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CHART PATTERN ANALYSIS

CONTINUATION PATTERNS WORK IN ALL TIME FRAMES-DAILY, WEEKLY, REAL-TIME

By David Vomund

Of all the chart patterns, most traders consider continuation patterns to be the most effective because they occur frequently and they have a high probability of profit. These patterns are effective because you buy into the trend.

A continuation pattern is typically represented by a pause in the prevailing trend. Sometimes the security's price moves sideways and forms a triangle pattern before the trend

resumes. At other times there is a small pullback against the trend. In all cases, the security has a steep advance or decline and then briefly pauses to "catch its breath" before taking off again in the direction of the overall trend.

Continuation patterns work in all time frames. They are found in 1-minute charts, 60-minute charts, daily charts, and weekly charts. Continuation patterns are typically short-term in duration, meaning that the actual pattern is only a small portion of the overall trend.



DAVID VOMUND

Trading continuation patterns using real-time charts is for scalpers who like to take quick profits....For those interested in holding a stock from several weeks to a few months, trading continuation patterns on weekly charts is highly effective.

Real-Time Charts

Some real-time trading systems are designed to capture large short-term moves in securities. This is not the case with continua-

tion patterns. Trading continuation patterns using real-time charts is for scalpers who like to take quick profits. While the profit per trade is small, the probability of profit is high.

When a quarterback in football lacks confidence, coaches often call

CHART PATTERN ANALYSIS *continued* . . .

short passing plays such as slants or screen patterns. The thought is that after completing some easy passes confidence will improve. That's how some real-time traders use continuation patterns. The high probability of profit helps build confidence when you are in a slump.

For a look at this scalping technique, see **Figure 1**. This graphic shows a 1-minute chart of the S&P 500. The SPX began a rallying phase at 12:41. Once the rally is underway, watch for a pause in the rally. In this case, a flag formation developed at 13:33. In a bullish flag pattern, there is a sharp price advance and then the flag appears as a tight pullback against the trend.

The buy signal comes when the security completes its pause and breaks above an upper trendline that contained the pullback.

After the flag pattern, the SPX continued its rally and at 14:12 began to pause once again. This time a triangle pattern developed. With the triangle formation, trendlines are drawn at the extremes of price activity. The security fluctuates less over time and the trendlines converge.

The buy signal comes when the upper trendline is broken and the overall trend resumes.

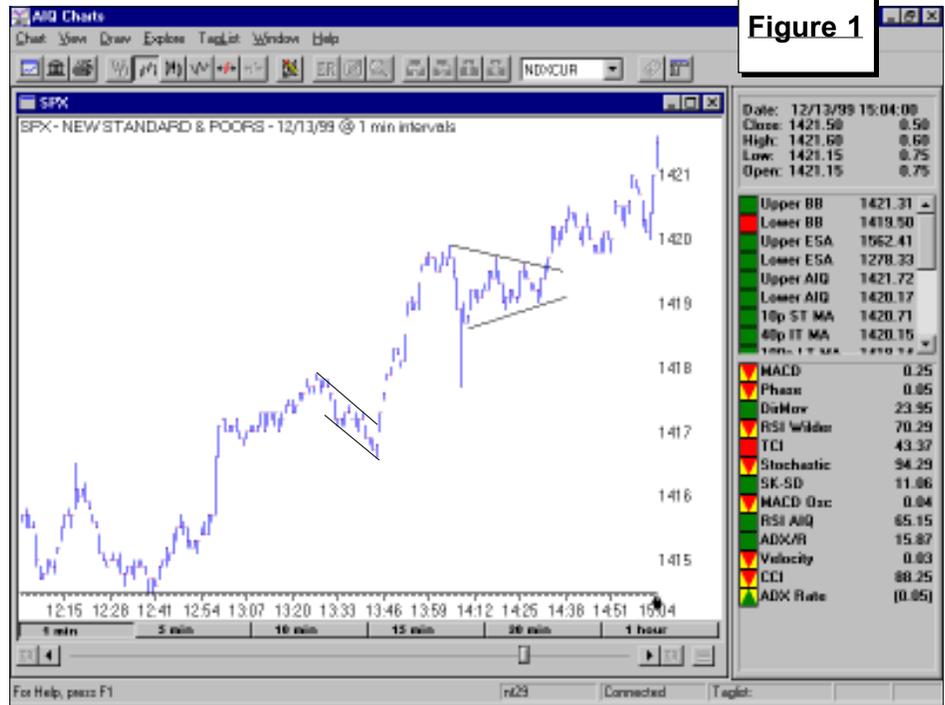


Figure 1

Two minor continuation patterns form at 14:38 and at 15:00. These patterns led to profitable trades but on real-time charts trends don't last long so only the first few continuation patterns should be acted on. Once four or five pauses take place the probability of profit is significantly lower.

Continuation patterns work on the sell side as well. At 10:00 on the next trading day, the SPX was moving lower (**Figure 2**). A quick continuation pattern developed at 10:22 and lasted only five minutes. Only the most active traders would act on this one.

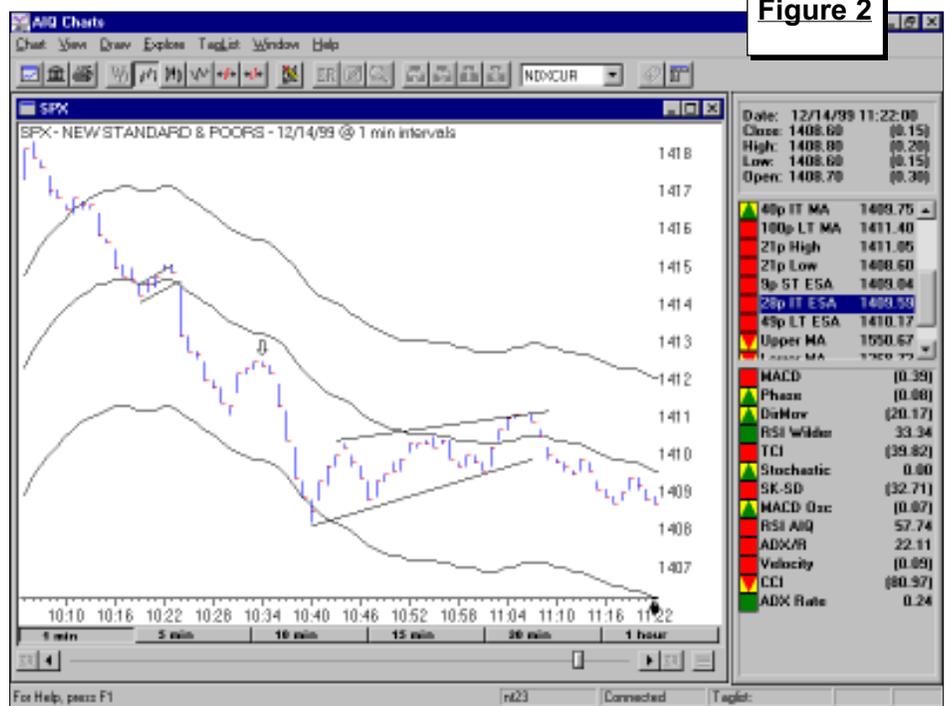


Figure 2

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CHART PATTERN ANALYSIS *continued* . . .

Sometimes it helps to keep the AIQ bands and the 28-period moving average displayed because a continuation pattern is often marked by a move back to the 28-period moving average. At 10:34 another quick pause came when the SPX rallied back to its moving average.

A more defined pattern developed at 10:40. After a sharp decline, the SPX rallied from its lower band to the 28-week moving average.

A trendline is drawn connecting the daily low points. At 11:10 the SPX was near its 28-minute moving average and broke below the support trendline. The pattern was complete and the downtrend resumed.

Scalpers follow the market in the morning to get a feel for that day's environment. In a slow and listless market, there is no work to do. Most often, however, the market makes significant moves.

When a rally or decline starts, wait for a continuation pattern to develop. During the pause, draw a trendline and act once the overall trend resumes. On a minute chart, continuation patterns are only used for quick trades. Once the pattern is broken, traders will only hold a trade for a few minutes.

Several examples of continuation patterns can be found on the SPX nearly every day.

Daily Charts

Those who trade continuation patterns based on one-minute charts look for very quick short-term moves in a security. The same type of analysis can be performed on daily charts. Trading continuation patterns on daily charts typically implies an average holding period of a few days to a couple of weeks.

Nearly every stock in an uptrend will contain a series of continuation patterns. In most cases, the patterns coincide with a move from the upper trading band to the 28-day moving average. In **Figure 3**, a chart of

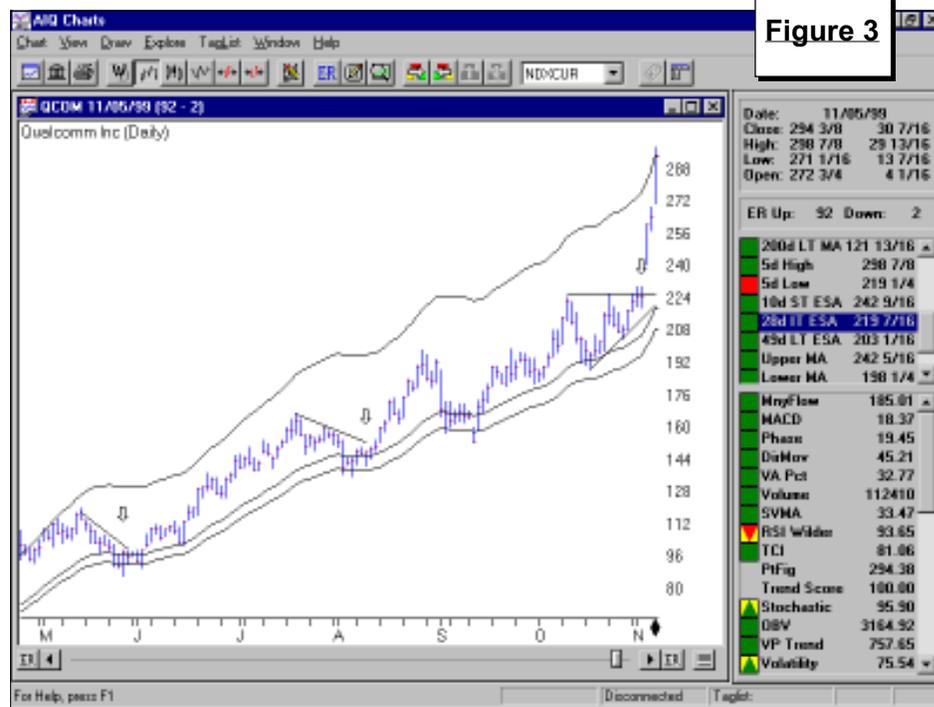


Figure 3

Qualcomm (QCOM), we can see three continuation patterns. In May and July, flag formations are formed. During the pause in the price advance, QCOM corrected in a narrow and orderly fashion. We've drawn a trendline at the top of each flag pattern. When the trendline was broken the stock was near its 28-day

moving average.

The third continuation pattern came in October in the form of an ascending triangle. A horizontal trendline is drawn connecting the high points and an upward sloping trendline is drawn connecting the low

Chart Pattern Analysis continued on page 4

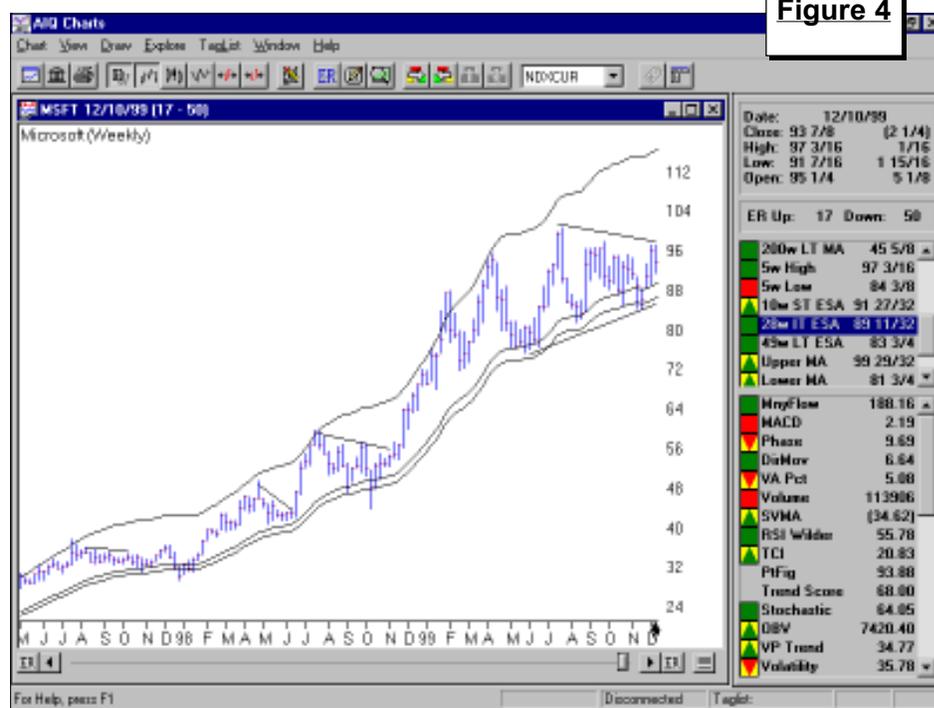


Figure 4

CHART PATTERN ANALYSIS *continued* . . .

points. Once the stock breaks above its upper trendline, the rally resumes.

What if QCOM broke below the pattern instead of above it? A breakdown of a triangle pattern may signal a trend reversal but that is a trade with low probability of profit. Most often, the stock eventually moves in the direction of the overall trend.

After a breakdown, watch to see if the stock demonstrates a new downward trend. If so, trade bearish continuation patterns.

Weekly Charts

For those interested in holding a stock from several weeks to a few months, trading continuation patterns on weekly charts is highly effective. Following weekly chart patterns plays an important role in my own analysis.

At AIQ seminars, I talk about a "stairstep" pattern where the security bounces between the upper AIQ trading band and the 28-week moving average. In reality, this pattern shows an uptrending stock with continuation patterns.

A good example of a weekly chart with continuation patterns is Microsoft (MSFT). Microsoft fluctuated between its upper AIQ weekly band and the 28-week moving average (Figure 4).

During the overall advance, there were several cases where the stock paused and "caught its breath". In most cases, it fell back to its 28-week moving average, decreasing in a tight trading range.

More recently, it has formed a triangle pattern. A break above the triangle implies a resumed uptrend. For a similar example, plot Comcast Corp. (CMCSK).

One could do well by simply buying this pattern but it is best to incorporate some form of indicator analysis after a continuation pattern buy signal. A very effective strategy is to buy stocks with weekly continu-

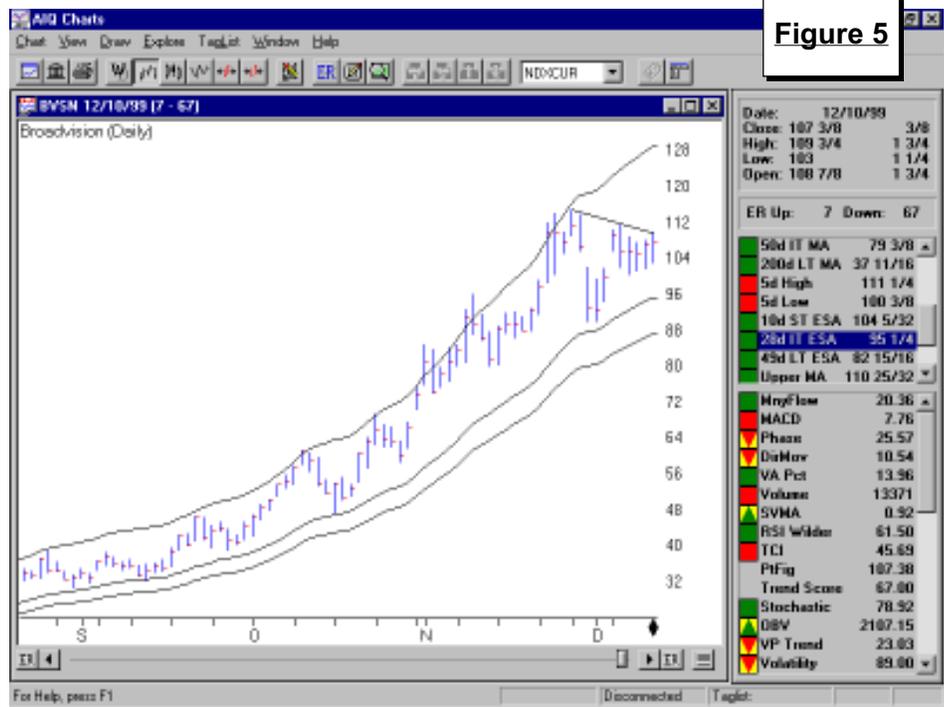


Figure 5

ation pattern buy signals that also appear on AIQ's Daily Persistence of Money Flow report.

High-Growth Expert Design Studio Model

AIQ's Expert Design Studio (EDS) package is unable to search for specific patterns such as flags or triangles. It can search for strong stocks that have recently paused, however.

To create a very high growth model in EDS, we used two rules to find uptrending stocks that have paused. The first rule says that the stock must have doubled in price in the last three months. The second rule says that the stocks have moved lower over the last ten days. The final code is:

Uptrend if [close] / val([close],66)>2.

**Pause if HiVal([close],9)
<val([close],10).**

Allworks if increase and pause.

This model does not give you a list of stocks that have broken out. Instead, it gives a list of stocks that may be in continuation patterns. If a

stock is in a drifting mode, draw a trendline at the upper end of the range and wait for a breakout.

Using this model on December 10, the second stock on the list was Broadvision (BVSN). A well-fit trendline is drawn connecting the high points during the pause (Figure 5).

Traders can use Real-Time Alerts to be alerted to trendlines broken during the day. Or they can use the Trendline Breakout Report at the end of the day for a list of possible trades. We'll further develop this model in an upcoming *Opening Bell*.

This EDS model is best used on a large database and is designed to pick aggressive selections. Users can change the constants to fit their individual needs. ■

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

INTERESTED IN OPTIONS TRADING? IT'S IMPORTANT TO UNDERSTAND THE BASICS

With the release of AIQ's new OptionExpert program, we will periodically include option articles in the *Opening Bell*. Before jumping into option analysis and actual trading strategies, we'll first present a basic overview of how options work and explore what drives their price. It is important to understand the basics because option analysis can be complex and confusing.

Many investors believe that options are strictly for speculators interested in gambling for high returns. While there certainly are high risk strategies, there are other safer strategies that can benefit conservative investors. We will be addressing such strategies in future articles. But let's begin with the basics: the purchase of a call or a put option.

The most prominent type of option is the "call" option for stocks (equity option). One option gives the buyer the right to buy (or call away) 100 shares of a specific company at a specific price at any time up to a specific date.

Figure 6 shows a section of the options quotes page from *The Wall Street Journal* for AT&T. The number at the far left side, 53 3/8 is the closing price of AT&T.

The next column shows the "strike price" (or exercise price), which is the price at which the option buyer can purchase the stock. Buyers of options with a strike price higher than 53 3/8 are speculating that AT&T will rise above the strike price.

The third column lists the month that each option expires. Options expire on the third Friday in any given month, so a "January Call" will expire on January 21.

The remaining figures are the closing day's "premiums", or the price the buyer has to pay for calls or puts on a particular option. Premiums change minute by minute as market factors change.

To continue the example, the January call option with a strike price of 60 has a premium of 5/8. Since this gives the buyer the right to purchase 100 shares of AT&T at 5/8, the option will cost \$62.50 (5/8 x 100). This call option gives the option

several factors that affect the price of an option. First is the current price of the underlying stock. As the market price of the stock increases, so does the call premium. Investors will pay a higher price for the right to buy AT&T at \$60 if AT&T were currently trading at \$70 instead of \$53 3/8.

A second factor is the strike price of the option. When an option is in the money, it is said to have "intrinsic value". Intrinsic value is the difference between the stock price and the exercise or strike price. Using data from Figure 6, the intrinsic value of a January 50 call option is 3 5/8 (53 3/8 - 50 = 3 5/8).

The third factor affecting the price of an option is the time remaining until expiration. "Time value" or "decay" is the excess of the current price of the option over its intrinsic value. The intrinsic value of the January 50 call option is 0.88 (4.5 - 3 5/8 = .88). Options are a wasting asset, and the time value is zero at expiration.

The fourth factor affecting price is the prevailing market condition.

Options 101 continued on page 6

"While there certainly are high risk (option) strategies, there are other safer strategies that can benefit conservative investors."

buyer the right to buy AT&T stock at 60 any time between now and the close of the third Friday in January, when the option expires. This is an "out of the money" option since the price of the stock (53 3/8) is lower than the strike price (60). Call options are "in the money" when the stock price is greater than the strike price.

Put options are the reverse of call options. Put options give the buyer the right to sell 100 shares of a stock at the strike price anytime before expiration. "In the money" put options are those where the stock price is below the strike price while "out of the money" put options are those whose stock price is above the strike price.

There are

Figure 6

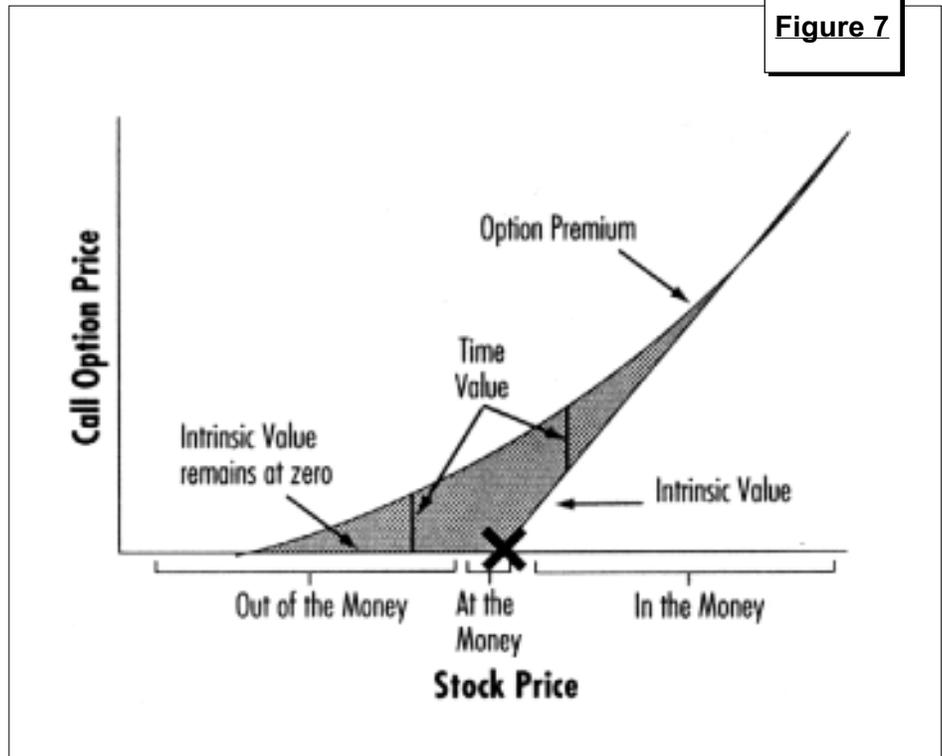
Option/Strike	Exp.	Vol.	-Call- Last	Vol.	-Put- Last
AT&T	25 Dec	543	28
53 ³ / ₈	50 Jan	975	4 ¹ / ₂	633	1 ¹ / ₈
53 ³ / ₈	55 Dec	1082	1 ¹ / ₈	586	1 ³ / ₄
53 ³ / ₈	55 Jan	1101	1 ¹ / ₂	549	3 ¹ / ₂
53 ³ / ₈	60 Jan	1134	5 ¹ / ₈	222	7 ¹ / ₈
53 ³ / ₈	65 Jan	1252	1 ¹ / ₄
AT&T	23 ³ / ₈ Jan	2603	30 ¹ / ₈

OPTIONS 101 *continued* . . .

Premiums are low when the market lacks direction and high when the market becomes more active. Call premiums are high when the mood of Wall Street is bullish and put premiums are high when the sentiment is bearish.

These concepts are better understood when viewed in graph form. **Figure 7** shows an option's price or "premium". Option premiums are higher when they are in the money. When an option is out of the money, its intrinsic value is zero but it has some time value. Point X is the strike or exercise price. Note on the graph that the intrinsic value increases as the stock price increases when the option is in the money. The premium is the sum of the option's intrinsic value and its time value.

Once you understand this graph, you're over the biggest hurdle and on your way! ■



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
Fidelity Holdings	FDHG	3:2	01/04/00	Costco Wholesale	COST	2:1	01/14/00
InfoSpace.com	INSP	2:1	01/05/00	Chico's FAS Inc.	CHCS	2:1	01/17/00
Whitehall Jewellers	WHJI	3:2	01/05/00	Libarate Techs	LBRT	2:1	01/17/00
C-Cor.Net Corp.	CCBL	2:1	01/07/00	Adv. Marketing Svcs.	ADMS	3:2	01/18/00
Pegasus Systems Inc.	PEGS	3:2	01/10/00	KLA Tencor	KLAC	2:1	01/19/00
Daktronics Inc.	DAKT	2:1	01/10/00	Oracle Corp.	ORCL	2:1	01/19/00
Foundry Networks	FDRY	2:1	01/10/00	Portal Soft	PRSF	2:1	01/20/00
InterNap Networks Svcs.	INAP	2:1	01/10/00	Progress Software	PRGS	2:1	01/24/00
AVT Corp.	AVTC	2:1	01/11/00	Morgan Stanley D.W.	MWD	2:1	01/27/00
Doubleclick Inc.	DCLK	2:1	01/11/00	CVB Financial	CVB	5:4	02/01/00
Intertan Inc.	ITN	3:2	01/14/00				

Name/Ticker Changes:

Central Hudson G&E (CHG) to CH Energy Group Inc. (CHG)
 Exxon Corp. (XON) to Exxon Mobil Corp. (XOM)
 Landry's Seafood Rest. (LDRY) to Landry's Seafood Rest. (LNY)
 Photoelectron Corp. (PECX) to Photoelectron Corp. (PHX)
 Rhone-Poulenc (RP) to Aventis ADS (AVE)

Trading Suspended:

Authentic Fitness Corp. (ASM), Big Flower Holdings (BGF), Citation Corp. (CAST), Cyprus Amax Minerals (CYM), DSP Communications (DSP), Harnischfeger Inds. (HPH), Honeywell Inc. (HON), Int'l Telecomm. Data Systems (ITDS), Mobil Corp. (MOB), Outdoor Systems Inc. (OSI), PacifiCorp. (PPW), Pool Energy Services (PESC), Premark Int'l (PMI), Promus Hotels (PRH), Xoom.com Inc. (XMCM)

MARKET REVIEW

OFF YEAR FOR AIQ MARKET TIMING

By David Vomund

After years of steady and consistent performance, the AIQ market timing model had an off year in 1999. Actually, the model performed well through most of 1999 but missed the important fourth quarter rally.

A historical backtest of the market timing model reveals that the highest returns come from simply using the market timing model without confirmation. That is, you buy when an upside signal of 95 or greater is registered and you sell when a downside signal of 95 or greater is registered. The reason people use confirmation is that it helps to avoid some of the bad signals.

The confirmation technique that most people use utilizes the Price Phase indicator. With this technique, a buy signal is not acted on until the Phase indicator increases. Conversely, a sell signal is not considered a sell until the Phase indicator decreases.

On October 25, an unconfirmed sell signal was registered. This ill-timed signal was near a market low and was the reason the market timing model lagged a buy-and-hold strategy. At the time of the signal, the Phase indicator was increasing (**Figure 8**). Using the Phase confirmation technique, the October 25 sell signal was not confirmed until November 10 when the Phase indicator decreased.

As is the case with all bad signals, the slower the confirmation indicator the better the result. The problem with too slow of a confirmation technique, however, is that most of the Expert Rating signals are good. By applying too slow of a confirmation, you buy too late after a good signal and overall returns are lower.

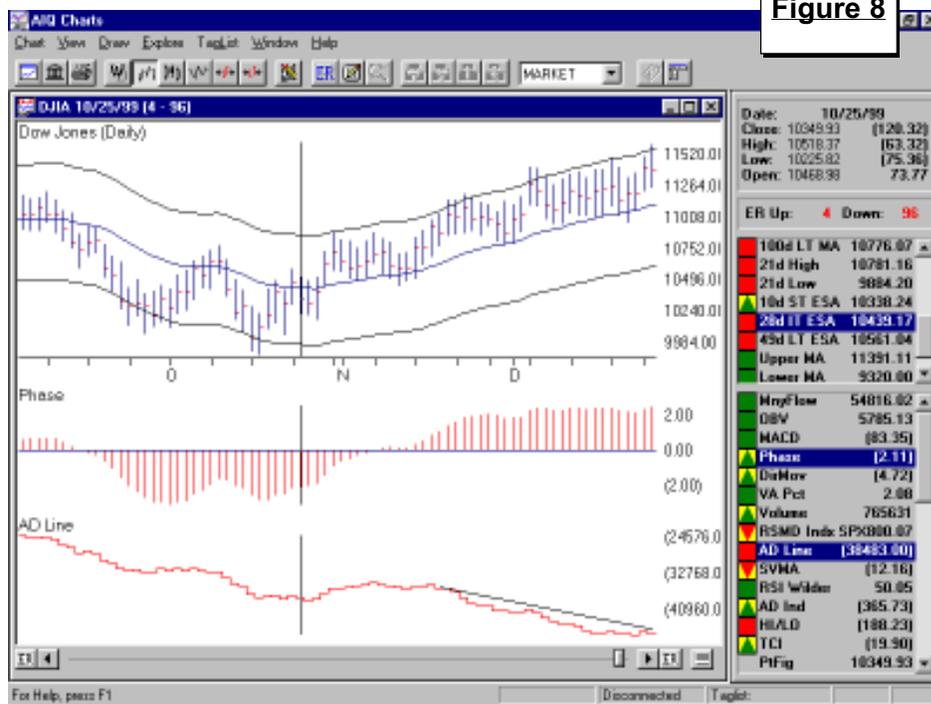


Figure 8

For most people, the Phase indicator is the appropriate indicator for confirmation.

The 1999 buy and sell signals are listed in **Table 1**. The results assume that you buy the S&P 500 the day a buy

signal of 95 or greater is registered and you sell the day a 95 or greater sell signal is registered.

The 1999 return was 6.5%. That compares to an S&P 500 buy-and-hold return of

19.53 % (thru Dec. 31). **Table 2** lists the results using Phase confirmation. Once again we

Market Review continued on page 8

Table 1

No Confirmation

Entry Date	Expert Rating	Exit Date	Expert Rating	S&P500 % Change
12/31/98	N/A	01/13/99	100	0.42
01/25/99	95	02/25/99	100	0.89
04/16/99	95	06/09/99	98	-0.30
06/29/99	100	07/20/99	97	1.90
08/02/99	98	08/18/99	96	0.36
09/27/99	95	10/12/99	100	2.32
10/14/99	99	10/25/99	96	0.80

1999 Return: 6.5%

MARKET REVIEW *continued* . . .

assume you buy and sell the day of confirmation. The trading results are 10.2%.

What went wrong? Quite simply, there was no participation in the market. The market timing model gives signals pertaining to the overall market and the broader market was bearish, even during the fourth quarter. Looking at Figure 8, the NYSE Advance Decline Line hit new lows throughout the quarter. While the S&P 500 rose 19.5% in 1999, half of the S&P 500 stocks had negative returns on the year. Simply put, the S&P 500 overstated the returns of the entire market.

In 1999, we learned the importance of group rotation and stock

selection. Each year there are groups that do well and groups that do poorly. 1999 was unique in that there was very little rotation. Technology stocks did well for most of the year while nearly all the other industry groups had anemic yearly returns. The technology heavy Nasdaq Composite experienced its strongest year ever. ■

Table 2

Phase Confirmation

Entry Date	Exit Date	S&P500 % Change
12/31/98	01/13/99	0.42
01/29/99	02/25/99	-2.71
04/16/99	06/09/99	-0.30
06/29/99	07/20/99	1.90
08/11/99	08/27/99	3.56
10/04/99	10/12/99	0.65
10/20/99	11/10/99	6.51

1999 Return: 10.2%

S&P 500 Changes

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

Molex Inc. (MOLX) replaces PacifiCorp (PPW). MOLX is added to the Electrical Equipment (ELECTRIE) group.

Old Kent Financial (OK) replaces Honeywell (HON). OK is added to the Banks-Major Regional (BANKSMAJ) group.

Citrix Systems (CTXS) replaces Mobil Corp (MOB). CTXS is added to the Computers-Software & Services (COMPUTES) group.

Yahoo! Inc. (YHOO) replaces Laidlaw (LDW). YHOO is added to the Computers-Software & Services (COMPUTES) group.

Transocean Sedco Forex (RIG) replaces Helmerich & Payne (HP). RIG is added to the Oil & Gas-Drilling & Equipment (OIL&GASD) group.

First Security Corp. (FSCO) replaces Foster Wheeler (FWC). FSCO is added to the Banks-Major Regional (BANKSMAJ) group.

NCR Corp. (NCR) replaces Republic New York (RNB). NCR is added to the Computers-Hardware (COMPUTEH) group.

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