THE KEVIN HAGGERTY INNER CIRCLE TRAINING PROGRAM

August 9th, 2005

Business Cycle Checklist

- Long-term interest rate peaks and bottoms follow short-term interest rate peaks and bottoms.
- Velocity of money peaks and bottoms occur near or shortly after long-term interest rate peaks and bottoms.
- Stock market bottoms occur at the same time as long-term interest rate peaks.
- Stock market peaks occur <u>after</u> interest rate bottoms.
- Economic peaks (beginning of recessions) occur before inflation and interest rate peaks.

Business Cycle Checklist

- Economic bottoms (end of recessions) occur before inflation and interest rate bottoms.

- Stock market turning points occur very near the turning points in the C/L ratio and the leading indicators.

- Money supply turning points coincide with or precede stock market turning points.

Business Cycle Checklist

<u>Turning Point Checklist (1)</u>

1. M2 money bottom
2. <u>Stock Market bottom</u>
3. C/L ratio bottom
4. Leading indicator bottom
5. Capacity utilization bottom
6. Coincident indicator bottom
7. Official: "Expansion in progress."
8. Lagging indicator bottom
9. Consumer credit ratio bottom
10. Producer price inflation bottom
11. Consumer price inflation bottom
12. Short-term interest rate bottom
13. Percentage change in M2 peak
14. Long-term interest rate bottom
15. M2 money supply peak
16. <u>Stock market peak</u>
17. C/L ratio peak
18. Leading indicator peak
19. Capacity utilization peak
20. Coincident indicator peak
21. Official: "Recession in progress."
22. Lagging indicator peak
23. Consumer credit ratio peak
24. Producer price inflation peak
25. Consumer price inflation peak
26. Short-term interest rate peak
27. Percentage change in M2 bottom
28. Long-term interest rate peak
29. Velocity peak

Business Cycle Checklist

Your sequence knowledge will be your primary tool in identifying major market turning points, but having a good idea of where the economy is in the checklist will be excellent supporting evidence.

(1) The source of this information is a book called "Strategic Market Timing" by Robert K. Bowker. It is an older book, but is the best practical information I have read about the business cycle and relationship to the stock market.

Option Strategies with Sequence

With the kind of equity markets we now have with the ever-increasing volatility due to futures and other derivatives, I strongly suggest that you get an option education that will be beneficial for your longer-term position trading. Under no circumstances should you be involved with derivatives unless you are qualified.

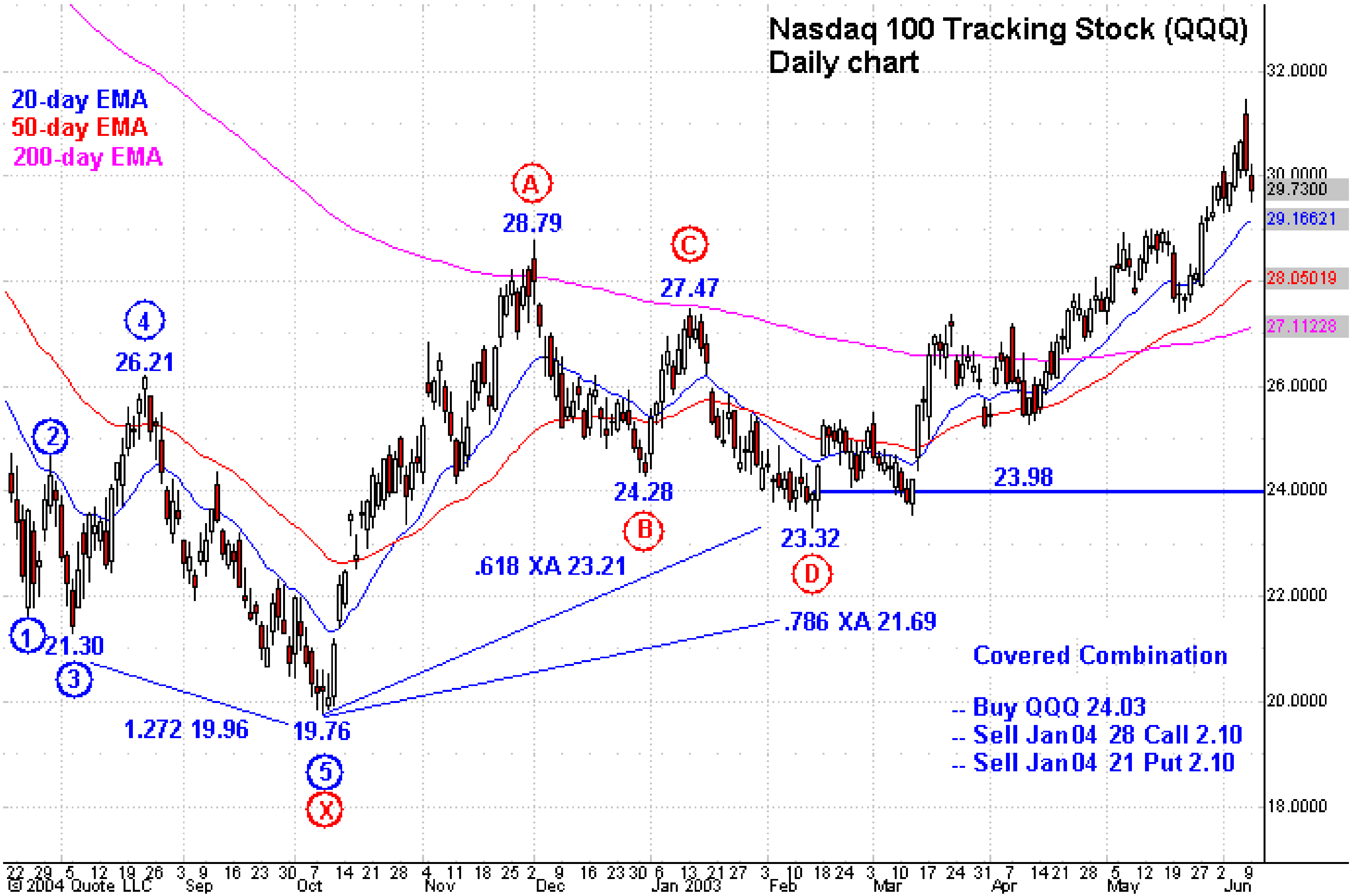
One of my favorite option strategies is the <u>Covered Combination</u>. It is the sale of a covered call and a cash-secured put against the purchase of an index proxy, such as the QQQ.

It is a strategy for someone who wants to buy a particular index proxy or HOLDR, but is not quite sure whether it is the right time to buy it. Of course, that is the feeling most investors have at market turning points after significant declines, but you feel that it is a good time to put some money to work.

Option Strategies with Sequence

Key Point: The cash-secured put involves selling a put and depositing the money for the purchase of the stock at your brokerage firm. The purpose of having the money in your brokerage account is to assure that the funds are available to purchase the stock should the put be assigned, which is the strike price of the put that you sold. The risk profile of a cash-secured put is the same as a covered-write. The buyer of that put that you sold will generally exercise the option only if the underlying stock falls below the strike price.

Option Strategies with Sequence

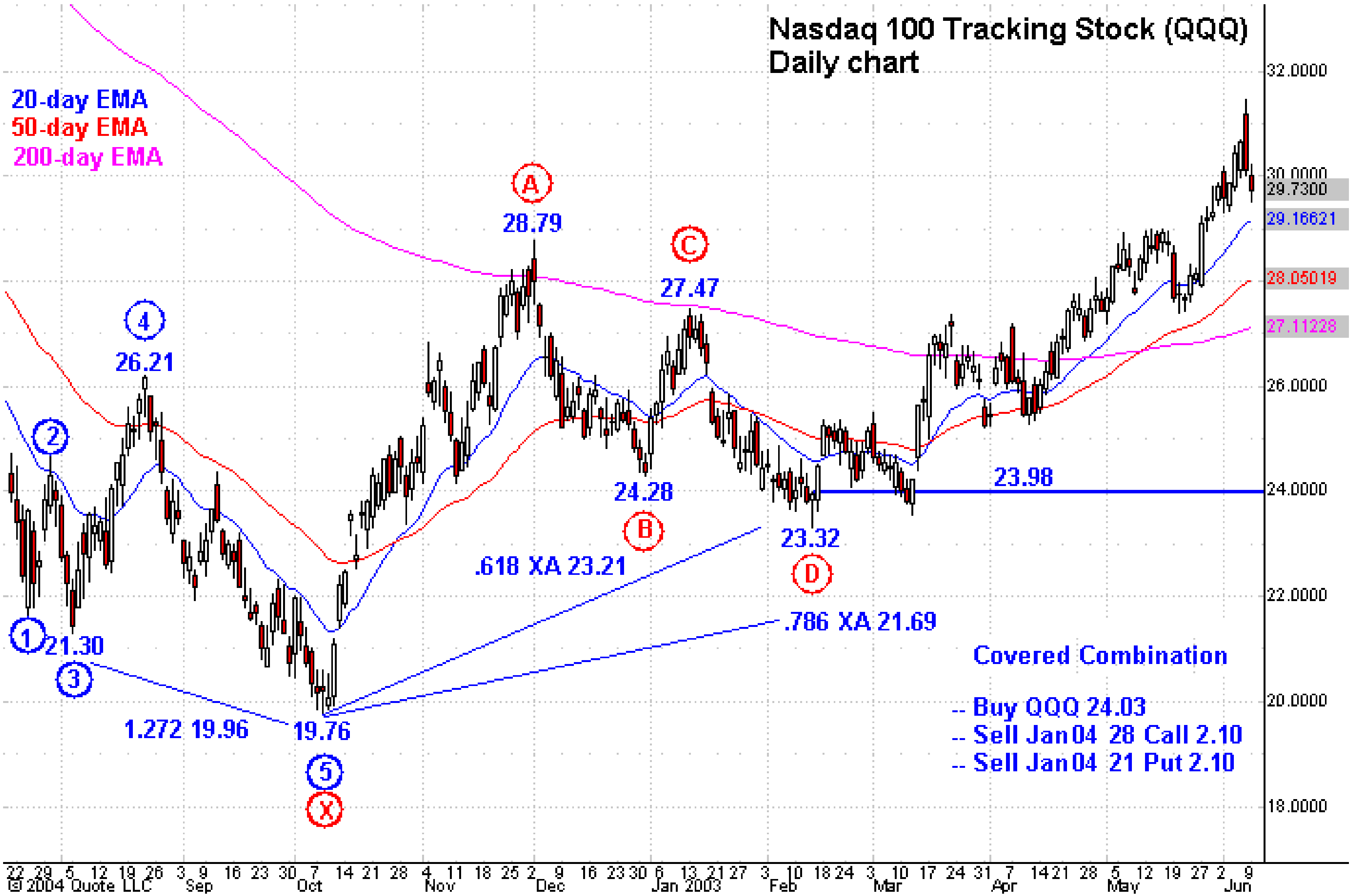


Option Strategies with Sequence

This QQQ chart is an actual example of the strategy. This chart is the October 2002 19.76 QQQ bottom with sequence and then the .618RT to that 19.76 low. This is all in conjunction with the major bottoms in the major indices and SMH, as seen in the previous charts.

If you did not enter sometime after the 19.76 low, then as a sequence investor, you had to consider a position on the retracement to 23.32. I have included the prices of the covered combination on the chart. Implied volatility was high at the time and premium full enough to provide a good strategy for the individual that wants to get long, but is nervous about the market.

Option Strategies with Sequence



Option Strategies with Sequence

I will give you an outline of what the transaction looks like, but you should go to www.cboe.com for a full explanation of this and other types of strategies, in addition to an outstanding education section.

Key Point: When you employ this strategy, you decide what your normal initial position would be, then buy only 50% of that position. The reason for that is if the put you sold is exercised, you will own that stock and that will bring your position size to 100% of the maximum you would allocate.

Key Point: This strategy, in effect, lets you buy stock at a discount, which allows you some room, but in order to get that benefit, you give up some of the upside potential.

Option Strategies with Sequence

Transaction

Buy 500 SHS QQQ at 24.03	24.03
Sell 5 Jan 04 28 LEAP calls at 2.10	-2.10
Sell 5 Jan 04 21 LEAP puts at 2.10	-2.10
Net cost	19.83

Key Point: You sold $4.20 in premium which reduces your 24.03 initial cost.

Key Point: There are about 10 months until the expiration of these LEAP options.

Option Strategies with Sequence

Returns

1. **QQQ is above 28 at expiration**

The put options will expire worthless and the investor will be assigned on his call options. In other words, the QQQ will be called away, and you have to sell the stock at 28. The return is:

$$\begin{array}{rl} 28.00 & \\ \underline{-\ 19.83} & \text{(net cost)} \\ 8.17 & \text{(point profit)} \end{array}$$

$$\frac{8.17}{19.83} = +41.2\%$$

Key Point: Your maximum return is 41.2% over a 10-month timeframe. Not all bad seeing that you were nervous about the initial position. However, it is only on 50% of your maximum size allocated to the QQQ at any one time.

Key Point: You took the position with a net cost at the 19.76 October 2002 lows and locked yourself in to a maximum 41.2% gain if called away. Not all bad.

Option Strategies with Sequence

2. QQQ is below 21 at expiration

Having sold the put, you have an obligation to purchase another 500 shares at 21 no matter how low the stock has fallen below the strike. (This would be more apt to happen with individual stocks on company-specific news than an index proxy like the QQQ.)

Result: After the purchase of the additional 500 SHS at 21, in addition to the original 500 SHS with a net cost of 19.83 because of the two premiums sold, you would be long 1000 SHS at 20.41. That is a 15.1% discount from the original 24.03 purchase price. You have lowered your breakeven and might decide to sell a combo again if it made sense at that market juncture.

Key Point: If the stock did nothing and remained at 24.03, your return would be +21.2%

$$\begin{array}{r} 24.03 \\ \underline{-19.83} \\ +4.20 \end{array}$$

$$\frac{4.20}{19.83} = 21.2\%$$

Note: Returns exclude any commission costs and interest.

Option Strategies with Sequence

You can see that you don't lose money unless the QQQ trades below 20.41, and you max out above 28 while making various amounts between 21 to 28. The QQQ closed above 28 in early May 2003 and never looked back, so the trade was the maximum return, unless it was taken off earlier when the actual return got to +30% as the time went by and price advanced. When you get your option education, you will learn the nuances of the trade management and other important aspects of covered combinations.

Key Point: I gave you this example to get you thinking about how to combine sequence with a more conservative way to initiate a position.

Option Strategies with Sequence

- Markets are not always making a bottom or a top. In the momentum phase of a stock, there are many contracting volatility patterns which result in continuation breakouts in the direction of the trend.

- The Symmetrical Triangle is a pattern that is easily defined, sets up frequently and has about a 75% probability to break out in the direction of the trend. It can also be a reversal pattern and that would be the 25% probability.

- If the triangle sets up after thrust, there is a high probability for a continuation breakout in the direction of the current trend.

- One option strategy that enables you to anticipate the expected immediate move and take a position within the Symmetrical Triangle is the Long Straddle.

1,2,3 Closes

In the Trap Door section, you will see a graphic of a mini 1,2,3 and many of those are what I call 1,2,3 closes, which is an early way to enter or trade from an extended zone.

This reversal strategy reduces the normal 1,2,3 higher bottom or 1,2,3 lower top down to the lowest common denominator of using closes rather than the trendlines and swing point guidelines you use for the bigger 1,2,3 patterns.

Key Point: It in no way replaces the 1,2,3s you have learned and is only useful if the sequence is compelling at an extended zone with improving dynamics and positive/negative divergences. It is simply an early entry for a change in direction from a very significant level. In fact, the 1,2,3 close entry will often become a larger 1,2,3 higher bottom or 1,2,3 lower top.

1,2,3 Closes

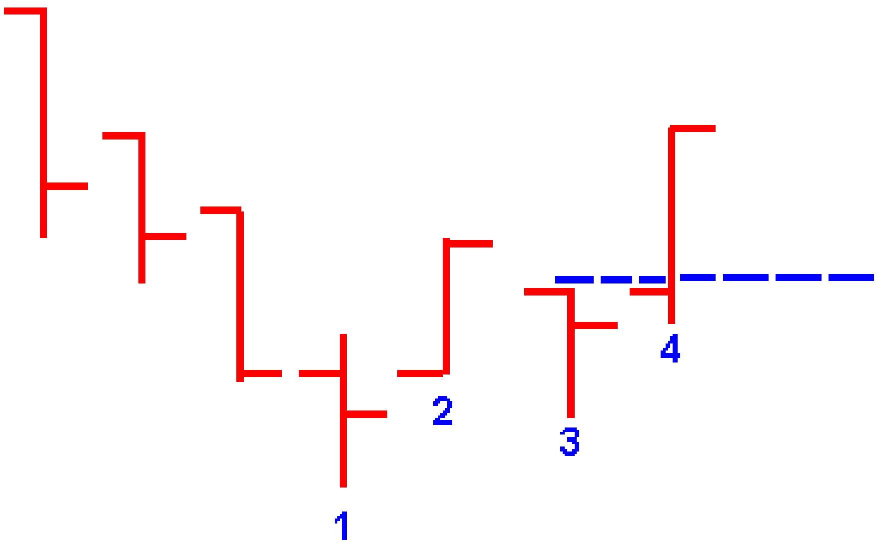
The 1,2,3 close pattern can be used in any timeframe, but on the intraday charts, the only rule is that the setup must be preceded by at least a seven- to eight-bar low. On the daily, weekly and monthly charts, it should be what appears to be a significant retracement/extension, which would most often be more than seven bars.

Rules (sells reversed)

- Must be at least a seven-bar low.
- You need an up close. This close can also be on the same bar as the low.
- Next, there must be a down close, but not necessarily the next bar.
- You enter long above the high of the down-close bar, provided it has formed a swing point low with a higher low on each side of it.
- If there is a new lower low before you get entry, then the count would start over again, and you would follow the rules again.
- The entire entry pattern should take no more than 10 bars.

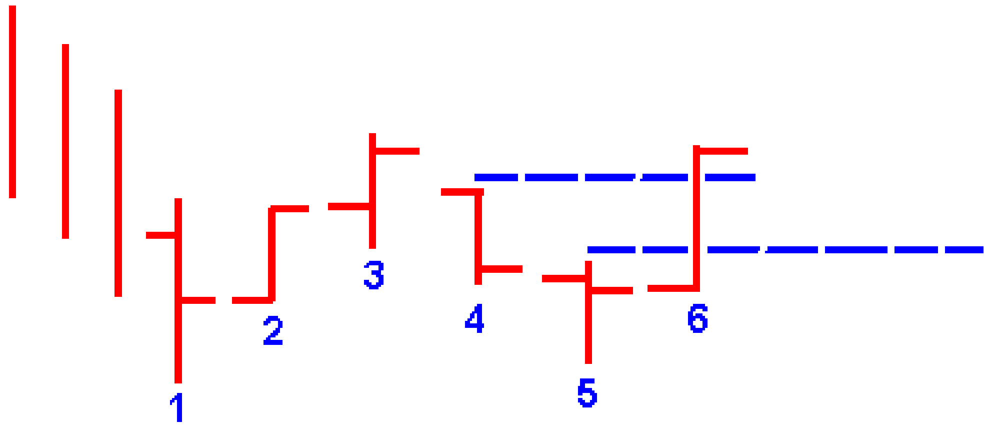
1,2,3 Closes

The following graphic examples show you the entry pattern, but it is assumed it is at least a seven-bar low.



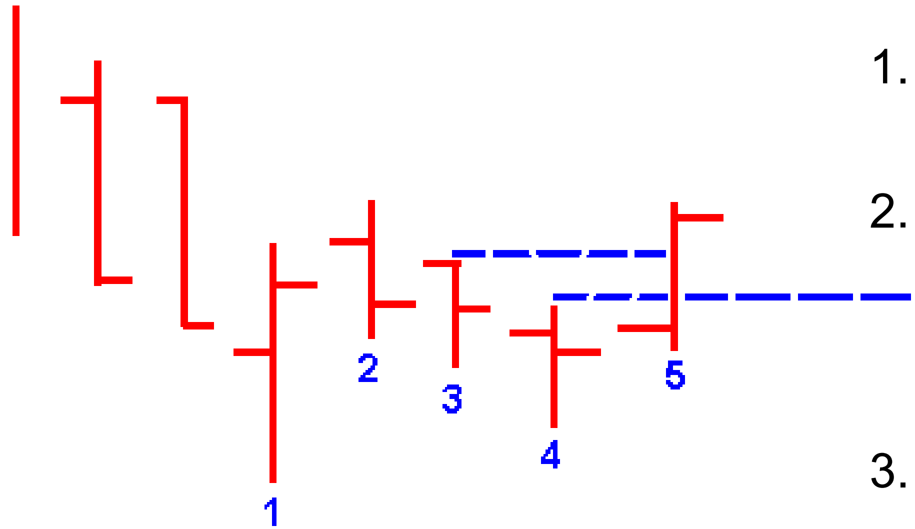
1. Seven-bar low.
2. Up close.
3. Down close and entry is above the high of that bar (3).
4. Entry is above the high of the previous lower-close bar (3), and it is a good entry because bar 3 is a swing point with a higher low on each side of it.

1,2,3 Closes



1. Seven-bar low and close.
2. Up close.
3. Another up close.
4. Lower close -- draw entry line here.
5. Lower close -- draw entry line again.
6. Entry is good above high of bar 5 because it is a swing point.

1,2,3 Closes



1. Seven-bar low, plus an up close on the same bar.
2. Low close, but entry above this bar would be invalid because bar 2 would not qualify as a swing point because of bar 1 lower low.
3. Lower close -- draw line.
4. Lower close -- draw line, as entry level is now reduced.
5. Good entry because bar 4 is a valid swing point -- higher low on each side.

<u>Key Point</u>: In Graphic 3, if, for example, bar 4 made a lower low than bar 1, you would start the count all over again.

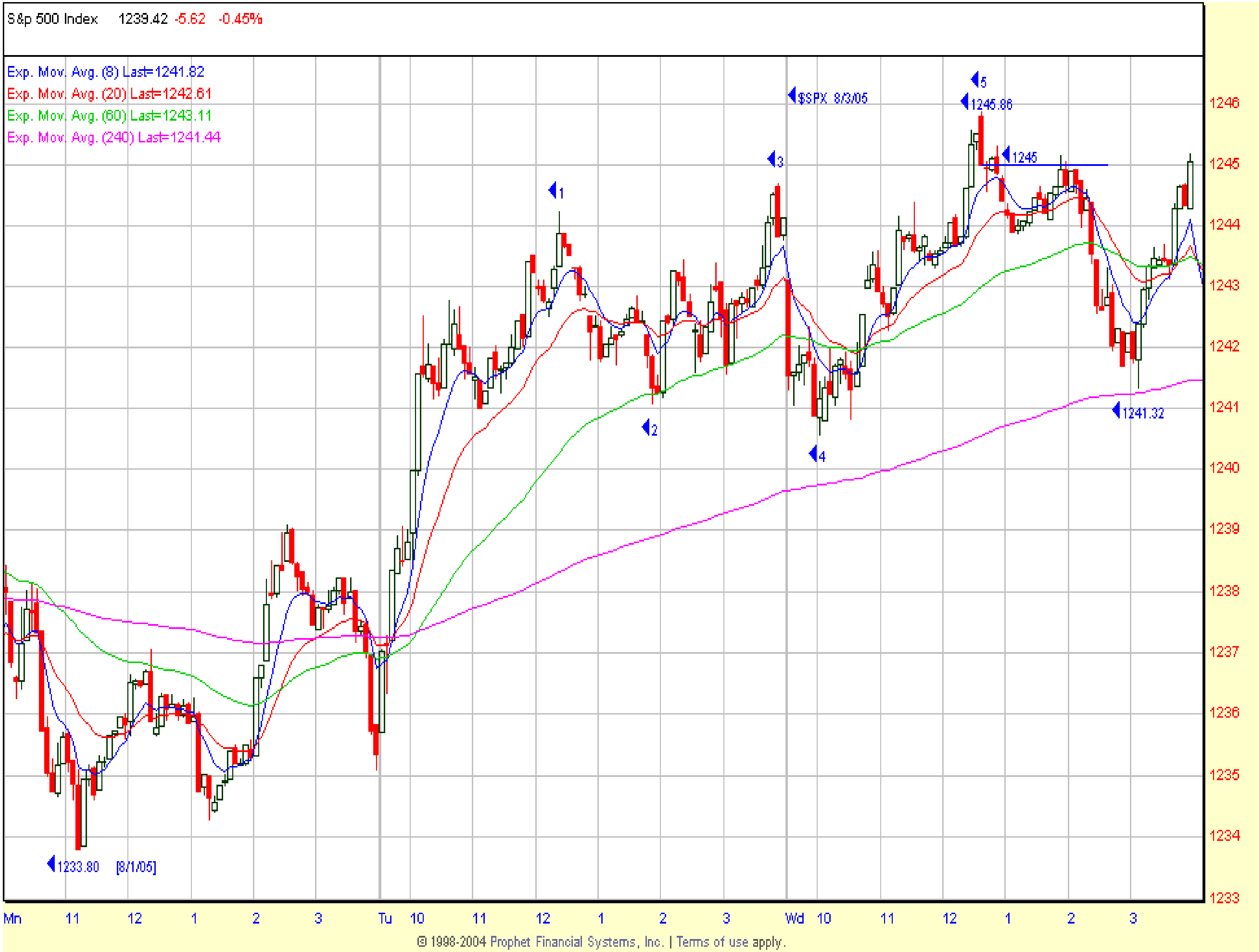
This is a simple reversal-bar entry pattern, but often an excellent early entry in a key sequence zone.

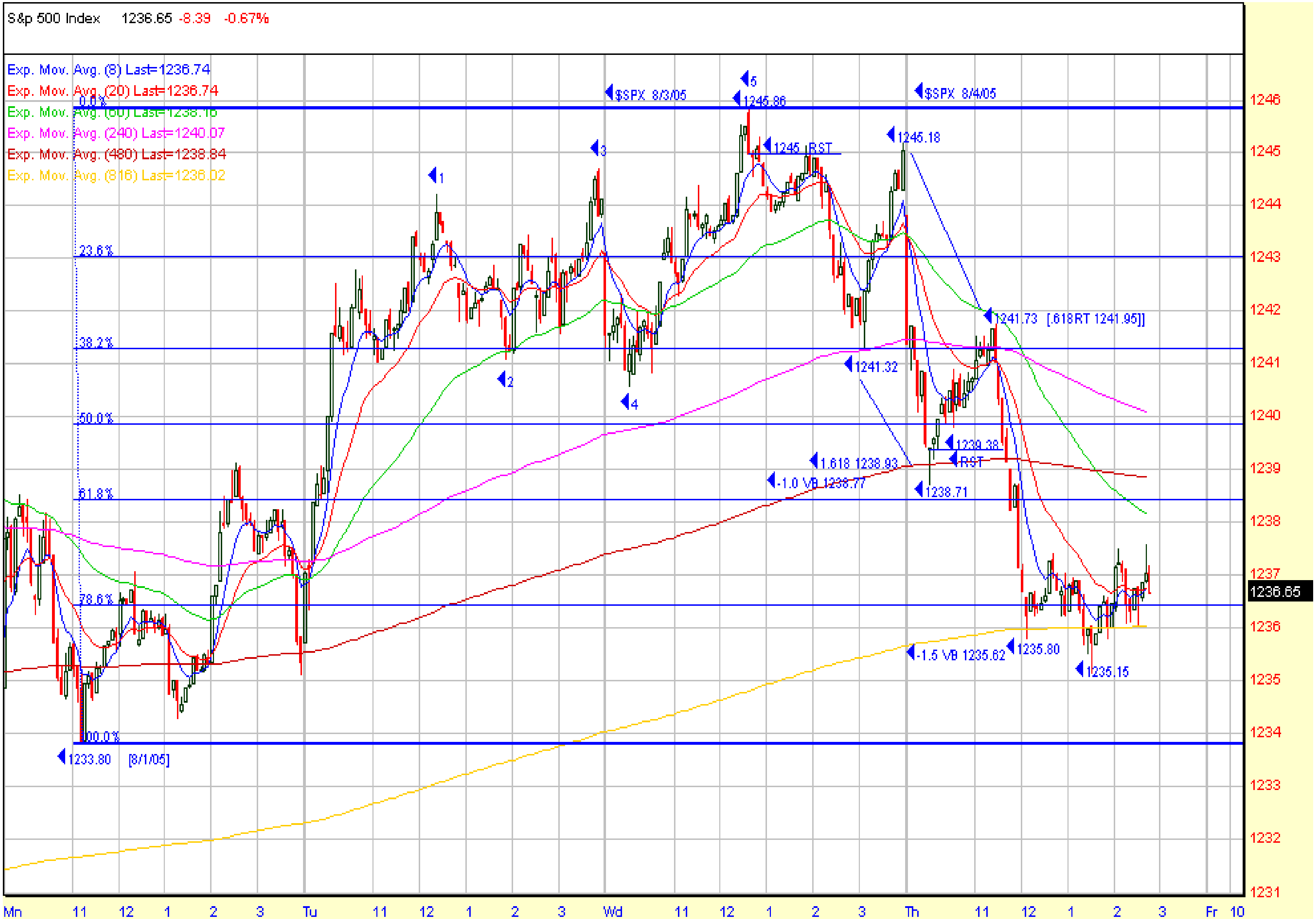

NEWMONT MINING CORP 40.17 2.03 5.32%
NEM 8/3/05
40.27
40.17
+3.0 VBAND 39.92
39.80
39.87
39.43
39.27
+2.0 VBAND 39.20
38.87
38.68
38.65
38.14 PC
37.42
40
39.8
39.6
39.4
39.2
39
38.8
38.6
38.4
38.2
38
37.8
37.6
© 1998-2004 Prophet Financial Systems, Inc. | Terms of use apply.
Volume (Thousands)
300
250
200
150
100
50
0
Tu 10:00 10:30 11:00 11:30 12:00 12:30 1:00 1:30 2:00 2:30 3:00 3:30 Wd 10:00 10:30 11:00 11:30 12:00 12:30 1:00 1:30 2:00 2:30 3:00 3:30 Th 10:00

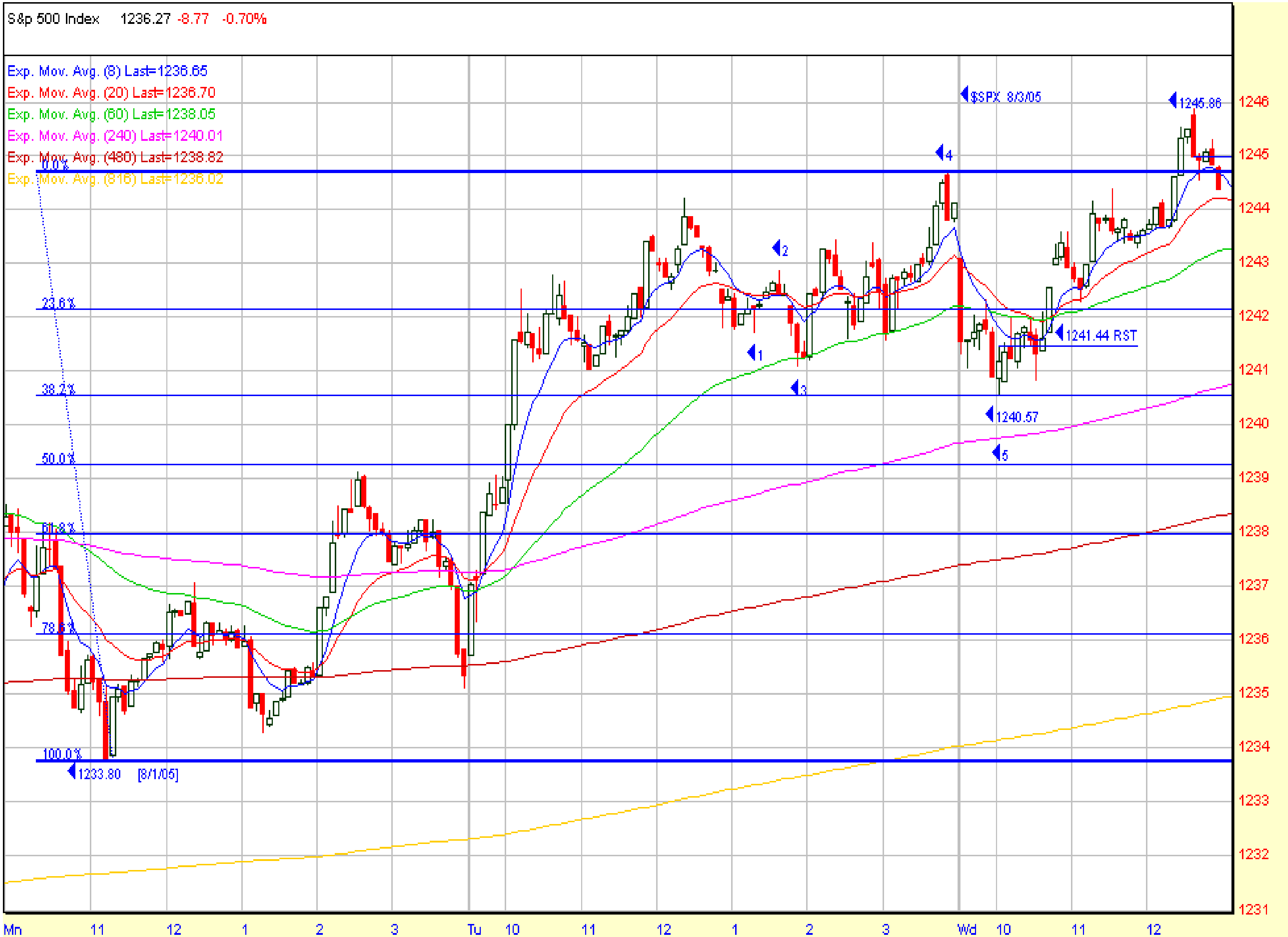
Newmont Min Cp (hldg 40.17 2.03 5.32%
Exp. Mov. Avg. (10) Last=38.25
Exp. Mov. Avg. (20) Last=38.13
Exp. Mov. Avg. (50) Last=38.31
Exp. Mov. Avg. (200) Last=40.35
46.51
NEM 8/3/05 DAILY
[2]
40.33
40.34
40.27
40.17
2
38.85
38.68
38.65
37.34
37.42
123 HB
36.38
3
36.55
[3]
35.69
123 CLOSE
34.80
1
© 1998-2004 Prophet Financial Systems, Inc. | Terms of use apply.
Volume (Millions)
Mar
Apr
May
Jun
Jul
Aug
RSI, Wilder (5)


EXELON CORPORATION 54.33 0.50 0.93%
Exp. Mov. Avg. (10) Last=54.27
Exp. Mov. Avg. (20) Last=54.31
Exp. Mov. Avg. (50) Last=54.37
Exp. Mov. Avg. (89) Last=54.26
Exp. Mov. Avg. (200) Last=53.88
EXC 8/3/05
54.88
54.68
54.48 [2.5 x RISK]
53.86
FLIP TOP & OR [ABOVE 53.83]
53.61
54.8
54.6
54.4
54.33
54.2
54
53.8
53.6
53.4
53.2
53
52.8
Tu
1:00
1:30
2:00
2:30
3:00
3:30
Wd
10:00
10:30
11:00
11:30
12:00
12:30
1:00
1:30
2:00
2:30
3:00
3:30
Th
10:00


Exelon Corporation 54.33 0.50 0.93%
Exp. Mov. Avg. (10) Last=53.12
Exp. Mov. Avg. (20) Last=52.49
Exp. Mov. Avg. (50) Last=50.88
Exp. Mov. Avg. (89) Last=49.31
Exp. Mov. Avg. (200) Last=45.78
EXC 8/3/05 DAILY
54.88
54.08
543.85
52.01
51.40
49.70
49.22
47.37
44.14
54.33
55 54 53 52 51 50 49 48 47 46 45 44 43 42 41 40
04/04 04/11 04/18 04/25 05/02 05/09 05/16 05/23 05/31 06/06 06/13 06/20 06/27 07/05 07/11 07/18 07/25 08/01 08/08 08/15
© 1998-2004 Prophet Financial Systems, Inc. | Terms of use apply.


S&p 500 Index 1239.42 -5.62 -0.45%
Exp. Mov. Avg. (8) Last=1241.82
Exp. Mov. Avg. (20) Last=1242.61
Exp. Mov. Avg. (60) Last=1243.11
Exp. Mov. Avg. (240) Last=1241.44
1
2
3
4
5
$SPX 8/3/05
1245.86
1245
1241.32
1233.80 [8/1/05]
1246
1245
1244
1243
1242
1241
1240
1239
1238
1237
1236
1235
1234
1233
Mn 11 12 1 2 3 Tu 10 11 12 1 2 3 Wd 10 11 12 1 2 3
© 1998-2004 Prophet Financial Systems, Inc. | Terms of use apply.


S&p 500 Index 1236.65 -8.39 -0.67%
Exp. Mov. Avg. (8) Last=1236.74
Exp. Mov. Avg. (20) Last=1236.74
Exp. Mov. Avg. (60) Last=1238.16
Exp. Mov. Avg. (240) Last=1240.07
Exp. Mov. Avg. (480) Last=1238.84
Exp. Mov. Avg. (816) Last=1236.02
$SPX 8/3/05
$SPX 8/4/05
1245.86
1245 RST
1245.18
1241.73 [.618RT 1241.95]]
1241.32
1239.38
RST
1.618 1238.93
-1.0 VB 1238.77
1238.71
-1.5 VB 1235.62
1235.80
1235.15
1233.80 [8/1/05]
0.0%
23.6%
38.2%
50.0%
61.8%
78.6%
100.0%
1236.65
Mn 11 12 1 2 3 Tu 11 12 1 2 3 Wd 11 12 1 2 3 Th 11 12 1 2 3 Fr 10


S&p 500 Index 1236.27 -8.77 -0.70%
Exp. Mov. Avg. (8) Last=1236.65
Exp. Mov. Avg. (20) Last=1236.70
Exp. Mov. Avg. (60) Last=1238.05
Exp. Mov. Avg. (240) Last=1240.01
Exp. Mov. Avg. (480) Last=1238.82
Exp. Mov. Avg. (816) Last=1236.02
0.0%
23.6%
38.2%
50.0%
61.8%
78.6%
100.0%
1233.80 [8/1/05]
$SPX 8/3/05
1245.86
1241.44 RST
1240.57
1
2
3
4
5
1246
1245
1244
1243
1242
1241
1240
1239
1238
1237
1236
1235
1234
1233
1232
1231
Mn 11 12 1 2 3 Tu 10 11 12 1 2 3 Wd 10 11 12


DIAMONDS TRUST 105.65 0.00 0.00%
Exp. Mov. Avg. (8) Last=105.78
Exp. Mov. Avg. (20) Last=106.07
2
107
4
107.16
DIA 8/5/05 60 MIN
107.04
106.10
105.75
1
105.64
3
1.618 105.52
105.54
5
107
106.8
106.6
106.4
106.2
106
105.8
105.65
105.6
105.4
Mn Tu Wd Th Fr Mn Tu Wd Th Fr Mn Tu Wd Th Fr Mn


DIAMONDS TRUST 105.65 0.00 0.00%
Exp. Mov. Avg. (8) Last=105.64
Exp. Mov. Avg. (20) Last=105.65
Exp. Mov. Avg. (60) Last=105.71
DIA 8/5/05 5 MIN
105.84
105.58 RST
105.54
106.4
106.3
106.2
106.1
106
105.9
105.8
105.7
105.65
105.6
105.5
© 1998-2004 Prophet Financial Systems, Inc. | Terms of use apply.
Volume (Thousands)
1000
800
600
400
200
0
Th 3:00 3:30 Fr 10:00 10:30 11:00 11:30 12:00 12:30 1:00 1:30 2:00 2:30 3:00 3:30 Mn 10:00
Stochastic, Full (8,3,3)
100
80
60
40
20
0