.



David Vomund

David Vomund, the chief analyst at VIS, graduated from the University of California at Davis with a degree in Economics and California State University at Hayward with an MBA in Finance. He worked four years at Target Inc. as a market analyst before joining AIQ Systems as chief analyst in 1991. At AIQ, he published a daily fax service for institutional investors. He currently authors their highly acclaimed Opening Bell educational newsletter. Vomund'a analysis and forecasts have appeared in Stocks & Commodities, Los Angeles Times, USA Today, and Barron's.