Institutional Fund Flows: A Different Approach to Volume

By Rob Brand, CMT

Many traders and analysts incorporate some form of volume analysis in their decision-making. Volume takes various forms, but one that is as yet still little used but is rapidly coming to the fore is institutional fund flows. This article looks at how one particular flows indicator, published by State Street, can be used to help anticipate market movements in global equity markets.

Flow analysis: The Underlying Idea

As the term indicates, institutional fund flows are the volumes that are traded by investment managers, such as asset managers and pension funds. In many cases, the large asset managers are the driving force behind share price movements since they hold huge positions and may take time to get into a particular sector or stock. In other words, if the institutional investors head in a particular direction, this is likely to have the effect of driving up share prices on account of the large volumes traded over an extended period of time. The question that arises however is, how can we know what the large institutions are buying and selling?

In order to answer this question we need to turn to the stockbrokers. They act for the institutional investors and settle a high proportion of all institutional equity transactions. Such brokers include The Bank of New York and State Street. State Street is the worldwide administrator of over 11 trillion dollars, representing 15% of the total volume of tradable securities. Therefore, they are eminently well placed to measure the flows generated by asset managers.

Every month, State Street Global Markets research draws up a report with a detailed analysis of institutional players’ equity flows. State Street Global Markets measures the aggregate volume by calculating the balance of purchases minus sales in each equity sector. This is termed the Equity Flow Indicator (EFI), or “flows” for short. The EFI shows whether institutional investors are in fact making purchases or sales with the flows being subdivided into countries, sectors and regions. This makes it possible to respond to the sectoral choices made by institutional investors in certain regions.

Do Flows Have Predictive Value?

The question naturally arises as to whether the flows have predictive value. Over the past ten years, State Street Global Markets has analyzed the flows of institutional investors. If the flows were to be random, the expectation would be for an average flow (purchasing or selling) to last two months (see Figure 1). In fact, the flows last much longer on average, thus suggesting that they have an effect on the market.

The ability to identify a trend reversal in the cumulative flows in the sectors at an early stage can be highly profitable. An example of the cumulative flows in the Telecom sector is shown in Figure 2. The pale line shows the cumulative flows: institutional investors are clearly making net sales in telecom sector shares. The dark line shows the relative performance of the sector in relation to the world index. A reversal in the flow trend is often associated with a turnaround in relative performance. This is exceptionally

Figure 1. Average monthly flow per sector
(Source: State Street Global Markets, MSCI)

Figure 2. Cumulative flows and relative performance in the Telecom sector
(Source: State Street Global Markets, MSCI)

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MTA Members and Affiliates:
This past month has been a very exciting time for me personally and for the MTA Headquarters Staff as we conduct reviews on what is working, what needs to be done and most importantly what our vision is for the future. We are making progress on all fronts. Let me address just three areas this month:

I. Headquarters Staff & Library Location

Ever since the 9/11/01 disaster, the MTA has desired to return to the NYC location. We are pleased to announce that the Board of the MTA has approved that return, a site selection has been made that will service the needs of the MTA and its Members, and we expect to be housed in NYC by the start of 2007. We strongly believe the NYC presence will increase our visibility to our Members, of our library materials, calibration with affiliated sponsors, etc., and will help promote our international growth objectives.

When our new location is ready for occupancy, we will inform our membership and ensure orderly transition without service disruption.

II. CMT Test, Training Materials & Its Future

The CMT Level I-III tests are being conducted as this Newsletter goes to press. We have worked closely with our outside test proctoring vendor, Thomson Prometric, to ensure a smooth test taking process is available for all. Good luck to our test takers.

The CMTi (CMT Institute) completed its on-line test preparation reviews with excellent results. Our institute technology, Macromedia Breeze, allowed for on-line dissemination of information and an interactive forum for questions and answers. We are excited about the technological capabilities in this area and intend to continue to explore extensions for this technology in our overall Body of Knowledge (BOK) as we proceed in 2007.

III. Our “Home” and “Member Web” Capabilities

We are now in the process of reassessing our external (general public) and internal (member-based) web capabilities. At this time, we are getting input from all constituencies on our web process to find out what’s possible, its priority to the MTA and its membership, and to create a timetable for the improvement to ensure a cost effective, efficient and accountable plan of action.

While we are requesting input from a variety of sources, internal and external, and will continue to do so, I urge you to contact me with any thoughts you may have on our web capabilities and potential improvements, and I will ensure they become part of our evaluation process. I can be reached at Toms@mta.org.

Finally, we are still on track to present a consensus-driven strategic plan for the MTA by early 2007, and will be reporting on that progress at our Miami Mid-Winter Retreat on January 19th-20th. The seminar is shaping up to be a very informative and relaxing event. I hope to see you there!

Best Regards,

Tom Silveri
Executive Director
MTA Third Annual Mid-Winter Retreat

From the desk of...........

Seminar Chairman, Tim Snavely, CFA, CMT

This year’s Mid-Winter Retreat offers MTA members and affiliate members a high quality, advanced-topics, learning and networking event in Miami Beach, Florida, at exceptional value. The redesigned Retreat will be held January 19th and 20th at the gorgeous Eden Roc Resort & Spa, and it will feature:

• Presentations from John Bollinger, Peter Eliades, Ian Notley, Sam Stovall, Jason Goepfert, Tim Hayes, Bob Fulks, and more – all geared toward intermediate and expert technical market analysts.

• A networking-oriented “Walkabout,” led by Ian Notley, that will enable attendees to strengthen relationships as we share market insights.

• An Awards Banquet (!) – one of the MTA’s finest traditions – to recognize the important contributions of members of our community: Mike Epstein, David Krell, CMT, and Shelley LeBeck – all of whom will attend.

• An expert panel discussing “Quantitative Methods in Technical Market Analysis” to help technical market analysts solidify their understanding of modern methods in the technical approach.

• Additional presentations by Phil Roth, President, and Tom Silveri, Executive Director, regarding the State of the MTA and Our MTA’s Future, respectively.

• A low, low priced Spouse/Guest Rate, and spouse- or guest-friendly dinners and breakfasts so that they can join in the fun.

This year’s Retreat promises to be exciting! It represents the cumulative effort of many volunteers, and it demonstrates the MTA’s renewed commitment to serving its membership. In particular, the incredibly low cost of the event at only $350 for members and affiliates is possible due to generous corporate sponsors.

Review the itinerary and the growing list of attendees. There is no better place to be this January 19th and 20th than in sunny Miami Beach with your friends and professional TA colleagues. We’ll see you there!

For more information, go to www.mta.org, or contact Tim Licitra, Marketing Services Coordinator, at (732) 596-9399.

Sincerely,
Tim Snavely, CFA, CMT

Current Registrants*

Ralph Acampora, CMT
John Bollinger, CFA, CMT
Whitney Broach
Andrew Burkly, CFA, CMT
Ed Carson
Charles Cosse with guest
Jon Dahlberg with wife Laura
David DeWitt
Peter Eliades
Mike Epstein
Jason Goepfert
John Graef
Sam Hale, CMT with guest
Timothy Hayes, CMT
Kristin Hetzer, CFP, CIMA, CMT
Joni Jensen
Sam Kasle
David Keller, CMT
David Krell, CMT
Patrick Lauderdale, CFP
Shelley Lebeck
Tim Licitra (MTA Staff)
Tom MacMahon
Sherman McClellan with guest
Ian Notley
Fred Meissner, CMT
Jeffrey Parent
Jim Rohrbach
Philip Roth, CMT
Dalbir Sethi
Tom Silveri (MTA Executive Director)
Tim Snavely, CFA, CMT
Sam Stovall
Kenneth Tower, CMT
Adam Westphalen, CFP, CIMA
David Wisehaupt

* As of October 24, 2006, more to follow.
useful for investors in a position to make use of sector rotation. Tim Viner, at State Street Global Markets adds, “We make portfolio recommendations using the EFI indicator. For example, if we see a flow change then we consult other factors such as valuation, earnings momentum and technicals. If they support the message from flows then we adjust our position. It is essentially a top down approach”.

What are the Flows Saying at this Point?

We now know that flows can have predictive value, which begs the question as to what the flows are saying at this point. In order to obtain more insight into the flows, State Street Global Markets publishes daily “Tornado” charts (see Figure 3). This chart shows the flows over three periods: the last week, the last month and the last six months. In this way, the analyst obtains an insight into the flows and it is possible to respond in good time to a flow turnaround. The flows for the energy sector, for example, are declining for all three time periods. This indicates that institutional investors are making heavy sales in energy shares, although this is not yet reflected in the relative performance of the energy sector, which is still positive.

Apart from the notable outflow in the energy sector, the Tornado chart also indicates that institutional investors are buying shares in the consumer staples, telecom and utilities sectors. These flows clearly indicate that institutional investors are engaged in risk-averse positioning. This picture is further confirmed by the large flows out of the Consumer Discretionary and information technology sectors, both notably cyclical sectors that are expected to do well when the economy is strong. It is therefore clear from the flows that institutional investors are switching out of cyclical sectors into more defensive ones. As noted, three sectors stand out: consumer staples, telecommunications and utilities. The cumulative flows in these three sectors are depicted in Figure 4. The strong inflows into these three sectors clearly indicates that the institutions have become less confident about the economy.

 Needless to say, State Street Global Markets also breaks the flows down by region. This can provide a particular advantage for investors seeking to take advantage of regional effects. The flows within the regions are interesting in themselves: positive for Europe and negative for the US, (see Figure 5). This is consistent with the relative performance of the two regions in recent months: underperformance by the US and outperformance by Europe. What does stand out is the strong outflow from emerging markets, one of the regions in the State Street Global Markets model. This outflow is however limited to the most recent week and month so that it remains to be seen whether the six-monthly indicator will also be negative. A fall in emerging markets is also often associated with a weaker economic climate, which would be consistent with the other flow signals.

Regime analysis

In order to give the analysis further substance, State Street Global Markets also conducts a regime analysis. This analyses the relationship between the flows and a number of fundamental factors such as dividend yield, beta, earnings growth expectations and relative valuation. The advantage of this additional analysis is that apart from the signals we obtain from the flows, we also derive an impression of the kinds of shares being bought and sold by institutions. This increases the insight into the strategy behind the sectoral and regional allocation and can ultimately tell us something about the market in general. A good example of a fundamental factor is the beta. This measures the sensitivity of a share or sector in relation to the market. Investors are prepared to buy high beta shares if they have positive expectations of the market. Investors therefore seek to position themselves cyclically in order to benefit from their positive outlook. The flows have already allowed us to establish that Institutions are buying shares in the consumer staples, telecom and utilities sectors. That in itself already tells us that they are positioning themselves more defensively. It is now of interest to examine whether the regime analysis provides the same picture.

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Figure 3. Tornado chart (Source: State Street Global Markets, MSCI)

Figure 4. Cumulative flows for the Staples (.Source: State Street Global Markets, MSCI)

Figure 5. Tornado chart (Source: State Street Global Markets, MSCI)
The regime analysis of the flows indicates that investors are selling shares with strong earnings growth expectations and a high beta. Additionally, the flows also reveal that shares with a high dividend yield and a low relative valuation are being bought the most heavily. Is this logical? The answer is an emphatic yes, for the more defensive positioning of equity portfolios by institutional investors is often associated with the buying of shares with a (safe) dividend yield and a low valuation. Since the end of 2002, a value strategy (i.e. low PE) has generated a higher return than a growth strategy (high PE). Analysts expected this trend to come to an end this year; the flows therefore suggest the contrary.

**Conclusion**

Institutional fund flows offer a different and useful angle on volume. The flows are able to provide us with a timely warning of a possible trend reversal in the different sectors. In the case of an investor pursuing active policies in respect of regions and sectors, the flows are an excellent aid to making such allocation decisions. The flows are telling us at the present time to be cautious about the equity market and to adopt a defensive portfolio allocation.

Rob Brand is a Chartered Market Technician (CMT) and employed as portfolio manager at ABN Amro Asset Management in Amsterdam. The views and opinions expressed in this article may be subject to change at any given time. Individuals are advised to seek professional guidance prior to making any investments.

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**CMT EXAM TEST TAKERS**

To our members and affiliates scheduled to take this year’s fall administration of the CMT Exam, the MTA would like to wish you all good luck.

If you have any questions or concerns pertaining to the MTA’s CMT Program and Exams, please contact Marie Penza at the MTA Office at (732)596-9399, or at Marie@mta.org.

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**Technical Analysis CMT I**

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- Point & Figure, GANN, Elliott Wave, Fibonacci Numbers, Cycles, Japanese Candlesticks
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* Past performance is no guarantee of future results.
In Depth

Part II: Josh Rosen Interview

By Molly McLaughlin Schilling

An interview with Josh Rosen, CMT, a New York Stock Exchange Specialist with Kellogg Group, conducted by Molly Schilling.

We continue our conversation with Josh Rosen, a Specialist on the floor of the New York Stock Exchange. We are at the famous Bobby Van Restaurant on Wall Street.

Molly Schilling: What do you think of the proposed merger between The New York Stock Exchange and Euronext?

Josh Rosen: You know I have to say this, I’m still wrapping my arms around hybrid and the new technological advances at The New York Stock Exchange. John Thain came in here, and I don’t know if he was always a fan of the listed marketplace, but I do know that he has become a huge proponent of it now. Here’s a guy coming in from Goldman Sacks, takes a look and says I’m a technology guy. And then after actually seeing the type of price discovery that we do he becomes a huge proponent of specialists in the marketplace -- so that’s a big nod for us.

MS: Just unwind that a little bit more… what does that mean? What does he see now that he didn’t see before?

JR: I think he got to see what the specialists and the brokerage community could add… And what they can add is huge value -- value to institutions (buy side and sell side), value to the retail customer… And what the specialist can do as far as adding liquidity and depth to the marketplace, and removing unnecessary volatility. And I think he became a huge proponent of the marketplace because of that.

That being said, we have begun to develop an incredible hybrid market system, that’s going to be a huge technological advance for the industry. It’s going to add speed to the marketplace, which is what everybody is looking for -- but it won’t take away the human element and the value-added.

As far as the merger – I don’t know. I mean, I’ve read some stories in a few magazines, I’ve listened to some people -- and I don’t know what to think about it right now. I know that Euronext is technologically advanced. I would hope that any merger is a coming together of synergies, where you take the best from both worlds and you can create a new platform where both sides can grow together. I would hope that that’s what mergers are all about in the end, and I would hope that that’s what’s behind John Thain’s thinking and The New York Stock Exchange’s thinking as well.

That being said, I don’t know. There are a lot of questions about market structure, there have been for years. We’re seeing things happen in the markets that are unprecedented – mergers across continents, across functions. This is a big business now, and I absolutely have to keep on top of what’s going on, but I’m waiting for more information to unfold before I have any major opinions on what’s going on.

There are two schools of thought – one says, people have been talking about the end of this institution since 1920, and “it’s not like the old days”… but here we still are! And then there’s the other school of thought that says “maybe we’re just out of our element…” Maybe technology is going to come around and take over, and the person won’t be as integral as they once were on the floor. Maybe there’s a mix, but I don’t know right now.

But I do know that I enjoy the markets, and I will always be involved, regardless of the platform. But computers as such, still need to be programmed -- and I think that if there was an incredible electronic computerized trading system out there, there would be quite a few more billionaires. There is still a need for the market to be handled by human beings with ideas, analysis and trading acumen.

MS: So you will always need people behind the computers…

JR: Absolutely.

MS: …Or with the computers.

JR: Right, it speaks to accountability. And that’s a huge thing on the floor of The New York Stock Exchange. When I trade down there I’m accountable to The New York Stock Exchange, it’s rules and constitution. I’m accountable to the rules of the SEC, 1933/1934, any amendments. I’m accountable to my specialist firm in particular and what they deem fair and orderly. I’m accountable to the companies that have entrusted us with listing their issues, their stocks. And most importantly, I’m accountable to the shareholders. At any point one of those CEOs could call me up, I have a relationship with them; our upstairs communication has a relationship with them. And I have to have a reason for what I think happened.

Not everything is always going to be wonderful and rosy, but they can at least call me and say “hey, why did this happen?” -- At least I can have a dialogue and let them know what I’m seeing at the point of sale. You know, there’s accountability no matter what I do, and once again that goes back to a measure of our integrity and our character. I don’t know how many people understand this. Everything we do in that machine is monitored electronically via some very advanced technology, surveillance. At this point on the floor a lot of things are becoming monitored via video and recording. We are not for the most part doing anything that we shouldn’t… we simply can’t, and I’ll tell you why, (a) it’s technologically impossible, and (b) you have to absolutely go out of your way to do it and be the type of person that would to that. We don’t have a lot of those people; we are monitored, and there’s surveillance to make sure that we do our job and we do it correctly.

MS: Let’s go back to your day -- so we can just get a little more feeling for who you are and what your life is like. You wake up at six and you’re on the computer for a while and then you take off on a subway…What time do you get into work?

JR: I get in about 7:00, 7:15.

MS: What do you do at 7:00, 7:15 in the morning, since the market doesn’t open until 9:30?

JR: I’m on the computers; mail, of course -- clean that out; various news services, I look at about four or five.

MS: What are your favorite news services?

JR: I look at Market Watch, Yahoo!; I look at Market Center, Big Charts, Stock Charts, Reuters, and a couple more -- I try to get the flavor – I flip around quite a bit. I often read some online stuff from Barrons.

I also look at technical sites, some blogs, some Elliott sites, just to get a feel for what other analysts are thinking. I try to read as many CMTs as I can in the morning and I do get a little research from some of the sell side firms as well, to try to get a feel for their analysis. So I have quite a bit of reading to do in the morning.

MS: …And where do you get your coffee?

JR: Right there at work. We have a beautiful office. We’re actually at the Kellogg Group, I’m a Kellogg specialist, and we have quite a growing operation, we have an upstairs trading department including various strategies, the brokerage side for direct access, and specialists on the floor of The American Stock Exchange as well as the NYSE.

MS: So, where is Kellogg, is it right in the building, The New York Stock Exchange building?

JR: No, but we’re in a building right near the Exchange. I go there first in the morning, grab my coffee, go back into the specialists’ room where we’re all doing research, recapping and getting ready.

MS: So you chat away with your colleagues at that point?

JR: Oh, yes, there’s a lot of talking. We have

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CNBC, or Bloombergs, so we have everything. And those couple of hours before the market opens goes by a lot quicker than you might think. There are a lot of meetings going on, plenty of research happening, and a lot of reading. I do a lot of analysis, still, in the morning, anything I didn’t get done the night before. I’m always bringing more analysis down to the floor with me, so I’m working on that until the last minute as well. And I usually have a little breakfast with my coffee.

MS: Is it good coffee... Starbuck’s coffee?

JR: No, we actually have our own special machine, the “Pod”. So I use the Pod machine. Some people stop for breakfast in the morning, some guys go out for breakfast together. I’m usually in the office, I have a little breakfast -- oatmeal or something, and we have it right there while we’re doing our work. And from there little by little everybody moves on down to the floor. Some guys get down there very early -- start standing around, looking at the early interest on the display book. Some guys get down there just a few minutes before. I tend to be in the middle -- I usually look at my watch at about 9:05/9:09 and start my walk down to the floor, outside, into the NYSE, through all the security, onto the floor. Put my stuff away, get my badge on, take a look around, see if the futures have moved at all, take a look at my trading assistant -- I’ll immediately know if there’s anything I should know about.

I’ve already checked all the news in my stocks, so there should be no surprises. Of course, you never know what the early interest on the floor has to offer. So he could tell me -- hey, just so you know, get ready, we have $50,000 to buy in XYZ, or something. I have my badge on, said good morning to everyone....

MS: Do you wear anything in particular, or do you just wear a suit?

JR: I happen to wear my suit. You can wear a smock, I have a smock. I used to wear it a lot, I don’t anymore. I put my badge right here on my left lapel, that gives them my badge number, my name, my firm. And after that I pretty much turn around, get in position, start looking at my screens, seeing what type of orders are coming in, and let’s do some trading. And let’s try to stay away from any major opinions. So he knows where my mind is, and I know where his head is. Do we always agree 100%? Absolutely not. Do we have absolute respect for each other? Yes. He’s got a great feel for what’s going on. Like I said, yesterday I walked away. It wasn’t extremely busy yesterday, it was a very quiet day, and I lost my feel for it and I just couldn’t get back on track.

MS: ...On another note, you enjoy reading the magazine, The Economist, so you’re obviously inclined toward political philosophy. What else do you read? What else do you like? ...Any books that you’ve found to be useful in your work?

JR: I can give you quite a few books that I’ve loved. An incredible book that contains economic analysis, technical analysis and the psychology of trading all in one was written by Vic Sperandeo called Trader Vic. Jack Schwager has written Market Wizards, which really gives you a keen insight into what some of the top market performers have done over the years.

Let me think -- Investment Psychology Explained, by Martin Pring-- I really love how he delves into human psychology. Steve Nison and John Murphy’s books introduced me to technical analysis. And Bob Prechter’s books are very helpful… that goes without saying. I just read a book called Fooled By Randomness by a man named Nassim Taleb, who explains derivatives. Barton Biggs opens up the world of hedge funds in Hedge Hogging. I think he uncovers a side of the market a lot of people just don’t know about. He focuses on personalities through anecdotes. Against The Gods is a financial book by Peter Bernstein that really uncovers the mathematics of trading.

MS: ...Anything in philosophy or ethical/moral reflection?

JR: I especially like the works of Ayn Rand. One of my favorite books altogether is Atlas Shrugged. And I just recently read The Virtue of Selfishness. I love the philosophy of economics -- I was a finance major in college.

I later studied psychology and philosophy, so I’ve read a lot of philosophy -- from Aristotle to Kant. I’m always thinking about ethics. I read The Tipping Point recently, and it was a really illuminating book. It really challenged my perspectives.

MS: Did your background in philosophy help you as a trader? Has it influenced you?

JR: Absolutely, it’s opened me up to a myriad of different thought processes. And it’s opened me up to be able to understand how two totally different thought processes can work -- reflective thinking and strategic thinking. You can approach the market philosophically from an economics standpoint, a fundamental standpoint, a technical standpoint, or a quantitative standpoint, as long as you have something to back up those ideas. You can be successful by adding a psychological aspect to it by understanding who you are, what is energizing you to apply these different philosophies -- and then thinking about how you are going to react when you’re wrong, when you’re right, when you’re profitable, when you’re losing -- and what that does to you emotionally. If you don’t cultivate the ability to adapt, and overcome, and change, then I don’t think you can be successful.

MS: Who was your favorite philosopher when you were studying philosophy?

JR: The ancient Greek philosophers -- Plato and Aristotle. I loved their ability to argue. What I learned is that many ideas can be argued very well and you have to be able to dissect them and take out of them what is true to you, and maybe not take out of them what doesn’t necessarily rhyme with what you believe. So, what I took out of them was their ability to argue either side and to really dissect what someone else is saying, rather than just take it at face value. And that takes a lot of discipline.

MS: ...And what do you do for fun, or is this fun for you?

JR: This is fun for me. I do this for fun. I also spend a lot of time with my wife. We love to just take walks, go out for dinner, travel -- that’s awesome, so that’s a lot of fun for me. I love playing golf. I’m really a student of the game. I think there are a lot of parallels with the market. It takes so many different speeds to play that game right, as well as emotional discipline. So, I really love that. I love getting better at it, of course, like a lot of people do.

I’m a huge exerciser, I love to ride my bike. And I do study a certain form of martial arts a couple of nights a week. So I stay very active, spend a lot of time with my family, study the markets, and travel. Those are some of the things off the top of my head that I really enjoy, and I do love reading -- reading about whatever. I love non-fiction, I love learning about new cultures and ideas. So that’s how I keep myself busy for the most part.

MS: Great. Josh, what a wonderful interview -- thank you very much.

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MS: Great. Josh, what a wonderful interview -- thank you very much.

Josh Rosen blogs his analysis of the market on a daily basis at TheTrendline.blogspot.com; Molly McLaughlin Schilling, Editor-At-Large for MTA’s Technically Speaking Newsletter, is a writer and a trader.
A Short Study of NYSE Retrac EOD data

By Lawson McWhorter, CMT

The New York Stock Exchange recently introduced a new suite of data products called InfoTools. One of these tools, Retrac, captures time, side (buy/sell), symbol, and quantity for all orders entered by retail investors. The data is reported in real-time as well as aggregated by symbol and made available nightly via a NYSE ftp site. End-of-day data from March 23rd 2005, the first available date historically, through August 31st 2006 is the focus of this short study.

Sentiment analysis has long been a staple of the market technician’s toolbox. This type of analysis generally attempts to identify extremes in investor psychology that often presage market reversals. Traditionally, the small investor—the proverbial odd-lotter of yesteryear—has been considered the “dumb” money and the most fertile subject for contrarian analysis.

Advances in technology, market structure, and regulation have all leveled the playing field, yet the assumption of the unsophisticated retail investor and the cool, calculating institutional investor persists. (This has almost become a caricature over the years, as we all know professionals who chase one hot sector after another, while John Q. Public patiently dollar cost averages into low cost index funds.) One of the problems with sentiment analysis is that there is usually no way to separate the actions of the “smart” money from the “dumb” money. In the case of Retrac, presumably the NYSE has done the work for us.

I aggregated all Retrac observations by date, summing the number of buy trades, buy shares, sell trades, and sell shares. The correlation between aggregate number of trades and shares was approximately 0.88, so for the purposes of this study, I have chosen to focus on aggregate shares only. The chart below shows the S&P 500 with the ratio of aggregate buy shares to aggregate buy plus sell shares (in other words, retail buy volume in relation to total retail volume). A five-day simple moving average is overlaid on the raw ratio.

The first interesting thing I noticed about the data is that retail investors were net sellers for all but one day (7/7/2006) of the 364 observations. Structural factors most likely explain this persistent bearishness rather than a market view, as the American Association of Individual Investors weekly sentiment survey showed periods of considerable bullishness over the same period.

The daily data is quite noisy and even the smoothed ratio shows no obvious correlation to intermediate market swings. I had expected the ratio to behave like traditional sentiment indicators, with buy activity being positively correlated to market trend. Instead, I found that retail investors didn’t pile in near the top nor stampede out near the bottom as traditional sentiment analysis might assume. In fact, retail investors appear to be counter-trend traders. The correlation between the one-day percentage change in the S&P and the Retrac buy/(buy + sell) ratio was –0.31. Retail buy activity, within the context of overall net liquidation, clearly increased on down days. The Retrac ratio increased versus the prior day on seven of the ten of the largest down days in the S&P. Conversely, the ratio declined on eight out of ten of the largest up days in the S&P (in other words, retail investors sold more than usual into market strength).

Given the modus operandi of many smaller investors, perhaps this finding should not come as a surprise. If a trade goes against them, they are often loath to realize a loss and will hold until they can “get even.” This strategy may work in many market environments, but as many investors discovered to their detriment during the last bear market, there is no guarantee you will ever get back to even.

The S&P’s largest close-to-close decline over the limited period studied was –7.70%; moreover, the largest up move from the low in April 2005 to the peak in May 2006 was 16.55%. After the extreme volatility of the late 1990’s and early 2000’s, perhaps these moves aren’t big enough to get the fear and greed flowing anymore. Over a full market cycle, Retrac may hold more insight. In particular, it will be interesting to see if retail investors maintain their counter-trend tendencies through the full market cycle, Retrac may hold more insight.

In particular, it will be interesting to see if retail investors maintain their counter-trend tendencies in the face of larger market moves. If they begin to sell into weakness or chase strength, it may signal capitulation. Should the smoothed Retrac ratio approach 25% on the downside or 75% on the upside, my guess is these readings would likely get the fear and greed flowing again. If a trade goes against them, they are often loath to realize a loss and will hold until they can “get even.” This strategy may work in many market environments, but as many investors discovered to their detriment during the last bear market, there is no guarantee you will ever get back to even.

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W. Lawson McWhorter, CMT has been a member of the MTA since 1993. He currently works for the Structured Products Group of a global investment firm helping manage quantitative portfolios.
2007 Charles H. Dow Award Competition

George A. Schade, Jr., CMT

The Charles H. Dow Award for excellence and creativity in technical analysis has been presented since 1994. The papers honored with the award have represented the richness and depth of technical analysis. Having been involved with the Dow Award since first presented, I believe it is the most important recognition in the field of technical analysis.

The competition for the 2007 Dow Award is open. The last day to submit papers for consideration will be February 28, 2007.

The guidelines have been reviewed and revised. Two major changes have been made. The standards for judging a paper have been raised to require accepted models of testing and robust research, and for the first time, a cash prize of $1,000 will accompany the award.

The winning author will also be invited to discuss the paper at a national MTA seminar or at a monthly meeting of an MTA chapter. The winning paper or a summary may be published in the MTA’s Journal of Technical Analysis, the MTA newsletter Technically Speaking, and the MTA website.

The new guidelines and standards are posted on the MTA’s main Web site page under Activities.

Inquiries should be addressed to DowAward@mta.org.

Recipients of the Charles H. Dow Award:

- 1996 Timothy W. Hayes, CMT, “The Quantification Predicament”
- 1999 Eric Bjorgen and Steven C. Leuthold “Corporate Insiders’ Big Block Transactions”
- 2004 Jason Goepfert, “Mutual Fund Cash Reserves, the Risk-Free Rate, and Stock Market Performance”

MTA New York Region Update

October 2006

By David Keller, CMT

The New York Region welcomed Connie Brown to our October meeting for a dynamic session on technical analysis and horses (no, that’s not a typo). In the first half of Connie’s presentation, entitled “Trading Probability, Conviction, and Execution,” she outlined a technical strategy involving Fibonacci retracements, Elliott Wave theory, oscillators, and volume. She went through a number of examples to illustrate how she determines price projections, and the probabilities related to these projections. She also touched on how more esoteric techniques such as Gann Analysis and Astrofinance could add value to the price pattern analysis.

This is where the presentation took a major left turn, and became literally a “dog and pony show.” Connie explained that she originally turned to horse riding as a release from the stresses of trading. However, she quickly found that the lessons she learned in training horses could be directly applied to her trading strategies. Connie introduced her mentor Bruce Anderson, who gave us some background on how he approaches a horse for the first time, and begins the training process. Next, a brave member of the audience (thank you Leon, glad it wasn’t me) attempted to follow Bruce’s instructions for using a lasso to rope one of the chairs in the room. By going through this exercise, Bruce and Connie were able to demonstrate how the ways in which we follow instructions and react to feedback in the marketplace are essential to our success as traders.

We are now webcasting all New York chapter meetings. You can watch the session from your location, and interact real-time with the speaker via chat room. Please join us next month! The video for this session can be found on the MTA website--go to www.mta.org, click on “Member Home”, then select “Video Archive” in the left column.

Connie Brown, CMT

Connie Brown, CMT, Bruce Anderson, and Leon Tejtelbaum
Trend Trading: Timing Market Tides
By Kedrick Brown

Reviewed by Mike Carr, CMT

Systems traders have long been known to employ profitable trend following strategies in the futures markets. Applying those concepts to stock trading has proven to be difficult, although the idea of trend following in stock markets dates back at least the days of Charles Dow. In a new book, Kedrick Brown, a former vice president at Knight Equity Markets, LP, redefines trend trading and offers readers a lot to think about, and readers of Technically Speaking will find a large number of testable ideas.

Brown reviews the basic tenets of Dow Theory, and summarizes the underlying idea as, “Dow Theory thus assumes that it is only worth owning stocks during confirmed bull markets in the major indices, and that one should be out of stocks otherwise.” He also offers a straightforward definition of a trend following trading strategy as, “Any preplanned, rule-based strategy for managing open position P&L in which open profits could hypothetically grow indefinitely under a limited set of circumstances, while open losses are limited under all circumstances.”

Member Awareness

The MTA wants to actively create awareness on what our fellow MTA Members and Affiliates have distributed in the form of print and/or media communications to the general public.

If you can send us either the print copy of the communication, or an e-mail on how we might capture that data, the MTA will maintain a column in this Newsletter informing our membership of your fine work.

In addition, some of our Members and Affiliates periodically publicly speak to the on-line and television media regarding market trends and/or dynamics. If you know in advance of these public speaking arrangements, please inform us. We will make every attempt to capture and share this information as well.

Please contact Tim Licitra at Tim@mta.org for any questions regarding the implementation of this initiative.

MTA INTERNSHIP COMMITTEE

The MTA is looking for volunteers to help with the Internship Committee. If you would like to volunteer to help start this committee, or feel that this is something that you or your company would be interested in taking part in, please contact Fred Schutzman, CMT.

Fred Schutzman, CMT can be reached by phone at (212) 671-1954, or by e-mail at fredschtzman@hotmail.com.

Published by Wiley, 2006, $55.00, 219 pages.

Other trading strategies are comprehensively developed in the book, and the reader is always given a complete understanding of the underlying principles. Brown also devotes a large portion of the book to a detailed discussion on position sizing, and provides worksheets that traders can use or adapt for their personal use to develop trading plans. Overall, the book can serve as a complete “how to” manual for the beginning trader, but offers a great deal for more experienced traders.

In an interesting, but brief section, Brown addresses the institutional money manager’s need to add alpha by outperforming, on a relative basis, a benchmark. Assuming the benchmark is the S&P 500, Brown notes, “If you hold a proxy for the S&P 500 at all times when not trading, you need only to outperform the proxy during the holding periods of your trades to beat its long term performance (before commissions and taxes).” The discussion and test results of this point are worth considering for all those attempting to outperform a benchmark.

Member Benefits Update

MTA members are now eligible to receive a FREE subscription to Futures magazine. Futures is written for traders who use commodity and financial futures, options, stocks and forex markets to make money. It is a valuable learning tool for novice and seasoned traders alike, providing the education and insight necessary to stay ahead of the market. Each monthly issue is full of indispensable information including interviews with industry insiders about trading strategies and tactics, technical analysis, money management best practices and much more! Please visit www.mta.org, and go to the benefits section for more information.
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Upcoming MTA Regional Chapter Events

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