Colin Nicholson: Newsletter 96

26 February 2010

Hear Colin speak

My speaking program is set out on www.bwts.com.au on the ***Hear Colin speak*** page. I have now reduced my forward speaking program drastically on medical advice. The slides for the presentations I give will continue to be uploaded to the paid section of www.bwts.com.au. My books and my website will together now become my main focus in educating investors.

Win one of three books

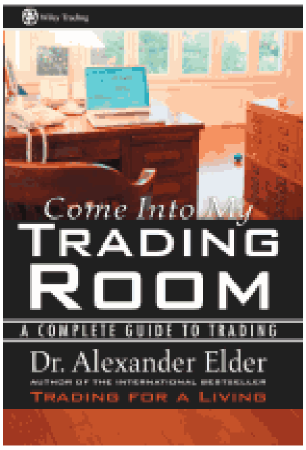
The best way we can improve our investment skills is through practice. To give readers an incentive to get started on practising their analysis skills, I am offering prizes for the best ***analysis of the Australian stock market*** as at the close of trading on Friday 5 March 2010.

To win one of the books, you need to email me at colin@bwts.com.au an analysis in a Word document ***by 9am Monday 8 March 2010 Sydney Summer time***. The rules are:

1. You must start with a monthly view (up to 20 years)
2. You must then work down to a weekly view (up to 5 years) and optionally a daily view (up to 1 year).
3. Your analysis must be of the ASX All Ordinaries Index (XAO) or of the S&P/ASX 200 index (XJO). There is not 20 years of history for the XJO, so it may limit your monthly view.
4. You must write up your analysis in no more than 1,000 words. Charts do not count as words, but any explanations that have been added to charts should be included in the word count. Similarly, any words included in tables.

The best three entries will win a prize as follows:

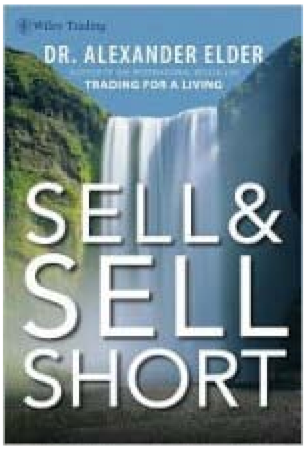
First Prize



A new copy of Dr Alexander Elder's book ***Come into my Trading Room*** that has been signed by Dr Elder. The book has been donated by Dr Elder. For my review of the book see http://www.bwts.com.au/text.cfm?27

Did you know that the ***Book reviews*** page has been moved from the paid to the free section of www.bwts.com.au?

Second Prize



A new copy of Dr Alexander Elder's book ***Sell & Sell Short*** and the ***Study Guide*** that have been signed by Dr Elder. The books have been donated by Dr Elder. For my review of the book see http://www.bwts.com.au/text.cfm?27

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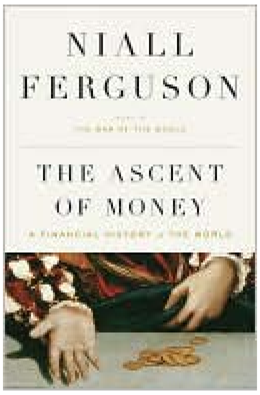
Third Prize



A slightly used copy of Niall Ferguson's book ***The Ascent of Money***. For my review of the book see http://www.bwts.com.au/text.cfm?27

Did you know that the ***Book reviews*** page has been moved from the paid to the free section of www.bwts.com.au?

Dr Elder's books may also be purchased from his website www.elder.com. If you indicate in the Comments box that I sent you, he will give you the cheapest possible mailing rate. Dr Elder also signs books if you request it.

I will publish the three winning entries in the next newsletter.

Please remember that the most benefit will be gained by doing the analysis yourself, rather than waiting to read the winning entries. In this way, everyone who enters their analysis will already be a winner.

Cairns Support Group Sophie Allen is interested in starting a small support group in Cairns Queensland. Her idea is that people who have learned investing from me and developed their own investment plans might get together to help each other. If you are interested and live in postcodes 4861 to 4885, please email Sophie on cairnssharetrading@yahoo.com.

Out of Sight, Out of Mind

Life presents us with many situations in which we are called upon to make a decision, often without allowing us the luxury of having full information. This is known as decision making under conditions of uncertainty. Investing is a very good example for two general reasons:

1. The future is always unknowable. Nevertheless, there is no shortage of people who profess to be able to forecast the future, sometimes based on projections of the past and other times using arcane methods with no proven basis for reliability. Even well regarded experts may be of little help in divining the future. For example, how many of them warned of the impending global financial crisis in 2007?

2. There may be information available, but finding and assessing it is both time consuming and difficult for typical private investors, who lack education in investing and who are time poor.

What this means is that we should all seek to extend and improve our investment knowledge and our skills at finding and assessing information. This is likely to be an unending life-long task, which can be very rewarding in both money and satisfaction, but a great deal of time and effort is required. In effect, we need to train ourselves in a new profession that may be quite different to what we have already experienced at school and university and in the workforce.

Heuristics

Instead of making every decision from scratch, we develop what psychologists call heuristics, devices we may recognise by the simpler name of rules of thumb. These rules are developed and refined progressively as we find things out by formal study or by life experiences.

In investing, some common heuristics might include only buying stocks with low price earnings ratios, high dividend yields and low debt to equity ratios. If these heuristics are solidly based in logic and validated by research into how they have worked in the past, these may be very valuable rules. They might be very powerful at least as an initial filter for drilling down to a short list of the best opportunities to choose from.

When we need to make a decision, we use these heuristics to make sense of difficult situations in which we have to make choices. We apply the heuristic to the limited information that is available. To the extent that our heuristic is closely reflecting reality, it will serve us well. However, most heuristics are imperfect, in that they are at best rough guidelines and do not stand up well in all situations. This opens us up to errors and biases in our decision-making.

Availability Heuristic

One of the more pervasive rules of thumb is called the availability heuristic. The availability bias affects each of us every day, whether we realise it or not. The good news is that once we know how subject we all are to the availability bias we can start to deal with it consciously. The bad news is that continuing in ignorance of the availability bias can lead us to make very poor decisions, if not mistakes.

The availability bias is this: when called upon to make a judgement or express an opinion about something, we draw on our memory. We therefore rely for our judgement or opinion on those things that come to mind most readily from our memory. What comes to mind will depend on what we have been exposed to, our experience and knowledge, but also those things that are most recent or which made the most vivid impression on us.

Joan's accident

Joan is a case in point; she was recently involved in a car accident involving a young person who was speeding. This left a strong impression on her because it was recent, happened to her personally and because she was emotionally affected by the accident. A week later she is still very timid about driving in traffic. When she meets with friends, or talks to them on the telephone, she relates to them what happened to her. This reinforces the strength of her memory of the event. Not surprisingly, when talking about the accident, she offers the opinion that young people cause most traffic accidents. This is the availability heuristic in action. Joan has drawn a conclusion from her own recent and vivid experience. The availability heuristic may well serve her well in that there may turn out to be a statistical basis for her conclusion. However, in many situations, the availability heuristic may cause her to reach altogether unwarranted conclusions.

We should not see the availability heuristic as only a negative bias. Much of the time, the availability heuristic will serve us well because events that occur frequently are more likely to be remembered than things that happen rarely. We are therefore able to quickly and accurately make good judgements and form useful opinions.

The danger in availability

Nevertheless, reliance on the availability heuristic can play havoc on our ability to accurately assess how often something has happened in the past and, more importantly, the likelihood that it will occur in the future. This happens when we have very limited knowledge, such that we do not have a clear picture of the whole universe of possibilities. It can also happen when the subject is highly emotional, such that it has made an impression on our memory that is out of all reasonable proportion. A good example would be if we were personally involved in a traumatic situation compared to another situation we only read about in the newspaper.

My parents' generation was emotionally scarred by the great depression of the 1930s. They, or their parents lost money in the great stock market crash and may have suffered years of unemployment and degrading work for the dole. Some never received the education they might have been able to afford in more normal times.

Ernie's story

Ernie was in high school when he saw his father lose his savings in the stock market and then his business failed in the depression. Their family spent a decade eking out an existence as best they could. Ernie never forgot this and still today, all of his meagre savings are in government bonds and bank accounts. Clearly, this investment policy is driven by the availability heuristic and it has left him with a strategy that has seen him living off the pension, when he may have made far better use of his savings in providing for his retirement.

The sad part of this is that the first decade of the twenty first century has seen another dramatic fall in the stock market. Many people will have been badly hurt financially. They will be likely to be ultra cautious in their investments for the rest of their lives and will pass that caution on to their children and will reinforce the opinions of their friends. The availability heuristic will have struck again. In their minds the next crash is just around the corner. Yet severe stock market crashes are neither common nor frequent: 1929, 1974, 1987 and, 2008. The sad part of the availability heuristic is that many of the people affected will invest going forward on the basis of one bad experience, which happens very rarely.

Shares versus property

As we have just seen in Ernie's experience, investment is a fertile field for availability bias. One of the most common examples is the volatility of prices. We will all have heard the opinion that share prices are far more volatile than property prices. Sometimes this even takes the form of an assertion that share prices often fall, but property prices only ever go up. These assertions are based on the availability heuristic. There is an active, well reported, market in shares. Comparison is easy because all Telstra shares are the same no matter where the shareholder lives. We can see prices changing minute by minute on the internet and certainly we see reports of rises and falls in share prices every day on the television news, on the internet and in the newspaper. Against this, property prices are far harder to come by and are reported infrequently, if at all, for long periods. Moreover, every house in every street is different, not to mention in different suburbs and different states. Comparisons are very difficult as anyone will know who has had to buy or sell a house. Some houses only sell once in a generation, so there is no reference point that allows any clear idea of their prices. Out of sight, out of mind is a saying that neatly sums up the availability bias.

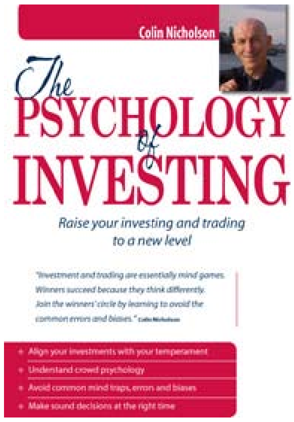
As someone who spends a lot of time reading and researching shares, I have learned to recognise the availability bias in action all the time.

Jason's tip

Someone asks for an opinion about a share. While I am weighing up the information in my memory, Jason, a tyro investor beats me to the punch with a strongly held view based on something Rebecca told him recently over a dinner in the local restaurant. When I question the basis for Rebecca's knowledge, I am told that she says that she heard it from another friend, whose father works for the company in the warehouse. I am immediately aware that the availability heuristic is staring me in the face. I ask a few more questions, which begins to irritate Jason, who then admits he has a large investment in the company on the basis of Rebecca's informed view.

Often, I may be reluctant to express a view at all because there is so much conflicting or vaguely remembered information available to me. I need to research the matter more thoroughly and assess it carefully before being confident to express a view.

The antidote to availability bias is to substitute research for memory. Be very wary about relying only on the most recent or most visible report about a share. Seek to form a rounded view based on the available facts. Be especially cautious when any situation looks to be an absolutely black and white case. There should always be positive and negative factors to weigh up, or we are in grave danger of becoming a victim of the availability heuristic.



If you feel this article is of interest and use to you, there are many more like it in my book *The Psychology of Investing*. My price is $40 including postage to Australian addresses. To buy it, go to http://www.bwts.com.au/text.cfm?55

The amount risked is the same on every investment

When I write about or talk to groups about where I place my sell stops, a common reaction is questions from people aghast at how far away my stop is from the buying price. The reason for these questions is that my questioners are focussing on the wrong thing.

For example, suppose I buy a stock for $0.71 per share. Then I say that my sell stop $0.34 away at $0.37. The questioners will have made a quick mental calculation that a fall back to $0.37 means a $0.34 loss per share. This is 48% of the buying price, so they are aghast. The questioners often say they would never risk this much on any investment.

Investing is about making a return from a total portfolio. My investment plan calls for me never to risk more than 1%, and commonly less than 0.5% when I buy a stock. (for those who find this at odds with *Building Wealth in the Stock Market*), since publishing it I have modified my plan to allow 1% maximum risk when a stock is already trending. Breakout buys still only risk 0.5%.

These percentages for maximum risk are percentages of my total investment capital allocated to shares. That total capital figure is the sum of the total market value of all current investments plus the cash reserve for share investments.

So, if my total capital has a value of $100,000, I would not risk more 1% of it on any one stock, which means $1,000. Since the risk on the stock mentioned above is $0.34 per share, that means I can only buy $1,000 ÷ $0.34 = 2,941 shares.

This calculation is at the very heart of my money management rules. What it means is that no matter how far the stop is from my buying price, I never risk more than 1% or $1,000 on any one stock. What changes for each stock is how many shares this rule allows me to buy.

In this example, I may decide that 2,941 shares in that stock will be too small a holding to be worth making a purchase. My options then are to move on to another opportunity in another stock, or to await a later entry point in the trend. This may allow me to set a sell stop that is closer to the buying price and therefore allows me to purchase a larger number of shares.

The point of this little discussion is to help clarify the way risk should be measured and dealt with. The bigger the risk in dollars per share, the fewer the number of shares my rules let me buy. If the risk in dollars per share is smaller, my money management rules will let me buy many more shares. In both cases the risk is the same.

This is an absolutely essential concept to successful investing. If readers are not comfortable with it, I suggest looking at lots of examples and making the calculations.

Usernames and passwords

January 2010 brought a rash of emails from website members wanting their username and password again because they had deleted the original emails. I am always happy to help, but self help is the best first course.

We all have myriad usernames, passwords, account numbers and so on which we need to keep. There are some specialised software programs to deal with this with strong encryption. However, most of us will have the tools already on our PC, or be able to cheaply buy the tools, which I find are also useful in many other ways. What I did myself is this:

I initially recorded all my existing security codes and data in a Word table format. I could then password it, but prior to Office 2007, the Microsoft password system has been weak and easily broken (there is free software on the internet to do it). I then moved the Word file into a Winzip zip file and encrypted it using the strongest setting and with a strong password. Then I permanently deleted the original Word file.

From then on, I open the Word file at any time and update it. Then I save it again as the encrypted zip file without ever saving the unencrypted Word file. I have a shortcut to the zip file on my desktop and also a hotkey to get to it while in another program.

To do this you will need Winzip or something similar, most of which software is very cheap and useful in many other ways.

This has saved me countless hours over the years looking for membership numbers, account numbers and all the numerous passwords and usernames. It is a very good idea to also put your software licence keys in the file.

If you are worried about having even this strongly encrypted file stored on your PC, you can create it and save it on a USB drive and then encrypt it as described, and/or use the encryption on the USB drive itself if it is good enough. Then the file is never on your PC, except when you open the file to get something. The USB drive approach is more trouble, but you may feel happier about it.

I know there are lots of ways to achieve this objective. If you know a better way, that is fine. There is no need to tell me – I have read widely on this issue.

This issue can therefore be easily solved. The difficult steps are taking the time to input your backlog of sensitive data and then having the discipline to keep it up to date. At the very least it is better to start now and then add to the file gradually as you find that you need something that is not already in the file. To delete a file or email once may be an accident. To not learn from the mistake is negligence.

I use the same method for other sensitive personal and family information that I need to have on my PC for reference from time to time.

Needless to say, all of the above is a waste of time if you do not have strong and up to date security software on your PC. Browsing without it is like having unprotected sex with strangers.

Need a debit card for your SMSF or company?

It is increasingly common for all sorts of goods to be purchased online on secure websites. Amazon and airlines, for example have developed huge businesses in this way. Many businesses like mine now only provide for credit and debit card payment.

What concerns most people is fraud. While commonsense and good security software will keep us out of trouble most of the time, there are other simple measures that help reduce risk to a minimum:

1. Use a debit card on which you only have the money needed for each purchase or a small balance that is not a disaster if it were lost.

2. Use a separate credit card with a small credit limit for internet and telephone/mail order transactions. This is what I do. If a large purchase is required, it can be used like a debit card by making an electronic deposit of extra funds before doing the transaction.

One problem some people have is that they wish to make the purchase through their SMSF or private company because the fund or company has a higher marginal tax rate than applies to their personal tax return, which in turn generates a larger deduction. This is now far easier to do with ANZ Bank announcing a debit card that may be issued to businesses. A SMSF often has a company as trustee, so this is worth looking into.