Colin Nicholson: Newsletter 100

21 June 2010

This is the one hundredth newsletter that I have sent out roughly monthly since I began writing them in November 1999. In that time they have evolved from a single page to many pages. The known readership has grown from less than 100 to close to 7,000. I have had tremendously positive feedback from readers over the years, for which I thank you all. I hope to continue to provide useful information and insights into aspects of investing and analysis.

Stop Press!

It is now over a decade since I had the pleasure of working with Dr Alexander Elder at one of his traders' camps. As readers will know, Dr Elder has been a friend for a long time and I regard him as the best teacher of short term trading in the world. He has taught me a lot over the years and he has still more to give because, like all great traders, he never stops learning and developing his powerful trading methodologies.

Dr Elder has now invited me to work with him again as a guest instructor at his Pacific Traders' Camp in Macau in early November 2010. I am looking forward to the opportunity to update myself on his latest ideas as well as the opportunity to teach four sessions dealing with aspects of my investment methods.

Dr Elder has already taken a number of bookings, some of which are from Australia. There are only a limited number of places, so if the camp is attractive to you, don't delay in booking a place, or you may miss out. All bookings are done through Dr Elder's office. Full details are on his website www.elder.com at http://www.elder.com/Macau2010/tc-welcome.html
For details of what I will be teaching, see the ***Hear Colin Speak*** page on www.bwts.com.au at http://www.bwts.com.au/index.cfm/resources/hear-colin-speak/

> By the way, if you are thinking that education in trading and investing is expensive, consider for a moment the cost of ignorance; the market will teach you, but its lessons are not free, they can be very costly.

Hear Colin speak

My speaking program is set out on 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 the next opportunity:

Gold Coast

Tuesday 27 July 2010
Australian Investors Association Conference Plenary session
Topic: ***The need for an investment plan***
Colin believes from his own experience that without a sound investment plan investors will be more likely to fail. He also advocates the importance of having the plan in writing. Colin will

discuss the risks that should be managed by the plan. He will then explain why it can be difficult to implement an investment plan in practice. Colin will provide strategies to help you prepare and implement your plan. He will also explain how and why you need to evaluate your actual performance against the plan.
Further information: http://www.investors.asn.au/events/national-conference/ or Silvana Eccles, AIA Secretariat 1300 555 061 silvana.eccles@investors.asn.au

> If you don't know what you want to achieve and how you are going to achieve it, you cannot expect to reach your objective and will end up in some other place.

Recent additions to the website

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

17 June 2010 Michael Kemp's book *Creating Real Wealth* is now available for sale from the website at Buy Books/Creating Real Wealth.

16 June 2010 The slides used for a presentation Questions and Answers given to the AIA North Shore Sydney meeting 16 June 2010 has been uploaded to the Presentations page on the paid website.

9 June 2010 A case study of an investment in Bradken to 8 June 2010 has been uploaded to the Stock Case Studies page on the paid website. It includes discussion of the SPP.

8 June 2010 A case study of an investment in CSG to 7 June 2010 has been uploaded to the Stock Case Studies page on the paid website. It includes discussion of the SPP.

4 June 2010 A case study of an investment in CSL to 4 June 2010 has been uploaded to the Stock Case Studies page on the paid website.

4 June 2010 A completed case study on the investment in BHP Billiton has been uploaded to the Stock Case Studies page on the paid website

4 June 2010 A case study of an investment in Melbourne IT to 4 June 2010 has been uploaded to the Stock Case Studies page on the paid website.

1 June 2010 The end of May 2010 files have been uploaded to the Resources page on the free website and the Interesting Charts page on the paid website.

29 May 2010 The review of the book Union Atlantic, originally published in Newsletter 99 has been uploaded to the Book Reviews page on the free website.

29 May 2010 The review of the book The Big Short, originally published in Newsletter 99 has been uploaded to the Book Reviews page on the free website.

22 May 2010 Speaking engagements in Sydney in June and August have been added to the Hear Colin Speak page on the free website.

Please note that the hyperlinks to pages on the paid website require paid 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 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/

> Any bubble can be an exception to the rule, but bubbles have quite a few things in common, and housing bubbles have a spectacular thing in common; every one of them is considered unique and different. Jeremy Grantham

Forecasting competition – reminder to enter

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.

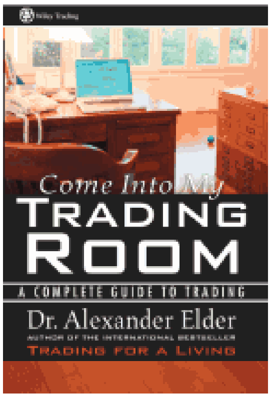
However, I will publish the names of the winners – those who have succeeded in making the closest forecast of the actual value of the index.

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).

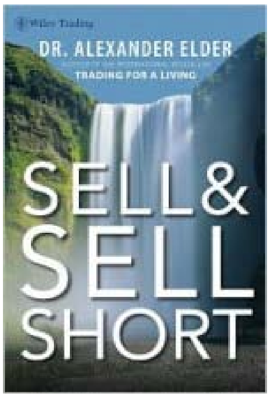
Second Prize (second closest forecast)



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?

Third Prize (third closest forecast)



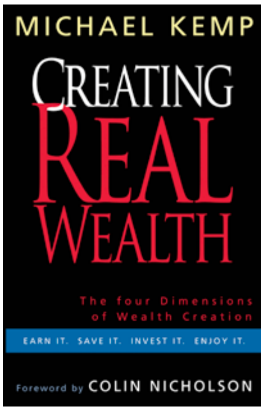
A new copy of Dr Alexander Elder's book ***Sell & Sell Short*** and the ***Study Guide*** that have been signed by Dr Elder. The books have been donated by Dr Elder. For my review of the book see http://www.bwts.com.au/text.cfm?27

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

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.

> It you're buying [houses] at 7.5 times family income, how high does a floating rate mortgage need to go before you are guaranteed buried?
>
> If interest rates rise to 10 per cent, and you have borrowed 7.5 times your family income ... that seems suspiciously like 75% of all your income is tied up in housing ...
>
> It is just like a time bomb, waiting for the interest rates to become impossible.
>
> We live in a mean reverting world, all bubbles break ... things go back to normal, even Australian housing prices. Jeremy Grantham



Book Review: *Creating Real Wealth* by Michael Kemp

Author: Michael Kemp
Price (RRP): $39.95

Michael Kemp was kind enough to let me read a draft of his book *Creating Real Wealth*. As I read it, one thought that came into my mind was that this was a book that I wish I had written. However, I doubt I could have written it anywhere near as well as Michael has done. The reason I was so struck with the book is that it covers material that I have myself taken as assumed knowledge. My own writing on investing has started where *Creating Real Wealth* leaves off. I was so impressed with this book that I agreed to write a foreword.

As someone who teaches investing, I am only too well aware of the low level of knowledge in the community about things connected to money. As someone who has always prepared their own tax returns, I continue to be amazed at the high proportion of taxpayers with very simple affairs who have to pay someone to do it for them. When it comes to investing their savings, the landscape is even bleaker. Huge numbers of people either just blindly follow whatever a financial adviser suggests without the faintest idea what is being suggested or try to do it themselves and blindly muddle through. One of the things Michael's book brings home to its readers is just how important investing is to our lives and our enjoyment of them in the fullest sense.

Creating Real Wealth starts right at the beginning, with what money is and what it means to our lives. Then it progresses to an understanding of where the money to make investments comes from. Along the way, the reader learns the importance of starting early as a way to shape a full and rewarding life through to our last days.

The greatest value from this book will be to young people who are towards the end of their education or are just starting out on their first employment. This is the generation that will have the maximum opportunity to construct a life that meets their objectives in the widest sense. The tools to do this are saving and investing, but before that, the youngsters must have an overall blueprint in which they should work. This is what Michael provides in his book.

However, if you are further advanced in your life, there is still a great deal to offer in *Creating Real Wealth*. Over and over again, I am told by people that they are too old to get the benefit of investing and through it of consciously framing a full life. With the exception of one or two who are in their nineties, most of them have a life expectancy of one or more decades. There is plenty of time to improve what they will have in the future, even if it is not the full result that may have come from reading a book like this in their early twenties.

If you buy this book and read it, I suspect that you may well want to buy more copies for your children and grandchildren. I believe the ideas in this book represent one of the most important gifts you could give them.

How you can buy *Creating Real Wealth* by Michael Kemp

I am selling Michael's book off my website www.bwts.com.au. There is a description of it there and an illustration of the book. Either go to the website and click on ***Buy Books*** or use this link to go straight there:
http://www.bwts.com.au/index.cfm/buy-books/creating-real-wealth/

Passive Investing – Dead or Alive?

*This article has been written for the newsletter by Michael Kemp, author of the book **Creating Real Wealth**, which I am now selling off my website (see book review and notice above). This should give you a taste of Michael's work. I will be inviting him to write more for future newsletters on various subjects that will be of interest and use to readers.*

Passive investing is an investment technique whereby available capital is deployed in the stock market for the long haul. No attempt is made at market timing hence it is often also referred to as "buy-and-hold". It is driven by the time-in-the-market philosophy that states "It's not about timing the market, it's about time in the market".

There has been much talk recently that passive investing has become less relevant. Whilst a drover's dog could tell you that the buy-and-hold philosophy hasn't been looking too good over the last couple of years, no investment technique should ever be judged over such a short time frame. This is particularly true of buy-and-hold since, by definition, it is a technique that derives its return over the long haul. The recent shift in sentiment has much to do with the fact that as humans first, and investors second, our conclusions as to the appropriateness of an investment technique are overly influenced by prevailing market conditions. John Maynard Keynes expressed this eloquently when he said: "the facts of the existing situation enter, in a sense disproportionately, into the formation of our long term expectations". Thus even though the present might not be indicative of the long term trend, it tends to become our guiding light at any point in time.

So is passive investing really dead? Is it still relevant? Or is it in hibernation? Let the judgement begin.

The Folly of Changing Investment Fashion

American historian, Carl Becker, once wrote: "A man without history is the victim of amnesia". Well it seems that there are plenty of victims of amnesia around at the moment. You see, we've been here before. The concept of passive investing is neither new nor is this the first time that its relevance has been challenged. William Worthington Fowler extolled the benefits of buy-and-hold 130 years ago in his classic book "Twenty Years of Inside Life in Wall Street". And he was by no means the first. Since Fowler two influential proponents of buy-and-hold have been Edgar Lawrence Smith ("Common Stocks as Long Term Investments" – 1924) and Jeremy Siegel ("Stocks for the Long Run" – 1994). However, the fact that both books were published during the course of bull markets shouldn't be ignored. Smith's credibility was crushed during the course of the grinding bear market that followed the 1929 Crash. Siegel's credibility has held up a bit better. Since his book was first released the Dow has more than doubled despite its poor performance over the last 11 years.

The central tenet of Smith's book was that since companies typically retain a proportion of earnings their capital base, future earnings and share price should, over time, grow exponentially. Unfortunately those who used Smith's book as their guiding light to investment found any success to be short lived. After the Crash of 1929 they had to wait 25 years before the Dow returned to its nominal pre Crash level yet alone grow exponentially, as Smith had advocated. And in real (inflation adjusted) terms it didn't recover to its September 1929 level until December 1958. Countering this, a buy-and-hold investment made a few years after the 1929 Crash would have produced very favourable returns. But aren't we now talking about timing the market?

Market Timing

Proponents of buy-and-hold are often quick to argue that market timing is not possible. They say that diving in and out of the market exposes an investor to the vagaries of chance and that mistiming a move can result in both significant real losses as well as opportunity costs. But this does not, nor should it, sit well with those who have used market timing to their advantage. Successful market timing is a skill that takes time and experience to develop.

But for some this skill might never be achieved. For this group buy-and-hold could prove to be their best strategy. The choice between market timing and buy-and-hold also boils down to personal traits, to what suits one's character. Warren Buffett tends to buy-and-hold and, as he puts it: "it is a quirk of character appealing for a mixture of personal and financial considerations".

The Dividend Factor

Despite the fact that the return from stock investments comes from two sources (dividends and capital gain), investors tend to ignore or downplay the income component and focus excessively on the capital gain component. Much of this stems from a preoccupation with index watching. But the contribution of earnings to overall returns should never be understated. Interestingly if we analyse returns more closely we will find that much of what we refer to as capital gains are in fact the result of retained earnings. Edgar Lawrence Smith hit on this point in his 1924 book. Buffett's Berkshire Hathaway is a case in point. Berkshire doesn't pay a dividend. A significant factor in its capital growth has been the retention and reinvestment of retained earnings. Even without adjusting for this factor, Jeremy Siegel tells us that returns from real (inflation adjusted) capital gains have been less than half that of returns from dividends over the last two centuries. This adds some strength to the case for buy-and-hold and reminds us that when considering investment returns we shouldn't simply study charts of non-accumulating indices. So if you don't feel confident in timing the market just buy solid stocks, sit back and reinvest the dividends.

How strong is the dividend factor? Well I've already said that from 1929 to 1958 the US market gained no ground when measured on an inflation adjusted capital value basis. But what of the investor who continued to hold stock from 1929 and reinvested the dividends? When dividends are included in investment returns the time period to get square would have been halved.

Best and Worst

We have already established that buying at the crest of a bull market can seriously erode the benefits of a buy-and-hold strategy. But the reality is that few investors actually invest this way. More typically investment capital is drip fed into the market over a period of time. It would be an extremely unlucky investor who actually devotes all of his capital to the market at the peak of a bull run. But is there a way whereby potential buy-and-hold investors, with a lump sum to invest, can avoid investing the lot at a peak?

Whilst market tops are notoriously difficult to pick, there are tools which might help us to identify when markets are seriously over-cooked. If we can avoid the bad ones then our buy-and-hold strategy has a better chance of working out for us. Dow theory is one method but let me introduce another.

Ben Graham and David Dodd gave us a clue back in 1934. In acknowledging that one of the greatest weaknesses of the PE ratio was its use of a single year's earnings as the denominator, Graham recommended instead the use of 10 year average earnings. This reduced the vagaries of the business cycle on the calculation. More recently Bob Shiller has applied Graham's concept of average earnings to derive a useful and objective index in the search for over-valued markets. In deriving his index Shiller divides the real S & P Composite Index by the 10 year moving average of real earnings on the Index.

Shiller has constructed a spreadsheet which shows the monthly indices going back to 1881. This spreadsheet is regularly updated by Shiller and you can find it as well as a graphical representation of the figures at www.econ.yale.edu/~shiller/data.htm. After entering the site just click on Excel file (xls) to download the data and the graph.

Interestingly Shiller's index reached its highest levels in 1901, 1929, 1966, late 1999/early 2000 and 2007, all years that should be readily recognised as historical bull market peaks. Whilst the index is not predictive, it is, at any point in time, indicative. By comparing the current level of the index with other periods it is possible to obtain a feel for the market's prevailing value. Let's see then if the use of Shiller's Index would have helped us in the past in timing entry to the market. Could we have commenced a buy-and-hold strategy at a more appropriate time or alternatively avoided entry at a poor time?

Below I have listed the 10 best and the 10 worst years over the course of the last century to have commenced a buy-and-hold strategy. This information has been taken from Smithers and Wright's book "Valuing Wall Street". They have not chosen a specific number of years to represent their buy-and-hold period. Acknowledging that buy-and-hold means different things to different people, they calculated the average return achieved over a range of different time horizons (1 to 40 years) for investments that commenced in any particular year from 1900 to 1996. To be included as a good investment year the ensuing 1 to 40 years had to, on average, rate highly when compared with those following alternative commencement years. Next to each year I have listed what the Shiller Index was in January of the same year.

Worst 10 Investment Periods (Commencement Year)	**Shiller Index (January of Associated Year)**
1972	17.26
1929	27.08
1968	21.53
1967	20.43
1971	16.46
1965	23.27
1928	18.80
1969	21.19
1973	18.71
1909	14.76

Best 10 Investment Periods (Commencement Year)	Shiller Index (January of Associated Year)
1932	9.31
1948	10.42
1920	5.99
1953	13.01
1949	10.25
1942	10.10
1921	5.12
1974	13.53
1931	16.71
1947	11.47

It is interesting to compare Smithers and Wright's list against Shiller's Index. We see that at the commencement of only one of the ten worst investment periods was the Shiller Index below the long term average of 16.4. That was in 1909. And at the commencement of only one of the ten best investment periods was the Index above the long term average (in 1931). There appears to be a strong correlation between a high Shiller Index and poor portfolio performance in the following years. Conversely it appears that a low Shiller Index would indicate a good time to invest.

Where Now?

So where is the Index now? As at June 2, 2010 it was at 19.99, 22 percent over the long term average. On this basis, it could be argued that despite recent falls the US market is still over-priced. But the Index is certainly nowhere near the highs of 1929 (32.56) or late 1999 (44.20), after which buy-and-hold performed so poorly.

You might by now be thinking that this has been all about the United States and since your investments are in Australian stocks you want to see an Australian version of the Shiller Index. I don't have one but hands up those who weren't watching the Dow's fluctuations like a hawk during the 2008 melt down. And who thinks it was sheer coincidence that on October 20, 1987 the Australian market had its largest ever one day fall only hours after the US market had its largest ever one day fall?

You see the big corrections in our market tend to be triggered from offshore and to date from the US. To buy in after the corrections and then hold your ground should continue to be a good plan for those who don't want to or don't have the skill to continually market time.

Still Want to Hear About Australia?

Okay, then let's talk about Australia. Andex Charts constructs accumulation charts based on share price growth plus dividends. Research undertaken by them during the GFC looked at 585 10 year buy-and-hold investment periods commencing every month end from January 1, 1950 to August 31, 2008. The investment vehicle they considered was Australian shares. The period considered takes in 10 bear markets and includes the large 59 percent fall in 1973/74.

They found that the highest 10 year return was 28.7 percent a year (for the 10 years ended September 30, 1987). The worst return was 2.9 percent a year (for the 10 years ended September 30, 1974). Thus no 10 year period resulted in a loss.

Considered over a longer period, the Australian market has provided an average annual return of 10.5 percent over the last 40 years. Using buy-and-hold you would have ended up with a capital pool double that if you had invested in cash or bonds. How would you have gone against a market timer? If you had found a good one I suspect they would have done better. But a bad one could have done much worse.

Conclusion

So is buy-and-hold dead as a strategy? Definitely not. Is it appropriate as a strategy now? Based on the Shiller Index today might not be ideal. There have been better times: but neither is it currently a highly dangerous time. Remember that the US market was extremely overpriced in early 2000. The market has been struggling ever since. The Dow is now at the same level it was over 10 years ago. In order to justify the prices paid back then, earnings have had to and will need to continue to increase. Over the same period the Australian market has done better, presently up over 40 percent. But our economy has been performing much better than the US.

The Shiller Index will never ring a bell when it's time to enter the market but it will at least reduce the chances of you buying in just before it's about to blow up. So keep an eye on it particularly in what you suspect to be over-heated markets. A final and very important point is that ultimately it is companies that you will be investing in. Unless you are simply buying Index Funds there needs to be some process of company selection. The search for value can be undertaken at any stage of the market cycle. It's just that at market lows the search will be much easier and the subsequent returns are likely to be more fruitful. You shouldn't get hurt if you start a buy-and-hold strategy now but look for value and be prepared to hold on for the long haul. Don't change your mind midstream. Even if the market comes off from here it's 10 years out that you should be thinking about. You either adhere to the philosophy or you don't.

> Rory Robertson, Macquarie Bank's interest rate strategist ... recently won a wager on house prices that forced Steve Keen, an economics professor at University of Western Sydney, to walk from Canberra to Mt Kosciusco ... Professor Keen has not changed his view that house prices will fall 40 per cent from peak to trough over the next 10 to 15 years, despite plenty of time for reflection on the long march to Kosciusco. Stephen Shore AFR 16/6/10

Forgotten your password?

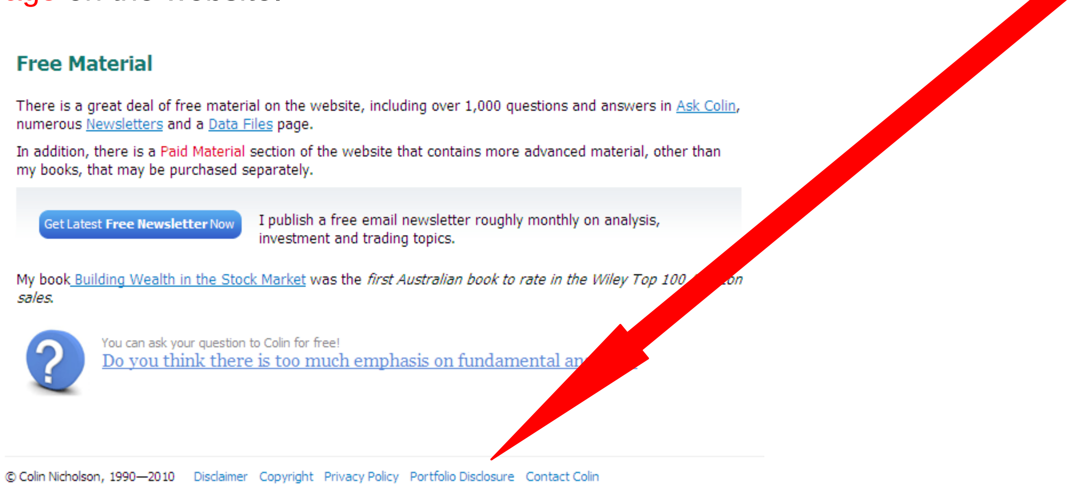
If you are a member of my website and cannot recall your password, this is how you can get a new password:

- Launch www.bwts.com.au
- 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/

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.



Twelve Important Lessons

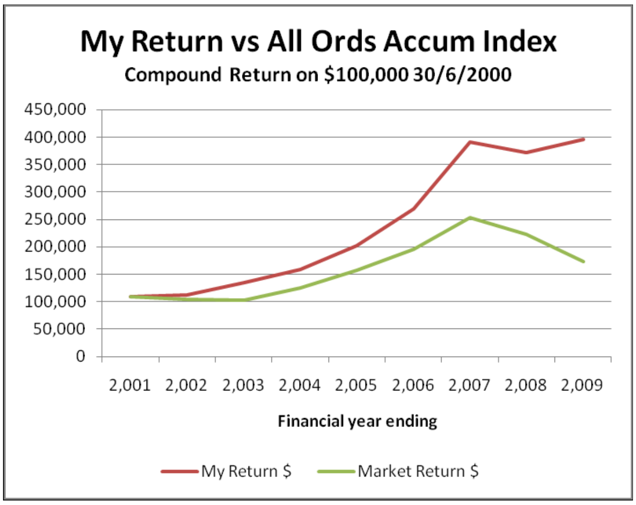
I recently gave a questions and answers presentation to the Australian Investors Association Sydney North Shore meeting. The slides I used are on the paid website on the Building Wealth Resources/Presentations page http://www.bwts.com.au/index.cfm/building-wealth-resources/presentations/. Since giving this presentation, I have tweaked a few things and made it twelve lessons, rather than eleven. Here is a summary of the twelve lessons I have learned in over forty years of investing:

Lesson one
It takes ten years of full time study to become a good investor
The point here is that there is two-stage process. First we learn the basic knowledge. This is the easy part. Then we learn how to apply the knowledge from experience. This is the tough part. What I have learned is that the key aim in the ten years is to try not to lose too much while we are learning. This leads into lesson two.

Lesson two
Over 90% of investors are better in index funds, LICs* or managed funds
Lesson one suggests that most people do not wish to make the time and expend the effort to become good investors. However, they need not despair. My formula is that if they still want to try to improve their skills and maybe become a good investor one day, it is best to start managing no more than 10% of their investment capital. The rest should be invested in the above instruments. Then, if they are able to beat the index fund, gradually take more of their investment capital under their own control.

* LICs are Listed Investment Companies. Note that they do not all have the same cost structure, so check this, which will bias you towards the bigger and longer-established LICs.

Lesson three
Market timing is possible, but very difficult
Market timing is what I do and teach. It took me a lot longer than ten years to learn, because I did it while earning my crust in a day job. It was my hobby. It was a very rewarding journey. Market timing is far more difficult than passive investing. It takes great skill and experience. It requires a lot of time and effort. My investing record over the last couple of cycles is evidence of what can be done:



I disclose my investment record for one purpose only: If I teach the subject, you should know whether I can do it myself. I will never be the world's greatest investor, but my record suggests that I know how to beat the market. This chart and more is on my website at About Colin. I will update it to June 30 2010 as soon as possible after the end of the financial year.

Lesson four
Investing without a plan is like flying on a wing and a prayer
The origin of this expression comes from the first world war, when a pilot landed a plane with only one undamaged wing. He confessed to praying all the way in and a wag coined the expression on the spot.

My experience teaches me that a successful investor is more than likely to have a ***written*** investment plan. It will be complete. It will have been tested. It will always be a work-in-progress, but fewer changes are made over time as it is honed to the required level and begins to fit closely to the investor's personality. I will be teaching this subject at the Australian Investors' Association Conference next month – see Hear Colin Speak earlier in this newsletter.

Lesson five
Fundamental analysis and technical analysis are best used in combination
I use both, but those who use only one and think the other is useless all regard me as a heretic. The reason I use both is that they are different tools and they are best used for what they do well:

> **Fundamental analysis** gives us great insights into relative value. I use it in stock selection to ensure that the stocks I buy have a margin of safety. It gives few useful insights into timing.
>
> **Technical analysis** gives us great insights into timing. I use it to decide when to buy, where to situate sell stops, when to build positions, when to take profits and when to sell. It gives few useful insights into relative value.

Lesson six
The price paid for a stock is irrelevant
This is the one that I rate very highly as being a turning point in my journey to being a good investor. It is something that many beginners never get past and begin to think like good investors. The price of a stock is what you can sell it for. If it was bought much more cheaply in the past, we cannot go back and buy more at that price. We have to assess whether to buy it at the current price. Likewise, if the stock was bought at much higher prices, we cannot go back and sell at those prices. We have to assess whether to sell it at the current price. This leads into lesson seven.

Lesson seven
If our stock falls in price there are three options

> **Best option**
> Sell it and buy a better prospect - think of "switching" rather than "selling" or "taking a loss", if it helps your psychology.
>
> **Second best option**
> Sell it and sit in cash awaiting a better opportunity. Sometimes there is no obvious better prospect. Cash earns interest, so is better than sitting in a stock which is trending down – death by a thousand cuts.
>
> **Worst option**
> Keep holding it, hope and pray. Good luck. You still have much to learn.

Lesson eight
If you cannot understand both sides of a trade don't do it
We cannot make sound decisions unless we can first see both the pros and the cons of a situation. We are most vulnerable as investors when we can only see one side. Ask: if our buy is a certainty, why would there be a seller? The way out of this hole is to do whatever it takes to get an opposite view – more research or find someone who can act as a devil's advocate and show us the contrary view. Then we can weigh it all up and reach a much better decision.

Many investors do the exact opposite. They seek views that reinforce their certainty. This is fatal in my experience. The best friends we have are those who suggest there are things to ponder that we have not thought of or were unaware. Of course, this makes the whole job harder in that every decision means more work and the decisions can seem more difficult. This, however, is good – welcome to the real world of the good investors.

Lesson nine
It is the losses that destroy portfolio performance
This is an expression of one of the most durable of Wall Street sayings – let your profits run and cut your losses short. It is usually dismissed as being the bleeding obvious. Yet most beginners and many quite good investors still do the opposite and at times grab small profits quickly, but let losses run and build until they are so deep in the psychological mire that they are frozen into inaction. This is when I hear the excuse: "it is now worth so little, it is not worth selling". This is translated into the language of good investors: these investors still cannot bring themselves to understand and act on lessons six and seven.

Lesson ten
Start investing when you are young
Survey after survey in western countries comes up with the conclusion that most people do not understand compound interest and therefore the whole idea of compounding returns. What comes out of a good understanding of compounding is that it is very difficult to make up for lost time and beyond a certain point it is probably impossible unless we win Lotto. The key to investing is in Michael Kemp's book that I reviewed earlier in this newsletter: Right from when we earn our first pay packet, we should spend less than we earn, also known as saving. Then invest the savings progressively through our working life. Through our life and into retirement we will have created the means of living a rich life in which we have more freedom than 99% of the population. While we cannot make up for lost time, it is never too late to start.

Lesson eleven
It is never different this time
Of course the details change. However, the basic drivers do not. The best way to learn this is to read the rich history of markets, investing, speculation, bubbles and crashes. My mantra is that when someone makes the claim that "it is different this time", I automatically translate it to "we are in a market bubble".

Lesson twelve
Trying to predict the future is futile and useless
Book after book has been written that shows how poor all human beings are at predicting what will happen in any part of their lives. Of course, the near term is easier to get right sometimes than the more distant future. Even so, it should be obvious to anyone who thinks about it that predicting the future is very difficult if not impossible.

It is also true that most beginners think that the answer to their investing problems is to just find someone who can accurately and consistently tell them what is ahead. In my experience this is an unsound belief that is not supported by the evidence. What evidence that is trotted out will tend to be the odd occasion when someone does predict what will happen. However, what is absent in these cases is any details on how many predictions were made by that person compared to the one which was correct. Afterwards, they only talk about the correct predictions.

There is a better way, which I have found in my experience really works far better. However, it does require, as many of these twelve lesson do, that we change the way we think away from the thinking patterns of beginners and towards the thinking patterns of good investors. This is the secret:

1. Assess what is happening in the market
2. Design a strategy to take advantage of the situation
3. Carry out that strategy (the difficult part)
4. If what is happening changes, start the process over again.

My book *Building Wealth in the Stock Market* sets out my investment plan. This idea runs right through it. It has worked well for me over many years and cycles. It is endlessly adaptable.

I hope readers find these twelve lessons of value.

Another source of *The Economist* articles and more

A reader has suggested another source of articles from *The Economist* and much more:

*Having read your newsletter [No 99] today I wonder whether it's worth pointing the following resource out to people who may not be aware of it. It's with reference to the Special Report you discuss in **The Economist** from April 17th and the fact that you can get your 14 day free trial through the website.*

*It's also possible to gain unlimited FREE access to articles such as those in **The Economist** through your local library website. I am a big fan of my local city and town libraries. I have read many of the books you recommend in The Aggressive Investor by borrowing through the local library and inter library loans. Through their websites you can access thousands of full text magazines, newspapers, reference books, and transcripts —plus thousands of* *pictures, maps, weblinks, and audio/video files without having to subscribe, if you can't afford it.*

*All you need to do is join the library, log in online and go the eLibrary / online database section. There you'll find newspaper and magazine articles going back several years. Some don't get published here straight away due to copyright issues and publishing restrictions that would affect sales, but they'll get there after a few months. There is no delay in access to **The Economist** publication, for example, and I was able to get the whole special report you discuss by doing exactly this. So in case anyone is not aware of this I thought it was sharing the knowledge.*

More on How Asia is different – a view of the future

Following this article in the last newsletter, one reader emailed me as follows:

*I read the article in the economist with interest. I live and work in China so see these things on a daily basis. Since you liked this article I thought you may like a book titled **Globality - Competing with Everyone from Everywhere for Everything.** ISBN10- 0-446-17829-2 by Hemerling, Sirkin, & Battacharya I found it along a similar vein with more studies and details, interesting reading.*

Some interesting quotations

I collect quotations from what I read. Here are a few quotations that resonated with me for various reasons to get you thinking:

The most difficult subjects can be explained to the most slow-witted man if he has not formed any idea of them already; but the simplest thing cannot be made clear to the most intelligent man if he is firmly persuaded that he knows already, without a doubt, what is laid before him. Leo Tolstoy 1897 quoted by Michael Lewis in *The Big Short*

Investing was something you had to learn on your own, in your own peculiar way. Michael Lewis *The Big Short*

"It is ludicrous to believe that asset bubbles can only be recognised in hindsight, ...There are specific identifiers that are entirely recognisable during the bubble's inflation. One hallmark of the mania is the rapid rise in the incidence and complexity of fraud ..." Mike Burry quoted by Michael Lewis in *The Big Short*

*"I hated discussing ideas with investors, because I then become a **Defender of the Idea**, and that influences your thought process." Once you became an idea's defender you had a harder time changing your mind about it.* Mike Burry quoted by Michael Lewis and Michael Lewis in *The Big Short*

The closer you were to the market, the harder it was to perceive its folly. Michael Lewis in *The Big Short*

"In public markets you have people focused on quarterly earnings rather than the business franchise ... They believed, further, that public financial markets lacked investors with an interest in the big picture .... I don't think the problem is specific to finance. I think that

parochialism is common in modern intellectual life. There is no attempt to integrate." The financial markets paid a lot of people extremely well for narrow expertise and a few people, poorly, for the big, global views you needed to have if you were to allocate capital across markets. Charlie Ledley quoted by Michael Lewis and Michael Lewis in *The Big Short*

The options suited the two men's personalities: They never had to be sure of anything. Both were predisposed to feel that people, and by extension markets, were too certain about inherently uncertain things. Both sensed that people, and by extension markets, had difficulty attaching the appropriate probabilities to highly improbable events. Both had trouble generating conviction of their own, but no trouble at all reacting to what they viewed as the false conviction of others. Michael Lewis in *The Big Short*

The model used by Wall Street to price trillions of dollars' worth of derivatives thought of the financial world as an orderly, continuous process. But the world was not continuous; it changed discontinuously, and often by accident. Michael Lewis in *The Big Short*

...people, and markets, tended to underestimate the probability of extreme change, ... probabilities of disasters in real life. People underestimated these, too...because they didn't want to think about them. There was the tendency, in markets and in life, for people to respond to the possibility of extreme events in one of two ways: flight or fight. "Fight is, 'I'm going to get my guns'...Flight is, 'We're all doomed so I can't do anything about it'." Michael Lewis in *The Big Short*. The quotation within it was of Ben Hockett

These people believed that the collapse of the subprime mortgage market was unlikely precisely because it would be such a catastrophe. Nothing so terrible could ever actually happen. Michael Lewis in *The Big Short*

The subprime mortgage market... never had done anything but rise. The people in it who were regarded as successes were those who had always said 'buy'. Now they should really all be saying 'sell', but they didn't know how to do it. Michael Lewis in *The Big Short*

"There were more morons than crooks, but the crooks were higher up." Vincent Daniel quoted by Michael Lewis in *The Big Short*

"We turned off CBNC. It became very frustrating that they weren't in touch with reality anymore. If something negative happened, they'd spin it positive. If something positive happened, they'd blow it out of proportion. It alters your mind. You can't be clouded with shit like that." Danny Moses quoted by Michael Lewis in *The Big Short*

... the reason they refused to acknowledge that his bet was paying off was that they were on the other side of it. "When you talk to dealers, you are getting the view from their book. Whatever they've got on their book will be their view." Michael Lewis in *The Big Short* and quoting Mike Burry

... these people whose money he ran were incapable of keeping their emotional distance from the market. They were now responding to the same surface stimuli as the entire screwed-up subprime mortgage market, and trying to force him to conform to its madness. "I

do my best to have patience. But I can only be as patient as my investors." Michael Lewis in *The Big Short* and quoting Mike Burry

*Formalised as an approach to financial markets during the Great Depression by Benjamin Graham, **value investing** required a tireless search for companies so unfashionable or misunderstood that they could be bought for their liquidation value. In its simplest form value investing was a formula ... Burry did not think investing could be reduced to a formula or learned from any one role model. The more he studied [Warren] Buffett, the less he thought Buffett could be copied; indeed, the lesson of Buffett was: To succeed in a spectacular fashion you had to be spectacularly unusual. "If you are going to be a great investor, you have to fit the style to who you are," [Mike] Burry said. "At one point I recognised that Warren Buffett, though he had the advantage in learning from Ben Graham, did not copy Ben Graham, but rather set out on his own path, and ran money his way, by his own rules ... no school could teach someone how to be a great investor."* Michael Lewis in *The Big Short* and quoting Mike Burry

Readers will notice that all of these quotations are from *The Big Short* by Michael Lewis. I reviewed it in Newsletter 99, which is now on my free website www.bwts.com.au at Resources/Newsletter Archive: http://www.bwts.com.au/index.cfm/resources/newsletter-archive/ and also Resources/Book Reviews: http://www.bwts.com.au/index.cfm/resources/book-reviews/