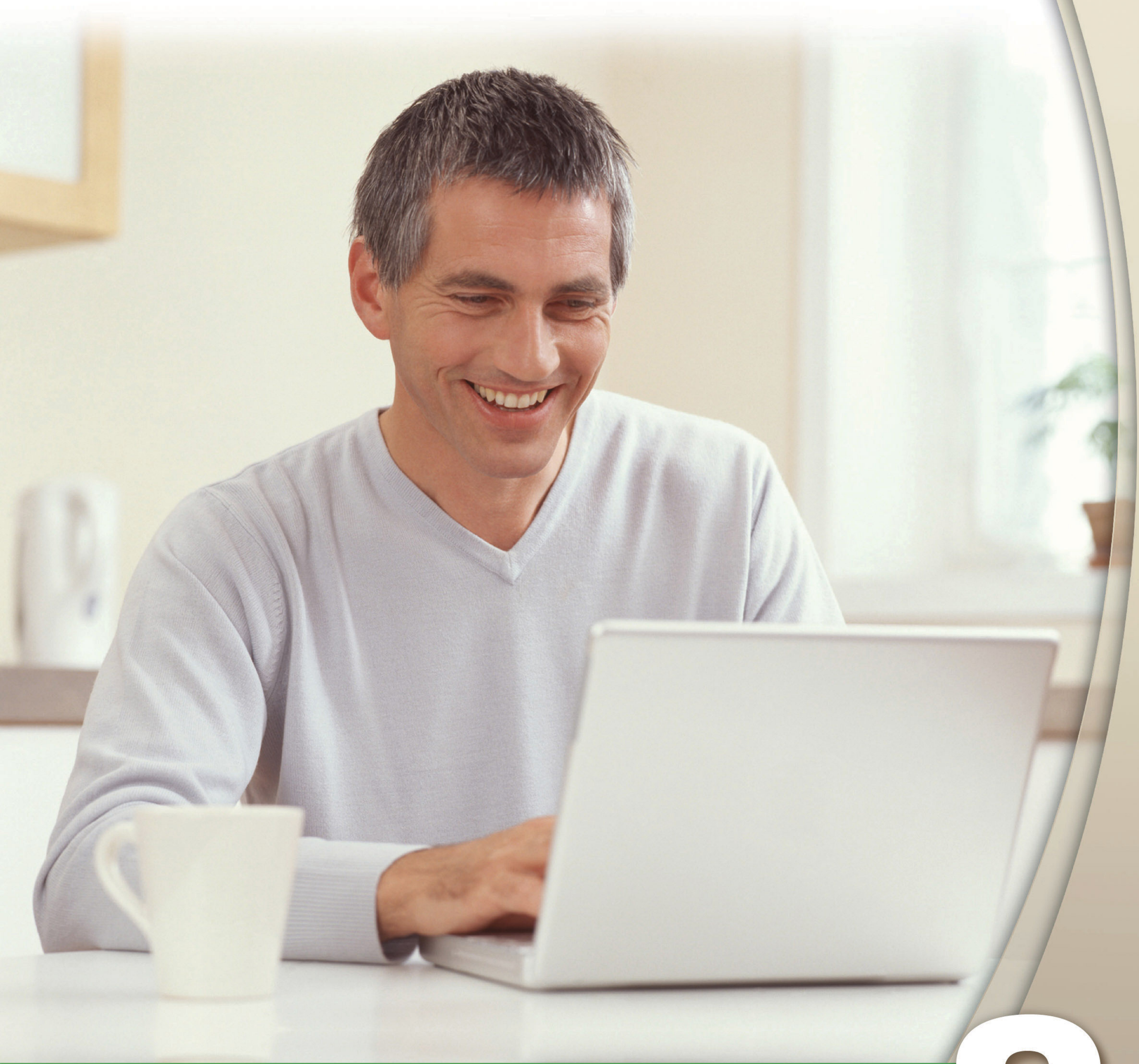
ZACKS
INVESTMENT RESEARCH



Lesson 3
(PART 2)

Disclaimer

The performance calculations for the Research Wizard strategies were produced through the backtesting feature of the Research Wizard using the DBCMHIST database and consist of the total return (price changes + dividends) of an equal weighted portfolio. Returns are calculated on a specified periodic basis (most often one or four weeks) and assume no transaction costs. The portfolio is rebalanced at the start of each new period. Returns can be stated as either annualized or compounded.

Stock trading/investing involves risk and you can lose some or all of your investment. Hypothetical or backtested results may not always be duplicated in the real world. Backtesting can at times produce an unintended look-ahead bias. Results can also at times be over or understated due to the exclusion of inactive companies. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading, not the least of which is the ability to withstand losses or to adhere to a particular trading strategy in spite of trading losses. These are material points which can also adversely affect actual trading results. The backtested results prepared for these materials were done using the DBCMHIST database and consisted of only active companies. The Research Wizard program has been aligned, to the extent possible, to eliminate look-ahead bias. Zacks however cannot make any guarantees in regard to this or any other possible limitation. For more information on backtesting, please go to: http://www.zacks.com/performance.

The performance of the Zacks Rank portfolios for annual and year-to-date periods are the linked monthly total returns (price changes + dividends) of equal weighted hypothetical portfolios, consisting of those stocks with the indicated Zacks Rank, assuming monthly rebalancing and zero transaction costs. These are not the returns of actual portfolios. The hypothetical portfolios were created at the beginning of each month from January 1988 forward based on the values of the Zacks Rank available to Zacks' clients before the beginning of each month. The portfolios created monthly from 1988 through September 2006 exclude ADRs and are comprised of stocks that have the indicated Zacks Rank and were covered by at least two analysts at the time of the stocks inclusion in the portfolio. Starting in October 2006 and going forward, the portfolios are comprised of all stocks with the indicated Zacks Rank and do not exclude ADRs, which is more reflective of the list of stocks that customers will find on the Zacks web sites. These performance numbers have been audited from 1995 through 2003 by Virchow, Krause & Company, LLP.

The S&P 500 Index ("S&P 500") is a well-known, unmanaged index of the prices of 500 large-company common stocks selected by Standard & Poor's. The S&P 500 includes the reinvestment of all dividends, no transaction costs, and represents the gross returns before management fees.

Table of Contents

Symbol Guide

To assist you in the use of this ***Zacks Method for Trading: Home Study Course Workbook***, icons have been used to identify specific areas of interest. They include:

Assignment: Identifies areas that require completion before moving on to the next lesson in the workbook.

Exercise: Identifies activities or exercises used to review or test your knowledge in the application of the tools or strategies.

Key Point: Identifies objects, lessons, main ideas or terms to help you gain expertise while developing strategies for trading.

Lesson: Designates practical information helpful in gaining knowledge and understanding of the Zacks Method for Trading in the stock market.

Notes: Indicates an area provided in your workbook allowing you to take notes and record additional information from your personal studies.

Objectives: Identifies information as well as targeted areas for discussion to be covered during your home study course.

Lesson Snapshot: Provides a brief summary or recap of topics or concepts covered in the lesson.

Web Address: Indicates a website or web address with supporting information or additional resources to help develop your skills.

Lesson Three (part 2)—
Creating Screens and Trading Strategies and Backtesting Them for Success

Objectives

The objectives for this lesson include:

- **Step 2: Analyze**
  – How to Backtest Using the Research Wizard
  – Backtesing Example Using the Best Buys Strategy
- **Step 3: Manage**
  – How to Trade the Strategies
  – Other Rebalancing Methods
  – Stop Loss Orders

Assignments and Exercises

The following assignments will help you in understanding the information in this lesson:

- **Watch the following DVDs:**
  Disc 3: Screening for Stocks and Creating Your Own Trading Strategies

  Disc 4: Backtesting Your Strategies for Success
- **Complete Exercises 3.1 - 3.12**

Plan to devote a minimum of 15-30 minutes per day to completing the assignments and exercises for each lesson. It is imperative to spend time educating yourself about the market in order to have long-term success and consistency in profitable investing.

Step 2: Analyze

How to Backtest Using the Research Wizard

Now that you've created your own screens, it's time to test them out. But first, be sure to understand what 'kind' of screen it is you want.

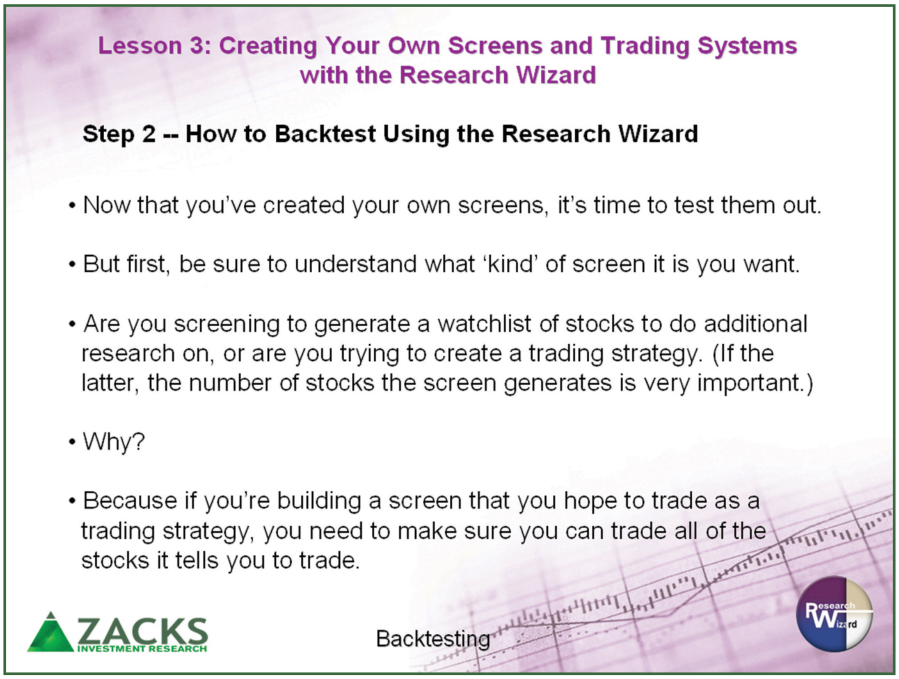
Ask yourself…

- Am I screening to generate a watch-list of stocks to do additional research on?
- Or, am I trying to create a trading strategy?

If the latter, the number of stocks the screen generates is very important because if you're building a screen as a trading strategy, you need to make sure you can trade all of the stocks it tells you to trade.

Notes

How to Backtest Using the Research Wizard



For example: If you have a strategy that makes a 100% return a year, but you have to buy 60 stocks every month, it doesn't make sense for you to try and trade it if you can only buy 10 stocks.

Why? Because the very moment you don't buy all of those 60 stocks, is the very moment you're no longer trading that strategy. If on the other hand, you're simply trying to generate a list of stocks that have merit so you can do additional research, then the size of the list no longer really matters that much.

These are important things to consider when creating and backtesting your screens and trading strategies.

Backtesting Example Using the Best Buys Strategy

The first strategy we used in the DVDs to demonstrate how to run a backtest and how to interpret the report was the Best Buys Strategy.

Notes

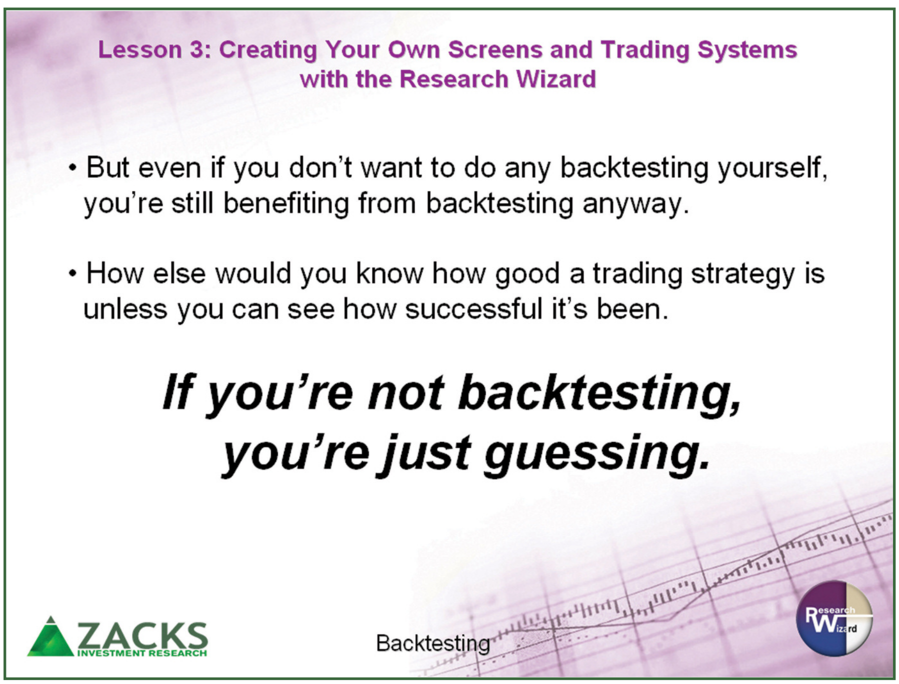
But please review any of the strategies we've covered so far (and even those we haven't). Just remember that the key to being successful with any kind of trading strategy is to make sure the strategy agrees with your style and risk tolerance.

You should look at the win ratio, the number of stocks held in your portfolio at any one time, the amount of trading or turnover there is and the maximum drawdown and more. Also, if you're creating your own strategies, it's critical to test them over both up and down markets, to know how your strategy acts in both bullish and bearish periods.

Few traders ruin their account when the market's going straight up. It's when the market goes down that people get into real trouble. Unfortunately, even bad trading decisions can get rewarded in bull markets. But there's no mercy for bad decision makers in bear markets.

So test your strategies if you're going to be building them on your own. Or use only proven, profitable trading strategies, like the ones presented here so far.

If You're Not Backtesting, You're Just Guessing



Notes

Exercise 3.10: Trading Strategies

Best Buys Strategy

Refer to DVD **Disc 4: Backtesting Your Strategies for Success** for the Best Buys Strategy and the other strategies demonstrated in the DVDs.

Assignment: To backtest this screen in the Research Wizard, follow along with the procedure on your DVDs while duplicating the steps illustrated by the instructor. Complete the procedure before moving on in this workbook.

~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~

Step 3: Manage

How to Trade the Strategies

As we have previously discussed, implementing these trading strategies is very easy. After 'identifying' what kind of trader you are and what kind of strategies you want to trade, then all you have to decide on is *how often* you want to trade.

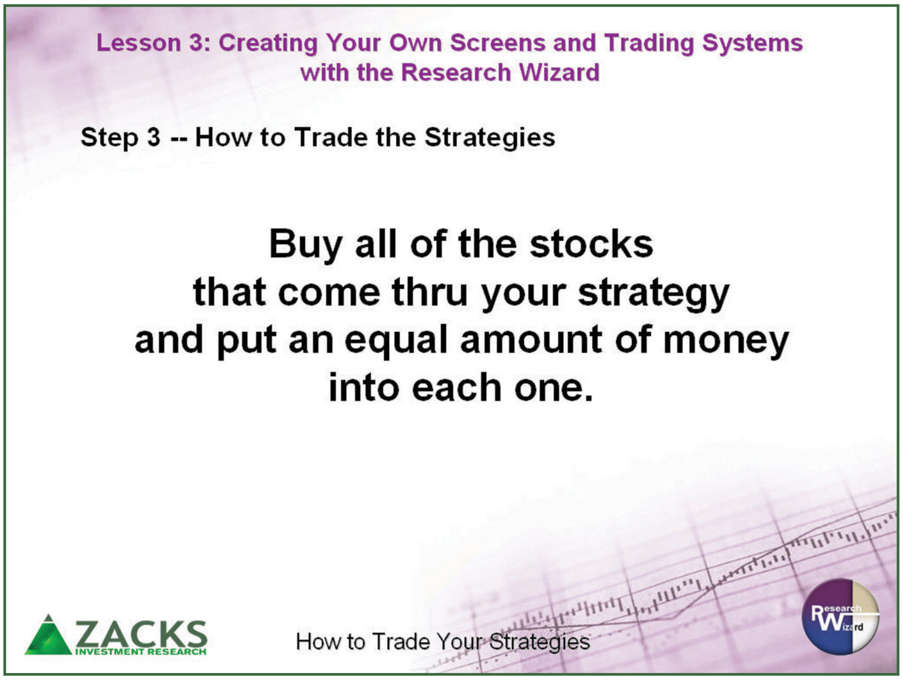
But whether you've decided you want to trade every one week, two weeks, four weeks, or even a couple times a year, the process is the same and very quick.

At the beginning of each period (whether it be weekly, monthly or quarterly), you will run your screen for Monday morning and see what stocks come through.

Just a note... What is meant by 'for Monday morning' is to run your screen on either Saturday evening, or anytime on Sunday or Monday morning.

Notes
~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~

How to Trade the Strategies



The Trading Strategy Process

When trading your first period, purchase all of the stocks that come through your screen in an equal dollar weighted manner, meaning you'll be putting the same amount of money into each stock. This is important because you never know which one could be a big winner or which one for some reason may not do so good.

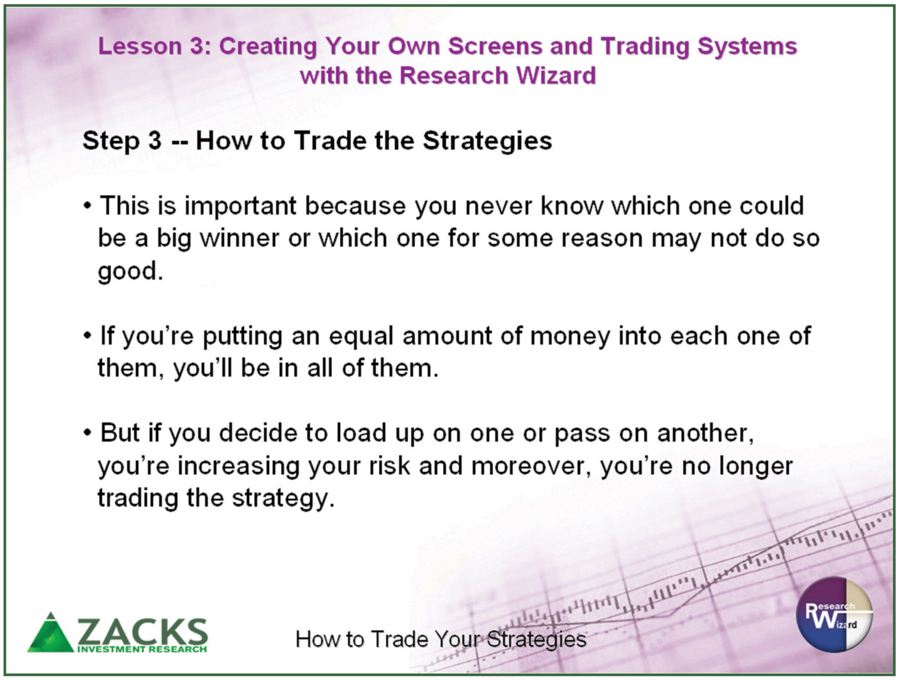
If you're putting an equal amount of money into each one of them, you'll be in all of them. But if you decide to load up on one or pass on another, you're increasing your risk and moreover, you're no longer trading the strategy. So buy all of the stocks that come through in an equal dollar weighted manner.

And remember, you'll hold onto those stocks for the duration of your holding period -- one week, four weeks, 12 weeks, etc. At the end of that holding period is the beginning of the new period and the screen is run again.

Notes

You'll keep the stocks that remain qualified (the ones that came through again), sell the stocks that no longer qualify (whether it be at a profit or a loss) and you'll buy any new stock(s) that newly qualify.

How to Trade the Strategies



Determining the Holding Periods

Many of these strategies were created to be rebalanced every four weeks while others are better suited for longer hold times like the Dividend Paying strategies or even the Value oriented strategies.

As we have demonstrated in some of the previous screens, performance can be enhanced when rebalanced weekly or even every two weeks. But some don't want to trade that often. While it will only take you approximately 10 minutes to rebalance your portfolio (whether it is once a week or once a month or once a quarter), if you don't want to trade that often, then don't. This is all a part of 'Identifying' the kind of trader you are or the kind of a trader you want to be.

Notes

That includes the kinds of stocks you want to get into and how often you want to trade. One of the key points to trading success is being able to just do it. But if it's hard or time consuming, you'll find yourself not doing it. And even the best trading strategy, if you don't use it, won't make you any money.

So, set yourself up in a winning situation. Trade a strategy you like. If you don't like stocks making new 52-week highs, even though it's a great strategy, don't trade it. If you prefer to trade once a month or even once every three months, do so.

Don't try to make a weekly strategy work for you if you simply don't want to trade every week. Also, don't try to fit yourself into longer term rebalancing period, if you want to be a more active trader.

Other Rebalancing Methods

Another way to trade these strategies is by using a combination of both the 4-week and 1-week holding periods. This can also be very effective. This is done by running the screen on a weekly basis, but holding those stocks for a 4-week period.

For example:

1. Run the screen at the beginning of the week.
2. Buy all of the stocks that come through the screen.
3. Hang on to the stocks for the next four weeks.

Then:

4. Next week, run the screen again.
5. Buy any new stocks that made it through the screen, being sure to hang on to those stocks for the next four weeks.

Notes

Do this week after week. Each week a stock comes through the screen, a new four-week hold count begins. If a stock never comes through again, sell the stock in four weeks. So, even though a four-week holding period is being used, the screen is being run weekly and only a portion of the portfolio is being rebalanced each week.

One of the benefits to this strategy is if you're running a great screen, you are participating in every start date, meaning you'll have the opportunity to pick up any and every new stock that comes through at the beginning of each period.

Key Point–

This strategy can help you increase your returns and smooth out your performance. Even though running your screen each week is an active approach, you are also incorporating a longer hold-time for stocks coming through the screen.

It's also a good strategy if you have a larger portfolio and want to include more stocks to hold at any one time.

~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~

Stop Loss Orders

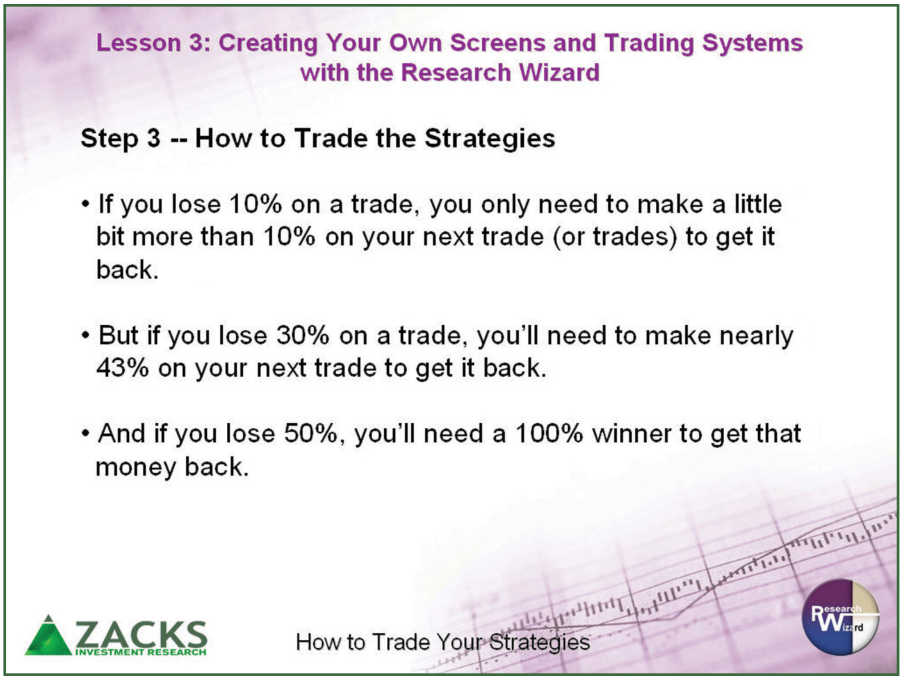
The great performances you've seen so far in the DVDs and from all of these different strategies, were all done without the use of stop-losses or any other type of money management rules. Some view this as a testament to how solid the strategies are.

If a proven, profitable strategy that has been backtested through and through has a stock doing poorly, it's likely it's going to be kicked out of your screen at the next rebalancing period. So in a way, it acts like a built-in protection for your portfolio. And these risk-to-reward metrics can be viewed in the backtest report.

But some still like using stop-loss orders. It's something you might want to consider for yourself.

Notes
~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~

Stop Loss Orders



A popular place for a stop-loss is 10% from your purchase price. If you have a 10% loss on a trade, you only need to make a little bit more than 10% on your next trade (or trades) to get it back. And if you're running an excellent strategy with a big win ratio, your probability of gaining that back should be very good.

However, if you get hit for a 30% loss, you would now need to make nearly 43% back on your next trade or trades to get back to where you were. And if you get hit for a 50% loss, then you would need a 100% winner to get that money back. So trying to keep your losses small and reasonable makes sense.

Additionally, if you know you would sell a stock that falls 15% or 20% or more, why not just utilize a stop-loss at the relatively painless area of 10% without doing any real damage and give yourself permission to get back in if there's reason enough to do so.

Another benefit for some in cutting losses at a planned percentage is that it helps them stay focused by not getting down on themselves or getting gun-shy on their next trade.

Notes

The decision is yours whether you decide to use stops or not. But we thought we'd share with you how some people use stop-loss rules in their own trading.

~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~

Exercise 3.11: Stop Loss Orders

Read the following scenario and answer the questions below.

Scenario: You are considering setting a10% stop loss on the stocks you are trading. One of the stocks, XYZ Corp, came through your screen yet it tends to be volatile. But you have also seen some good profits in the past. Therefore, you don't really want to sell the stock if drops down below the 10% because it might swing back up and make a larger profit.

1. What are your options for trading this stock?

____

____

____

____

2. Will you set the stop-loss? Why or why not?

____

____

____

____

3. If you set a stop loss and were stopped out, and the stock started back up, what should you consider *before* buying the stock again?

____

____

____

____

Notes
~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~

4. What else could you do to remove the emotion from your trading?

~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~

Exercise 3.12: I AM Review

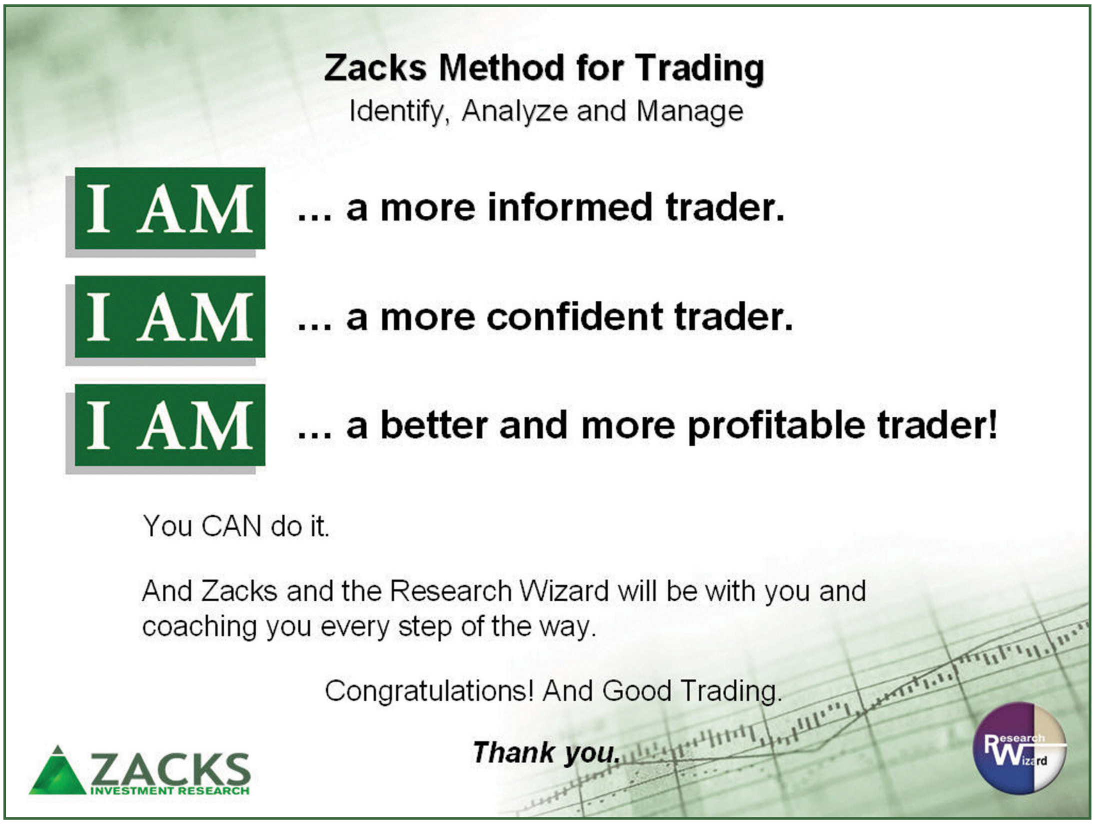
In your own words, briefly explain how each of the following can make you a better investor/trader:

Identify …

Analyze …

Manage …

Notes
~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~


Zacks Method for Trading
Identify, Analyze and Manage
I AM ... a more informed trader.
I AM ... a more confident trader.
I AM ... a better and more profitable trader!
You CAN do it.
And Zacks and the Research Wizard will be with you and coaching you every step of the way.
Congratulations! And Good Trading.
Thank you.
ZACKS INVESTMENT RESEARCH

Notes

Lesson Snapshot

Your investments are probably the largest, most important chunk of money you'll ever be responsible for in your entire life. And if it isn't now, it probably will be one day.

You now have the method—the Zacks Method—to better take care of your investments. Today's decisions will determine your financial resources tomorrow.

After watching the DVDs and participating in the exercises and assignments in this Home Study Course, you should be able to say ...

I AM … a more informed trader.
I AM … a more confident trader.
I AM … a better and more profitable trader!

In the Home Study Course, we categorize many of our top trading strategies—the ones covered here (and many that were not)—complete with performance charts and graphs and the reasons behind them.

Final Review

Pick and choose from the proven, profitable trading strategies that Zacks has already created and that come loaded with the Research Wizard. Or use the program to create your own screens and trading strategies.

Then backtest them to know if they work. Backtesting gives you the opportunity to test new trading techniques and ideas and discover how successful they are before you put your money at risk.

You now have the tools and the knowledge to backtest to see if something new to you works better than what you're doing now. That includes new screens and trading strategies and maybe even how often you trade. You might realize that trading a little more often can make all the difference in your final results. You may also realize that you're overtrading and by rebalancing your portfolio less often, your bottom line will improve.

Notes

Let's also review again 'how' to trade these strategies and the different ways you can implement them.

Remember these important points in the process:

- Determine the strategy and the rebalancing period that's right for you, then run your screen at the beginning of each period. (Once a week, every two weeks, every four weeks, every 12 weeks, etc.).

On your first week (Monday morning), buy all the stocks that make it through your screen.

- Each stock should be purchased in equal dollar amounts. (An equal amount of money is put into each stock.)
- Hang on to those stocks for the duration of the holding period.
- At the end of the holding period (which is the beginning of the new period), run the screen again and see what stocks come through.
- Keep the stocks that still qualify.
- Sell the stocks that no longer qualify (whether you take a profit or a loss – sell those that no longer qualify).
- Buy any new stock(s) that newly come through the screen.

That's it. It's that easy.

You can do it. And Zacks and the Research Wizard will be with you and coaching you every step of the way.

Congratulations! And Good Trading.

~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~

Notes
~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~~

Notes