AIQ Opening Bell® Monthly

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Feature

Sections

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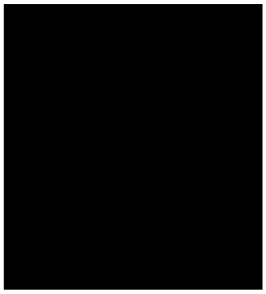
STOCK ANALYSIS

The Successful Investor Knows How to Take a Loss

By David Vomund



DAVID VOMUND

In this newsletter, we selectively choose examples and describe our analysis. Not surprisingly, most of the examples we choose are winners. This may be a mistake because taking losses is something every investor faces. In many cases, how an investor reacts to a loss determines how successful he will be in the future.

At AIQ we receive calls from users who are very successful at their trading. We also hear from users who are struggling. One critical difference between these two types of users has been discussed in several Opening Bell articles--the successful users have developed a strategy that they have confidence in. Some of our successful users rely on the stock reports to perform a bottom-up approach to stock selection. Others prefer a top-down approach using the Group/Sector Report. Some use the Market Log in their market timing while others rely solely on the Expert Ratings. Regardless of the approach, confidence is built by testing the strategy with historical data and then paper trading for a period of time before real money is invested.

The second critical difference and one that is not often discussed is that the successful investor knows how to take a loss. No strategy is 100% accurate. In fact, a person who has winning trades only half the time will make money as long as the winners are bigger than the losers. A friend of mine, Ken Trester, plays far out-of-the-money options. He loses money most of the time but when he wins he wins big and his gains more than offset his losses. In this game, taking a loss is part of making money.

Successful investors don't dwell on losses. They have confidence in their system and look forward to their next trade. People who struggle with their investments often decide to change their stock selection strategy after they experience a few losses. Whereas the successful investor refines his trading strategy, the unsuccessful investor constantly scraps and builds a new trading strategy.

1994 was a year when most people who were long the market had a lot of practice taking losses. I'm no exception. Listed below are a few of my war stories.

Stock Analysis continued on page 2

STOCK ANALYSIS *continued . . .*

You'll notice they follow the philosophy I've outlined in previous articles. The only difference is they didn't work as planned.

Figure 1 is a daily chart of Green Tree Financial (GNT). Its weekly chart reveals the nice uptrending pattern discussed in my longer term investing articles. The daily Accumulation/Distribution and On Balance Volume readings were in new high ground. Other indicators were also showing strength and the stock was fundamentally attractive. Everything was in place but I was stopped out three weeks later with an 11% loss.

Figure 2 is a weekly chart of Datascope (DSCP). DSCP broke above an 18 month consolidation on heavy volume. In the next few weeks I had a 10% gain but coming off such a long consolidation period I expected that this gain was only the beginning. That may eventually happen but the stock pulled back enough to hit my stop at 16 3/8 and I was out at a loss of 4%.

Figure 3 is a short position in Norfolk Southern (NSC). NSC was moving sideways but its Accumulation/Distribution and On Balance Volume were hitting new lows. The Stochastic also gave a sell signal. This was perfect! Unfortunately, merger news gave a boost to the rail stocks and NSC rallied above its October high and reached my stop point. My stop point turned out to be the stock's high point and the stock has since fallen 7%.

In conclusion: Joe Montana may be the best quarterback of all time, yet he throws some interceptions. When he walks on the field after an interception, he is confident and wants to throw again. The same should be true for investors. Build a trading system that fits your needs and stick with the system even when you are seeing losses. ■

Figure 1

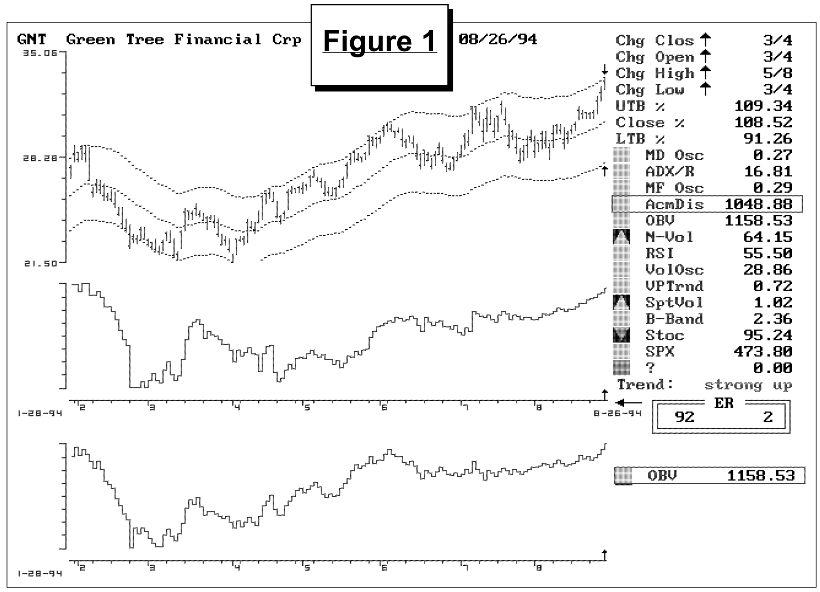


Figure 2

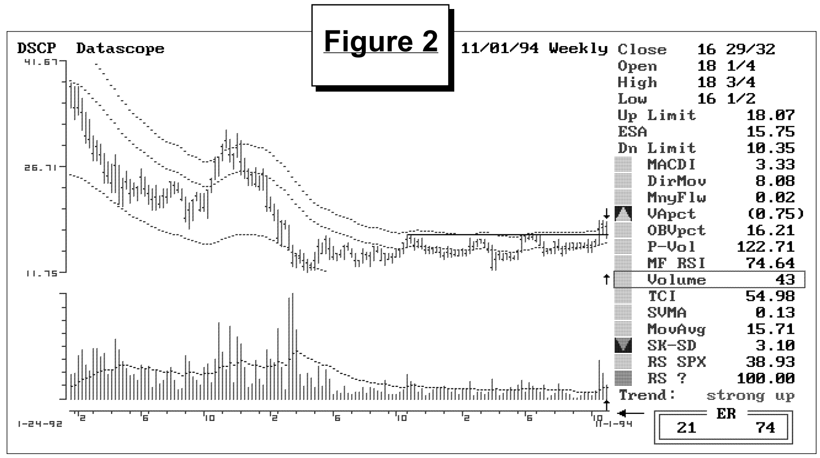
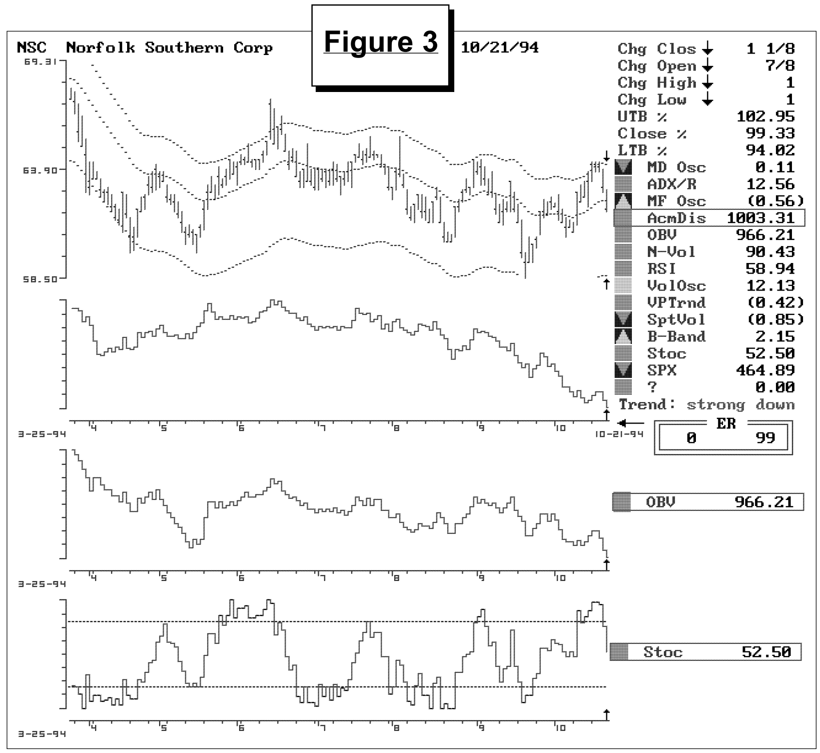


Figure 3



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GROUP OF THE MONTH

THE NEW AIQ PYRAMID

Last month, we revised the structure of the AIQ Pyramid, the industry group structure that is classified on both a fundamental and a technical basis. As a quick review, AIQ's MatchMaker program was used to test the correlation of stocks to their industry groups. Since only stocks with high correlations are retained, stocks that move independent of their industry group don't distort the group index. When all the stocks are highly correlated to their group index, the group index becomes a better representation of the underlying stocks. This structure is best suited for people who perform a top-down analysis and prefer large or mid-cap stocks.

These correlations change over time so we update the Pyramid structure about every six months. The current structure has 80 highly correlated groups that contain just under 400 stocks. The stocks that are part of the S&P 500 but are not correlated to any industry group are placed into miscellaneous files. The groups are placed into fourteen sectors. AIQ Pyramid owners can order this update for $44. The Pyramid is $188 for first time buyers.

Let's look at an example, the Banks-Western group. Dow Jones classifies eight stocks into the Banks-Western group. AIQ's MatchMaker shows that some of these stocks, including First Hawaiian, U.S. Bancorp, and Zions Bancorp, show a low correlation to the industry group index. An index of the remaining stocks is then calculated. The result is shown in Table 1. All correlation coefficients have a score that is greater than 500 so the Banks-Western group is formed from the following stocks: Bancorp Hawaii, First Interstate, First Security, Wells Fargo and West One Bancorp. ■

Table 1

6026A Banks, Western

AIQ MatchMaker Weekly Analysis

12/1/93 - 12/1/94

Coef.	Ticker	Stock
692	BOH	Bancorp Hawaii Inc
689	WFC	Wells Fargo & Co.
683	WEST	West One Bancorp
596	I	First Interstate Bancorp
559	FSCO	First Security Corp.

MARKET REVIEW

By David Vomund

Before we look at recent market timing signals, there is a correction to be made in last month's article. We said there was a 98 down signal on October 10. That should have read a 98 down on October 20. Now we know people do read our articles!

A 100 sell signal was registered on November 1. At that time, the Advance Decline line was hitting new yearly lows. Three days later, fully 80% of the stocks giving confirmed signals were on the sell side. On Balance Volume was at a five-month low and Money Flow was at a four-month low.

The next week, a 95 buy was registered on November 7. At that time, the Advance Decline line was still making new lows and few stocks were giving confirmed buy signals. The signal was confirmed by the Price Phase a few days later but not by the MACDI. Taken by itself, this was a bad signal. The lack of participation of stocks and activity on the Market Log made the signal suspect.

Finally, a 98 buy signal was registered on November 28. This signal was very different than the prior buy signal. 91% of the stocks giving unconfirmed signals were on the buy side and 75% of the stocks giving confirmed signals were on the buy side. The market initially lost ground testing people's confidence, but this signal has foretold what many are labeling the "Santa Claus rally." ■

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Thursday, Friday, and Saturday
March 23, 24, 25

Where:

Hyatt Regency Orlando International Airport

Featured Speakers:

AIQ founder Dr. J.D. Smith and "Market Wizards" author Jack Schwager

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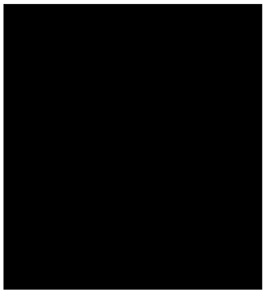
PATTERN ANALYSIS

CHART PATTERNS, PART II

By David Vomund



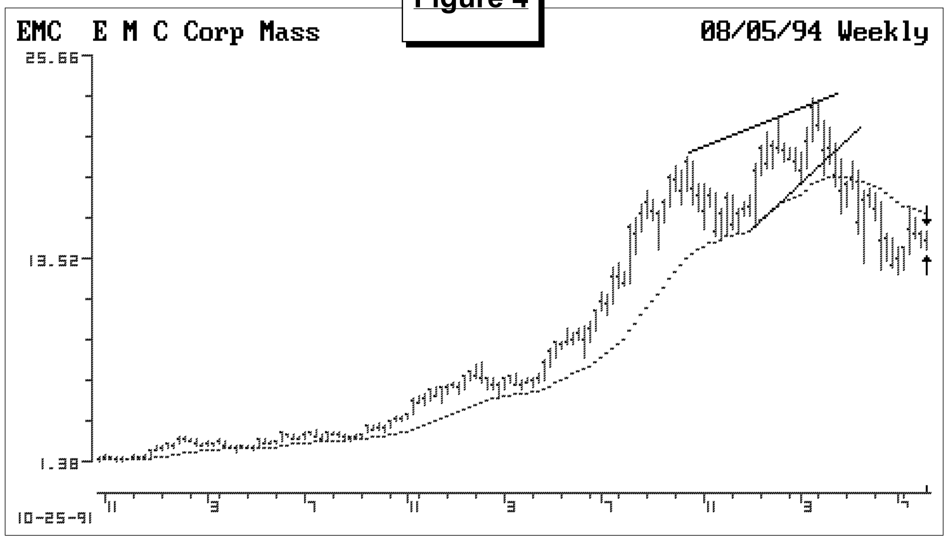
DAVID VOMUND

As discussed last month, knowledge of a handful of chart patterns can be of great value to a trader. It allows one to apply insightful analysis on top of the work performed by the AIQ software. Short term traders often prefer to use daily charts for pattern analysis, while the weekly charts give a longer term picture.

Wedge

A wedge is a pattern whose sides are not parallel and whose point is in the direction of the overall trend. The range of daily prices narrows as the price enters the wedge's intersection. Wedges are typically formed after a strong upward or downward move. For a stock in an uptrend, the break below the wedge means the security will likely begin a sideways consolidation or move lower. Ideally, volume dries up when the security is in the wedge and then the breakout occurs on heavy volume.

Figure 4

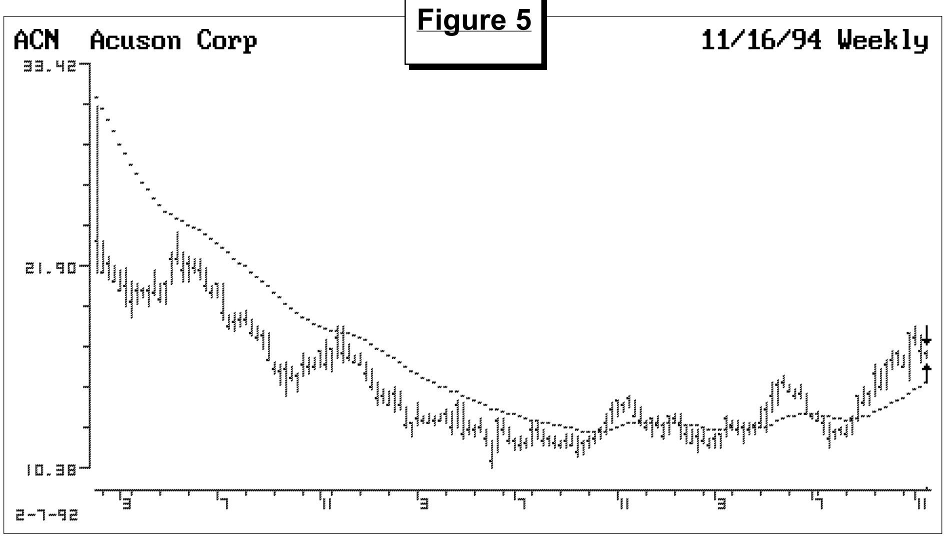


A wedge pattern is found in EMC Corp in **Figure 4**. EMC Corp was in a nice uptrend but as prices moved higher, the volatility decreased. The break below the wedge signaled the start of a correction.

Rounded Top/Bottom

This pattern is smoother than other reversal patterns. The pattern is just like its title---a direction change takes place in a smooth arching motion. This pattern is more prevalent in bottoms since expensive stocks usually don't stay high for very long. Ideally, volume is high at both ends and is low in the center. An example is seen in **Figure 5**.

Figure 5



Double Top/Bottom

This pattern is formed when a security's price rises, falls to a previous high/low, but fails to make a new high/new low. This pattern is more common but somewhat less reliable than the previously discussed patterns.

Two double top formations are seen in **Figure 6.** The main double top formation came as the stock reached a high in March '93 and then retested the same level in September '93 but failed to penetrate the March highs. A trendline is drawn at the highs. Another double top is seen in 1994's price action.

Pennant

A pennant is found when two trendlines are drawn which converge toward an apex. This is similar to the wedge except the security isn't in as

PATTERN ANALYSIS *continued* . . .

strong a trend. The direction of the ultimate breakout is unknown so trades are placed when the pennant is broken. Ideally, volume decreases as the security bounces in the pennant formation. A pennant formation is found in **Figure 7.**

Trading Channel

A trading channel is similar to the rectangle except the trendlines and the underlying security are moving up or down. The upper trendline shows resistance while the lower trendline shows support. Buy points occur when an uptrending security falls to its support trendline. When the support trendline is broken, however, it is likely that the uptrend has ended and either a consolidation or a period of sideways movement will follow.

Figure 8 is a chart of Danaher, which is currently in a trading channel pattern. The stock is in a nice uptrending pattern but the stock undergoes temporary setbacks when the upper trendline is reached. The lower trendline shows good buy points.

A good exercise is to look at your favorite stocks and try to spot some of the price patterns. Once you are able to spot the patterns historically, it is easier to spot them as they occur. When a developing pattern is seen, draw trendlines on the stock to further highlight the pattern. The Trendline Breakout Report will then tell you if any of your stocks have broken above or below one of the trendlines. ■

David Vomund is publisher of two advisories for stock and sector fund investing available by fax or mail. For free samples, phone 702-831-1544, or write Vomund Investment Services, P.O. Box 6253, Incline Village, NV 89450.

Figure 6

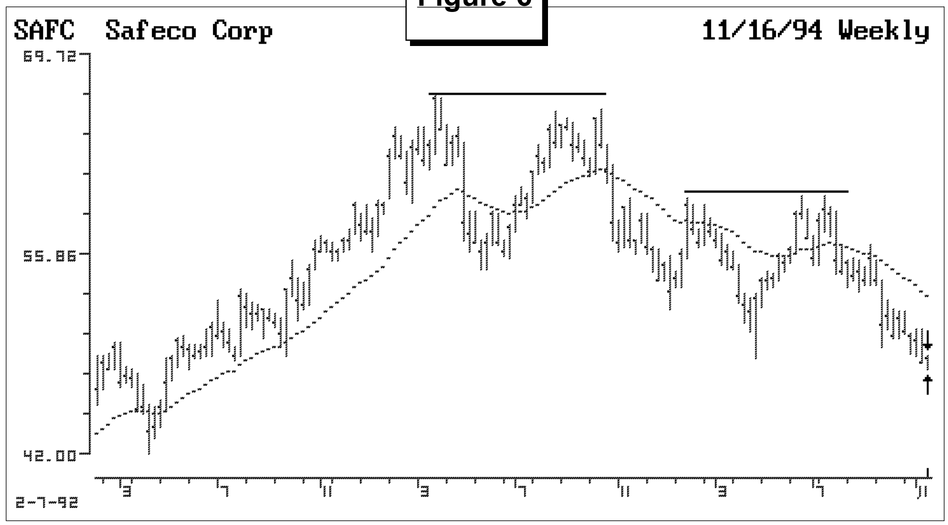


Figure 7

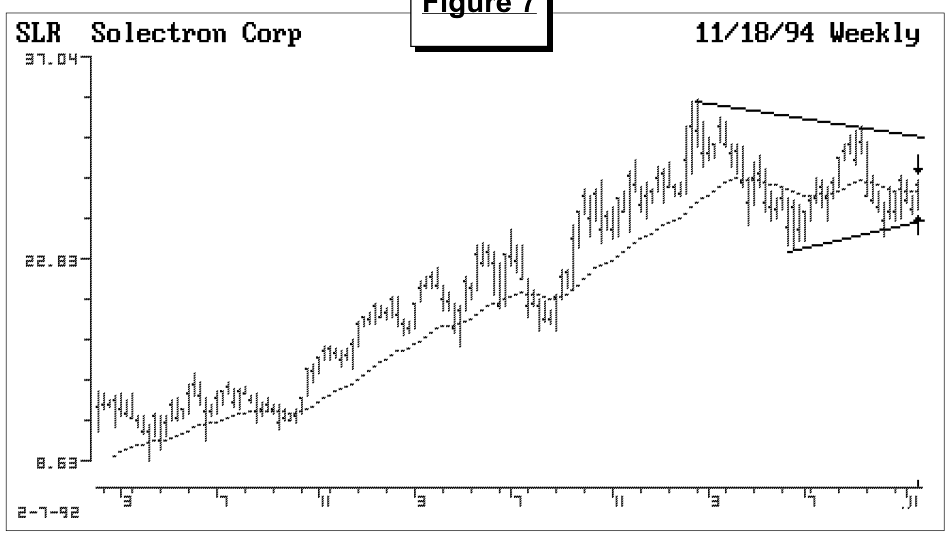
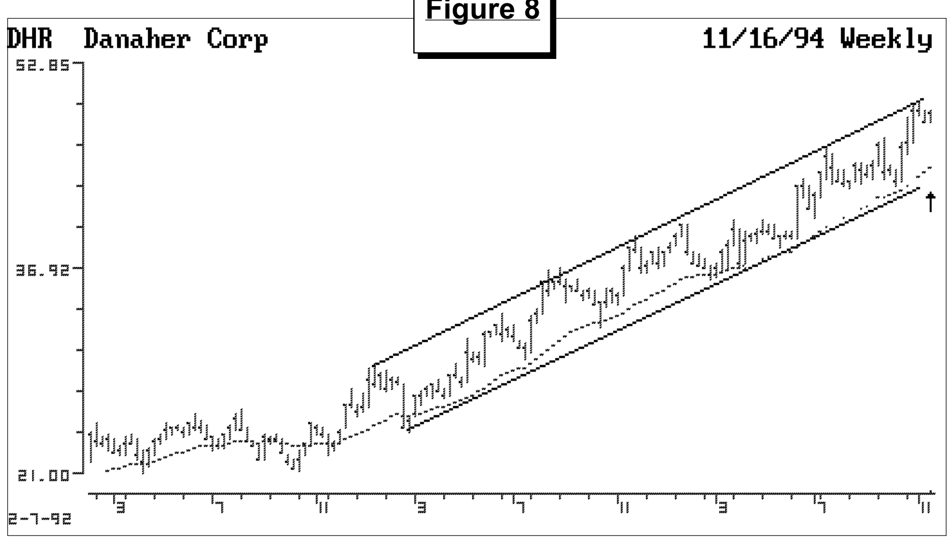


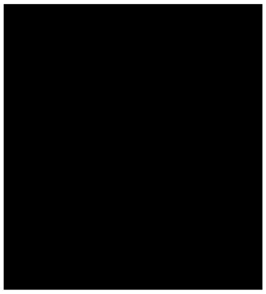
Figure 8



TOOLS OF THE TRADE

MULTIPLE CANDLESTICK PATTERNS

By Carol Tong



CAROL TONG

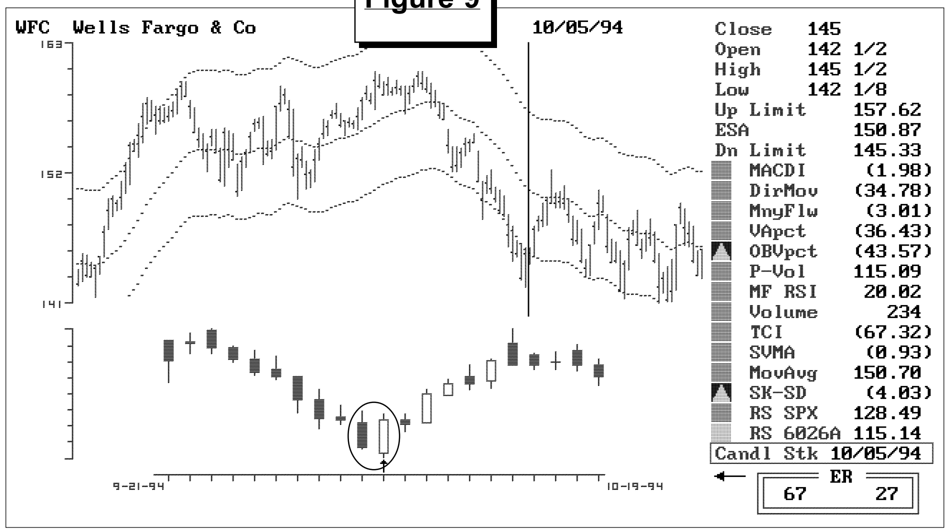
Last month, we discussed some single Candlestick formations and their significance. This month, we'll review some multiple Candlestick patterns, specifically reversal patterns.

Engulfing Patterns

Among the simplest to recognize are the Engulfing Patterns. An Engulfing Pattern is formed by two candles: the body of the first candle–white in an uptrend, black in a downtrend–is completely enclosed or engulfed by the following day's body of the opposite color, signalling an end to the existing trend. The Engulfing Pattern must occur during a trend to be considered significant, and may be bullish or bearish, depending on the color of the second, or engulfing candle.

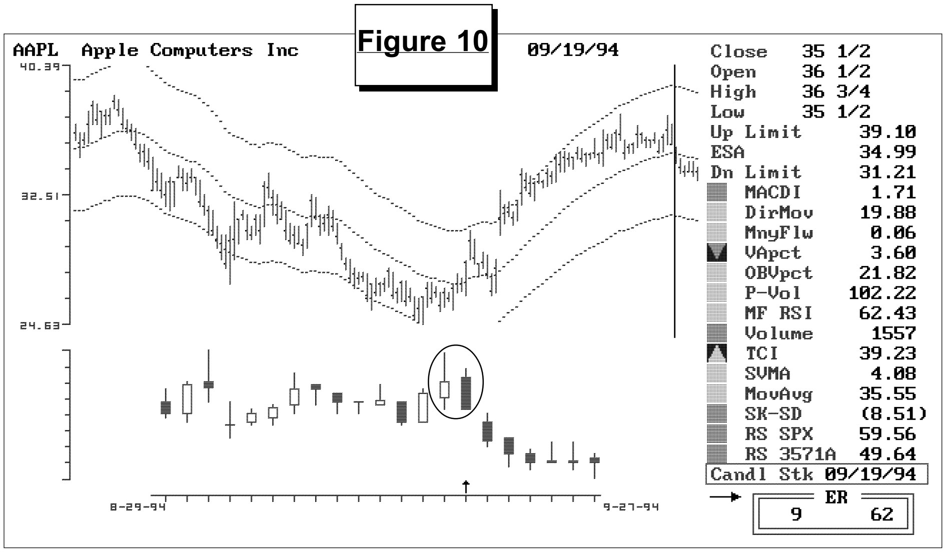
A Candlestick Chart of Wells Fargo (WFC) shows a bullish Engulfing Pattern on October 5, ending the stock's five week decline (see **Figure 9**). Here, a series of falling black candles is halted by a long white candle whose real body completely wraps around, or engulfs, the prior day's black real body. The bullish implications are easy to see – the stock opened lower than the prior day's close, but then the bulls pushed prices up to close higher than the prior day's open, forming a long white candlestick.

Figure 9



The bearish Engulfing Pattern is just the opposite: during an uptrend, a white candle's real body is completely engulfed by a long black candle body, signifying the rally is over. AAPL on September 19, 1994 is an example of a bearish Engulfing Pattern (see **Figure 10**). The Engulfing Patterns do not require, but can be especially significant if (1) there is high volume on the second (engulfing) day, reinforcing the turnaround or power shift between buyers and sellers, (2) the first day's real body is engulfed by 30% or more, or (3) confirmation is provided by a third candle of the same color as the engulfing candle.

Figure 10



Dark Cloud Cover

Unlike the Engulfing Patterns, the Dark Cloud Cover, is always bearish. This pattern is similar to, but less bearish than a bearish Engulfing Pattern. The Dark Cloud Cover is formed by two candles. The first should be a long white candle, appearing in an uptrend. The second is a black body day, opening above the prior day's high and closing at least halfway into the prior day's real body. Compaq (CPQ) showed a Dark Cloud Cover on July 13, one day after a 98 sell signal (**Figure 11**). Again, we see the uptrend in progress, when on July

TOOLS OF THE TRADE *continued . . .*

13, the stock opens higher than the prior day's close, but then the bears take control, pushing the close well below the midpoint of the prior day's body and casting shadows over the rally.

Morning Stars and Evening Stars

Three candles are required to complete this pattern. The first is a long real body day, white in an uptrend, black in a downtrend. The second day is a small real body (either color) which gaps away from the first candle, and forms the "Star". This small candle, which opens in the direction of the trend, then closes very near the open, reflects indecision in the market. The third candle's color is opposite to the trend and the first candle body color, closing well within the first candle's real body. This third candle confirms that the trend has ended and, ideally, it should gap away from the second (Star) candle.

Motorola in March of 1994 is an example of an Evening Star pattern (**Figure 12**). The stock has been in an uptrend for two months when, on March 8, a white candle body signals trend continuance. The following day, Motorola gaps up on the open, trades lower, but manages to close near the open, forming a small real body - the Star. This particular Star reflects especially bearish sentiment with its long lower shadow (Hanging Man). The third candle on March 10 confirms this with a long black real body. Although this candle did not gap away from the Star, it closed well into the first white candle body.

Three Black Crows

Another bearish pattern, Three Black Crows consists of three consecutive long black real bodies occurring in an uptrend, each one successively lower than the candle prior. The first black candle typically opens above the prior day's close. The two candles that follow are characterized by an open within the prior day's real body and a close at or near the prior day's low, creating a downward stairstep

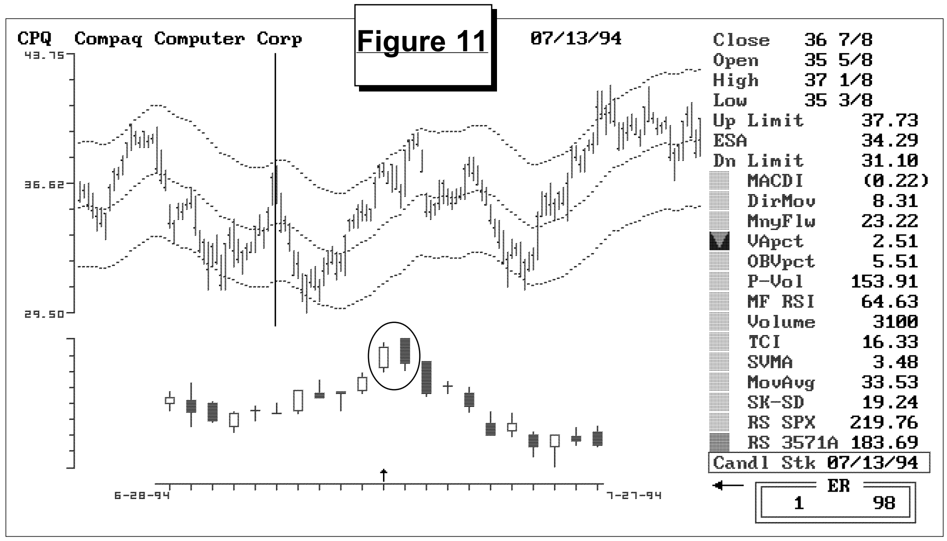


Figure 11

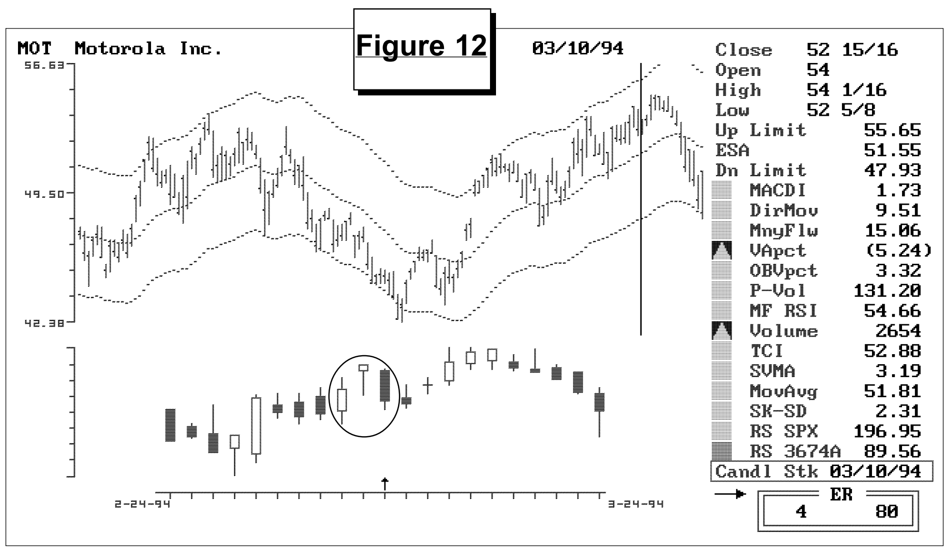


Figure 12

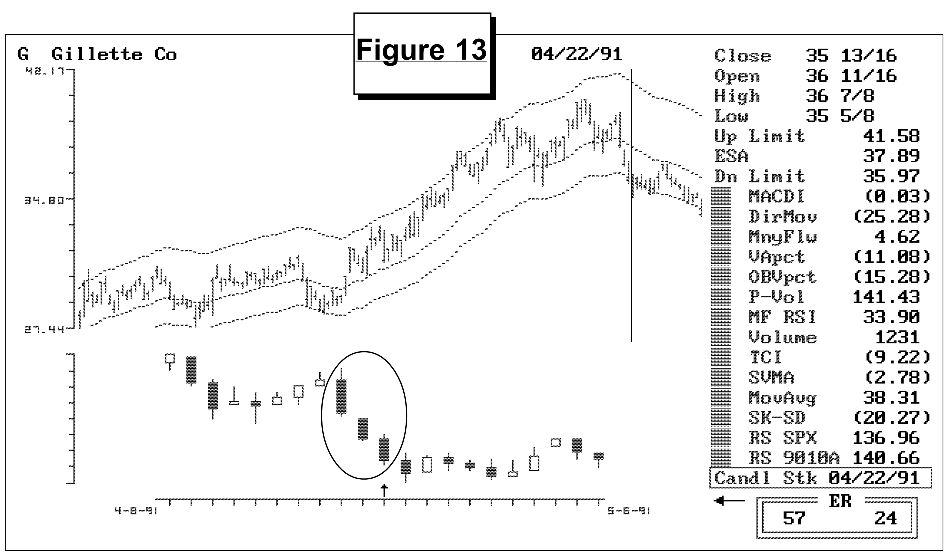


Figure 13

pattern. The Three Black Crows also translate into one very long black candle, sending a message of trend reversal. A similar pattern called Three Identical Crows is more pronounced and even more bearish. Three Identical Crows is also three downward stairstep days occurring in an uptrend. However, the second and third "Crows" open at or near the

Tools of the Trade continued on page 8

TOOLS OF THE TRADE *continued . . .*

Gillette (G) shows Three Identical Crows in April 1991 (**Figure 13**). The first "Crow" closed just beneath the 21 day ESA, which had been a support level for the four month uptrend. It's simple to see that the Three Identical Crows combine into one very long black day, ending the bulls' control over Gillette.

A mirror image of Three Black Crows is known as Three White Soldiers. Occurring during a downtrend, a series of three long white candles in an upward stairstep formation shows the downtrend is over.

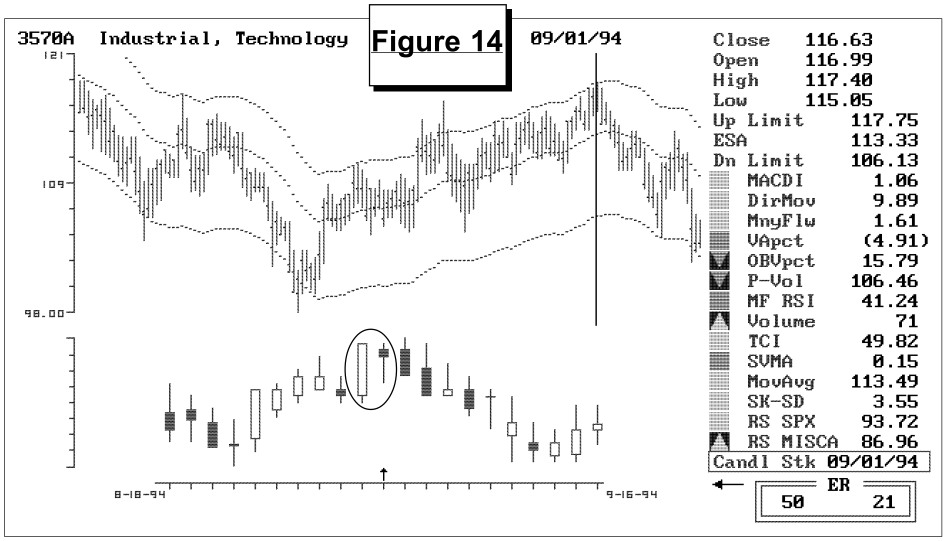


Figure 14

Harami

Our final pattern, the Harami, is a small real body which is contained within a prior relatively long real body. "Harami" is the Japanese word for pregnant. The long candlestick represents the mother and the small candlestick represents the fetus. The Harami predicts the end of a trending situation. A bearish Harami is found in **Figure 14**. Notice that on September 1, the second session has a minute real body relative to its prior candlestick and it is also contained within the prior candle.

People often believe that Candlestick Charts can only be used as a separate trading strategy. Realistically, this charting method is best used in conjunction with the other information that the AIQ software provides. Candlesticks are best used as a confirmation indicator. In other words, a bearish candlestick pattern is better when the Expert Ratings are giving bearish readings and other indicators are flashing warning signals. ■

STOCK DATA MAINTENANCE

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

Stock	Ticker	Split/Div.	Approx. Date
Analog Devices	ADI	3:2	01/05/94
United Fire & Cas.	UFCS	3:2	01/05/94
Glenayre Tech.	GEMS	3:2	01/06/94
Genovese Drug Stores	GDXA	10%	01/06/94
Pacific Scientific	PSX	2:1	01/10/94
Wackenhut Corp	WAK	5:4	01/10/94
CPAC Inc.	CPAK	5:4	01/13/94
Cagles Inc.	CGLA	2:1	01/17/94
Harolds Stores	HLD	10%	01/19/94

Stock	Ticker	Split/Div.	Approx. Date
Bush Industries	BSH	5:4	01/23/94
Danaher Corp	DHR	2:1	01/23/94
Rykoff Sexton	RYK	5:4	01/25/94
Hercules Corp	HPC	3:1	01/31/94
Jupiter Nat'l	JPI	2:1	12/16/94
StrataCom	STRM	2:1	12/16/94
Credit Acceptance	CACC	2:1	12/21/94
Conmed Corp	CNMD	3:2	12/28/94
X-Rite	XRIT	2:1	12/28/94

Ticker Changes:

Barrett Resources (BARC) to Barrett Resources (BRR)

Cavalier Homes (CXV) to Cavalier Homes (CAV)

Trading Suspended:

Anthem Electronics (ATM) Joy Technologies (JOY) Input Output (IPOP) SPI Pharmaceuticals (SPI)

Baltimore Bancorp (BBB) Keptel Inc. (KPTL) Snapple Beverage (SNPL)