

# Colin Nicholson: Newsletter 110

29 April 2011

## Forecasting Competition

We have now finished the third stage of the forecasting competition. The aim of the contest was to forecast the value of the S&P/ASX All Ordinaries price index at the end of September 2010, December 2010, March 2011 and June 2011.

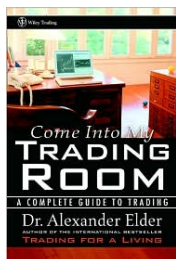
The winners so far have been:

September 2010	
1	Tooraloo (nickname)
2	Bruiser (nickname)
3	Lindsay Hackett
December 2010	
1	Max Mail (nickname)
2	Andy 101 (nickname)
3	Tooraloo (nickname)

**First prize** in each round is:

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

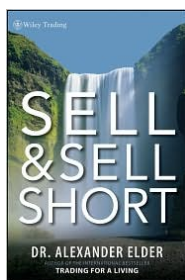
**Second prize** in each round is:



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 kindly donated by Dr Elder.

For my review of the book see <http://www.bwts.com.au/text.cfm?27>. The book may be purchased from [www.elder.com](http://www.elder.com) (remember to say you are one of my readers when you place your order).

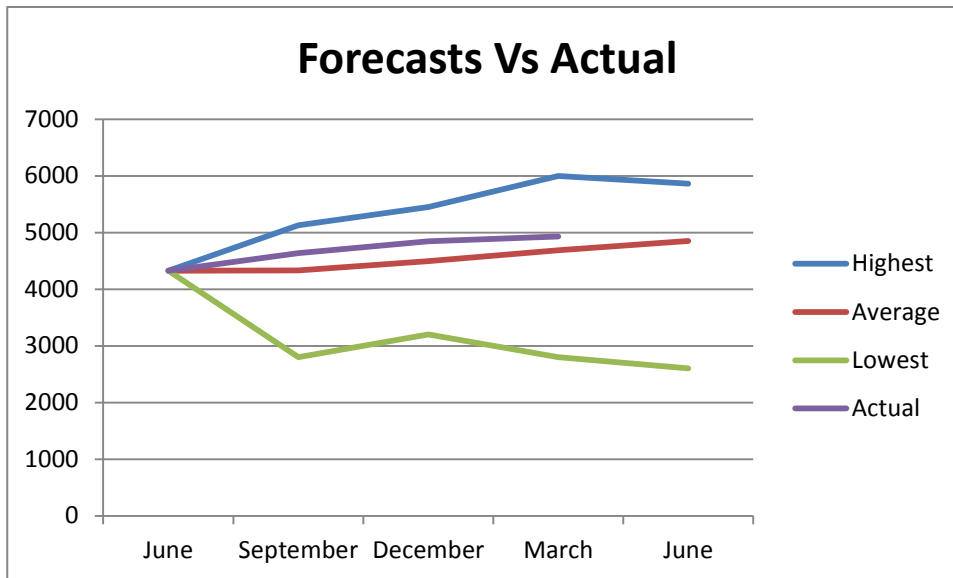
**Third prize** in each round is:



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 kindly donated by Dr Elder.

For my review of the book see <http://www.bwts.com.au/text.cfm?27>.

Before I announce the winners for the third round, this is a summary graph for the forecasts and actual values of the index to date:



What is interesting about this graph is the way the average forecast has closely tracked the average of the 39 forecasts, even though they varied widely individually. Although 39 forecasts is not a large number, this is substantiating a well-known tendency for the average of a large number of forecasts to approximate the actual value. In this respect I thank the 39 readers who took the time to participate. Perhaps, if I run another such competition after this one is finished; more readers may see the value in being part of the exercise. Then we can watch whether this has simply been a fluke or whether it will work in a market that has moved further over the period and perhaps changed direction.

The winners for the third round are:

<b>March 2011</b>		<b>Index: 4928.6</b>
1	Disso (nickname)	Forecast: 4922
2	Tooraloo (nickname)	Forecast: 4896
3	Anonyms22 (nickname)	Forecast: 4999

Once again I thank all those who have participated in the competition and wait expectantly for the final round results at the end of June.

## Thoughts arising from Warren Buffett's 2010 letter

Every year I read Warren Buffett's letter to shareholders of Berkshire Hathaway, his investment vehicle. This has two payoffs: I pick up ideas I had not come across before and I am prompted to again think about important ideas that have slipped from my conscious thinking. The long Easter break this year provided an excellent time to do this. Below are some of the ideas that I thought I would share with readers.

## Rail versus Road

The 2010 letter begins by reviewing the recent acquisition of the Burlington Northern Santa Fe railway company, something that when it happened caused many of us to wonder if Buffett had maybe lost his marbles. Not so, as he explains in the letter. What interested me was his assertion that the movement of goods by rail is *three times* more fuel efficient than by road transport. He calculates that last year every ton of freight the company moved travelled 500 miles on a (US) gallon of diesel fuel. Thus, he sees his railway as providing enormous benefits to the US society in terms of cost savings and reduced greenhouse pollution, not to mention profit and cash generation for his shareholders. He sees more freight being moved by rail rather than road in the future.

## Faith in America

Every day in the US, the media is saying how uncertain the future is. The same is true in Australia and many countries around the world. Buffett harks back to 6 December 1941, 18 October 1987 and 10 September 2001 as times when, after adversity, the media saw only disaster ahead. He makes the point that the future is always uncertain, even when the times seem good. Yet in his lifetime Americans have become many times better off than they were. He sees no reason why this should not continue to be the case and is investing accordingly. Yes, he holds a lot of cash for opportunities, but even in the current uncertain times he is investing billions each year. This suggests that the large number of investors in Australia sitting on cash and fearful to invest it should reconsider their strategy in the lucky country.

## Target Returns

As he has been stressing for years, Buffett acknowledges again that he cannot continue to generate the returns he achieved earlier. This is simply because his portfolio of businesses is now worth so much more than it used to be. In other words, he has become a victim of his own success. This, by the way, is something all funds managers are aware of – the highest returns are often achieved by funds with smaller funds under management and their returns fade as they become larger. However, Buffett is still aiming to beat the S&P500 (including reinvestment of dividends) over time, rather than every single year, which is near impossible.

Every time I read this I reflect on how lucky we are as private investors. We are all where Buffett was four decades ago and our small funds under management gives us a great advantage. However, to gain that advantage we must continue to build our knowledge and skills. That way we can take advantage of being smaller and more nimble in investing.

Buffett also shows that although there are individual years when he failed to beat the market, there is no five year period in which he did not beat the market. What I found even more of a wake-up call was that he asserts that he will do better relative to the market in bad years and trail the market in the good years. This I found very interesting when I remember that survey after survey in Australia found private investors sitting only or mainly in cash over the last difficult year. We should be asking whether we are missing opportunities as the market climbs its wall of worry. As is disclose on my paid website, I am currently 70% invested in stocks and 30% invested in cash at call. I am actively looking for opportunities all the time to move towards being fully invested.

I always find it interesting that Buffett starts his annual letters with his results over time. This is something that I learned from him many years ago, so that I track my results right through the year. As of Thursday 22 April, for the current financial year I know exactly how I am

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tracking against the All Ordinaries Accumulation index and my target return. This is a recent screen-shot of the relevant portion of my spread sheet:

<b>Market return year to date</b>	<b>19.43</b>
<b>Target average annual return</b>	<b>12.50</b>
<b>Portfolio rate of return year to date</b>	<b>18.21</b>

I have shown this, not to highlight the return, which does not include all interest on the cash reserve and some upcoming dividends, but to impress upon readers the importance of this discipline. I **know** I am running slightly behind the market. I **know** this is because the returns from invested funds have been greater than on the cash reserve. I am all the time looking for opportunities to address that deficiency. The important point is that I **know** how I am going and what I need to work at. Do you know how you are going this year? If you don't know, how will you know what you need to do? Could I suggest that every private investor should set a goal for the next year to track their performance through the year? If we do not know how we are travelling, how do we know where we are relative to our objective and therefore whether corrective action is needed? I used to use the excuse that "I knew in general terms". I have since realised that they were *weasel words* with which I deceived myself.

### Capital Allocation

Berkshire Hathaway is an enormous conglomerate now. An interesting section of the letter dealt with the way there is a separation of functions in the conglomerate. The managers of the businesses run the businesses. Buffett and Munger allocate the capital to existing businesses and to new opportunities. I was struck by how we might see what we do as investors in a similar way. As investors we allocate our capital to stocks we buy. That is our real function: strategic capital allocation. The businesses we buy part ownership in are run by their managements (boards and executive teams). It is important that we understand our key role as Buffett does. Selecting stocks is the bit where we contribute. When we get it wrong because the management does not subsequently perform to our expectations, our role is to reallocate capital to better opportunities. Yes, we can tilt at windmills and try to change management and cut their pay, but that is simply a waste of time. While we do that, opportunities elsewhere are being missed and part of our capital is stuck in the mud. There is no return on indignation and protesting in investing. Instead we need to be continually alert for underperforming investments and switch the capital into better performing businesses.

### Retained Earnings

When looking at his stock holdings, Buffett remarks on the high level of retained earnings (reinvested in the business rather than paid out as dividends) in the stocks in which he is invested. He makes this interesting statement: *These retained earnings are important. In our experience – and for that matter in the experience of investors over the past century – undistributed earnings have been matched or exceeded by market gains, albeit in a highly irregular manner.* This highlights the long term nature of his investing in great businesses. While many private investors focus on the dividend yield, this statement suggests that Buffett's real focus is on the total return over time.

In the methods I use, dividend yield is a parameter that I look at, but it is often overshadowed by the price earnings ratio. I am looking for stocks with low price to earnings. This means that

sometimes I will invest in a company with a low dividend yield provided two things are in place: a low payout ratio (high retained earnings) and a very strong return on equity, which suggests that over time the company is effectively reinvesting earnings. Over time this will result in either higher than usual price appreciation and/or higher dividends. However, this requires very good discipline. If I find that I get it wrong, I need to quickly move on.

One thing that Buffett's remark reminds me of is that while we all use some heuristics, based on research, in the way we select stocks, we should never lose sight of the fact that these are just guidelines. We still need to have a very clear concept of how superior returns are created and to be prepared to **think** about what we are doing, rather than just following our guidelines. Sometimes an unusual situation will appear to be outside our guidelines for stock selection, but present a great opportunity for us if we look more closely at the drivers of returns in that particular business. When I buy one of these, I often get emails from readers asking why I am breaking my own rules. My reasoning will often become apparent in case studies of those stocks on the paid website, which are intended to be teaching aids. Buffett explains how this applies in the recent past to his investment in Welles Fargo. His letters are also teaching aids.

### **What makes a good investor?**

Buffett includes this year an interesting discussion about what he looks for in an investment manager. He begins by saying that it is not difficult to find investors with good track records. However, he states clearly that past results are not everything he looks for when looking at the prospects for that manager's future performance. For this he looks at the manager's understanding of and sensitivity to risk. *In respect to the risk criterion, we were looking for someone with a hard-to-evaluate skill: the ability to anticipate the effects of economic scenarios not previously observed.*

This reinforces something that I have taught over the years and try to implement myself: read widely about where the world may be heading. No idea is too much out of left field to be considered and assessed. Considering something does not mean that we must accept it. On assessing it, we may decide it is not useful. This is the idea behind contrary thinking. Try to query everything and test it against the evidence. The key thing to remember is that the crowd is right most of the time. But when it is absolutely wrong will be at turning points. We should keep trying to question all widely held wisdom and to be most on alert when everyone seems to believe the same thing is true. I read widely looking for insights into what may be ahead of us and also for different explanations for what is actually driving events. This latter point can help to anticipate changes in the situation in ways that few people anticipate. In this respect I learned a great deal from Michael Lewis' book *The Big Short*, which I reviewed on the free website. The discussion paper *A Decade of Debt*, which I discuss in the paid section of this newsletter is another example.

### **Valuation of derivatives**

Buffett has a large exposure to derivatives. He sees this as similar to underwriting in his insurance business. I found this lengthy section of his report made interesting reading. This is not the first letter in which he has visited this issue. As he has done before, Buffett takes a swipe at the academics who hold dear the Efficient Market Theory and the Black-Scholes model for valuing derivatives, especially options. His concluding remark in this section is an important aside: *You can be highly successful as an investor without having the slightest*

*ability to value an option. What students **should** be learning is how to value a business. That's what investing is all about.*

Of course, elsewhere in the report Buffett has discussed how difficult it is to measure intrinsic value. He means by this to put a precise number on it and mentions that he and Charlie Munger would give different answers if asked for the intrinsic value of a business. It seems to me that what he is saying is that even though precision is impossible, it is still reasonable for a good investor to have a fair idea of intrinsic value, at least in a general sense about a business. I feel that what Buffett does is a valuation in the widest sense and not limited to a specific date, but to an indefinite future. In other words he knows a good business when he sees one, though he admits to some errors in hindsight.

I found this fascinating and the key to what is different about Buffett and most other investment managers. His difference is in the holistic way he looks at a business and the extended time frame over which he assesses the business. He reminds us at one point in his letter that his holding period is forever. This, I think, is what sets him apart. It is well worth ongoing contemplation.

Of particular relevance in this issue is the lengthy section in which he deals with the issue of unrealised investment gains and losses, which he does not think are relevant to the assessment of his investment returns, although the media always thinks they are. In assessing his returns, unrealised gains and losses on stocks are not included in his preferred measure. What is relevant is the carrying value, with the underlying realisation that the market value is far higher much of the time. So, even with his stock investments, as apart from where he owns the entire business, his large unrealised gains are not included in the returns that he talks about and believes to be realistic and conservative.

In other words, Buffett could not be further from what most of us do in that we see the increase in market value as being an integral part of our return. I certainly do this, but then I am explicitly a market timer, whereas Buffett aims to hold forever. It is important that we understand that we can learn a great deal from Buffett, but in seeking to model our own work on his methods, we should think deeply about whether our intended holding period is forever. Mine is not, so I can only ever adapt some of what he does to my own investing. I think that is fine. The key is to understand what the differences are between what he does and what we do and not confuse the two in key areas where his objectives and philosophy are at variance with ours.

### **Financial risk**

Buffett has a section of his letter to shareholders titled *Life and Debt*. I am not going to quote what I think are the most important parts from it because to do so would be to reproduce most of it. I would encourage my readers to go to the Berkshire Hathaway website and read it for themselves. I am not exaggerating if I say that I think it is one of the best descriptions of the dangers of financial risk, or leverage, or debt, whatever we want to call it, that I have come across in a long time.

During the last bull market, as I spoke to audiences around the country warning of the dangers of debt, I was frequently interrupted by someone who wanted to voice disagreement. Always, their line was something like: *everyone else is doing it* (quoted from part of a memo attached to Buffett's letter to shareholders). This is the single worst reason anyone can give

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for doing something that is the opposite of common sense. Interestingly, many people have come up to me in 2009 and 2010 to tell me they were glad that they had listened to me.

I have never borrowed to invest. Like many people, I borrowed to buy two houses, but I paid the mortgages out as soon as I could save the money to do so. In retrospect, those were the two worst investments that I ever made in terms of return including the opportunity cost. Had I rented instead, I would be much richer than I am today. However, in those days I was younger and did not know what I know today, or as the comic says: *If only I knew now what I thought I knew when I was twenty.*

One thing that Buffett describes is a letter written by his grandfather. In it the grandfather proposes a strategy that is very similar to what I spoke about publicly in 2009/10. This is that all retirees should have two to three years of living costs in liquid form at any time in the cycle if they are buy-and-hold investors. This is the only way to survive bear markets and not have to sell good investments at silly prices, permanently losing capital. To be fully invested at the wrong time while dependent on selling some long term shareholdings to pay their living costs is an accident waiting to happen. This time few in my audience wanted either to argue with me or to laugh at my conservatism. Buffett says it in his letter, but he puts it better than I can do, which is why I suggest reading this section of his letter. I might even go so far as to suggest it be framed and placed on the wall of the room where our investment decisions are made.

The last part of this section of Buffett's letter also alludes nicely to the concept of compounding and his explanation as to why, by reinvesting all income, his business has grown more than any other in America. The way to build a fortune, or a solid income from investing, is not difficult to understand. However, it is difficult for most people to carry out. It requires patience, and above all, discipline.

That concludes the thoughts that were provoked in me by Buffett's latest letter to shareholders. I hope these ideas are of value to readers.

**I now have a special package on my website**

**1 copy *Creating Real Wealth* \$40.00**  
**1 copy *Building Wealth in the Stock Market* \$65.00**  
**1 copy *The Psychology of Investing* \$20.00**

**Normal cost for all three books is \$125.00**

**Special package price for all three books is \$99.00 including postage to Australian addresses**



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## Algorithmic versus High Frequency Trading

I was recently asked to define the difference between Algorithmic and High Frequency trading. Of course, this question arises out of the frequent confusion or inter-changeability of usage in the media. As best as I can determine, the difference in definition is as follows:

**Algorithmic Trading** is activity aimed at breaking up large, often institutional, orders into small numbers of shares in order to disguise the presence of large orders that, if known, could distort the market to their disadvantage. Thus, most algorithmic trading is conducted by traditional institutional or professional investors.

**High Frequency Trading** is activity aimed at bombarding the market with high volumes of small orders in order to profit from small, often fleeting, price discrepancies in the prices quoted for single stocks (perhaps on multiple stock exchanges) or between pairs or groups of stocks. Indices may also be traded as derivatives. Some high frequency trading may also be aimed at detecting and profiting from the presence of large institutional orders whether they are undisclosed or disguised in algorithmic strategies. High frequency traders tend to be private proprietary traders, which has raised regulatory issues around monitoring and supervision.

Both algorithmic and high frequency trading seem to be legal, but consideration is being given by regulators around the world to greater monitoring and supervision.

## Hot Stocks books

I recently had a question from a member asking if I intend to write another *Hot Stocks* book. This is my response, which will be of interest to all readers:

I wrote two *Hot Stocks* books – 2007 and 2008. They were not outstandingly successful from a business point of view as printed books because we were left with inventory of books that had a clear expiry date. While I won't say "never", I have no plan to do another one at this time. If I ever do, it will have to be as an ebook. That should work financially. However, the route I have taken is through the members (paid) section of my website. There I am publishing some market analysis case studies, but more importantly, many stock case studies, which have the following advantages over the books:

- Timeliness (I am making an effort to improve this)
- They are about stocks that I actually invest in myself. They may always be a selection, rather than all stocks that I invest in, because of the time they take – between half and a full day for many of them.
- I can explore more than just initial analysis, by describing how I have managed these investments and how I evaluate my performance. Many of the most valuable insights come from these.

This is where I am focusing most of my time at present, so the resource should expand with time. I hope you find the case studies to be of value, and maybe even better than the *Hot Stock* books.

## AIA conference: An opportunity for investors

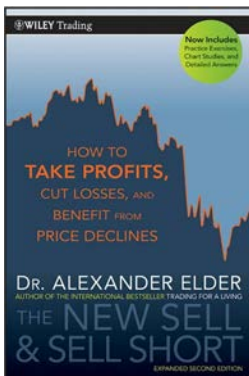
The Australian Investors Association (AIA) runs the best Australian annual conference for investors, whether they are fundamental analysis-based or technical analysis-based, or both as I am. I have attended many of their conferences and have been invited a number of times to make presentations, including this year.

Normally, the AIA conference is held on the Gold Coast. However, this year their usual venue is being refurbished and the conference has been scheduled in Sydney.

I would encourage investors to consider attending. I think it is outstanding value for money. You will meet many investors just like yourself. You will hear a range of speakers which you can select from several concurrent streams depending on your interests. You will also get to hear my own presentation on combining fundamental analysis and technical analysis in investing.

For more details, including the conference brochure, please see the **Hear Colin Speak** page on [www.bwts.com.au](http://www.bwts.com.au). The direct link to that page is [click here](#). Alternatively you can go directly to the AIA website with this link: [click here](#). I look forward to seeing you there.

## Book Review *The New Sell & Sell Short - How to take profits, cut losses, and benefit from price declines*



2008 marked the publication of Dr Alexander Elder's book *Sell & Sell Short*, which I reviewed in January 2009. That earlier review is on my free website [www.bwts.com.au](http://www.bwts.com.au) at Resources/Book Reviews.

Dr Elder has now revised the earlier book. It is now called *The New Sell & Sell Short*. However, he has now emphasised what it is about. The words in red at the start of this review are now more prominent on the cover of the book: **How to take profits, cut losses, and benefit from price declines.**

This clearly positions the new edition. **It is not only about short selling.** The focus of the new edition is first and foremost on two very important things that a trader must master to be successful, even if they have never shorted a stock in their lives and never intend to:

### Taking profits

As every trader soon discovers, there are two important aspects to trading. One is to buy at the right time and at the right price. The other is to sell at the right time in order to harvest as much as possible of the increase in price that has occurred. No long trade (buy low and sell higher) is ever completed until the sale of the position has been effected.

### Minimising losses

However, as every trader soon discovers, there is a dark side to trading. Every trade does not work out as planned or hoped. Any long trade could go wrong. One secret to trading is not to just know how to take profits, which might be called the easy part (though it isn't), it is learning the art of cutting losses quickly in order to protect the lifeblood of the trader: his or her capital.

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But wait – there is more to this book than these two parts.

The first part of the original book dealt with buying. This has been largely dropped to one short chapter. This is a welcome decision. Buying is already well covered in Dr Elder's other books such as *Come into my Trading Room* and *Entries & Exits*. However, retained from the original version of the book are invaluable chapters on psychology/risk management and record keeping. Now, many readers might think that record keeping is not important, but they are absolutely wrong. The importance of record keeping, and how it is essential in improving trading or investing skills, is one of the more important things that I have learned from Dr Elder over the years. This chapter, on its own, contains the ingredients to move our trading and investing skills to a higher plane.

The two chapters on selling short are retained in the new edition. Now, I am an investor, rather than a trader. It is well-known to my readers that I do not short the market or individual stocks as part of my investment plan. One reason for that is the difficulty of shorting in Australia unless I use derivatives, which might cause me to be taxed as a trader, or worse, my self-managed super fund might be deemed non-compliant, because I was using it to conduct a trading business. Nevertheless, a trader cannot just sit on the sidelines as can an investor. Traders need to keep the transaction stream ticking over and failing to take advantage of downward trends is like being sent to the sin bin for half the game. Big traders can use short selling in Australia (naked short selling is out legally, but covered shorts are very legal and very possible). Smaller traders may short use derivatives, including contracts for difference, which are not allowed in the US markets. Derivatives pose higher risks than covered shorts, but may be handled if good risk management and discipline have been learned.

There is also a completely new part to the revised book. This deals with the lessons that Dr Elder has drawn from the 2007-2009 bear market. In addition he has a new chapter headed *Groping for the Bottom*, which will be of great benefit to investors as well as traders who have not yet learned shorting and want first to learn the long side of trading.

The other aspect to the new edition is that the first three parts of the book finish with a series of questions and answers. There is no separate *Study Guide* with the new edition. Instead there are 100 questions and answers in the book itself. Some readers will be tempted to just read the answers, which will be valuable, but I think it will be a mistake. The intention behind these questions is to prompt the reader to move out of reading mode into understanding mode. This requires that we stop and ponder the questions. Ideally we will write down our answers before turning to Dr Elder's answers. His answers do not just say what the right answer was – nothing is really learned by that – but explain the reasoning behind the answers. These answers are a new gold mine for traders.

The new edition is beautifully produced on glossy paper with the charts in colour. It is now a paperback.

Please consider buying the book from Dr Elder on his website [www.elder.com](http://www.elder.com). Say that I referred you and ask for him to sign the book for you, which he will do on request. The recommended retail price is US\$40, but Dr Elder's price is US\$23. Dr Elder will give my

readers the best possible postage rate (US\$11.00 instead of the standard US\$15.00), but you must identify yourself as my reader in the order to get this rate.

## Paid Members Section

Starting with the last newsletter, I have begun a new section of the newsletter. It is only available to paid-up members of the website. When a newsletter is available for downloading, I will in future send two different emails:

- **Paid-up members of the website** will receive an email with a link to the newsletter file that includes the *Paid Members Section*.
- **Subscribers to the free newsletter** will receive an email link to the newsletter file that does not include the *Paid Members Section*.

I am intending that the *Paid Members Section* of the newsletter will be an **additional** resource and I have no intention of reducing the quality or quantity of material in the free newsletter.

There is a new page in the paid section of the website. It will have on it this new section of the newsletter as soon as it has gone out to paid-up members, so will be an alternative way for paid members to keep up with it. Currently paid-up members at any time will also be able to use this page to access the entire archive of the paid members sections of past newsletters, whether or not they were a paid-up member at the time of publication.

The free newsletter will list, at the end of it, the articles in the *Paid Members Section*. The latest one includes the following articles:

- A lesson on how I use Insight Trade software – creating my technical analysis filter.
- My technical analysis and Fundamental analysis scans are now available weekly on the paid website.
- Discussion of some issues from the discussion paper *A Decade of Debt* by Carmen Reinhart and Kenneth Rogoff.