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Preparing for Varying Market Conditions

A System for Short-Term Trading of Trending Stocks

By Steve Palmquist

An aircraft pilot has a large number of instruments available to him, and he selects the ones most suitable to current flight conditions and the task at hand. Traders, like pilots, must be able to understand current conditions and select the best tools to accomplish the job. AIQ's TradingExpert Pro enables traders to develop as many instruments as needed

for their trading cockpits to prepare for various market conditions.

Each evening I prepare for the next trading day by first looking at the market and determining if it is in an uptrend,

downtrend, or is moving sideways. I look at the volume to determine if there is conviction in the movement, and trendlines to determine if the short-term movement is just beginning or nearing an end.

I then run an Expert Design Studio (EDS) program with 15 separate scans.

Based on the market analysis, I select the most appropriate ones to use in the current environment. I know which ones are most appropriate at a particular time because I have developed, analyzed, and back tested them in EDS.

This article outlines the process for developing and testing a simple system for short-term trading of trending stocks. A system such as this should be part of your trading cockpit.

The first step in a trend trading system is to identify those stocks that are currently trending. TradingExpert Pro includes four pre-built routines for this purpose: [ADX Trend], [ADX rate up], [DIRMOV up and ADX trend], and [DIRMOV dn and ADX trend]. Either of the first two will provide a list of stocks that are either trending higher or lower. The third pre-built routine identifies stocks in an uptrend, and the fourth identifies stocks in a downtrend. You can easily access these functions through the "Builder" function in EDS.

When developing a system it is important to test each function or rule

Place
Palmquist Photo
Here

STEVE PALMQUIST

Steve Palmquist has been an active trader for nearly 20 years, and a full time trader since 1999. Mr. Palmquist is the founder of www.daisydogger.com, a trading educational and newsletter service. He has used TradingExpert as his analysis software package since 1995. This year he will be a guest speaker at AIQ's 13th Annual Lake Tahoe Seminar (October 7-9) where he will be sharing more trading ideas and EDS scans for current market conditions.

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P.O. Box 7530
Incline Village, Nevada
89452

along the way by running reports that are designed to verify that the rule is doing what you expect. Running a scan with an EDS rule that combines the *DIRMOV up* and *ADX trend* routines identified 45 stocks in my 1,800 stock database that were in clear uptrends.

The next step in the system is to define an entry point. For trading uptrending stocks, the entry may be defined using trendlines, Fibonacci retracement, or simple pullbacks. Each approach can be traded profitably and should be examined as part of the process of developing different tools for the trading cockpit.

For this system, we will first look for brief pullbacks in a strong upward trend. We shall define a pullback as three or more lower highs occurring on consecutive days.

The entry point is when the three-day descending trendline is broken by a higher high. **Figure 1** shows Countrywide Credit (CCR) in a strong uptrend in March and early April 2002. When a pullback occurs we wait to see three consecutive lower highs and then enter a position when CCR rises above the previous day's high, as shown by the

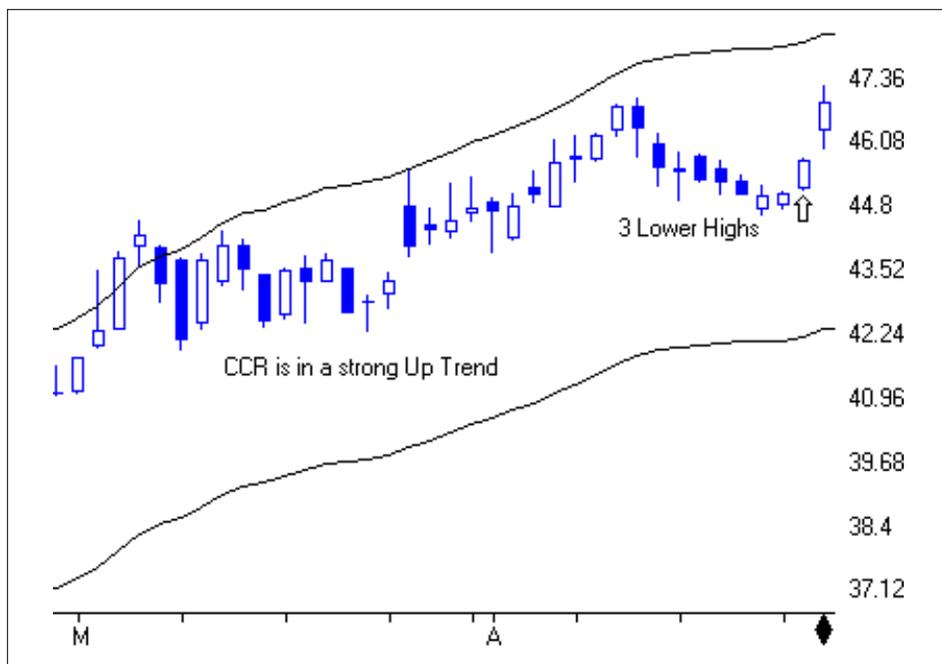


Figure 1. CCR is in a strong Uptrend in March and April 2002. The stock peaks at 46.95 on 04/10 and pulls back for seven days. On 04/22, moving above the previous day's high breaks the pullback and the stock runs up 4.4% in two days. The up arrow marks the entry point.

up arrow in Figure 1.

In order to build our system, we need to create an EDS rule that defines the entry point we are looking for. We first look for lower highs in the three days preceding the current day, and then look at the current day to see if the high exceeds

the high of the prior day. The EDS code that looks for a three-day pullback is listed in the second section of **Figure 2**. This code is a simple application of the EDS "Val" function.

The *set up* for the trade is to find an uptrending stock that has retraced with at least three days of lower highs. The *entry* is triggered when the stock moves above the previous day's high as shown by the up arrow in Figure 1.

The EDS code for the entry is shown in the fourth section of Figure 2. The rule, *Entry*, constitutes the first pass of our trading system for trending stocks and is ready for back testing and analysis.

Prior to doing any back testing, it is important to run a check on your database to look for price spikes or zero volume days. You can do this by running the EDS screen *Pricecheck.eds*, which is found in *EDS Strategies/Data maintenance strategies* in your WinTes32 folder. If this EDS screen finds stocks that are suspect, add them to a list and reload their history.

! Section 1: Identify Up Trending Stocks

! The following four lines are from the [DIRMOV up and ADX trend] pre-built routine

```
badadx if [adx]<25.
```

```
bad5day if ScanAny(badadx,5).
```

```
ADXup if Slope([adx],5) > 0 and not bad5day.
```

```
DIRMOVup if ADXup and [DirMov]>0.
```

! Section 2: Identify a series of lower highs in the three days prior to today

```
LHToday if [high] < Val([high],1).
```

```
LHYesterday if Val([High],1) < Val([High],2).
```

```
LH2DaysAgo if Val([High],2) < Val([High],3).
```

```
LH3DaysAgo if Val([High],3) < Val([High],4).
```

```
ThreeLowerHighs if LHYesterday and LH2DaysAgo and LH3DaysAgo.
```

! Section 3: Setup is an up trending stock with three days of lower highs.

```
Setup if DIRMOVup and ThreeLowerHighs.
```

! Section 4: Entry if stock meets the set up and triggers by moving above yesterday's high.

```
PriceVolumeFilter if [close]>10 and [Volume ESA]>2000.
```

```
Trigger if [high] > Val([high],1).
```

```
Entry if Trigger and Setup and PriceVolumeFilter.
```

Figure 2. First cut at the EDS routine for a system to trade trending stocks.

Someone once told me: “you navigate by the North Star, but you don’t expect to get there.” Back testing should be viewed in much the same way. It can give you a good indication of whether or not a trading idea is worth pursuing, and it provides an excellent tool for improving systems. However, it does not guarantee that your system will make a certain return or yield a given percentage of winners.

When starting out with a new system, I run a quick test over the past year using the default position opening price (next day’s opening price), and a fixed two-day holding period. I refer to these conditions as the standard test.

I use the standard test to get a quick read on whether or not the system is finding stocks that are ready to move. Once a system shows promise on the standard test, I explore possible improvements and look at the effect of different stop loss strategies.

The results from back testing the rule, *Entry*, are not very impressive as can be seen in **Figure 3**. The 4% ROI compares favorably to the 15% loss shown by the SPX during the one year test period, but the Reward/Risk Ratio is too close to one, and 548 total trades doesn’t give much room to work on improving results. When developing trading systems you often find, as in this case, that the first approach needs to be modified.

Given that the *DIRMOV up* and *ADX trend* pre-built routines only identified 45 out of 1,800 stocks in my database as being in uptrends, a logical place to start improving the scan is by using a different approach to defining an uptrend. Stocks in an uptrend usually have upward sloping moving averages and closing prices that are frequently above the 200-day moving average. Another characteristic of stocks in an uptrend is that the prices today are higher than they were a month ago.

opening bell eds Entry		Winners	Losers	Neutral
		=====	=====	=====
Number of trades in test:	548	276	257	15
Average periods per trade:	2	2	2	2
Maximum Profit/Loss:		27.61%	(17.01)%	
Average Drawdown:	(1.75)%	(0.28)%	(3.43)%	
Average Profit/Loss:	0.03%	2.96%	(3.11)%	
Average SPX Profit/Loss:	(0.10)%	0.02%	(0.23)%	
Probability:		50.36%	46.90%	
Average Annual ROI:	4.04%	367.58%	(425.49)%	
Annual SPX (Buy & Hold):	(15.39)%			
Reward/Risk Ratio:	1.02			
Start test date:	06/01/01			
End test date:	05/30/02			
Pricing Summary				
Entry price: [Open]				
Exit price: [Open]				
Exit Summary				
Hold for 2 periods				

Figure 3. Back test results for the Rule, *Entry*, are disappointing and imply changes need to be made to the system.

The EDS code for this new approach to finding uptrending stocks is shown below.

The first three lines define the 200, 50, and 20-day moving averages as having positive slopes. The fourth line requires that all three moving averages have a positive slope and the close is above the 200-day average. The fifth line adds the requirement that the close is higher than the close a month ago. The final rule, *Entry2*, represents the pullback in an uptrending stock with entry triggered and is the system that we want to test.

**Up200 if Slope([LT MA],20) >0.
 Up50 if Slope([IT MA],20) >0.
 Up20 if Slope([ST MA],20) >0.**

**UptrendMA if Up200 and Up50 and
 Up20 and [close]> [LT MA].
 UptrendMAclose if UptrendMA
 and [close] > val([close],20).
 ! This works**

**Setup2 if UptrendMAclose and
 ThreeLowerHighs.
 Entry2 if Setup2 and Trigger and
 PriceVolumeFilter.**

The results for running the standard test on the *Entry2* rule are

“When developing a system it is important to test each function or rule along the way by running reports that are designed to verify that the rule is doing what you expect.”

more encouraging. It produces a 17% ROI with 3304 trades and a Reward/Risk Ratio of 1.1. Since everything has moved in the right direction, we’ll use this approach.

The ROI and the Reward/Risk ratio can still be better, however, so we need to add filters to improve them.

We know that it is bullish for stocks to move up on increasing volume and bearish for stocks to move down on increasing volume. This implies that we would like to

see low volume on all three of the pullback days identified by the scan. The great thing about EDS is that when you have an idea like this it is easy to test. The code we need to add to our *Entry2* rule to test this theory is shown below. The new rule to be tested is *Entry3*, shown in the last line.

**LVYesterday if Val([Volume],1)
< [Volume ESA].**

**LV2DaysAgo if Val([Volume],2)
< [Volume ESA].**

**LV3DaysAgo if Val([Volume],3)
< [Volume ESA].**

**LowVpullback if LVYesterday and
LV2DaysAgo and LV3DaysAgo.**

**Entry3 if Entry2 and
LowVpullback.**

Running the standard back test on *Entry3* shows a 37% ROI, 1120 trades, and a Reward/Risk Ratio of 1.26. We now have good evidence that low volume pullbacks improve the results for this system.

A characteristic we often notice in strong stocks is a rising relative strength. To add a requirement to our rule that the relative strength must have an upward slope over the

opening bell eds Entry4		Winners	Losers	Neutral
		-----	-----	-----
Number of trades in test:	1062	558	489	15
Average periods per trade:	3	2	3	2
Maximum Profit/Loss:		25.26%	(22.42)%	
Average Drawdown:	(1.39)%	(0.31)%	(2.66)%	
Average Profit/Loss:	0.36%	2.89%	(2.52)%	
Average SPX Profit/Loss:	(0.13)%	0.07%	(0.35)%	
Probability:		52.54%	46.05%	
Average Annual ROI:	43.86%	360.54%	(294.03)%	
Annual SPX (Buy & Hold):	(15.02)%			
Reward/Risk Ratio:	1.31			
Start test date:	05/31/01			
End test date:	05/29/02			
Pricing Summary				
Entry price: [Open]				
Exit price: [Open]				
Exit Summary				
Hold for 2 periods				

Figure 4. Results of initial back test of trending stock strategy. Test was run on a database of about 1,800 stocks over a one-year period from June 2001 through May 2002 with a fixed 2-day holding period.

Holding Period	Number of Trades	Percent Winners	Annual ROI
2	1062	51	44%
4	1033	53	29%
6	990	51	31%
10	937	53	12%
20	820	55	4%

past 30 trading days, we add the EDS code shown below:

StrongRS if Slope([RS Indx],30) > 0.

Entry4 if Entry3 and StrongRS.

Running the standard back test on *Entry4* shows a 44% ROI with 1062 trades and a Reward/Risk Ratio of 1.31, as shown in **Figure 4**.

After the initial back test, I varied the holding period from two days to twenty days to see how sensitive the system is to the holding period. The results are shown in the above table. It appears that the system finds stocks with a nice two-day pop, and with a good stop loss strategy may be suitable for swing

trades of up to a week. With longer holding periods the results trail off. Nothing rises forever, especially in 2002.

At this point the system shows some promise as a short-term trading tool. However, the simulation still uses the EDS defaults for position opening price (next day's open) and position closing price (following day's open). In real life, it is more likely that the trader would enter on the higher of the set up day's high or the next day's opening plus an amount for slippage.

Making this change to the back test (using a slippage amount of 15 cents) improves the annual ROI to

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

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57% and the Risk Reward Ratio to 1.34, as compared to the values of 44% and 1.31 shown in Figure 4. This is starting to be interesting, especially given the difficult market conditions of the past year for long side trading.

"The wide variance between the bull and bear performance illustrates the reason for having a number of scans available in your trading cockpit. I use an analysis of current market conditions and trends to select the most appropriate of the scans for trading the next day"

The trader may also use a number of different stop strategies: the low of the set up, a trailing stop under the low of one or two days ago; a fixed capital protect of 2%, 5%, or 8%; selling after a gain of 5% or two days; trendlines on the 30 or 60 minute charts; support and resistance on the 60 minute charts; etc.

These different strategies can affect the risk and return profile of the system, and should be matched to the traders' style and the amount of time they have available to monitor the market. While the results of this system can be improved by

using different stop strategies, the advantage of the fixed two-day holding period approach is that it does not require full time monitoring and it shows reasonable returns even in the

difficult market conditions of the past year.

For recent market conditions, this system shows interesting returns on the long side. However, during bull market runs the system can show more than double the results discussed above. During the Q4 run of 2001 the rule, *Entry4*, back tests well, showing a 92% ROI with a

Reward/Risk Ratio of 1.60.

It is also important to note that the system shows poor returns during bear markets. During the April to June decline of 2002, the system showed an ROI of -16%. This was better than the NASDAQ, but not something you would want to trade.

The wide variance between the bull and bear performance, as outlined above, illustrates the reason for having a number of scans available in your trading cockpit. This system is similar to one of the 10 bullish scans that I run every evening, along with 5 bearish scans. I use an analysis of current market conditions and trends to select the most appropriate of the scans for trading the next day.

Opening Bell readers can download the EDS file from AIQ's web page at www.aiqsystems.com. Click on *Educational Products* and *Opening Bell*. Be sure to set your ST MA indicator to 20 days, the IT MA to 50 days, and LT MA to 200 days before running a scan.

If you have thoughts regarding this approach, or would like to share trading strategies and ideas, you can reach me through the contact form on my web site at www.daisydogger.com.

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date
Berkley	BER	3:2	07/03/02
Coach Inc.	COH	2:1	07/05/02
Smith Int'l	SII	2:1	07/09/02
Interchange Fin'l	IFCJ	3:2	07/15/02
MBNA Corp.	KRB	3:2	07/16/02
Midland Co.	MLAN	2:1	07/17/02

Trading Suspended:

Arch Wireless (AWIN), Bethlehem Steel (BS), Lands End (LE), NRG Energy (NRG), Remington Oil & Gas (ROIL)

Name Changes:

Mazel Stores (MAZL) to Odd Jobs Stores (ODDJ)
Morgan Stanley Dean Witter (MWD) to Morgan Stanley (MWD)

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Dogs Strategy Update

In Bear Market, Dogs of the S&P 100 Rose in Value While S&P 500 Fell

By David Vomund

At this stage of the bear market, investors are getting back to basics. Momentum investing is out of favor and the focus has switched to fundamental analysis. With AIQ, it is easy to use both fundamental and technical analysis.

In this article, we'll update the "Dogs" strategy that we first presented in the March 1998 *Opening Bell*. Next month, we'll use AIQ's Fundamentals module (which is built into TradingExpert Pro) to build a list of fundamentally attractive stocks that we can then run our mechanical trading models on.

In the mid 1990s, the Dogs of the Dow investing strategy gained great popularity. Mutual funds were formed to follow that specific strategy. Its popularity waned in the late 1990s as growth investing became the rage. The Dogs of the Dow strategy is a value strategy so it

it holds the stocks for an entire year.

In the March 1998 *Opening Bell*, we took the concept of the Dogs of the Dow strategy and modified it to comprise a broader set of large-cap stocks. Our concern was that too many people were following the Dogs of the Dow strategy and for that reason it would stop working. Since the strategy relies on choosing stocks with high yields, in our modified ap-

proach we picked the highest yielding stocks in the S&P 100 index (otherwise known as OEX).

This is how our Dogs of the S&P 100 strategy works: On January 2 of each year, we purchase

the 10 highest yielding stocks in the S&P 100 and hold them for an entire year, at which time a new list of high yielding stocks is purchased.

Table 1 shows the yearly returns of our Dogs of the S&P 100 strategy. Dividends are included in these returns. Notice that the average yearly return for Dogs of the S&P

Table 1

Dogs of the S&P 100 Yearly Returns

Year	Dogs Return (%)	S&P 500 Return (%)
1995	32.65	37.58
1996	16.23	22.96
1997	27.34	33.36
1998	4.77	28.58
1999	4.72	21.04
2000	9.35	-9.1
2001	19.40	-11.89
2002	0.25	-7.44
Average =	14.34	14.39

Updated through June 19, 2002

100 strategy is about the same as the yearly return of the S&P 500. The return from the Dogs strategy, however, is more stable than a buy-and-hold approach. Over the 7 1/2-year time period, there wasn't a single down year.

Looking closely at the returns in Table 1, the Dogs strategy performed poorly in 1998 and 1999 when growth investing was the preferred style. In 2000 and especially in 2001, value investing was in favor and the strategy outperformed the S&P 500 both years.

While the S&P 500 fell nearly 12% in 2001, the Dogs strategy rose 19%. Thus far in this bear market, this year is the toughest as the Dogs strategy is unchanged.

"In 2000 and especially in 2001, value investing was in favor and the Dogs of the S&P 100 strategy outperformed the S&P 500. While the S&P 500 fell nearly 12% in 2001, the Dogs strategy rose 19%."

underperformed badly at the height of the bubble. Since then, its performance relative to the S&P 500 has improved.

The key to this strategy is that the stocks that are purchased are all high-yielding well known stocks. The strategy buys those stocks in the Dow that have the highest yield and

Figure 1 shows an index of the Dogs stocks along with the S&P 500. The overall pattern for the two indexes is similar but closer examination shows why the Dogs of the S&P 100 strategy is outperforming this year. In May and June, the S&P 500 trended lower but the Dogs index was flat.

A listing of the stocks that make up the 2002 Dogs of the S&P 100 are shown in **Table 2**. For this strategy, these stocks are held through the rest of this year. AIQ users may also choose to individually analyze these stocks during times when value investing outperforms growth investing.

At the start of next year, the 2002 Dogs of the S&P 100 stocks are sold and a new set of stocks are purchased based on their dividend yields. A listing of the S&P 100 stocks can be found on Standard & Poor's web site at www.spglobal.com. This site also lists the S&P 500 stocks and their corresponding industry groups.

To get the yield for each S&P 100 stock, you can either look up each stock individually in the *Wall Street Journal* or you can use AIQ's Fundamentals module to automatically retrieve and sort the yield data. You cannot retrieve historical fundamental data so it is important to download the yield data after the market closes on December 31. We'll cover the use of AIQ TradingExpert Pro's Fundamentals module next month.

At the start of next year, we'll update the performance of the Dogs of the S&P 100 strategy, and we'll list the new set of Dogs of the S&P 100 stocks.

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



Figure 1. 2002 price performance of Dogs of the S&P 100 (upper chart) compared to the S&P 500 index (lower chart)

Table 2
2002 Dogs of the S&P 100

Ticker	Stock Name	Yield	Return % (thru 6/19)
MO	Philip Morris	5.1	19.83
GM	General Motors	4.1	15.93
FBF	Fleet Boston Financial	3.8	-8.16
BAC	Bank America	3.8	17.16
F	Ford Motor	3.8	4.83
DD	DuPont	3.3	4.49
CVX	Chevron Texaco Corp.	3.1	-3.36
EMR	Emerson Electric	2.7	-1.26
BMJ	Bristol Myers Squibb	2.2	-48.49
SBC	SBC Communications	2.6	-20.25

Market Review

One would think after two years of falling prices that the market would begin to stabilize. That wasn't the case in June. During June, the S&P 500 fell 7.2% and the Nasdaq Composite fell 9.4%. Unlike some earlier months, the small-cap stocks fell victim as well. The Russell 2000 fell 5.1%.

The AIQ timing model was on the wrong side of the market this month. Market timing buy signals were registered on 6/5, 6/10, 6/11, 6/12, 6/14, 6/17, 6/24, 6/25, 6/26, and 6/27. The market didn't care.

For the first half of the year, the S&P 500 fell 14.7% and the Nasdaq Composite fell 25%.

Transportation groups were the best performers in June. The Transportation-Trucking group rose 13% and Rail rose 9%. The usual suspects saw the brunt of the selling. Telecommunications-Cellular fell 37%, Media-Cable Television fell 28%, and Internet Network fell 26%.

There has been a lot of bad news during this bear market. There was falling corporate profits, a controversial presidential election, a terrorist attack on our homeland, and now



accounting fraud. In June it was found that WorldCom Inc. fudged their accounting books by about \$ 4 billion. The stock had already fallen about 90% this year. Can you imagine what the stock would have done if they stated their real numbers! A lot can be learned by examining price and volume.

After more than two years of a bear market, the Nasdaq Composite and S&P 500 have fallen to the lows

set in 1998. A Nasdaq chart is especially interesting because the September 2001 low came at about the same level as the October 1998 low (see figure above). This is a major support level. Many technicians would agree that support levels below 1350 are meaningless. The S&P 500 has a similar chart pattern. Its support is 940.

S&P 500 Changes

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

Simon Property Group (SPG) replaces Conexant Systems (CNXT). SPG is added to the Real Estate Investment Trust (REITRUST) group.

PPG Industries (PPG) moves from Specialty Chemicals (CHEMICAS) to Diversified Chemicals (CHEMICAD).

Ambac Financial (ABK) moves from Diversified Financial Services (FINANCID) to Property & Casualty Insurance (INSURAPC).

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