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The Opening Bell Newsletter is a publication of AIQ Systems
P.O. Box 7530
Incline Village, Nevada 89452
E-mail:
openingbell@aiqsystems.com

The Efficient Momentum System

'The Best of Both Worlds' -- Combine System That's Focused on Strength with One Focused on Consistency

By Jay Kaepfel

Some of the best trading ideas come from combining two already good trading ideas and using them in tandem. In the July 1999 issue of *Stocks and Commodities* magazine I first wrote about a system that I developed for trading sector funds, titled "Pure Momentum." Many AIQ users are familiar with this strategy, as I have written about it in the October 2002 *Opening Bell*.

Another strategy that AIQ users are familiar with is the Efficient Stock Strategy that acclaimed author Dr. Van K. Tharp wrote about in the October 2004 issue of the *Opening Bell*. What I have done is combine these two ideas. The results are fairly compelling.

Pure Momentum System

The Pure Momentum System is unchanged from the original version that I started using in the 1990's. The steps are simple:

- At the end of each month, identify the five Fidelity Select Sector funds that have advanced the most over the previous 240-trading days.
- Buy those five funds and hold them until the end of the next month, then repeat the first step, etc.



Jay Kaepfel is an independent trader and author. You can read his weekly column titled Kaepfel's Corner at www.Optionetics.com.

Some months there will be no trades as the top performers remain the same from month to month. Most months there will be one or two trades. The basic idea is simply to focus our investment in the top performing sectors and to ride them as long as they remain leaders.

Despite the simplicity of this system, the results have been quite good in the long run (see **Table 1** on page 2).

Since (and including) 1995, the average annual return has been 26.1%,

with an annual standard deviation of 32.2%.

The best year was 1999 when the system gained 110.8% and the worst year was 2002 when the system lost -14.1%. 2005 was an excellent year as the system latched on to the energy sector funds and rode them higher to a gain of +34.1% (**Figure 1**).

Efficient Funds System

I recently downloaded the EDS code for Dr. Tharp's Efficient Stock System. I then ran a test using the same methodology as the Pure Momentum System - i.e., run the test at the end of each month and buy the top five performing funds as ranked using Dr. Tharp's Efficient Stock code.

The annual results appear in **Table 2**. The best year for this system was 1995 with a gain of +47.4% (1999 was a close second at +47.3%). The worst year was 2002 with a loss of -8.0%. The system gained a healthy +21.2% in 2005.

As you can see, there is some good news and some bad news. The bad news is that - as measured by total return, this system underperformed the Pure Momentum System during the time frame tested, averaging an annual return of

21.3% versus 26.1% for Pure Momentum. However, there are two pieces of good news.

First, the annual deviation of returns was far less than that of the Pure Momentum System (17.6% versus 32.2%). This can serve to make the system more "tradable" for those who are a bit more faint of heart and cannot always stomach big swings in equity. Also, this system tends to be less concentrated in a given area (energy, finance, etc.) over time, as it looks at consistency of returns and not just the raw price gains.

The Efficient Momentum System

The second piece of good news derives from the act of combining these two models together into one. In other words, instead of choosing one strategy versus the other, an investor might simply consider using both strategies at the same time.

Using this combined approach - heretofore known as The Efficient Momentum System - ten "positions" would always be held, five from Pure Momentum and five from Efficient Funds. Each "position" would represent 10% of the overall

Table 1
Pure Momentum System
Annual Results

Year	Results
1995	36.1
1997	30.5
1998	23.1
1999	110.8
2000	18.2
2001	(6.4)
2002	(14.1)
2003	24.0
2004	12.6
2005	34.1
Average	26.1
Std.Dev	32.2
Ave./StdDev	0.810

portfolio. There will occasionally be overlap, where both systems hold the same fund. In that case a given fund would make up 20% of the overall portfolio rather than 10%.

Table 3 displays the data for the two systems separately as well as the combined results. These results are also compared to the results generated by buying and holding the S&P 500.

Some points of interest regarding the Efficient Momentum System (EMS):

- The combined results outperformed the S&P 500 in 8 out of 11 years.
- The best year was 1999 when the EMS gained +79%.
- The worst year was 2002 when the EMS lost -11.1%.
- The EMS outperformed the S&P 500 by 17.4 percentage points on average per year during the timeframe tested.
- \$1,000 invested in the S&P 500 on 12/31/94 would have grown to \$2,718 by the end of 2005.
- \$1,000 invested using the EMS on 12/31/94 would have grown to \$8,680 by the end of 2005.

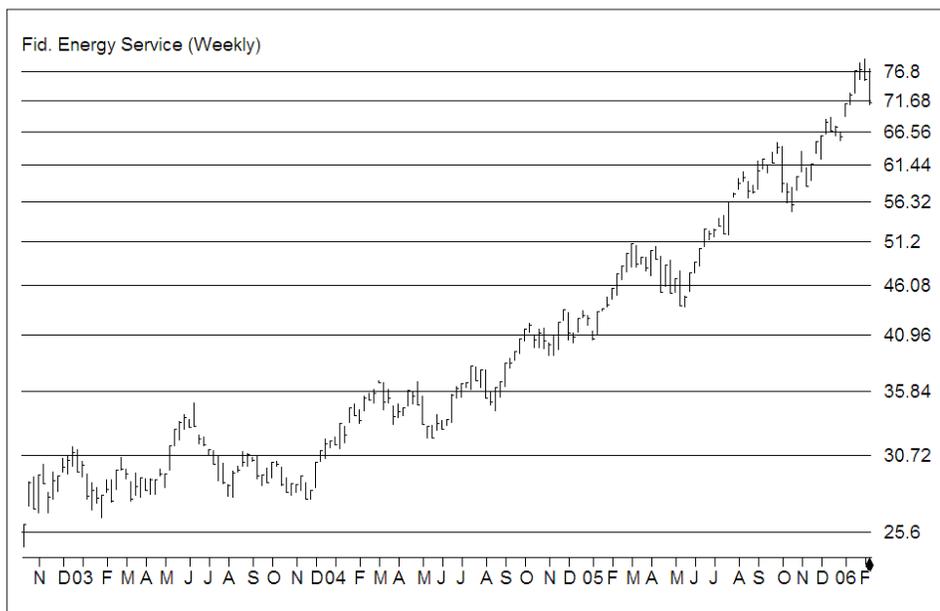


Figure 1. Fidelity Select Energy Services (FESX), the top performing select fund for 2005.

- \$1,000 invested in the S&P 500 on 12/31/99 would have shrunk to \$850 by the end of 2005.
- \$1,000 invested using the EMS on 12/31/99 would have grown to \$1,807 by the end of 2005.

In a nutshell, the EMS outperformed the S&P 500 handily both during a bull market and a bear market. This is the type of consistency that inspires the confidence that many investors seek when utilizing a strategy over the long run.

Current Portfolio

As of 1/31/06 the Pure Momentum System portfolio was as follows:

- Energy Services - FSESX
- Energy - FSENX
- Natural Gas - FSNGX
- Natural Resources - FNARX
- Brokerage - FSLBX

As of 1/31/06 the Efficient Funds System portfolio was as follows:

- Brokerage - FSLBX
- Natural Resources - FNARX
- Energy - FSENX

- Wireless - FWRLX
- Energy Services - FSESX

So as of 2/1/06 the Efficient Momentum System portfolio consists of:

- 20% Energy Services - FSESX
- 20% Energy - FSENX
- 20% Natural Resources - FNARX
- 20% Brokerage - FSLBX
- 10% Natural Gas - FSNGX
- 10% Wireless - RLX

Summary- The Efficient Momentum System

Both the Pure Momentum System and the Efficient Funds System have impressive track records on their own. When combined into one portfolio they potentially offer the best of both worlds - one system laser focused on the strongest sectors and another focused on the most consistent, or efficient, sectors in terms of performance.

In addition, because there is no way to accurately predict which system will outperform over any given timeframe, the added level of

**Table 2
Efficient Funds System
Annual Results**

Year	VT ES Results
1995	47.4
1996	19.8
1997	34.8
1998	16.9
1999	47.3
2000	18.3
2001	(3.3)
2002	(8.0)
2003	25.7
2004	14.1
2005	21.2
Average	21.3
Std.Dev	17.6
Ave./StdDev	1.208

diversification can result in superior risk-adjusted returns over time, as opposed to choosing one strategy over the other.

Table 3

Year	PM Results	VT ES Results	Combined Results	S&P 500	Combined vs. S&P	PM \$1,000	VT ES \$1,000	Combined \$1,000	S&P \$1,000
1995	36.1	47.4	41.8	34.1	7.6	1361	1474	1418	1341
1996	17.9	19.8	18.9	20.3	(1.4)	1605	1766	1685	1613
1997	30.5	34.8	32.7	31.1	1.6	2095	2380	2235	2114
1998	23.1	16.9	20.0	26.6	(6.6)	2579	2783	2682	2676
1999	110.8	47.3	79.0	19.5	59.5	5436	4099	4802	3199
2000	18.2	18.3	18.3	(10.1)	28.4	6426	4849	5679	2875
2001	(6.4)	(3.3)	(4.9)	(13.0)	8.2	6015	4689	5404	2500
2002	(14.1)	(8.0)	(11.1)	(23.4)	12.3	5166	4314	4806	1916
2003	24.0	25.7	24.8	26.4	(1.5)	6406	5422	6001	2421
2004	12.6	14.1	13.3	9.0	4.3	7212	6187	6801	2639
2005	34.1	21.2	27.6	3.0	24.6	9668	7499	8680	2718
Average	26.1	21.3	23.7	11.2	17.4				
Std.Dev	32.2	17.6	23.8	19.6					
Ave./StdDev	0.810	1.208	0.993	0.572					

What Every AIQ User Should Know, Part III

It's a 'Simple Process' -- Using AIQ's Powerful Expert Design Studio To Create Trading Systems

By David Vomund

In this third article of our series covering features that every TradingExpert Pro user should know how to use, we will focus on the Expert Design Studio (EDS) module. This is an extremely powerful module but many AIQ users don't use it because they believe EDS involves difficult programming. In reality, EDS can be as easy or difficult as you want it to be.

The EDS module comes with over 250 pre-built routines. This allows users to build effective screening models by simply opening the pre-built EDS files or cutting-and-pasting rules that AIQ has already created. Therefore, the user can build EDS models without any programming.

Before we describe how to create and run an EDS model, we'll first show you how important it is to learn how to use this feature. In the April 2005 and May 2005 *Opening Bells*, we printed the results of

“In Opening Bells, we have printed the results of extensive testing of all the pre-built rules, showing those that are the most effective and those that are the least effective...Users should know how to take advantage of this powerful information.”

extensive testing of all the pre-built rules, showing those that are the most effective and those that are the least effective. Making the tests even

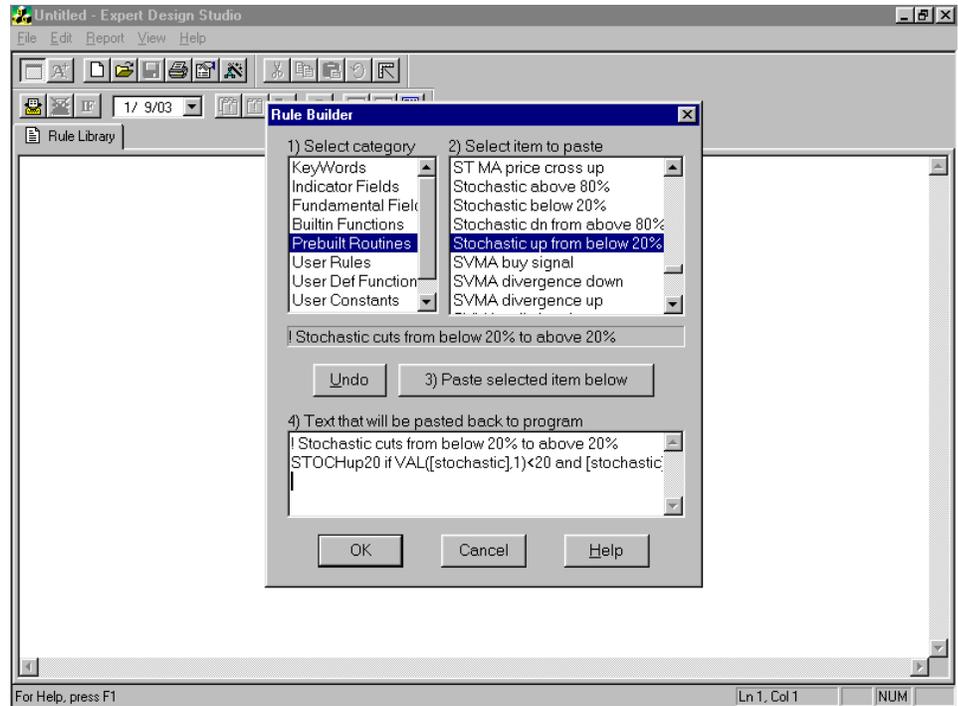


Figure 1. Expert Design Studio Rule Builder screen. Panel 2 displays list of pre-built routines that can be selected and transferred to the lower panel (4).

more useful, the back testing time period covered both bull and bear markets.

The most effective strategies outperformed when the market was moving higher and also did well when the market was moving lower. Users should know how to take advantage of this powerful information. It is not as hard as it seems.

At AIQ seminars, we ask attendees to give us some technical buy rules. We then use the pre-built screening formulas to create a model based on those rules.

For this article, we'll assume that

we want to create a model that screens for stocks that have given a Stochastic buy signal (i.e., the indicator moving above 20) at the same time that the MACD's Phase line rises above its Signal line.

The pre-built routines are in two areas of EDS. If you want to screen on one indicator, it is easiest to open a pre-built EDS file. To open EDS, go to the Quick Launch Menu and open EDS (the icon is marked *Studio*). Within EDS, click *File* and *Open*. In the *wintes32* folder, click *EDS Strategies*. For specific indicator rules, choose *Basic Indicator Strategies* and then the appropriate indicator.

Instead of using these files, we'll use the Builder and create our model from scratch. Open EDS and click on the *Rule Library* folder. If rules are in this folder, then open a new EDS file by clicking *File* and *New*.

The folder is empty now but we'll copy and paste pre-built rules to this area.

To see the pre-built rules, click *Edit* on the menu bar and then *Builder*. The Rule Builder screen will appear. From section 1, *Select category*, choose *Prebuilt Routines*. A list of the screening rules will appear in section 2, *Select item to paste*. You'll see that nearly every indicator in the TradingExpert software has three or four pre-built rules associated with it.

For our model, we are first looking for stocks with Stochastic buy signals. Therefore, we need to scroll down through the list of indicators to the Stochastic rules. There are four pre-built Stochastic rules. We want the one called *Stochastic up from below 20%*. Single-click this rule and click *Paste selected item below*. The code for this screening will appear in section 4 of the Rule Builder screen (Figure 1). Click *OK* and this rule will be pasted into the Rule Library.

“That’s it. We have created an EDS model by utilizing the pre-built routines. Creating a model in EDS may be initially intimidating, but we have shown that it is a simple process.”

The second rule in our model states that stocks must have a MACD indicator crossover. Therefore, we repeat the process but this time look for the pre-built MACD rules. Again click *Edit* on the menu bar, and *Builder*. In section 1, choose *Prebuilt Routines*. In section 2, scroll down to the MACD rules and click on the *MACD Cross Up* rule. Click *Paste Selected Item Below* and *OK*.

Our two rules are now in the Rule Library folder. Their rule names are the first word in the codes. Thus, the rule name for the

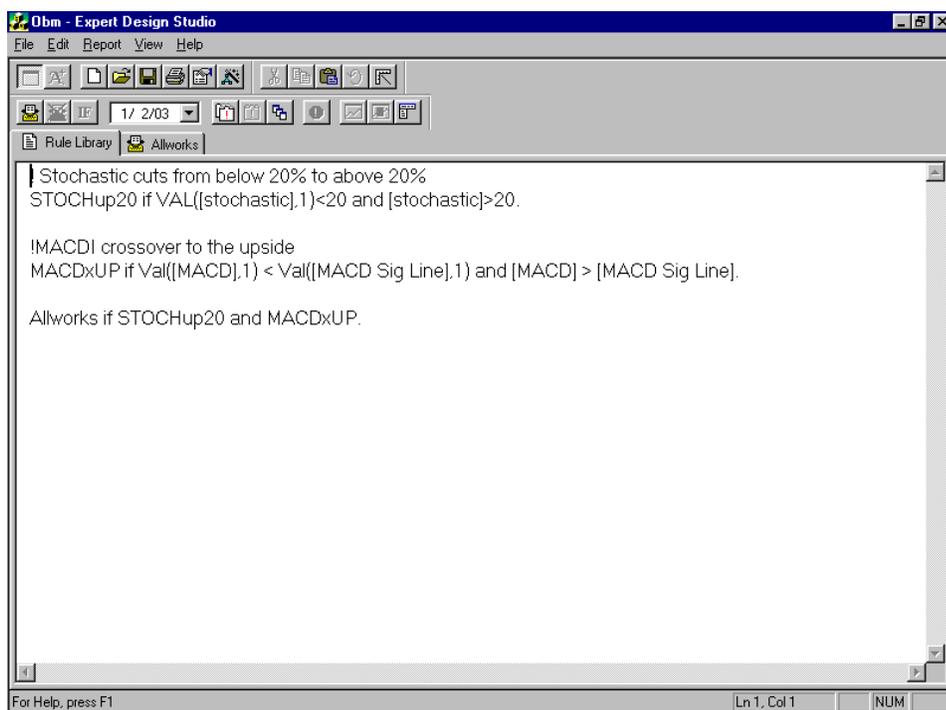


Figure 2. EDS Rule Library screen listing screening rules for the test model. Lines designated with an exclamation point (!) in the first position describe the rule appearing in the line below.

Stochastic filter is STOCHup20 and the rule name for the MACD rule is MACDxUP.

One additional rule is needed which states that stocks must pass both of our screening rules on the same day. We called our rule “Allworks” but you can call the rule any name you wish. Here is the simple code:

```
Allworks if
STOCHup
```

and MACDxUP.

Make sure there is a period at the end of the code.

The code for our model is now complete (Figure 2). All we have to do now is run the screening to see which stocks pass both rules. A report needs to be created for the new screening. On the EDS menu bar, click *Report* and *Insert*. If you want

to see which stocks pass each indicator screening, then you would create a report for each of the rules. We are only interested in the stocks that pass both indicator rules, so click on *Allworks* and *OK*.

We are now ready to screen our database for the stocks that pass our model. Click on the *Allworks* folder tab (next to the *Rule Library* tab) to make it active. In the date scroll box (above the *Allworks* tab), choose the date you want to run the screening. Then click *Report* on the menu bar and choose *Run Single*. If any stock

“We chose EDS as a tool every AIQ user should know because it easily tests simple technical analysis concepts and because we’ve published some very effective screening models...You should know how to run these models.”

passes the criteria, its ticker symbol will appear. Simply double-click the ticker symbol to see a chart of the

stock. That's it. We have created an EDS model by utilizing the pre-built routines.

Creating a model in EDS may be initially intimidating, but we have shown that it is a simple process. The bonus of creating a model in EDS is that the model can be back tested.

To run a back test, select the *Allworks* folder. From the menu bar, click *Report* and then *New Backtest*. TradingExpert uses the rule name as the name of the back test. Click *Next*. On the *Entry* page, select *Buy Long* and click *Next*. On the *Range* page, enter the time period for your back test and click *Next*.

On the next screen, *Pricing*, accept that trades are made using the next day's opening price. Click *Next*. On the *Exit* screen, choose the sell strategy. A useful exercise is to see how results change when a model is run using different sell strategies. Click *Finish*. The parameters of the back test are now complete. To run the test, click *Test* on the menu bar and choose *Run*.

The result of our back test is found in **Figure 3**. The most important statistic is the average profit/loss per trade compared to the average profit/loss for the S&P 500. In our test, the average trade gained 1.58% compared to an S&P 500 gain of 1.04%. If the average equity trade

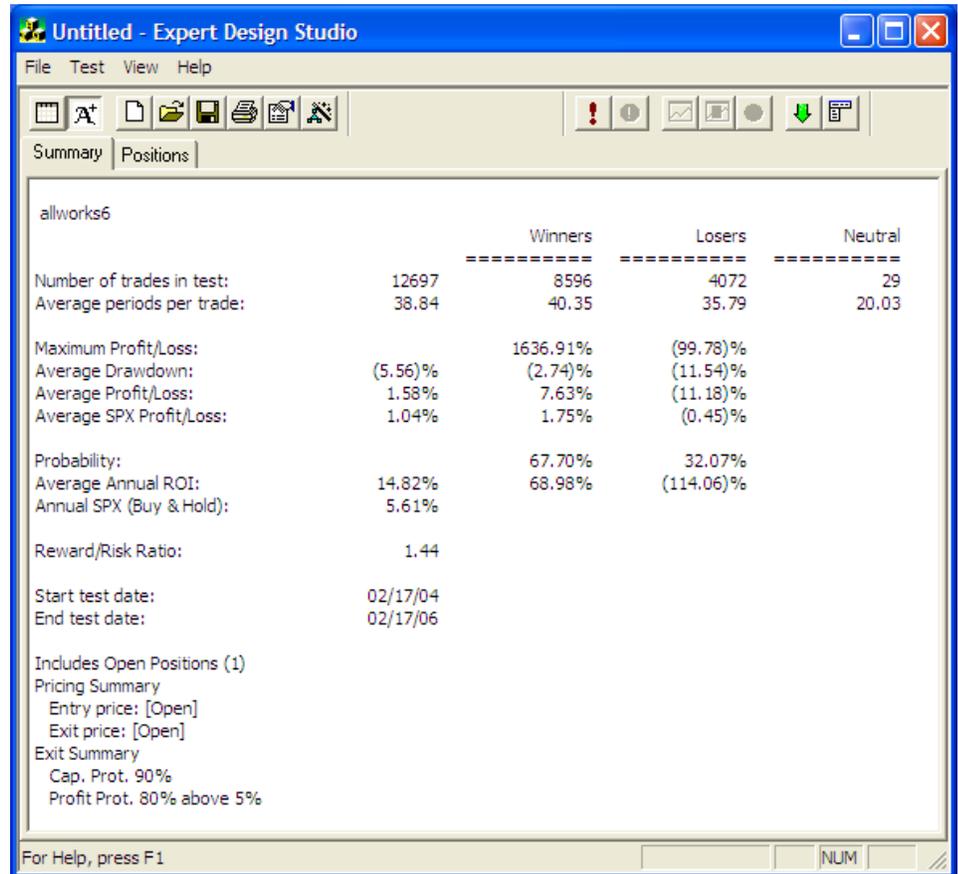


Figure 3. EDS back test screen showing test results for example Model. Test covers 02/17/04 to 02/17/06 time period and indicates a 14.82% avg. annual ROI.

has a lower return than the average S&P 500 trade, then the system has no value.

Some people want to create their own models but most people don't. We chose EDS as a tool every AIQ user should know because it easily tests simple technical analysis

concepts and because we've published and will continue to publish some very effective screening models (see the August 2005 *Opening Bell*). You should know how to run these models.

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date	Stock	Ticker	Split	Approx. Date
Qlogic Corp.	QLGC	2:1	03/03/06	Palm Inc.	PALM	2:1	03/15/06
Phelps Dodge	PD	2:1	03/13/06	SJW Corp	SJW	2:1	03/17/06
Atlas America	ATLS	3:2	03/13/06	Websence Inc.	WBSN	2:1	03/20/06
Building Materials Hldg. BMHC	BMHC	2:1	03/15/06	Quality Systems Inc.	QSII	2:1	03/27/06

Trading Suspended:

Liberty Corp. (LC)

Name Changes:

American Healthways (AMHC) to Healthways Inc. (HWAY),
Certegy Inc. (CEY) to Fidelity National Info. Services (FIS), Computer Associates (CA) to CA Inc. (CA),
Enterra Energy (EENC) to Enterra Energy Trust (ENT), Octel Corp (OTL) to Innospec Inc. (IOP)
Offshore Logistics (OLG) to Bristow Group (BRS)

Vomund is Again Ranked One of Top 10 Market Timers

AIQ Analyst David Vomund's advisory newsletter *VIS Alert* is ranked as one of the 10 best market timing newsletters in the nation by *Timer Digest* (www.timerdigest.com), an independent tracking service of newsletter market timing performance. Vomund uses unique tools found in AIQ's TradingExpert Pro to achieve this high ranking.

In addition to his work as senior analyst for AIQ and his contributions to AIQ's *Opening Bell*, David is president of Vomund Investment Services and publisher of the *VIS Alert* advisory newsletter. His market timing performance in *VIS Alert* ranks as one of the 10 best for the 10-year time period ending December 31, 2005 and also ranks as one of the 10 best for the one-year period ending February 20, 2006. For those accomplishments, he is featured on the cover of their current issue.



Cover of current issue of Timer Digest magazine features AIQ's David Vomund

Vomund relies exclusively on TradingExpert Pro for his market timing decisions. As the market has changed over the last 10 years, his market timing techniques have

evolved. He currently relies heavily on the unconfirmed signal ratio (US) found on the Market Log report and also on the Nasdaq's RSMD SPX indicator, an indicator unique to AIQ's TradingExpert Pro.

While others have temporarily held the top timer slot, Vomund takes pride in the consistency of his results. He explains, "an AIQ user once told me that the key to investment success is to understand that you can be wrong, but you can't be wrong for a long period of time. I've been on the wrong side of the market plenty of occasions, but I don't stay there long."

For a free trial to *VIS Alert* during the month of March, visit www.visalert.com.

MARKET REVIEW

After a strong January, most market averages were flat in February. That doesn't mean it was a quiet month. Selling dominated at the start of the month but that was short-lived and market averages rallied to their recent highs.

On a closing basis, the S&P 500 rallied almost exactly to its January high. The Nasdaq didn't quite hit its

January highs. The one index that did make a new high was the Russell 2000.

Although the market was flat, some groups did well while others fell. Defense & Aerospace and Biotechnology were the best performers, gaining 6%.

On the downside, Energy and Precious Metals both fell about 8%.

S&P 500 Changes

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

Harmon Int'l (HAR) replaces Siebel Systems (SEBL). HAR is added to the Housewares & Specialties (HOUSESPC) group.

VeriSign Inc. (VRSN) replaces Reebok Int'l (RBK). VRSN is added to the Internet Software & Services (NETSFTWR) group.

Barr Laboratories (BRL) replaces Scientific Atlanta (SFA). BRL is added to the Pharmaceuticals (PHARMAC) group.

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Market Truths *by David Vomund*

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David Vomund will cover the features within TradingExpert that every AIQ user should know. Basic features such as charting, report generation, and exploring will be discussed. Advanced features such as industry group creation and the use of Expert Design Studio will also be covered.

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David Vomund
Chief Analyst
AIQ Systems



Steve Palmquist
Founder
Daisydogger.com

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