



**COLIN NICHOLSON**

*Building wealth through shares*

13 August 2001

### **Email Newsletter No 13**

***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.***

I promised it would not be so long before I got another newsletter out, so here it is. I have had some really interesting questions to Ask Colin on my web site recently, so I thought I would share some of the best ones with you. I hope you find them useful. We now have about 300 questions and answers on the web site.

### **Sydney Seminar – Last Chance**

I am only running my weekend seminar twice more this year – in Sydney next weekend and in Melbourne next month. There are still places available in both. If you are thinking of coming to the Sydney one, please phone us urgently – Vera on 02 9389 8814 or Colin on 02 9436 1610.

If you are interested in the seminars, but live in a different state, please email me for more information.

I last ran the seminar in Auckland at the end of June. The room was packed and the feedback was great. The most common and important reason people lose money trading is because they do not have a plan. My seminar teaches what most people “don’t know that they don’t know” about creating a trading plan specifically and about trading generally.

If you cannot catch one of the seminars, consider the trading camp in October.

Details of the seminars and camp are on my web site [www.bwts.com.au](http://www.bwts.com.au). Please don't hesitate to phone Vera or myself to discuss them. We are not high-pressure sales people. I offer these learning opportunities for those who need them and if they will not help you, I will suggest you do not take them.

### **Unable to Pull the Trigger**

Here is a recent addition to the Ask Colin section of my web site, that I thought may be of general interest to readers:

#### **Question**

***I have been trading shares 10 years and futures for about 4 years. When I started in the futures market I lost a lot of money listening to the broker so I stopped trading and built my own methods on trading the futures. Now I have this mental problem on being able to push the buttons thinking maybe this is the wrong one take the next so on so on.***

#### **Answer**

If it helps, you are far from being alone with this problem. Most people start off having some degree of problem being able to "pull the trigger", as they say in the industry. Some people get over it fairly quickly, others take longer and some always find it difficult.

Advising you properly about this probably requires a trained psychologist, however, I can offer some thoughts from my experience.

My first thought is that it is not a bad thing in a way. The people who are the greatest danger to themselves in the market are the ones with no fear. They always end up over trading and lose a lot of money. So, having some degree of caution in your makeup is a sign that you have learned from experience in the market and in life. However, it is not a good thing to be so cautious that you never take a risk.

My next thought is about risk and follows on from the previous paragraph. When you look at it in the abstract, theoretical way, profits (and losses, of course) are made by assuming risk. If there was no risk, everyone else would already have arbitrated away whatever profit opportunity there was. So, the nature of trading is that you assume risk. The key to success is in recognising the risk and managing it sensibly.

The way we manage risk sensibly is a big subject. However the three key techniques are

1. Market exposure - limit the total amount of your trading funds that are exposed to risk at any one time in inverse proportion to the level of market risk you perceive. So, when market risk is high, you have a lower proportion of your funds in the market.
2. Diversification - you spread your invested funds out over several positions, so that failure of one investment is not catastrophic to your portfolio.
3. Position risk - you limit the percentage of your trading account that is risked on any one trade.

The way I trade is that I have developed a trading plan that deals with all the risks that I see in trading. I have strategies for the key architecture of my plan and tactics for how I manage trades. I know this plan works in the medium to long term, because I have tested it thoroughly. This gives me confidence that it will work, even if there are short-term periods where it does not work so well.

Having a plan like this makes decision making much easier. I have a clear framework for decisions. I find that most people who have trouble making trading decisions do not have a clear plan of what they are trying to do and how. So, everything is a big area of doubt, with which they wrestle constantly.

Now, it takes time to develop such a plan, but it is what all successful traders eventually do. There are many successful trading plans.

It is also very important to understand that trading involves losses. There is no "perfect" method to trade, where every trade is a winner. The key is only assuming reasonable risks and managing them sensibly.

The other problem some people have is that they try to follow a plan that is somehow in conflict with their attitudes, beliefs and tolerance for risk. They will continue to sabotage themselves in unconscious and subtle ways. I wonder from your question whether you might not be made up such that you are more comfortable with shares. If you have done that for 10 years, presumably you have something that works. Maybe the 4-year struggle with futures is trying to tell you that it is not the game for you.

Finally, I detected a subtle thought when you said you lost money listening to a broker. There are several things here:

1. We must all take responsibility for our trades. If a broker, or anyone else, suggests something, they are not taking responsibility for it being right for you. The trade will not be done unless you say to the broker that you want to place the order. At that point you must own the decision. The broker's advice is only one input to that decision.

2. Listening to the broker could not have been the reason you lost lots of money. You only lose lots of money if your money management is deficient in some way. This comes back to the trading plan. Losses are the result of unsuccessful management of risk.

3. Many investors and traders misunderstand what a broker's role is. It is clearest in a discount broking situation - he or she does executions for you. In a full service broking situation, the broker is selling you his or her wider service. A broker is a middleman. The broker makes money by transacting business for you. The more business you transact, the more the broker makes. Everything the broker says to you or does for you is by way of facilitating your doing business through him or her. I often joke that broker is spelled b-r-o-k-e-r, but pronounced "salesman". If a broker were a brilliant trader, he or she would not be working as a client adviser. This is not to say you cannot get good advice from a broker, but you must understand what is going on and assess the inputs you get from the broker yourself.

I hope these thoughts are of use in your trading and investing.

## 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](http://www.bwts.com.au). Click on Camps.

## Overseas Trading in Australian Shares

Several readers kindly emailed me in response to the notice board question in Newsletter No 12, asking where data was available on Australian stocks traded overnight in London.

From John Hansen:

It is important for your readers to note that the ASX codes are often different so it would pay to do a symbol search on these Exchanges:

<http://www.nyse.com>

<http://www.nasdaq.com/>

<http://www.londonstockexchange.com/default.asp>

For UK prices: <http://uk.finance.yahoo.com/>

This link will take you to a look up code page. The symbols are often different from the ASX symbols so you need to enter the name of the company or part there of. There is a 20 Minute delay on prices.

For the USA prices from the NYSE: <http://au.finance.yahoo.com/>

On the first drop down section it shows 'Australia (.AX)' , Change that to 'World Markets (.US)'

Again you should look up the symbol because of the different codes between countries.

The biggest benefit of Yahoo is that you can register for Free and the 'customise' your own page which will enable you to update these prices automatically.

From Larry Lovrencic:

US trading for Aussie stocks can be found at Yahoo's US site : <http://finance.yahoo.com/>

and UK site: <http://uk.finance.yahoo.com/>

An excellent site for charts for US stocks is StockCharts: <http://www.stockcharts.com>

and for futures - Barchart.com: <http://www2.barchart.com/mktcom.asp>

I have links to these and many more at my site: <http://www.firstpacific.net>

Steve Rawnsley also recommends:

The daily Morning Report in Investorweb has the information requested (and a lot more). One needs to register but the Morning Report is part of the free section. <http://www.investorweb.com.au> . Thanks, Steve.

Jim Wright advises:

To get directly to Australian ADRs in New York:

<http://finance.yahoo.com/q?s=anz+amcr+bhp+nab+nws+nwsa+wmc+wbk+tls+cm+pdlpy&>

To get directly to London Stock Exchange:

<http://www.prices.londonstockexchange.com/search.asp?alph=r>

Thanks to everyone who shared their knowledge on this.

## Charts on the Internet

John Hansen has also been good enough to answer the question about where to go to get good charts on the Internet if you do not have charting software of your own. Thanks again John.

The best free service that I know of is T.D. Waterhouse:

<http://www.tdwaterhouse.com.au/Rquote.asp>

It contains up to 10 years of data, is adjusted for splits, has SMA, EMA and RSI indicators and allows for 2 moving averages.

<http://www.bourseinvestor.com/> Has limited, simple, charts. Does not adjust for splits.

For anyone interested in World Economic outlooks they show look at Ed Yardeni's site.

<http://www.yardeni.com/stocklab.asp> Unbelievable amount of data

Are of my favourites is Ohio State University, Charles Dice Centre.

<http://fisher.osu.edu/fin/journal/jofsites.htm> This provides links to a multitude of research from Professors and Students from around the world.

And <http://www.equis.com/free/taaz/> This is a free site and provides detailed analysis of charting terms and techniques by Steven B. Achelis

## Important Correction

In the last Newsletter, I said that Almax adjusted the database of their clients for ordinary dividends. I am advised that this is incorrect. I am distressed that I published this error, because I set out to clarify an issue, not to cloud it further.

I misunderstood Almax's manual. I need to discuss this with my friend Allen de Rosario, but he has been ill. When I have done so, I will comment further if necessary.

In the meanwhile, I am changing the Ask Colin item in which it appeared. Email Newsletter No 12, which is going up on the web site soon has also been amended. If readers are keeping a file of the newsletters on their computer, please download the corrected version when it is there.

I have used, supported and recommended Almax for many years as arguably the most professional data service in Australia, particularly for MetaStock users. I remain of that opinion.

Allen asked me to correct the facts, which I have done immediately. The additional recommendation is voluntary and the least I can do having caused my friend to answer unnecessary queries from some clients

## Save on GST – Using the Government's Rules

I received this from a reader, who I had probably not identify as he is showing up a loophole in the GST system – it seems to be legal though:

*I recently made a large purchase from Traders Library in the USA. It was during their "Spring Sale" and many interesting items were dramatically reduced. The total order amounted to approx. US\$280 (A\$560 approx).*

*To my horror, Australian Customs Service levied an additional GST charge of AUD\$56. I naturally queried this charge, as previous orders had never incurred GST.*

*The customs officer informed me that all imports are subject to 10% GST on total value. (Total value includes shipping charges - even though some of the service was rendered overseas - as any retail price would have shipping built in).*

*However, to expedite small imports for personal use, they generally waive the GST if it is under AUD\$500. Conversely, if it is over AUD\$500, the tax is charged.*

*The moral to the story is: Keep all foreign mail-order purchases under AUD\$500. Furthermore, allow some leeway for the fluctuating exchange rate.*

*I hope this can prevent someone else from making the same mistake.*

I think that we should be aware that the Government might change these rules at any time. It is also probably true that they can waive their own rule at any time in this case – that is, GST is legally due and it is just that they do not choose to collect small amounts for administrative convenience.

I have also found that UPS and FedEx are more scrupulous at collecting GST than is Australia Post. So, I always order only one or two books at a time and specify post not courier delivery. Most sellers will split up a large order and post it in several lots a few days apart if you ask.

## Long Term Investing Philosophies

Here is another recent addition to the Ask Colin section of the web site that may be of general interest:

**Question**

I want to invest long term in the share market. I love Buffett strategies, however, I am having difficulty narrowing down the field. Buffett says ROE is the most important issue to look at, although recently a Broker said in Australia ROIC is the first place to look. What would be a good strategy to eliminate the undesirable stocks?

I was thinking along the lines of:

- obtain list of All Ords
- delete investment companies
- delete property trusts
- delete resource stocks

I want to narrow the field down & then look at whether EPS is strong & rising over the last 5-10 years, measure debt etc. Thanks for your time in answering my questions as no one else has.

Answer

I am disturbed by your last sentence. It disappoints me that you have asked people in a service industry for help and not got answers. Perhaps we can excuse them that they are too busy. However, there are retrenchments going on in broking these days. It seems to me that if more questions from people like you had been answered, there might be more clients wanting to invest. Anyway, that said, let me try to help.

You have asked an enormous question. I will try to address it, but if I do not cover things you need answers to, get back to me. I do not know everything, but I will tell you when I do not know and where you might go for help if I can.

Firstly, if you are interested in being a long-term investor, I suggest you get and read *Stocks for the Long Run* by Jeremy J Siegel (Irwin). I have just written a review of it for *Shares* magazine (October issue, I think). It is a great book. It is written by an academic, but in this case a particularly sane and self-interested one. He began to try to unravel the investment riddle for himself and has written up his findings. Unlike many books by snake oil salesman it is well researched and facts are documented. It is also not too difficult to read. It is also consistent with Buffett to a point, but certainly on the stress on taking a long-term approach.

Let me start by explaining that there are three basic approaches to investment:

1. The asset allocators. These people work on the basis that something like 90% of investment return is derived from the decision to allocate assets. So, the results are determined by how you allocate your total funds to shares and other asset classes. Then, within the shares allocation, how you allocate your funds between national markets. Then, within each national market, how you allocate funds to industry sectors. This is often called a "top-down" approach. Many professional fund managers use this approach. The extreme form is the Index funds.

2. The stock pickers. These people work the other way around and it is often called a "bottom up" approach. The idea is that they seek out the best stocks wherever they are. Buffett falls into this class. So does Templeton. Two of the best in the last 50 years. However, it is not an easy method and many fail at it.

3. The active managers. These people take elements of both the previous approaches. They use a basic asset allocation method, but try to tweak the allocation towards individual stocks they think are best. This is how many professional fund managers try to justify their fees - by "adding value" they call it. Many fail at it, so I guess they are "subtracting value".

The more I read about investment, the more I accept that there are many ways to make money. There is no single best way. It may depend a lot on the person involved.

Among the stock pickers and active managers there are two basic "styles", as they are called:

1. The value approach. These investors buy undervalued shares and hold them until the market re-rates them.

2. The momentum approach. These investors buy growth companies. They are often apparently over valued until one considers the potential growth in earnings.

Again, there are combinations of both approaches. There are also those who concentrate on big capitalisation companies and others who concentrate on smaller capitalisation companies within each of these styles. So, there are many ways to make money in the markets.

Your starting point must be to decide:

1. Your time frame - easy, you have already decided to be a long-term investor.
2. Your basic approach. Asset allocator or stock picker or a combination.
3. If you are to have an element of stock picking, whether you want to concentrate on value investing, momentum investing, or try to do both.

Only then can we start to answer the question you have asked.

Value investors will concentrate on measures of relative value like PE ratio, dividend yield, and price to net tangible assets.

Growth investors will concentrate on return on equity (however defined) and price to sales or price to cash flow.

You can read many books and different writers will have different favourite methods. The main thing is to select a methodology that has been tested and works in the long term. Then be consistent. John Train made the statement in one of his books that consistency is the real secret - that even a mediocre approach applied consistently will beat those who chop and change between methods.

I hope this helps you see the shape of the landscape. Let me know if I can help by trying to clarify any other issues.

## Computerised Trading Systems

Here is another recent Ask Colin item, which will be of general interest. It is probably the most common single question I have been asked over the years. Only the name of the program changes:

### Question

I am a subscriber to your newsletter and have also purchased your video package. Recently I was offered the opportunity to purchase a software package. I apologise for asking your personal opinion but I respect you as an experienced trader and chartist. I was wondering your views on trading software packages and if you believe in the spectacular gains that their promoters claim. This title of the package is Blue Chip Trading from the Micro Corporation. If you would prefer not to comment specifically about the program that is fine, but your general view would be much appreciated. It appears a fair bit of money to purchase, and I am debating whether that money could be better invested. I am an amateur investor, and prior to this opportunity have never viewed myself as a possible trader. I apologise again for requesting your personal advice but would greatly appreciate some guidance.

### Answer

I do not mind you asking. That is what "Ask Colin" was designed for.

In this case, I am not sure what I can add to what is already on my web site. Please see what is there for Micro Corp/Blue Chip Trader and also computerised trading systems generally. In the latter area, I have on the Articles page a description of the different types of software and some leads on where to learn how to test them.

You will be aware that it is difficult for any of us to comment about these products specifically, because the law in Australia protects scoundrels by making truth alone an insufficient defence against an action. One must also be able to prove the nebulous idea of "public interest" in telling the truth. The result is that only those with deep pockets can afford to speak the truth

about scams. Governments have deep pockets, but do not do enough of this. Accordingly, I will not comment about Micro Corp and Blue Chip Trader. Rather, I will talk about computerised trading systems in general terms.

Your first recourse should be to the ASIC. Find out if the promoter is licensed. This is no protection, but is a starting point. The ASIC will also give you the general warnings they have issued, which I have also put on my web site.

Your next move should be research. The Internet is a great source. For example, with respect to Micro Corp and Blue Chip Trader, you will quickly find that Trevor Sykes has twice covered this outfit in his *Pierpont* columns. Go to his web site [www.pierpont.com.au](http://www.pierpont.com.au). The first column was published 28 April 2000 and the second one 8 December 2000.

If you still want to go further with any system, you need to be prepared to buy it and test it before you use it. This where I hope my article on Computerised Trading Systems on my web site will be of some help.

Finally, consider these points:

1. If something seems too good to be true, it usually is.
2. If a system is that good, ask why the promoter is prepared to sell it to you rather than trade it himself. If I had something as good as they claim, I would have no trouble establishing a track record and attracting large sums from people to manage for them. In a few years the resulting fund would have most of the money in the world. Ask these promoters to show you the audited results of using their own system with their own money. Theoretical back testing is useless, really. By the way, I suspect that selling these systems makes more money than using them to trade. However, it is difficult to quantify this, so it remains just a suspicion.
3. If the problem of trading markets was as simple as putting some algorithms in a computer, why are the major fund managers not buying them up exclusively? These guys test everything looking for an edge. If it was there, they would have found it. The people who work in this industry are highly intelligent and highly trained. They also work very hard. I do not believe that they miss much.
4. If Warren Buffett can "only" make 25% compound over 40 years, he must be a fool not to have used these systems. I am still waiting for someone to tell me Warren Buffett is a fool.
5. If major companies can only make on average 10 to 12% return on equity over the economic cycle, why are they not selling up and going into trading? Their directors scour the world for good business models. Some of these directors are questionable, but most are not fools or blind.

I hope you find this useful. None of it is a direct comment about Micro Corp or Blue Chip Trader, which I have not checked or tested. Life is too short to tilt at windmills. Then again, I may just have a bias against this stuff. You will have to judge that for yourself.

## 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](mailto:colin@bwts.com.au)**

I received this really interesting question from a reader. Not having the time just now (and the maths ability?) to analyse it properly, thought I would throw it open to the experts in my readership. If someone would like to tackle this one, we will all learn something. Please email comments to me at [colin@bwts.com.au](mailto:colin@bwts.com.au) headed "Notice Board Reply". Thanks.

I am not a regular trader preferring to hold good stock over long periods. However at one stage I worked out a spreadsheet calculation, which would allow me to sell a favoured stock and then buy it back at a later date. Perhaps I could use an example of 1000 shares in XYZ Ltd bought thirteen months ago for \$10.00. The current price was recently \$14.90 and charts now indicated a downturn and with that sector's general market downturn I feel that the price is going to continue to drop for a while. I sell at \$14.60, realising \$14,600. From this I subtract the cost of broking plus the tax payable on the capital gain. When I sold I also expected to Re-buy at \$13.00 or less at some time in the future. Providing I had read the crystal ball fortuitously I would be able to buy 1037 shares. Thereby turning the stock's capital gain into increased stock holding.

If a stock 1000 of ABC Ltd was bought for \$6.25 and held for five years, the current price might be \$22.00, which I could sell and buy later for \$18.50 then with a similar calculation as for XYZ Ltd I would end up with 13 fewer shares. The reason of course is the larger rise in price from \$6.25 to the buying price of \$18.50 and clearly I would not trade in spite of the fact that I would have made a larger capital gain. Share price would have to drop to \$18.27 just to break even. This would represent a 16.9% market drop! Of course one could buy some other stock and feel they'd done well but it would not be comparing apples with apples. Why is that short term capital gain can more easily be turned to increased shared holding but longer term capital gains would be more difficult to exchange for increased shares? Does this mean that one should trade shares held just over the 12 months?

## **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.

## **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.

## **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.

## **Not Receiving Newsletters?**

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 (over quota). 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