

## Colin Nicholson: Newsletter 95

10 January 2010

**My book *Building Wealth in the Stock Market* was the first Australian book to rate in the Wiley Top 100 Amazon sales (No 76) in the week ending 22 November 2009.**

First, I would offer my apology for the longer than normal break between newsletters. I have done a lot of presentations around the country in the last few months, which take a great deal of time in preparation, travel and delivery. I hope that members of my website have enjoyed studying the slides of these presentations which are posted on the *Presentations* page of the members' website as soon as possible after each presentation. I will now do my best to resume a roughly monthly schedule of newsletters.

### Hear Colin Speak

My speaking program is set out on [www.bwts.com.au](http://www.bwts.com.au) on the **Hear Colin Speak** page. There are already nine presentations scheduled for 2010. The places and dates are listed, so please mark them in your 2010 diary. Further engagements will be added in due course, so don't despair that I am not yet scheduled to speak in your state. As details of the topics are agreed with the organisers they are added to the website.

### Predicting the Market

I am asked very often to predict the market. These questions usually come from beginners, who are still learning the craft of investing and it is natural for the untrained investor to think naively that we can predict the future. However, this question is sometimes asked by more experienced investors, who frankly should know better. For readers who would like to study this area further, I would recommend an excellent book on the appalling record we humans have in trying to predict the future in many fields, called *The Fortune Sellers* by William Sherden.

In Newsletter 83 (accessible on the **Newsletters** page on [www.bwts.com.au](http://www.bwts.com.au)) I addressed this question under the heading *A Very Common Question* and set out how to deal with the issue. Recently a media person asked me to predict the market for 2010 in an email interview. My answer repeats the philosophical case I made in Newsletter No 83, however it will be published in Chinese. I thought that readers might like to read my answer in English:

#### Question

Where is share market heading to?

#### Response

*The short answer to this question is that I have no idea. Some people may think they have an idea of where it is going, but these are really just unreliable guesses. I say this because we are very poor at predicting the future. The very short term may be roughly predicted, but the further out we look, the less reliable are our guesses of what will happen. This applies to experienced and knowledgeable people just as much as to the man or woman in the street.*

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*The problem is that we naturally feel that if we can predict the future we will know what to do. The problem is that little word "if". The whole assumption here hinges on that word. If we cannot predict the future accurately, the whole foundation or assumption on which everything rests, it follows that the whole thing crumbles into nothing.*

*However, there is a way out of this, which good investors have learned. The trick is not to try to predict the future. Predictions are dangerous, especially if they are made in public. All of us have an ego which we protect jealously. So, once we make a public prediction we actually mess up our own mind. We fall into a largely unconscious trap where we become selective about the information that reaches us. Without realising that we are doing it, we emphasise the facts which support our prediction and downplay the facts which do not support our prediction. So, we lose our tenuous grip on objectivity.*

*What the good investors do is totally different. They acknowledge that they cannot predict accurately and that trying to do so is dangerous. Instead, they analyse the condition of the market now and devise a strategy to simultaneously do two things. On the one hand, the strategy should take advantage of the market situation. On the other hand the strategy should protect the downside.*

*It really is that simple. So, at the present time (late December 2009) we are in a sideways pattern within an upward trend. The upside strategy is that we are in a bull market and should be heavily involved. The downside is that if the market breaks down below the lows of the sideways pattern, then there is increased risk and we should be ready to act ruthlessly on our sell stops on individual stocks.*

## **What's New on the Website**

[www.bwts.com.au](http://www.bwts.com.au) already has a News column on the Home page. However, that column is limited to only a few of the most recent additions to the website. I have now created a **What's New** page which will list all future additions to the website in order with the latest at the top. The page explains three kinds of addition to the website which will not be added to the **What's New** page for the reasons stated there.

## **Choosing Software**

I get many requests to advise people about what software to buy. There are two problems with these requests:

1. I am not able to advise people about this in Australia without an advisers licence.
2. Even If I could do it legally, for me to give advice that is not negligent, I would need to know a great deal about the person making the request, including their detailed financial plans and their written detailed investment or trading plan.

In any case, this is one of those things that somebody else cannot do for an investor or trader. It is a very necessary part of the journey every investor or trader must make as they

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travel along the road from complete ignorance to mastery of their craft. There are no short cuts. The only contribution we can make to their journey is to show them the map. Then they must set out on their voyage of self discovery.

This is how I answered a recent query, in which I set out the itinerary:

### **Question**

I have now become a fan of Dr Alexander Elder, and I need to reorganize myself with new software and data compatible with Dr Elder's methods. So, are there any you would recommend?

### **Response**

I am not allowed legally to advise you without an advisers licence.

That said, while I am aware in reasonable detail with Dr Elder's methods, I am not aware of what software he uses in any detail. In any case some of it may not be easily available or suitable in Australia.

The way I suggest you approach this is:

- Write out your trading plan in detail (you indicate that you would base it on Dr Elder's approach – that is fine but he advocates that you should vary it to suit who you are).
- From your plan, make a list of the functions you require in the software you will use.
- Study the available software, checking off each of your requirements.
- Cost could be important, so arrange the final candidate list by cost as well.

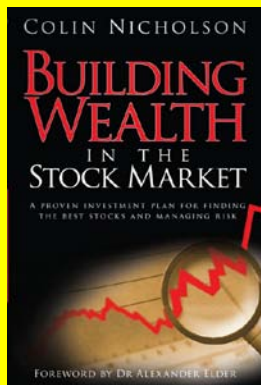
Really, once you do this in an organised way, the decision should more or less make itself. The first bullet point is the tough one for most people. Once past that it should just be time and diligence.

The Australian Technical Analysts Association is in the process of preparing an updated survey of software and data vendors in Australia. I am not sure when it will be released or whether it will be made available to non members at a price. However, this should be on their website [www.ataa.com.au](http://www.ataa.com.au) at some point. This could help you in your search.

Good luck. Time and effort will be required, which is the necessary downside. However, the upside is that you will learn a great deal from this process and be a better investor or trader by the end of it.

## 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.** There are 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.** On-line ordering on my secure website uses SSL technology and is perfectly safe.

## The Vexed Question of Stops

After market prediction, by far the most common question I am asked by beginners is how to set a stop and do I place stops in the market in advance?

As with the question on choosing software, if this question comes from an individual investor or trader, if I do not take care when answering it, I will have crossed the line into giving specific advice, which is illegal for me in Australia without an advisers licence. Even if it was not illegal for me to give specific advice without a licence, if I decided to answer that question in terms of how that individual should set their stops, I would also be required to observe the **know your client rule**, which would involve me asking a great deal of information about that person, including their specific investment or trading plan.

Other than it being illegal for me to answer the question, there is also the other issue that seeking an answer to it is an important part of the education and development of the investor or trader. It is not something that someone else can do for them, despite the claims of some people selling expensive seminars. Using someone else's plan usually fails because the investor or trader has not tested that plan, just adopted it. When they come under pressure in the market, I will bet you that they abandon the plan. This happens all the time to most beginners, so it is not just you. It is a stage everyone passes through from the search for the Holy Grail or a magical guru to a mature stage where they become effective investors or traders.

So, as with choosing software, I can show these people the map, but they must make the journey themselves. Unless they make that journey, they will not progress to a higher skill level as an investor or trader. This is what I see as the map or itinerary for that journey:

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1. The first thing to do is to develop a written investment or trading plan. This is the most difficult step. It generally takes at least ten years of hard work to develop the knowledge and experience to do it. Initially, beginners read one book or do one seminar and it all seems easy. Then they read more books and do more courses and the waters become very muddy. They have learned more, but now have to pick and choose which tools suit them into a coherent plan. I must emphasise again that there is no short cut here. Each new investor or trader must make this intellectual journey of learning, choosing and testing until they know deeply that what they have works for them. I wrote the book *Building Wealth in the Stock Market* for these beginners. In it I set out my investment plan as a model for them to flesh out. I define the risks which must be managed and the way I manage them. That is as far as I can go, because the model then has to be changed to suit each person and everyone is different.
2. One of the things an investment or trading plan should do is to clearly define the entry set-up, or set-ups, that will be used. Then the plan should describe what the investor or trader expects to happen. No plan is complete until its owner has this clearly laid out. It leads into the next step.
3. From the outline what the investor or trader expects will happen after making a purchase, it should then be easy to define when it is not happening. In other words, if what is expected to happen does not happen. For a start, this will be where the initial stop loss is placed – where the purchase has gone wrong. Further, if what the investor or trader expects to happen begins to unfold, at any time they should know where their expectation has failed. This is where they would be wrong about the investment or trade. It is where their stop should have been moved to in order to cut losses quickly, or to protect paper profits.

So, what we have now is a plan, whose internal logic determines where the stops should be before and during the investment or trade. The whole idea is as simple as that, and should be relentlessly logical. However, I know from experience just how long it takes and how difficult it is to reach that point; all the learning, experience and hard thinking that is involved.

That is the itinerary. It will take time. It will take hard work. However, in the end it is what must be done to reach the goal of being a good investor or trader. And it does not stop there. The task is never completely finished because markets can change and the owner of the plan can change in terms of age, capital, risk tolerance and so on. Then the plan will need tweaking and retesting. Nevertheless these modifications should be a lot easier than arriving at the initial plan.

The final issue is whether to execute stops manually or to place them in the market in advance when making a purchase and adjust them as the investment or trade unfolds.

I do not place stops in the market in advance. However, that is me and my investment plan. There may be important differences between what I do and what readers should do. Some of the important considerations are these:

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1. If the investment or trade involves leverage, then automatic stops should be used. The financial risk involved with leverage is too great to leave positions unprotected against sudden and unexpected movements. And do **not** think that if investments and trades are only made in so-called blue chip stocks, that significant sudden and unexpected moves cannot happen. They do.
2. Some stocks in the Australian market have sufficient volume and depth to allow automatic stops to be used easily. However, this is not the case for more thinly traded stocks, which by number, but not capitalisation, are the big majority of stocks on the ASX. The danger with automatic stops in stocks with no real depth is that one stop triggers another and so on in a rapid cascade. Everyone will have seen these downward spikes where the price falls rapidly on low volume only to spring back to near the original level after all the stops have been cleaned out, or by-passed because it all happened so fast that limits on automatic stops were quickly exceeded.
3. Automatic stops might also be used by beginning investors or traders who feel that they lack the discipline to execute their stops manually. So, for some years they should consider taking the stops out of their own hands and having them in the market to be triggered automatically if key levels are breached. That said, remember point 2 above. They should steer clear of stocks with little volume and/or depth of orders. These stocks are for more experienced investors and traders who have developed the skills and discipline to deal with them manually.
4. Before using an automatic stop, make sure that the mechanism and rules used by your broker and the market is fully and clearly understood. In particular, know how the limits on stop orders work in practice. Also understand in what circumstances corporate actions can cause the ASX to purge all outstanding orders and whether this could affect stops. Likewise, understand how the closing or opening auction may cause a movement of such magnitude that the limit on your stop is exceeded and it is never triggered. Another example is to understand in what circumstances trading may be suspended and your stop therefore cannot be executed. This can be dynamite for a short position in a takeover situation. This general point is all about Warren Buffett's dictum to never invest in anything you do not understand.

That is the itinerary for developing and using stops to protect positions from catastrophic loss. The positioning of stops will vary from investor to investor and from trader to trader in the same stocks. However, there are some common and obvious places where stops are likely to be placed. Think about them and try to avoid having stops in these places in case the professionals out there can easily run your stops and take you out of sound positions to their advantage. It is a tough world out there in the markets and only you can protect yourself. Never assume that anyone else in the market is going to help you, because the reality is that everyone is out there trying to maximise their profits.

## The Thinking Process is Far More Important than the Answer

Most readers would be astonished by an analysis of the emails I get from readers or my books, newsletters, website and attendees at various presentations around the country. The proportion of emails asking me what I think is the answer to an analysis of the market or a stock is close to 100% and the remainder are those who offer their analysis for my comment. I think this is a great pity.

I recently received this email question:

*I have recently read your book Building Wealth in the Stock Market and am reading/ studying it again to make sure I have grasped every point. I perceive we are in a bull market phase two quite quickly heading towards phase three (rampant speculation), but not yet there. Is that your assessment also? Will you declare your thoughts in this regard to your members in due course? I am quite fully invested at this time and acutely alert to the need to start to start selling when the signs are right. As a newcomer I need some help interpreting those signs.*

My answer may surprise some readers:

*Thanks for the idea of another case study example at some point, which I will add to my list.*

*However, I think you are missing the point of what I am trying to do. I do not want to be an investment adviser. Instead I want to help you learn to be a good investor. So, my case studies are meant as examples for you to use in the learning process and may usually be read after the event in order for me to stay within the law on advising without a licence to do so.*

*In my book I outlined the key markers for each phase. The case studies in the book and the market analysis examples and presentations on the members website give you samples of how I do the analysis, but the key is for you to have a go at it yourself, rather than for me to keep telling you my answer to the questions.*

*So, why don't you do a written analysis using as headings the key markers in the book? You will learn far more from trying to do this yourself rather than relying on me to give you the results of my analysis. It is the doing process, not the answer that is important.*

*If you want to send me your analysis I will read it and maybe comment on it, perhaps in the form of further questions where I think you need to think more deeply about something.*

So, could I request that anyone who is looking for an answer to an analysis question might like to send me their own analysis and I will look at it and comment to the extent that I am allowed by Australian law? This is separate from questions seeking facts about the way markets operate and methods of fundamental or technical analysis. Therefore, my new rules are:

1. You are free to ask for facts about anything affecting stock market investing.

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2. However, if you seek an opinion about the market or a stock, questions I cannot legally answer, I will guide you to the extent that I can, but first you need to send me your analysis. I will then answer in such a way that prompts the further development of your ability to think properly and well as an analyst.

In learning to be a good investor, it is the thinking journey that polishes your analysis skills, not being simply told my conclusion. This is the case even when I write an analysis as a case study. This is a guide for you, but real progress is made by you trying to practise and improve your thinking skills. As I have already said in this newsletter a couple of times, as a teacher I can demonstrate the techniques to show you the roadmap and itinerary for your intellectual journey. After that, my best contribution to your progress is as coach who reviews your work and asks more questions for you to think about on your way to a higher plane.

***There are many truths of which full meaning cannot be realised until personal experience has brought it home.*** John Stuart Mill

## **Book Review: *The Ascent of Money***

Some readers may have seen the television series based on the book *The Ascent of Money* by Niall Ferguson. Instead, I had already read the book when it was first published. There are many books published on the history of financial markets, but I found this to be one of the really good ones.

Niall Ferguson is professor of history at Harvard University and a senior research fellow of Jesus College, Oxford University. As well as being an excellent historian, he is a gifted writer in the sense that this work, which deals with somewhat arcane topics at times is very easy to read and understand by the layman.

The subtitle of the book is quite grand: *A Financial History of the World*. Normally this would put me off, because I mostly read these days for a depth of knowledge that is unlikely to be found in single volume histories of the world, which to me are like most television - skating superficially over a subject. Nevertheless I found the book difficult to put down and quite easy to read and understand. While Ferguson has avoided the endless detail of some histories, he has taken us through financial history like the narrative of a novel.

He begins in ancient times when money was first invented and we follow its progress through until today. In his final chapter and the Afterword, he also ventures a look into the future. However, this was the least satisfying aspect of the book, considering my philosophical view that explaining history well is a different skill to predicting the future, which is at best an entertainment.

Once you have read this book, you will understand where money started and how it has developed. You will learn about bonds, a security type which tends to be difficult for most beginners to get their mind around. Of, course, a major chapter is about stocks and the booms and busts that punctuate history.

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After that Ferguson explains insurance, another concept of which most people have only the most superficial understanding. After reading this chapter you are unlikely to see insurance in the same light.

You will have by now been waiting for Ferguson to get to the global crisis of 2007-09, which he explains through a history of home owning, the financing of property ownership and right up to the US sub-prime crisis. Again, it is all superbly simply explained.

The final chapter *From Empire to Chimerica* is interesting and well written, but much of it moved from history based on fact to speculation of where history might be leading us.

The whole book is clearly very well researched and for those who wish to follow things up, there are extensive notes and references at the back of the book.

Even the most experienced investors will enjoy this delightful story and enrich their knowledge. However, my thought is that this book would be great for people who are just starting out on their journey from relative ignorance to mastery of the craft of investing. Much like starting a study of geography from the overall picture on a globe of the world, this book will be ideal for those who are just starting out as investors and need an overall picture of the key concepts in the financial world. It would make an ideal gift for children who are just finishing their education and beginning their working lives. One of the saddest things in investing is how many people waste all those early years in the workforce when they could be simply and painlessly developing the saving and investing skills that will enable them to retire rich, time that can never be made up later.