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Style Index Trading Strategy

Outstanding Results! This Style Index Strategy Stands Above All Our Other Long-Term Strategies

By David Vomund

Which will perform best, large-cap stocks or small-cap stocks? Will value stocks outperform growth stocks or will growth outperform value?

Truth is, nobody knows and there is no point in guessing. Instead of guessing, build a strategy that automatically rotates to the best performing market segments, no matter what those segments are. That's what my Style Index strategy is all about.

In the *Opening Bell*, we publish a lot of strategies that we have found to be effective. Some strategies are for swing traders, some are for longer-term traders. All are strategies I believe in. But for me, the Style Index strategy stands above all other long-term strategies. This is the strategy that I use for the model portfolio in my *VISalert.com* newsletter. This is also the strategy I use for my managed account program. (www.lvim.com). Got your attention? Then read on.

The Style Index strategy trades

securities that track various market indexes. These "style" indexes include large-cap growth, large-cap value, small-cap growth, small-cap value, etc. While mutual fund families like the ProFunds (www.profunds.com) have funds that track these indexes, I



DAVID VOMUND

"Instead of guessing, build a strategy that automatically rotates to the best performing market segments... This is the strategy that I use for the model portfolio in my newsletter. This is also the strategy I use for my managed account program."

believe the best vehicle for trading style indexes is Exchange Traded Funds (ETFs), the fastest growing financial product in the United States. In 1999, total ETF assets were \$23.4 billion. In

2002, despite the bear market, total assets jumped to \$106 billion.

First launched in the early 1990s, ETFs are securities that combine elements of index funds, but do so in a different way. Like index funds, ETFs are pools of securities that track specific market indexes at a very low cost. Like stocks, ETFs are traded on major U.S. exchanges and can be bought and sold anytime during normal trading hours.

Trading style indexes allows investors to gain well-diversified exposure to a specific area of the market. And, since an ETF holds a basket of stocks, one bad performer should have only a minimal effect on the price of the ETF. For more information on ETFs, visit www.amex.com.

To develop my Style Index strategy, I ran numerous tests using different trading parameters. Tests were performed manually and trades were entered into the AIQ Portfolio Manager. AIQ's Expert Design Studio cannot be used for the Style Index method.

Table 1.
Style Index Trading Vehicles

Ticker	ETF	Benchmark Index
DIA	Diamond	Dow Jones Industrial Average
QQQ	Nasdaq 100 Tracking Stock	Nasdaq 100
SPY	S&P 500 SPDR	S&P 500
MDY	MidCap SPDR	S&P 400 MidCap
IJS	iShares Small-Cap Value	S&P 600 SmallCap/BARRA Value
IJT	iShares Small-Cap Growth	S&P 600 SmallCap/BARRA Growth
IWM	iShares Small-Cap Index	Russell 2000

Since price history on ETFs is limited, it is not possible to run a backtest that covers both bull and bear markets. Most of the ETFs began trading in 2000. Therefore, a backtest of a trading system cannot be run

using ETF trades but must instead

“Trading style indexes allows investors to gain well-diversified exposure to a specific area of the market. And, since an ETF holds a basket of stocks, one bad performer should have only a minimal effect on the price of the ETF.”

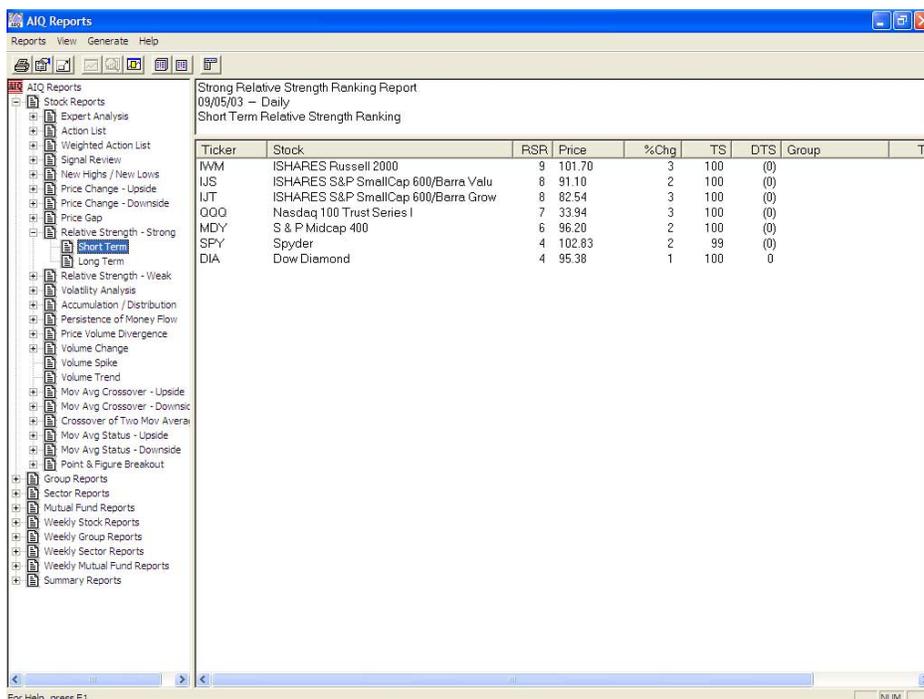


Figure 1. Relative Strength (Strong) Report for September 9, 2003. The report was run on list of ETF's and shows two small company stock tracking funds, IWM and IJS, in top positions.

be run on the benchmark indices that the ETFs track.

For example, before the Nasdaq 100 ETF (QQQ) was traded, our backtest purchased the Nasdaq 100 index. Before the Dow Diamond was traded, the backtest bought the Dow Jones Industrial Average. Before the iShares Small-Cap Russell 2000 was traded, the backtest bought the Russell 2000 index, etc. A list of the ETFs used in our backtest along with their benchmark indexes are found in **Table 1**.

Looking at Table 1, there is a growth and a value choice for both large-cap and small-cap stocks. Instead of adding a growth and value choice for mid-cap stocks, I'm only following one mid-cap index. More ETF choices can be added to this list but that also creates more turnover.

The Style Index Strategy

The strategy utilizes AIQ's Relative Strength report. The Short-Term Relative Strength-Strong report was run every other Friday on the ETFs listed in Table 1. This report looks at the last 120 trading days (approx. 6 months) and breaks them into quarters. A percentage return figure is calculated for each quarter. These returns are then averaged with twice the weight placed on the most recent quarter's worth of data.

At the start of the test, the two highest ranked ETFs were purchased with equal dollar amounts to establish a fully invested portfolio. Two weeks later, the Relative Strength report was run again. If the current holdings were rated as one of the three best in the report, then there were no trades. If a holding had fallen in the Relative Strength report to where it was no longer in the top three, then it was sold and the highest rated ETF was purchased.

Figure 1 shows the relative strength report on September 9. Looking at the report, it is apparent that small company stocks are leading. As long as the two portfolio holdings are in the top three positions, then there are no trades. At this time, IWM and IJS were being held so no action was taken.

The portfolio was always fully invested in two ETFs or equivalent indices and rebalanced at the end of

"It is a growth strategy . . . yet, it holds market indexes so there is no need to fear that a stock holding will fall by 20% after a profit warning."

every year, giving the two securities an equal weighting. I rebalanced the accounts each year to better see how the strategy performed on a yearly

basis but the rebalancing lowered the overall return. Rebalancing forces you to partially sell your best holdings.

The strategy is designed to rotate to the segments of the market that have the best performance. During the bullish years, returns were led by the strength of the Nasdaq 100 (QQQ) holding.

During the bearish years, the portfolio outperformed because it exited the QQQ and rotated to a position in Small-Cap Value (IJS). Small-cap stocks actually rose in value during 2001.

Those who want to employ this strategy may be concerned with liquidity in the ETFs. With ETFs, however, volume does not define their liquidity. Unlike a

Table 2.
Yearly Returns (%)

Year	Style Index Portfolio	S&P 500 Index
1998	39.28	28.58
1999	50.01	21.04
2000	-3.10	-9.10
2001	2.10	-11.89
2002	-18.11	-22.10
2003	20.07	14.75

(thru 9/30)

Past performance does not guarantee future results. No strategy can guarantee losses will not occur.

stock or a closed-end mutual fund, the number of iShares in the marketplace is not fixed: if the demand for a given ETF outstrips supply at any point, an ETF specialist can create

"During the 5 ½-year time period (1998-2003), the strategy rose 103.27% while the S&P 500 rose 11.44%. Best of all, the backtested portfolio is above its December 31, 1999 level. This growth strategy has erased the effects of the bear market!"

new ones from a basket of the underlying securities in that fund. When a large transaction is placed, shares can be created or redeemed to meet demand. Studies show a high, but not exact, correlation between the benchmark indexes and the ETFs.

Results

Although this strategy is simple, the results are outstanding. The yearly results are found in **Table 2**. For the years 1998 through 2002, results were computed by a backtest. Year 2003 results represent an actual

portfolio using the strategy. The strategy outperformed the S&P 500 index every year and it held its value during the 2000 through 2001 bear market years. It wasn't until the third quarter of 2002 that all style indexes fell in value, accounting for the 2002 loss.

Figure 2 shows the returns since the inception of the backtest. During the 5 ½-year time period, the strategy rose 103.27% while the S&P 500 rose 11.44%. Best of all, the backtested portfolio is above its December 31, 1999 level. This growth strategy has erased the effects of the bear market! Because the strategy rotated to aggressive securities during bull runs, the strategy outperformed during up phases. Because it rotated out of technology to more conservative indexes, it also limited downside movement.

Keep in mind that this is a backtest so it does not represent actual returns. The purpose of the backtest is to create and gain confidence in a strategy that will be used to trade ETFs which track style indexes. Refer to **Table 3** for backtest assumptions.

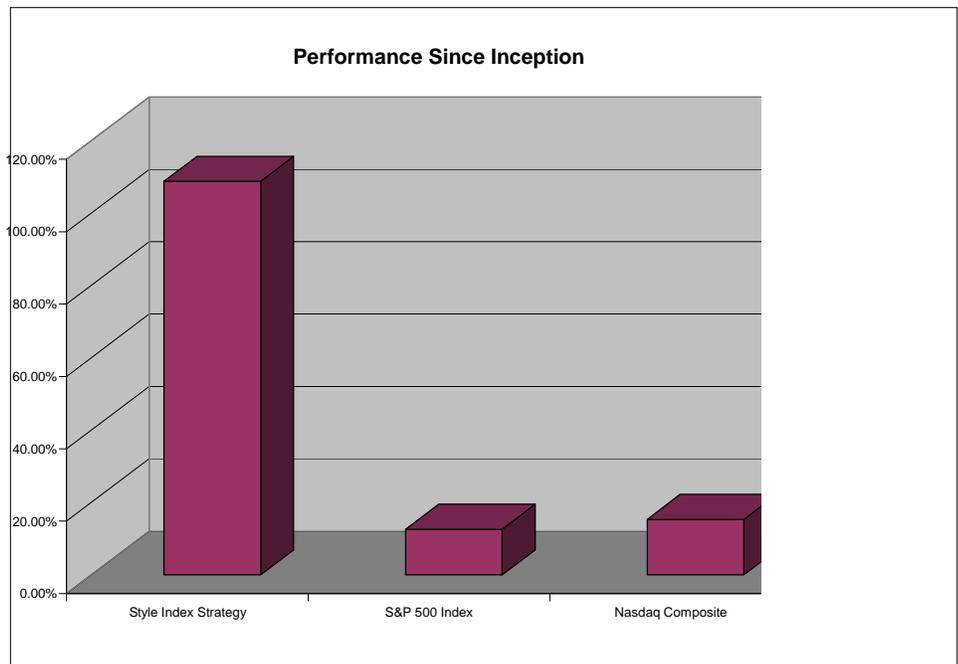


Figure 2. Performance graph shows strategy total return vs. S&P 500 and Nasdaq Composite. Returns are for 5 ½-year time period ending mid 2003. For 1998-2002 period, strategy returns were computed by backtest while 2003 return represents actual fund performance.

Concluding Thoughts

An effective long-term trading strategy must have three criteria:

1. Sufficient profit potential to meet your financial goals.
2. A risk level that allows investors to stick with the strategy over all market cycles.

3. A level of ease that allows investors to trade the model in the same manner in which it was backtested.

For most people, the Style Index strategy accomplishes these goals. It is a growth strategy with higher risk than an S&P 500 buy-and-hold

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

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While the information in this newsletter is believed to be reliable, accuracy cannot be guaranteed. Past performance does not guarantee future results.

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Table 3. Backtest Assumptions

The backtest assumed the portfolio was always fully invested in two ETFs. Many of the ETFs were not yet available to purchase at the beginning date of the backtest. When the ETF wasn't available, the backtest used the ETF's benchmark index as a substitute. The backtest used price data from actual ETFs once they became available.

Securities used for the backtest were purchased using the closing price the day after the buy/sell signal. A commission of \$25 was used. Slippage of 1.2% was also factored in.

The percentage returns from 1998 through 2002 represent a hypothetical backtest of the Style Index strategy, not an actual portfolio. Since this is not an actual portfolio, the impact that material economic and market factors might have had on the decision making process cannot be represented. The return in 2003 represents the performance of an actual portfolio using the strategy.

As with any strategy, past actual or model performance does not guarantee future results. Losses can occur.

investor will experience. Yet, it holds market indexes so there is no need to fear that a stock holding will fall by 20% after a profit warning. As there are about nine round trip trades per year, you don't have to be a full-time trader to implement the strategy.

What's the downside to the strategy? It leaves little to talk about at cocktail parties—there are no good stock stories. In effect, this is an active index investing strategy. Since most of its trades are short-term, it works best in tax-deferred accounts.

The use of index vehicles might imply that this is a conservative approach with limited upside. However, because of the variety of indexes that can be traded with ETFs, the strategy becomes more of an aggressive growth trading model. During volatile periods, it can become a Nasdaq 100 (QQQ) timer with much of its performance hinging on whether or not the QQQ is being held. As each holding is 50% of the portfolio, the highly volatile QQQ can have a big impact on performance.

Our Style Index strategy assumes a fully invested portfolio but it is easy to include market timing as well. Since the portfolio only holds two securities, it only takes two sell orders to move to 100% cash.

For information on David Vomund's managed account program, visit www.lvim.com or call 775-832-8555.

S&P 500 Changes

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

Express Scripts (ESRX) replaces Quintiles Transnational (QTRN). ESRX is added to the Health Care Services (HEALTHSS) group.

The VIX Revisited: CBOE Announces Changes to Volatility Index

By David Vomund

In September the Chicago Board Options Exchange (CBOE) announced changes to the Volatility Index (VIX). The VIX was discussed in an article in last month's *Opening Bell*. A detailed list of the changes can be found at www.cboe.com/vix.

There are three main changes to the VIX. First, it will now be based on the S&P 500 Index options instead of the S&P 100 Index options. Second, the new VIX will use nearly all of the available S&P 500 options in its calculation instead of using eight options. Finally, the VIX now uses a completely different formula in its calculation. The CBOE will soon have historical VIX prices available dated back to 1986.

Overall, the movement in the old VIX versus the new VIX is very close but the new VIX tends to be slightly lower than the old VIX. Those who look for relative numbers must make appropriate adjustments. As an example, the old VIX peaked at 50.48 in 2002 but the revised VIX shows a peak of 44.29.

Have no fear if you are comfortable with the old VIX and don't want to accept the changes. The CBOE will maintain the old VIX methodology using a new ticker symbol. That ticker symbol is VXO.

STOCK DATA MAINTENANCE

Stock Splits and other changes:

Stock	Ticker	Split	Approx. Date
First Financial Corp.	THFF	2:1	10/16/2003
Middleburg Financial	MBRG	2:1	10/20/2003
Monro Muffler Brake	MNRO	3:2	11/3/2003

Trading Suspended:

J.D. Edwards & Co. (JDEC)
Northwestern Corp. (NOR)

Name/Ticker Symbol Changes:

NBTY Inc. (NBTY) to NBTY Inc. (NTY)

Market Review

September is historically the worst month for the market. This year, September started well but sellers emerged and by month's end the market fell. Both the S&P 500 and the Nasdaq Composite fell 1.3%. For the year, the S&P 500, including dividends, is up 14.75% and the Nasdaq

Composite is up 33.80%.

At the end of September the AIQ software was giving bullish readings. The AIQ timing model fired a buy signal on the last day of the month and 99% of the stocks giving unconfirmed signals were on the buy side.

Control Emotions for Proper Position Sizing

Proper Allocation of Your Assets Is Critical Factor for Successful Trading

Stock moves are based on fear and greed. Unfortunately, basing buying decisions on greed and selling decisions on fear leads to bad decisions. Buying greed and selling fear leads to buying high and selling low. It's not just the execution price that is the problem, however. Being controlled by fear and greed leads to bad money management decisions.

Nearly all investors can state a case where they were extremely confident about a stock — and whether it was based on a strong technical or fundamental picture, greed takes over and money management decisions are ignored.

The stock may be at \$10 and you are certain that it will hit \$20. As a result, you load up on the stock with a large portion of your assets. Unfortunately, before hitting \$20 the stock falls to \$7. You were right about the move but wrong on the timing. Because you had too much

Many traders lose everything in the markets because they wager an inappropriate percentage of their trading capital on a single position. Unfortunately, that single position invariably turns out to be the worse of all the holdings. When the trade goes badly, the adverse effect is crippling.

Staying power is important in successful trading. While valuation, trend direction, and timing are all important,

proper position sizing is the most critical. With proper position sizing you can be wrong and play another day. With bad position sizing, you'll end up with big losses and little hope of recovery.

Instead of buying from greed, treat every position like it could be a loser. Yes, there is power in positive thinking but overconfidence leads to bad results. Recall that 80% of all

motorists think they are above average behind the wheel. Shun your pride and you will make better decisions. Don't attribute winning positions to smarts and losing positions to bad luck.

Having a positive attitude about your trading system and your long-term goals are important. However, overconfidence in any single trade

can cause you to mismanage it by taking on an undue amount of risk. If you believe every trade will be a winner, the need to confirm that belief may cause you to stay too long in a trade that has moved against you.

“Many traders lose everything in the markets because they wager an inappropriate percentage of their trading capital on a single position... When the trade goes badly, the adverse effect is crippling.”

It may also prompt you to take a position size that is simply too large. Staying in a trade longer than you should or having too much money at risk is the surest road to disaster.

“While valuation, trend direction, and timing are all important, proper position sizing is the most critical. With proper position sizing you can be wrong and play another day.”

money invested, you couldn't stomach the drawdown and the stock was sold for a loss.

The lesson to long-term success is proper allocation of your assets. In our example, if the investor had not loaded up on the stock trade, he could have ridden out the short-term decline and enjoyed the benefits of his correct projection.

AIQ's 14th Annual Lake Tahoe Seminar

October 13, 14, and 15

At Harvey's Resort and Casino South Lake Tahoe

This year's AIQ Seminar will be entirely hands-on, with attendees using PCs to follow sessions focusing on trading system design.

FEW SEATS LEFT!

For more information or to reserve your seat:

Call 1-800-332-2999

Improved Charting in Version 7.2

Charting Features Requested by Users Now In TradingExpert Pro's Alerts Module

By David Vomund

AIQ has released version 7.2 of TradingExpert Pro. This new version is a free upgrade for those who lease the program. For a listing of new features or to download version 7.2, visit www.aiqsystems.com and click AIQ Upgrade Site. The majority of new features are found in the Alerts and Portfolio Manager modules.

In this article, we'll focus on the new charting features in version 7.2. All the new charting features are found in the Alerts and not the Charts module.

W

hen AIQ developed the charting for the Alerts module in TradingExpert Pro, the charts

lacked features found in the end-of-day charting module. That's changed. The charts in the Alerts section of the program now have more capabilities. Even end-of-day users will now want to use the Alerts module to analyze their charts.

"Over the years, many users suggested that our charts should have some room at the end of the price data. This allows users to more easily make price projections. This feature is now available."

The Alerts module requires a subscription to myTrack. All charts within Alerts, including end-of-day charts, retrieve data from myTrack's database rather than your computer's hard disk.

To open charts within the Alerts module, go to TradingExpert Pro's

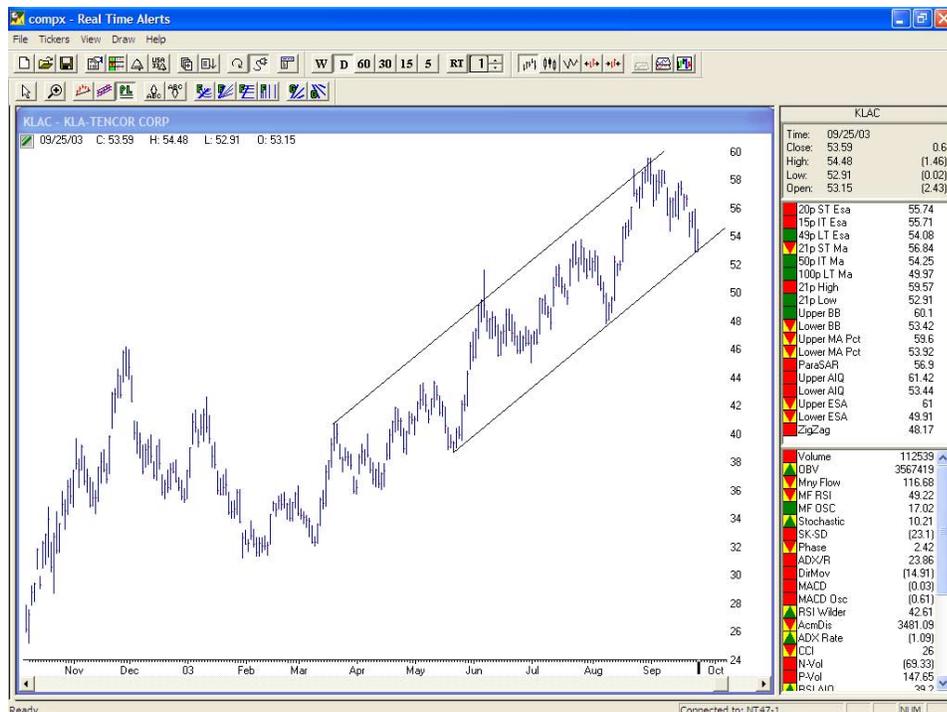


Figure 1. Daily chart of KLAC displayed from Alerts module. Notice that the time scale extends beyond the current date to allow the user to project trendlines into the future.

Quick Launch Menu and click *Alerts*. Last month, we reviewed how using this section of the program allows you to receive an Alert each time a stock passes the criteria defined in your technical model. In this article, we'll concentrate on charting so we'll remove the technical Alerts from the screen. On the menu bar, click *View* and uncheck *Alert Grid*.

To chart a ticker symbol, click *Tickers* and *Add* (or press your Insert key). You can also add an entire list by clicking *Ticker* and *Add Tickers From List*. By right-clicking your mouse, you can select *Properties* and change the format of the charts to fit your style.

I'm used to the format of AIQ's regular end-of-day charts, so I removed the grid lines and put blue high/low bars with a red close. If you plot an end-of-day chart, there will be a price bar for the current day, even if the market is still open. There is no need to do an intra-day update.

The ticker symbols on the left section of the screen are available for charting. If you often chart different list structures, then add the tickers from one list and save the Alerts page by clicking *File* and *Save*. For instance, you may have an S&P 500 page and a Nasdaq 100 page. Click *File* and *Open* to switch back and forth between the two page options.

Over the years, many users suggested that our charts should have some room at the end of the price data. This allows users to more

easily make price projections. This feature is now available. Click *File* and *Chart Properties*. At the bottom-right section of the Properties screen is the *Right Margin* option. Increasing this number increases the space at the end of the chart. Notice in **Figure 1** that the chart price data is through September 25 but the x-axis goes through early October.

Another popular request from users is the ability to draw parallel trendlines. That feature is now available in version 7.2. Figure 1 shows KLA Tencor (KLAC) and its rising trading channel. To draw these parallel trendlines, click the icon that shows "PL." The first trendline was manually drawn connecting the May low to the August low. To draw the upper parallel trendline, I went to the March high and clicked the mouse. A trendline parallel to the first trendline is automatically drawn.

There is a Zoom feature in both the Charts and Alerts modules but this feature is more advanced in Alerts. By clicking the *Zoom* icon (a magnifying glass), you can highlight any area of the chart and see a

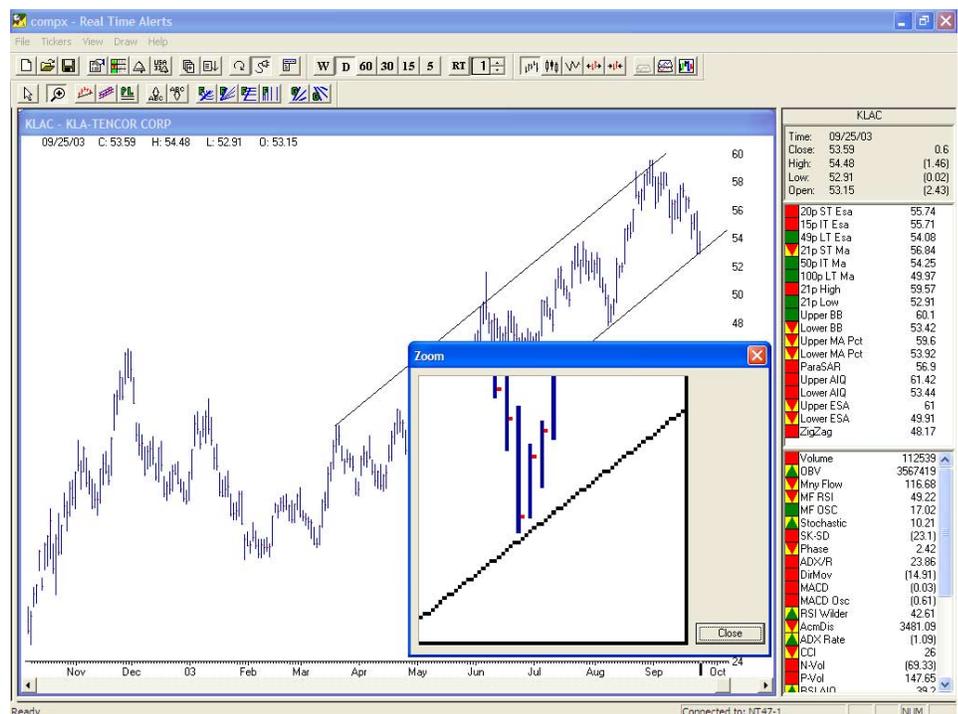


Figure 2. Same chart as Fig. 1 with Zoom window. This window, which shows a magnified view of an area of the chart, is displayed by clicking the area with the *Zoom* icon (magnifying glass).

magnified version of it (**Figure 2**).

In Alerts you can also set your screen to show one security charted in two different time periods. For example, **Figure 3** shows a Nasdaq Composite end-of-day chart on the top part of the screen and a Nasdaq

Composite 1-minute chart on the bottom part of the screen.

To accomplish this, you must open an Alerts page for each chart. To illustrate, I plotted an end-of-day Nasdaq chart and then saved the screen under the name COMPX. I then minimized this screen. Next, I opened Alerts again and this time charted the Nasdaq using a 1-minute chart. I saved this screen to a new file name.

Now you can arrange the two open charts so they can be viewed together as shown in the figure. If you run multiple monitors from one computer, you can plot separate charts on each monitor.

There are many new features in the Alerts module, more than we can cover in this newsletter. If you have specific requests or want to get Alerts set up more efficiently for your trading style, call our technical support staff at 775-831-2999. AIQ's technical support people can help you tailor this charting module to your specific needs, including how to set up Alerts shortcut icons on your desktop screen.



Figure 3. Alerts window displaying two Nasdaq Composite Index charts, each with a different time period. The upper chart is end-of-day and the lower is a 1-min real-time chart.

New Features & Trading Strategies

AIQ Announces Release of TradingExpert Pro v7.2

By Stephen Hill

Now's the time to upgrade to AIQ TradingExpert Pro v7.2. Best of all it's FREE for clients on the monthly plan with myTrack. New features are concentrated in two very important areas of the software, Real-Time Alerts and Portfolio Manager. Also available are over 60 new trading strategies and indicators.

Real-Time Alerts Features

RTAlerts is now the mainstay charting and analysis area within AIQ.

This module offers the ability to run trading systems both real time and end of day, in addition to traditional charting capability. TradingExpert Pro 7.2 has several new features added at the request of AIQ clients. These include:

- **Space on right-hand side of the chart.** This is ideal for drawing tools and chart pattern users. You can configure the size of the right-hand space to suit your needs; the drawing tools all extend into the space.
- **Multiple instances of RTAlerts launched from AIQ Menu.** New feature allows alerts on multi-time frames. Now you can launch multiple instances of RTAlerts, and each can have its own time frame and ticker list running different trading systems.
- **Vertical grids.** This tool helps divide the chart into zones.
- **Parallel Lines.** Draw one line and the next 4 lines drawn with this tool are all drawn parallel.
- **Zoom feature.** Click and drag the zoom box around chart area and zoom it. This high-powered zoom allows close-up scrutiny of any selected chart area.

Other RTAlerts Features in TradingExpert Pro v7.2

- - +/- DMI indicator.
- Per-indicator color selection.
- Clear alert list at exit.
- Modified toolbar icon for drawing arrow to indicate attribute is actually arrow and text.
- Keyboard shortcuts: CTRL + for increase spacing, CTRL - for decrease spacing.
- Candlestick colors independent of hi-lo bar colors.
- Added hot key (F11) and menu item to show/hide the price/data pane in the indicator panel.
- Center divider in indicator panel now acts like a splitter.

New in Portfolio Manager

AIQ's Portfolio Manager and the built-in Simulator are fast proving to be invaluable in trading system development.

Often overlooked, Portfolio Manager and the built-in trading system Simulator are again proving to be valuable for money management and trading system design. The new features in TradingExpert Pro v7.2 include many fine tuning additions that make the Portfolio Manager a professional money management system for traders.

New Features in Risk:

- Addition of automatically calculated SEC fees.
- Calendar-based Performance analysis.
- Charting of IRR or Portfolio Value. Allow use of comparative index.

For a complete list of all new features in TradingExpert Pro v7.2 and to download this upgrade visit:

<http://www.aiqsystems.com/TESindex72.htm>