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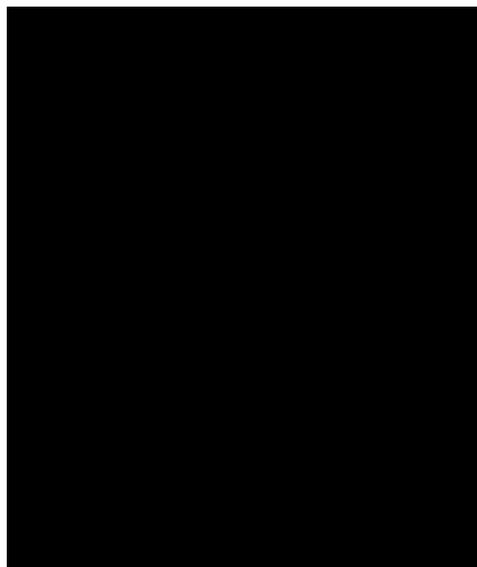
The *Opening Bell Monthly* is a publication of AIQ Systems
 David Vomund, Chief Analyst
 P.O. Box 7530
 Incline Village, Nevada 89452

INTERVIEW

THE GOOD AND BAD OF OPTIONS TRADING — SOME EXPERT ADVICE

By David Vomund

David Schultz is a trader, hedge fund advisor, and President of Summit Capital Holdings, a registered investment advisory and equity research firm specializing in risk management, volatility analysis, and sector rotation. Mr. Schultz is also the publisher of SectorVue, a daily report which reviews market activity. Together with Lawrence McMillan, Mr. Schultz will lead all all-day options workshop on October 4, the day before AIQ's annual Lake Tahoe Fall Seminar begins. Mr. Schultz can be reached at schdav@aol.com.



David Schultz

OBM: When someone begins to trade options, how much of the portfolio should be devoted to option trading?

Schultz: In general, people should allocate about 5 to 10 percent of their portfolios to options. In this context, long-term stock holdings may be 60% of your portfolio and short-term trading stocks 30% of the portfolio. The options can add some bang to your buck but will not blow up your investment plan.

OBM: In your managed account program you trade both stocks and options. Since you have a lot of option

experience, do you devote a larger percentage of the portfolio to options?

Schultz: Most of our managed account clients are long-term investors but we enhance the long term positions by trading options around the stock. For example, one of our largest holdings is EMC, which has been a great money maker but it does go up and down with the tech sector. When EMC is at a short-term low, we will sell put options if we wouldn't mind owning more shares. Or,

INTERVIEW *continued* . . .

we buy call options when we are expecting a short-term pop to the upside.

I also sell calls if we are at a major top and we get a sell signal on the market. I am nervous every time I sell calls on a wealth builder like EMC but it has added some cash to the kitty. Trading options on a core holding leverages my time as well as my money. I am already watching every tick on EMC and feel comfortable with the stock. Why go looking for trouble somewhere else?

Experience has also taught me to be in cash more often with the trading side of the portfolio. I do not have a need to trade every day or every week.

Then again, I may go from cash to very leveraged when we get a buy signal from a very oversold position. This is when the market moves the most in the shortest time period. It is also when traders have the greatest fear. This is when it is most useful to have a tool like call options available with limited risk and unlimited upside.

OBM: Options involve leverage. How much leverage should be used?

Schultz: In general, if you are buying call options on a stock you should buy twice as many calls as you would shares of the stock. So if you normally buy 500 shares of a stock,

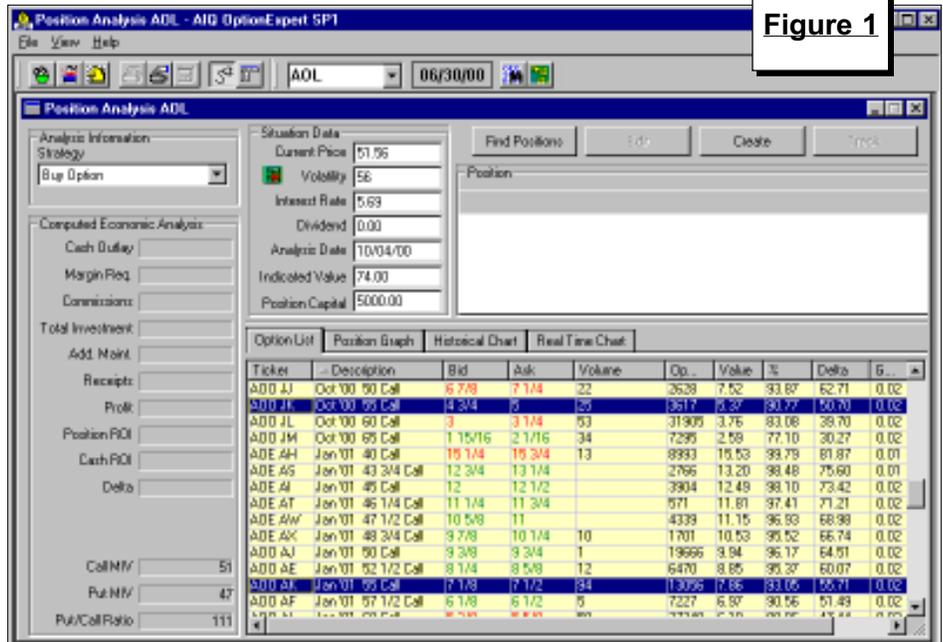
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you would buy 10 option contracts, the equivalent of 1,000 shares of stock. There is an old saying that goes along with this - Have a hunch? Bet a bunch. Hunch is wrong? Bunch is gone.

OBM: What if you are a put seller?

Schultz: When you sell a put you are agreeing to buy stock at a certain price. Never sell more puts than you can afford to buy the underlying shares for.

You will never get in trouble if you are willing and able to purchase the shares. You simply buy a great stock at a lower price. If you contract to buy a boatload of stock by selling too many puts and it wiggles the wrong direction, you will sink your portfolio.

OBM: I've heard that about 90% of all options expire worthless. If this is the case, Should people just sell

options and rarely buy options?

Schultz: Before options exchanges and pricing models like Black-Scholes came into use, options traded by appointment and were very expensive.

This gave a clear advantage to the seller. Now, everyone knows the theoretical price and trading is very efficient. Options are priced so neither the buyer nor seller has an advantage. AIQ's

OptionExpert does a good job of letting you know what the option price should be and what it will do when the stock moves. These days, about 55% of options are traded out before they expire, about 10% are exercised, and only about 35% expire worthless. Buyers and sellers have an equal chance.

OBM: How important is the choice of which broker to use?

INTERVIEW *continued* . . .

Schultz: The choice of broker is extremely important because most brokers do not understand the use of options. One simple test is to see if they can take limit orders or stop orders on options. If not, it probably means they do not have people on the floor of the exchange to execute your order. This is a big factor. Good execution and guidance is more important than a cheap commission.

OBM: How much of a liquidity problem is there for index and equity options?

Schultz: Broad based index options like the OEX or QQQ, which track S&P100 and the Nasdaq 100 index, are very liquid and efficiently priced. Equity options are much less so. You want to stick to the most active options in order to reduce trading costs.

OBM: Unlike stocks, there is an end of the year tax situation with options. Can you explain this?

Schultz: Based on the December 31 value, you pay taxes on an index option as if you closed out your position. I generally do close out all my options before the end of each year. Also, broad-based index options are taxed 60% long term and 40% short term, regardless of your holding period.

Additionally, buying a put on a stock freezes your holding period in figuring long-term capital gains for a stock holding. Be aware there are different rules for options and do not assume your accountant knows this. Make your accountant look it up.

OBM: What general guidelines do you give to option buyers?

Schultz: Time is an enemy of option buyers so it is a good idea to buy an option about twice as long as you think it will take for the stock to move. If you expect the market to move in a month or two, then buy an option two to four months out. As a rule, you should never own an option

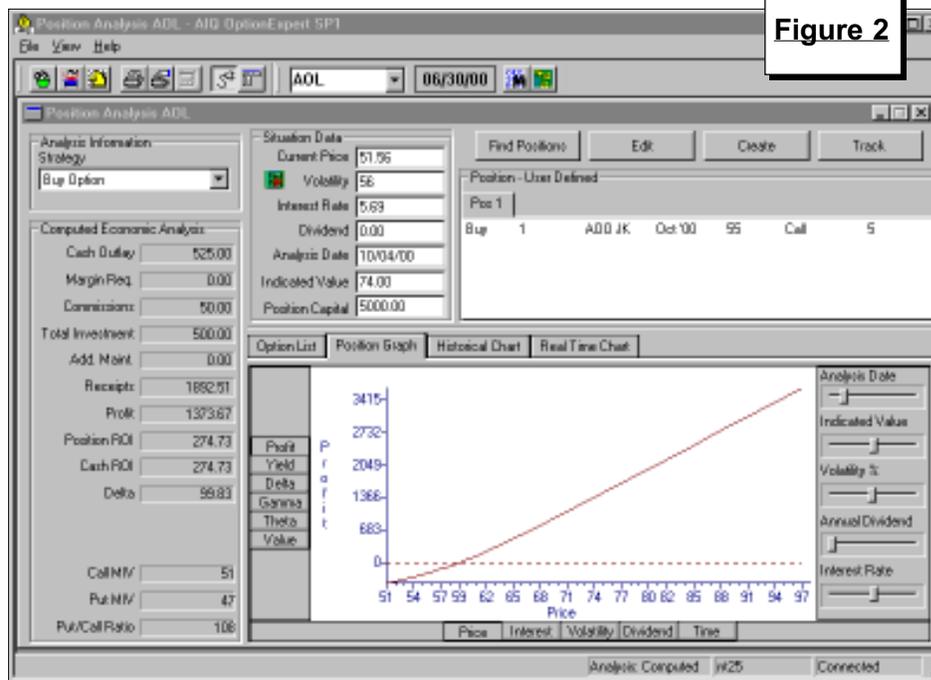


Figure 2

in the month that it expires. Buy in the money or at the money options.

I also prefer to buy options on stocks that are priced at least \$25 and preferably \$50 or more. It is easier for a \$100 stock to move \$5 than a \$25 stock to move \$5 and the options are

if they are called away. If you agree to purchase stock at a certain price by selling a put, you better have the cash or reserves to buy it. You may not be happy but you have to be able to fulfill the contract. By preparing for the worst case, you'll be able to come back

and play another day. Because time premium decays the quickest in the last month, I prefer to sell options that are one or two months away from expiration. This also allows me to use some repair strategies if the market goes against me.

OBM: Can you give us an example of an option purchase and explain how AIQ's OptionExpert can be used to determine which option was purchased?

Schultz: Let's take for example AOL. If we feel AOL will get government approval of the TWX merger by Oct 4 (the date of our AIQ options seminar) and rally to its recent highs of \$74, which call should we buy?

Looking at OptionExpert's Option List (Figure 1), we highlight two

"Before options exchanges and pricing models like Black-Scholes came into use, options traded by appointment and were very expensive. This gave a clear advantage to the seller. Now, everyone knows the theoretical price and trading is very efficient... neither the buyer nor seller has an advantage."

cheaper on a relative basis for the more expensive stocks.

OBM: What guidelines do you give to option writers?

Schultz: Always be willing and able to perform what you have agreed to in the option contract. If you sell a call, then you are agreeing to sell the stock at a certain price. If that is the case, you better have the shares ready

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INTERVIEW *continued* . . .

options – the Oct 55 call which trades at 5 and the Jan 55 call trading at 7 1/2. Both have similar deltas, 51 and 56, with the slight advantage of a larger delta in the January option. The January option will make more money for the same move in AOL stock.

A Profit Graph using October 4 as the target date also shows a difference in risk. If the stock only rallies to \$57, the October option will be worthless while the January option still carries some value (Figure 2 and Figure 3).

The illustrations show that the longer term option, while more expensive, has greater profit potential and less risk over the limited time frame of October. We'll see what this position does and review it at our options seminar.

OBM: Can you explain what a delta is, using the AOL example?

Schultz: The Delta is how much an option will move for every point the stock moves. A delta of 50 means the option will move about 50 cents for every dollar the stock moves. In the above example, the October option would move 51 cents and the January option 56 cents for every dollar AOL stock moves up.

OBM: What sell strategy do you suggest for option buyers?

Schultz: First of all, use time stops and perhaps a price stop of 50%. If you own an option, you should always be within one strike price of the stock. If you own a call with a 50 strike price, close it out if the stock gets below 45.

Taking profits is difficult because you cannot just let it sit. Initially, you may want to have specific profit targets like doubling your money then review the trades and circumstances to see if you are leaving money on the table.

It takes a bunch of trades to get a

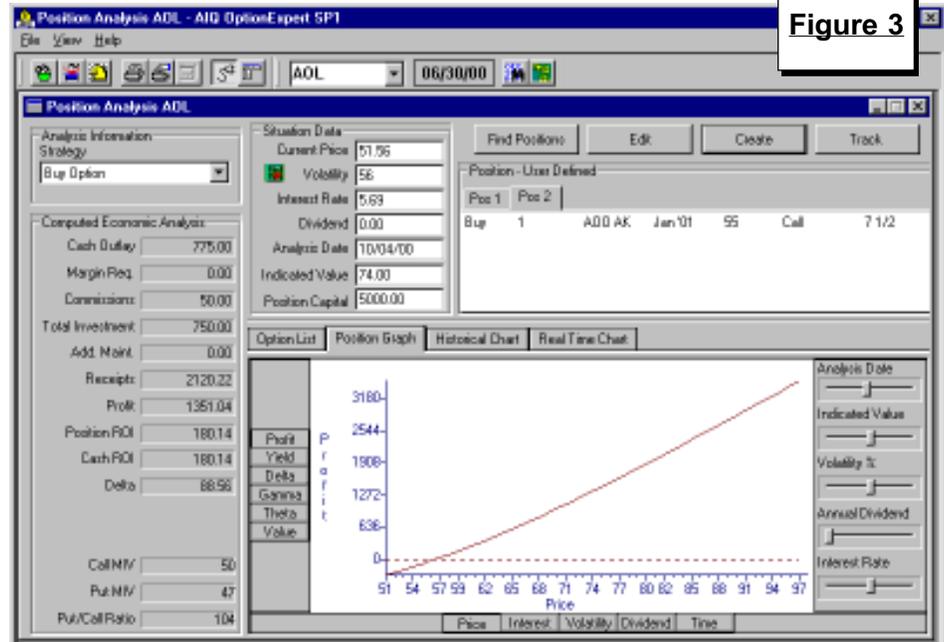


Figure 3

good sample of how things work and how you will react emotionally to different circumstances.

OBM: What about option writers?

Schultz: When selling options, if you are right the option will just expire and you do not need to do

anything. If substantially all of the profit is made in a shorter time period, for instance should I sell a call at \$3 and it is now

worth 1/2 a point, I usually buy the option back. There is no reason to leave the bag open for the profits to jump out of.

If the position moves against you, then take your lumps early and move on to another trade. Avoid getting buried in a trade, hoping it will come back some day. This is also true of repair strategies. You can roll an option out once or twice, but if it continues to chew on your leg then move on to something else.

These are all good topics to cover

at the Tahoe seminar. I encourage people to bring some examples and we will review them.

OBM: Thank you for sharing your thoughts with us and we look forward to seeing you at our Tahoe seminar in October. ■

S&P 500 Changes

The following are changes to the S&P 500 Index and Industry Groups:

Sanmina Corp (SANM) replaces Warner Lambert (WLA). SANM is added to the Electronics-Instrumentation (ELECTRIE) group.

JDS Uniphase (JDSU) replaces Rite Aid (RAD). JDSU is added to the Communications Equipment (COMMUNEQ) group.

Palm Inc. (PALM) replaces 3Com Corp. (COMS). PALM is added to the Computers-Hardware (COMPUTEH) group.

TESTING THE RSMD INDICATOR

WHICH TYPE OF STOCKS WILL BE LEADERS? USE THE RELATIVE STRENGTH INDICATOR

By David Vomund

DAVID VOMUND

There are times when it is best to be in large cap stocks and there are times when it is best to be in Nasdaq stocks. In like manner, there are times when one should concentrate in growth stocks and there are times when one's concentration should be in value stocks. To help determine which type of stocks will be leaders, use the Relative Strength indicator.

Relative Strength compares the strength of one security or index to another security or index. We will concentrate on the RSMD SPX indicator. The RSMD SPX is the Relative Strength of the displayed ticker (stock or index) to the S&P 500 index.

Relative Strength is most often computed by dividing the price of one security by the price of another. With the RSMD indicator, we smooth the resulting value by applying the formula for the MACD indicator. The faster line (typically green) is computed as the difference between two moving averages on relative strength and is called the Difference Line. The second line (typically blue) is an exponentially smoothed average of the Difference Line and is called the Signal Line. The constants for this indicator are identical to the MACD indicator.

When the Difference Line is rising and is above the Signal Line, then the plotted security is outperforming the S&P 500. The opposite is true when the Difference Line is falling and is below the Signal Line.

Comparing the Nasdaq Composite to the S&P 500 using the RSMD SPX indicator has become an impor-

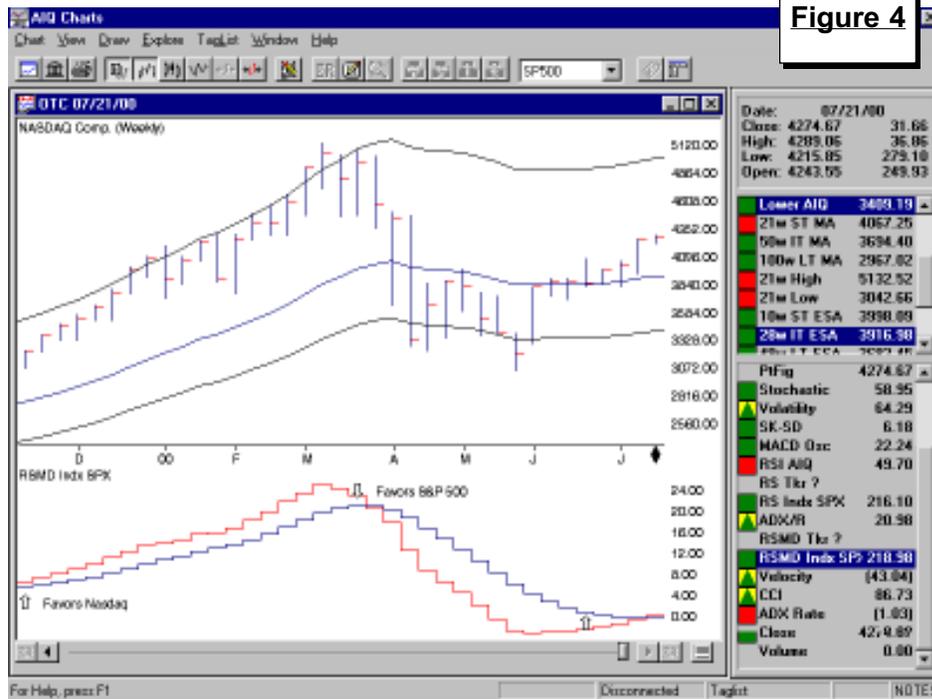


Figure 4

tant part of my analysis. First, it serves as a good market timing tool. When the Nasdaq is outperforming, it indicates that traders are willing to take aggressive positions and are seeking maximum profit. Generally, these are bullish time periods.

When the S&P 500 takes leadership over the Nasdaq, then it implies people are moving to more conservative stocks and are seeking safety. The market rarely has a strong rally when the RSMD SPX favors the S&P 500.

Comparing the Nasdaq Composite to the S&P 500 also tells whether it is best to be in growth stocks or value stocks. The Nasdaq Composite is an outstanding measure of growth stock performance. Since the S&P 500 is a diversified index and contains most of the large-cap old economy stocks, it can be used to measure the performance of value stocks.

When the RSMD SPX indicator favors the Nasdaq Composite, buying aggressive high relative strength stocks generally works well. When the indicator favors the S&P 500 index, however, it is generally a good time to hold a conservative and well diversified portfolio. It is during these times that growth investors often give back their gains.

Short-term traders will prefer to use a daily chart of the RSMD SPX while long-term traders will prefer a weekly chart. Using the default parameters, I've found that the daily chart acts too quickly and gives too many whipsaws while the weekly chart is too slow and misses too much of the price movement.

I could have adjusted the indicator parameters to fit my need. Instead, I've changed the way I interpret the

Testing RSMD Indicator continued on page 6

weekly chart. Rather than relying on crossovers, I look at the direction of the weekly RSMD SPX indicator. Under my interpretation, a trend is in place once the Difference Line (the fast line) moves two weeks in the same direction.

Let's clarify this with an example. In **Figure 4** we see the Nasdaq Composite and its RSMD SPX indicator. From November through mid-March the indicator is rising, which implies the Nasdaq Composite is outperforming the S&P 500. This also implies growth stocks are outperforming value stocks.

In mid March, the indicator began to fall. Rather than waiting for the Difference Line to drop below the Signal Line, we simply wait for the indicator to fall for two straight weeks before we shift our assets out of growth stocks. Similarly, the indicator rose for two weeks in mid-June. This signaled a shift to Nasdaq stocks four weeks before the actual crossover.

Using this method of analysis, it is important that you look at the graph for direction changes rather than using the number next to the indicator. The number to the right of the indicator is meaningless.

How has this method of analysis worked in the past? We tested the indicator's signals going back to 1995. In **Table 1** the first two columns show the dates that the RSMD SPX indicator shifted directions for two weeks. The third column shows whether relative strength favors the Nasdaq Composite or the S&P 500. When relative strength favors the Nasdaq, our strategy buys the Nasdaq Composite. When relative strength favors the S&P 500, then our strategy buys the S&P 500 index.

The fourth column shows our trading results. The final two columns show the percentage return figures for the Nasdaq and the S&P 500.

Looking at the Summary Statistics, we see that the S&P 500 returned 222%, with compounding. The Nasdaq Composite doubled the S&P

Table 1**RSMD Indicator Test Results**

Updated through July 20, 2000

Entry Date	Exit Date	Rel. Strength Favors	Trading Index % Ch.	Nasdaq % Ch.	S&P 500 % Ch.
1/13/95	2/5/95	Nasdaq	1.30	1.30	2.72
2/5/95	2/17/95	S&P 500	0.70	1.93	0.70
2/17/95	9/22/95	Nasdaq	33.85	33.85	20.70
9/22/95	2/23/96	S&P 500	13.30	6.11	13.30
2/23/96	6/14/96	Nasdaq	8.53	8.53	1.03
6/14/96	9/6/96	S&P 500	-1.53	-6.08	-1.53
9/6/96	10/25/96	Nasdaq	7.30	7.30	6.90
10/25/96	12/13/96	S&P 500	3.95	5.10	3.95
12/13/96	12/27/96	Nasdaq	0.50	0.50	3.86
12/27/96	1/10/97	S&P 500	0.36	3.15	0.36
1/10/97	2/14/97	Nasdaq	2.64	2.64	6.45
2/14/97	5/9/97	S&P 500	2.02	-2.35	2.02
5/9/97	10/24/97	Nasdaq	23.66	23.66	14.17
10/24/97	1/30/98	S&P 500	4.10	-1.91	4.10
1/30/98	5/29/98	Nasdaq	9.85	9.85	11.28
5/29/98	7/2/98	S&P 500	5.10	6.47	5.10
7/2/98	8/28/98	Nasdaq	-13.43	-13.43	-10.40
8/28/98	11/6/98	S&P 500	11.09	13.23	11.09
11/6/98	2/26/99	Nasdaq	23.24	23.24	8.53
2/26/99	4/9/99	S&P 500	8.88	13.33	8.88
4/9/99	4/23/99	Nasdaq	-0.09	-0.09	0.63
4/23/99	7/2/99	S&P 500	2.53	5.80	2.53
7/2/99	8/20/99	Nasdaq	-3.38	-3.38	-3.93
8/20/99	9/3/99	S&P 500	1.54	7.35	1.54
9/3/99	10/29/99	Nasdaq	4.34	4.34	0.42
10/29/99	11/12/99	S&P 500	2.43	8.59	2.43
11/12/99	3/24/00	Nasdaq	54.08	54.08	9.41
3/24/00	6/23/00	S&P 500	-5.63	-22.52	-5.63
6/23/00	7/20/00	Nasdaq	8.55	8.55	3.80
Average =			7.23	6.87	4.29

Summary Statistics:

Percentage Returns with Compounding

Trading Return = **533.32%**Nasdaq Return = **448.23%**S&P 500 Return = **221.75%**

500's return, gaining 448%.

While it would be hard to beat the Nasdaq's return over this time period, if you switched between the S&P 500 and the Nasdaq Composite based on relative strength, then you would have a 533% return.

Traders can actually follow the strategy used in our study. The SPDR (SPY) can be purchased when the S&P

500 is outperforming, and the Nasdaq 100 tracking stock (QQQ) can be purchased when the Nasdaq is outperforming.

Even if you don't follow this actual strategy, it is important to monitor this indicator because it tells a lot about the market environment and where to concentrate your investments. ■

MARKET REVIEW

At the end of June, the AIQ market timing model switched to a buy mode with a 97 up signal. This was immediately followed by a 99 up signal on July 3. The Phase indicator increased and confirmed this second signal on the same day.

A broad-based rally followed the buy signals and lasted to the middle of the month. Since many stocks participated in the advance, the Advance/Decline Line increased to a four-month high.

As the market rallied, the technical picture began to deteriorate. On July 15, the Market Log report showed that about 80% of the stocks giving unconfirmed signals were on the sell side. The market began to fall and a confirmed 95 down signal was registered on July 24. The unconfirmed sell signals for many of the stocks became confirmed as the market moved lower. On the day of the

market timing sell signal, 78% of the stocks giving confirmed signals were on the sell side.

Two key indicators played a role in the market timing sell signal. Volume Accumulation Percent was negative and moving lower at the time of the signal. In addition, the Stochastic indicator had recently registered a sell signal (Figure 5).

The market immediately moved lower after the July 24 downside signal. Between that date and the end of the month, the Dow only dropped 1.5% but more damage was done in the Nasdaq growth stocks. Over the same time period, the Nasdaq Com-

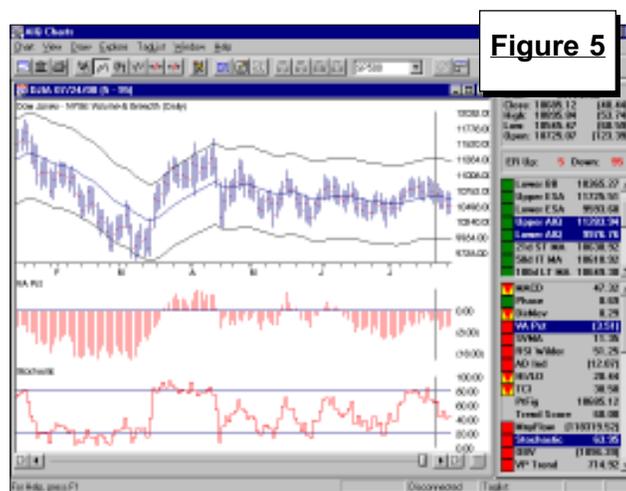


Figure 5

posite fell 5.4%.

For the month, Brokerage was the best performing group, increasing 25%. The worst performing groups were Building Materials, Computers-Software, Electronics, and Gold Mining. All four of these groups fell about 17%. ■

STOCK DATA MAINTENANCE

The following table shows past and future stock splits and large dividends:

Stock	Ticker	Split/Div.	Approx. Date	Stock	Ticker	Split/Div.	Approx. Date
AEP Co.	QEPC	5:4	08/02/00	Silicon Image	SIMG	2:1	08/21/00
Natural Microsystems	NMSS	2:1	08/08/00	Cable Design Tech.	CDT	3:2	08/22/00
Biomet Inc.	BMET	3:2	08/09/00	Advanced Micro Devices	AMD	2:1	08/22/00
Syncor Int'l	SCOR	2:1	08/10/00	Affymetrix Inc.	AFFX	2:1	08/22/00
Altera Corp.	ALTR	2:1	08/11/00	Protein Design Lab	PDLI	2:1	08/23/00
Bed Bath & Beyond	BBBY	2:1	08/14/00	Inhale Therap	INHL	2:1	08/23/00
Silicon Graphics	SIGI	3:1	08/14/00	Vertex Pharm	VRTX	2:1	08/24/00
Direct Focus	DFXI	3:2	08/15/00	Extreme Networks	EXTR	2:1	08/25/00
Actuate Corp.	ACTU	2:1	08/15/00	Waters Corp.	WAT	2:1	08/28/00
COR Therapeutics	CORR	2:1	08/16/00	Citigroup Inc.	C	4:3	08/28/00
Catalina Marketing	POS	3:1	08/18/00	Atmel Corp.	ATML	2:1	08/28/00
Proxim Inc.	PROX	2:1	08/21/00	Merrill Lynch	MER	2:1	09/01/00

Trading Suspended:

Arvin Industries (ARV), Champion Int'l (CHA), Hadco Corp. (HDC), Hartford Live Inc. (HLI), Hussmann Int'l (HSM), PairGainTech. (PAIR), Rexall Sundown (SAFT), Shoney's Inc. (SHN), UnionPacific Resources (UPR), Warner-Lambert (WLA)

Name/Ticker Changes:

Carolina Power & Light (CPL) to CPL Energy Inc. (CPL)

Grey Advertising (GREY) to Grey Global Group (GREY)

IMPORTANT MARKET INDICATOR

THE ADVANCE/DECLINE OSCILLATOR HELPS TO DETERMINE FUTURE MARKET DIRECTION

Since the Advance/Decline Oscillator was developed by Sherman McClellan, it is often referred to as the McClellan Oscillator. This indicator is based on market breadth (number of issues within a market that advance and number that decline on any given day) so it is only available for market indexes that have breadth associated with them.

The Advance/Decline Oscillator (AD Osc) is calculated as the difference between two exponential moving averages of the daily advances minus the daily declines. By default, the two averages are for 19-day and 39-day time spans. The oscillator is, in effect, the MACD formula applied to market breadth. Positive values are recorded when the short-term average moves above the longer-term average. The reverse is true for the sell side.

With this indicator, a buy signal is registered when the AD Osc crosses above the zero line and a sell is registered when the indicator falls below the zero line. As with most oscillators, there can be frequent whipsaws so it is best to combine the activity of this indicator with other available indicators.

The AIQ market timing model not only looks at whether the indicator is above or below zero but it also compares the oscillator to the performance of the Dow. An example can be seen from the rules that fired on the day of the June 30 buy signal. By clicking on the ER button on that day, we see that part of the buy signal was a result of the Dow hitting a new 21-day low while the AD Osc was above zero.

Many people look for divergences in the AD Osc to help determine future market direction. A positive divergence occurs when the market falls to a new near-term low while the indicator is above its recent low. A negative

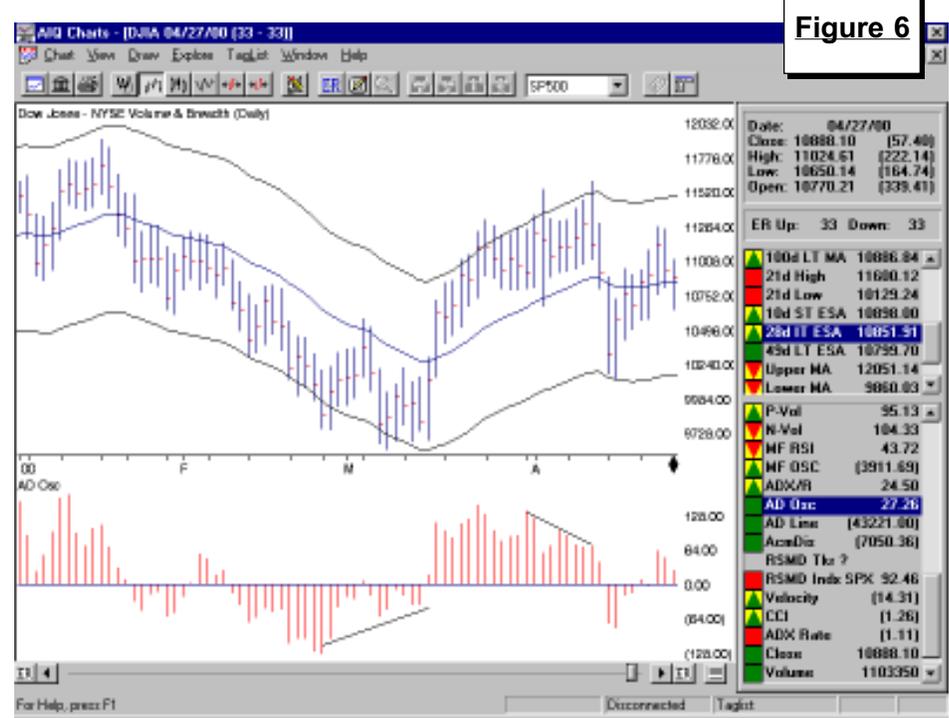


Figure 6

divergence occurs when the market reaches a new high but the AD Osc fails to make a new high.

A recent example of a positive divergence can be found in early March. In **Figure 6** we see that the Dow hit a new near-term low in early March but the AD Osc remained above the low it reached in late February. A negative divergence developed a month later when the Dow hit a new near-term high while the AD Osc was moving lower. Although AD Osc divergences are not always followed by market reversals, this type of analysis can be very helpful for short-term traders.

In TradingExpert, the Advance/Decline Oscillator appears in the indicator section of the Charts control panel when the Dow Jones Industrial Average (DJIA) is plotted. By creating a "market", you can show the AD Osc with an index other than the Dow.

For example, if you want to see the AD Osc with the S&P 500, then go to the *Data Manager* and click *Ticker* and then *New*. Type in *SPXMKT*, choose *Market*, and click *OK*. Under *Description*, type *S&P 500 Market*.

Under *Market Breadth Data Source* use the default, which is *New York Stock Exchange*. Under *Price Ticker*, type *SPX*. Click *OK*. With this completed, you can plot the S&P 500 with the AD Osc by charting the ticker *SPXMKT*.

The Advance/Decline Oscillator is an important indicator to watch because it shows market participation. Since its calculation is based on the number of advancing and declining issues, we know that few stocks are participating in an advance when the indicator is flat or negative. Picking winners is easier when the Advance/Decline Oscillator is giving a bullish reading. ■