



COLIN NICHOLSON

Building wealth through shares

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This email newsletter is published free from time to time to people who have previously contacted me about technical analysis and trading. If you would prefer not to receive it again, please let me know.

I do not allow anyone else to use my list.

If you have friends who you think would like to receive the newsletter, please feel free to email it on to them and invite them to contact me to add their address to the list.

Once again, time has simply flown by since the last Newsletter. I have been incredibly busy building up the web site, writing and travelling. I feel most guilty that I have let two months go by without sending out a newsletter. Indeed, this was brought home to me graphically when I received several recent emails asking if I was still doing the newsletters. The rest of this year does not look quite so busy (yet!), so I will be trying to do two things: Firstly, this newsletter will be bigger and better than ever to reward your patience. Secondly, newsletters will be more frequent in future.

Web Site

One of the things a lot of my time has gone into this year has been my web site. It continues to grow, especially the Ask Colin section, which has the answers to about 250 emailed queries on all sorts of topics within the general fields of trading, investing and technical analysis. The address is www.bwts.com.au. Back copies of the newsletters are available on the web site.

I am currently working with Vera Krasnova, who created and updates the website for me, to launch a subscription section. We have decided that it will represent real value. For a low annual charge, you will be able to access a rich resource of all my past articles and other writing. Over time we are going to add other interesting features. When it is ready, I will let you know in one of these newsletters.

By the way, I am always open to feedback on the web site. If there is something you think we could improve, or that you would like us to add to it, please drop me an email. If you don't let us know, we might not think of it.

Trading Psychology

A few years ago I organised a panel session at an Australian Technical Analysts Association meeting in Sydney. The idea was that some of the more experienced professional traders in the association would field questions from less experienced members. We invited questions in writing, so that the panel could consider them before the meeting and so give better answers.

This was some time ago and I have forgotten all but one of the questions. That one was simply this: *Please tell us how you decide what and when to buy and when to sell.* However, there was a rider to the question: *Please do not go into the psychology behind the process, just stick to how you make the decisions.*

Now, this has stuck in my mind, because it brought home to me how important psychology was in trading. This member was not an inexperienced trader. What came through to me was that he was in denial about his real problem – psychology. He somehow wanted us to give

him rules that would solve his problem. Yet his problem was not just a lack of the right decision rules. It was not how to manage his trades. It was how to manage himself.

Some people come to trading as a way to solve the problems in their life. Here is an occupation that promises potential unlimited profits, without the usual constraints of having a boss, having to go to work at set times, do all the unpleasant and boring things most jobs entail and so on. In a word, these people are looking for the markets as a place to escape all the things that are currently wrong with their life.

Well, they always get the same wake-up call from the market. If there is a problem in your life, the market will find it like a heat seeking missile and expose it in all its ugliness. You cannot run away from problems in the market.

I recently came across a very interesting quotation that is relevant to this situation and to most people's lives and the way they live them:

We often think that happiness involves things being different. We believe we will be content when a relationship changes; we get a new job, change our place of living or acquire another material possession. The hero knows we can each be happy here and now. The difference isn't in the world in which we live, but in how we see that world. Margot Cairnes

The message from all of this is that it is the psychology that matters in trading. Most beginners do not even know that that they do not know this. Sooner or later it becomes clear to them. Most of them will deny it and sooner or later fail at trading and leave it for good. A few will confront the problem and go on to become successful traders.

And just in case you investors out there are reading this and thinking it does not apply to you – think again. You see, both trading and investing are about decision-making. Making decisions is not easy. It requires discipline. Most people lack discipline, in all of their life. However, we cannot just pluck discipline out of the air. There is a way to develop it in trading.

The first step, of course is to realise that all decisions must be made in a framework. There must be a plan that we are following. That plan must have an objective that is clear and unambiguous. Then there must be strategies that we are going to follow to reach that objective. Finally. We must have some clear tactics that we will use in the execution of those strategies. This is what I call a trading plan.

In developing a trading plan we need to frame it in such a way that it suits our tolerance for risk, our personality, our attitudes and our belief systems. In simple terms, if we are uncomfortable with the plan, then we will never be able to follow it.

Now, having been telling people this for years, I found that the message was not getting through. On asking why people did not have a plan, I found that many did not know how to start writing one down. This is when I started to teach my trading plan. I taught it, not for students to take and use as it was, but as a model that could be adapted to their needs.

In my weekend seminars, I teach everything that is in my trading plan. I explain what risks I am managing, how I manage them and why I do it the way I do. It is then much easier for students to take my plan and vary it in ways with which they are comfortable.

This leads into the second step and that is to test the plan. The first level of testing is what is called "paper trading". This is where we trade in theory, without risking real money. We get to see how the plan works in real markets as they unfold. We build up real experience. At least we should, but most people do not bother with this step. The call of instant gratification that runs through modern society is too strong. They buy a computer, open an account with a broker and "just do it".

They "do it" all right – at least they "do" their money. You see, the market is a ruthless teacher. It charges a high price for using ignorance. If you do not do your learning before you start trading, the market will give you lessons. And the cost of those lessons is called losses.

Why is paper trading so important? Because it enables us to develop some confidence in our plan. That it works. That it will make losses, but that they are controllable. And when we make profits they should be larger than the losses. Only when we have this confidence in our plan will we be able to stick with it under pressure. What most people do under pressure is to start doubting and then rethinking on the run the very plan itself. This is the road to trading disaster. Discipline is gone. Losses are inevitable.

Finally, we need to start developing real experience. We have to start trading in a small way. As we are successful – and that may not be at first – we can start to commit greater funds to the market. Trading is not an easy way to make a living. It is a hard way to make an easy living. But it has many rewards. These rewards need to be earned though. They are not just there to be plucked.

If you want to take the first step, have a think about doing my weekend seminar or come to our trading camp in October. It may be the best investment you make this year.

Building Wealth Through Shares Seminars

Sydney 18-19 August

Melbourne 22-23 September

Full details of seminars are on www.bwts.com.au. Click on Seminars.

My intensive version of the seminar, given in New York, is also available on videotape. Details are on www.bwts.com.au. Click on Videotapes.

Trading Camps Come to Australia

Trading camps are a very popular way to learn trading. Dr Alexander Elder has run them in the US and the Caribbean for several years. I have worked with him at the Pacific camps in Fiji in 2000 and Vanuatu in 2001 and in the Caribbean in 2000.

Many readers have asked why they cannot be run in Australia. There were many obstacles, but I have worked through them and can announce that the first Australian Traders and Investors Camp will be held at Terrigal, just north of Sydney 19 to 24 October 2001.

I have arranged for Tony Plummer (author of **Psychology of Technical Analysis** – US title, **Forecasting Financial Markets** – UK title), Neil Costa and Garnett Znidaric to join me in the teaching.

Tony Plummer is a recently retired professional trader and fund manager, with a lifetime experience in the UK. He is now working as a consultant to very senior UK fund managers. He will speak briefly at the ATAA Conference, but the camp is a unique opportunity to learn from him in depth.

Neil Costa and I will both teach our trading approaches in detail. Garnett Znidaric will add very useful insights to trading.

The value represented by the camp is extraordinary, compared to taking seminars or courses from us separately. And you will have time to discuss things with us.

Full details are on www.bwts.com.au. Click on Camps.

Adjusting Share Price Data Bases

Recently I posted this on the Ask Colin page on the web site:

Question

My question is with regard to data accuracy. I use and notice that you also use Almax as a data supplier and my question is specifically about the data for QAN on the week of 25-08-

2000. My Almax data for this week shows a high of \$3.84 yet some of my colleague's data show a high of \$4.25. I questioned Almax about this and was sent this reply:

QAN paid a special dividend on 9 November 2000 and the ASX recently advised us that a dilution factor of .9046 should be applied. We did this via our automatic data maintenance on 06 June 2001. This will be the reason for the difference. I trust this explanation addresses your concerns about our data accuracy.

Can you explain why the historical data should be adjusted for a dividend? I was under the impression that data should only be adjusted when it affects the actual numbers of shares available? Won't this negatively affect the historical accuracy of support/resistance levels?

Answer

Generally we do not adjust historical data for dividends. The reason for this is that as soon as a share goes 'ex' one dividend, it theoretically becomes "cum" the next dividend. So, notionally there is a build up of value in the share price as it moves toward the next dividend, then drops to zero on the "ex" date, before starting to build up again. To adjust properly for this is very complex, so most people do not adjust for dividends.

However, there is one exception - special dividends. Special dividends, which are large, create a discontinuity on the chart. Since they are by nature "special", once they are paid there is not a new build up of value in the price afterwards. Also, special dividends are often in the nature of capital returns - it is just that the capital return is being paid as a dividend. This is done because the dividend can be franked and the franking credit is valuable. So, I do adjust for any significant special dividend.

The reason we adjust historical data is so that we can compare prices before and after the event (which may be a special dividend, capital return, split, consolidation, reconstruction, call, bonus issue or rights issue). Take the special dividend on Qantas as an example:

If you bought Qantas on the high day of the week you refer to, you would have paid \$4.25. When the special dividend was received, you received 37c of your purchase price back as a special payment amounting to a capital return (because some of Qantas' capital was paid out to shareholders, reducing its shareholders funds and therefore notionally its capitalisation). So your net adjusted cost was \$3.88 (4.25 - .37). Unless you do this, you would not be making a fair comparison.

Now it gets complicated. The market by convention does not do the calculation correctly. What you should do is reduce every price before the payment by 37c. This is notionally the only truly correct method. However, the market, the ASX, and most software packages and/or data vendors use a factor that is applied to all past data. In the Almax case they used a factor of 0.9046 giving an adjusted high for 210801 of \$3.84455. My software made a slightly different calculation and arrived at \$3.844716.

You are correct that this affects support and resistance levels. In this case, where the price being adjusted was not too far different to the price on the day the adjustment was generated, the difference is not great - \$3.84 Vs \$3.88. Support and resistance levels are not exact, so a 1% difference is not significant. However, for prices much further away from the price on the day the adjustment was generated, the error becomes greater. You then have to make a judgement about how well the market will adjust the prices. Remember that everyone does not use charts. A fundamental investor will do the correct calculation to establish their adjusted cost. If you think support and resistance levels are critical and there have been this kind of adjustment, it may pay to make the correct calculation just in case. Life was not meant to be easy.....

By the way, it is easy to do this with Insight Trader, because the system always keeps the unadjusted data file and well as the adjusted one. So it is always possible to do as I suggest and check the calculation if you need to. With Metastock, you have to first try to undo all the adjustments in order to get to the original price. This is one of the things I do not like about Metastock.

I hope this explains this complex area of charting.

Questions to the Web Site

One of the largest sections of the web site is Ask Colin, in which I answer questions about technical analysis, software, education, trading and investing. Please understand that I choose not to give advice. I am not a licensed adviser. Please do not ask questions about specific current markets. I am happy to answer questions about almost anything else, though. Please also check the site to see whether I have not already answered your question, before sending them to me.

Notice Board

If there is something you want to know, or you want to contact people with particular knowledge or interests, you may use the notice board section of the Newsletter to post a request or notice. Just email me at colin@bwts.com.au

One recent question sent to Ask Colin on the web site was:

I was wondering if you could tell me where I can go on the web of a morning to see how Australian shares traded overnight in London and New York?

If anyone could help with this, please email me at colin@bwts.com.au and I will post the answer on the web site for other to use.

Another frequent question is what web sites have good charts for those who do not have charting software. If readers could let me know their favourite sites with good charting facilities I will also publicise these.

Technical and Fundamental Analysis

Another recent addition to the Ask Colin page on the web site was this one:

Question

If technical analysis is so sound that one may largely disregard fundamental analysis, why aren't there any managed funds that explicitly sell the fact that they only employ technical analysis in trading stocks?

Answer

There are a number of reasons why there are no funds relying only on technical analysis:

1. Technical analysis is not generally accepted as a technique for analysing and trading markets. This is a bias that is very pervasive in the industry and flows from academic teaching over the last half century in particular. However, there is increasing academic acceptance that there may be more in technical analysis than has been assumed. For example, there is a good, though brief discussion in Jeremy Siegel's book *Stocks for the Long Run* Chapter 16. There is also the growing field of behavioural finance, which is tending to validate some of the ideas on which technical analysis is based.
2. Fund managers have to protect their backs. If they were to be sued for poor results, they need expert witnesses to stand up and say that they used generally accepted practice in running their fund. Technical analysis is not the generally accepted practice, so it would be difficult to win such a case. The safer course is to say they use one of the accepted fundamental approaches, even if they tweak it with technical analysis.
3. Technical analysis is not a stand-alone methodology any more than fundamental analysis is. Fundamental analysis tells you what stocks appear to be good, but not when the market will recognise that fact. Hence, it works mainly for buy-and-hold approaches. Technical analysis is strong on timing, but weaker on investment merit. Hence, they are best used together as a complete method.
4. I believe that a purely technical analysis driven approach is extremely dangerous. It is my firm view that some level of fundamental analysis is necessary. I see many people lose money using technical analysis, because of ignorance of the fundamentals. Of course, they

are often also lacking in money management and discipline as well. However, to trade anything without knowing what it is and its basic fundamentals is to court disaster.

For all these reasons, it would be really stupid of a fund manager to take a purely technical analysis approach. There are even pressures that make it dangerous to even say they rely heavily on technical analysis. However, some hedge fund managers will do what you say. They are a different animal altogether and not available to the public - only to so called "sophisticated investors". I still doubt that a hedge fund manager who timed trades entirely on technical analysis would be doing so without knowledge of the fundamentals for the instrument he was trading.

The main group who try to rely on technical analysis only are the "punters". They do it because they think fundamental analysis is too hard, rather than any exploration of the problem that proves the technical approach works by itself. It is estimated that at least 90% of them lose their money. I am not surprised

Back Issues of the Newsletter

One of the more important functions of my web site is making back issues of the email newsletters available for downloading. This is much faster than email attachments and very flexible by allowing readers to only download what they want.

Newsletters will generally be posted to the web site when the following issue is sent out, so my email list is still the fastest way to get to see it.

Market Comment

As I am not a licensed adviser, I cannot make comment on the markets in these newsletters. I prefer anyway to teach trading rather than give advice. However, I do write for *Shares Magazine* and *Shares Weekly* on the Internet, where readers can read my views.

My *Trend Trader* column in *Shares Magazine* September 2000 (which is published mid August) starts like this:

Profits are made in the stock market by assuming risk. Successful investors understand the risks and manage them properly. However, I see two classes of traders or investors who do not manage risk very well.

The first group are the ones who do not understand the risks. They usually take on too much risk in ignorance and do not know how to manage it. They usually lose a lot of their money. The solution to their problems lies in education. However, they rarely have the time or the inclination to read, study or attend seminars. Their future is not good.

The second group suffer from a very common misconception. This is that there is some magic method of investing or trading. They are looking for a strategy that never makes losses. I see these people all the time. They go from method to method looking for the "holy grail" of investing. The solution to their problem lies in developing an understanding that all investment and trading strategies involve some losses as well as some gains. The realistic expectation is that this will happen and the nature of the investment or trading task is to control the inevitable losses, while capitalising on the good ones.

The second group also suffer from another problem. Because they are so fearful of losses, they wait and never "pull the trigger" on investment and trading opportunities. So, some sit on the sidelines and miss the opportunities entirely. However, it can get worse than this. Some envy others making money while they sit on the sidelines. As this process continues, the psychological pressure builds and they regret bitterly that they missed a great opportunity. Eventually, they can stand it no longer and jump in right at the top.

The present markets are a great trial for these people. We have had a great bull market for a decade in major world markets. Then the tech and Internet bubble burst and lots of people lost money. They read that a bear market has started. So, they pull their horns in and swear

off the stock market until things improve. Right now there are thousands of readers sitting on the sidelines.

This is a pity, because there have been good opportunities in the Australian stock market in recent months. At the end of July, I assessed how my portfolio had gone in the first month of the new financial year. It was up just over 2%, or a 24% annual rate of return. This is without dividends and interest on cash reserves, just capital growth. And my portfolio is very defensive. So, let me review the current situation and outline a suggested strategy.

Readers who find my commentary of interest and use may want to read the rest of this column when it is published. I always take a clear view of the markets, with stated reasons and a suggested strategy to deal with conditions as I see them.

Readers who are interested to read how my trading results are obtained might like to consider my seminars or the October camp.

Duplicated Addresses

If you receive two copies of this newsletter, it may be that I have two different addresses for you in my list. If you do not want both copies, please email me which address to delete.

Whenever I send out the Newsletter, I get a great number that are returned undeliverable. Many are cancelled addresses, but a fair number are because the mailbox is full. I do not re-send these Newsletters. Also, after sending two Newsletters unsuccessfully, I delete the address from my list. If you hear anyone complain they did not receive the Newsletter from me, please ask them to get in touch with me to reinstate their address on the list. Thanks

Regards Colin