

Feature

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The *Opening Bell Monthly* is a publication of AIQ Systems
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INTERVIEW

LINDA BRADFORD RASCHKE ON SHORT TERM TRADING STRATEGIES

By David Vomund

This month we are pleased to present an interview with Linda Bradford Raschke. Linda is President of LBRGroup, a firm specializing in trading and commercial hedging. She is featured in Jack Schwager's book *The New Market Wizards* and coauthored the best selling book *Street Smarts - High Probability Short Term Trading Strategies*.

Linda will be a keynote speaker at AIQ's Lake Tahoe seminar scheduled September 25 thru 27. Her speech is entitled, "Back to the Future - Modern Applications of Classic Timing Techniques." She will examine which systems and techniques have withstood the test of time, in addition to using sector analysis in your overall timing.

DV: Thanks for joining us for this interview. In your book 'Street Smarts' you give several strategies for short term traders. Do you think that anyone can trade short term or are certain personality traits required to be a successful short term trader?



Linda Bradford Raschke

LBR: Anybody who wants to can be a successful short term trader. In terms of personality, you either want to trade or you don't. People who like to trade tend to be more active traders. These are the people who do well in the markets. Several studies of FCM (Futures Commission Merchant) accounts have shown that the most successful traders

are those with the highest activity levels. Even the best intermediate term investors who use trend following systems constantly massage and adjust their positions. All the people I know who are able to support themselves by

trading tend to be very active. But in the most recent stock market environment, one has obviously been able to do well by good old fashioned investing!

DV: *How much is your own judgment a factor in your trading?*

LBR: I have found that I do better using discretion as opposed to trading a system. There are a few select systems that I trade because they force me to place a trade that I might otherwise feel far too uncomfortable with using my own discretion. These systems serve as the trigger. Many of the patterns discussed in *Street Smarts* actually have a mechanical entry or trigger to make it easier for people to trade. The system keeps them from failing to pull the trigger. For example, it is helpful to have buy stops resting in the market which will automatically take you into the trade, but then you must manage the trade in terms of how the market responds.

DV: *In 'Street Smarts' you say that the single most important secret is this: 'Listen to the markets and do not impose your will upon them.' Can you expand on this?*

LBR: It simply means not letting your positions speak for you. A lot of people get into scenario building. They might examine what they

Holy Grail Pattern

Buy rules (sells are reversed)

1. The 14-period ADX must initially be greater than 30 and rising. This is the value to the right of TradingExpert's ADX/R indicator.
2. Look for a retracement in price to the 20 period exponential moving average. This will usually be accompanied by a turndown in the ADX.
3. When the price touches the 20 period moving average, put a buy stop above the high of the previous bar.
4. Once filled, enter a protective sell stop at the newly formed swing low. Trail stops as profits grow.

perceive to be fundamental data and then make evaluation judgments. For example, they may think the market is

these losing streaks and do you ever get the urge to change your strategy when they occur?

"The worst thing you can do in terms of market timing is to buy in the middle of a trading range. Either buy new highs, or buy pullbacks, but don't put your capital to work in the middle of a trading range."

too high so they go short. On the other side of every trade is somebody who is equally convinced that it is going in the opposite direction. Who is right? The market is. The market is going to do what it wants regardless of your convictions.

If you pay attention to what the market is saying rather than forcing your will on the market, it will give you subtle clues as to what it is going to do. For example, moves often start in either direction with an impulse and a thrust. It may be a range expansion, an increase in standard deviation, a breakaway gap, or even a failure to make a lower low. There is always a message but you are not going to pick it up unless you have an open mind.

DV: *You say consistency is a necessity for successful trading, but every trader has losing streaks. How do you treat*

LBR: Consistency speaks in reference to following a specific methodology. Unfortunately, most methods don't always work in all market conditions and market conditions never persist forever. What happens is that the minute you become discouraged with a particular methodology and abandon it, market conditions change and the system begins to work again. You end up exiting every methodology at its low draw down on its equity

curve so you are always one step out of sync. If you are always switching strategies, you are probably just leaving the one that is ready to kick in.

As for losing streaks — a losing streak for most professionals is more than likely to be characterized by a flat period instead of huge losses. There is absolutely no reason in this business for small losses to become big losses. Unless you are following a trend following system which gets whipsawed during consolidations, losing streaks come from sloppy habits, trader error, or stubbornness.

I have never been tempted to change my style because I feel that my patterns and strategies don't change. The market is very basic — you buy pullbacks in a trending issue, you buy divergences, or you buy breakouts from congestion areas. Likewise on the sell side. These things don't

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INTERVIEW *continued* . . .

change over time.

DV: How important is market timing in your analysis?

LBR: Very important. It helps determine how much you want to risk and it helps determine the degree of follow through. If your timing is such that you are hopping on board right when there is an increase in momentum, then you have greatly increased the probability of follow through in your direction. Likewise, if you are not in a period of high momentum, then you may want to buy on a pullback or at the lower end of a trading range to minimize your risk. The worst thing you can do in terms of market timing is to buy in the middle of a trading range. Either buy new highs, or buy pullbacks, but don't put your capital to work in the middle of a trading range.

DV: AIQ users are primarily equity traders rather than futures or commodities traders. Do you trade stocks or are you primarily a futures trader?

LBR: I trade stocks as well. People don't appreciate that small investors have much more flexibility, especially in stocks, than institutional investors. Small investors don't have to move as much size, they don't have



to justify their decision making process to stockholders, and they don't have to show that they are 95% invested long at the end of the quarter. Institutional investors always have a different type of psychological gun to their heads.

DV: One of the easiest patterns to find that is listed in your book is the Holy

Grail (preceding page). Can you explain this pattern and give us a few examples?

LBR: This pattern uses Welles Wilder's ADX (Average Directional Index), which measures the strength of a trend over a period of time. The stronger the trend, the higher the ADX reading. This pattern takes advantage of the fact that the odds are very high that when a security makes a new momentum high and pulls back, it will retest its recent high. Therefore, any pullback from a new momentum high can be bought. Most people hesitate to buy pullbacks because a top may be in place. With this pattern, the odds that a top is in place is probably only 5% to 10%. If you look at stocks that have participated in the market's advance in the last two or three months, you'll see the majority of them have had Holy Grail patterns.

The 20 period exponential moving average often acts as support for stocks. Recently, Chevron (CHV) provided a good example. With the Holy Grail pattern, we want the stock to fall back to a 20 day moving average after its ADX indicator has moved to a value above 30.



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A good example of a Holy Grail buy is Cincinnati Milacron (CMZ) on June 23 and 24 (see **Figure 1**). CMZ touched the moving average and then continued to rally to a new high. Another example can be seen in American Express (AXP). AXP touched the moving average on July 1, rose the next day, and then jumped 7 points the following day.

When you research this pattern, you should also look at cases when it fails. A good example is Eaton Corp. (ETN). The stock had a huge thrust up and pulled back nicely to the 20 period moving average. The ADX indicator was quite high. But in the last five days (July 1 to July 8) there was little movement in the stock (see **Figure 2**). You haven't lost any money but you haven't made any money either. Today (July 8), the stock was down when the Dow made a new high. This is a case where there is no reason to be in this trade. Don't give it the benefit of the doubt.

DV: *TradingExpert has a Price Gap report which makes it easier to spot the Three-Day Unfilled Gap Reversal pattern (see description next page). Can you give us some examples of this pattern?*

LBR: Gaps are a classic tool in

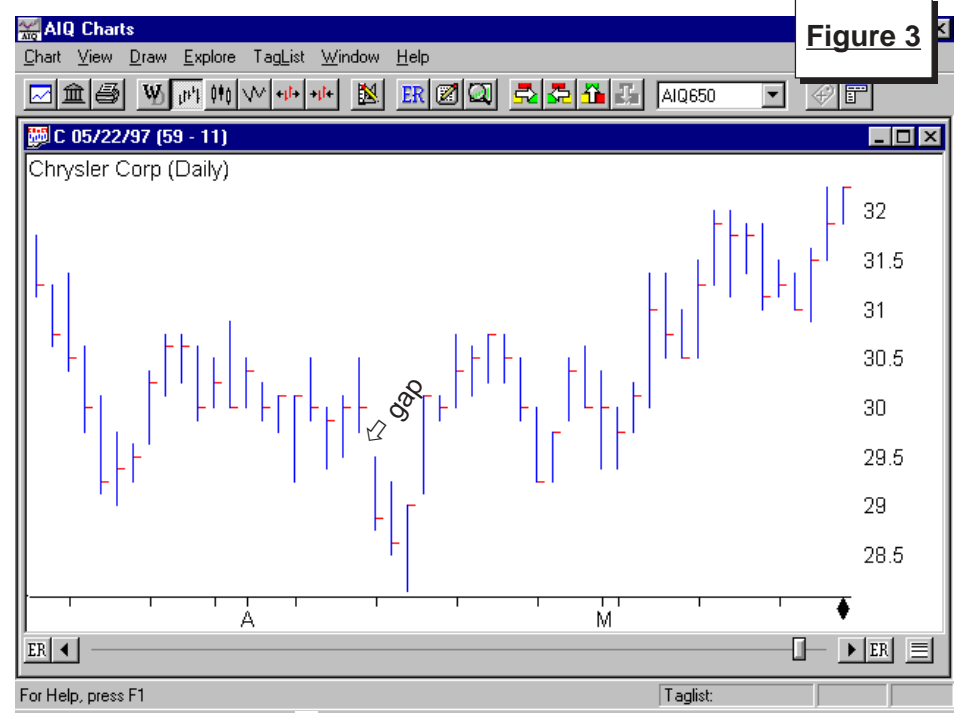


Figure 3

technical analysis. There are different types of gaps such as breakaway gaps or exhaustion gaps which come at the extremes. The Three Day Unfilled Gap Reversal signals periods where the security has exhausted itself and a reversal is close at hand. A lot of stocks had beautiful buy setups in April of this year. If you look at

Chrysler (C) you will see a perfect example (**Figure 3**). On April 11, Chrysler gapped down (see arrow). Two trading days later, the April 11 high point was surpassed. Other examples can be seen in Sears (S) and General Motors (GM). These are classic examples of trades that would still be winners as the market has never looked back.

A more recent example is Worldcom Inc. (WCOM), which gapped down on June 6 with the buy signal coming on June 10. In this case, the gap might have been caused by news, creating a false shake-out. On the sell side, Amoco Corp. (AN) just filled a gap yesterday (July 7).

DV: *Another strategy that only uses price analysis is a pattern you call the Wolfe Wave (see description next page). Can you give us some examples?*

LBR: I'll give you several examples because once you study this chart pattern you will automatically get a magically trained eye and will be able to immediately recognize the pattern. Keep in mind that when you look at this pattern you are seeing accumulation or distribution. In the last two months, we've been in a very strong upward move. There are many

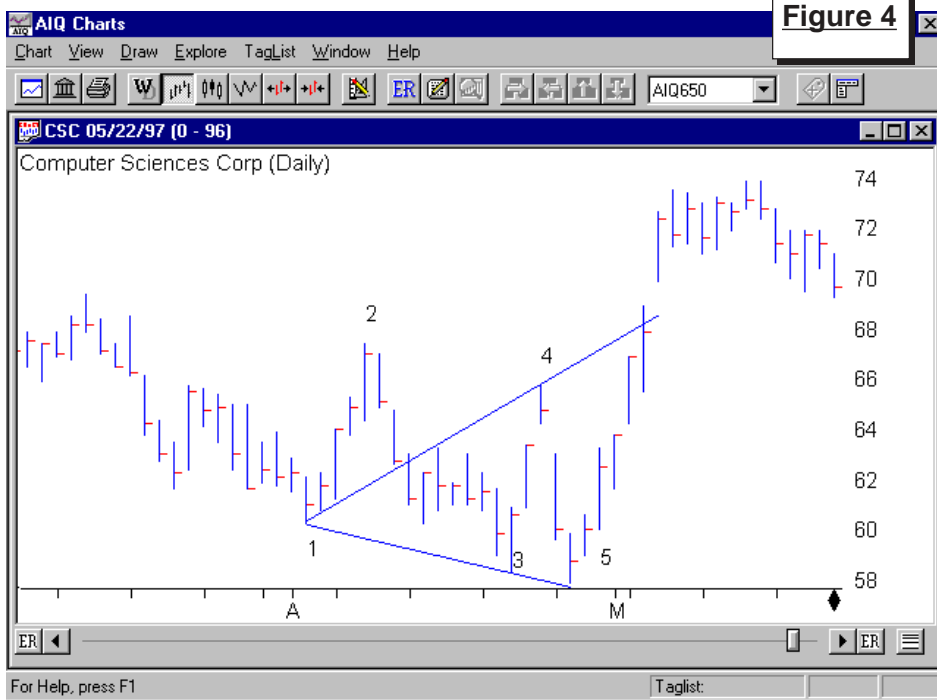


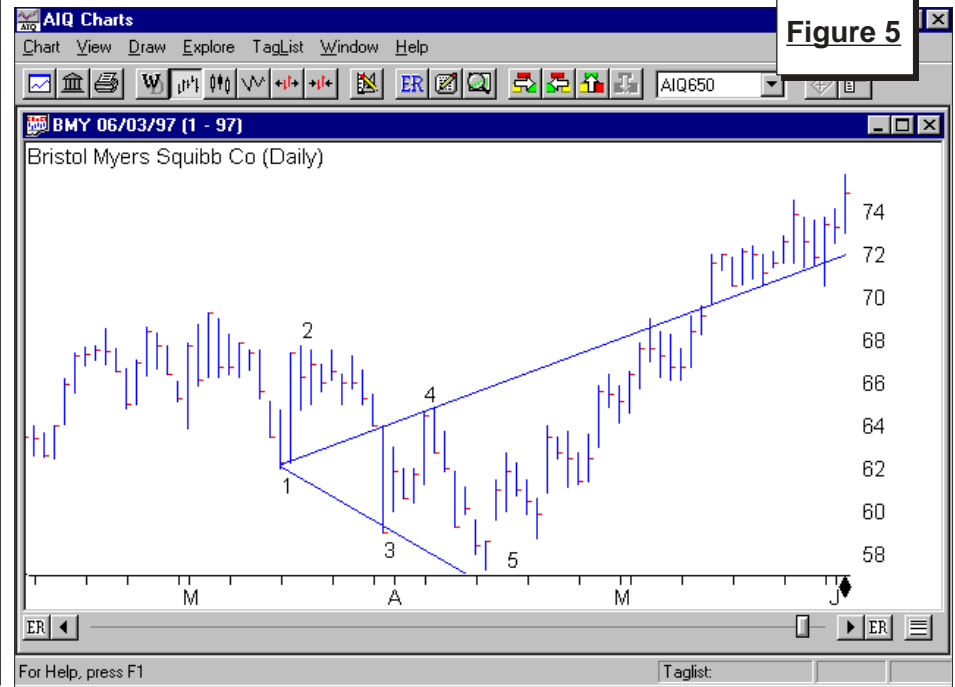
Figure 4

INTERVIEW *continued* . . .

examples of Wolfe Wave buys in April and May and now fewer are appearing as the market moves higher.

A good example is Computer Sciences Corp (CSC) during April (see **Figure 4**). Wave 1 was on April 2, wave 2 on April 8, wave 3 on April 22, and wave 4 on April 24. The buy came on April 28. Interestingly, there was also a Wolfe Wave buy on July 1 but that is more readily seen using hourly data. Another example is Bristol Myers Squibb (BMY) which gave a buy on April 14 (see **Figure 5**). Yet another example is Disney (DIS) which also gave a buy on April 14. Since the overall market is so strong, the stocks have rallied past their target prices.

You have to train your eye for sell signals as well. An example on the

**Figure 5**

Three-Day Unfilled Gap Reversals

1. Today the security gaps lower and does not fill the gap.
2. Over the next three trading sessions, have in place a buy stop one tick above the high of the gap-down day.
3. If filled, place a protective sell stop at the low of the gap-down day.
4. Protect any accrued profits with a trailing stop.
5. If not filled after three trading sessions, cancel the initial buy stop.

Wolfe Wave Construction

1. Wave 2 is the top of a bar chart.
2. Wave 3 is the bottom of the first decline after wave 2.
3. Wave 1 is then the bottom prior to the wave 2 top. Point 3 must be lower than point 1.
4. Wave 4 is the top of wave 3. Wave 4 should be higher than the wave 1 bottom.
5. A trend line is drawn from point 1 to point 3. The extension of this line projects to the anticipated reversal point which we call wave 5. This is the entry point for a ride to the target line (1 to 4).
6. The price objective of this pattern is from a trendline drawn from points 1 to 4. The initial stop is placed just beneath the newly formed reversal at point 5. It can then be quickly moved to break-even.

Note: You cannot begin looking for the Wolfe Wave until points 1, 2, 3, and 4 have been formed.

sell side is Ralston Purina (RAL). In **Figure 6** (next page), the pattern on the sell side is simply a reverse of the buy side. RAL gave a sell on June 13 and the stock fell right to its target.

Another example on the sell side is International Game Technology (IGT), which gave a sell on June 20. Digital Equipment (DEC) also gave a sell on June 20 but has since moved sideways. Here is a case where you have to manage your trade. The best trades work very well and there is no doubt that they are working. When the security starts to chop back and forth, like DEC, then you have to listen to the market rather than impose your will upon it. DEC is saying it does not want to go down.

These patterns also work with weekly data. Kroger (KR) is an example of a weekly chart that looks like it is forming a top.

DV: *Let's talk a little about stop strategies. Obviously you keep them pretty tight.*

LBR: Different patterns have different stops. Most often, I'll get out if the market fails to do what I thought it would do. The best patterns give

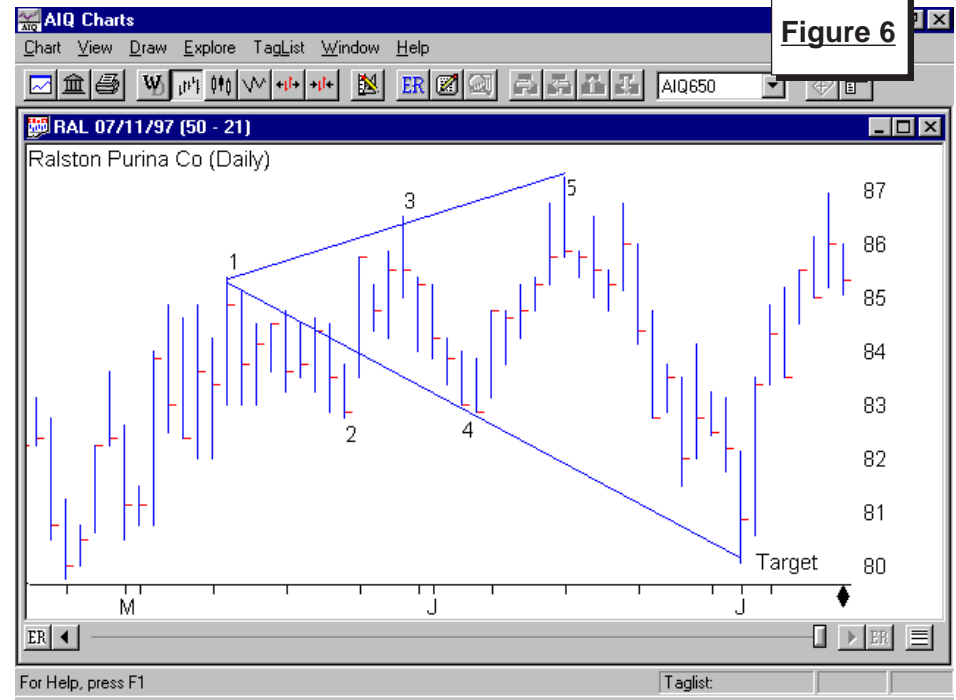
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you instant feedback. How tight a stop you use depends on how aggressive or conservative you are. If a trade feels uncomfortable, I sometimes find it easiest to place an order to exit the market on close. This takes away the psychological anguish of trying to time the exit.

DV: *It is nice to be able to sleep at night! Thanks for the interview and we look forward to seeing you at our AIQ seminar in September. ■*

Street Smarts - High Probability Short Term Trading Strategies can be purchased by calling Oceanview Financial Research at 800-797-2584. AIQ users will receive a 20% discount off the book's regular price of \$175.



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
Torchmark Corp.	TMK	2:1	08/04/97	Benchmark Elect.	BHE	2:1	08/18/97
Wesbanco Inc.	WSBC	3:2	08/04/97	Encore Wire Corp.	WIRE	3:2	08/19/97
Roper Inds.	ROP	2:1	08/04/97	Micrel Inc.	MCRL	2:1	08/20/97
Solectron Corp.	SLR	2:1	08/05/97	Tekelec	TKLC	2:1	08/25/97
Walgreen Co.	WAG	2:1	08/11/97	Plexus Corp.	PLXS	2:1	08/26/97
Dekalb Genetic	DKB	2:1	08/11/97	Level One Comm.	LEVL	3:2	08/27/97
Diamond Offshore Drill.	DO	2:1	08/15/97	AES Corp.	AES	2:1	08/29/97
Oracle Systems	ORCL	3:2	08/18/97	Keane Inc.	KEA	2:1	09/01/97
Supreme Int'l	SUPI	3:2	08/18/97	Yahoo! Inc.	YHOO	3:2	09/01/97

Trading Suspended:

Verifone Inc. (VFI), Oshkosh B'Gosh Inc. (GOSHB), Great Western Fin'l (GWF), Portland General (PGN), Fibreboard Corp (FBD), Tambrands (TMB)

Name/Ticker Changes:

Pride Petroleum Services (PRDE) to Pride Int'l (PRDE), Fed Home Loan Mtg Corp (FRE) to Freddie Mac (FRE)
 CWM Mortgage Holdings (CWM) to INMC Mortgage Holdings (NDE), Proffitt's Inc. (PRST) to Proffitt's Inc. (PFT)
 Ambac Inc. (ABK) to Ambac Financial Group Inc. (ABK), Winton Fin'l (WFCO) to Winton Fin'l (WFI)
 Stryker Corp (STRY) to Stryker Corp (SYK), Glendale Federal Bank (GLN) to Golden State Bancorp (GSB)

USING AIQ REPORTS

REDUCING THE RISK OF RELATIVE STRENGTH INVESTING

By David Vomund

DAVID VOMUND

In this year's April and July issues of the *Opening Bell*, we reported on several studies that were performed using the Relative Strength report. These studies revealed that results of buying into strength are impressive, but also the risks are high. As relative strength investors know, a small correction in the Dow can turn into a bear market for high relative strength stocks, especially for small company stocks. What goes up fast can come down faster. In this final article on relative strength investing, we'll look at ways to reduce the risk of high relative strength investing.

Using Market Timing

The most obvious way to reduce risk is to not be invested during corrections. Incorporating AIQ's

market timing model, as reported in the April 1997 *Opening Bell*, accomplishes this.

A creative technique discussed by Ian Woodward at last year's Lake Tahoe seminar is to create an index of high relative strength stocks and then use the index to help identify when relative strength investing is turning out of favor. The theory is that when the market leaders turn sour, the market will soon follow.

As an example, I ran the Relative Strength-Strong report on April 15, the day of the last AIQ buy signal. A group was created using the top ten stocks on the report (see [Figure 7](#)). When this group begins to break down, market risk is high and relative strength investing is out of favor. Depending on your time frame, a breakdown can be as quick as a drop below the 28 day moving average. A less sensitive technique would be to require both the Direc-

tional Movement Index and the Positive Volume Index to turn negative (DMI below zero and P-Vol below its signal line).

Incorporating Fundamental Analysis

A second method of reducing the risk of relative strength investing is to incorporate some form of fundamental analysis. A few of these techniques were discussed in our interview with James O'Shaughnessy, which appeared in the May 1997 *Opening Bell*. To lower risk, he will limit his relative strength screenings to stocks with a PE ratio of less than 40. A further screening discussed was to only buy high relative strength stocks with a price to sales ratio below 1.5.

By combining fundamental analysis with relative strength investing, the "war story" stocks like Micron Technology or Iomega won't be purchased at the top.

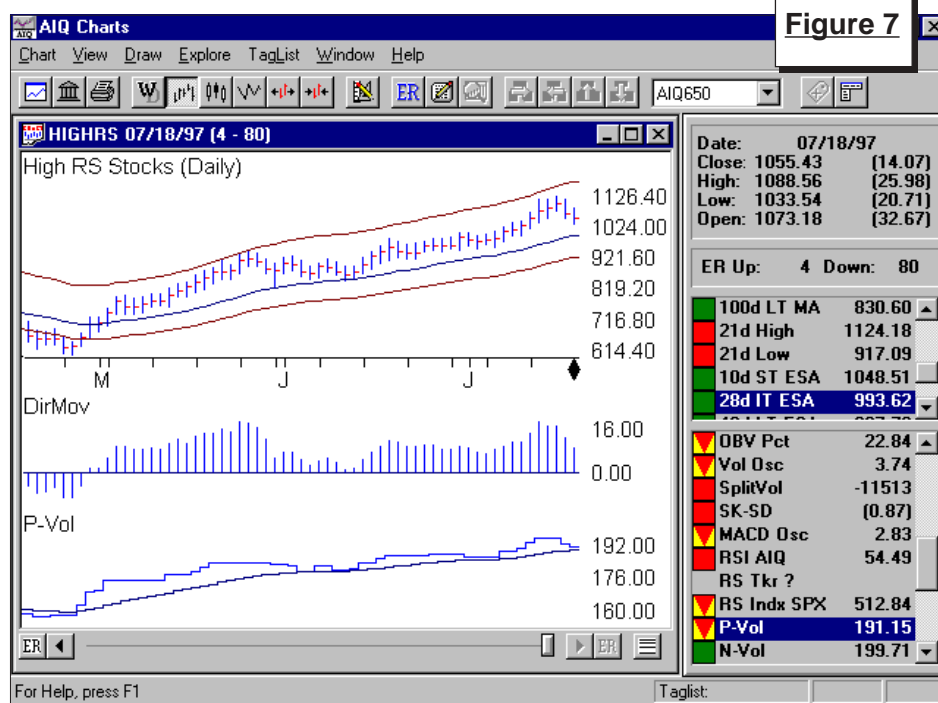
Additional Screening Reports

A final method of lowering the risk of relative strength investing is to run an additional screening report on the high relative strength stocks. Since volume is not a factor in relative strength analysis, it makes sense to run a report like Price Volume Divergence or Persistence of Money Flow on the stocks that appear near the top of the Relative Strength report.

Instead of combining a volume report with the Relative Strength-Strong report, we've chosen to use the Point & Figure Breakout report. The Point & Figure Breakout report lists stocks that have undergone a sideways consolidation followed by a break above the consolidation.

The stocks that appear near the top of the Relative Strength-Strong report are usually risky because they

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have been so strong that there are no clear support levels near their current prices. By requiring that the high relative strength stocks also appear on the Point & Figure Breakout report, we get a list of strong stocks that have recently broken above a consolidation pattern.

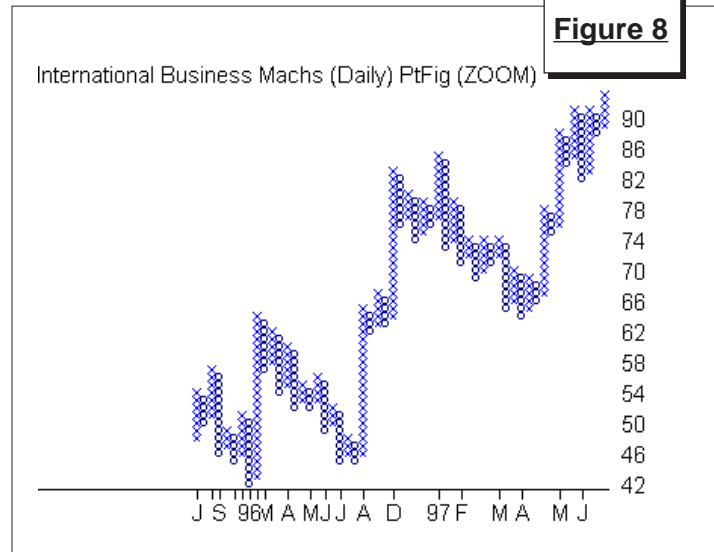
In order to screen the stocks using this technique, we'll first run the Relative Strength-Strong report and create a list of the stocks that appear near the top of the report. We'll then run the Point & Figure Breakout report on this newly created list. The result will be high relative strength stocks with recent Point & Figure breakouts.

As an example, we ran the Relative Strength-Strong report on the S&P 500 stocks on July 1. We wanted the stocks that were on the first page of the Long Term section of this report to be eligible for purchase. In order to create a list of the stocks that appear on the first page of the report, we designated the print range of the Relative Strength-Strong report to 2 pages (one page for the Short Term section, one page for the Long Term section). To change the print setting, go to the Reports application and choose the *Settings* command on the menu bar. Go to *Report Criteria*, then *Daily Stock Criteria*. Highlight the Relative Strength-Strong report and indicate 2 pages in the *Print Range* setting, which is found in the lower right corner.

After the report is generated, single click on a ticker in the Long Term section and then choose the *Build List* icon on the toolbar. This will create a list of the top stocks from the Long Term section of the Relative Strength report.

We next want to run the Point & Figure Breakout report on this newly created list. Once again, in Reports go to *Settings*, then *Global Criteria*, and *Daily Global Criteria*. Next to the *Stock* choice, select the newly created list (the default name is "reports"). Then run the Point & Figure Breakout report on this newly created list.

In our July 1 example, only one stock, Int'l Business Machines (IBM), met both criteria — a strong stock that recently broke above a consolidation pattern. Its relative strength is high as it has increased about 80% in the last year. The report places more weighting to the price activity in the last three months, a time period where IBM rose about 35%. Although IBM's relative strength was high, it did just break above a short



term consolidation pattern. This is most easily seen on IBM's Point & Figure chart (see **Figure 8**).

Notice that in May and June, IBM rallied to about \$92 but in each case sellers came in and the stock fell (X's represent rallies, O's represent declines). It wasn't until the last column of X's that IBM was able to break above the \$92 level. This level, which acted as resistance, now becomes support (as does the low point in the previous column of O's). We can see that this two-part screening process will find stocks that have performed well but have recently "taken a breather."

In Conclusion

In our series of articles on relative strength investing, we've seen some fantastic results of using the Relative Strength-Strong report. If performance was based just on returns, more people would be buying into strength. However, risk is an important part of overall performance and the risk of relative strength investing is high.

We've seen that there are ways to lower risk such as incorporating market timing, performing fundamental analysis, or running additional screening techniques on the high relative strength stocks. ■

MARKET REVIEW

The market continued its advance in July with the S&P 500, Russell 2000, and Nasdaq at all-time highs at month end.

July was a month in which market timing signals differed depending on your source of market data. Using Dial/Data or WSJ data, the market timing model fully participated in the advance as no sell signals were given. With this data, the model remained on the March 21 buy signal and a

continuation buy signal was registered on July 30, the sixth straight upside signal. However, with Telescan or Interactive Data, sell signals were registered near the end of July. Signals sometimes differ with Telescan because they use actual high and low Dow prices instead of theoretical values. Interactive Data's signals are almost always in line with Dial/Data. The sell seen near the end of July is a rare exception. ■ --D.V.