STOCK SPLIT MANUAL

Stock splits as part of your investment plan.

There are many different investing and trading strategies in the marketplace. Everyone is aware of the rise (and subsequent fall) of the day trader as a new and large addition to the investor community. Along with the day trader there is the long-term investor interested in quality stocks for the long run; the covered call writers who produce income from stocks bought solely for the purpose of writing calls to get the stock called away or who write calls on their long-term holdings with no intention of losing their stock; the long-term options investors (LEAP holders); medium term stock and options investors (a few weeks to months); short term stock and options investors (from a few hours to a few weeks); and any combination in between. We fit into each category because we buy quality stocks to hold for growth as well as trade for the short term to generate income. Playing stock splits can apply to any category listed above. We often buy our long-term holds when we feel a split is upcoming to enjoy the appreciation before and right after the split announcement, the run up to the actual split, and then get additional shares to boot. If the market is in a good upside momentum move, we will just as quickly buy options on a pre-announcement candidate minutes before the close only to sell the next morning at the height of the surge after the announcement. We buy LEAPS (Long Term Equity Appreciation Securities) on great companies that split their stock often (e.g., APOL, TSCO, CECO) so we can enjoy the fantastic appreciation of value as the LEAPS split in half and then rise back above their split price. We write covered calls on our long-term holds while things are quiet and the stock is in a trading range so we can increase our revenue beyond the actual split announcement. All of these are related to our split plays, some more directly than others. Yet, while all have a common heritage, they all require different game plans and different timing. To be successful in any one of the

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above strategies, you have to understand the underlying purpose of the play, and develop a game plan that implements that play. While some of the strategies listed share common attributes, if you try to combine them, you could have conflicting short-term goals that could lead to bad decision-making as you try to reconcile diverging market movements. This manual is designed to help you define your goals for each play by laying out for you our philosophy on trading stock split pre-announcement and pre-split plays. When we expand our service to cover playing splitting stocks with covered call and LEAPS strategies, we will expand this manual. If you want these services, gives us an email. Nothing like demand to drive supply.

Why we love stock splits and why you should too.

Before we dive into the actual strategies, we would like to talk about the popular perception of stock splits and their impact on stock prices, some general ideas about our stock split trading strategies, and some musings on the markets and the state of mind you need to be successful at investing and trading. Our intent is not to lecture you, but to provide you perhaps another perspective to trading and how the markets and emotions impact success. If we get too deep into the philosophical for you, skip ahead. We won't know, so we won't care.

Many commentators and investors ask, "Why stock splits?" You have all seen it, even in the financial magazines that quote me and my views on stock splits. The main argument: stock splits add no value; they do nothing more than tear the number of shares in two, three, four, or whatever ratio the split is. In a vacuum, this is technically correct. We do not, however, trade and invest within a vacuum. While companies may split their stock for many diverse reasons, the companies that split again and again, year after year, have certain common attributes: they are leaders in their industries, they make money, and they attract investors. These stocks rise in price, split, and then run right back up to split again. You know people who own stock such as TSCO Tractor Supply), APOL (Apollo Group), EBAY, and CECO (Career Education) with a cost basis of $5 or less even as these market leaders trade from $50, $75 to $100. Buying these market leaders and letting them appreciate and split, appreciate and split is an excellent method to build wealth. So, while the act of splitting in and of itself may not add value, investors know that good companies that are growing earnings and sales have stock prices that rise and split, only to rise and split again. This attracts investors, and when a split is announced and when a stock actually

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splits, the investors take the opportunity to get in on these great companies. This generates excitement with these issues resulting in price appreciation in anticipation of the announcement, at the announcement, and at the actual split. We play these stocks for long term appreciation arising from the repeated splits as well as short-term gains generated by the split excitement. These are the stocks we love.

As for long-term appreciation, you did not (and probably cannot) go wrong buying leadership stocks such as APOL, EBAY, ERES and TSCO. We all remember stocks such as DELL, CSCO and MSFT that built the bull market of the 1980's and 1990's; they rose and split time and time again before the bear market removed them as leaders and installed new leaders such as TSCO. There will be new leaders in the market that emerges from the 2000 - 2003 bear market as well. These stocks are often held for the long term for their ability to rise in value year after year. We own many of these leaders in our long-term portfolios, but we do not just hold them. We actively manage them, selling calls when the stocks are at a top in price, and buying the calls back when the stock falls. We often write and buy calls in conjunction with stock splits. This is one way to really put power into your retirement accounts or other long-term holdings, and is nothing new. Warren Buffet is known for his buy and hold patience. Not many realize, however, that while Mr. Buffet was buying and holding, he was writing covered calls on those stocks. It has been said that the majority of the appreciation enjoyed by Mr. Buffet's holdings is attributable to intelligent writing of covered calls on his long-term holdings. Again, while lucrative, writing calls on long term holdings is not the subject of this manual, but we would be happy to provide that type of service if our membership desires.

With respect to our split strategies, while they have proved themselves very profitable for us, they are not the end all in playing splits. We recognized the value of playing split announcements back in the early 1990's, and they are a, if not the, major part of our overall investment strategy. We have found, despite what the commentators say, that stock splits move a stock in the short term as well as the long term. We are all aware that a split announcement can really move a stock's price even after the bear market; the moves may not be 20% in an hour, but when a strong stock announces, investors get excited. We have also seen how a stock can run right before the actual split no matter what the market condition. As to the long-term effects, they are definitely present as well. In any event, we have

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continually refined our split strategies as time passed, and you should continually strive to improve how you play them as well.

We used to be able to buy stocks right after the split announcement and enjoy a nice gain. We would simply have our brokers scan for split announcements and call us when an announcement came. Market makers caught on, and started immediately raising option prices on an announcement even though the stock had not yet started to move. So, with the market makers stacking the deck, we needed to find a new way to take advantage of this powerful play. We did. It takes a lot of effort, but the rewards can be huge. We developed a new approach, forecasting the splits and playing the stocks after the announcement based on what the market makers and the rest of the crowd was doing. You can always make money if you are willing to look at things differently from the herd. That mentality has proved itself very successful for us, and you should always be willing to look at a play from a different angle. We always share with our subscribers any new wrinkles we come up with. As we said, there are many ways to make the same play, and we are always looking for new ways to improve the bottom line profit on any trade. As a successful investor, you should do the same.

<u>A quick view of our split strategies.</u>

We play three main strategies with stock splits, though we always look at market leaders as new potential split candidates and often include these on the report in order to take advantage of any emerging market leader that could turn into a main stock split workhorse. The key to any successful play is finding solid stocks in good technical patterns and then acting when the stock tells you it is time to act. Our three main strategies take advantage of the technical patterns and the split overlay and consistently produce great results for us.

The first is the pre-announcement where we put in the long hours of research, chase down leads and rumors, and pump our contacts for information in order to determine if a split is in the works and to pinpoint an announcement date. Pinpointing the date is our primary goal as this allows us many more options in how we play a split. As we primarily focus on leadership stocks in good technical patterns, if we see the stock make the breakout we will get in earlier and ride the wave of speculation up to or through the announcement. Pinpointing a date and time also allows us to

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open positions immediately prior to an announcement, minimizing our exposure time to the market whims. We employ this strategy regularly in a number of situations. When we have ridden a stock for a few days, a week, a few weeks, up to the forecast announcement, we often have a lot of profit built in. After all, these are leaders and they attract attention moving into earnings, shareholder meetings, etc. We often sell some positions (all or a partial), lock in the profit, and take positions with higher strike call options near the current stock price at a cheaper cost if the stock is not overextended, i.e., has done all of its running before the forecast announcement. This way we bank some profit from the early run, and take some of that profit to play the actual split. Even if the board pulls a fast one on us and does not announce, we still have profit in the bank. This method also works well when the market is choppy, and we do not want to hold positions long. We can often buy right before the announcement and then sell when we feel the split announcement has run its course and the stock starts to pull back. Narrowing the predicted date and time of the split gives us these options.

The second primary strategy involves what we call the pre-split run. Stocks often start a run anywhere from right after the announcement to 10 days on down to a day or two before the actual split. We painstakingly analyze key technical indicators to determine if we believe the stock is going to start a move, and then when the move starts, we get in, make some quick profit, and get out. We love these plays because the stocks tell you when they are ready to move up, and we wait until we see that move and then get in. The stocks also tell us when the run is weakening, allowing us to get out and preserve our profit. We also love these plays because they produce profits day to day. These stocks are very volatile at this time, and we can often play them more than once before the split. Our subscribers have made huge profits in a matter of days, even hours, on this powerful play (e.g., NTE IN June and July 2003). These may not get as much attention from most split services as they are not as sexy as the pre-announcement plays, do not overlook them as they add consistent profit on a daily basis to your split trading. There will be some clinkers, and when the market is really bad even the power of the pre-split play can be affected, but overall these are consistent profit makers if you are willing to watch and buy and sell when the time is right.

The third primary strategy is the post-split play. As noted earlier, the key to split plays is the leadership quality of the stock. That means growing sales, growing earnings and correspondent market leadership. Thus we don’t just

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forget about stocks after the split. Post-split stocks will sometimes just keep on running higher through the split. Other times they will pull back, form another base, and then start the run all over again. Sometimes a stock will move from our Post-Split section right back to the Pre-Announcement candidate section in without ever leaving the report (e.g., ERES)! That is the beauty of playing leadership split stocks, not just any stock that may announce a split. Leaders tend to lead, and that is why they are called leaders.

<u>Thoughts on the Market.</u>

Despite such sayings as "make the trend your friend" and the like, the market is not your friend. When things are going great and the market just keeps rising, it appears to be your friend as it rewards you with ever-rising stock prices. The market, however, does not always rise, and when it turns or moves against you, it exploits you emotions making you doubt yourself and the moves you know you should make. Many investors learned this hard, hard lesson after the market peaked in March 2000 and suffered the worst bear market since the Great Depression. To be a successful investor, you must ALWAYS fight your emotions. We like to step back and analyze the market every day, look at what the crowd is doing and why, listen to what the so-called experts are saying, and watch what the smart money is doing. A lot of this is noise that can and should be ignored. There are very few television personalities that mesh with our investment style. This doesn't surprise us. They make their money from the television. We make ours from the market. What we really watch are the technical indicators. These compile all of the market sentiment, money, and momentum into a picture. While fundamental analysis is part of our mix (we prefer to play the solid stocks, and it just so happens that stock split companies more often than not fit this category), it does not tell the story of what the stock is doing this week, this day, this hour, this minute. We then structure a plan based on the story the market and the stocks are telling us. You have to put aside your emotions, read the market, develop a plan, and take what it gives you.

For example, when market sentiment turns against a sector as it did against most of the former leaders starting March 2000, we don't fight it. We play the selling or find those sectors that are being favored. Even during the first year of the bear market many of the newly powerful tech stocks continued to perform well and announce splits (e.g., BRCD, AMCC, JNPR) before they caved in. Moreover, many retail, banking, and financial stocks continued to

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perform in the bear market as mortgage rates were low and consumers continued to consume. They continued to rally and split until they too were taken down by the bear market. That is the nice thing about technical analysis: it shows you what stocks still have money moving into them and what stocks and sectors money is leaving.

Usually the market rotates slowly enough to make the shift without too much pain, but sometimes it jumps back and forth between sectors as it did between the techs and the cyclicals. This makes it more difficult to play as the investor is jumping back and forth, trying to pick tops and bottoms as he or she tries to determine when a sector has run out of gas and which one is going to start moving. This can be done more or less when things are steadily moving in one direction. When market sentiment jumps back and forth, however, it is easy to get whipsawed. An investor will often hold firm on a position as it moves against him or her, and after being buffeted by the emotions and second-guessing as a position dwindles, the decision is made to jump sides. By this time, however, the seeds of change are already sprouting, and the switch is made just in time to get knocked down going the other way. The market always tests an investor's resolve on each play. As long as things go our way, the test goes unnoticed. Unnoticed, that is, unless we ignore sell signals and stay too long. Then it is again decision time, but now under difficult conditions. And then the emotions that kept you in the play when you should have sold ("I can make a little more money") often lead you to sell at the wrong time when the pressure is on. It happens every day, and it happens to the best traders. The good investors know it can happen to them at any time, and are always alert and playing defense. It is better to exit a trade that appears to be going against you and then get back in if you were wrong than stay too long and lose your investment. Capital preservation is key. You need to keep your stake, and keep your profits. Let a stock move up, but be ready to exit quickly if it starts behaving in a questionable manner. We talk about that later in the 'when to get out' sections.

The point of all this you ask? You need a plan, and you need to incorporate market analysis as a major part of that plan. That is why we start every report with a discussion of the market. That is why we have the Board so our members can see at a glance what the major indices are doing and how the stocks are holding up in relation. How the market is performing bears on when we enter our plays and how we structure our plays. Let's face it. To be successful in the market, you have to be ready to make the right plays in

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the right market climate, and know how to enter and exit. As noted above, when the market gets choppy, we enter plays right before we think the time is right, and exit quickly thereafter. When the market is climbing, we enter pre-announcement plays much earlier and enjoy the move to the actual announcement. Gear your strategies toward the market conditions.

<u>Stock split strategies.</u>

<u>Pre-Announcement Strategies.</u>

Pre-announcements are the true art in stock split trading. As noted earlier, at one time we could be reactionary, waiting for a split to occur. With a good broker, you could make handsome profits. All that changed with the advent of beeper services that alerted thousands to splits as they occurred. Market makers caught on quickly and would jack up option prices on the announcement even though the stock had not started to move. Another strategy was needed. We went back to the drawing board. We combed all available information. We interviewed people from all walks of investing and company relations. We built contacts with companies and within the markets. Our goal was to gather every scrap of available information to help us narrow down to a precise date when a split would be announced. A tremendous amount of work goes into each split forecast. We thoroughly research all of our plays and we like the ones we put in the report. If we have a concern about a play, we tell you.

Once a forecast is made, we have to look at making the play. With variables such as market conditions, news, the stock's technical pattern, etc., the approaches can be diverse. The following attempts to outline our approach to various situations.

<u>Have a plan.</u> This step is critical. Enter every trade with a purpose, and structure your trade to fit that purpose. In short, map out what you want to get out of the play, structure a plan that covers when to get in (a price and time component), when to get out (also a price and time component), and when to let it ride in order to effectuate that plan. Still, you never know what a given board of directors is going to do. So, no matter what the market conditions, we hedge the bet. If we are buying options, we buy several months out. If the split announcement is not forthcoming and the stock drops, we have plenty of time to recover. When a stock drops on good earnings news, we are pretty sure the stock will be back as long as it

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maintains its uptrend and the market continues its trend as well. Also, if the stock proceeds to run for the entire next month (not unusual in an up trending market after a strong stock announces), we have time to enjoy the run without jumping in and out of our positions and paying higher option premiums when the stock runs and volatility jumps. We may add additional positions when the stock dips, but we have the luxury of being able to continue to ride a winner ever higher.

We also buy in the money options. If the stock drops, we don't lose as much value, and when it recovers, we recapture lost premium much faster. If we are buying the stock, we look for the right time to enter the trade from a technical standpoint and we include this analysis in each report that goes out. As noted earlier, we buy stock when we want to own it for the longer term and enjoy the wealth effect related to multiple splits. To maximize that wealth effect, we want to buy at the best price we can. Technical analysis helps pinpoint when we should make a buy.

<u>Stick to the plan.</u> Don't lose sight of the plan regardless of whether the trade goes your way or turns against you. Know ahead of time if you are going to sell if a certain event occurs or if you are going to ride it out. This applies to profitable trades and losing trades. Do you let a winning trade ride or cut it off at a target price? We have a target price, and if we hit that price and things are still positive (very positive), we will continue the position, but with even heightened scrutiny. We will even take a partial gain if the target is hit and the stock still looks strong. That way we lock in gain and can let the stock continue to work for us. When it gives the next pullback to support that presents another buying opportunity, we can then average up into the stock, thus focusing on a winner even after we have already taken some nice gain from it.

We have sell points on losing trades, and stick to them unless we know for certain something is going to happen. Usually, such "sure things" are just wishful thinking, meaning you should stick to your original sell point. Remember, 'hope' rhymes with 'dope.' We keep a sell price and stick to it the best we can. Even when we buy long-term options, we set a sell price that we feel the stock cannot recover from in the remaining time. Sometimes, if things really tank, the stock may blow right by you and you don't have time to sell where you want. We never panic sell at that point, as stocks always tend to rebound before dropping again. There is usually a window to sell higher. Maybe not at your target price, but at a higher price

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than at the open. This can also occur over a few days or a few weeks. Again, another reason for the longer term options. If you are going to hold on, however, be aware of devastating news versus temporary news. If news is really bad, the stock may keep bleeding to death on you as time passes. If things really get bad, we always try to sell when the value of our options is cut in half. We would rather have half our money than none. Also, you need to watch time decay on your options. This is where your option value erodes faster and faster as the expiration date approaches. Inside of 4 weeks it starts, and with three weeks or less, the value drops faster and faster. This is another reason we buy options that are further out. It gives us some more time cushion so we can make some choices if we have to. More on selling and stop loss strategies and option issues later.

What to buy (or sell). We like to play options on pre-announcements because we get more bang for our buck. We also buy stock on pre-announcements, however, because many of the stocks that are announcing splits are stocks we want to own. Let's look at options first. We covered some of this in the "Have a Plan" section. We prefer options at least at or slightly in the money on up to 1 to 2 strike prices in the money. If a stock is $106, we would look at $105, $100, and maybe even $95 strike prices on nearer term expirations. We look at the incremental cost of a lower strike price versus the additional intrinsic value we are buying, i.e., the additional in the money portion of the option. If we can pick up an extra $5 in the money for $2, we will usually do it if the delta is better as well. The delta tells you how much your option will move given a $1 move in the stock. We like deltas of 75 or better, but that is sometimes very expensive. That means, for every dollar the stock moves (up or down), the option should move $0.75 in the same direction. The bigger the delta, the quicker you can hit your target profit price (or your loss price). Sometimes it is difficult to find a reasonably priced 75 delta option on some of the popular stocks. There, you may have to drop to 60-70. We also look at the percent to double--this is a proprietary number calculated by Salomon-Smith Barney. The lower the better. We really like them under 10%, but we have bought them as high as 15%. For stocks, there are no deltas or percents to double. Our criteria are do we want to own the stock, and is it at a good position to buy? If it is a solid stock that has great revenues and rises and splits, we like to own it. As to whether it is in a good position to buy, that is where our technical analysis comes in to play. If the stock could announce a split but the technical pattern is in the trashcan so to speak, the split announcement

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most likely won't save it. Best to look for a stock in a stronger pattern ready to make the move.

When to open a play. Timing your buy often depends on the market, the type of play, and individual preference. If the market is good, you can sometimes get by just jumping in on a momentum move. We always, always prefer, however, to get in on a good breakout from a sound technical pattern. If the market is choppy, we like to limit our exposure to possible downside. Thus the pattern becomes even more important as strong patterns hold up much better in weak markets because the strong pattern shows continued accumulation in the stock even as others are sold. If the market gets really bad right before the time we think an announcement might come, we may not get in at all as the stock probably won't move up enough even if the announcement comes. Think about it. Making that play when the market is bad may net you a point or so if you are lucky, but the probability is that you will lose unless you are very good at timing. Is it worth the risk? Knowing when to sit one out is equally important as knowing what price to buy at and what option to buy. Picking up a point on any single trade won't make you rich, and in a bad market, taking large risks for potentially small gains could end up costing you a lot more. In short, making bullish trades in bearish or choppy conditions won't make you, but if the trades go south fast, they can break you.

This is part of structuring the trade--what is the upside versus the downside, and do I want to take the risk? We like to stack the deck in our favor as much as possible, and splits are a great way to do this. There are occasional periods when split announcements don't overcome the market's bearish sentiment or the gains we see are reduced. Factor this into your plays by reducing the time you are exposed to the market or by passing on questionable plays. The market will turn around fast enough for us to get in on many split plays each month. We don't push it.

The type of play also determines when we open a position. If an earnings announcement is coming up, and the market is humming along, we will take a position early on when the stock appears to be technically sound and moving up. This way we can ride the pre-announcement surge that often accompanies good stocks that have large followings. EBAY and TSCO often do this as investors anticipate good things from the news to come.

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We also love to take a position right before the close when the market is strong we think an announcement is coming after the close or before the open the next day. This is particularly true if some news event is anticipated, e.g., earnings, and the market is rewarding positive earnings. Market leaders that are growing sales and earnings and have solid patterns typically beat expectations, and these are the stocks we like to make this play on. People who are playing the earnings will sell beginning sometime during the day before the announcement. We start watching in earnest an hour before the close to see if the stock has sold down and is going to run to the close, or is going to start selling off. We have often bought options 10 minutes before the close when we see the selling bottom, and then watch the stock move back up so we start out ahead even before the announcement! We also frequently buy with less than 5 minutes left in the session as the last nervous sellers want out, and the prices drop. This gives us a good price and limits our window of exposure.

One of our favorite plays involves announcements at shareholder meetings. Many companies prefer to announce the good news for the shareholders. If it is a good company that from the technical indicators looks poised to move higher, we will take a position further out and try to capture some upward movement. This is happening more as more investors are playing the shareholder meetings. We also love to buy in right before the meeting starts, again to limit our time exposure. When we do this, we will watch the stock's price movement to try and time our buy to get the best price, but we will start a position (typically a partial position) before the meeting gets too far along so we don't miss the split announcement. The announcement usually comes anytime after an hour has passed from the beginning time of the meeting, though we have been surprised with announcements before the meeting or the following morning. We post the meeting times for you in the SSR.

Ultimately, in deciding when to open a play, if we like the stock and feel it is in a position to move up in the short term, we will take a position. If things change, we can always sell and take a new position again when the time is right. There have been plays where we open and close positions well before the split is actually announced just because the profit was good and there was no reason risking a downturn before the announcement. If we still believe in the play, we will often then buy back in with new, higher strike options (because the stock price has risen), and still have money in the bank as net profit after rolling back in with higher strike prices. If the split comes

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and the stock jumps up more, all the better. We still make more money, and we played it smart by taking defensive steps while not capping our gains.

When to sell. Your plan should incorporate target sell prices, both on the upside and downside. On the upside, our sell prices are soft. That is, when we hit a pre-established price (maybe at a resistance level), we will look to see if all technical indicators are still good, what the percent to double is (for options only; if it gets to be 30%, is there that much upside left for now?), how the market is doing, and how far we are from the forecast split announcement. For options, the sell price can be based on the option price or the stock price. For example, if we feel a stock has resistance and will fall if it hits 70, we might tell our broker to sell the option at whatever price it is when the stock hits 70 and shows weakness (i.e., stalls or starts to fall back). If the stock is showing real strength after the announcement and we are not as concerned about resistance, we will base our sell on the option price, but ALWAYS letting the stock's action determine when we sell. If the stock falters and our game plan is to sell when the good news runs out on the announcement date, we will sell when the stock starts to falter regardless of the option price. If the plan is to let the stock run for a few days, we will overlook moderate profit taking as long as the overall trend is holding and the market remains solid. In any event, we don't like to sell a winner. Remember the oft-quoted rule: let your winners run and cut your losers. We add to that: let your winners run, but play defense with your profits. Don't let them disappear on you.

On the down side, we have a hard number that we sell at if hit. This can be based on the option price or the stock price, but usually on the downside we are looking at the price of the option itself. If we have long-term options, we will give ourselves more leeway as we bought the extra time to allow recovery. Still, a good rule of thumb for option traders is to sell if your option's value is half of what you paid for it. That doesn't mean you have to wait until it hits half value to sell, but that it is a good idea to sell at that level if your trade has dropped that much. In retrospect, who would not love to have 50% of all their options losses back? We would be standing in that line. If the underlying stock breaks support we sell the stock if it cannot recover quickly, usually the next session. If your options are down 20% and the stock breaks support, there is no reason to wait for the option price to fall further. Its price is in large part based on the underlying stock's performance. If the stock breaks support, it most likely is going to sell

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further. That means your option is most likely going to lose more value as it does. No point in hanging around to see it happen.

Another point regarding options is time decay. As you approach the option expiration date (the third Saturday of each month), time decay accelerates. It starts to get noticeable 60 days before expiration and then really starts in earnest about 30 days before expiration. We always try to plan to be out of our options before this starts. It doesn't always work that way, but this is the major reason why we buy extra time. It costs you more to play longer-term options. If that extra month allows you to make a winning play where you would otherwise have lost your investment, however, the cost for that extra month is peanuts. Give yourself enough time to make the play work if you decide to stay in or if the stock takes an unexpected jolt.

With stock purchases, we look at whether we bought the stock for a long-term hold and just want the split as a way to increase our share holdings for, say, covered call writing, or whether we are playing it short-term. If short-term, on the downside we look to sell when the stock drops 8-10%. You can protect yourself automatically by placing a stop loss order with your broker. This is an automatic mechanism for selling a stock when it hits a certain level. We typically use mental stop losses, i.e., not setting them in the system because stop losses often let you down when you need them most. Usually for us, that price is about 7% or 8%. If the stock gaps through that price, however, the price you sell at will be the next price the stock sells at. In other words, if you have a stock that is trading at $60 and you set a stop loss at $55.20 (8% less), but the stock gets hit with some bad news and gaps down to $53, you will be hit at $53, not $55.20. That is the downside of a stop loss versus a stop limit. Sometimes this is good, sometimes bad. Many times a stock will bounce up after a sudden drop. Many times it will continue down and you will be glad to be out. On the upside, we trade it like an option, looking to see whether the market and the stock's technical indicators appear to allow for more upside.

When we open a play well before the announcement and the stock has a nice run, we often hit a target sell price before the anticipated announcement. What to do? Again, if things look technically good, we will often stay in a position, but be very cautious moving forward. If there is a chance there may be selling coming into the picture such as occurs right before earnings, we will look at selling all or half of our position to lock in profits. Then, as we noted earlier, if we still have confidence in the play, we can open a new

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position with options at a higher strike (remember the price has run up) using profits from the previous trade! Not a bad way to play a split. Plus, we may be able to take advantage of any nervous selling to get a good price on the new position. Another good aspect of this strategy: once you are out of a position, you can think much clearer than you can while you are in. This is true no matter how experienced you are. Then you can decide whether it is really the right time to get back in while your profits are not at risk. It is amazing how clear your head gets once your profits are not on the table. We consciously practice looking at trades in a third person context. We don't want to let our emotions control our trading. We can celebrate, have a glass of wine, beer, champagne, fruit juice, or whatever suits you when we get that execution confirmation. Until then, keep those emotions locked away.

The type of stock we are playing often tells us when we will sell. By type of stock, we mean that the stock is a bellwether, a blue chip, a leading stock, a mediocre stock, a small cap stock—a whole range of possibilities. We like to play leaders and will let them run for as long as they maintain a strong trend. We can ride through a few selling sessions after a nice run as long as the trend remains in place and we are not in time danger with any option plays. Stock plays are no problem as long as the stock maintains its trend. On options we prefer to lock in nice gains; there is no harm in taking half the money off the table and letting the rest ride.

The health of the market plays a major role in how long you can hang on, even with the leading stocks. If the market is falling, don't take chances with your profits. As long as the market is in an upward trend, however, the leaders can and often will keep on going up with the market. On other stocks that do not have the glamour of the big names, we tend to sell when we think we have hit the peak of the run on the day of the announcement. We try to tell you which stocks are which in the SSR. We repeat again, the market condition plays a huge factor here. If in doubt, we err on taking a profit rather than risk the stock crashing on us. If the market is good, however, we will suffer the pain of temporary down days in letting a big winner make our quarter.

Wild Cards. When we see a good stock at a previous split level, but their split history is erratic or no splits have previously been announced, we sometimes list that stock as a wild card. We usually do not play stocks for splits if we cannot pinpoint a possible date for the split. At times, however,

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a good stock is at the right price and a possible date is approaching that may act as a trigger, or, and most importantly, the stock is setting up a good technical pattern. If we like the play from a technical standpoint, we will look at taking a position to be in if a split is announced and to catch any move based upon the technical pattern. This is kind of a cross between a pre-announcement play and a pre-split play: the stock is at split level and could announce at any time, and the technical pattern is good allowing for a possible gain even if no announcement comes. If it does, the stock can really move. We perform technical analysis, and if things look good, we tell you at what point we will or would be getting in.

We try to avoid just posting these stocks for the sake of posting them, but we want our members to be aware of stocks that could split, but forecasting an exact date for that split announcement is difficult at best. If it is a stock you want to own, the price is right for a split, and the technical indicators are good, you can buy with more confidence. For options players, this may not be that good of a strategy as time decay can steal your investment before a split comes. That is why a good technical pattern is our focus as we can still make great profits when a stock breaks out of the pattern even if no split is announced. We just would not hang around once that move occurs waiting for a possible split announcement. Some split services simply post stocks that they think will split when the stock hits a certain price. That is helpful, but only one small part of the puzzle. The trick is to know when the announcement will come, when to buy, and when to sell.

Pre-Split Strategies

Below is a discussion of how we play pre-split plays, i.e., plays after the split announcement but before the actual split occurs. Overall, these can be our favorite plays because, while often not flashy, they are consistent workhorses that repeat a pattern over and over again. We have found that stocks often rally right before they split, allowing us to look for the right entry position, enjoying a few points (or more) run, and then taking our profit. We continually analyze the technical patterns of stocks as they approach their splits. We make these as low risk as possible by applying good technical analysis to stocks that have the additional momentum of an approaching split, and then taking a position as the move upward begins. That is right. We don’t act until we see the move up. That is another reason we love these plays. The stock tells us when it is time to open the position. This can be at the open (not usually as we prefer to let stocks settle into their

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daily patterns), mid-day, or at the close. Those of you who have been with us know that the upward move can be steady or explosive.

In all cases, the stocks are volatile at this time, and we do not like to risk profit once we have a good run. We try to avoid selling too fast on a good run, but these stocks can move either way in a hurry. Our rule of thumb is, look at the stock and how it can run (based on its past history), how its current technical pattern looks, and if there appears to be more upside, let it run. If the stock's action starts to waiver or becomes problematical, we will take profit. If we are wrong, we can look for another chance to get back in.

When to get in. Times have changed. Most splits are from market leaders, not just any old stock that ran up because the bear market took the wind out of those stocks. Thus when a split is announced we start looking for a pre-split run to set up from day one. We really look in earnest 3-10 trading days before the actual split. In the SSR's we will start most stocks at 10 to 12 days, but if we see a good pattern setting up, we will put it on.

The theory is that as stocks approach their split day, investors get really interested in a stock. The price rises into the split, and then can either drop shortly after the actual split or, as we saw during the big downtrend, just keep on rallying. Seems investors wanted to be in certain stocks, and that is where their money went split or not. Whatever the cause, we have seen this pattern repeat itself over and over again. Analysts and brokerages are aware of this pattern, and they often coincide the release of positive news about a company in the days immediately preceding the split date. It is a kind of insurance as the analysts can usually count on some pre-split momentum to help their pick move up. It feeds on itself, creating a great opportunity for profit. The pre-split run does not always happen, but one of the features of these plays is their consistency.

We analyze stocks as they approach their pay date. The pay date is the last day before the split is reflected. The ex-dividend date, or ex-date, is the first day the stock trades reflecting the split. The dates listed in the SSR are the pay dates. We do this because our research shows that stocks that run up to the split date then can trade lower after the actual split. We do not want to ever get caught holding a pre-split we wanted to sell before the split. Sometimes we have other reasons to hold the stock, i.e., if we bought the stock and want to keep it in our long-term portfolio or if it is running well and a real market leader. If we are playing just for the short-term pop,

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however, we never want to risk accumulated profits. We will keep a position after a split at times if the stock is moving very well, but not often.

If the technical pattern looks good, we will wait for the day we see the stock begin a solid move up. How much of a move depends on the stock. We usually always wait for a move accompanied by increased volume, but that does not always happen on these plays. That is the amazing thing about pre-splits—they can move up with no real sound technical basis. Sometimes a stock has very poor technical indicators, and we never see an entry point. This happens for various reasons, but usually because the sector is being hammered, the stock had some bad news after the split announcement, or the market is really in bad shape. If we don't see the upward movement, we don't get in. We may miss a play, but as we have said, we try to stack the odds in our favor.

On some stocks we will make a play even if the technical indicators are poor. These are the big name stocks that people seem to love no matter what the technical condition. As noted earlier, we have found that while stocks may look bad, analysts seem to know this pattern of a stock rising before its split, and tend to release some good news about the company in this time frame. It is a good risk to release the news as the stock may rise anyway, and then the good news feeds the momentum the stock was building for the split. Kind of keeps the cycle going.

<u>What to buy.</u> We buy options and/or stock. On options, we buy as deep in the money as reasonable for the extra cost as this usually gives us the most movement in our option when the stock moves. One factor we really look at in determining how deep in the money we go is what the option's delta is. The delta is how much the option price moves in relation to movement in the stock price. A delta of 1 or 100 means for every dollar the stock moves, the option moves a dollar as well. This is also called moving 'tick for tick.' We like deltas of 75 or better, but realistically we don't want to pay $10 for an option with a 75 delta when we are looking for a $4 stock move. Better to look for a lower delta. Thus, when looking at what options we may buy, we as for the delta. If a stock is trading at $100, and the 95 call has a 75 delta while the 90 call has a 77 delta but costs $4 more, all else being equal, we would favor the 95 over the 90 because we just are not getting that much more delta for the extra $4.

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As far as expirations, we look 1 to 2 months out. The closer to expiration, the more volatile an option is. If we see the stock start to move up, we want the option that will move the fastest and capture the most of what may be a short run. These are usually the shorter-term options. Expiration is on the third Saturday of each month. If a stock is splitting a few days before the expiration for options that month, we most likely would not buy the option for the month that is to expire. Too many things can happen and there is no time for recovery. We never plan on holding these long, but we do not want to slice it too thin—that is simply too speculative. Better to spend a little more money to have another month of time. For stock plays, we will base our buys on the technical analysis just as we do option purchases, and we often put in orders to buy at a certain price when we get close to the pay date. That way we automatically buy the stock when it starts its move up and we capture more of the upward move, putting more profit in our pockets. We watch these carefully, however, in the event the stock drops. If we still like the play, we will then drop our buy price, again in order to capture as much of the run when and if the stock turns and starts to move up.

When to get out. Pre-split stocks tend to be very volatile. They can run up 2 days and then turn around on a dime. If a chart looks questionable going in, we are happy to get out with a couple of points. If a chart looks great, we will give it the benefit of the doubt, but are ready to sell any time we start to see weakness. Signs of weakness can be a subtle as a change in character in how the stock is moving. We usually like more concrete evidence, however. Thus, we look for a widening trading range where the stock finishes well off its intra-day high, a smaller gain on increasing volume, a smaller gain on decreasing volume, or a loss on increasing volume. We also watch the candlestick chart patterns each stock gives each day for patterns that indicate a change is coming. Candlestick patterns usually have to be confirmed, but they give us a warning of what may be coming. Don't worry about going out and learning candlestick chart reading. We look at these every day and will tell you if there is something worth your concern.

We often sell before the actual split, but there is no longer a hard and fast rule on this as there was before the bear market. Basically, if a stock runs hard up to the split and shows a doji or reverses off the intraday high and falls, we will close at least some of the positions. If it looks strong and is a market leader, we will tend to let it run after perhaps taking some of the gain off the table.

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We have sold out too early and missed part of a run, but we have also avoided disaster by pulling the trigger when things got iffy. While it is possible to make huge amounts of money on these trades (e.g., NTE option plays in June and July 2003) in very little time, we often use them to capture $2-$5 moves in the stock. Whether the stock jumps $2 or $40, they exhibit the same symptoms when they are running out of steam: widening trading range and lower gains or slight losses on greater volume. We also look at the particular candlestick pattern for the day to see if it indicates any sign of a reversal. When we see any of these, the party is probably over. We would rather get out and bank some profit and then get back in if things still look good than lose the profit we have accumulated. In many cases we can get back in later at a better price.

As with pre-announcement plays, we also set stop losses on pre-splits, especially after we have built in some profit. We will trail our gains with a rising stop loss so that we will not lose built in profit. Stop losses can be tricky and as noted earlier, we typically use mental stops, not ones set in the system. On some NASDAQ stocks, we have seen the market makers run a stock down a half point or more to take out a stop loss, and then run the stock right back up. It can be cut throat. Still, if you are comfortable with that profit, you won't lose your profit in that scenario. Just be aware that you can be taken out of a good rally in this manner. It doesn't happen often, but it has happened to us. Setting the stop loss is more art than science as a lot depends upon the stock's volatility. A $4 stop loss on a stock that can move that far in one session is typically too tight while the same stop loss on a $30 stock would lose you too much profit. We typically put it under near support such as the 18 day MVA, a level up trending stocks typically hold above when they test lower in their runs. For an additional discussion of stop losses, see the "When to Sell" section under pre-announcement plays.

Split Strategy On Announcements Heading Into Earnings.

We have been trying some new methods of playing stock splits, particularly those that deal with announcements heading into earnings. We have been working with various types of spread plays and some of those work fairly well, though the cash outlay is quite higher as you have to buy and sell various positions resulting in more money per play not only for the options but in commissions as well. We are still working to perfect this method.

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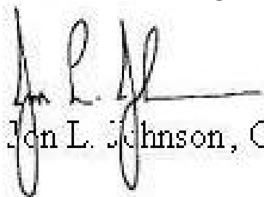
A method that we have found to be very lucrative and a way to provide protection as well involves combining short term and long term long call positions. What we have been doing is entering short term and long term call positions at good technical entry points. By short term, we mean call options that expire in the month (but after the date) of the forecast split announcement or the next month. By long term, we mean options that expire at least two full months after the forecast announcement date. What we are doing is riding the short-term options up to the announcement date (or until we see the stock starting to top) and then selling them before the announcement. Money in the bank, and it often more than pays for the long-term options. We then ride the longer-term options through the split. If the stock roars on the announcement, fantastic. If the stock does not move much on the announcement, we can get out with still great profit on the long-term position as well. If the stock stumbles, we can bail out and still save profit or break even, or continue to ride the long positions if the news was positive overall and there is just some selling on the news. We have seen many stocks rise after a short stumble on the announcement as profit takers come in. We have the time to ride them out to gains as the momentum comes back. The beauty is, we have already banked some great profit on the short-term position and have the luxury of having choices.

We hope this primer will prove useful to you as you continue with your investing. Stock splits have been a major part of our investment strategy for several years now, and as the market changes, we continually update and upgrade our specific strategies. For example, one we are looking at now involves a new play shortly after the split announcement occurs. If this proves to be a consistent winner for us, we will add that to our arsenal and fill our members in on how the play works. We have found that there are always different ways to look at plays and to make money from the same circumstances. We will always keep looking, and if you have any methods you find are working and want to discuss them, drop us a line.

Good investing!



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