

8 March 2003

Colin Nicholson's Email Newsletter No 29

This is a complimentary email newsletter for people interested in technical analysis, trading and investment. If you would prefer not to receive it again, please let me know.

I do not allow anyone to use my list of email addresses used for this newsletter.

If you have friends or clients who you think would like to receive the newsletter, please email it on to them and invite them to email me at colin@bwts.com.au to add their address to the list. My only proviso is that the newsletter be sent in full and unchanged. It may also be posted on the Internet, if you clear the specific site, newsgroup, list or chat room with me in advance.

Please read the Important Statement at the end of the newsletter.

BEATING THE GREMLINS

The last few issues of the newsletter have been sent out a new way in order to overcome the various spam blockers that stop legitimate email as well as spam. Unfortunately, the downside was that some readers received a newsletter with HTML code through it. After trying to find a solution for some time, I have decided to send the newsletter out in plain text. If you would like to read it with full formatting, you can use the pdf file on the newsletters page of www.bwts.com.au

ASK THE RIGHT QUESTION

The question and answer is an interesting one because, on the surface it raises quite an important issue. However, the premise on which the question rested betrayed what I feel to be incorrect thinking about trading and investing:

Question

How can I know which stocks are going down because of general market sentiment and which ones are going bust?

Answer

Almost the only answer I know would be to use relative strength. Relative strength is a widely used and very intuitive indicator. Most charting software will calculate it for you. However, if you do not have charting software, you could find the data on a web site like *Yahoo* and drop it into a spreadsheet. You can then easily calculate relative strength yourself.

Relative strength = Stock price divided by the Market Index. This yields a ratio. If the value of the ratio is rising, then the stock is stronger than the market. If the ratio is more or less constant, the stock is falling with the market. If the ratio is falling, then the stock is weaker than the market.

It may be tempting to calculate what is called a "point-to-point" relative strength by taking (say) the ratio 12 months ago and the ratio now. However, this is very dangerous. The current ratio could be higher than a year ago, but in that year the

ratio has been much higher and is now falling rapidly. You must look at the slope of the relative strength line to make a valid reading.

So that is the best way that I know to do what you want with an indicator. Having answered your question, I now want to question the basic premise of your question. This is that you are holding a stock that is trending down and want to know whether to hold it or sell it in case it goes bust.

The only way you can make a profit by buying shares is if the price goes up. It does not matter how fast the whole market is going down and how slowly your stock is going down, you cannot make a profit from holding a down trending stock. PERIOD.

In my opinion, there is no logic to holding a stock that is trending down. It must be sold immediately you recognise that it is trending down. What you paid for it is irrelevant – you have already lost the money. That you may look silly for buying it in the first place is not relevant – you will look even sillier if it goes bust! What the management says is particularly irrelevant – they always put the best light on it and long experience suggests bad news is followed by more bad news in most cases. What analysts say should be taken with great suspicion, because there are constraints on analysts telling you to sell. The only thing you have that is trustworthy is the price. If the smart money that knows whatever are the "true facts" is selling, then the price will be trending down. You must sell the stock. You can always buy it back again if it starts trending up, which will happen in a small minority of situations.

It is my strongly held belief that if investors followed this rule alone, they would make fewer, much smaller losses when they get it wrong, which is about half the time even for the best stock pickers.

SHARES CHARTING ISSUE 2

The second issue of *Shares Charting*, which is mainly my work, is now on sale in newsagents. Its focus is the management of market risk, which is an area of investing and trading that is not widely covered in textbooks. This publication is a substantial re-write and update of my seminar notes, which also accompanies my *Building Wealth Through Shares* videotape of the seminar – see www.bwts.com.au for details.

DEALING WITH FEAR IN TRADING

Dan Gramza is a Chicago based hedge fund manager, experienced trader and brilliant teacher. He loves Australia and is coming back soon to run two weekend seminars. I think Dan has so much to offer, that I am going to attend the Sydney one and fly to Brisbane for the weekend to attend the other one.

The Sydney seminar is on 29 and 30 March 2003 and deals with "Advanced Japanese Candle Trading Strategies and Applications".

The Brisbane seminar is on 24 and 25 May and covers the material in Dan's upcoming book "Trading in the Eye of the Storm".

I don't recommend many things in these newsletters, but these two opportunities are outstanding. Full details are in the flyers. I am not attaching them, because I don't want to annoy readers who are not interested. Just email me at colin@bwts.com.au and say which or both flyers you would like.

The following is the second excerpt from Daniel Gramza's book "Trading in the Eye of the Storm". The first excerpt was published in Newsletter No 28.

Techniques to Deal with Fear

Samurai warriors were without a doubt some of the fiercest fighters who ever existed. The key to the samurai's incredible fighting ability was the complete elimination of their fear of death and their complete focus on being in the present moment. They did this by entirely de-energizing their fear of death. If a person in a fighting situation is distracted by thoughts of being hurt or dying, he will be the loser. Samurai warriors were unencumbered by these fears. They were courageous in the face of the unknown. They were empowered by a lack of fear, and this allowed them to completely focus, react and stay in the present moment. They fought without hesitation and with complete confidence. This is exactly the mindset of the successful trader.

Here are ways to deal with fear and eliminate it from your trading experience.

Face Your Fears

The first step in controlling fear is to face it. If you are not willing to face your fear, then fear, not you will control your life. When you are afraid, use deep centred breathing (discussed in the relaxation section), acknowledge the fear, and face it head-on. Tell yourself, "I am stronger than my fear, I control my fear, and I can overcome my fear."

You will become more comfortable in the presence of a fear by decreasing your sensitivity to it. As you repeatedly face your fear you will realize that your energy in the fear will decrease.

Courage is moving ahead even though you're afraid. There is a wonderful true story of Ishi, the last living member of a Native American tribe. Ishi and his tribe believed trains were monsters that ate people. One day, Ishi found himself in the position of having to take a journey by train. When he boarded the train, he was asked by a person who understood the beliefs of his tribe, how he could step on the train. Ishi responded, "Since I was little, I was taught to always be more curious than afraid". Use fear as an opportunity to learn and progress.

Acceptance of Responsibility

A critical element in dealing with fear is to accept that you alone are responsible for the creation and intensity of your fear. You must realize that you are responsible for your thought choices and the amount of energy you feed them. This recognition alone can put fear in perspective, diminish the energy in the fear, and prepare you for the acceptance of new thought choices.

Accepting responsibility for your thought choices puts you in control of your fear, not the other way around.

Identify the Thought Choice

Our fears are created by our thought choices. In order to eliminate our fears, we must change the thought choices that create them. For example, if a trader fears losing money, he is unconsciously saying to himself, "I choose to experience the fear of losing money."

That same trader can choose not to feed energy to this fear choice and make a different, conscious, choice. He can say, "I choose not to fear losing money and I accept that losing money is a part of the trading business."

Until you identify your fear thought choice, you cannot change it, and you keep the fear alive. Allow yourself the freedom to make this new choice without judgment. Exercise your positive, conscious thought choice whenever the old fear choice returns. Each time you do this, you drain the energy from the old fear and you create the change you are striving for.

Acceptance of Risk

It is very important that the trader completely and honestly accept the risks involved in trading. Trading is a business of percentages. Not every trade will make money. If a trader cannot accept the risk, he cannot fully commit himself to the trade. If he cannot fully commit himself, taking the next trade can be a frightening experience. He will lose confidence and become frustrated and locked in a cycle of fear and doubt.

On the other hand, if the trader has complete acceptance of the risk and all possible results, then he can be optimistic, committed and realistic about the next trade and its outcome. He can now move aside the interference caused by fear and confidently deal with any future outcome.

Eliminate Self-Sabotage

Every trader has a level of comfort and familiarity with trading. To go beyond this level of comfort usually requires taking a risk. This is when fear, as an unconscious act of self-sabotage, can creep in. This fear is actually misguided self-preservation, intended to protect the trader from the fear and anxiety he may experience if he leaves his level of comfort and risks the possibility of things not going his way. A trader may fear that he would suffer embarrassment and personal devastation if he tried his best and failed. Fear as self-sabotage becomes the trader's excuse to maintain his level of comfort and the status quo. The easiest way to protect himself is not to try.

He can also self-sabotage his trading by initiating a trade that does not meet his trading strategy requirements. This way, if the trade doesn't work, he can tell himself that it wasn't his best effort because it wasn't his main strategy. He unconsciously has protected his comfort zone and his false mental perceptions.

The bottom line with self-sabotage is that the trader is linking his self-worth to trading. If the trader doesn't meet his own expectations of what being a successful trader means, his self-esteem will suffer. To avoid this blow to his ego, the trader trades carelessly, doesn't give it his all, and then uses the excuse that he didn't really fail because he wasn't really trying. This trader doesn't realize that a trading decision outcome has nothing to do with his self-worth, but is merely a profitable or unprofitable business decision.

The first step in eliminating self-sabotage is to recognize it. The trader must ask himself: Do I select trades that imply illusions of grandeur? Do I select trades with total disregard for my trading strategy? Do I feel that the trade is too much to handle and I just want to get it over with? A "yes" would indicate poor trade selection and lack of a risk management exit, both of which imply a total disregard for his trading strategy.

Secondly, the trader must re-centre himself with deep breathing and focus on the strict application of his trading strategy.

Reality Check

As a trader, if your greatest fear came true, what is the worst that can happen? Your honest answer can help you examine and deplete the energy of your fear.

Visualization

Visualization is a powerful tool that allows a trader to identify, examine, experience and de-energize a fear. It allows you to mentally envision solutions to your fears in a non-threatening way. Visualization will reduce your anxiety and prepare you if you're faced with the fear producing situation again. There are a number of visualization techniques that can assist in this process and are explored in the Visualization Section of the book.

Fear Lead Up

It is possible to stop fear before it gets started by identifying the conditions that immediately precede the fear, and by changing your reaction to the fear-producing situation.

For example, a trader has a solid, well-researched trading strategy. The trade entry and profit or loss exit is completely established before the trade is entered. However, once the trade is initiated, the trader watches every little price movement of the market. Eventually, the trader gets emotionally involved with each price move, becomes afraid, and feels a sense of urgency to exit the trade. The result is that the trader exits the trade before either its profit or loss price objective is reached. He never gave his well-researched trading strategy a chance to work for him.

The trader's lead up to fear was his watching every movement of the market. In order to de-energize his fear, he changes the fear-producing conditions: once he has entered a trade with the appropriate profit and loss orders in place, he does not continually look at that market. Instead, he periodically checks the trade. This change eliminates his anxiety associated with every price change, and gives his trade and his trading strategy an opportunity to work for him.

Trading Plan

A solid trading plan is crucial for any trading business. It provides the trader with strategies for trading in any market condition, and a solid foundation for a successful trading business. It can also protect a trader from one of the things that can destroy a trading business, or any business for that matter - the surprise event. A well-planned trading strategy, including capital allocation parameters, and defined entry, exit and risk management criteria will allow the trader to trade without fear, knowing he is prepared for any potential event.

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LEARN THE BASICS OF CANDLESTICK CHARTING

A new addition to my subscription web site www.bwts.com.au is a mini course on candlestick charting. It has all the basics and assumes you know nothing about candlestick charting when you start. There is enough there to get you up and started on using candlestick charts.

I invite you to visit www.bwts.com.au and at the bottom right of the home page click on "CONTENTS...etc" which will take you to a listing of what is on the subscription web site. All my published work is there – over 300 articles and columns and two mini courses. For a joining fee of \$33 and an annual subscription of \$55, you can read them, download them or print them out. More articles and columns are added every month

HOW I FIND INTERESTING STOCKS

Here is a recent question and answer to the Ask Colin page on my web site www.bwts.com.au. There are now over 700 questions and answers on this section of my free access web site.

Question

Many of the stocks you recommended in *Shares Weekly* or *BRW* do not seem to come from your value or growth searches. How have you chosen them?

Answer

First, let me correct something in your question. The stocks that I have discussed in *Shares Weekly* or in *BRW* are NOT RECOMMENDATIONS. It says so at the bottom of the *BRW* columns and said so in the general disclaimer in *Shares Weekly*. They can not be recommendations also because I can not know the circumstances of any specific reader, so I could not make an intelligent and relevant recommendation. They are merely interesting stocks that readers might like to consider to see whether, subject to their own further research or their adviser's recommendation, they might fit into their investment plan. So, the columns are my view of stocks that might go up or might go down (which is which is always clear from the discussion).

As far as the stocks where I held the view that there is a strong possibility of them going up are concerned, I generally use my established and published methods for selecting them. However, at the time I have the space to write about them may not be the ideal time to have bought them, because at that time I may have used the space I have in the column to discuss some other stock. I may therefore be discussing them during the mark-up phase rather than at breakout.

While there are some exceptions where I discuss a stock that has been extensively covered in recent news, I generally find the stocks to discuss in three ways:

1. The value screen. While I taught the use of a triple test based on PE ratio, AND Dividend Yield AND Price to NTA in the videotape, I have generally found more recently that PE ratio alone will find most of them, as described in the Mini Course on my subscription website. The PE ratio I use is as described in the Mini Course - i.e. related to the bond yield to allow for interest rates/inflation. However, this is not all that critical and a PE of 10 or less is a good all-purpose tool. However, although I screen only for PE ratio, I then check the dividend yield. It needs to be strong for me to proceed to the next step of considering the chart.

2. The 52-week new high in the last 5 (or even 20) days scan as described in the Mini Course. I also sometimes run a 26 week new high scan to pick up faster-moving stocks, with narrower accumulation areas or that have swung from downtrend to uptrend with little accumulation.

3. Visual inspection of charts looking for value model patterns, growth model patterns or already in strong mark-up phases.

Other useful scans are monthly MACD in buy mode and above a 260-day moving average. I use these less often than the three methods described.

This brings me to the specific stocks you mentioned. Normally, I am not able to discuss specific stocks with a particular individual. However, on the understanding that what I now say is NOT A RECOMMENDATION of any kind, but purely an explanation of how I located these stocks for discussion in the columns, I will outline briefly for you how I found these stocks:

Abbreviations: SM = *Shares* magazine. SW = *Shares Weekly*. BRW = *BRW* magazine.

SKE: (SM Apr 02 SW 16 Nov 02) Value model chart. Low PE scan and high DY. 52 week new highs scan.

IAS: (SW 16 Nov 02) 52 week new highs scan. Low PE scan with good DY. Strong mark-up phase, but no accumulation at the bottom.

NBL: (SW 23 Nov 02 BRW 6 Feb 03) Low PE scan with high DY. 52 week new high scan. Break out of accumulation pattern after listing (value model chart).

ABC: (SW 28 Apr 01 and 2 Nov 02) Value model chart. 52 week new highs scan. Low PE scan with reasonable DY.

ALN: (SW 2 Nov 02) 52 week new high scan. Low PE scan with high DY.

AJL: (SW 8 Dec 01 as down trending stock and SW 26 Oct 02) 52 week new high scan. Value model chart. It had high DY, but no earnings in the last year.

CMI: 52 week new high scan. Big value model pattern on monthly chart. Had high DY, but PE was on the high side.

As you can see, all of these stocks came up on the 52 week new high scan and often also visual inspection or the Low PE scan.

You may have noticed that of all the stocks you listed, I personally only bought one of them. The stocks I hold at any time are listed on my web site. That I hold them personally is NOT A RECOMMENDATION because I may have bought them some time ago and my investment plan may be unsuitable for a specific reader. (They are listed on my web site as an up-to-date disclosure of my holdings for anyone reading my *BRW* columns). However, it does make the point that as a journalist, I need to discuss stocks all the time. Just because I discuss them, they are not recommendations, but simply interesting stocks for readers to consider.

THE SINGING TRADER AND IQQ

Garnett Znidaric runs an excellent weekend seminar that helps new traders understand what is involved in trading and sets them on the right path to develop a comprehensive and effective trading plan. His material is also of great value to traders who have been around for a while, but are not entirely happy with their results and want to take a fresh view of trading. This article was written by Garnett. It makes some very important points about trading and gives you a taste of his material.

THE SINGING TRADER AND IQQ

Many people know me as Mr.Trading Plan. There are some with damaged hearing that refer to me as *the singing trader*. I earned that title when I sung/murdered a verse of a classic Sinatra song at the start of a presentation on applied technical analysis. Having completed the verse, to every one's delight, I thanked the audience because now I could put on my resumé that I had sung to a packed house of over 200. I then added that putting it on my resumé did not make me a singer. I then challenged the audience to think about speakers who had stood in front of them suggesting that the only way to be successful was the way being offered by the speaker.

Many in the audience started to see what I was suggesting. As some of them, and you, may be aware there are unscrupulous people out there trying to separate you from your capital by offering less than legitimate schemes for making money out of trading. Then there are those who, in good faith, supply concepts that have exceeded their "use by" date. The challenge is in sorting out the wheat from the chaff.

Looking at it from another perspective I would suggest that all ideas should be treated as chaff until you can prove otherwise. And that may be simpler than you think, though note I didn't say it would be easy.

What I want to offer is an idea drawn from the classic business book, *The E Myth* by Michael Gerber. From his insistence on developing systems and then quantifying the results I now use and advocate what I refer to as the ***Identify, Qualify and Quantify*** (IQQ) approach. In essence, what I am suggesting is that on your way to developing an accurate sense of expectancy about a particular strategy, you need to understand how and why all the various components work and interact. Because, despite what some speakers may suggest, the ideas may not work for you or for the markets in which you wish to trade or invest.

Identify the concept

Pick something you want or need to quantify such as the reliability of an indicator, a breakout, or parabolic stop or even the reliability of a particular system. Then you have to...

Qualify the components

It is most important that you accurately define what it is that you have identified as worthy of study. For example, I often challenge people to define a trend. Many find that a lot harder than they thought when I first ask the question. And some find it impossible to define when a trend does not exist. But make sure you take the time to be accurate and then having accurately qualified or defined the subject.....

Quantify the results

Count how many times the idea has worked and according to the statisticians, find at least 30 examples. In some cases it may be expedient to do the testing by computer, but I would suggest that it is better to either do the counting by hand, or visually examine the computerised results one example at a time. This is important at a number of levels. For example, if in the sample period all the results are bunched at one end, it may suggest that the idea is either working well now or only worked well in the past. And if it takes 15 years to find 30 examples, then frequency may become an issue.

Also as you go through the exercise of counting the results, you will either build confidence in the particular indicator or system or you will become more skeptical. Either way you will have a more personal understanding about the idea. According to Dan Gramza quantifying results is the basis for developing understanding, which leads to confidence and that leads to comfort while trading.

Another point Dan Gramza suggests is to look at what happens when an indicator fails. Sometimes this can have more profitable results than using the idea the way it was intended, but you will never know if you don't have a look yourself and quantify the results.

Garnett Znidaric is a private trader who has traded equities and futures and currently manages his own Super Fund and an equity trading account. As ACT State President of the ATAA he found that many people lacked basic knowledge, or had forgotten what they had learned. He therefore developed a two day workshop designed to help people either discover for the first time or rediscover the principles on which sound trading systems are developed.

Three of these workshops are planned for the first half of this year. If you are interested contact Garnett at garnett@tradingplan.com.au or (02) 6254 5023

Sydney 26 - 27 April
Melbourne 24-25 May
Brisbane 21-22 June

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, about a month later, 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. Common reasons for failure to receive a Newsletter are:

Readers change address and don't tell me.

The reader's mailbox is full (over quota) - especially Hotmail.

The reader has failed to keep their Hotmail or similar account active.

The reader has not allowed my messages through their anti-spam blockers.

The reader's ISP is using anti-spam blockers that stop legitimate messages as well as spam.

Regrettably, I do not have time to individually 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, using an address that does not have anti-spam blockers on it. Thanks

Important Information

The newsletter is intended to be a forum for discussion of interesting ideas about technical analysis, trading and investment. It is primarily educational in nature. I have taken reasonable care in its preparation. Nevertheless, everything in it should be read as my opinion, unless otherwise stated, and requires the reader to check the accuracy of facts and test the validity of my opinions before acting upon them. My opinions are not intended to be recommendations to trade or invest in any stock or financial security. Nor are they intended to be recommendations to use any particular trading or investment method. Readers who do not have the ability to assess the relevance to them of any matter discussed in the newsletter should consult a competent and licensed adviser before acting upon them. I am not a licensed adviser.