

# Colin Nicholson: Newsletter 99

27 May 2010

## 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: <http://www.bwts.com.au/index.cfm/resources/hear-colin-speak/>. The following item is a recent addition:

## Sydney

Wednesday 16 June 2010

Australian Investors Association North Shore Information Meeting

**Topic:** *Q&A session featuring Colin Nicholson*

Colin will begin by setting out ten of the most important things he has learned about investing in the stock market from his experience since the late 1960s. He will then make some brief comments on the state of the major world and Australian stock markets. After that he will be open for any questions about stock market investing and analysis.

### Further information

Venue: Chatswood Club, 11 Help Street, Chatswood

Parking available in adjacent streets, one block west of the Pacific Highway. If a member of the Chatswood Club you can park free under the Club.

Program: 7.00: Registration

7.30: Q&A session featuring Colin Nicholson

9.00: Refreshments

Cost: Members \$10pp / Non-Members \$15pp. Includes refreshments.

## Recent additions to the website

Since the last newsletter the following have been added to the website:

24 March 2010: The June 2010 Loan Market Group newsletter article on the *Return on Assets* ratio has been uploaded to the paid website on the [Fundamental Analysis Articles](#) page.

17 April 2010: Newsletter 98 has been uploaded to the Resources/Newsletter Archive page to deal with problems with the link in the email advising its availability.

10 May 2010: A market case study as of the close of 7 May 2010 has been uploaded to the [Market Case Studies](#) page on the paid section of the website.

17 May 2010: A presentation given in Brisbane 15 May 2010 has been uploaded to the [Presentations](#) page of the paid website.

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Please note that the above hyperlinks to pages on the paid website require members to login before the pages can be accessed.

Readers may check additions to the website at any time. The last couple of additions are listed on the home page [www.bwts.com.au](http://www.bwts.com.au) and there is a full list on the **What's New** page at <http://www.bwts.com.au/index.cfm/whats-new/>. For many additions readers may use the RSS channels which is explained in the link on the home page under the News items. Stock case studies are also flagged by asterisks on the *Portfolio Disclosure* page: <http://www.bwts.com.au/index.cfm/portfolio-disclosure-warning/>

## Forecasting competition

As we approach the end of the Australian financial year it is natural for investors to ponder what may be ahead of them in the year to come (July 2010 to June 2011). Bearing in mind that forecasting the future is very difficult, if not impossible, I thought that readers might like to have a little fun by guessing where the market will go in the year ahead.

All you need to do is email me using this link <http://www.bwts.com.au/index.cfm/contact-colin/> the following forecasts of the value of the ASX All Ordinaries index (XAO) as at the close of trading on the last trading day in:

September 2010

December 2010

March 2011

June 2011

Your email must reach me by midnight on Sunday 4 July 2010 (Sydney time). This is to give you a few days and a weekend to finalise and send your forecast after the end of this Australian financial year on 30 June 2010. So, may I suggest you put a note in your diary to do your forecast and send it?

I chose the ASX All Ordinaries index as the broadest measure of our market. Forecasts of other indices are not acceptable in the competition, or things would be just too complicated.

I am going to publish the forecasts in the newsletter, but I do not want to embarrass anyone, so you might like to give yourself a one word nickname for this purpose. If you do not give me a nickname you would like to use, I will allocate one to you. The reason for publishing them is to add interest by allowing everyone to see their forecast in relation to all of the other forecasts.

However, I will publish the names of the winners – those who have succeeded in making the closest forecast of the actual value of the index.

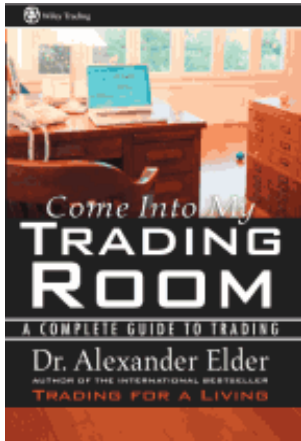
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While the competition is intended to be fun and I hope everyone will try their hand at forecasting, there will be some prizes for the winners for each of the four forecast dates:

### First Prize (closest forecast)

One year's free membership of my paid website if you are not an existing member (value: \$99) and two years extension of your membership if you are an existing member (value: \$110).

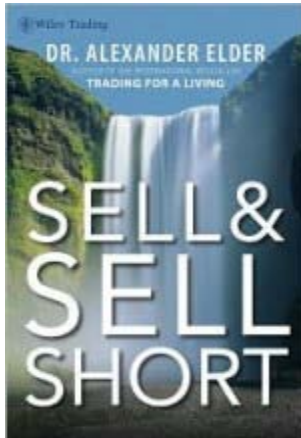
### Second Prize (second closest forecast)



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](http://www.bwts.com.au)?

### Third Prize (third closest forecast)



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>

Did you know that the **Book reviews** page has been moved from the paid to the free section of [www.bwts.com.au](http://www.bwts.com.au)?

### Summary

What you need to do to enter:

1. Email me (<http://www.bwts.com.au/index.cfm/contact-colin/>) your forecasts for the end of September and December 2010 and March and June 2011 for the XAO.
2. Provide your name and a one word nickname.
3. The email must reach me by midnight 4 July 2010.

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## Managing a portfolio while travelling

I recently received this question from a reader:

*Hope you enjoyed your holiday overseas. My question relates to how you manage your open share positions whilst away for an extended time. I am planning to be overseas later in the year for 7 weeks and I expect that I will have open share positions. I suspect one answer is if that you are worried about just sell but I noticed on your portfolio page that you still have some open positions.*

I thought that my reply would be of general interest:

Over the years I have used a number of methods, depending on the circumstances:

Sell everything before I go. This is most appropriate for speculators because their time frame is so short relevant to travelling time. It is some time since I was a speculator, but I have done it. Now that I am an investor, such that my time frame is longer, I have used other methods.

When I am able to take my PC with me and will have near daily access to the internet, I manage my positions this way. I have done this a number of times successfully in a number of countries. Although I have taken my laptop in the past, which can be a hassle when travelling, the advent of small netbooks makes this option very workable. However, the key is to have a secure connection. I would never use my PC on a public wi-fi connection for banking or share transactions because of the security risk. It is better to pay up for direct broadband access at a hotel or use one at a friend's place. I would never log in to my broker's site and do a transaction in an internet cafe.

When travelling in Australia, I use wireless broadband, which is secure and cheaper than hotels charge for broadband. This is also very appropriate when I am staying with friends/relatives rather than in hotels. If staying overseas in one country for a reasonable time, this method could also be practical, but I have not done it.

When I stay in London I have access to my daughter's Mac, which has a secure connection. I am happy to use that to check the market and to do transactions on my broker's website if necessary. If readers are wary about this, the actual transactions can be done by telephone – cheap with a calling card, but inconvenient in other time zones like London.

I have also had three different trusted people execute my sell stops for me. This was effective. However, it is not ideal unless there is someone I trust and they have the discipline to act on sell stops. Most people cannot act reliably on their own sell stops (if they have them) let alone someone else's sell stops. It is a very big ask and requires a special person. I used this several times when I was trekking in Nepal where there was no internet access of any kind for several weeks.

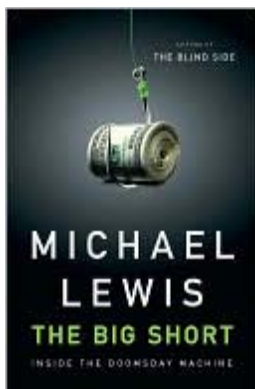
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Sell stops can be set with brokers. I have never done this. They are not reliable because brokers require both a trigger price and a limit price. If the market falls through the trigger price and also the limit price without the broker's system being able to execute your sell stop then the method fails, even though the investor might have sold had they been on deck. So be careful that the mechanics are well understood and that the risk of sell stops not being executed is acceptable.

In conclusion, there are many alternatives that have to be weighed up against the circumstances. There is nothing that is perfect when travel takes us away from any contact for some time.

If any readers have discovered other methods, I am interested to hear about them. Email me using this link: <http://www.bwts.com.au/index.cfm/contact-colin/>

## Book review: *The Big Short*



At the end of the 1980's Michael Lewis wrote a book called *Liar's Poker*. It became an international best seller, giving a highly entertaining insight into the greed that pervaded the City and Wall Street in the 1980s.

Michael Lewis has now written a book called *The Big Short* about the sub-prime mortgage market that was the catalyst for what is now dubbed the global financial crisis.

I am sure that readers' first reaction will be that they have heard enough about it already. However, this book is truly outstanding. Michael Lewis is a very knowledgeable writer about the financial markets, who also writes in a highly entertaining way about a difficult to understand subject. Along the way I found myself reading the best and clearest explanation of what the sub-prime disaster was all about.

The way Michael Lewis has done this is to take a story many of us may not have heard much about. This is a small group of people who independently developed an understanding of what was wrong about sub-prime and set about trying to work out how to profit from the coming disaster. Each of them in their own way made many millions of dollars out of shorting sub-prime loans using credit default swaps, hence the title of the book: *The Big Short*.

I found the individual stories read like a novel, yet they are true and well researched. The book takes us along the parallel journeys of these very unusual people. It is worth reading for this story alone. Yet there is more. As each story unfolds, Michael Lewis explains what sub-prime loans were, how they were cut up into tranches and sold as bonds or as collateralised debt obligations with the connivance of the ratings companies. Then how the banks creating these arcane instruments ran out of sub-prime loans and what some regard as fraud was perpetrated to try to keep the game going. Finally, we learn the story of how credit default swaps were created and how the short positions were created that would profit hugely from

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the eventual near collapse of the financial system. This subject is currently in the news with the charges against Goldman Sachs, who have been before the US Senate committee and are heading for the courts.

This book is the clearest explanation of these instruments and how sub-prime all came about and then played out that I have read anywhere. It is not difficult to read. In fact I found that I was picking it up again at every opportunity while I was travelling overseas. A bit sad you might think that I was reading about the markets while on holiday. However, this book is in my opinion worth it. I learned a great deal from it. I could not recommend it more highly.

Readers will probably find it in good local bookshops, but if not, the Educated Investor bookshop at 500 Collins Street Melbourne has it in stock and it can be ordered online at <http://www.educatedinvestor.com.au/>. Just type *The Big Short* or Michael Lewis in the Search box and you will find it.

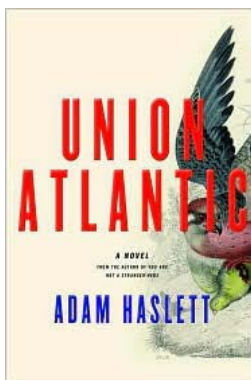
## Forgotten your password?

If you are a member of my website and cannot recall your password, this is how you can get a new password:

- Launch [www.bwts.com.au](http://www.bwts.com.au)
- In the top right hand corner, click [Login now](#)
- In the login box which opens, click [Forgot your password?](#)
- Enter your username. Unless you have changed it, 99% of usernames will be the part of your email address before the @ sign.
- An email will then be sent to your email address with the username and a new password.

If that fails for some reason, send me an email using the Contact Colin link at the bottom of every page on the website: <http://www.bwts.com.au/index.cfm/contact-colin/>

## Book review: *Union Atlantic*



When I mention books in this newsletter, they are usually non-fiction works about the markets. However, while I was travelling I read a novel called *Union Atlantic* by Adam Haslett. This is Adam's first novel. It follows his writing debut in the form of a brilliant book of short stories called *You Are Not A Stranger Here*, which I have also read and recommend, though there is nothing in the stories even faintly connected to the markets. *You Are Not A Stranger Here* was a finalist for the US National Book Award and a National Magazine Award, so he is clearly a well regarded writer of fiction.

In *Union Atlantic*, he gives us an insight into American culture through his main character who is a senior executive in a fictional bank called Union Atlantic. While the whole story is fiction, the main thrust of the plot hinges around a story that is eerily similar to the scandal involving Nick Leeson, right down to a huge short position in the Nikkei by

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someone who had control of both the trading and the reporting functions. I found that it gave a good insight into how such rogue trading can take place and especially how the situation might arise and escape attention at the highest levels back at the bank headquarters until it is too late.

It is a very easy read and can be justified in that it gives an important insight into the way markets work as well as being very entertaining.

## My portfolio

One of the most popular pages on my website is one of the legal pages which lists the stocks that I personally own. This page is there purely to satisfy my legal obligation to disclose any stock I own and mention on the website or elsewhere. If you have an interest in this page, it is still where it was on the old website – scroll down to the **foot of every page** on the website.

### Free Material

There is a great deal of free material on the website, including over 1,000 questions and answers in [Ask Colin](#), numerous [Newsletters](#) and a [Data Files](#) page.

In addition, there is a [Paid Material](#) section of the website that contains more advanced material, other than my books, that may be purchased separately.

[Get Latest Free Newsletter Now](#)

I publish a free email newsletter roughly monthly on analysis, investment and trading topics.

My book [Building Wealth in the Stock Market](#) was the *first Australian book to rate in the Wiley Top 100 Amazon sales*.



You can ask your question to Colin for free!

[Do you think there is too much emphasis on fundamental analysis?](#)

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## How Asia is different – a view of the future

*The Economist* published a special report titled: *The world turned upside down* in the April 17<sup>th</sup> 2010 edition. One of the things that I recommend investors do to improve their knowledge is read this kind of in-depth article in magazines and newspapers. Even more important is that these articles can give us valuable perspective on the world and insights into what is unfolding around us, but which most people do not become aware of until after it has happened. This is far more important than reading reports of what the markets did yesterday, something on which we have the data and should be able to form our own view. If we find that we need this kind of explanation, it could be because we are still learning the independent thinking skills that are essential in the journey from beginner to seasoned investor.

The special report is sub-titled: *A special report on innovation in emerging markets*. The author Adrian Wooldridge suggests that developing economies, which we have long regarded as based simply on low cost labour, are now beginning to challenge the developed world economies in the field of business innovation. I found this of great interest and it reminded me of the excellent special report on the developing world bubble in real estate prices and borrowing written in May 2003 and the level of risk taking in banks including CDOs

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and CDSs in May 2007. These gave ample time to know what was coming, although maybe not how soon. Having read these reports, there was no excuse to be caught unawares in late 2007 and 2008 as the global financial crisis played out.

The discussion about Asian innovation trends opens with a reminder of how the Japanese car manufacturers changed the world car industry by inventing and exploiting *lean manufacturing*, also sometimes referred to as *just-in-time* manufacturing. It is suggested that a similar revolution is beginning in the developing economies. Moreover, it is not just in one industry or one kind of commercial activity, it is right across all industries and all business functions.

The innovation that is blossoming is developing new products and services that are a fraction of the cost of the same things produced or provided in the western economies. This is being driven by two main influences:

Ambition to become multi-national players

Fear of other developing countries which also have cheap labour and might supplant them in simple products and services

The result is that Asian countries are moving to higher value and higher technology products and services. They are re-engineering everything from products and services through to the underlying business processes and models. Their new products and service offerings are often far cheaper than the equivalents in western economies, albeit often simplified to the basic functions consumers want rather than the 'does everything' model we are accustomed to in the western economies.

The statistics are likely to jolt many of us:

Number of multinationals based in the developing world: 21,500

Number from BRIC countries in the FT500 list 2006: 15, 2008: 62

Number of graduates in engineering & science each year China: 75,000, India: 60,000

Although western multi-nationals are recognising and moving into these developing markets, they find that these markets are difficult in many ways. Some of the challenges are:

Weaker or non-existent distribution systems

Highly variable income streams

Shocking pollution

Difficult governments – frustration, meddling and lack of basic services and rule of law

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Pirating of intellectual property

Widespread poverty

Some western multinationals have not even gone into these markets or have largely retreated from them in the face of these difficulties. Nevertheless, these emerging economies present some important and huge opportunities if they can be exploited effectively:

Huge population growing quickly

Hundreds of millions of Chinese and Indians will become much richer in the next few decades

Fast growing economies

Few expensive “legacy” systems – opportunity to start at the ground floor without writing off past investments

Low cost and plentiful graduates – China 5 million and India 3 million annually

Those who are succeeding have to be creative. Some things they are doing which turns western approaches on their head:

Aim for volume rather than margin because most consumers are plentiful but poor

Continual improvement of products because piracy is rife i.e. instead of the western reliance on intellectual property rights, their products are updated and improved frequently and faster than pirates can move to exploit them

In much the same as was done in Japan in the 1980s, these entrepreneurs are converting difficulties into opportunities in creative ways.

The old idea is that the west creates dramatically new technological products which are initially sold at high margin to the elites and then are repriced as they drift down to the mass market, including exporting them to developing economies. However, what is happening in developing countries is that innovation takes the form of continual small improvements in goods and services plus the business processes that create and distribute them. These are aimed at the huge low income base of the populations in these economies.

*“This is a region that, to echo Churchill’s phrase, sees opportunities in every difficulty rather than difficulties in every opportunity.”*

This is a summary of the two and a half page introduction to this special report. The remaining eleven and a half pages flesh it out in a series of articles that are headed:

**First break all the rules – the charms of frugal innovation**

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**Easier said than done** – emerging market consumers are hard to reach

**Grow, grow, grow** – what makes emerging market companies run

**Here be dragons** – the emerging world is teeming with new business models

**New masters of management** – pervasive innovation adds up to a new management paradigm

**The power to disrupt** - business innovations from emerging markets will change the rich world too

## Conclusion

I found this special report to be fascinating and have read through it several times. There is not space here, nor do I have time, to take you through it all. I found as I read the report that I had the uncanny feeling that I was reading about our future as well as that of the developing world. Some dislike globalisation and many of us embrace its opportunities, but the future cannot be avoided, whichever way we regard it.

If you would like to read the full report there is a way to do so. Go to <http://www.economist.com/members/members.cfm?act=registration> and register. Registering will allow you a one-off opportunity to receive a complimentary 14-day pass that grants you unrestricted access to the premium online content at *The Economist* online. Registration is free, and there's no obligation to subscribe.

Make the most of your 14-day pass. You might even decide to subscribe.

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## Some interesting quotations

In Newsletter 97 I included some quotations to fill in some spare space. The feedback was very positive, thank you. Here are a few more to get you thinking:

*The world is on a journey to an unstable destination, through unfamiliar territory, on an uneven road and, critically, having already used its spare tire(s).* PIMCO Secular Outlook May 2010

*...a financial crisis is an event that forces policy officials to spend a long weekend trying desperately to announce a new bailout package in order to avoid national and global panic before the markets open on Monday.* Nouriel Roubini

*When the unthinkable suddenly becomes the inevitable, without pausing in the realm of the improbable, then you have contagion.* *The Economist* Leaders column 1 May 2010

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