

# Colin Nicholson: Newsletter 93

28 September 2009

## Hear Colin speak

### Melbourne

Friday 2 and Saturday 3 October 2009

Trading and Investing Expo

### Special Offer – Half Price Admission to the Expo

Readers of my newsletter may apply for unlimited half price tickets (\$7.50) to the Expo which are normally \$15 at the door or \$10 in advance on the expo website. All you need to do is visit <http://www.tradingandinvestingexpo.com.au/seminars/melbourne> and click on the TICKETS tab. When asked for the special promotional code, enter the word **SPEAKER** and the special offer will be automatically provided.

**11.30- 12.00 Friday 2 October 2009 and Saturday 3 October 2009**

### ***Bear market rally or new bull market?***

Do you have your share investments in place yet for the new bull market? If so, that is good, because most investors leave it far too late to put their money to work in a bull market. They then find it difficult to make decisions to act for fear that they have left it too late. So they wait for a pull-back. Then when it happens they think the bull market has finished. So they wait for another upward move and the cycle of indecision continues until they finally act out of desperation when it really is too late. If this scenario rings true for you, then you need to come to this presentation. Colin will explain his strategy which has consistently got him into bull markets near their start and out again before the bear begins to roam Wall Street. He will explain how to tell which phase of the cycle we are in. He will also visit the Coppock indicator and basic market trend analysis. From this he will suggest an appropriate strategy for the current market.

**1.45 - 3.15pm Friday 2 October 2009 and Saturday 3 October 2009**

### ***How to plan for stock market investing success - in any market***

We have just lived through one of the worst bear markets in decades. This event has exposed weaknesses in the investment plans of many people, principally those in or nearing retirement. Most of the problems exposed by the bear market come back to poor planning. A good investment plan makes allowance for periods of declining share prices. Colin's investment plan has enabled him to sail through the bear market virtually unscathed. You can do this too, if you know how. Don't miss this must-attend seminar as Colin clearly outlines what you can do now to refocus your investment plan to ensure you minimise the damage from future bear markets.

**Further Information:** [www.tradingandinvestingexpo.com.au/trading](http://www.tradingandinvestingexpo.com.au/trading) and there is also a link to the complete Expo Show Guide on the *Hear Colin Speak* page of [www.bwts.com.au](http://www.bwts.com.au)

### **Further speaking engagements**

I have now posted the dates and the available details for my 2009 speaking engagements on the *Hear Colin Speak* page on [www.bwts.com.au](http://www.bwts.com.au).

### **My presentation slides**

I am now publishing the slides from all of my presentations on my members' only website as soon as possible after each presentation. I have already uploaded files of slides for presentations that I have given so far in 2009.

## Suggestions Welcome

My objective in writing books and for my website is now firmly focussed on teaching private investors how to improve their investing decision-making. I do not wish to advise investors, but rather to provide some sort of framework in which they can better negotiate their journey from wherever they are on the spectrum from ignorance to mastery.

In doing this, I charge for access to much of my work. There are two reasons for this. First, nobody truly values what they are given for nothing. Second, the charges I levy for access to my work pays the costs of running the website and for my travel and accommodation as I move around the country giving presentations. In this respect, I have done a lot of travelling and speaking this year. Indeed, I still have a demanding timetable out to the end of 2009.

In addition, I will soon be working on changes to my website with the objective of improving the delivery of my work. You will see this progressively through late 2009 and into 2010. This work is sometimes very time-consuming. I am always open to suggestions for the things readers would like to see, or of which they would like to see more, on the website or in newsletters.

However, please do not ask me to do anything which could be construed as advice. Advice is defined in law as: **... a recommendation, a statement of opinion, or a report of either of those things, which is intended to influence, or which could be reasonably regarded as being intended to influence, a person in making a decision in relation to a particular financial product, a class of products or an interest in such products.**

Rather, suggestions should focus on ideas aimed at better teaching the craft of investing. That means education aimed at teaching readers how to make their own investment decisions into the future. To email me, please use the Contact Colin facility on [www.bwts.com.au](http://www.bwts.com.au). Do not click reply to the email advising you that the newsletter is ready to download. It will not reach me as explained below:

Please note that I have changed something about the way I notify when newsletters are available. The email I send now has a "noreply" sender's address. This is in order to automate the deletion of addresses from the list if emails to them bounce three times. The implications of this are:

1. Add [noreply@bwts.com.au](mailto:noreply@bwts.com.au) to any white list for spam filters that you have installed.
2. If you want to send me feedback or a question, send it to my email address. Use Contact Colin on [www.bwts.com.au](http://www.bwts.com.au). **Do not just click the "reply" button.** If you do that, I will not get your email.
3. If you change your email address, newsletters will stop after the old address bounces three times. So please go to the NEWSLETTERS page on my website and alter your email address if it changes. **Bounces also include mailboxes over quota (often a precursor of a discontinued address) so if you go away for a while and do not clear your mailbox, your address may have been removed from the list.**

## Case Study Example

Regular readers for my newsletter will be aware of some new developments on my website. I first set out my investment plan in my 2005 book *The Aggressive Investor*. This year, that book was replaced by a new book *Building Wealth in the Stock Market*. My aim in writing these books is to provide my complete investment plan as a model for what should be in an investment plan and for readers to adapt in developing a plan that suits them.

An important part of the book is the examples and case studies, which bring the method to life by explaining it using current real investment situations. I am endeavouring to add value to the book by publishing more examples and case studies on the website. The latest case

study I have published on the website is Western Australian Newspapers, which I am uploading today.

I thought readers, who are not yet members of the website, might like a taste of the new material. At the same time, I hope it will be educational in its own right. In reading this material please be aware of three things:

1. This discussion is provided as teaching my thinking using a practical example. It is not a recommendation for any reader to purchase this stock. If any reader wishes to consider buying this stock, that decision must be their own responsibility and readers should seek the necessary advice from a licensed adviser. Stocks which are suitable for my portfolio are not necessarily suitable for readers' portfolios.
2. This discussion is in the context of my investment plan. To fully understand it, a good knowledge of my plan is necessary. My plan is in *Building Wealth in the Stock Market*.
3. I cannot legally answer questions about this stock or this case study from individual readers. See my policy on questions on the previous page.

## Stock Case Study: Western Australian Newspapers Holdings (WAN)

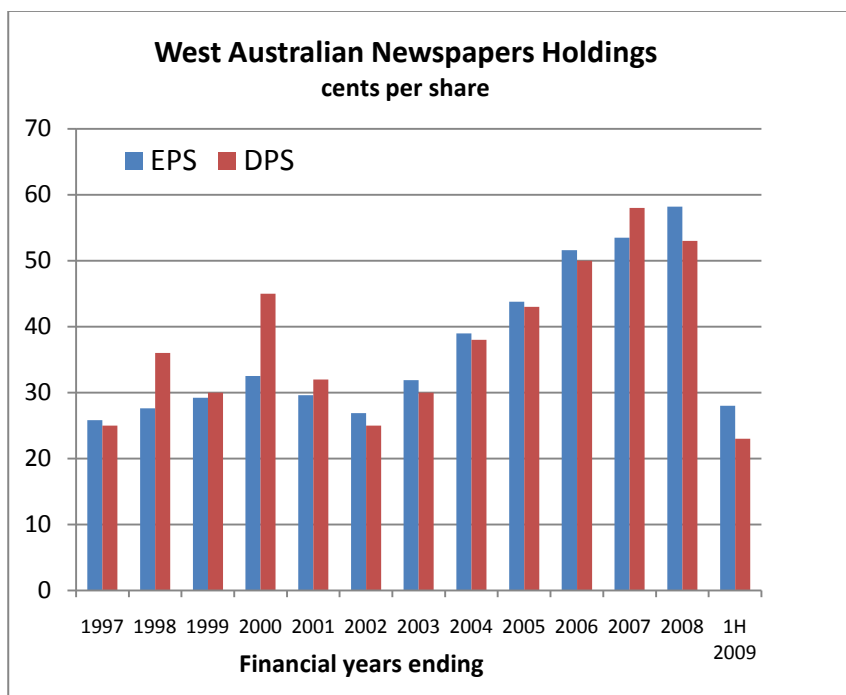
### Company Profile

Activities consist of newspaper and digital (online) publishing, commercial printing and radio broadcasting.

A significant change in the last year was the disposal of the Hoyts cinema exhibition, cinema advertising and film distribution operations.

Source: 2008 Annual Report

### Earnings and Dividend Quality



Note that the 2009 bars are for only a half year. This was the situation when I bought the stock.

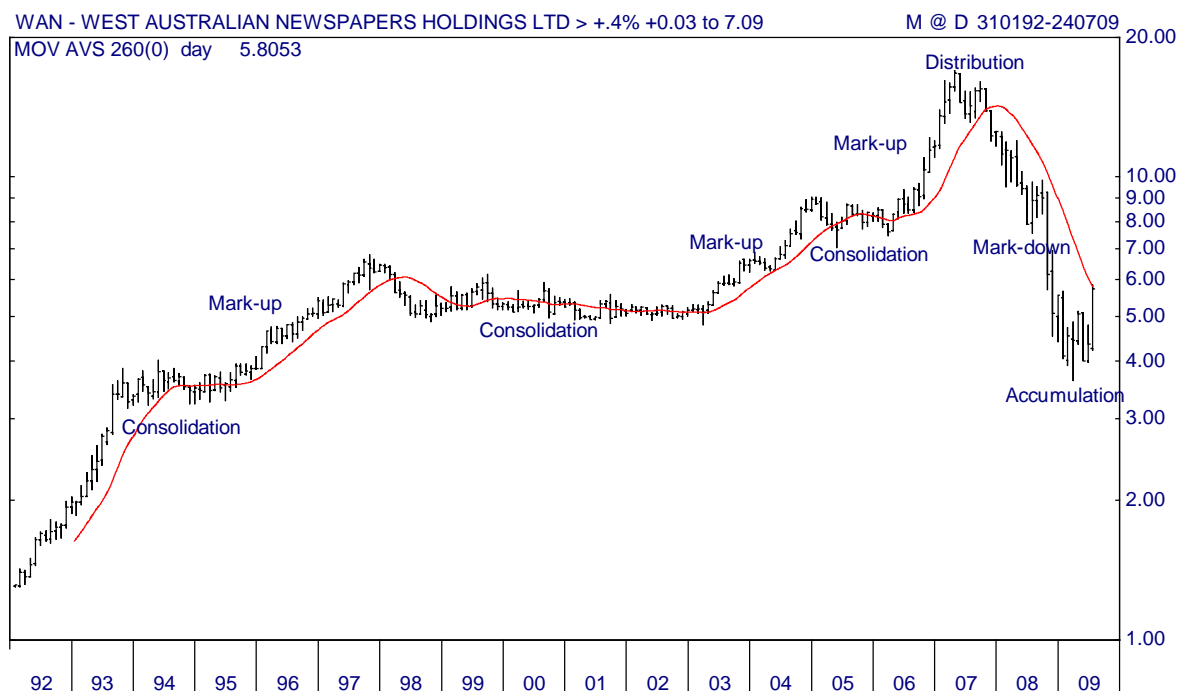
After consistent, but low growth, in profits and dividends from 1997 to 2003, the bull market saw significant growth and dividends in 2005 through 2007. Although 2008 saw a further growth in earnings, the dividend was slightly reduced. This has not been unusual as companies have generally held or reduced dividends as they batten down the financial hatches for the duration of the recession.

Western Australian Newspapers is clearly a cyclical stock in that advertising revenue is generally reduced during tough times. My judgement is that I had an opportunity to buy Western Australian Newspapers around the time that may turn out to be the low point for the economic cycle.

### Chart Model Assessment

West Australian Newspapers Holdings had been on my watch list for a while, after I had noticed that it may be forming an accumulation pattern on its chart. It had come up again on a fundamental analysis scan (low Price earnings ratio - see *Building Wealth in the Stock Market* for an explanation) during the week 24/07/09, when I had also seen the breakout on my watch list chart.

I do the chart model assessment by starting with the monthly bar chart for 20 years, or as much data as is available if the stock has not been listed for that long. Western Australian Newspapers Holdings had been listed in January 1992, which is when my chart begins:



This is an interesting chart. It begins with a mark-up phase, which could have been a value model phase or a growth model phase. There was no way to know which it was at that time. Nevertheless, my strategy would have been the same – buy into the uptrend.

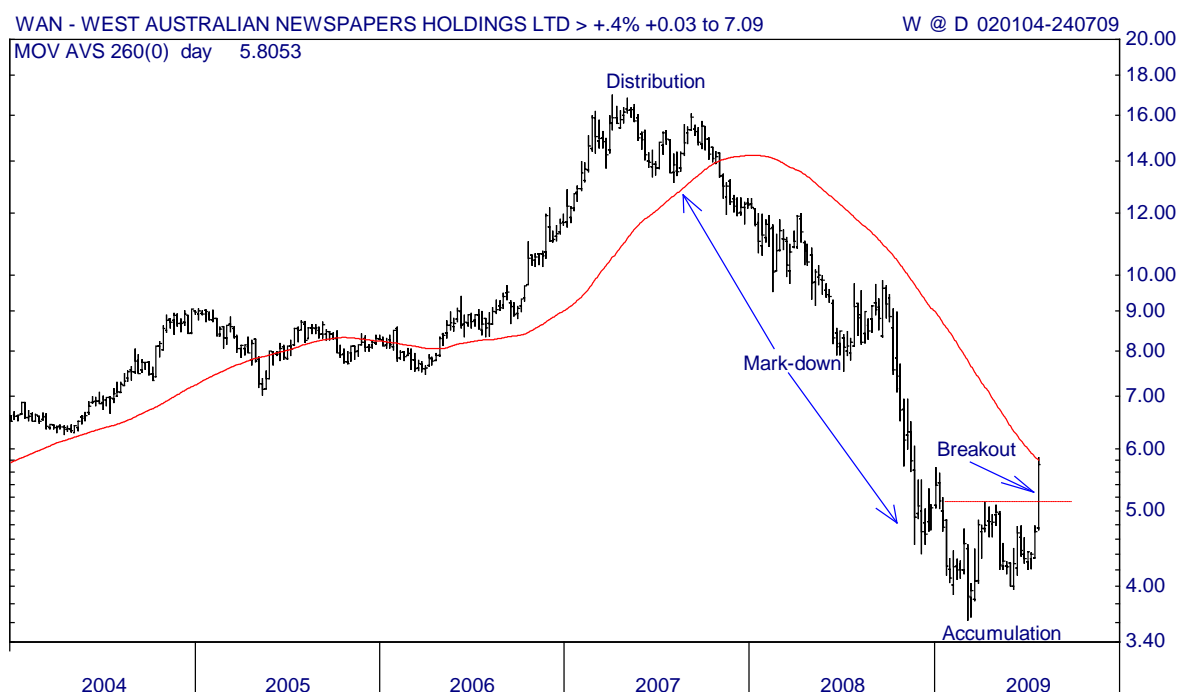
This upward trend was followed by a sideways pattern, which again could have been a value model distribution phase or a growth model consolidation phase. The best indication was the direction of the breakout from the sideways pattern.

When the breakout was upward, I could still not be sure which model I was looking at, because there are often consolidation-like patterns on mark-up phases in value model charts. However, the upward breakout was pushing the probability towards a growth model chart, such that the recent sideways pattern should most likely be labelled as a consolidation phase.

After the mark-up phase had faltered, there was a six-year sideways pattern. Now I had the key that I needed. The breakout was upward, so I really had to see this as a growth model chart breaking out from a wide consolidation phase.

The mark-up phase which followed led into a third consolidation phase and then a fourth mark-up phase.

2007 brought another sideways pattern. The assumption had to be that this was yet another consolidation phase in a growth model chart. However, once the breakout was in a downward direction, I could be sure that the model was changing. I will continue this discussion from the perspective of the weekly chart:



The mark-down phase was savage, cutting the price to around one quarter to the peak level. There were two distinct sections to the mark-down phase, with a sideways phase around the level of the 2004 through 2006 consolidation pattern that provided some support. More significantly, the subsequent fall sliced through expected support from the six-year consolidation pattern as though it was not even there. This is a good lesson about the reliability of chart patterns, which are at best only good probabilities. They tend to be least reliable in crisis situations as we had in 2008.

2009 had seen an accumulation pattern formed and, in the week to 24 July 2009, we had a clear breakout upwards. My plan called for me to consider buying into the breakout.

### An Aside

The breakout was very clear. Moreover, it has also taken out the late 2008- early 2009 upward spike, which may or may not have been a part of the accumulation pattern. This gave

me some additional comfort. However, in discussion with some close friends, I realised that the extent of this breakout was of real concern to some. For me it was a signal of strength. For them it was a sign that they had missed the breakout and should wait for a pull-back to the breakout level.

Now, I am writing this after the event, and know what happened. However, before I knew what happened, I had acted on my view by buying the stock. So, my view is still clear based on the evidence on the above chart. I continue to be mildly amused by the action of many beginners who will not buy low prices and also will not buy strong breakouts. Instead they prefer the weakest breakouts where, as perfectionists, they try to buy the exact breakout point. I am a perfectionist by nature, but long experience has taught me that perfectionist tendencies do not work very well as an investor. Instead, buying strength is far more important than buying at the so-called “perfect” time.

### Ratios and Assessment

Criteria	WA News Hold	Market Average	Assessment Value Model
Price earnings ratio	8.92	10.91	OK
Dividend yield	10.24%	4.92%	OK
Debt to equity ratio	370.2%	Aim <60%	Fail – see below
Market Capitalisation	\$1,141m	Ideally >\$100m	OK
Liquidity	Av. 652,000 shares per day	Adequate for my order size	OK

This showed that everything was alright on my plan except for the debt. On the surface this looked to be far too high and possibly fatal for my plan. However, the aim of <60% was a guideline and I will often look further with care and diligence when a company is outside the guideline.

Even before I began to look at the evidence, I was cognizant that this was a cyclical business, even though the chart had been a growth model chart for many years. There can be a divergence between the nature of the business and the chart in exceptional growth situations and when the economic cycle is not too severe. The company was situated in a resource-rich state and had just been through a resources boom. This may explain the long six-year consolidation phase on the chart, which in the absence of the strength in resources, may have seen instead a value model situation on the chart.

The other issue in my mind was that this was a media business. As such it has a base level of revenue somewhere, even in a recession. All advertisers do not crawl totally into their bunker even in tough times. We were clearly in a recession, or at least that was a general consensus, so I reasoned that we were probably near the worst situation in terms of debt servicing. If the company had not joined the rush to raise more equity, then it could probably carry the debt load.

Firstly, I looked at the historical debt load. This showed that the company had successfully carried debt higher than my guideline for some time. It also showed that debt had been expanded in 2006 and 2007, but been reduced in 2008, presumably with the sale of the part ownership of Hoyts:

## WA Newspapers Holdings Debt to Equity

Year	Debt \$mil	Equity \$mil	D/E%
1999	0.0	233.0	NA
2000	128.0	117.7	108.8
2001	164.0	121.7	134.8
2002	157.0	130.9	119.9
2003	151.0	174.0	86.8
2004	144.0	190.4	75.6
2005	298.0	195.2	152.7
2006	414.0	144.3	286.9
2007	503.0	85.6	587.6
2008	342.0	92.4	370.1

Next, I looked at the historical financials on the Aspect Huntley section of my broker's website:

HISTORICAL FINANCIALS										
	06/99	06/00	06/01	06/02	06/03	06/04	06/05	06/06	06/07	06/08
Revenues (\$million)	318.9	330.7	319.0	296.7	318.0	347.7	372.1	395.2	446.2	470.4
Operating margin(%)	37.4	38.4	37.0	34.6	37.2	40.2	43.0	53.5	46.4	49.7
Depreciation (\$million)	-15.0	-15.9	-17.8	-17.2	-17.0	-17.0	-17.4	-42.0	-34.9	-30.7
Amortisation (\$million)	0	0	0	0	0	0	0	0	-2	-2
Net profit before abnormals (\$million)	60.3	68.2	61.0	55.6	66.5	81.5	91.7	107.5	111.9	121.9
Net profit (\$million)	62.4	91.9	66.6	51.2	64.0	79.5	90.6	69.3	54.0	109.9
Income tax rate(%)	34.5	27.2	31.2	29.7	29.5	28.8	29.9	28.3	42.0	27.7
Net profit margin(%)	18.9	20.6	19.1	18.7	20.9	23.4	24.6	27.2	25.1	25.9
Employees (thousands)	0.0	0.0	0.0	1.3	1.4	1.3	1.4	0.0	0.0	0.0
Long term debt (\$million)	0.0	128.0	164.0	157.0	151.0	144.0	298.0	414.0	503.0	342.0
Shareholders equity (\$million)	233.0	117.7	121.7	130.9	174.0	190.4	195.2	144.3	85.6	92.4
Return on capital(%)	29	29	24	21	22	26	20	22	21	33
Return on equity(%)	25.9	58.0	50.1	42.4	38.2	42.8	47.0	74.5	130.7	131.9
Payout ratio(%)	103	138	108	93	94	98	98	97	114	91

This showed that:

1. The return on capital was very good. In addition, the debt increased the return on equity. This is not always the case and may change if interest rates rise in the future.
2. Debt was only 2.8 times the 2007-08 net profit. This should not be a great concern to lenders considering the strength in revenue and the strong net profit margin.
3. The 2007-08 interest bill was \$29 million, so that the net profit covered interest 3.8 times. This was reasonably healthy.
4. Debt was only 3.1 times net profit.

So, I decided that the debt situation was marginal, but acceptable when the other criteria were so well met.

## Setting a Sell Stop Level

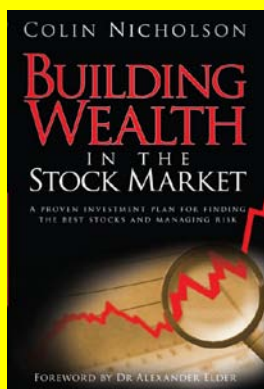
Next, I needed to set a sell stop level so that I could calculate my position size. The chart looked like this:



There had been an extreme low trough in March, followed by a rally to a lower peak. This was followed by a higher trough in June. Now that the breakout had taken us toward a new higher peak, we had an upward trend in existence. This enabled me to set my sell stop under the low of the June trough rather than under the low of the March trough. I set the sell stop at \$3.94, two ticks under the low of \$3.96. This was quite close to the low of the trough, but to get there, the price had to have already violated a higher short term trough.

## Building Wealth in the Stock Market

My new book *Building Wealth in the Stock Market*, presented handsomely in a hardback format, is available for purchase directly from me postage free to Australian addresses.



*Building Wealth in the Stock Market* replaces *The Aggressive Investor*. Most of my basic method has not changed over many years. However, since I wrote *The Aggressive Investor*, I have refined a few things, notably how I view charts in the right time frame, my maximum risk per stock and my focus on an additional financial ratio. While these things are minor in some respects, they have improved what I do. In addition, I revised the way ideas were presented throughout the book. Of most significance, there are completely new and later case studies, plus examples that were not printed in the original book.

For a complete description of the book see <http://www.bwts.com.au/text.cfm?55>

I sign all copies of the book which are purchased directly from me.

**Price:** A\$65.00 including GST (Australia only). **Postage free to Australian addresses.** This price applies only to online orders and mail orders on a credit or debit card. Telephone orders and mail orders paid by cheque or money order attract a surcharge of \$5.00 for handling. On-line ordering on my secure website is perfectly safe and the cheapest way to buy the book from me.

## Determining Position Size

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I made the position size calculation for the SMSF portfolio using the position size calculator which may be downloaded from the Resources page of my free website:

<b>Date</b>	22/07/2009
<b>Stock</b>	WAN
<b>PE Ratio</b>	8.92
<b>Div Yield</b>	10.24
<b>Debt/Equity</b>	370.2
<b>Market Cap</b>	1,141
<b>Total Capital</b>	1,829,341
<b>Buy Price</b>	5.51
<b>Sell-Stop</b>	3.94
<b>Risk</b>	1.57
<b>% Capital to Risk</b>	1
<b>Maximum Position</b>	11652
<b>% Capital to Invest</b>	3.5
<b>Position it buys</b>	11620
<b>Position to buy</b>	11620

The most important issue here was that I used 1% of capital as my maximum risk. This is double the risk percentage it was using when I wrote *Building Wealth in the Stock Market*. It represents a return to my previous setting as I had it in *The Aggressive Investor*. The full reasoning for this revision to my investment plan is more detailed than that and is fully explained in the Toll Holdings case study on my members' website. In essence the issue was that Western Australian Newspapers was already trending prior to the breakout.

I also wanted to invest more than the minimum 2% of capital (see the Toll Holdings case study for a full explanation of the revised plan). I altered the setting for % Capital to Invest by trial and error until I could see what commitment of capital I was making. (Yes, I could alter the spreadsheet to do that and probably will when I have time. This is a very recent revision to my investment plan).

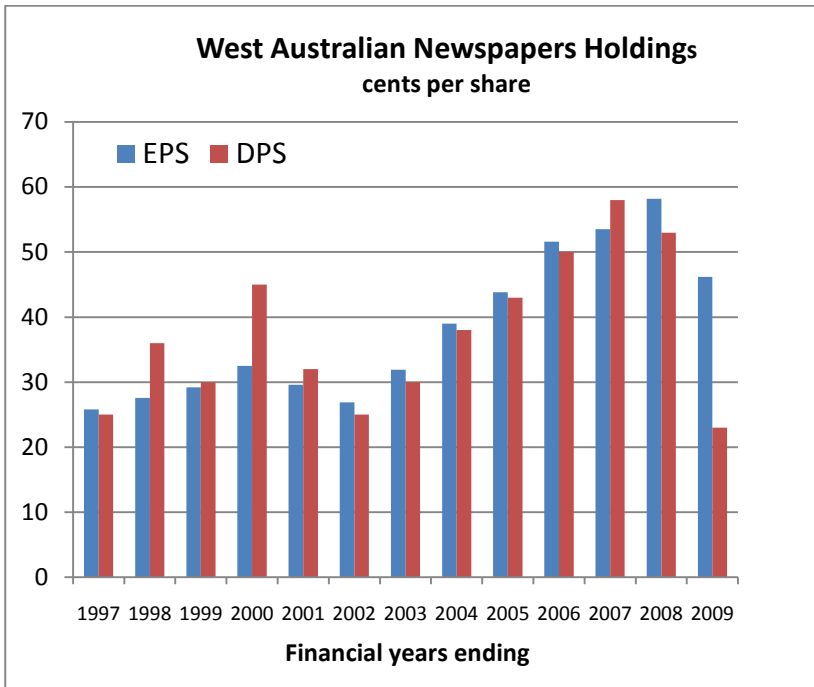
I bought 11,600 shares at \$5.51.

I also manage another family portfolio on the same investment plan and made a similar purchase for it as well.

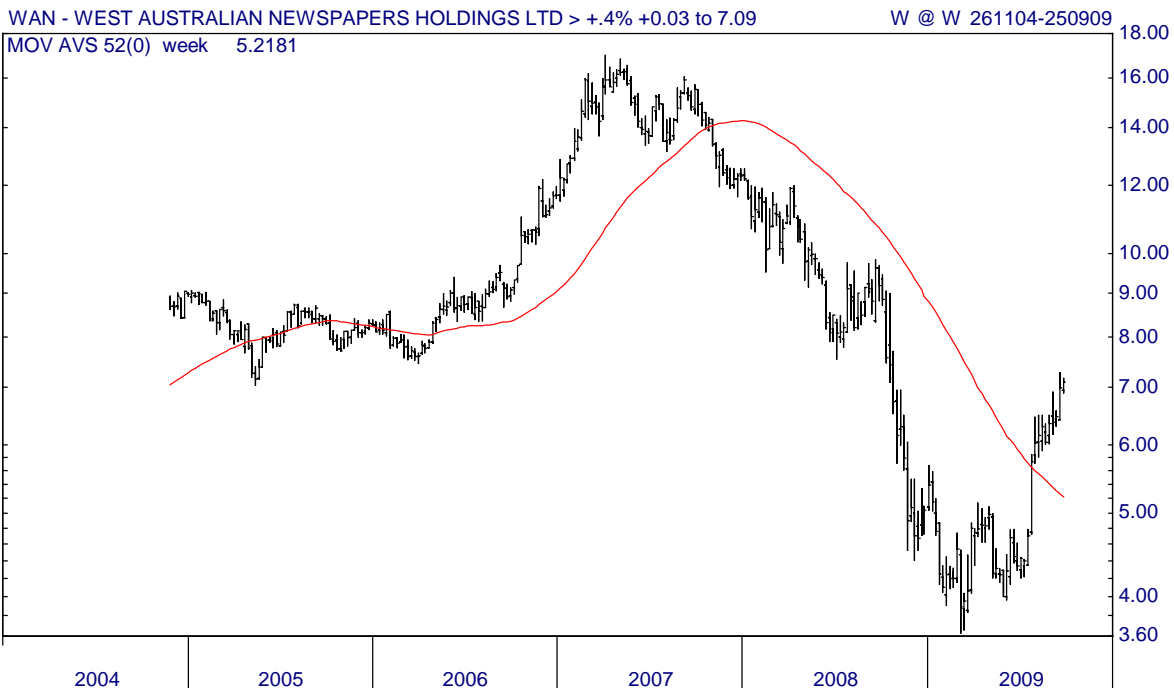
### Assessment at 28 September 2009

Since then, the second half results for 2009 have been announced and the earnings and dividend quality graph is shown on the next page.

This shows that, as expected, the earnings were down on the previous year. The final dividend was cut, which has not been unusual in that many companies have reduced or cut dividends to conserve cash resources. The debt situation would also have been an issue here, because lenders would prefer repayment of debt to payment of dividends. This is not surprising in that the debt to equity ratio has blown out to 469%, due to write-offs reducing equity. Long term debt has been reduced slightly from \$342 million to \$318 million.



I am reasonably comfortable with this in that the smart money is clearly anticipating improvement going forward as reflected in the share price chart to 25 September 2009:



I bought at \$5.51 after the breakout. The upward swing in the mark-up phase has moved to \$7.09 by the close of 25 September 2009. Since there has not been a higher trough in the trend, my sell stop has not been moved. However, bear in mind that my plan involves two other sell signals, which may, and are likely, to occur at a higher level than the sell stop (see *Building Wealth in the Stock Market*).

I hope newsletter readers have enjoyed this taste of the material I am now progressively adding to the members' website. My intention is that over time the books will be kept alive and relevant by the addition of the website material.

Readers should note that these case studies are written for educational purposes only. They refer to my investment plan as set out in *Building Wealth in the Stock Market*. Case studies are not intended to provide either general or specific advice to any reader. They are simply examples of my methods as a teaching tool only.

Case studies may not have been updated for more recent developments. Readers must assess the implications of those developments for themselves in the context of their own investment plans.

I am not a licensed adviser. Therefore, **I cannot legally answer questions about this case study from individual investors**. If there is some issue which a reader wishes me to consider addressing, that is fine, but I will choose whether to address it in the case study and when I may do that within the law.

## **Book Review: *The Panic of 1907***

***The Panic of 1907* by RT Bruner and SD Carr published by John Wiley & Sons**

The subtitle of this book is *Lessons learned from the market's perfect storm*. It was recommended to me by a friend at a time when I was keen to increase my study of past market crashes. In particular, I was looking to better understand what causes crashes, so I will be better able to anticipate them and act accordingly.

This book tells the story of one of the worst crashes in US history. It reads like a novel, but has been solidly based on records from the time. The story carries the reader along from crisis to crisis through the panic.

What makes the book especially interesting is that, although the markets and their regulation were different then, the similarities to 2008 were striking. In 2008, the rescue was led very much by the Federal Reserve and the Treasury. In 1907, the situation was largely saved by the intervention of JP Morgan, even though he was at the time quite ill with a heavy cold or flu, with some help from the Treasury.

The story is brought to life through the characters of the time, many of whom were quite colourful. Above all, the story reveals the root causes of the panic, which like 2008, lay in

### **Difficulty accessing the newsletter**

Each time I send out an email advising that a new newsletter is available, some readers click on the link to it and are requested for a username and password.

This is a transient problem that seems to be caused by the server being overwhelmed by the number of requests for the newsletter. The newsletter advice email goes out to several thousand people. We have put in place some measures that may help, but there is no guarantee.

Please be patient in this situation and try again a little later. Sometimes only a few minutes changes the situation. If more than 24 hours pass and several attempts fail please email me at that point and I will try to help.

the misuse of debt mixed liberally with some dubious business practice and reckless risk taking. Readers are taken through an extraordinary chain of events which show that even in 1907, the whole financial system was interconnected more heavily than most people understand. It was in many ways a rehearsal of 2008. Indeed this book is an excellent example of my policy of reading a book about the markets every month. It is only by understanding history that we can avoid or at least learn better to deal with crises in our own time.

The other remarkable aspect of the 1907 story was the way in which financial institutions were prepared to club together to avert a worse crisis, albeit at one point JP Morgan locked all the bankers in his library until they agreed to assist.

Today, the Federal Reserve and the Government would be responsible for doing what Morgan achieved. Indeed, this crisis led to the formation of the Federal Reserve. Prior to 1907, the US did not have a central bank. The book also explains clearly the very real differences in the US banking system which are still there today.

Then, when the story has been told, the authors draw some lessons, which for me were the most valuable part of the book. These are the key issues which led to the panic, many of which can still arise today:

1. The financial industry is actually a giant system with tentacle-like links everywhere. This aspect rather than size of the firms was the key reason the crisis became a panic as it was impossible to quarantine a failure in one firm. So, the failure of a speculation by Otto Heinze & Co, who tried unsuccessfully to corner the copper market. This brought down their broker Gross & Kleeberg (broker) and spread quickly to several banks and was implicated in the spectacular failure of the Knickerbocker Trust. This in turn put pressure on other trust companies and banks. It then spread across the country and overseas.
2. The precursor was a period of buoyant growth, with ill-advised lending and risk-taking. Always, a crisis like this is preceded by a relaxation of standards in lending and borrowing, which flows into wild speculation. *Easy credit amplifies the boom, and tight credit amplifies the contraction.* In a situation where there was simply a shortage of money supply, we had the recipe for a financial Armageddon. The parallels with 2008 when banks were afraid to lend even to other banks are striking. The basic concepts are consistent and only the details are different.
3. There were inadequate safety buffers. Some developments as a result of the crisis and since have helped, but this factor was also evident in 2008 when the problem was so large that an extraordinary global effort was needed lest we again slip into a 1930's scenario.
4. Adverse leadership was a factor in 1907, with a US President who had taken a verbal stick to large companies. This did nothing to help when panic developed and in fact was a factor in increasing fear and loathing. The book makes very clear how little things can provoke a run on a bank or trust company, an eerie shadow that again fell over us in 2008.
5. Crises and panics always tend to have some triggers. From the 1906 earthquake in San Francisco through financial scandals, adverse court rulings, rising regulation and outlandish rhetoric from the President was anathema to business confidence and

public confidence in their financial institutions. The scene was set for crisis in much the same way as the 2008 crisis had its antecedents in the sub-prime mortgage scandal in the US which emerged from mid 2007. The authors point to four key ingredients in the situation which seem to be common to other similar crises:

- A real event or events which affect the economy
- The trigger event was large and costly
- The trigger event was an unambiguous signal to investors
- The situation was surprising in the sense that it came as a shock to most investors

6. There tends to be a strong emotional element in the panic situation. The authors point to undue fear, uncontrolled greed and other behavioural aberrations.
7. Although there was considerable collective action led by JP Morgan, there was not enough similar action in and especially outside New York. The key was the action of the famous prisoner's dilemma from games theory which is well explained in the book.

The book was written in 2007. In the Lessons chapter the authors ask whether it could happen again and take us through the key issues as they saw them at this time. This is especially valuable, because they were in the same position then as every ordinary investor, except that they had a better conceptual model of what to look for.

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