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Letter from the Editor

While the goal of the Journal of Technical Analysis is to present to you a publication of the highest standard with the best academic work in our industry, it is also our goal to push a few buttons so that readers and contributors alike may reflect on the direction of our industry and provide fuel for thought for our further development.

In this issue you will find six eloquently written papers with opinions backed and derived from testing. Some readers may have read a few of these papers before as several are award winners. But as your editor, let me ask you to revisit all these papers because they shed a light on our industry in a way that is meaningful as a collected body of work. One question we need to ask ourselves is, Where do we want technical analysis to be in five, ten, or perhaps twenty years from now? Another question I challenge our entire industry to reflect upon is this; What responsibility does a technical analyst have to minimize risk to principle and minimize capital drawdown? Are these responsibilities entirely in the hands of the trader? As an example you will find Parker Evans, in An Empirical Study of Rotational Trading Using the %b Oscillator, offers in his own conclusion, “Admittedly, we have presented back test results that fly in the face of the well-worn trader’s axiom, Cut your losses short; let your profits run. Table 2 confirms that the %b BW system offers no protection against ruinous losses at the asset level.” In the paper named Ichimoku Kinko Hyo, by Véronique Lashinski, Table I: offers total results showing the percentage of winners is less than 40%. In Buff Dormeier’s paper, Price and Volume, Digging Deeper, early versions had a bullish bias to the paper that was identified by the Judges for the Charles Dow Award. When a larger look back period within the charts was requested, it was discovered the equity curve in Chart 7 experienced a sharp drawdown in 1998, though the summarized results would not be significantly impacted.

If any logic being examined experiences a 40 - 50% drawdown at any point, yet still ends with a strong finish that yields a statically backed positive conclusion, is this something we can view as reality and genuine growth to our Body of Knowledge about our tools and methods? Would a professional analyst still be employed the full duration of a test interval if a sharp equity curve “blip” occurs? We each have different views about acceptable risk exposure. While this is not an easy answer, the question must be considered.

Statistics is essential to prove the validity of our methods, but are our methods being tested to mirror how they are used by the most skilled technicians? If only small integral parts of a skilled technicians’ logic tree is tested, does it help or hurt our industry and the method being examined? I do not know how to bring the best technicians and most accomplished academic statisticians together, but I am confident our industry as a whole would benefit if we could find a solution to this pickle we find ourselves currently. These papers deserve the highest recognition, but it is my hope they prompt you to give the goals of our industry and how best to move our craft forward much deeper thought.

The final article is a reprint excerpt from the book Benner’s Prophecies of Future Ups and Downs in Prices written by Samuel Benner in 1884. Benner touches upon Fibonacci cycles and considers cycles of prosperity and contraction in several markets. We will begin to include a reprint in each Journal issue from hard to find works that mark historical milestones in our industry. Benner’s Prophecies is a most appropriate selection to begin this new addition to the Journal because the book is recognized as the first financial book written in North America with technical forecasts. Considering current global equity market trends you will find this work written over a century ago on market panics a most intriguing read.

Respectfully,

Connie Brown, CMT
Submission and Style Instructions

1. All submitted manuscripts must be original work that is not under submission at another journal or under consideration for publication in another form, such as a monograph or chapter of a book. Authors of submitted papers are obligated not to submit their paper for publication elsewhere until the Journal of Technical Analysis renders an editorial decision on their submission. Further, authors of accepted papers are prohibited from publishing the results in other publications that appear before the paper is published in the Journal of Technical Analysis, unless they receive approval for doing so from the editor. Upon acceptance of the paper for publication, we maintain the right to make minor revisions or to return the manuscript to the author for major revisions.

2. Authors must submit papers electronically in Word (*.doc) format. All figures (charts) in *.jpg or *.bmp format to the editor, Connie Brown, (journal@mta.org). Manuscripts must be clearly typed with double spacing. The pitch must not exceed 12 characters per inch, and the character height must be at least 10 points.

3. The cover page shall contain the title of the paper and an abstract of not more than 100 words. The title page should not include the names of the authors, their affiliations, or any other identifying information. That information plus a short biography including educational background, professional background, special designations such as Ph.D., CMT, CFA, etc., and present position and title must be submitted on a separate page.

4. An acknowledgement footnote should not be included on the paper but should also be submitted on a separate page.

5. The introductory section must have no heading or number. Subsequent headings should be given Roman numerals. Subsection headings should be lettered A, B, C, etc.

6. The article should end with a non-technical summary statement of the main conclusions. Lengthy mathematical proofs and very extensive detailed tables or charts should be placed in an appendix or omitted entirely. The author should make every effort to explain the meaning of mathematical proofs.

7. Footnotes: Footnotes in the text must be numbered consecutively and typed on a separate page, double-spaced, following the reference section. Footnotes to tables must also be double-spaced and typed on the bottom of the page with the table.

8. Tables: Tables must be numbered with Roman numerals. Please check that your text contains a reference to each table. Indicate with a notation inserted in the text appropriately where each table should be placed. Type each table on a separate page at the end of the paper. Tables must be self-contained, in the sense that the reader must be able to understand them without going back to the text of the paper. Each table must have a title followed by a descriptive legend. Authors must check tables to be sure that the title, column headings, captions, etc. are clear and to the point.

9. Figures: Figures must be numbered with Arabic numerals. All figure captions must be typed in double space on a separate sheet following the footnotes. A figure’s title should be part of the caption. Figures must be self-contained. Each figure must have a title followed by a descriptive legend. Final figures for accepted papers must be submitted as either * . jpg or *.bmp files.

10. Equations: All but very short mathematical expressions should be displayed on a separate line and centered. Equations must be numbered consecutively on the right margin, using Arabic numerals in parentheses. Use Greek letters only when necessary. Do not use a dot over a variable to denote time derivative; only D operator notations are acceptable.

11. References: References to publications in the text should appear as follows: “Jensen and Meckling (1976) report that …” References must be typed on a separate page, double-spaced, in alphabetical order by the leading author’s last name. At the end of the manuscript (before tables and figures), the complete list of references should be listed in the formats that follow:

For monographs or books:
Fama, Eugene F., and Merton H. Miller, 1972, The Theory of Finance (Dryden Press, Hindsdale, IL)

For contributions to major works:

For Periodicals:

Please note where words are CAPITALIZED, italics are used, (parentheses) are used, order of wording, and the position of names and their order.
An Empirical Study of Rotational Trading Using the %b Oscillator

H. Parker Evans, CFA, CFP, CMT

Introduction

Academic finance is replete with studies supporting or denying the existence of serial correlation in securities prices.\(^1\) In effect, such studies test the weak form efficient market hypothesis (EMH). *Simply put, can investors use technical analysis to beat the market?*

Before an attempt is made to answer that question, it is necessary to define “the market.” For the purposes of this paper, “the market” is the constituent stocks of the S&P 500 Index. The S&P 500 Index, after all, is probably the most widely recognized market proxy and in practice, investors index billions of dollars to it. S&P 500 stocks are liquid and extensively researched by a multitude of technical and fundamental analysts. Consequently, one might expect that these stocks would represent a highly efficient segment of the stock market.

Bollinger Bands and the %b Oscillator

The %b Oscillator is a technical indicator derived from the well-known, popular Bollinger Bands indicator. “Bollinger Bands are a technical trading tool created by John Bollinger in the early 1980s. They arose from the need for adaptive trading bands and the observation that volatility was dynamic, not static as was widely believed at the time.”\(^2\) Bollinger bands are moving average envelopes typically plotted two standard deviations above and below a moving average of price closes. In an end-of-day price chart, %b plots as an oscillator, measuring the closing price in relation to its upper and lower Bollinger Band. An analogous technical indicator is the raw stochastic %K oscillator.\(^3\) Raw %K measures the closing price relative to the high and low price of a trading range of specified length. By definition, %K oscillates between 0 and 100. Zero means the stock closed at the low of the trading range, 100 means the stock closed at the high. Likewise for %b, except that on rare occasions a stock can close with %b below 0 or above 100, representing a two-sigma event. Conceptually, %b numerically identifies the closing stock price relative to its volatility-adjusted trading range.

In Figure 1, the dprice chart for Wal-Mart stock (WMT) covers five years of daily high-low-close prices. In the top pane, is plotted a simple 65-day moving average of closing prices represented by the middle blue line. The related Bollinger Bands are plotted in red, exactly two-sigma above and below the middle blue moving average line. In the bottom pane, plot %b is plotted as an oscillator. Here %b is defined as overbought when it is greater than 90 and oversold when less than 10. The overbought %b condition is highlighted in red and oversold is highlighted in green.

Figure 1. WAL - Daily

\[\text{Created with AmiBroker - advanced charting and technical analysis software, http://www.amibroker.com}\]
Rotational Trading

Rotational trading is a method of using rank-ordered asset lists to construct investment portfolios. For example, both Value Line and Zacks Investment Research offer well-known research products featuring proprietary stock timeliness rankings. These services assign a rank, one to five, to each asset in their coverage universe. Using these rankings, a rotational system might buy stocks ranked #1, sell when they drop below rank #2, and rotate those proceeds back into stocks ranked #1. For many years, Investor’s Business Daily has published proprietary relative strength rankings for stocks ranging from one to ninety-nine. Such increased granularity is useful for active rotational trading, as will be demonstrated further on.

As always, a complete trading system must address position sizing and answer: What percentage risk of total portfolio equity can be exposed on any given trade or asset?

Portfolio Selection Using Relative %b

The basis for using %b as a momentum oscillator stems from the empirical observation that extreme price excursions have a tendency for mean reversion, i.e. possible negative serial correlation. In Technical Analysis Explained (Pring, Martin J., McGraw-Hill, 2002), Martin Pring warned against relying solely on momentum oscillators when analyzing individual securities. “Momentum signals should always be used in conjunction with a trend reversal signal by the actual price.” This paper will test the opposite idea within a portfolio context. We will boldly buy weakness and sell strength without waiting for evidence of a reversal in price. To mix metaphors, the strategy will systematically “catch the falling knife” and sell the “dead cat” bounce without regard to any other technical indicator.

Specifically the trading algorithm will buy stocks with the very lowest %b ranks and sell when they increase rank relative to other stocks. Understand that a portfolio of stocks will be bought that have the lowest %b relative to all other stocks in a specified selection universe.

In Technical Analysis from A to Z (Achelis, Steven B. Chicago: Irwin, 1995), John Bollinger states, “When prices move outside the bands, a continuation of the current trend is implied.” Because a reasonable observer could interpret this rule as a contradiction to what we propose to test, we will also consider what happens if we reverse our trading rule, buying strong stocks with the very highest %b (presumably stocks “outside the band”) and selling only when they drop in rank.

Now to answer the original question, by using the %b oscillator coupled with rotational trading rules, we can select stock portfolios that beat the risk-adjusted return of the S&P 500 index. We report empirical evidence supporting this thesis later in the results section of this paper. In addition, an important purpose of this paper is to provide sufficient detail to allow other analysts to replicate our (back-tested) results and to modify or adapt our methods if desired. That detail comes next in the methods and materials section of this paper.

Methods & Materials

Sample Selection

Acquiring an appropriate sample for back testing proved daunting. Initially we ran some preliminary back tests of our proposed %b indicator on a sample consisting of those stocks in the S&P 500 as of February 2007. This back test generated very impressive results from 1990 forward. In fact, the results seemed too good to be true. We realized that other analysts could justifiably criticize the backtest sample as suffering from survivor bias and look-ahead bias. Look-ahead bias results from using information in a backtest that was unknown during the period analyzed. Clearly, investors in 1990 had no way to know what stocks would constitute the S&P 500 in 2007. Survivor bias results when a study fails to account for stocks that have ceased trading due to mergers, acquisitions or bankruptcies. Survivor bias also results when for other reasons an index selection committee deletes and replaces a constituent.

What we wanted for our sample was the full history of closing quotes for all stocks that were in the S&P 500 from 1990-2006 during the time those stocks were in the index, including the non-surviving stocks. We were unable to acquire that sample. Instead, we created a sample selection universe using the following protocol.

Our sample contains end-of-day-prices for seventeen years, 1990-2006, on S&P 500 constituent stocks. From 1990-1997 we included only stocks that were on the January 1990 S&P 500 constituent list. From 1998-2006 we included prices for all stocks on the January 1998 constituent list. Starting in 2004 for the period 2004-2006, we added all prices for all stocks appearing on the January 2004 constituent list. For all spans and the full period, we included prices of non-surviving stocks up to the date that they ceased trading. Our sample contains 815 stocks, 490 of which were trading at year-end 2006.

Software Tools and Data Services

We downloaded constituent lists for the S&P 500 and prices for inactive, non-surviving stock from the Bloomberg Professional Terminal. We downloaded surviving stock price histories from Yahoo Finance. We primarily used Amibroker’s popular technical analysis and charting software application, and the Amibroker Formula Language to design and test trading strategies and indicators. We used also Microsoft Excel for various purposes in our study.

Variables, Trading Algorithm, Code

We tested a system based on 65-trading-day (three months) %b against our sample selection universe. At the close of every trading day over the test period, our trading algorithm ranked all stocks from highest to lowest according to %b score. On the first trading day, January 2, 1990, the trading algorithm bought the 40 lowest ranked stocks, investing 2.5% of portfolio equity in each stock. Once purchased, the algorithm held any given stock until it moved up and out of the ranks of the 80 lowest ranked stocks. At that point, the algorithm sold the stock and rotated the proceeds back into one of the 40 lowest ranked stocks not already held. The back test ended December 31, 2006. The algorithm recorded trade executions at the closing price the next day after order entry. The algorithm continued to execute this rotational trading every trading day of the 17-year back test period. At the time of purchase, the amount invested in any stock purchase could not exceed 2.5% of current portfolio equity but could be less if available cash was less than 2.5%. There was no rule forcing rebalancing of existing positions. The system traded long only, without margin, and stayed 100% invested. We named this strategy “%b BW” (Buy Weakness).

Here is the code in Amibroker Formula Language:

```plaintext
//Indicator
PB=100*(C-BandBot(C,65,2.5)) / (BBandTop(C,65,2.5)-BBandBot(C,65,2.5));
//Filter
z=Iff(C1 AND DateNum()<980101,0,1);
//System and Backtest Settings
EnableRotationTrading();
SetOption("worstrankedhold",80); SetOption("maxopenpositions",43); SetOption("allowpositionshrinking",true); SetOption("hold winners",4); PositionSize = 2.5;
PositionScore = (100 - PB)*z ; PositionScore = Max( PositionScore, 0 );
```
Variable Initialization and Optimization

Note that in the fourth line of the code we applied a filter. This filter removes stocks from purchase consideration and forces a sale if the stock price was under $1.00 and the date was after January 1, 1998. Although this filter actually reduced system total return, we used it anyway because when inspecting the trade logs we noticed that the system was initiating trades in low price stocks that were no longer in the S&P 500 (though they were at one time). Because our sample price data is split-adjusted, we avoided applying the filter to prices before 1998 since many stocks before that time traded at actual prices much higher than their sub $1.00 split-adjusted price would indicate and were in fact in the S&P 500.

In order to reduce trade activity, we also required the algorithm to hold a stock at least four trading days before selling (SetOption("holdminbars", 4)). We chose 65-day %b, 80-rank “worst rank held”, and 2.5% position size without rigid optimization for maximum total return or any other specific outcome. In our judgment, system performance was reasonably robust across a relevant range of optimization values.

Our reported back test results assume a 0.1% cost per trade (0.2% round-trip). We noticed that very short (5-20 day) %b BW back tested impressively with a 0% assumed cost, but performance degraded dramatically when tested with a 0.1% cost per trade.

We also tested our rule in reverse by changing the second to last line of the code from – PB to + PB. We named this strategy “%b BS” (Buy Strength) since it buys strong stocks with high relative %b. Recall that high %b means that a stock price is near or above its top Bollinger Band.

Results

Table 1 presents the results of our back tests on the custom sample described previously. The first column represents a buy and hold strategy on the S&P 500 price index over the backtest period. The second column tests our proposed strategy, %b BW. The final column tests the %b BS Strategy.

<table>
<thead>
<tr>
<th></th>
<th>Buy and Hold S&amp;P 500</th>
<th>%b BW (Buy Weakness)</th>
<th>%b BS (Buy Strength)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial Capital Invested</strong></td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>Ending Capital</strong></td>
<td>$401,329</td>
<td>$3,909,757</td>
<td>$142,890</td>
</tr>
<tr>
<td><strong>Total Return</strong></td>
<td>301%</td>
<td>3809%</td>
<td>43%</td>
</tr>
<tr>
<td><strong>Annualized Total Return</strong></td>
<td>8.50%</td>
<td>24.10%</td>
<td>2.10%</td>
</tr>
<tr>
<td><strong>Annualized Standard Deviation</strong></td>
<td>15.90%</td>
<td>17.70%</td>
<td>-</td>
</tr>
<tr>
<td><strong>Sharpe Ratio</strong></td>
<td>0.35</td>
<td>1.19</td>
<td>-</td>
</tr>
<tr>
<td><strong>Annualized Alpha vs. S&amp;P 500</strong></td>
<td>0</td>
<td>13.89</td>
<td>-</td>
</tr>
<tr>
<td><strong>Tracking Error</strong></td>
<td>0</td>
<td>12.04</td>
<td>-</td>
</tr>
<tr>
<td><strong>Information Ratio</strong></td>
<td>0</td>
<td>1.15</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total # of Trades</strong></td>
<td>1</td>
<td>13,778</td>
<td>17,166</td>
</tr>
<tr>
<td><strong>Average Trades per Day</strong></td>
<td>0</td>
<td>3.2</td>
<td>4</td>
</tr>
<tr>
<td><strong>Average Net Profit per Trade</strong></td>
<td>301%</td>
<td>1.20%</td>
<td>0.11%</td>
</tr>
<tr>
<td><strong>Average # of Trading Days Held</strong></td>
<td>4288</td>
<td>14.37</td>
<td>11,64</td>
</tr>
<tr>
<td><strong>% of Total Trades Profitable</strong></td>
<td>-</td>
<td>65.20%</td>
<td>41.70%</td>
</tr>
<tr>
<td><strong>Worse Loss on a Single Trade</strong></td>
<td>-</td>
<td>-98.30%</td>
<td>-98.20%</td>
</tr>
<tr>
<td><strong>Maximum system % Drawdown</strong></td>
<td>49.20%</td>
<td>-33.40%</td>
<td>46.00%</td>
</tr>
<tr>
<td><strong>Applied % Transaction Costs per Trade</strong></td>
<td>0.00%</td>
<td>0.10%</td>
<td>0.10%</td>
</tr>
</tbody>
</table>

*A similar back test of %b BW on our initial biased sample (the current S&P 500 constituents) generated annualized total return of 31.6%, %b BS generated annualized total return of 3.2%. We provide this information as an example of the potential effects of sample bias on reported system performance. Also, note that the pronounced difference in total return between the two strategies appears to be relatively consistent regardless of the sample.*
Figure number two is a profit distribution histogram of all trades executed by the %b BW (Buy-Weakness) Strategy over the 17 years back-test period. Table 2 lists the 14 trades returning the extreme losses in the histogram.

![Figure 2. Profit Distribution Histogram of 13,788 trades, %b BW Strategy, 1990 -2006](image)

Table 2. The 14 largest losers of 13,788 trades, %b BW Strategy 1990-2006

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Asset Description</th>
<th>Date Bought</th>
<th>Price</th>
<th>Date Sold</th>
<th>Exit Price</th>
<th>% loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>ENRNQ UN Equity</td>
<td>ENRON CORP</td>
<td>10/23/2001</td>
<td>19.79</td>
<td>11/29/2001</td>
<td>0.36</td>
<td>-98.18%</td>
</tr>
<tr>
<td>ACKH UN Equity</td>
<td>ARMSTRONG HOLDINGS INC</td>
<td>9/15/2000</td>
<td>14.0625</td>
<td>11/30/2000</td>
<td>0.9375</td>
<td>-93.33%</td>
</tr>
<tr>
<td>DPHIQ</td>
<td>DELPHI CORP</td>
<td>9/12/2005</td>
<td>4.21</td>
<td>10/11/2005</td>
<td>0.36</td>
<td>-91.45%</td>
</tr>
<tr>
<td>WCOEQ UQ Equity</td>
<td>WORLDCOM GROUP</td>
<td>1/22/2002</td>
<td>12.28</td>
<td>5/30/2002</td>
<td>1.67</td>
<td>-86.40%</td>
</tr>
<tr>
<td>KMRTQ UN Equity</td>
<td>KMART CORP/OLD</td>
<td>12/5/2001</td>
<td>6.26</td>
<td>1/23/2002</td>
<td>0.89</td>
<td>-85.78%</td>
</tr>
<tr>
<td>DCNAQ UN Equity</td>
<td>DANA CORP</td>
<td>1/18/2006</td>
<td>4.84</td>
<td>3/6/2006</td>
<td>0.76</td>
<td>-84.30%</td>
</tr>
<tr>
<td>WAN/B UA Equity</td>
<td>WANG LABORATORIES - B</td>
<td>7/27/1992</td>
<td>2.75</td>
<td>9/24/1992</td>
<td>0.44</td>
<td>-84.00%</td>
</tr>
<tr>
<td>SGID UN Equity</td>
<td>SILICON GRAPHICS INC</td>
<td>4/24/2001</td>
<td>2.6</td>
<td>7/11/2001</td>
<td>0.51</td>
<td>-80.38%</td>
</tr>
<tr>
<td>KMRTQ UN Equity</td>
<td>KMART CORP/OLD</td>
<td>2/28/1995</td>
<td>12.75</td>
<td>3/22/1995</td>
<td>3</td>
<td>-76.47%</td>
</tr>
<tr>
<td>CPNLQ</td>
<td>CALPINE CORP</td>
<td>11/7/2005</td>
<td>2.04</td>
<td>11/30/2005</td>
<td>0.51</td>
<td>-75.00%</td>
</tr>
<tr>
<td>DALRQ UN Equity</td>
<td>DELTA AIR LINES INC</td>
<td>7/28/2005</td>
<td>2.85</td>
<td>9/13/2005</td>
<td>0.78</td>
<td>-72.63%</td>
</tr>
<tr>
<td>ETS UN Equity</td>
<td>ENTERASYS NETWORKS INC</td>
<td>2/5/2002</td>
<td>32</td>
<td>4/30/2002</td>
<td>8.8</td>
<td>-72.50%</td>
</tr>
<tr>
<td>NT</td>
<td>NORTEL NETWORKS CORP</td>
<td>2/14/2002</td>
<td>57.2</td>
<td>6/4/2002</td>
<td>18</td>
<td>-68.53%</td>
</tr>
</tbody>
</table>
The top pane in Figure 3 is the weekly closing value for a unit of equity in the %b BW system. The lower panes plot rolling 52-week Alpha*, Beta, and R-squared on the closing value vs. the benchmark S&P 500 from 1990-2006.

**Figure 3. BW (Buy-Weakness)**

*We calculate the alpha depicted in Figure 3 differently than the alpha reported in Table 1. The alpha in Figure 3 is a linear regression estimate modeled as Strategy Return = alpha + Beta (Return on the S&P 500). The alpha reported in Table 1 is the annualized mean difference of paired comparisons on 4287 observations of daily returns on the S&P 500 versus a unit of equity in the % BW strategy.
Is the difference in return between the %b BW strategy and the S&P 500 statistically significant? To answer that question, we used a paired comparisons test of 4287 paired differences in daily returns from 1990-2006. The sample mean difference was .0533% per day (the mean daily alpha). The sample standard deviation of the mean difference was .7462% (the daily tracking error). The standard error of the sample mean difference was .7462% * 4287^.5 = .0114%. The calculated test statistic was $z = \frac{.0533}{.0114} = 4.68$. The two-tailed $P$ value is less than 0.0001. The difference in returns is extremely statistically significant.

Is the risk-adjusted return of the %b trading strategy statistically significant? The Information Ratio, also known as the appraisal ratio, is a widely used risk metric that measures risk and return relative to an appropriate benchmark. The information ratio equals alpha divided by tracking error. We tested to determine if the information ratio (IR) of the %b strategy was greater than zero:

From Table 1 we see the information ratio for the %b strategy equaled 1.15. So our test statistic is $t = 1.15 * 17^.5 = 4.74$ with $df = 16$. The two-tailed $P$ value equals 0.0003. The difference is extremely statistically significant.

The evidence supports our thesis that a rotational trading algorithm using relative %b rankings can select stock portfolios that beat the risk-adjusted return on the S&P 500. Moreover, those portfolios consist only of S&P 500 constituent stocks. For perspective, a search of the expansive Morningstar mutual fund database in February 2007 reveals that just three mutual funds had an annualized rate of return in excess of 18% over the past fifteen years. None of those returns exceeded 19%. The %b BW Strategy* returned 24.1% annualized with surprisingly little risk relative to the benchmark. The charts in Figures 3 and 4 as well as the Sharpe and Information Ratios reported in Table 1 provide the relevant risk assessment analytics.

*The historical performance of a simulated trading strategy is not a guarantee of future returns.

Admittedly, we have presented back test results that fly in the face of the well-worn trader’s axiom “Cut your losses short; let your profits run.” Table 2 confirms that the %b BW system offers no protection against ruinous losses at the asset level. The diversification of an equal-weight 40 stock portfolio afford the only downside protection, a striking demonstration of the critical importance of position sizing and diversification in system development.

While our results are statistically significant, the economic significance is less straightforward. The system trades frequently averaging over three trades per day. For taxable investors, returns would be taxed 100% as unfavorable short-term capital gains. From Table 1 we see the average profit per trade is 1.2% net of an assumed .2% round trip transaction costs. That is likely satisfactory only for a trader using an efficient broker and perhaps more importantly, trade size must be sufficiently small to have only a modest impact on market prices. Assessing potential slippage is clearly an important consideration when evaluating any system.

Finally, the results suggest that investors overreact, possibly to news or changing prices, in a three-month (65 trading day) frame of reference. By design, our indicator look-back period corresponds with the three-month earnings report cycle for stocks as well as the performance reporting cycle for many asset managers capturing possible earnings-announcement and window dressing effects.

Tests of Statistical Significance

$\frac{t - \text{statistic}}{\sqrt{}} = IR \cdot T$

Where $T$ is the number of years.

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Discussion

The evidence supports our thesis that a rotational trading algorithm using relative %b rankings can select stock portfolios that beat the risk-adjusted return on the S&P 500. Moreover, those portfolios consist only of S&P 500 constituent stocks. For perspective, a search of the expansive Morningstar mutual fund database in February 2007 reveals that just three mutual funds had an annualized rate of return in excess of 18% over the past fifteen years. None of those returns exceeded 19%. The %b BW Strategy returned 24.1% annualized with surprisingly little risk relative to the benchmark. The charts in Figures 3 and 4 as well as the Sharpe and Information Ratios reported in Table 1 provide the relevant risk assessment analytics.

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End Notes

1 http://serial-correlation.behaviouralfinance.net/ retrieved from the web February 2006
2 http://www.bollingerbands.com/ retrieved from the web February 2006
5 http://www.investopedia.com/terms/l/lookaheadbias.asp retrieved from the web February 2006
6 http://amibroker.com/ retrieved from the web February 2006
11 http://www.investopedia.com/terms/w/windowdressing.asp retrieved from the web February 2006

About the Author

H. Parker Evans, CFA, CFP, CMT is a Vice President and Senior Portfolio Manager with Fifth Third Private Bank in Clearwater, Florida. Parker has over twenty years experience as a professional investment advisor. He has a penchant for technical analysis of alpha persistence and mean reversion in securities prices.
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The Chartered Market Technician (CMT) designation is awarded to candidates who demonstrate proficiency in a broad range of technical analysis of the financial markets. It is made up of an educational component, an experience requirement, an ethics requirement, and a membership requirement. It is also the only examination for Technical Analysts that qualifies as a Series 86 exemption.

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• To promote and encourage the highest standards of education; and
• To grant the right to use the professional designation of Chartered Market Technician (CMT) to those Members who successfully complete the Program and agree to abide by the MTA Code of Ethics.

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• View the “CMT Process” webcast on the best practices for preparing for the CMT Exam
• Watch the Panel Discussion on the “CMT Informational Session”
• The CMT Brochure
• The CMT FAQ
• A sample of the MTA Body of Knowledge
• The CMT recommended reading list

If you have any questions on the CMT Program, please feel free to contact Marie Penza at Marie@mta.org or call any of our MTA headquarter staff at (646) 652-3300. We would be pleased to assist you in any way we can.
2009 Charles H. Dow Award

The competition for the 2009 Charles H. Dow Award is open! This award for excellence and creativity in technical analysis has been presented since 1994, and today is the most significant writing competition in the field. The recipients of the Dow Award in the past are among the most notable technicians in the market today.

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