

# AIQ

# Opening Bell<sup>®</sup> Monthly

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The *Opening Bell Monthly* is a publication of AIQ Incorporated  
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## AIQ USERS SHARE TECHNIQUES

# BROKER MARRIES FUNDAMENTALS AND TECHNICALS TO IMPROVE HIS CLIENTS' RATE OF RETURN

By Grace Barbor  
Opening Bell Editor

*The following is an interview with a retail broker from a national brokerage firm. This broker, who manages over \$50 million for several hundred individual investors, has used AIQ systems as a technical complement to his trading process for eight years. In compliance with the brokerage firm's policies, neither the broker or his firm can be identified in the Opening Bell Monthly. The interview was conducted on February 11, 1997.*

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*"If you have very positive fundamental information on a stock and at the same time the technical picture is very attractive, you can dramatically increase your success."*

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**OBM:** I understand that your AIQ expertise is well known throughout your firm and brokers new to AIQ often call you. What advice about using TradingExpert do you give other brokers?

**Broker:** We get superior fundamental information from our research department. But AIQ can be a good

complement to our fundamental research — it delivers a thorough technical picture. I suggest new users first load in the S&P 500 data, add all the fundamentally recommended stocks, and then make the recommended stocks a separate group on which to run reports. They can then follow the S&P 500 along with the recommendations. Fundamentals and

earnings are what drive stocks, but the technical picture tells you when to buy. Overall, the market timing model is the most valuable aspect of AIQ. It's better than good. It's deadly. Don't

ever mess with it.

**OBM:** What instruments do you trade?

**Broker:** Individual stocks. My typical client will be diversified between an appropriate mix of tax free and taxable bonds, good equity mutual funds, and individual stocks. I encourage people to diversify in bonds and in

AIQ USERS SHARE TECHNIQUES *continued* . . .

equity funds so that they have as wide an investment footprint as is possible. For typical individual investors, especially those new to investing, I recommend larger companies with low volatility. Investing in something that is not too risky with good earnings and an upward trend helps clients temperamentally and builds their confidence in you.

**OBM:** How many stocks do you track?

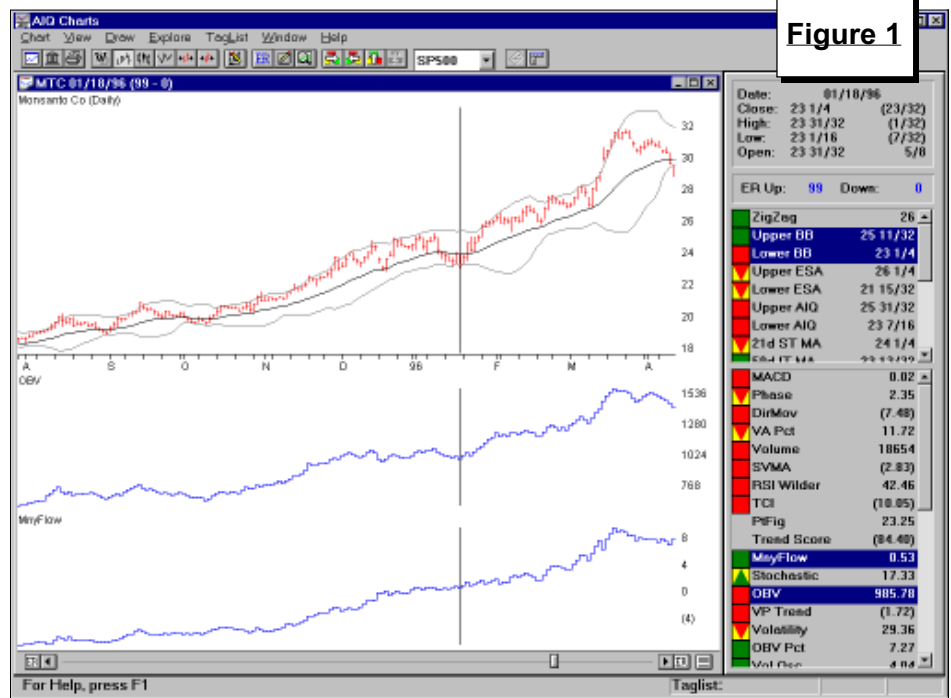
**Broker:** I have over 3,000 stocks in my database.

**OBM:** How do you come up with your list of candidates?

**Broker:** I have a list of fundamentally attractive stocks from my firm's research sources — hundreds of stocks in different group areas. They are conservative type stocks such as telephones, utilities, and large caps.

**OBM:** How do you further prune that list?

**Broker:** I marry fundamental with technical information to come up with the best selections. I watch group rotation to see what groups are in favor. I then look within these groups for stocks with superior fundamentals. If you have very positive fundamental information on a stock and at the same time the



technical picture is very attractive, you can dramatically increase your success. You also have the confidence to hold that stock if there is a short term correction. For example, occasionally negative news will affect a stock but if you feel your information is very accurate, you have the confidence to maintain your position.

**OBM:** Do you put equal weight on fundamentals and technicals?

**Broker:** Yes. By combining the two, I can improve my clients' rate of return. My research department provides me with fundamentally attractive ideas. But the more positive the technical picture, the better chance I have of making the right decisions. Monsanto is a good example of how combining fundamentals with technicals can result in a successful investment.

Our research indicated that the fundamental nature of Monsanto's business had changed from a specialty chemical company to a very innovative agricultural biotech company. Now, in addition to Roundup and Nutrasweet, they had developed insect and Roundup resistant corn, cotton, and wheat.

We felt the PE ratio could expand as Monsanto would no longer be valued strictly as a chemical company. The fundamental story was improving dramatically and this was reflected in the technical picture. Monsanto started to take off early in 1995.

One good entry point is in the middle of January '96 when AIQ issued a buy signal after a consolidation phase (**Figure 1**). OBV and Money Flow were positive. The stock increased and split 5/1 in June of '96. If you missed it, you had similar conditions after it split and corrected a bit. (**Figure 2**)

**OBM:** With several hundred clients, how many individual stocks do you follow?

**Broker:** At any given time, I am intensely following about 25. My universe of holdings for all my clients is in the area of 100, but if there is no news on a stock and if it is not showing up on any of my AIQ reports, I am not worried about it.

**OBM:** Do you have a long term or short term approach?

**Broker:** We are basically a buy and hold type company, although I

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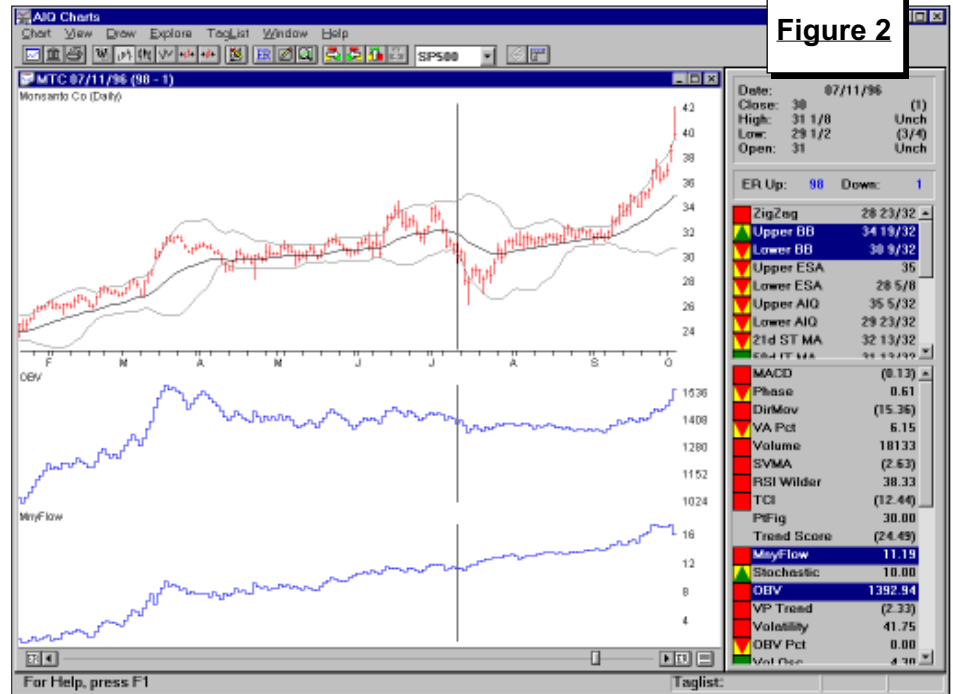
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AIQ USERS SHARE TECHNIQUES *continued* . . .

have a few clients who are traders. I try to tailor an approach to a client's temperament and personality. Most individual investors like issues that they can hold over the long term. Those are usually some of the larger caps on both the NASDAQ and NYSE, issues that have been successful for many, many years. The main concern is when to buy them. AIQ is perfect for this. Oftentimes during a normal correction a really great stock will pull back to a trendline and AIQ will give a buy signal. That is a perfect time to pick up a high quality stock.

**OBM:** Can you give us an example?

**Broker:** In the case of Microsoft, I have a positive recommendation from our analyst who understands the company. Look at the chart of Microsoft in the fall of '96 (**Figure 3**). We have a period of consolidation, a buy signal, and increasingly positive OBV and Money Flow. I don't know how it could be any clearer. This is a perfect example of an attractive entry point in a stock that regularly makes new highs. Often, I will hear "yes, I know Microsoft is a great company, but isn't it too high?" I review the



fundamental background on the stock and then explain that the stock has consolidated for awhile. I then add that this is a very attractive time to buy the stock for the long term. With OBV and Money Flow positive, along with a buy signal, I am very confident of the stock's direction.

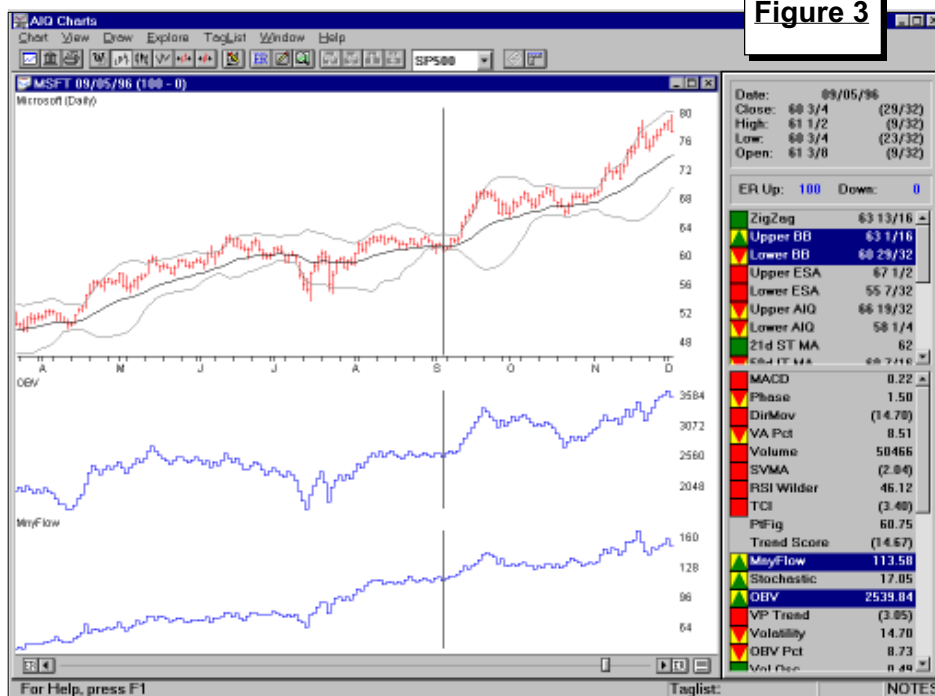
One process I go through is to

double check the valuation. One of my criteria is the historical relative price earnings ratio. It must be within normal parameters. In other words, if Microsoft normally trades at 30 times earnings, we won't necessarily look at it when the price is more than 45 times earnings — we'll wait until the price earnings ratio is about equal to the growth rate.

Microsoft in the last four quarters has traded roughly between 30 to 45 times earnings. Its five-year growth rate is 25 - 30 % so its PE on fiscal '96 (JUN) earnings of \$1.72 at 60 is 35, certainly within range. I am in pretty good shape. But, if you look ahead to the estimates for fiscal 1997 — the market trades on forward estimates — and you multiply the 1997 est. (2.75) by 30, you get 82 1/2. So MFST at 60 looks good. Fiscal '98 erns. est. are roughly \$2.30. If MFST meets or exceeds these estimates, well you do the math to see the potential.

I use Daily Graphs from *Investor's Business Daily* to complement my technical analysis. Daily Graphs give you insider trading, relative strength, and earnings per share rank. In the case of Microsoft, it has an EPS and

*Techniques continued on page 4*



RS rank of over 80. This is further confirmation.

I have positive fundamental information, I have a strong technical picture and a stock breaking above a consolidation area. I don't necessarily need an Expert Rating buy signal, although we have one. I would call my key clients and tell them that this is a great Blue Chip stock and a good time to buy. At that point, Microsoft ran up from the low 60's, the 80's and onward.

**OBM:** How does TradingExpert fit in with your overall trading process? How do you use TradingExpert to select issues from your list of fundamentally sound stocks?

**Broker:** Through the use of stock reports. I first print the Market Log, then Price Gap, Weighted Action List, Point and Figure Breakout, Persistence of Money Flow, and Price Volume Divergence. I sometimes print the Accumulation/Distribution and Relative Strength as well. I generate these reports on my lists of fundamentally recommended stocks to see which are technically attractive. Price Volume Divergence is a great report — price can be going down or sideways but this report finds stocks where Money Flow or OBV are going up (diverging). Point and Figure shows consolidation breakouts — a wonderful tool. Price Gap is excellent because you can find stocks that have gapped to the upside.

I run all these reports in the evening after the market closes so I have all my information the next morning before the market opens. The reports tell me which stocks from my fundamental list are the most technically attractive and enable me to quickly find some very attractive candidates.

**OBM:** What's the next step?

**Broker:** I examine the charts. On any given day, I look at the charts of 10, 15, and sometimes 50 stocks. I'm

doing several things including checking the status of my existing positions. If I am on a market timing buy signal and I have a healthy general market, I will also look at the market charts (the Dow, the S&P 500, and the OTC) to determine which market is outperforming. Then I will concentrate on individual stocks, looking for positive OBV, positive Money Flow, and a positive relative strength line compared to S&P 500. If I can see all that in a consolidation area, I start to get really excited. And if there's a buy signal — we're downtown.

**OBM:** Do you need a buy signal?

**Broker:** No, but I would like to

ing this type of signal would reduce the overall effectiveness of the system. So you have to learn to recognize this anomaly and to properly interpret sell signals that occur in this type of situation.

**OBM:** If the market is healthy and one of your fundamentally attractive stocks which has been in a consolidation period gives an AIQ sell signal, you are saying that the sell doesn't bother you?

**Broker:** No, most of the time I ignore it. If the overall market is healthy and that sector is performing well — technology in the case of Microsoft — there is no reason for that sell signal. It's an anomaly.

**OBM:** Let's talk about AIQ's market timing signals.

**Broker:** To me, these signals are number one in importance. Although I am not trying to time the market or a stock with absolute precision, I want to always be aware of the health of the market. In addition to the AIQ Expert Rating signals, I track the Weighted Action List

(WAL) and the Unconfirmed Signal Ratio from the Market Log (US). A market timing signal confirmed by the WAL and US is huge to me.

*(Editor's Note: AIQ's "Market Timing" educational video explains in detail how to use the WAL and US for confirmation of market signals. Call AIQ for more information on this video.)*

Let's say I am chugging along on a buy signal, and we get a sell signal with a US ratio of 20 up and 80 down...TradingExpert is saying there is going to be a correction. Oftentimes, TradingExpert will pick that up before fundamental weakness is apparent. We know, that as the market goes down and the US ratio changes from 20/80 to 80/20, there is a good chance we will get a buy signal. History tells me that the WAL and the US are good indicators of how close we are to a change in market direction.

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***"...I look for positive OBV, positive Money Flow, and a positive relative strength line compared to S&P 500. If I can see all that in a consolidation area, I start to get really excited."***

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have one. On the other hand, if I get a sell signal with the aforementioned characteristics — I interpret it as a buy signal. Most people have a hard time understanding that the system works in this way, but Dr. (J. D.) Smith explained it well.

**OBM:** How do you explain the situation when a sell signal is actually a buy?

**Broker:** I can only paraphrase what Dr. Smith wrote in the OBM (see *Opening Bell Monthly* July 1994 and May 1992). Basically, as a stock starts to break out after a period of sideways consolidation, the AIQ system will sometimes generate a sell signal.

This happened with Microsoft in January of 1997. Once the stock breaks out on decent volume, it's obvious that the sell signal was wrong. As I understand it, the developers concluded that eliminat-

AIQ USERS SHARE TECHNIQUES *continued* . . .

Last summer, we had a vicious correction and then AIQ gave two or three buy signals in a row, but the market was still pretty volatile — it was tense. But I encouraged people to build positions — as long as that Unconfirmed Signal Ratio moved towards and above 80 I was confident the market was near the end of the correction. And it turned out that way. It gave me a tremendous amount of confidence to be able to tell concerned investors that a correction is nearly over. I should add here that the overall market conditions were still positive — good earnings, low interest rates and inflation — which bolstered my viewpoint.

**OBM:** When the market gives a down signal confirmed by the WAL and the US scores, do you advise your clients to sell?

**Broker:** It depends on the client. For people who want to trade and take profits, yes, I would encourage them to sell.

**OBM:** Right now, how do you handle this seesaw market?

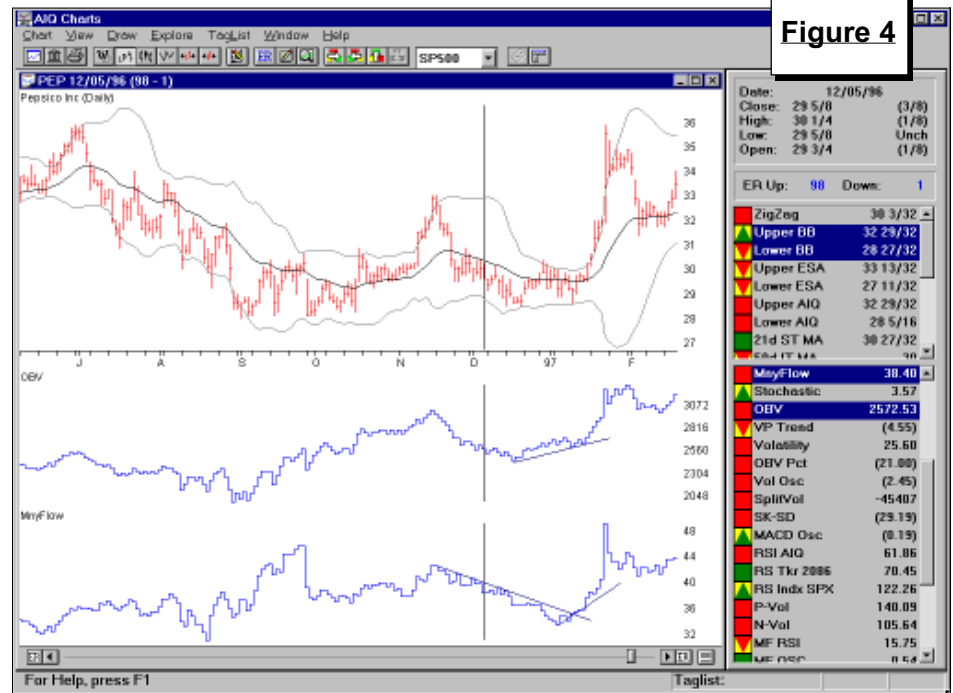
**Broker:** When AIQ is on a buy signal, it's almost always right. Particularly in the last several years.

**OBM:** On a buy signal such as now, the seesaw doesn't bother you?

**Broker:** No, not at all. In fact, it opens some great buying opportunities. My WAL is 50% up and 50% down and the US is close to the same. My WAL and US scores will be a little different from David Vomund's and others because we follow different stocks. I have the S&P 500, the AIQ 650, plus many many others — I have as broad a cross section as possible. Right now I'm not concerned. The Bond Market is stable and interest rate policy is a known quantity. We have a rolling correction in technology but my WAL and US ratios are not deteriorating and there is no sell signal.

**OBM:** How important is group and sector rotation?

**Broker:** It's not critical to me but I



do pay attention to it. The group has veto power. One of the last things that I do before I buy a stock is to check its group. I want the group strength positive. If, in *Investor's Business Daily*, the group relative strength is below 70, I am concerned. I would have to really be confident in the individual stock.

**OBM:** You said you look at the Market Log first thing every day — what precisely do you look at?

**Broker:** The Market Log is telling me several things. I look at the Expert Rating signal (ER), and if it has changed. I look at the WAL and the US. Let's say the market goes down 50-100 points or more without a sell signal, and the WAL and the US hover around 50-50. That tells me the market's not selling off, but rather we're undergoing some kind of a rotating correction. I am not alarmed. Now if the WAL was 10-90 and the US was 75 or 80 down — then I would be concerned.

I get a lot of calls daily asking me what I think of the market. All I have to do is look at the Market Log. If there is no sell signal but the US is deteriorating — it means that we might be nearing a short term top. I

can always tell my clients how the market looks at the moment. Right now, for example, I can say that the market looks to be in good shape. The stocks I'm looking at are acting pretty healthy. Yes, the Dow was down but the NASDAQ was even. I interpret what AIQ is telling me, and I put it in common language. And I will add comments like, "remember the overall climate is very positive." We have low interest rates, they're stable, we have low inflation, it's stable, the Republicans are in control of Congress, the Democrats control the White House — there's a balance there. The market likes a consistent and predictable environment.

I know that we're in one of the best bull markets in history, if not the best. While these things work well in this situation, I am always on the lookout to see if that long term trend is going to change as it did in 1994. At that point, I hone my criteria. I don't have clients who sell short. We deal with individual investors and it's too hard for them.

The worse the shape of the market, the more selective my criteria. And I move towards the defen-

*Techniques continued on page 6*

sive industries — high dividend stocks, phones, utilities, and food, beverage, and medical.

There used to be the saying: as goes General Motors so goes the U.S. market. I believe that comment now applies to General Electric. General Electric is now the bellwether. I don't trade General Electric. We buy and hold it. I think GE is a microcosm of the American economy and is an extremely important stock.

**OBM:** If one of the fundamentally attractive stocks that you track starts appearing on the up sections of the reports and it is not held by any of your clients do you recommend it?

**Broker:** Yes. Especially if it further diversifies their portfolios. A good example is Pepsi Cola. Pepsi has suffered some earnings disappointments. They lost one of their distributors in Venezuela. Nevertheless, analysts concluded that this was a good long term stock that had suffered some temporary weakness. It traded sideways for a while, bounced off 28 a whole bunch of times, which led me to believe that

there was reliable support. All the bad news was factored in, and it continued to hold above 28. This went on from basically the later part of '96 into 1997. During this time, it ran up to 33 and then went back down but never violated support at 28. Pepsi started to show up on the Price Volume Divergence Report, and we all know what that means — accumulation was going on.

Fundamentally, Pepsi is a good long term conservative growth stock because it is in the food and beverage group. The stock has recently been weak because of problems in the international arena. Also, Pepsi owns Taco Bell, KFC, and Pizza Hut, and the restaurant units have been weak.

At this point, I simply didn't think it was going lower than 28 because all the bad news is factored in. And I thought that in the next 12 to 18 months, we were likely to see some positive things happen. Certainly the beverage sales will stabilize and our food analyst thought there was a good chance that Pepsi would spin off its restaurant units. It made

sense. And, even without a restaurant spin-off, Pepsi was attractive fundamentally and technically.

Technically, at this time Pepsi was showing good accumulation in OBV and Money Flow as indicated on the Price Volume Divergence Report. And it has a nice long consolidation base (see **Figure 4** on page 5). And we had an early buy signal foretelling this. We can comfortably build positions with conservative investors. For a beginning stock position for an individual investor, this is a very good choice.

News turned positive when Pepsi announced the spin-off in January and the stock ran up to 35. When earnings came out a couple of days later, they were below expectations, which knocked the stock back down to 32. But the stock did not go back down to its previous level. It found support at 32 and to date has again risen towards 35. ■

*Next month: A discussion of sell strategies.*

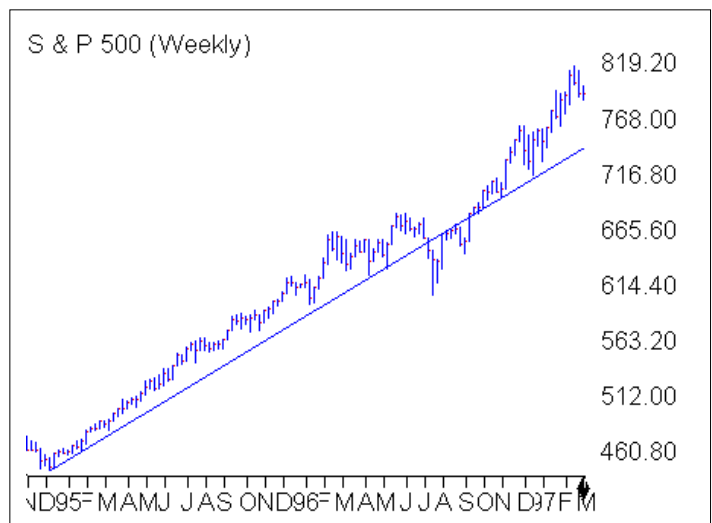
**MARKET REVIEW**

The market started out strong in February as the Dow and S&P 500 hit new highs. The rally was primarily in large-cap stocks as the Russell 2000 and Nasdaq Composite failed to reach new highs. There were no Expert Ratings to report this month. If you use Dial Data market data with AIQ's market timing model, the last signal was the January 7 buy signal. As a check, the Expert Rating on February 28 was 12 - 88.

One of the strongest groups of the past month was precious metals. The tip-off to the advance came on February 7 when several gold issues had an outside reversal day. The issues include American Barrick Resources, Battle Mountain Gold, Newmont Gold, and Placer Dome Gold. This pattern was highlighted in the November 1996 Opening Bell's short term analysis article.

In the January, 1997 Market Review, we showed a chart of the S&P 500 with its long term trendline. At that time we discussed how the trendline acted as support and resistance. We include the graph again this time looking at over-bought levels. Since the trendline began in 12/94, the S&P 500 has been at least 6% above the upward sloping trendline eight times. In each case the market either had a short term correction or moved sideways. Until this month, the highest the

S&P 500 was above the trendline was 9% on 2/96. The market matched this level again this February. The market was unable to sustain this lofty level and corrected toward the trendline late in the month. ■ **D.V.**



## SIGNAL ANALYSIS

# COMBINING AIQ'S MARKET AND STOCK TIMING SIGNALS CONTINUES TO SHOW GOOD RESULTS

By David Vomund

DAVID VOMUND

A mechanical trading system combining AIQ's market timing Expert Ratings with the Expert Ratings for stocks continues to show good results. We first tested this system in May 1992. This was a test of AIQ's original technology prior to industry group rotation and the new screening reports now available in TradingExpert. We reported trading results again in March 1995 and now have updated the study through 1996.

Results of this simple mechanical system which combines AIQ's market timing signals with the Weighted Action List report show that the portfolio rose 21% in 1996, including commissions.

Using a database of the S&P 500 stocks, we ran a Weighted Action List every time there was a market timing buy signal (an Expert Rating of 95 or greater). Only the first signal in a string of buy signals was used. The top five stocks in the Weighted Action List with buy signals were purchased and held until a market sell signal was registered, at which time all

positions were moved to cash. Only stocks over \$10 were purchased and the Expert Rating buy signal had to be 95 or greater.

To obtain percentage return figures, we made the following assumptions:

- The portfolio started with \$25,000 in January 1992.
- All profits/losses were reinvested in the next block of trading with each of the five stocks receiving an equal amount of capital.
- The buy and sell points on the stocks were the opening price the day after the market Expert Rating.
- Commissions were factored in using deep discount brokerage rates.
- Slippage, dividends, and money

market interest received were not factored in.

**Table 1** lists the trade by trade results. The entry and exit dates represent the day after a market timing Expert Rating was registered. The third column lists the percentage change in the S&P 500 index, while the fourth column shows the results of trading the top five stocks on the Weighted Action List. Listed are the results since 1995. Refer to the March 1995 *Opening Bell* for trade by trade details for 1992 through 1994.

The yearly returns are found in **Figure 5** and **Table 2** (next page). Overall, the mechanical trading system shows an average annual rate of return of 21% since 1992.

This mechanical process should not be considered to be a complete

*Signal Analysis continued on page 8*

**Table 1**

## AIQ Trading Detail

Entry Date	Exit Date	S&P 500 % Change	Stocks % Change	Portfolio Holdings (Stock Symbols)
11/08/94	04/21/95	9.19	-0.29	CCB, CYM, DGN, GWF, KBH
04/24/95	06/19/95	6.16	11.92	CC, STJM, AAPL, CA, NOVL
08/28/95	10/03/95	3.86	10.26	BMET, MDT, MRK, SMED, BKB
10/13/95	10/20/95	1.29	-0.19	BMET, INGR, CMCSK, DWD, MER
11/17/95	12/19/95	1.59	-3.43	BMET, DWD, BKB, GPS, AHM
01/17/96	04/04/96	7.80	11.01	SUNW, AHM, SRV, WFC, MCIC
04/16/96	04/18/96	-0.14	0.27	STJM, LIZ, LUV, TJX, S
05/09/96	06/10/96	4.32	-0.25	GLD, INGR, BOAT, RLM, CCI
07/10/96	08/30/96	0.41	0.98	GPS, ECO, PDG, HPH, HNZ
09/10/96	01/06/97	12.70	15.68	TJX, BSX, HAL, CA, FITB

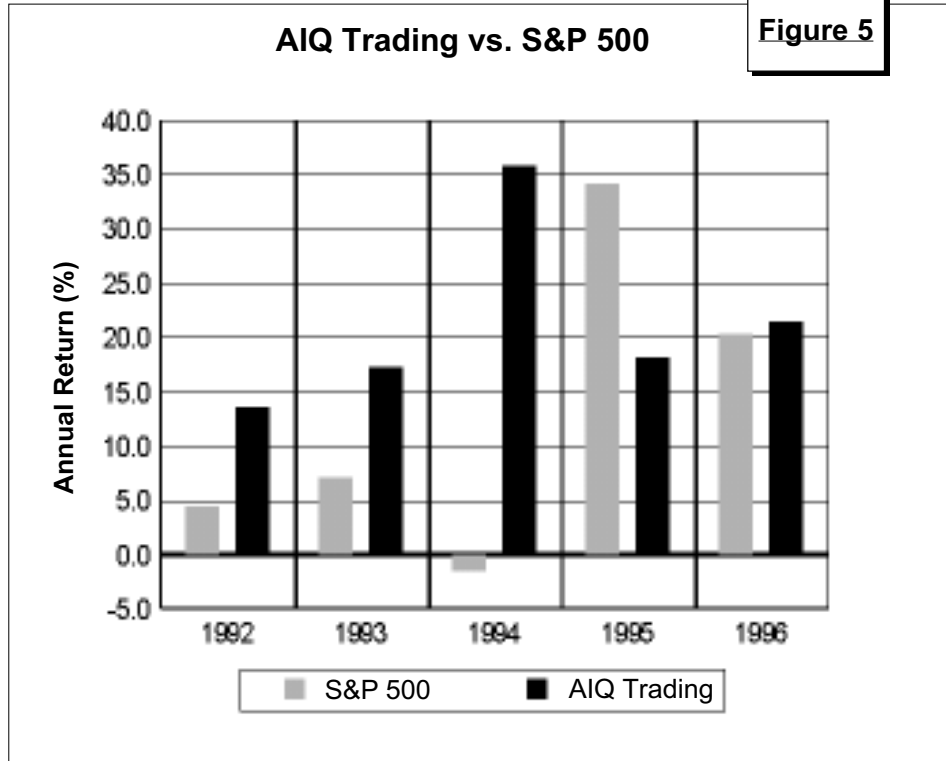
**SIGNAL ANALYSIS** *continued . . .*

trading strategy because there is no stop loss procedure if things go wrong. Nevertheless, it continues to amaze me how good the results are considering how simple the strategy is and that there is no back-fitting or optimizing involved. ■

**Table 2**

Annual Return (%)		
	S&P 500	AIQ Trading
1992	4.46	13.53
1993	7.06	17.26
1994	-1.54	35.75
1995	34.11	18.08
1996	20.26	21.44

**Figure 5**



**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
Brightpoint Inc.	CELL	5:4	03/04/97	Meredith Corp	MDP	2:1	03/18/97
Wind River Systems	WIND	3:2	03/11/97	Cross Timbers Oil	XTO	3:2	03/21/97
Lindsay Mfg.	LINZ	3:2	03/11/97	Hasbro Inc.	HAS	3:2	03/24/97
Andrew Corp	ANDW	3:2	03/12/97	Quick & Reilly	BQR	3:2	03/26/97
Campbell Soup	CPB	2:1	03/13/97	Sherwin Williams	SHW	2:1	03/31/97
Jack Henry & Assoc.	JKHY	3:2	03/14/97	Johnson Controls	JCI	2:1	04/01/97
Somerset Group	SOMR	5:4	03/17/97				

**Trading Suspended:**

Ornda Health Corp (ORN), Foundation Health (FH), Alexander & Alexander (AAL)

**Name/Ticker Changes:**

- Alco Standard (ASN) to IKON Office Solutions (IKN)
- Allied Group (ALGR) to Allied Group (GRP)
- Cable Design Tech. Corp (CDTC) to Cable Design Tech. Corp (CDT)
- Circuit City Stores (CC) to Circuit City Group (CC)
- Consolidated Graphics (COGI) to Consolidated Graphics (CGX)
- Dynatech Corp (DYTC) to Dynatech Corp (DYT)
- Mastec Inc (MASX) to Mastec Inc (MTZ)
- Price Costco Inc (PCCW) to Costco Cos. (COST)
- Quality Food Centers (QFCI) to Quality Food Centers (UQF)
- Tower Automotive (TWER) to Tower Automotive (TWR)