AIQ Opening Bell Newsletter

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In This Issue

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What's Gone Wrong with this Indicator?

The Old Advance-Decline Line... It Ain't What It Used to Be

By Paul Desmond

This article by Paul Desmond was originally published for Lowry's Reports, Inc. subscribers on May 29, 2003. Its message is just as important today.

Paul Desmond is the president of Lowry's Reports, Inc., the nation's oldest technical investment advisory firm. Mr. Desmond joined the firm in 1964 as director of research and advanced to president in 1972. He has been a distinguished member of the Market Technicians Association, serving as president of that group from 1997-1999. He is a co-founder of the American Association of Professional Technical Analysts (AAPTA). Information on Lowry's Reports can be found at www.lowrysreports.com.

PAUL DESMOND

One of the most popular tools for examining the internal condition of the stock market has gone awry. The Advance-Decline Line, which has been the standard measurement of the breadth of the stock market for more than 100 years, doesn't seem to work anymore. In recent years, at participating critical turning points in the equity market, the Advance-Decline Line has signaled a very positive bias to the market just before stocks turned decisively negative.

A brief background: The basic data needed to construct the Advance-Decline can be found in the NYSE Diary of each day's *Wall Street Journal* and in the Market Laboratory section of each week's *Barron's*. To calculate the Advance-Decline Line, take the difference between the number of Advancing Issues and the number of Declining Issues each day, and add or subtract the difference from the previous day's total.

In simple terms, the Advance-Decline Line shows whether more stocks are going up than going down. But, in a more important sense, it can show whether buying enthusiasm during a market rally is spread across a broad number of stocks (a positive indication), or whether buying is narrowly focused on just a few industry groups or sectors (a generally negative sign).

Thus, the Advance-Decline is referred to as a "breadth" indicator. It provides investors with a simple way to adjust the level of diversification in their portfolios. That is, as the Advance-Decline Line expands, indicating a broadening buying interest, investors should consider expanding the number of stocks in their portfolios. As the Advance-Decline Line contracts, investors should adopt a more selective portfolio strategy by culling out their weakest holdings.

Perhaps the most widely accepted value of the Advance-Decline Line is in "divergences" — when the Advance-Decline Line (market breadth) begins to improve during a period of market weakness (bullish), or when it begins to contract during a period of market advance (bearish). In particular, the Advance-Decline Line has often turned down about four to six months in advance of many major market declines in the past.

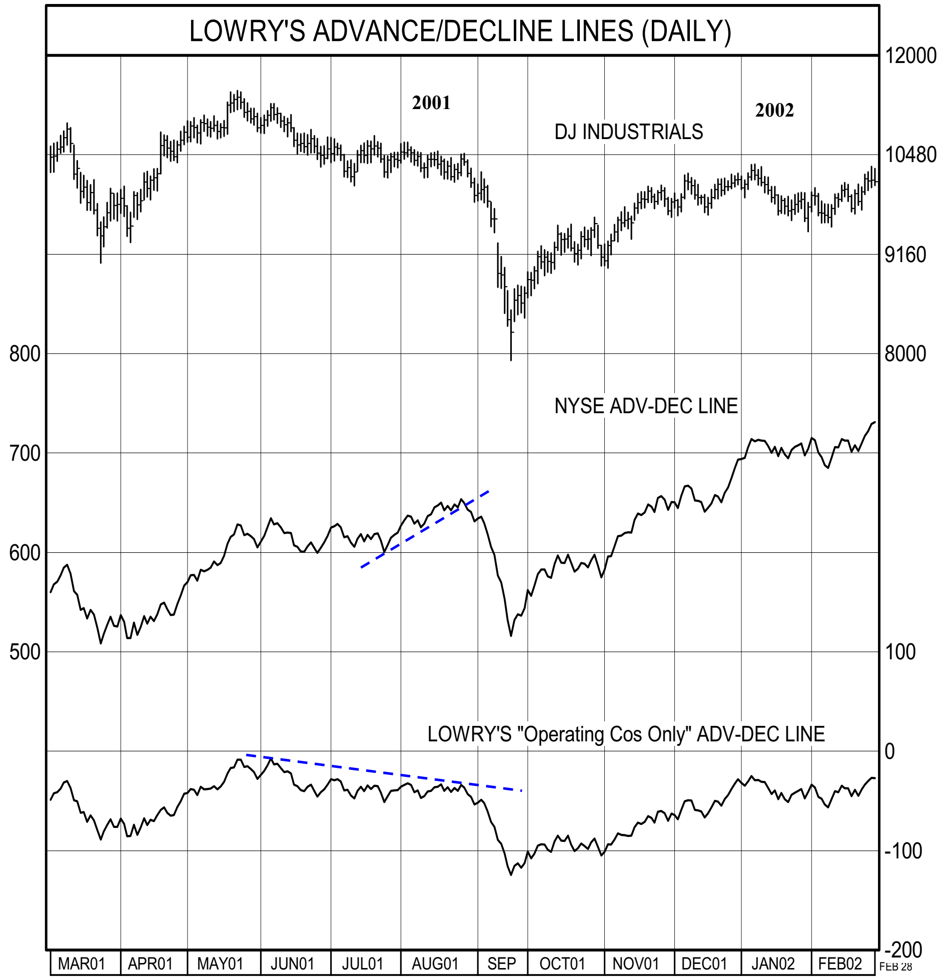

Figure 1. Chart of DJIA and two Advance-Decline indicators. Above is standard NYSE A-D Line and below is Lowry's Operating-Companies-Only Adv-Dec indicator.

Because of its elegant simplicity, and the valuable insights it has provided at market turning points, it has been highly prized by both fundamentalists and technicians throughout the decades.

But, in recent years, something seems to have gone wrong. For example, in July and August, 2001 (**Figure 1**), when the Dow Jones Industrial Average was moving in a sideways, indecisive pattern, the Advance-Decline Line began to rise vigorously, leading many investors to conclude that the internal strength of the market was improving.

> ***"How could the time-honored Advance-Decline Line give off such obviously false signals?…The change has occurred, not in the indicator, but in the data it measures. Over the past decade, the New York Stock Exchange has allowed trading in a growing number of issues that are not, or do not trade like, domestic common stocks."***

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A number of highly regarded analysts encouraged investors to buy aggressively in August, 2001, based primarily on the strength of the Advance-Decline Line. But, history shows that the market was actually weakening. The Advance-Decline Line was giving off a false signal. In the weeks that followed, the Dow Jones Industrial Average plunged 20.7%, exacerbated by the tragedies of September 11th.

In early September, 2002 (**Figure 2**), the Dow Jones Industrial Average was recovering from earlier losses. The Advance-Decline Line lead the recovery, rising to a new rally high, creating the impression among investors that buying enthusiasm was broadening. In fact, the market was weakening, and the DJIA dropped 15.3% during the next month, to the October, 2002 market low.

Again, in mid-January, 2003 (Figure 2), the Dow Jones Industrial Average appeared to be on the verge of a breakout to new rally highs. The Advance-Decline Line added to the illusion by rising to its highest level in six months, a seemingly very bullish indication that investors were pouring money into a broadening array of stocks. Many investors confidently rushed in to buy, only to find that the Advance-Decline Line was once again providing misleading information. Over the next two months, the Dow Jones Industrial Average plunged 14.9%, back to its earlier October, 2002 low.

What could have happened? How could the time-honored Advance-Decline Line give off such obviously false signals? The answer is simple, but not easily seen. The change has occurred, not in the indicator, but in the data it measures. Over the past decade, the New York Stock Exchange has allowed trading in a growing number of issues that are not, or do not trade like, domestic common stocks.

For example, of the 3,500 issues

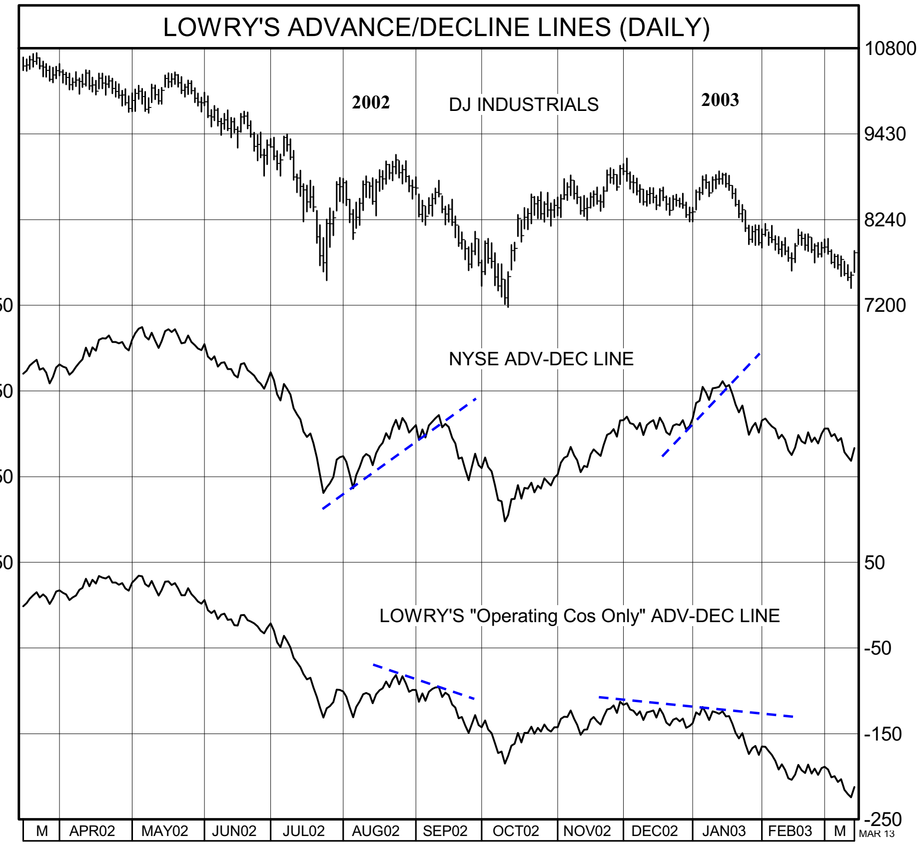


Figure 2. Chart of DJIA and two Advance-Decline indicators. Above is standard NYSE A-D Line and below is Lowry's Operating-Companies-Only Adv-Dec indicator.

listed on the Big Board, approximately 500 issues are closed-end bond funds. About another 600 issues are preferred stocks that trade more like bonds than common stocks. Then, there are more than 400 foreign stocks and ADRs that may, or may not, reflect the trends of our domestic stock market.

Lastly, there are roughly 300 real estate limited partnerships listed on the Exchange that are much like mutual funds, in that they are not operating companies. The bottom line is that almost half (48%) of the issues currently listed on the New York Stock Exchange are not really stocks — at least not what investors generally think of as stocks. These issues, which we refer to as non-operating companies, have been the principal cause of the false signals given off by the Advance-Decline Line in recent years.

"The bottom line is that almost half (48%) of the issues currently listed on the New York Stock Exchange are not really stocks…These issues, which we refer to as non-operating companies, have been the principal cause of the false signals given off by the Advance-Decline Line in recent years."

In each of the three cases cited above, common stocks were in a generally sideways trend, while the bond market was strongly rising. Thus, the common stock components of the Advance Decline Line offset one another, while the bond related components were rising strongly, giving the Advance-Decline Line an overall positive bias. In other words, during each of those periods, the Advance-Decline Line was, in essence, measuring the strength of the bond market, not the stock market. It's no wonder that the signals were misleading!

This is not a recently discovered phenomenon. In 1990, the analysts at Lowry's Reports, Inc. became concerned about the changing character of the Advance-Decline statistics. As a result, Richard Ramsey, one of our key analysts, and I compiled a new indicator called Lowry's Operating-Companies-Only Advance Decline, which excludes all preferred issues, all real estate partnerships, all foreign issues and ADRs, and all closed-end stock and bond funds. The remaining issues are simply domestic common stocks listed on the New York Stock Exchange.

"Throughout its twelve-year history, Lowry's OCO Adv-Dec Line has provided a far more accurate measurement of the internal strength of the stock market, particularly at critical turning points…"

Throughout its twelve-year history, Lowry's OCO Adv-Dec Line has provided a far more accurate measurement of the internal strength of the stock market, particularly at critical turning points, such as those cited above. As shown in the accompanying charts, in each of the three cases, Lowry's OCO Adv-Dec Line was correctly reflecting market weakness at exactly the same time that the standard Advance-Decline Line was showing misleading strength.

New distortions to the accuracy of New York Stock Exchange trading data may be coming. Recent news articles make it clear that the New York Stocks Exchange is working aggressively to add Exchange Traded Funds (ETFs) to the issues listed on the Big Board. If this comes about, the trading of ETFs (which essentially will double-count issues already listed on the Exchange) will play havoc with not only the Advance-Decline statistics, but more importantly with the Upside and Downside Volume statistics that investors have come to rely on over the years.

Interestingly, Lowry's Reports, Inc. originated the compilation of the Upside and Downside Volume statistics in 1938. Just to stay ahead of the curve, Lowry's has also been compiling Operating-Companies-Only Upside Volume and Downside Volume statistics since 1990. In an ever changing world, investors, or their advisors, must constantly reexamine the accuracy of the data that plays such a vital part in the management of investment portfolios.

You can visit Lowry's Reports online at www.lowrysreports.com.

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date
National Oilwell	NOV	2:1	09/10/07
Johnson Controls	JSI	3:1	09/17/07
Life Parters Hldgs.	LPHI	5:4	09/17/07
FC Stone Group	FCSX	3:2	09/18/07
Monro Muffler	MNFO	3:2	09/24/07

Trading Suspended:
Agile Software (AGIL), Arbor Holdings (AH), Brilliance China Auto (CBA), Hanson PLC (HAN), ServiceMaster Co. (SVM), Stride Rite (SRR), Triad Hospitals (TRI), Tweeter Home Ent. (TWTR)

Name Changes:
Acacia Research (CMBX) to Combi Matrix (CBMXD)
Advanced Magnetics (AMAG) to AMAG Pharmaceuticals (AMAG)
Affordable Residential Communities (ARC) to Hilltop Holdings (HTH)
Alteon (ALT) to Synvista Therapeutics (SYI),
Motient (MNCP) to TerreStar (TSTR)
Payless Shoesource (PSS) to Collective Brands (PSS)
Tag-it Pacific (TAG) to Talon Int'l (TLN)
Transaction Systems Architects (TSAI) to ACI Worldwide (ACIW)
Universal Compression (UCO) to Exterran Holdings (EXH)

S&P 500 Changes

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

American Capital Strategies (ACAS) replaces Dollar General (DG). ACAS is added to the Asset Management & Custody Banks (BANKGRP) group.

Akamai Technologies (AKAM) replaces Biomet Inc. (BMET). AKAM is added to the Internet Software & Services (NETSFTWR) group.

Our Advantage Over the Competition

Use AIQ's Breadth Builder to Create An Advance-Decline Line 'Without the Flaws'

By David Vomund

Paul Desmond, in the cover article of this newsletter, points out the importance of calculating advance-decline figures on domestic equities, rather than on closed-end interest rate instruments. AIQ's powerful Market Breadth Builder accomplishes this task. In this article we'll show how to use this function.

"In creating a custom Advance-Decline Line, we first have to decide which list of stocks to use in its calculation. A broad list of stocks is most appropriate so we'll choose to calculate market breadth on the Russell 3000 stocks."

In TradingExpert Pro, you can plot the standard Advance-Decline Line as reported from the NYSE. (Display market ticker DJIA and then select indicator AD Line.) This indicator is similar to what appears in the *Wall Street Journal* and *Investor's Business Daily*. Unfortunately it has the same problems as discussed in Mr. Desmond's article.

In creating a custom Advance-Decline Line, we first have to decide which list of stocks to use in its calculation. A broad list of stocks is most appropriate so we'll choose to calculate market breadth on the Russell 3000 stocks. This list includes 3000 of the highest capitalization stocks, which means it contains both large-cap, mid-cap, and small-cap stocks.

The Russell 3000 list can be downloaded at www.aiqsystems.com. Click *Data* and *AIQ List Files*. You will also need these 3000 stocks in your database. The easiest way to accomplish this is to use your Historical Stock CD that comes with TradingExpert (you can purchase a new CD for $39 by calling 800-332-2999). Place the CD into your computer, then enter Data Manager Make the Russell 3000 the active list structure. The 3000 tickers will appear on the left side of the Data Manager screen. A red "X" will appear next to the tickers that are not in your database.

To add the missing tickers, click *List*, then *Find and Create*. Click "*Do Lookup*." Most of the stock descriptions will appear. Finally, click "*Do Creation*" and *Done*. You should update the data to make sure it is current before proceeding.

To create the Advance-Decline Line, go to the Data Manager and click *Ticker* and *New*. Enter a ticker symbol to represent the new market (we used ticker RUSMKT). Click on *Market* and *OK*.

On the *New Market* screen, enter a description for the market. Under *Market Breadth Data Source* click on *Compute From All Stocks In List* and select *RUS3000*. We'll plot the S&P 500 with the Advance-Decline Line, so enter ticker SPX in the *Price Ticker* box (**Figure 1,** next page).

DAVID VOMUND

On the next screen, click *Compute It Now*. Since the first computation incorporates several years of data, it will take several minutes. To have TradingExpert automatically compute this Market after a download, go to the Communications screen. At the lower right, check *Compute Markets* and then click *Save Setup*.

To plot the new Advance-Decline Line, enter ticker RUSMKT in Charts. **Figure 2** shows our newly created market ticker. Plotted is the S&P 500 index along with an Ad-

> *"…the Advance-Decline Line is only as good as the data used in its calculation… TradingExpert Pro is one of the few software packages that has the flexibility to calculate an Advance-Decline Line based on any set of stocks. This gives us an advantage over the competition."*

vance-Decline Line calculated from the Russell 3000 stocks.

Although there are small variations between this new custom indicator and the standard Advance-Decline Line, it does show deteriorating market breadth. During June and July, the Advance-Decline Line shows deteriorating market breadth at the same time that the market index was hitting new highs. More recently, a positive divergence in the Advance-Decline Line has not emerged.

As Paul Desmond points out in his article (page one), the Advance-Decline Line is only as good as the data used in its calculation. Because of closed-end bond funds, there are flaws in the standard indicator. TradingExpert Pro is one of the few software packages that has the flexibility to calculate an Advance-Decline Line based on any set of stocks. This gives us an advantage over the competition.

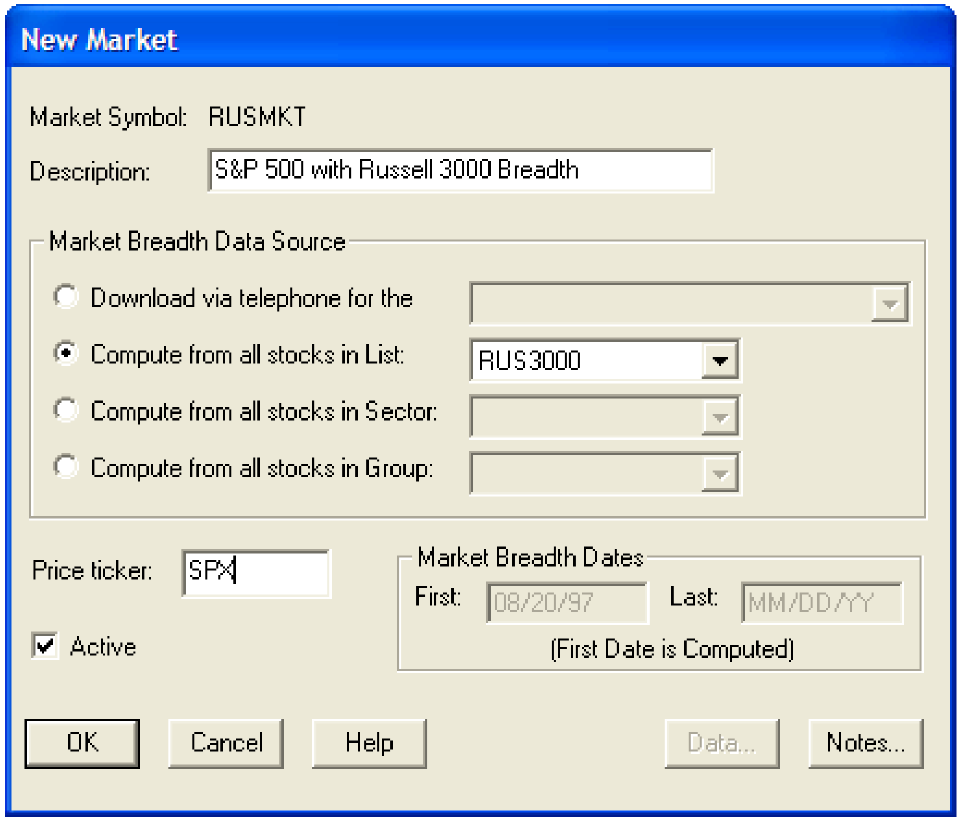


Figure 1. Data Manger's New Market screen is used to enter parameters for a new market ticker. The new ticker RUSMKT will use the Russell 3000 stocks to compute breadth data.

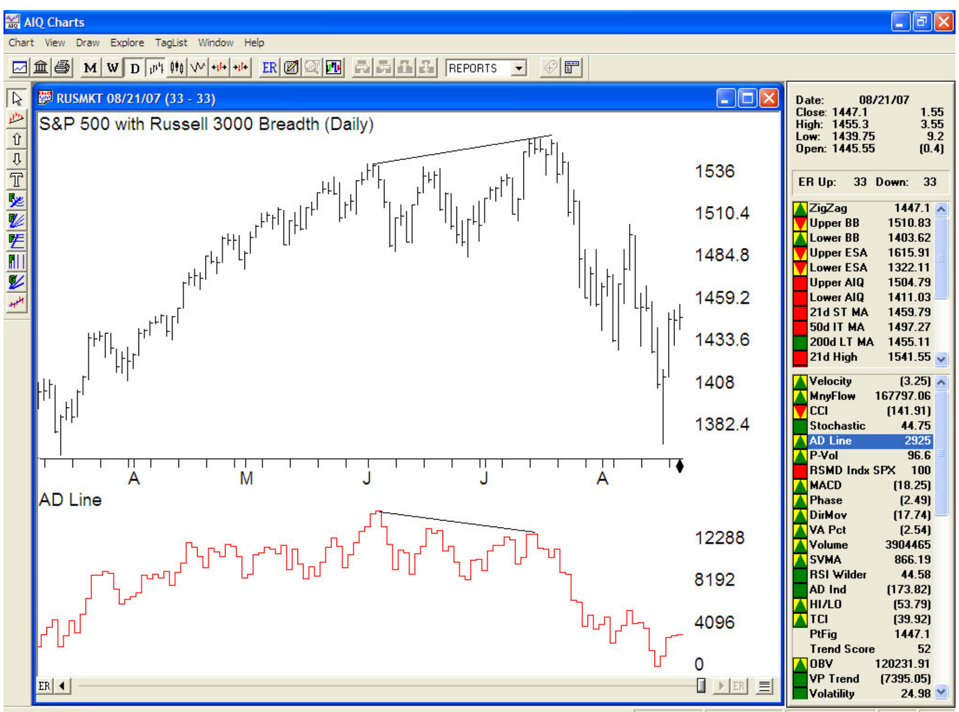


Figure 2. Daily chart of S&P 500 with the Russell 3000 breadth AD Line plotted in lower window. Note the divergence that occurred in the June/July period prior to the recent market decline.

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

MARKET REVIEW

In August the market posted small gains. The S&P 500 gained 1.3% and the Nasdaq Composite gained 2.0%. That doesn't mean the movement was steady and consistent. Mid-month, the market continued its corrective phase that began in early July. This was the largest correction in five years as the S&P 500 corrected 10% from its high to its mid-day low on August 16. That one-day capitulation marked the low.

The best performing sector was Real Estate, which gained 5%. The sector holds REITs. Precious Metals was by far the biggest loser, falling 8%.

AIQ's 18th Annual Lake Tahoe Seminar

October 1 - 3, 2007 Harveys Resort & Casino South Lake Tahoe,NV

Nelson Freeburg

11 sessions

Hosted reception

This year's keynote speaker

Nelson Freeburg

Founder Formula Research

Nelson Freeburg is editor of FORMULA RESEARCH, a financial letter that develops systematic investment models for stocks and bonds. When he first came to the financial markets, Nelson was pursuing a Ph.D. in world politics at Columbia University. Wholly taken by the excitement and promise of trading, Nelson said good-bye to the academic life. Nelson began researching the markets full-time. Eventually he would build a financial database that reaches back to the last century--and from this, a library of advanced trading strategies. Today Nelson uses these timing models to advise institutional clients and manage his own investments.

Many investment professionals rely on Formula Research. Gerald Appel, John Bollinger, Paul Tudor Jones, John Murphy, Martin Pring, Linda Raschke, Larry Williams--all of these and other industry leaders employ his proprietary research.

BONUS live webinar session with Linda Bradford Raschke. Linda is President of LBRGroup, Inc., a registered CTA and money management firm and president of LBR Asset Management, a CPO. She began her professional trading career in 1981 as a market maker in equity options.

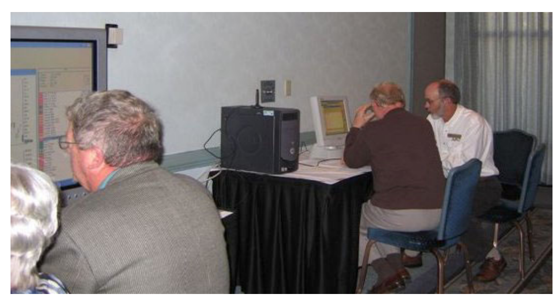
Also joining us this year will be **Martha Sipe**, CFA, a veteran of Wall St and president of mindingmatter.com, and **Bob Debnam**, founder of the ChartProfit service. We are also pleased to welcome back **Dale Wheatley**, founder of The Options Hunter service and **Steve Palmquist**, trader and founder of daisydogger.com. Our regular AIQ speakers **Steve Hill**, CEO and **David Vomund**, Chief Analyst round out the speaker line-up.

Every morning begins with an AIQ-hosted breakfast. Sessions begin at 8:30 each day and run through to 5:00 pm (12:00 on last day). Regular breaks during the day include an AIQ-hosted lunch on the first two days. Tuesday evening all attendees are invited to an AIQ catered buffet dinner.

Including meals, cost for all three days is only $895 per person.

Reserve your place now!

There will no Getting Started with AIQ track this year; instead we will be offering **one-on-one hands-on clinics** with senior AIQ staff. Appointment times will be accepted throughout the first two days of the seminar



Here's what last year's attendees had to say

"Tremendously valuable - the content and clarity of the presentations moved my trading education forward"

"This was an extremely useful session, advancing my understanding of several important chart patterns"

"Steve (Palmquist) actually told the group what works for him and what makes him a succesful trader, outstanding."

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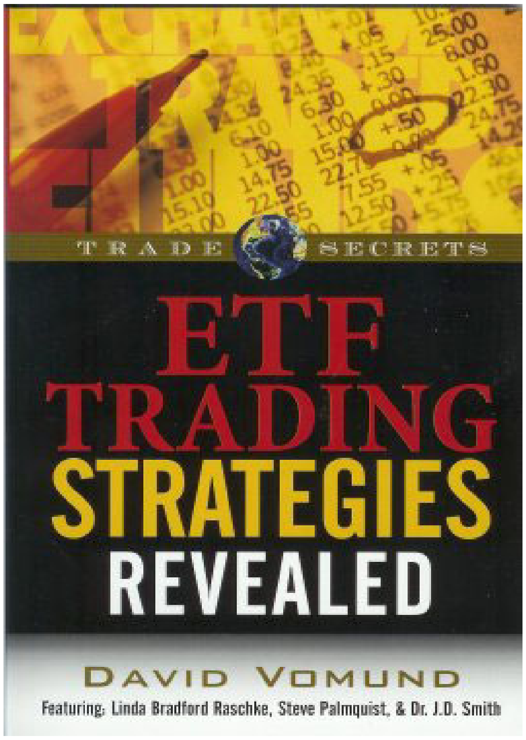
ETF Trading Strategies Revealed



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In his new book, David Vomund, AIQ's Chief Analyst reveals the secrets of profiting from a new and growing investment vehicle - the Exchange Traded Fund. Pulling from experts in the field like Linda Bradford Raschke and Steve Palmquist, this book has all the information you need to begin trading ETF's for profit.

- Learn the basics of ETFs; how they work, why they're growing in popularity, and how you can get your share of the profits.
- Discover the way to apply classic techniques to leverage your ETF investments for both the short-term and long-term.
- Study simple but highly effective mechanical ETF rotation techniques (style, sector, and international) that are now available to the. individual investor.

ETF Trading Strategies Revealed doesn't end there. Learn from long-time trader and founder of AIQ Systems, Dr J.D. Smith, what it takes to mentally be the best. When you have the emotional discipline to follow his technique, you'll find increased profits aren't far behind.

"Finally... a comprehensive book on Exchange Traded Funds! I have always enjoyed reading David Vomund's insights on the markets and his interviews with other successful traders, and I know you will prosper from the wealth of information contained in this ground-breaking book." **Price Headley, CFA, CMT**