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Trading with Candlesticks

Candles-based Sector Analysis

By Allen Thomas

Most of us have probably heard the cliché phrase "All boats rise in a rising tide." While choosing stocks to trade isn't quite as simple as merely determining the underlying trend of the overall market and jumping in accordingly, this time-tested market dogma does have merit in selecting stocks to trade within certain sectors and industry groups. It's been well acknowledged that stocks within certain sectors tend to trade in sympathy with one another.

Applying candlestick

charting analysis to indices and their

underlying industry groups can help pinpoint specific clusters of stocks ripe for trading in this "top-down" approach to stock screening. By

identifying an entire group of stocks that demonstrate a similar technical picture, your winning trade percentage

can increase dramatically.

Finding a specific stock with a candlestick reversal pattern pointing in the same direction as the sector or group it belongs to can serve as a powerful confirmation that the chart is forecasting a legitimate move. Just as combining multiple technical indicators increases the probability of an accurate forecast, so does screening stocks based on their overlying group.

Let's look at a few examples of varying time frames that exhibit this concept well. Late December 2001 saw the Networking index (**Figure 1**) rally

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Allen Thomas

An introductory article on candlestick charting by Allen Thomas appeared in the April 2002 Opening Bell. Mr. Thomas specializes in candlestick charting analysis, using TradingExpert Pro as his primary software package. He is a full-time trader and president of A-TeamTraders.com.

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about 65 points from the 300 area before forming a very bearish *Advance Block* reversal pattern.

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P.O. Box 7530
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89452

The *Advance Block* reversal pattern is made up of three white candlesticks with increasingly shorter real bodies as well as progressively longer upper shadows. This is a graphic depiction of a stock that is losing its upward momentum as the price closes farther off its high each day. This pattern gives excellent short selling signals when the market is in an established downtrend.

With the appearance of the *Advance Block* pattern predicting a trend reversal at a lower high than the last advance in early December, one could almost forecast the head and shoulders top forming as well. The Networking group has a bearish chart.

Now that we've identified a group with a rather bearish daily chart, we want to find individual issues within the group that would make for profitable low-risk shorts. **Figure 2** shows us one such example.

On the same day that the Networking group had completed its reversal pattern, JDS Uniphase (JDSU) also developed a bearish pattern known as a *Bearish Engulfing*

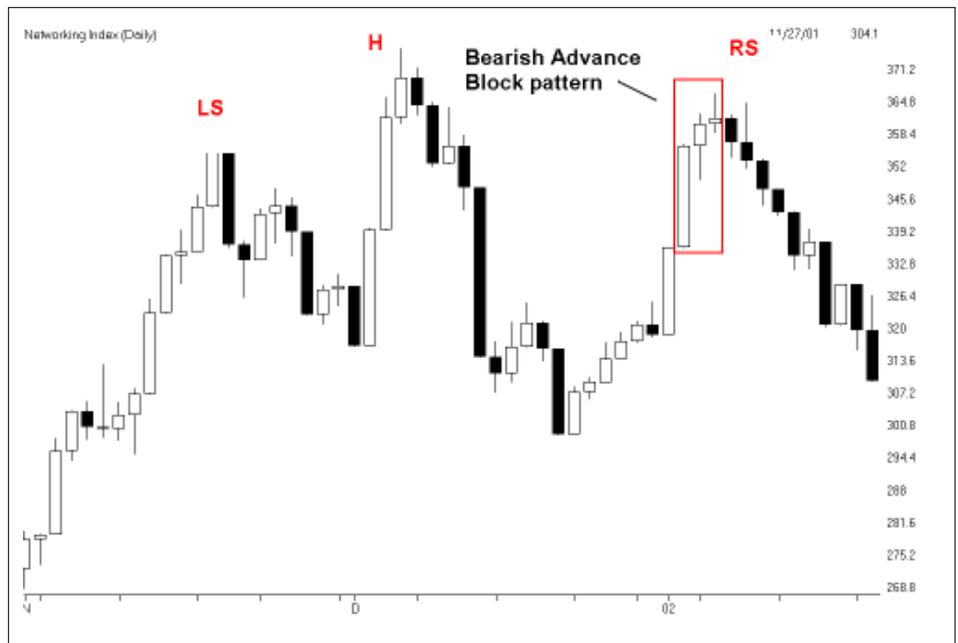


Figure 1. Candlestick chart of Networking index with Bearish Advance Block reversal pattern

Pattern. This is a two-day pattern where a large black candle “engulfs” the real body (a real body is the price difference between the open and close) of the previous trading session. This pattern is indicative of the exhaustion of the bullish camp as

“The Advance Block reversal pattern gives excellent short selling signals when the market is in an established downtrend.”

prices begin by gapping up over the previous day's close only to fall lower than the previous open, turning fresh longs into fresh losers.

In addition to the candle formation, JDSU had completed a 5/8ths Fibonacci retracement from the intra-day high on December 5 through the low on December 20. Often times, a counter-trend rally or sell-off moves between the Fibonacci zones of 3/8ths and 5/8ths before resuming the more primary trend, which in this case was clearly downward.

Fibonacci retracements can be a bit subjective depending on your starting and ending points. I tend to simply use the relative high and low points of a stock's recent price swings, looking for significant patterns to develop in the “zone” between the 3/8ths and 5/8ths retracement.

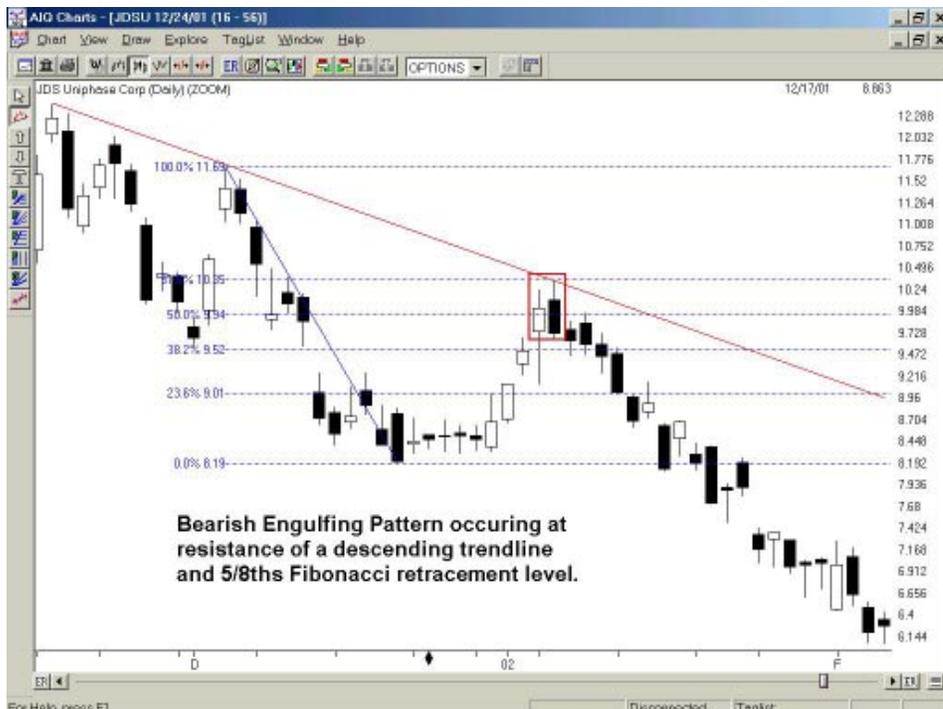


Figure 2. JDSU candlestick chart showing Bearish Engulfing pattern followed by steep decline

The final bearish element in JDSU was that the upper shadow of the engulfing candle touched but didn't break the resistance trendline drawn from the peak in November 2000.

The ensuing decline saw the price fall over an eight-week period from just under \$10 to \$4.75, a 50% plus gain for swing traders patient enough to have ridden the entire move. Note that during the time JDSU was declining, its corresponding index chart failed to form a bullish reversal pattern, suggesting that the bleeding within the parent group wasn't about to stop anytime soon.

One of the nice features of AIQ's TradingExpert Pro is the ability to overlay charts. By displaying the networking group and JDSU charts simultaneously, the impending trend change appears even more obvious and valid.

Figure 3 shows a chart of Ciena (CIEN), another of the networking stocks, during the same time frame. On January 4 to January 8, a bearish reversal pattern called an *Evening Star* was formed. This is one of the



Figure 3. Candlestick chart of Ciena showing Evening Star bearish reversal pattern followed by 50% decline in stock price.

most reliable of the candlestick reversal patterns.

The *Evening Star* is made up of three candles. The first is a long white candle that closes near its high and gives the appearance that the bulls are running and in charge.

This candle is followed, however, by a small real-bodied candle, either black or white, that gaps up away from the close of the previous day, and indicates a slowing of the bullish momentum as traders are unable to advance the price much higher than the previous session.

The final candle in this pattern is a long black candle that may gap lower at the open and closes well within the range of the first long white candle. More detailed descriptions of the *Evening Star* and the *Advance Block* patterns can be found in the April 2002 and May 2002 *Opening Bells*.

In the May issue of the *Opening Bell*, we took a detailed look at this pattern along with some trading rules to implement. One of the guidelines discussed was to wait for some positive retracement after an *Evening Star* has formed before initiating a short position. This not only reduces your risk since it places your short entry closer to your stops, but also aids the practical consideration of shorting with the uptick rule.



Figure 4. Hourly candlestick chart of SOX with Doji Evening Star followed by rapid price decline.

Following Ciena's *Evening Star* pattern, the price gapped higher allowing shorts to be entered around \$16. In a little over a month, the price was nearly halved as the network sector was in meltdown mode and CIEN was melting along with it.

Our final pair of charts demonstrates the technique of group/stock matching on an intra-day interval. In the middle of June of this year, the 30-minute chart of the semiconductor group (**Figure 4**) formed a classic *Evening Star* variant called a "Doji" *Evening Star* (a *Doji* candle is one where the opening and closing price are the same).

An *Evening* or *Morning Star* with a *Doji* as part of the pattern can be especially effective in signaling an upcoming reversal in the price trend. The *Doji* candle signals a stalemate between bulls and bears and serves as a yellow flag to longs when they develop following an extended price advance.

When the indecisiveness of the *Doji* is followed by a long black candle, confirmation of the trend change is complete.



Figure 5. 30-min. candlestick chart of Novellus showing bearish *Evening Star* pattern which is followed by reversal to downside and price slide that lasted for two days.

After peaking in the 460 area, the semiconductor index began to sell-off rather dramatically back to near the 400 level, the base from where the rally began.

This was a crystal clear warning to those who were long the semiconductors that it was time to book profits. Short sellers could

watch for an entry once the pattern was confirmed with momentum divergence or trendline violation.

Figure 5 shows a very similar pattern forming in Novellus (NVLS) with a break of an ascending trendline around \$38. An aggressive approach would be to short any gap-up or positive retracement immediately following completion of the pattern with stops set just over the high of the pattern, or in this case, at \$39.25.

Once NVLS violated the ascending trendline and confirmed the bearish *Evening Star* reversal, a two-day selling spree brought the price

down over \$5, a very nice move considering it originated off of a 30-minute chart.

When used correctly, candle-

"An Evening or Morning Star with a Doji as part of the pattern can be especially effective in signaling an upcoming reversal in the price trend."

sticks serve as a powerful tool in "top-down" sector analysis. Performing candlestick analysis on sectors or groups aids in identifying early stages of rotation. By searching for reliable reversal patterns in both the stock charts and their corresponding industry groups, you'll have a higher percentage of winning trades while avoiding false signals from rogue isolated chart patterns.

Allen Thomas can be reached by visiting his web page at www.A-TeamTraders.com.

AIQ Opening Bell Newsletter

David Vomund, Publisher
G.R. Barbor, Editor
P.O. Box 7530
Incline Village, NV 89452

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Market Review

July was a terrible month for anyone who was long the market. Both growth and value stocks went down. From the start of the month through the July 23 low, the Dow fell 16.7%, the S&P 500 fell 19.4%, and the Nasdaq Composite fell 16.0%. This was the first time I can recall that the Nasdaq outperformed in a falling market. Late in the month, the market rallied and as of this writing (July 29) about half of the losses have been recovered. Still, the Dow is more than 1000 points below 10,000.

The market began the month by falling below critical support levels. The S&P 500 had strong support at 940. This level acted as support in September 2001 and in October 1998. Once the S&P 500 fell below this level, sellers rushed for the exits. The 940 level now represents strong resistance and could put a ceiling on any rally over the short-run.

The AIQ market timing model registered two buy signals in July. A 99 buy came on July 24 and a 97 buy came on July 25. This counter-trend model has not fared well in this strong downtrending environment.

Those who follow sector rotation know that in almost every environment there are a few industry groups that do well. That wasn't the case in July, however. Out of about 160 groups in the AIQ Pyramid, only four rose in value through July 26. Automobile Manufacturers-Foreign, Telecommunications-Cellular, Finance-Mortgage Services, and Banks-Southwest all gained about 1%. On the downside, several computer, health, and oil groups lost about 25%. Even the mighty gold group lost a quarter of its value.

Looking forward, we'll see what role August 14 plays in market timing. This is the day CEO's are required to sign off on company accounting books.

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date
Wilshire State Bank	WSBK	2:1	08/16/02
Tracor Supply	TSCO	2:1	08/20/02
Myers Indus.	MYE	5:4	09/3/02

Trading Suspended:

Alpine Group (AGI), Cell Point Inc. (CLPT), HealthWatch Inc. (HEAL), Immunex Corp (IMNX), Interreliant Inc. (INIT), IVEX Packaging (IXX), JP Realty Inc. (JPR), Maynard Oil Co. (MOIL), ONI Systems (ONIS)

Name Changes:

Emulex Corp (EMLX) to Emulex Corp. (ELX)
Western Resources (WR) to Westar Energy (WR)
Sun Int'l Hotels (SIH) to Kerzner Int'l Ltd. (KZL)

S&P 500 Changes

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

Anthem Inc. (ATH) replaces Conesco Inc. (CNC). ATH is added to the Managed Care (HEALTHMC) group.

North Fork Bancorp (NFB) replaces Immunex (IMNX). NFB is added to the Banks (BANKGRP) group.

United Parcel Service (UPS) replaces Royal Dutch Petroleum (RD). UPS is added to the Air Freight & Logistics (AIRFREIG) group.

Goldman Sachs (GS) replaces Unilever NV (UN). GS is added to the Diversified Financial Services (FINANCID) group.

Prudential Financial (PRU) replaces Nortel Networks (NT). PRU is added to the Life & Health Insurance (INSURALI) group.

Electronic Arts (ERTS) replaces Alan Inc. (AL). ERTS is added to the Application Software (COMPUTES) group.

SunGard Data Systems (SDS) replaces Barrick Gold (ABX). SDS is added to the Information Technology (INFOTECH) group.

EBay (EBAY) replaces Placer Dome Inc. (PDG). EBAY is added to the Internet Retail (RETAILIN) group.

Principal Financial Group (PFG) replaces Inco Ltd. (N). PFG is added to the Diversified Financial Services (FINANCID) group.

AIQ's 13th Annual Lake Tahoe Fall Seminar

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In Today's Difficult Market, It Makes Sense to Combine Fundamental and Technical Data

By David Vomund

DAVID VOMUND

Market analysts typically fall into the technical or fundamental camp. Fundamental

analysts claim technicians are wrong because they buy stocks without knowing anything about the company. Now technicians can strike back claiming fundamental analysts are wrong because the accounting numbers that they analyze can't be trusted. A smaller group of people believes both camps are right. The term used to describe a style that combines fundamental data with technical work is "rational analysis."

In a tough market environment such as the one we are in, rational analysis makes a lot of sense. Risk is

"A style that combines fundamental data with technical work is termed 'Rational Analysis'.... Risk is lowered when a technical trading model is run on a database of fundamentally attractive stocks."

lowered when a technical trading model is run on a database of fundamentally attractive stocks.

With TradingExpert Pro, the process of combining fundamental and technical data is easy. One possibility is to make an AIQ List of fundamentally attractive stocks and then run AIQ screening reports or Expert Design Studio scans on that list of stocks instead of the entire

database. One way to do this is to use Value Line Reports, which are available at most public libraries. Instead of running mechanical screenings on a large set of stocks, scans can be run on Value Line's most timely stocks.

To create a list of stocks, go to TradingExpert Pro's Data Manager. Select *List* from the menu bar and then *New*. Enter a name for the list and click OK. Next, select *List* and then *Insert Tickers*. Type the tickers separated by semicolons and click OK. If you have a list of tickers in an Excel file, you can use

the Advanced List Edit function to import the list of stocks.

AIQ's Fundamentals Module

A list of fundamentally attractive stocks can be automatically generated using TradingExpert Pro's Fundamentals module. Within this module are many choices of pre-built fundamental strategies. To see what is available, click the Fundamentals icon from the Quick Launch

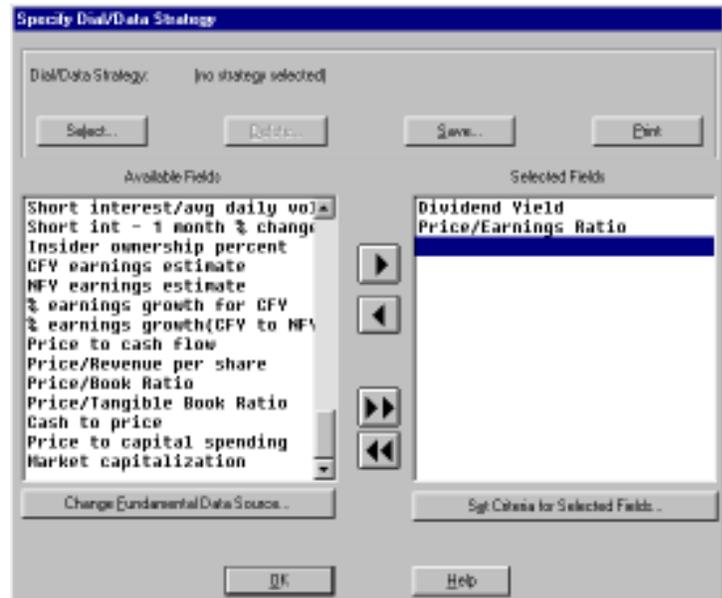


Figure 1. Fundamental Strategy Selection window with data fields provided by Dial/Data listed in left panel.

Menu. From the menu bar, click on *Fundamentals* and then *Specify Strategy*. In the upper section of the next window, choose the *Select* command. A list of the pre-built fundamental strategies will appear. Highlight the strategy you want and click *Select Strategy*.

For this article, we are going to create our own fundamental screening. During this bear market, value stocks have performed much better than growth stocks. Along the same lines, stocks with dividend yields have generally outperformed stocks without dividend yields. Therefore, we will create a simple fundamental model that searches for stocks that have price-to-earnings ratios (PE ratio) less than 20 and also pay dividends.

The first step in creating this model is to select the PE ratio and dividend yield fields and then retrieve this fundamental data from

your data vendor. In the Fundamentals model, select *Fundamentals* and *Specify Strategy*. The available fundamental fields will appear on the left section of the screen. The fields you are interested in should appear on the right section of the screen. Therefore, we highlight the Dividend Yield and Price/Earnings Ratio fields and move them to the right section of the screen (**Figure 1**). Click *Save* and name the strategy.

With our two fundamental fields selected, we can now retrieve the yield and PE ratio data for all of the stocks in our database. Go to Communications and place a check mark next to *Fundamentals* in the upper right portion of the screen. Click *Start Update*.

With the data retrieved, we can scan for stocks that have a PE ratio less than 20 and a dividend yield greater than zero by using either the Fundamentals module or Expert Design Studio. First, we will explain how to use the Fundamentals module. Later in the article we'll use the Expert Design Studio.

In the Fundamentals module, click on *Fundamentals* and *Specify Strategy*. With our two fields on the screen, click *Set Criteria for Selected Fields*. Double click *Dividend Yield*. For this demonstration we entered 1 for the minimum value and 15 as the maximum value. That means the stock must have a yield greater than 1%. Any yield over 15 is probably bad data so it is eliminated. Place a check next to *Rank field Dividend Yield* and set 50 as a *Fundamental Rating Weight*. Click *OK*.

Using the same method as above, double click *Price/Earnings Ratio*. Enter zero as the lower range (i.e., we don't want a stock that is losing money) and 20 as the upper limit. Place a check next to *Rank field Price/Earnings Ratio* and set 50 as a *Fundamental Rating Weight*. Continue to click *OK* until you return to the main Fundamentals page.

By default, the Fundamentals

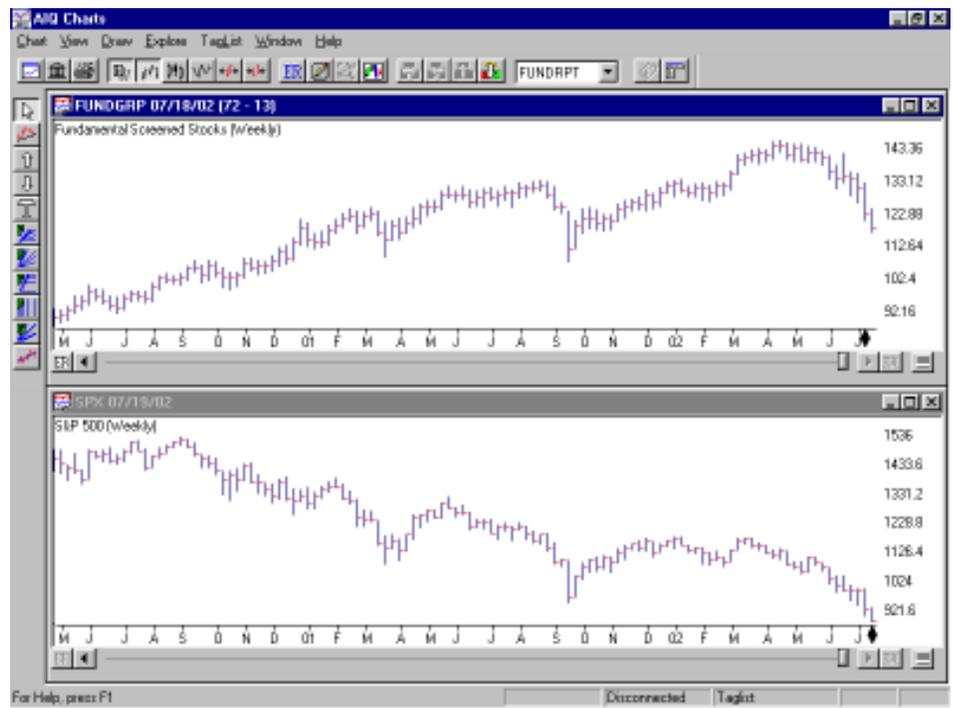


Figure 2. Price performance of screened stocks compared to S&P 500 for past 27 months.

module will stop screening for stocks once 50 stocks pass the model. We want that changed. Click *Fundamentals* and then *Preferences*. On the second choice, change the maximum number of symbols in the report to 5000. That way, the limit won't be reached.

It's time to see which stocks pass our screening. Click *Fundamentals* and *Rerank Fundamental Fields*. The ticker symbols for the stocks that pass the screening will appear.

Once the screening is completed, select *Report* and then *Build List*. This is the list that can be scanned by AIQ reports or Expert Design Studio models.

The Expert Design Studio

Once the fundamental data is retrieved from the data vendor, the Expert Design Studio module can also be used to screen for the stocks that pass our criteria. Here is the

code for our simple model:

- rule1** if [Dividend Yield]>1 and [Dividend Yield]<15.
- rule2** if [Price/Earnings Ratio]>0.
- rule3** if rule1 and rule2.

In my database, I found 580 stocks with a dividend yield of at least 1%. 620 stocks had a PE ratio between 0 and 20. Combining these

"Fundamental analysis can help you avoid buying a wildly overpriced stock while technical analysis helps with the timing. This rational analysis approach is made easy with TradingExpert Pro."

two, 304 stocks have both a dividend yield and a PE ratio between 0 and 20. Once the EDS screening is complete, a list file can be created by clicking the *Chart List* icon.

To get a feel for the behavior of these 304 stocks, we placed them into a group and charted them next to the S&P 500 (**Figure 2**). Notice how well these stocks performed relative to the S&P 500. It wasn't until the last two months that the

fundamentally screened stocks joined the S&P 500 in the bear market.

The 304 stocks that met our criteria passed our Fundamentals model but that doesn't mean they are ready to be purchased. Instead, we will run our technical models on these stocks.

A Rational Approach

In the May 2002 *Opening Bell*, we presented an EDS model that screened for stocks with attractive Money Flow indicators. For this article, we will use this model to select trading possibilities for the 304 stocks. This model can be downloaded from AIQ's web page at www.aiqsystems.com. Click on *Educational Products* and then *Opening Bell*.

To run this EDS scan on a stock list, go to Expert Design Studio and open the Money Flow file. Click on *File* and *Properties*. By default, EDS scans are run on the entire database so change the setting to run the scan on the fundamental stock list. AIQ Reports can also be run on a selected list as well.

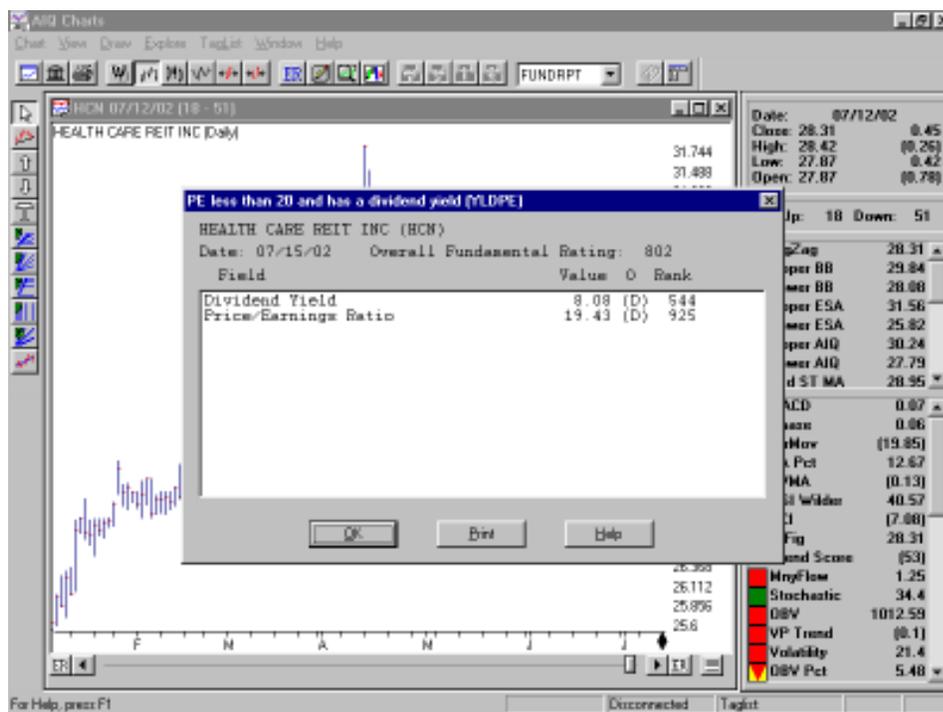


Figure 3. Fundamental data for HCN as of 7-15-02 with field rankings and Overall Fund. Rating.

Running the Money Flow model on July 12 gave one stock selection, Health Care REIT (HCN). **Figure 3** and **Figure 4** show why this stock was selected. Figure 3 shows the yield and PE ratio data for HCN. HCN's dividend yield is 8.08% and its PE ratio is 19.43. You can see a

stock's fundamental data by typing the "F" key when a chart is displayed. Figure 4 shows that HCN's Money Flow indicator has been moving higher for most of the last six months and is just off its high.

Users are unable to backtest a rational analysis approach. Data vendors only have current fundamental data so one cannot perform a two-year backtest based on fundamental data from two years ago. If you adopt a rational analysis approach, you will also want to periodically update the fundamental data. Retrieving fundamental data once a week seems appropriate.

Combining fundamental work with technical analysis makes sense, especially in a difficult market. Fundamental analysis can help you avoid buying a wildly overpriced stock while technical analysis helps with the timing. This rational analysis approach is made easy with TradingExpert Pro.

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

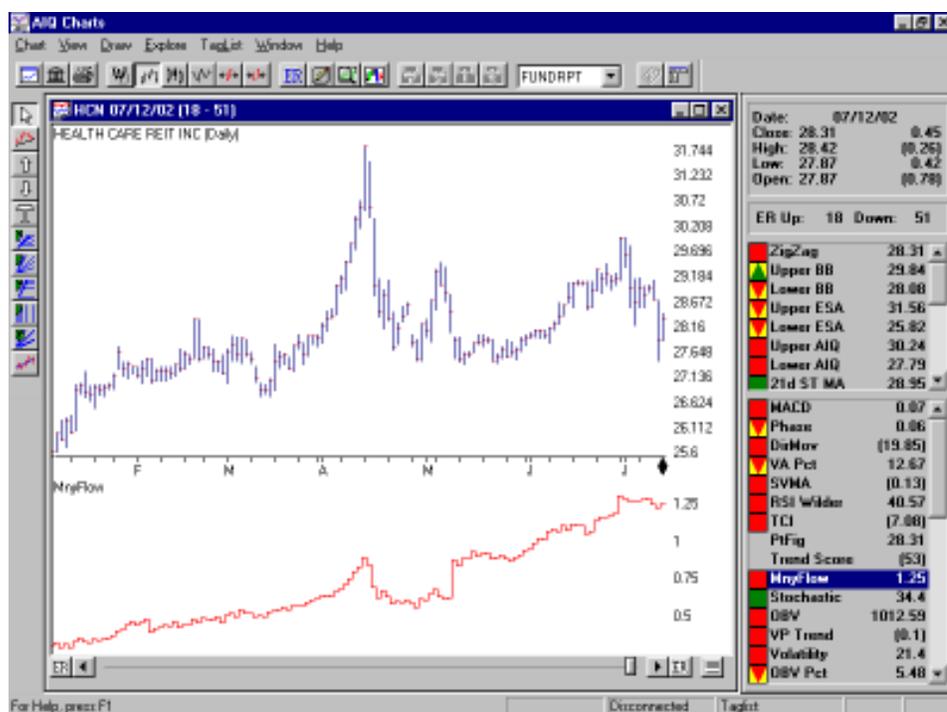


Figure 4. Six month chart of HCN with rising Money Flow indicator.