

## Colin Nicholson's Newsletter 37

11 May 2004

*This is a complimentary email newsletter for people interested in investment and trading.*

*I do not allow anyone to use my list of email addresses.*

*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](mailto: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.*

### Market Confidence

#### Question

In early 2004 you increased your portfolio holdings significantly. Does this indicate increased confidence in the market?

#### Answer

I try not to take a view on the future of the market. You will already be aware that I never try to predict the market. Instead, I try to assess the condition of the market, by which I mean the level of risk, and adjust my strategy accordingly.

My strategy calls for initial investment when I think we are seeing distress selling and then buying strong stocks, which means stocks trending up and making new highs. That came in late 2002 and early 2003.

The second stage of buying is when the Coppock indicator signal comes and then continuing to buy strong stocks. That came in 2003.

The third expansion of holdings is when the index starts trending. That came progressively in 2003.

The final buying campaign is once the market survives a significant correction. That came at the end of 2003 to early 2004.

You should have been able to see that process in my portfolio changes. However, something has complicated it that is really outside my investment plan. That is a significant addition to my investment capital, resulting from a switch in the second half of 2003 of funds that were previously managed in a different way. This was not entirely easy to quickly integrate into the plan. In particular, there was a decision about what to do about existing positions that had already run a long way from initial entry, but which should theoretically have been larger under the new capital total. In some cases, I decided not to increase them, but to go into other stocks instead. Hence, my portfolio currently has more stocks than usual in it.

The other problem was that since my capital had increased significantly, I needed to take much larger positions. Although this is easy to grasp intellectually, it is not so easy emotionally and I have been feeling my way to the greater allocations indicated by the plan (Dr Elder teaches this as 'size does count'). I am getting there, but it has been something of a mind game. This has also meant that I have more stocks in my portfolio than the plan indicates.

One thing you should take away from this is that everyone's situation is different and it can change over time. It requires a lot of courage sometimes to make changes and there realistically should be a period of adjustment. My portfolio is on my web site to meet statutory requirements for disclosure. It can be used as a kind of case study, but it must always be borne in mind that what I do is aimed at my situation, not all of which may be known to an observer.

## Limited Time Offer

Neil Costa is selling his videotape set *Mastering the Markets* for a special price of \$350 including GST for orders received up to 30 June 2004. The same deal applies to orders placed with me. After June 30, they will revert to the normal price of \$440. Why not invest some of your current year bull market profits into this excellent educational series and let the tax deduction help pay for it? What Neil's videotapes cover is on [www.bwts.com.au](http://www.bwts.com.au). While you are there, you may order online, or phone me on 02 9436 1610.

## Non-Performing Investments

### Question

If you take a position according to your investment plan and it fails to move, when do you give up on it?

### Answer

This is not an entirely straight forward situation to answer. In other words, it all depends.

In the last year, I have been building my portfolio as the bull market has unfolded. While it might be argued that I would have made more profits by moving in much faster, there is a large element of hindsight in that suggestion. Bull and bear market trends unfold slowly month by month. In the early stages of a bull market the risk is higher than once we have seen a few peaks and troughs and there is more certainty that it is a bull move and not just a bear market rally. So, I will increase my holdings progressively as the evidence mounts that the trend has changed and the risk is therefore gradually reduced.

In this building phase, I will give a non-performing stock plenty of room while it stays above its stop-loss level. It is always the case that all stocks do not move up together. Some companies will go very quiet for months and then spurt upward in a short period. Transaction costs and tax considerations have to be considered and in general I give them time to work out.

However, when the portfolio process is finished and I am fully invested, my attitude has to change a little bit. Not a lot, but a bit. If I see a good stock that is moving up well, the only way I can buy it is to sell something I hold. The question is what to sell? I sell the ones that have not yet performed.

It is important to understand what I mean by not yet performed. I mean a stock that I bought and has never gone much higher. I would sell this stock before I sold one that had gone up quite a lot, but was now not going far very fast. There is plenty of room for argument about this one way or the other and I don't think I am any more right than someone who makes a different judgement. My view is based on the idea of letting your profits run. So I sell the ones with little or no profit, rather than the ones where I already have a profit to let run.

## Psychology Seminar

Dan Gramza is presenting his two-day seminar *Trading in the Eye of the Storm* on the weekend on 22-23 May in Melbourne. Last year Dan presented this seminar for the first time in Australia in Brisbane and I flew up there to catch it. If you feel that you are well on the way to mastering the analysis side of trading and investing, don't miss this opportunity to tap into practical ideas on how to deal with the all-important aspect of managing your self as well as your money. For details, phone Paul Ash at Peter G Moloney & Associates on 03 9629 4233 or email me at [colin@bwts.com.au](mailto:colin@bwts.com.au) for the brochure.

## Equis Gets it Wrong

### Question

In your article on *Directional Movement*, you explain the extreme point rule differently to the Equis website. Who is right?

### Answer

This is what Welles Wilder says in *New Concepts in Technical Trading Systems*:

(page 47): "The system itself is extremely simple. When +DI crosses above -DI, a long position is taken. The position is reversed [stopped out] when -DI crosses above +DI....."

.....There is one more rule in following the Directional Movement System, and that is the **Extreme Point Rule**.

If you are *Long* the reverse point [stop loss point] is the **low** made on the day of crossing. If you are *Short* the reverse point [stop loss point] is the **high** made on the day of crossing. Stay with this point, if not stopped out, even if the indexes [+DI and -DI] stay crossed contrary to your position for several days."

The square brackets are mine. The italics and bolding are Welles Wilder's.

In my article, I interpreted the extreme point rule as:

"The extreme point on the day the DI lines cross should be used as a stop loss level even if the DI lines cross against your position for several days. The extreme point if +DI rises above -DI is the low of the day of the crossing. The extreme point if -DI rises above +DI is the high of the day of the crossing."

(The article was published on my subscription website, in the *ATAA Journal* and the same text is in the Securities Institute subject notes for *E114 Technical Analysis*).

I think that I fairly faithfully reported Welles Wilder.

Equis says at [www.equis.com](http://www.equis.com) :

"The basic Directional Movement trading system involves comparing the 14-day +DI ("Directional Indicator") and the 14-day -DI. This can be done by plotting the two indicators on top of each other or by subtracting the +DI from the -DI. Wilder suggests buying when the +DI rises above the -DI and selling when the +DI falls below the -DI.

Wilder qualifies these simple trading rules with the "extreme point rule." This rule is designed to prevent whipsaws and reduce the number of trades. The extreme point rule requires that on the day that the +DI and -DI cross, you note the "extreme point." When the +DI rises above the -DI, the extreme price is the high price on the day the lines cross. When the +DI falls below the -DI, the extreme price is the low price on the day the lines cross.

The extreme point is then used as a trigger point at which you should implement the trade. For example, after receiving a buy signal (the +DI rose above the -DI), you should then wait until the security's price rises above the extreme point (the high price on the day that the +DI and -DI lines crossed) before buying. If the price fails to rise above the extreme point, you should continue to hold your short position."

I think Equis have got it wrong.

## Equity Question

What Equity figure should I use in calculating Return on Equity?

### Answer

I would use Total Equity. This will be contributed equity plus retained profits, plus reserves. I would not include any minority interest, because you generally do not include profit attributable to outside interests in the other half of the ratio.

## Why no Blue Chips? Question

Your portfolio does not seem to have any blue chip stocks. Why not?

### Answer

Your question begs another question, which is what a blue chip stock is. There is already an answer to this question on the Ask Colin pages of my web site. This says that it is an imprecise definition but generally blue chip stocks are large, as measured by market capitalisation, and have long established businesses.

If we take the top 100 stocks by capitalisation on the ASX, I hold, or have held, a few of them:

I currently hold Tabcorp, which is No 38.

I held Amcor earlier in the year, which is No 28.

I held AGL earlier in the year, which is No 35.

I have also held a few others in recent years, like Boral and Paperlinx.

These capitalisations relate to 5 March 2004.

Of course, your definition of "blue chip" might not include these stocks.

Having clarified this, my investment plan is to focus primarily on second rank industrial shares. This generally means companies between No 100 and No 500 in capitalisation. I will also buy smaller companies from time to time, and I hold a few now. I will also buy larger companies and hold one now. I will also buy producing miners from time to time, but do not hold one now.

My reasoning is that it is more likely for a smaller company to double or triple in size or price in a short time, but more difficult for a large company. Of course it works the other way too: they can go down in price more and more quickly than large companies. So, I am taking more risk in that part of my investment plan. It is one reason why the working title of my book is **The Aggressive Investor**. It also explains why some people think my investment plan is quite conservative and risk-averse in other areas. There are several types of risk and if you take greater risk in one area, it may be prudent to take less risk in another.

## Why Didn't You Sell?

### Question

I notice you have held Noni B (NBL) since February 2003. Why did you not sell in October or November 2003?

### Answer

My investment plan is basically to hold while an uptrend is intact. The definition of an uptrend gives me three selling signals as explained in **Shares Charting Guide No 2** for Dow Theory. This is also in my videotape and will find its way into my book when I get to tactics.

Basically, the three sell signals are:

1. Price falls below the last major trough in the uptrend
2. Price makes a clear lower peak and falls below the trough between the lower peak and the last higher peak.
3. Price breaks downward below a significant trading range that is large enough to be a reversal pattern.

I am attaching a chart in a pdf file, which shows how I have defined the trend. It is not attached to the newsletter. Please go to the question on the Ask Colin page of [www.bwts.com.au](http://www.bwts.com.au) under the keyword **Trading Plan**

I can see why you may have been inclined to sell in October, but I don't think the trading range was unusually large compared to previous ones in the trend. So, I did not see a sell signal there.

I can also see why you may have been inclined to sell in November, but I don't think the lower peak there was of the same order of the peaks and troughs in the trend so far and it was just a minor rally in the correction from the last peak.

The rules are clear. It is the interpretation of the chart that is the tricky part sometimes. Most of that is experience. However, in this case the weekly chart gave a good perspective on a trading range that may have otherwise looked quite large on a daily chart.

## Importing ASCII Files to Excel - Update

In Newsletter No 35, I gave the steps to import an ASCII file from the Data Files page of my website to Excel. It has been brought to my notice that the first column (date) is tidier if specified as text. The revised instructions are as follows:

In Excel 2002 (XP) you do this:

Data

Import External Data

Import Data

Browse to the folder you have saved the ASCII file into

Set Files of Type to All Files

Double click on the ASCII file

Next

Next

Tick Text for Column A. Leave the other columns as General.

Finish

OK

If it is one of the advance-decline files (asxad or nysead), or the New High-New Low file (asxhl), you will need to construct an additional column accumulating the ADV-DECL column before you plot the chart.

## Reporting Dates

### Question

How can I find when a company will announce its results without watching the news reports for the 75 days of the reporting season?

### Answer

Most companies have a financial calendar. In many cases it is on their web site. For example, I went to [www.asx.com.au](http://www.asx.com.au), went to company information for Hills Industries (picked at random) and clicked on the link to their web site. Clicked on Corporate Information and then on Financial calendar and there were the dates.

If you cannot find the dates on their web site, you can contact the company and ask if the date has been determined.

Some broker web sites enable you to set up a list so that you are alerted if there is any news on a company. This might be useful if you only know an approximate date.

Sometimes the media will have done some of this work for you. The Australian Financial Review often indicates the expected results announcement for the next week for major companies. However, they do not generally cover smaller companies.

## No Magic Formula

### Question

How do I avoid being shaken out when good stocks suffer sharp falls and then recover?

### Answer

You mention in your extended question the situation on Fleetwood in late January 2004, where it seems that a small fall triggered stop-loss orders at progressively lower levels. As you say, the sellers were in error, because the stock recovered soon after and went much higher on good news. You suggested that it could have been someone trying to buy cheaply by triggering stop-loss orders.

This last idea is not illegal or unethical. The most memorable example was Baron Rothschild in 1815, when he had advance information on the defeat of Napoleon at Waterloo. He knew that would send British Consols higher once others knew. He was also aware that others might suspect he had advance knowledge. So he started selling. When everyone had seen him selling and started doing the same, he switched to buying and made a killing. It would still be legal today, so long as he was not using information he obtained as an insider. This is done every day in the markets today as professionals "run the stops". They guess where they are and go after them.

The key point about Fleetwood and stocks like it is that it is thinly traded. It is simply an unsuitable market to use stop-loss orders on unless you are prepared to accept potentially large slippage (the difference between your stop-loss and the best bid). It would be much better to use some of the alert services to tell you that your stock had hit your stop and you then manage the stop yourself. In such a disorderly market, you may have let the dust settle first. So, it is up to the investors concerned. There is no law against ignorance or stupidity. If they use these stop orders in an inappropriate market, they are going to get punished until they learn.

As for how you can know whether to sell or not in these situations, there is no magic formula. You have your investment or trading plan and you should follow it. My own approach in these situations is that if I get shaken out and have to climb back in again later, the brokerage and slippage costs are a kind of insurance policy against catastrophic loss. The name of the game is to limit losses, but let profits run.

Looking at the lessons from the Fleetwood situation, on my investment plan, I should have sold on the spike down, or on the next day, if I had not known what was happening during that day. I did not own Fleetwood, so I can only comment with hindsight, which you have every right to suspect. If I was watching it during the day, I think I might have sold near the low (unless I considered the market was disorderly on low volume and waited). However, there was no reason from the preceding days to cause me to think it was anywhere near my stop, so I believe I would not have

seen the situation until the next morning. Then, I may not have sold, because Fleetwood has spiked down so far and then closed right up where it was before. I think I might have monitored the next day or so. It then traded lower for several days and although it eventually turned around above my stop, I think I would have sold it on what I saw as confirmation of the original signal.

My investment plan calls for me to act on lows, so this is why I say that. However, others have a different plan that calls for action only on closes. If that had been my plan, then I would not have sold Fleetwood. Does that mean I should change my plan? No, because one example proves nothing.

There were other crutches you could have leaned on. For example, volume was not unusually high on that day. The long-term trend line was only touched, not broken and definitely it did not close below the trend line. It was above the 260-day moving average even at the low of the day. And so on. None of these are my plan, but they may be someone else's. These things may have saved them from selling here, but on another occasion, my plan would work the other way versus theirs.

In the final analysis, this question does not worry me much. If I had sold Fleetwood on the days after the spike down, I would have bought back on the new high. I did exactly that in Integrated Group this year. No matter what your plan, these things will happen sometimes. It is part of the game that there is no single tool that works perfectly all the time. The best we can do is to find tools that give us an edge. The rest is money management and controlling losses.

## Total Risk

### Question

Dr Elder risks a maximum of 6% on all of his positions at one time. What is your total risk in the various market phases?

### Answer

The answer to this is quite complicated, because you cannot make a simple comparison to Dr Elder's method and mine. The problem is that in my investment plan, everything is connected to everything else. There are several risks that have to be managed and there are various ways I do that. You cannot easily consider one area of the plan without understanding the total picture. It is all in my videotape and the book I am publishing progressively on my subscription web site. However, here is a direct answer to the specific question you ask.

Dr Elder risks up to 2% of his total capital on any one trade. He then risks a total of 6% at any one time on all of his positions in any month. If he has risked 2% on three trades, the only way he can take another trade is if he closes one of the trades out or he is able to move the stop on one or more of the trades so that the risk is less than 2%.

I have no maximum risk percentage that is equivalent to Dr Elder's 6% per month. I distinguish between market risk and specific risk. Market risk is managed by what proportion of my capital I will invest in a particular market phase. Basically I will be fully invested when the risk is low at the start of a bull market, reduce it when the bull market is getting overheated and the risk is high and maybe even right out of the market if there is a bear phase. This looks after market risk.

I look after specific risk much as Dr Elder does, by limiting my position size. However, I also employ the standard method of diversification, which Dr Elder does not do explicitly. So, I aim for about 15 to 20 positions when fully invested and limit risk on any one to 1% (usually 0.5% or less when I first start building the position). I do not monitor total risk after the trades are open in a rule-driven way. You can see that I might have a total risk of 20% or more if fully invested and early in a bull market. However, this is unlikely, because to have built full positions, I will usually have been able to reduce the amount risked. A total risk of maybe 10% might be more realistic. However, it does depend on how each bull market campaign unfolds.

## **New High-New Low and Advance-Divide**

I recently had this interesting email from a subscriber:

Subscriber: For the last four years I have building a data series in Excel of the Rolling year Records in the AFR. I count the Highs, count the lows, get the plus or minus difference and build a cumulative index. It gives a very definite upturn or downturn at the end of bull and bear runs, and seems simpler to interpret than the Advance-Divide. I am writing to suggest that your book should at least mention this index. But maybe you have found it wanting and do not want to mislead the reader.

To which I replied: Thank you for your insightful comments on the New High-New Low line, about which there is some material already on my free and subscription websites, including a bit more historical data than you have on the Data Files page, which you may care to download.

One of the problems I faced in originally writing down my investment plan was that it had grown up intuitively over many years. I actually had trouble determining exactly what I did. More importantly, I found it difficult to distinguish between the critical elements and what were only peripheral issues. This is difficult, because hindsight and specific situations sometimes trick us into thinking that a peripheral issue is more important than it is in reality.

You will be interested to know that I have been working over the last few days on the market risk section of my book. I have been agonising for some months over whether the Advance-Divide line is really that important in the way I run my strategy. It has been really difficult to find true perspective on it, especially when it seems to be giving a clear, though perhaps very early, signal recently (these words could come back to haunt me). I eventually made the decision to remove the Advance-Divide line from my market risk strategy. I now feel that the signals are not sufficiently consistent and the timing is quite a difficulty, so that I am always pulled to doubt them. So, the reality is that I am not acting on them, but on the other signals on the index charts themselves. The critical point for me was when I said to myself: "suppose you did not have the Advance-Divide line, would your decisions be hampered or different?" The answer is no, so out it went. That does not mean I will not look at it, but it will not be driving my strategy in any significant way, just maybe reinforcing other signals.

This brings me to the New High-New Low line. You are correct in saying that it gives quite good signals. They are much more unequivocal than the Advance-Divide line. However, close examination of the charts back as far as I have data shows that it is a lagging indicator. By the time we can be sure that it has turned, the markets are

already giving us signals. So, to me it is a useful confirmation, but not the key indication that I would make my decisions on.

Nevertheless, I will continue to track it and reassess it as more evidence comes in. You never know, I may find one day that I am relying on it more than I used to and that it becomes an important part of my plan. An investment plan is not cast in stone and never to be revised. Rather, it is a work-in-progress and if we stop learning we start to go backwards.

## Alinta – A Complex Situation

### Question

What strategy do you adopt when companies make heavily discounted share issues as happened with Alinta (ALN) recently?

### Answer

There is no general strategy. Every situation has to be considered on its merits. However, as far as taking action based on the chart is concerned, it is most important that the chart be properly adjusted for the share issue. I discussed the general issue of adjusting the chart for various events in Newsletter 31, which is available on my free access web site [www.bwts.com.au](http://www.bwts.com.au).

The Alinta situation was quite complex to unravel. There were four important events that took place:

1. A trading halt on 15 and 16 March, while a major acquisition and its funding was announced.
2. Alinta went ex a 21c dividend on 16 March (during the trading halt).
3. Alinta placed 29 million shares with institutions at \$6.75 during the trading halt.
4. Alinta announced a 3 for 7 rights issue at \$5.50 effective 19 March, two days after the trading halt.

All of this information is readily available on [www.asx.com.au](http://www.asx.com.au).

Working out what the Alinta price ought to be following these events is a simple exercise in logic:

Alinta last traded on Friday 12 March at \$7.66.

The theoretical effect of the placement is calculated by taking the capitalisation before the placement, adding the funds from the placement and dividing by the new number of shares. In this case, the calculation is:  $((168 \times 7.66) + (29 \times 6.75)) / (168 + 29) = 7.53$ . In longhand: 168 million shares times market price of \$7.66 plus 29 million new shares times their issue price of \$6.75 all divided by the number of shares after the placement.

So, Alinta should have traded at \$7.53 after the placement. This is a very small change and well within normal market fluctuation. Generally, a chartist would not have adjusted their chart for this.

However, before Alinta could trade after the placement, it also went ex a dividend. So, the price Alinta could be expected to trade after the trading halt was  $\$7.53 - 0.21 = \$7.32$ . Some chartists adjust their charts for dividends. However, most do

not. Nevertheless, the payment of a dividend is something a chart user should always be aware of. The information is readily available on [www.asx.com.au](http://www.asx.com.au) and most broker websites and elsewhere, like the Australian Financial Review on a Monday.

In fact, Alinta can back on the market on 17 March at \$6.89. This suggests that the market had repriced the expanded Alinta as well as simply adjusting the price. This repricing should be dealt with the same way as any other news event that affects a share - if it triggers a stop-loss situation, you should act on it.

The rights issue was quite straight forward and the market made that adjustment quite efficiently, leaving very little gap on the adjusted chart. The method of calculating the theoretical price after the rights issue was dealt with in Newsletter No 31. Most charting software should have made this adjustment for you.

In conclusion, it seems to me that the Alinta situation was complex, but easy enough to work through. The market acted adversely to the acquisition. The drop in price after the trading halt, which was well in excess of what was warranted by the dilution caused by the placement made at a discount and the payment of the dividend suggests that the market believed that the expanded Alinta would not earn as well as the old Alinta. Such an announcement is really no different to a profit downgrade and would be treated the same way. That is, if it took the price below the failure point for your trading or investment strategy, you should cut losses immediately.

### **Past Issues of the Newsletter**

*Past issues of the email newsletter are available for downloading from my free access web site [www.bwts.com.au](http://www.bwts.com.au). 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 addresses for you in my list. I try to avoid duplications. 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 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. 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.*

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