AIQ Opening Bell® Monthly

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Feature

Sections

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

INTERVIEW

LEARN TO USE CANDLESTICK CHARTS FOR MORE COMPLETE STORY

By David Vomund

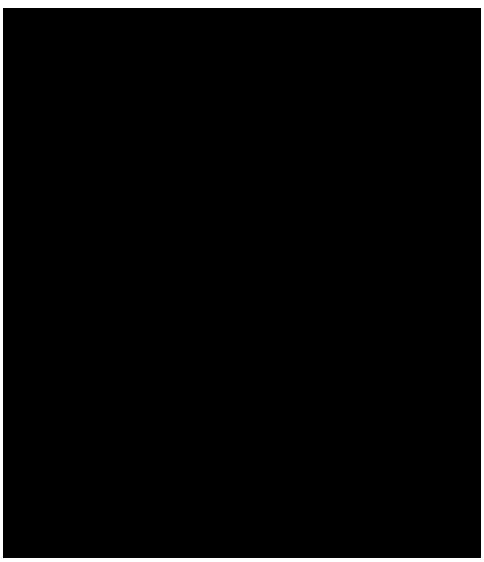
This month we are pleased to present an interview with Richard "Doc" Ehlers. Doc is a retired endodontist and a 10-year AIQ user. He has twice lectured at AIQ seminars on how Candlesticks can be used to enhance investing. He currently publishes Smart Monkey Memos, a free e-mail service.

OBM: How did you get involved in the investment field?

Ehlers: I bought my first stock, Chicago Railroad Equipment, at age 23. I am now 67 and have always been involved to some degree. My involvement accelerated after attending my first AIQ meeting in 1992.

OBM: Before talking about stocks, let's talk about your sector fund analysis. How much of your portfolio is set aside for sector fund trading and what advantage do sector funds have over stocks?

Ehlers: Nearly half of my portfolio is in sector funds. As a top down investor, the decision making process is quick and simple. When I decide which way the market is going and what sectors have the momentum, I'm done.



Richard "Doc" Ehlers

OBM: How do you use *Investor's Business Daily* to determine which funds to be in?

Ehlers: Every Friday I look in *Investor's Business Daily's* "Top Industry & Sector Funds in the Last 4 weeks" to determine which sectors have the best momentum during the

Interview continued on page 2

INTERVIEW *continued . . .*

last month. This can be found near the front of Section B in the newspaper. I trade Fidelity Sector funds and I divide my cash into 10 equal positions. Then I place one position in each sector fund that makes the “Best in the Last 4 Weeks” list. Should the sector repeatedly appear week after week, and this happens often, then I end up with more than one position in that one sector. There have been occasions where I have had as many as eight positions in one sector and I have a suitable saying for this — “Diversity insures Mediocrity”. Once I have filled all 10 positions then I’ll hold them until a new sector’s price change exceeds that of one of the sectors I own by at least 5% over the last month. Once a new sector exceeds a current holding by 5%, then I’ll make the switch. The whole process takes me about two minutes a week and rarely more than 20 minutes.

OBM: You also exit your fund holdings based on market timing. How does AIQ’s market timing fit in with when to sell?

Ehlers: I’ll sell non-technology related issues if the AIQ market timing model gives a confirmed sell signal and the Dow has a Dead Man’s Cross. A Dead Man’s Cross means the 7-day moving average drops below the 14-day moving average. For technology related sectors, I use the NASDAQ 100 market timing model that was featured in the May 1999 *Opening Bell*. I sell technology sectors when this model switches to a confirmed sell signal *and* the NASDAQ has a Dead Man’s Cross. IBD (*Investor’s Business Daily*) also plays a role in my market timing.

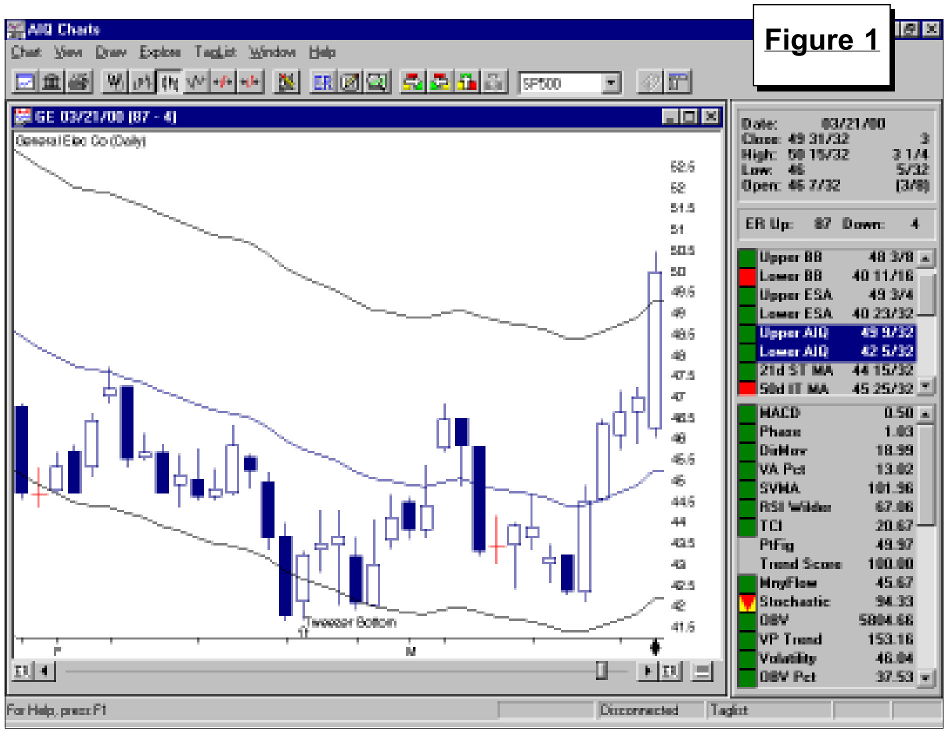


Figure 1

OBM: How so?

Ehlers: In the “General Market & Sectors” section of IBD you can see all the markets. This section is found near the back of Section A in the newspaper. On this page, you will also find the “IBD Mutual Fund Index.” I prefer to call this the “Smart Monkey Index” because it is an index of 25 outstanding mutual funds. The individuals that manage these funds all have their roots in fancy business schools and are consistently rated above their peers. If this index of smart monkeys drops for four straight days then I’ll sell. In addition, I’m bearish if the index is below its 50-day or 200-day moving average.

“Bar charts don’t tell you anything that Candlestick charts can’t. But there are all kinds of things you can learn from Candlesticks that you’ll never see on bar charts.”

When any of the above happens and I am in margin, I get out of margin. Also, if the index exceeds the 50-day average by 6%, I reduce margin by 25%. If the index exceeds the moving average by 7%, then I reduce margin by another 25%. At 8% I reduce margin by another 25%, and after 9% I am entirely out of margin. This works so well that I am considering getting entirely out of the market when the index exceeds the moving average by more than 10%.

When there is a correction like happened in late March, we were

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Opening Bell Monthly
G.R. Barbor, Editor
P.O. Box 7530
Incline Village, NV 89452

INTERVIEW *continued . . .*

out of margin when IBD's Mutual Fund Index rose to 10% above the 50-day moving average. On March 31, the Index fell below its 50-day average, which means half of the core funds should be sold. By April 13, the index had dropped on four consecutive days. This was one day prior to the big tech wreck and AIQ's sell signal.

Sometimes it helps to get lucky as well — in mid-March I went to New Zealand so I sold my entire portfolio before the weakness began!

OBM: Once you are out of the market, how do you get back in and not get burned?

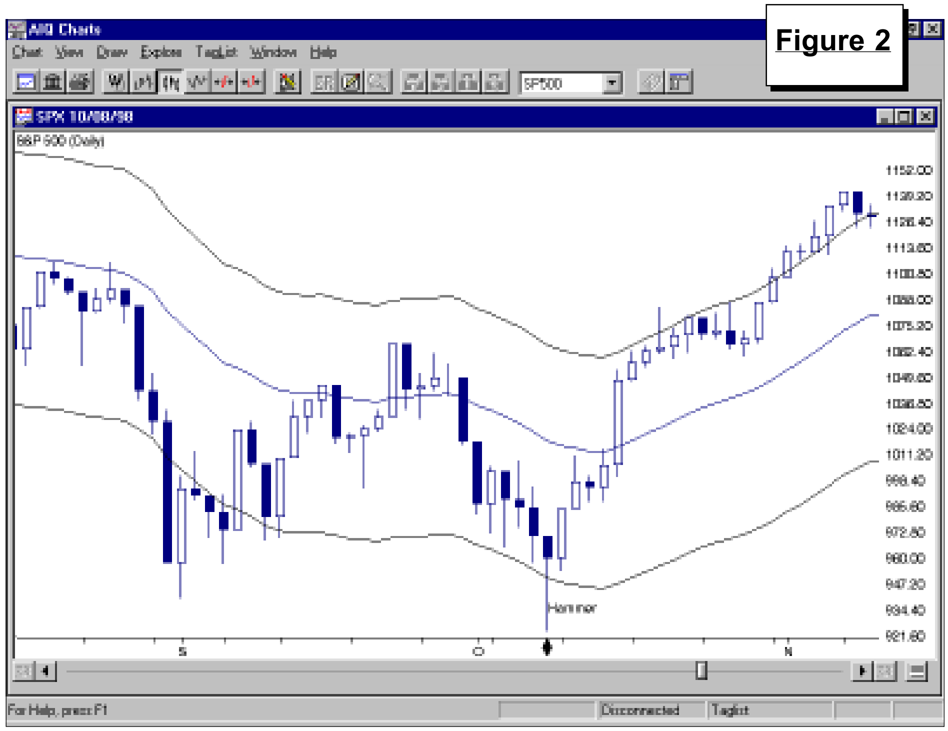
Ehlers: The first AIQ buy came on April 20. This signal was suspect as the April 14 low had not been retested and the signal came on a day with lousy volume. Because I was scared, I committed only 25% of my core money. On May 3, AIQ gave a 100 sell and I was back to 100 % cash.

Two days later, AIQ gave a buy signal which was followed by two more buys coming on May 11 and on May 12. Again with sorry volume, the major averages struggled to get above their 200-day averages. It was apparent by this time that we were going nowhere fast in what I like to call "watching wet paint dry."

We got two more buys on May 26 and 30, which I didn't act on because the IBD Mutual Fund Index wasn't above its 200-day average.

The picture turned decidedly bullish when on June 2 the NASDAQ Composite opened a window to the upside (a gap between the open and the previous day's high price). The market indexes had by now retested their lows several times and the IBD Mutual Fund Index had broken above its 50-day moving average.

Figure 2



OBM: What other market timing techniques do you use?

Ehlers: I set my moving averages to 7, 14, and 28 days. I usually wait to buy until we have a Bright and Shiny Day. A Bright and Shiny Day is a term I use when the 7-day crosses above the 14-day average. When in doubt when to sell, I will wait for a Dead Man's Cross, when the 7-day moves below the 14-day average.

OBM: How important is market timing in your portfolio? Is any portion of your portfolio always fully invested?

Ehlers: The only long-term investments I have are unrelated to the stock market. At my age I don't even buy green bananas!

"I prefer to call (the IBD Mutual Fund Index) the 'Smart Monkey Index' because...the individuals that manage these funds all have their roots in fancy business schools and are consistently rated above their peers. If this index of smart monkeys drops for four straight days then I'll sell."

OBM: When and why did you begin using Candlestick charts?

Ehlers: I began using them after hearing Steve Nisson speak about them at an AIQ seminar in 1992. Because Candlesticks show each day's open as well as the close, they tell a more complete story. Bar charts don't tell you anything that Candlestick charts can't. But there are all kinds of things you can learn from Candlesticks that you'll never see on bar charts.

OBM: What are your favorite Candlestick patterns?

Ehlers: Tweezers Tops and Bottoms are especially meaningful, notably when formed at or beyond

Interview continued on page 4

INTERVIEW *continued* . . .

the AIQ Upper and Lower Bands. A Tweezer Top is formed when the highs on two consecutive days match each other. Conversely, a Tweezer Bottom is formed when the lows of two consecutive days match each other.

A good example of this pattern combination is seen in General Electric (GE) on February 22 (**Figure 1**). On this day, GE was below the lower trading band and its low price equaled the previous day's low. As I picture it, AIQ Upper And Lower Bands are like the second standard deviation of the bell curve laying on its side. Since there is only about a 5% chance of price continuing up (or down) when outside the bands, any reversal signal becomes stronger in this situation.

The Hamari pattern (pregnant women) is important. Another hair-raising pattern is the Hammer. A Hammer is a Candlestick with a small real body and a long lower shadow formed near the lower AIQ band (see page 92 of AIQ's *Technical Indicators Reference Manual* for an explanation of real bodies and shadows).

In **Figure 2,** we see that the S&P 500 formed a Hammer on October 8. Notice the long lower shadow combined with price action below the lower trading band. Looking at individual stocks, Hammers formed "Abandon Babies" all over the place! One of my favorites is Microsoft, which had the same pattern as the S&P 500. If we ever see that many signals again, I am going to mortgage the farm and buy everything in sight.

OBM: An "Abandoned Baby" sounds bad, but you're saying it is a bullish pattern?

Ehlers: It is a bullish pattern when the security has been moving

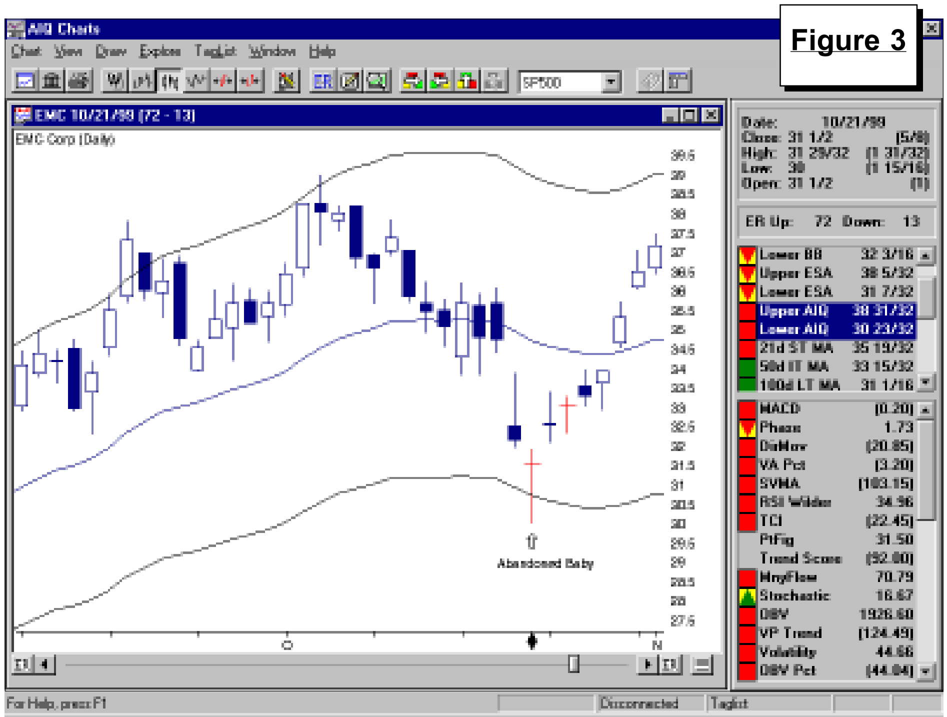


Figure 3

lower but bearish when the security has been rising. This pattern occurs when there is a window (a gap) on both sides of a Candlestick. A great example is EMC Corp. (EMC) on October 21, 1999. Once again, EMC was below the lower trading band for part of the Candlestick (**Figure 3**). EMC has never looked back.

OBM: What indicators do you use in conjunction with Candlestick charts?

Ehlers: Understand I never use Candlesticks to initially select a stock. The first step is to narrow down the stocks that I'm willing to purchase. The stock ideas come from a number of sources. I get ideas from David Schultz's *Sector Vue* newsletter (David Schultz was featured in the August 2000 *Opening Bell*) and from your *VIS Alert.com* newsletter. I get stock ideas from *Investor's Business Daily* as well. On Thursday, IBD runs a nice section called Internet and Technology, which gives good stocks to watch. Most of my selections come from the 'NYSE Stocks In the News' and the 'NASDAQ Stocks In the News'. Then, I run AIQ's Weighted Action List and Relative Strength-Strong reports. Once the stocks are selected, I use Candlesticks to pick the cream of the crop.

"I learned from AIQ's founder, Dr. J.D. Smith, that 'the best reason to sell a stock is to buy a better stock'. This is my first (sell strategy) rule."

OBM: Can you give us examples of some of the stocks you've purchased and explain why they were attractive?

Ehlers: You bet! In the previous examples, stocks were bought on weakness but I'm primarily a momentum player. Instead of buying low and selling high, I try to buy high and sell higher.

You selected Corning Inc. (GLW) in your *VIS Alert.com* newsletter portfolio, which called

INTERVIEW *continued . . .*

the stock to my attention. You liked it because of its strong Money Flow; I liked it because it formed a window (a gap) and gave a Parabolic SAR buy signal (**Figure 4**). Instead of buying the stock, I purchased July calls on GLW on April 25 for $19. Then I purchased the stock at $202 and again at $229 on additional open windows. The call options closed today at $84.

OBM: How has your stock picking strategy evolved over time?

Ehlers: The older I get the fewer stocks I can track. So my discipline has gone from holding 10 issues to only six. One problem I have is that it is sometimes difficult to follow all my trading rules. For a complete list of my problems, please contact my wife!

OBM: Can you explain your sell strategy?

Ehlers: I learned from AIQ's founder, Dr. J.D. Smith, that "the best reason to sell a stock is to buy a better stock". This is my first rule. I don't like big losses so I'll cut losses to 8% below the purchase price. You do have to give stocks some room to move. After all, about 40% of my stock purchases pull back to the buy point. Once the stock moves up, I'll place a trailing stop, but I try not to sell if the stock is up 20% in only two or three weeks because these stocks often turn into big winners.

I will sell stocks based on market timing as well. The sell criteria that I discussed for sector funds are also often applied to stocks. Once I get a sell signal, I will look for verification to sell stocks by a Dead Man's Cross, Parabolic Sell, or other Candlestick reversal formations.

OBM: What advice would you give those new to AIQ to speed up their learning curve?

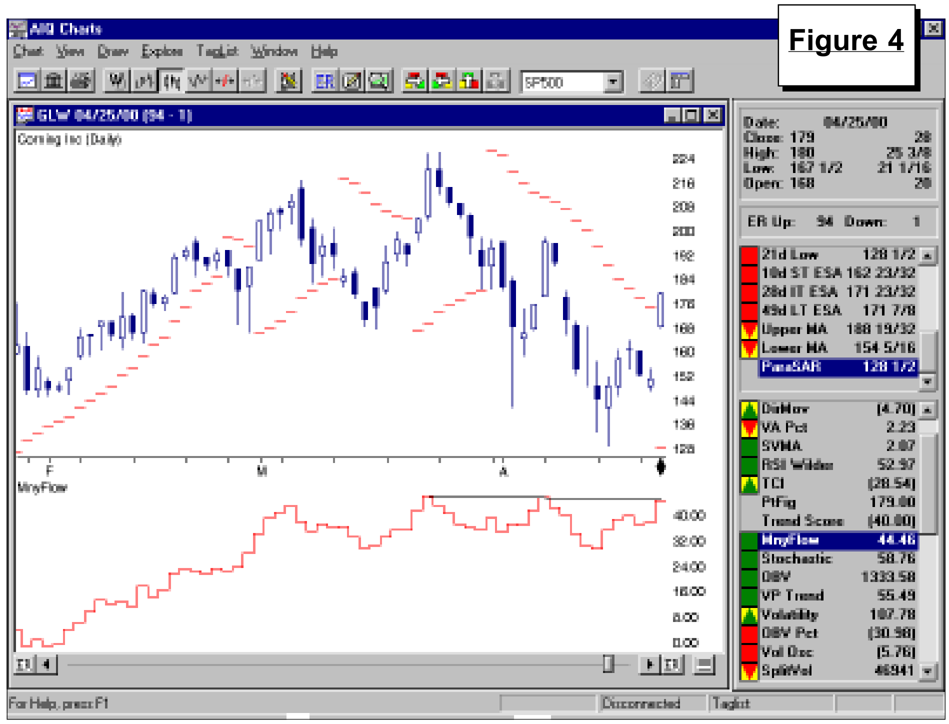


Figure 4

Ehlers: First, users should attend an AIQ fall seminar. Meeting other users is very beneficial. It works well to follow along with a mentor for a while to see what he (or she) does and discover how you can match or maybe improve on the techniques. Finally, join an AIQ user group if one exists in your area.

OBM: My weekly newsletter helps my own analysis because it forces me to put my thoughts on paper, somewhat serving as a market log. How has sending e-mails out with your analysis helped your own trading?

Ehlers: It keeps me focused and honest, or at least somewhat honest! It also helps to remind me of my disciplines. Yes, I get as much out of the memos as anyone else.

OBM: We've talked about your short-term trading but you also have a contrary strategy that forces you to buy into extreme weakness. Can you explain this?

Ehlers: Basically, you dollar cost average during time periods when the Dow is moving higher. At the same time, you hold some reserves in a money market fund. Once the Dow corrects 10%, then you put one-third of your reserves to work. If the Dow continues to drop another 10%, then you invest the remaining reserves. If the Dow continues to fall and corrects 30% or more, then you do whatever you can to invest. A Dow correction of 30% or more would be very rare. For a more complete explanation, visit my home page at *http://members.aol.com/docehlers*. You can substitute a different index than the Dow if you wish.

OBM: I like this strategy because it forces you to buy right when your emotions tell you to sell. Thank you for sharing your thoughts with us. ■

S&P 500 Changes

Recent changes to the S&P 500 Index and Industry Groups:

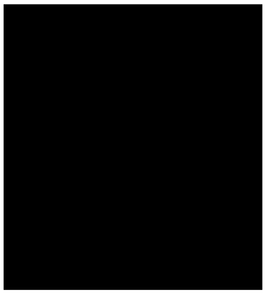
KeySpan Energy (KSE) replaces New Century Energies (NCE).

KSE is added to the Natural Gas (NATURALG) group.

POINT AND FIGURE CHARTING- Part 1

Point and Figure Charting Offers Unique Advantages

By David Vomund



DAVID VOMUND

Most people use bar charts or Candlestick charts in their analysis. Another charting form, Point and Figure, is lesser known but offers some unique advantages over the more traditional charting methods. The Point and Figure charting technique first became popular in 1948 when A.W. Cohen published *The Chartcraft Method of Point & Figure Trading*. Amazingly, the methodology has hardly changed.

Unlike bar charts where the vertical coordinate is based on price and the horizontal coordinate is based on time, the Point and Figure chart is only concerned with price. Although the year and months are reported on the horizontal axis, they are shown merely to establish a frame of reference. Since time is not a factor, small fluctuations in price are often not charted. Without these disturbances, it is easier to spot critical support and resistance levels. It is also easier to visually locate chart patterns.

AIQ's *Technical Indicators Reference Manual* has a good explanation of the mechanics of Point and Figure charting (Chapter I). To give a short summary, Point and Figure charts are plotted with X's and O's. Vertical columns of X's represent increasing prices while the O's represent decreasing prices. Each X or O represents a specific increment of change in price, which is called the box size.

For example, each X may represent a $2 increase in the price of the stock. Every time the stock increases by $2, an X is plotted. Time is irrelevant so it doesn't matter how long it takes for the security to make the $2 advance.

When X's are being plotted, we know the stock is advancing. TradingExpert's pre-set default values specify that a stock must fall by three times the box size before a new column of O's will appear to indicate a trend reversal. In our example of a $2 box size, a stock must fall by $6 (3 times $2) before a new column of O's is plotted. The three box reversal is what eliminates all minor and sometimes confusing fluctuations.

Using a similar concept as Log Scale charting, AIQ's software uses different box sizes depending on the price of the stock. By default, each box for a stock between $20 and $100 represents a $1 move. If the stock is between $5 and $20, each box represents a $0.50 move.

The default box sizes have worked fine in the past, but I'm finding in today's volatile market that larger box sizes are more appropriate. This is especially true with Nasdaq growth stocks. I've doubled the recommended box sizes so that a stock between $20 and $100 has a $2 box size and a stock between $100 and $500 has an $8 box size. With the larger box sizes, the reversal areas represent more significant support and resistance levels. To change the indicator settings, see the *Changing Indicator Constants* section in Chapter I of the *Technical Indicator's Reference Manual.*

It is helpful to understand the mechanics of Point and Figure charting but it is not critical. The software will take care of the

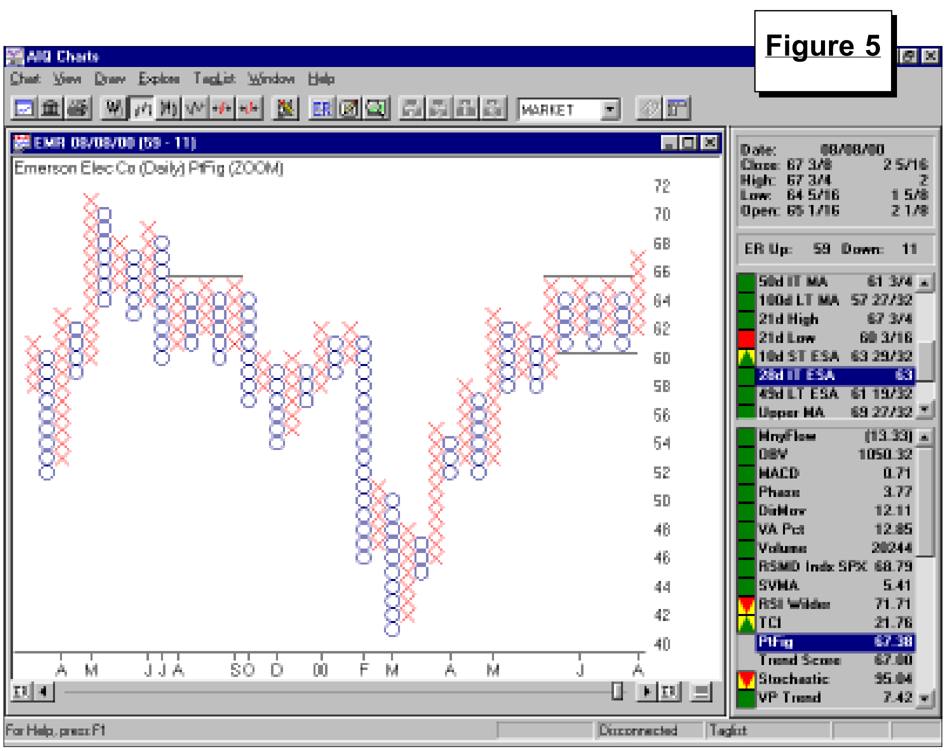


Figure 5

Point and Figure Charting *continued . . .*

construction of the charts, allowing you to concentrate on their interpretation. Luckily, it is much easier to interpret the charts than it is to understand their construction.

To plot a security using the Point and Figure technique, first chart the security and click on the *PtFig* indicator in your Control Panel. The chart will initially appear very small so AIQ's *Zoom* feature must be used. Place your mouse cursor on the Point and Figure plot at the bottom of the screen and press the Z key. The plot will then fill the entire window. Pressing the Z key again restores the plot to original size.

As we noted earlier, it is easier to identify support and resistance levels for stocks using Point and Figure charting techniques. For resistance levels, look for a level where several columns of X's end. Examining Emerson Electronics in **Figure 5**, we are able to quickly identify a resistance level at around $65. EMR rose to this level three times over the last three months but sellers emerged each time the level was tested. We can see the same level acted as resistance in August 1999 as well.

To find support levels, look for a level where several columns of O's end. We see three columns of O's ended at about $61, which represents a support level for the stock. We drew trendlines on the EMR chart to help you identify the support and resistance levels.

Editor's Note: TradingExpert does not have the capability to draw trendlines on a Point and Figure chart. Trendlines were inserted on the charts in this article to help highlight the chart patterns. Many people like vertical and horizontal gridlines on their charts as well. With TradingExpert, you can see horizontal gridlines on a Point and Figure chart by pressing the G key when a chart is displayed.

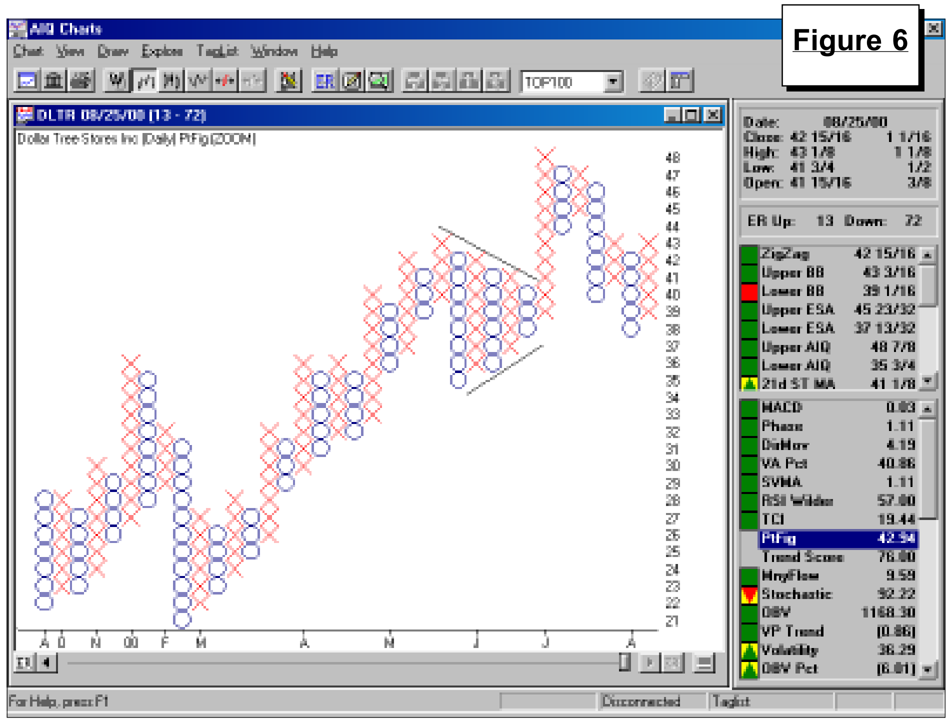


Figure 6

A buy signal is registered on a Point and Figure chart when one column of X's moves higher than the previous column of X's. The theory behind a buy signal is that the stock is able to rise above an important resistance level (i.e., a price level where sellers have appeared when the stock previously reached this same level). A buy signal is never registered when a stock is at or near its lows. Instead, the buy signal comes when a stock "breaks out" above resistance. The stock then remains on a buy signal until a column of O's falls below a previous column of O's.

We can now spot buy and sell signals but how do we know which will be the best signals? There are patterns that can be identified which point toward the more significant buy and sell signals. The first pattern we'll explore is the Symmetrical Triangle. In this formation, there is a pattern of lower highs and higher lows. Each column of X's ends below the previous column of X's and each column of O's ends above the previous column of O's.

It is either a bullish or bearish pattern depending on the direction of the break. A buy signal occurs when one column of X's rises above the previous column of X's. A sell occurs if a column of O's falls below a previous column of O's. This pattern takes a minimum of five vertical columns in its formation.

Figure 6 shows a Symmetrical Triangle for Dollar Tree Stores (DLTR). We've drawn trendlines to highlight this pattern. The pattern started in May when the stock entered a tightening trading range. It wasn't until July that the stock broke above the pattern, giving a buy signal.

The Symmetrical Triangle occurs infrequently and pure Point and Figure enthusiasts might even disagree with our example because the trendlines were not drawn at 45 degree angles.

Point and Figure Charting continued on page 8

POINT AND FIGURE CHARTING *continued . . .*

More common than the Symmetrical Triangle is the Triple Top pattern which is a bullish pattern. For a Triple Top pattern to occur, the stock must rally to a specific level at least two times before sellers emerge. That means that two columns of X's will end at the same level. To complete the pattern, the stock must then rally above the high point of the previous column. This formation must have a minimum of five vertical columns.

An example of a Triple Top buy signal is found in **Figure 7**. Concord EFS Inc. (CEFT) entered a trading range from May to August. On two occasions, CEFT rallied to $29 but sellers emerged. It wasn't until the third attempt that CEFT rallied above the $29 resistance level, thereby registering a buy signal. AIQ's Point & Figure Breakout report lists all the stocks that have given Triple Top buy signals. ■

Next month: More patterns that identify significant signals.

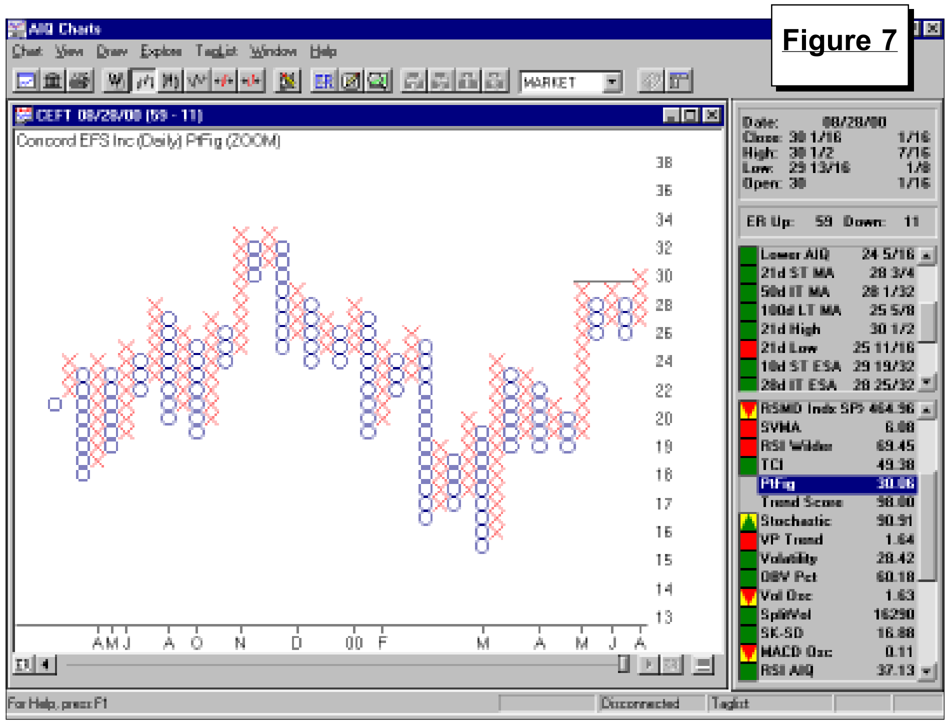


Figure 7

MARKET REVIEW

In July the market experienced a broad-based correction but at the start of August the AIQ software saw an improving technical picture. A 95 buy signal was registered on August 1 and the market rallied from there. In the month of August, the S&P 500 rose 5.54% and the Nasdaq rose 11.66%. No other signals were registered the rest of the month.

Technology sectors led the advance. Computers (Networking) rose 31%, Electronics (Instrumentation) rose 30%, and Computers (Peripherals) rose 29%. The best performing sector, however, was Tobacco, which rose 32% in August. The worst performing sector, Paper & Forest Products, was unchanged. ■

STOCK DATA MAINTENANCE

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

Stock	Ticker	Split/Div.	Approx. Date
Netegrity Inc.	NETE	3:2	09/05/00
St. Mary Land & Exp.	MARY	2:1	09/06/00
Siebel Systems	SEBL	2:1	09/11/00
Nordson Corp.	NDSN	2:1	09/13/00
FuelCell Energy	FCL	2:1	09/14/00
Orbotech Ltd.	ORBK	3:2	09/18/00
SonicWall Inc.	SNWL	2:1	09/18/00
Anheuser Busch Co.	BUD	2:1	09/19/00
Insight Enterprises	NSIT	3:2	09/19/00
Harman Int'l Ind.	HAR	2:1	09/20/00
II-VI Inc.	IIVI	2:1	09/21/00
SBS Techs	SBSE	2:1	09/21/00
Precision Castparts	PCP	2:1	09/22/00
Semtech Corp.	SMTC	2:1	09/26/00
Emcore Corp.	EMKR	2:1	09/26/00
Microchip Tech.	MCHP	3:2	09/27/00
MapInfo Corp.	MAPS	3:2	09/29/00

Trading Suspended:

Cooker Industries (CGR), Justin Industries (JSTN), North Face Inc. (TNFI), QCF Bancorp (QCFB), Spyglass Inc. (SPYG), Wynn's Int'l Inc. (WN)

Name/Ticker Changes:

Aztec Manuf. (AZZ) to AZZ Inc. (AZZ)
Digital Microwave (DMIC) to DMC Stratex networks (STXN)
MGM Grand Inc. (MGG) to MGM Mirage (MGG)