

Colin Nicholson's Newsletter 39

10 July 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 to add their address to the list. My only proviso is that the newsletter be sent in full and unchanged.

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

You will be surprised to receive another newsletter so soon after the last one. However, there were some long gaps between newsletters earlier this year while I was travelling and then very busy. Indeed, I got so far behind emailed questions to the *Ask Colin* page on my website that I found myself answering January emails in late June. I am gradually catching up on the backlog, which is now down to 60 from over 100. Those readers still awaiting a reply: please be patient.

The result of my catching up with the backlog is that I have a lot of material for another newsletter quite soon, so I hope it will make up for lost ground in the first half of the year.

What Did I Do Wrong?

Note: This item refers to some charts. I am unable so far to find a way to put charts in the newsletter. However, the answer will be quite understandable without the charts. The full answer will go up on my website at the end of July 2004 and will include the charts in a pdf file.

Question

In December 2003, I bought Ammtec (AEC) at \$1.56. It climbed to \$1.85, but then fell through my stop. Can you give me some pointers?

Answer

Your full question was:

- *In December 2003, I bought Ammtec (AEC) at \$1.56.*
- *I watched it climb to \$1.85, keeping a close watch on the Depth.*
- *At the start of January 20 2004 there were only three sell orders, which ranged from \$1.85 to \$2.00.*
- *However, I found at the end of the day that AEC had fallen to \$1.72 - through my (theoretical) 2 times Average True Range (ATR) stop-loss level of \$1.77.*
- *I do wonder about the psychology of that day.*
- *Where did all these sellers come from and why?*
- *You also had AEC in your portfolio. Why didn't you sell it in September or December when it lost a lot of ground?*
- *Or alternatively what stop loss method you use?*

- *I don't want to be in and out of stock unnecessarily but the mantra of "protect your capital" is one that is repeated incessantly in various publications.*
- *I am about to start investing more actively and this is my biggest bugbear. Can you give me some pointers?*

Answer

The first thing you need to appreciate is that there will often be more participants in a market than are shown on the Depth screen.

There can be undisclosed quantities. Sellers may also only offer a part of what they have to sell. When it goes, they offer another lot. This is simple tactics of not showing all of your hand to the buyers, because if buyers know there is a large seller hanging over the market, they will not be as keen to bid the price up. They may even hang back hoping the large seller will lose patience.

There is also no rule that says a seller has to put his or her offer on the screen. They may simply watch until there is a bid from a buyer at an attractive price and hit it with a sell order. This seems from my experience to be quite common.

The market can also comprise many people who act at different times. A common experience is that you put your buy order in the market then look an hour later and find many transactions took place above your bid, but below the best offer when you placed your order.

The market is a very fluid place. Information comes out all the time. Rumours fly around the place. I checked the ASX site for announcements by the company, but there were none. However, there may have been an article in the financial media somewhere that came out that day. Alternatively, there may have been some news about the industry or a competitor or a major client that caused some shareholders to alter their view.

There are myriad other reasons why someone might need to sell on that day: Winding up a deceased estate or raising the deposit for a mortgage etc. So the sellers that came in on that day could have come from anywhere and for any reason, related to their opinion about the stock or totally unrelated, rationally or quite emotional.

The psychology of the day is a little easier to identify from the information available to a technical analyst. I do not have intra-day data for that day now, but looking at the candlestick chart below there are some things we can say about it.

The day you are talking about was the big black candle in the centre of the chart. The market had been rising and closed the day before on its high. Sometime after you looked a seller came in at \$1.84. Sellers drove the price down all day. They were clearly very keen or very frightened. They were still this way at the end of the day, because it closed on the low of \$1.73.

There is another possibility. There may have been automatic stop-loss orders in the market which were triggered at some point. Their limit might have been lower, so the stock was sold lower. This might have triggered other stop-loss orders and so on. If those stop-loss orders cleaned out all the buyers, then it could close on the low. This is no different to what I described in the previous paragraph. The sellers were still keen or frightened; they just made their decisions beforehand in the form of a

stop-loss order. They may have not thought through the implications of their stop-loss level and limit in a thinly traded stock. However, there are no rules that say everyone in the market has to be smart or rational.

In fact it seems there were still sellers around the next day, which opened lower and sold off further before finding buyers at \$1.66.

You placed your stop at 2 times the Average True Range. I am not enamoured of this method, but it has a certain logic to it in that you exit is there is a larger than normal day against your trade. Let me examine it for a moment. The first thing is that you did not say which ATR you used. There are many of them depending on the period you choose to calculate the ATR for. Not did you tell me the time from for your investment, which might let me comment on how appropriate your choice of ATR was.

The chart below takes us back to the start of September. The very first thing to strike me is how inappropriate ATR appears to be for such a thinly traded stock. Even quite a long period for the ATR would probably have taken you out, because the ranges were quite small from the end of November through to your fateful day. However, prior to that there were some large range days, some being as big, or bigger, than the day that threw you out of the trade.

My first question then is how much back-testing had you done on this stock or other similar stocks before deciding that the period you used for the ATR was appropriate for a stock of this character and likewise for two times ATR. Maybe you should have used more than two times ATR for this sort of stock. Then again, maybe ATR is simply not a good method for thinly traded stocks. That would be my view from all my experience. Remember averages are tricky things, as evidenced by the apocryphal news story about the man who drowned in a river with an average depth of ten centimetres.

Now, to your question of why I did not sell AEC in September or December. The simple answer is that it did not hit my protect-profit stop level. You anticipated that answer by asking where my stop was. The next chart shows where my stops were at the two times you mentioned. As explained in my video *Building Wealth through Shares*, which may be purchased from my website, I move protect-profit stops up, when a new high is made, to just under the last trough in the uptrend.

However, this is not the only way to set stops and I would not even claim that it is the best way. It will depend on the other elements in your investment plan. As explained in *Building Wealth through Shares*, it is logically consistent with my plan, which is to exploit an uptrend.

Finally, you comment that you do not want to be in and out too often. This does not seem to me to be consistent with a stop-loss that was as close as you had it unless you had extensive testing behind it that said it worked well in this stock and stocks of a similar character. If that was the case, then you should be pleased that the stop took you out, because that was your plan.

Without meaning to be uncharitable, though, I wonder whether you are like many other beginners and do not have a clear plan and/or have not tested it extensively. If you have a clear plan and the expected happens, then I don't see a problem. Every

method will give some inappropriate signals when something unusual happens. That is part of the game. Exit rules are there to protect your capital.

If you have a plan and the unexpected happens too often then you need to re-examine the plan. Note though that this does not mean that an exit signal did not capture the whole trend. Investing is not an exact science, it is an art. There is no such concept as perfection. The name of the game is to make a satisfactory result over a period of time. One imperfect trade proves nothing really.

I hope this helps.

Building Wealth through Shares now on DVD

My Videotape seminar *Building Wealth through Shares* has now been transferred to DVD. It is on three DVDs and is accompanied by a CD that contains the 148 pages of notes for the seminar and a series of update articles. The videotape version remains on sale, so you have a choice of format. The price for both is the same: \$440 including postage and GST. Order online at my website www.bwts.com.au, download the order from the website and post or fax it, or telephone me on 02 9436 1610.

Several people who have bought the videotape version have expressed interest in upgrading to DVD. Previous purchasers of the videotape version may buy the DVD version at a special price of \$195 until 30 September 2004. The website is not set up for this special offer, so please phone me on 02 9436 1610 or email me your phone number and I will call you.

Coppock Indicator

Question

Am I right in saying that the Coppock indicator is a form of body language for the markets? Not always right, but it does give you a good hint?

Answer

The way you have put it is interesting. The Coppock indicator is a long term momentum oscillator. In general terms, when the market rises, it will rise and when the market falls it will fall. The slope of the line is a reflection of the speed with which the market rises and falls. Before a market changes direction, it will usually show a slowing in its momentum, so the indicator will flatten out and then turn. A "crash" or a panic sell off followed by a very fast recovery may be the only exceptions.

The Coppock tends to be asymmetrical in that it gives better buy signals than sell signals. Coppock seemed to be saying that this was due to the nature of the markets. Bull markets tend to be longer and rise gradually, whereas bear markets tend to be shorter and steeper. So, the indicator will tend to fall steadily and then rise, but with many twists and turns. This is why it seems to be good for the buying decision, but not so good for selling.

This is brought out in recent experience. We had a longer than usual bear market in the US and Japan. Their Coppock indicators gave several inappropriate signals well before the bottom. In Australia, where the bear market was different, the indicator was a better instrument, but we may have just been lucky. The Australian bear market was unusual in that it fell sharply, and without giving a Coppock signal,

rallied back to all-time highs. Then it fell again and this time did give a buy signal on the Coppock. That has been followed by a rise to new all-time highs.

The Coppock indicator has a very good record of indicating when we are somewhere near the bottom of bear markets. It will rarely pick the exact month. Sometimes it will be early and sometimes it will be late. Also, from time to time it will give an inappropriate signal. That is the nature of the indicator, which is essentially a long term momentum oscillator. It should be used only as one element in the decision process. Coppock only claimed for it that it signaled a time to look for stocks to accumulate for long term investment. The important proviso he made was to look to buy stocks making new highs. If there were none around, the signal may well be early or inappropriate.

Using the downturns in a momentum oscillator in an uptrend as a sell signal is not a good strategy for an investor. It can be useful for traders to take profits. Coppock did not advocate its use as a sell signal. I don't use it that way either. I find that analysis of the market trend is more rewarding combined with firm action on failure of the trend on each individual stock.

Question

Is there a website where I can see the Coppock indicator for Australia and the US?

Answer

I do not know of a website where you can see it. However, I put the complete historical spreadsheet file up on the *Data Files* page of my website www.bwts.com.au at the end of every month. It is quite easy to download this and chart it in Excel. However, you do not need to chart it. There is only one calculation point each month and what you need to know is easily seen from the last column of the spreadsheet without plotting it in a chart.

Trend Trading

Question

Although I am trying to trade a big trend, I find it difficult to sit through corrections of up to 25% because there is no support level at a higher price at which to set my stop-loss level. Any comments?

Answer

This is the most difficult thing in trend trading: There is an extremely strong upswing in the trend that leaves the last trough in the trend well behind. I think there are a number of way this can be dealt with:

1. Accept that this is a part of trend trading and learn to develop the discipline. It might help if you invest smaller amounts in each stock until you get used to it.
2. My approach is to take profits progressively. I take half of my position off each time a stock doubles, but there is nothing to stop you having a different rule for taking some profits. I find that taking some money off the table locks in some profits and also makes it easier psychologically to let the rest run.
3. Maybe it will always be too hard for you to sit through the corrections. There is nothing to say that you cannot have a plan to take profits when a trend is well

extended on the upside and buy back again either when the correction seems to be over or when the trend makes a new high.

I hope one of these makes sense to you or feels right for you.

Special Offer on Audiobook

In Newsletter No 24 I reviewed Dr Alexander Elder's Book *Come into My Trading Room* under the heading *The Most Important Book Ever Written on Trading*.

We are all short of time to sit and read books. However, many of us spend countless hours behind the wheel of a car. Why not listen to this great book while you drive? Dr Elder has a special price until July 14 2004 on the complete recording of *Come into My Trading Room* on CDs or cassettes, read from cover to cover by Dr Elder himself. 10% off between now and July 14. Audiobook on 12 CDs normally \$US119, now \$US107; on 6 cassettes normally \$US99, now \$US89. Prices do not include shipping, but Dr Elder will send them at the special airmail rate of \$US5 for readers of my newsletter if you ask for it when you order. The best way for Australian readers to order using a credit card is by fax to +1 718 639 8889, or phone during New York working hours on +1 718 507 1033. For more information and to hear the Introduction, go to www.elder.com.

Discussion on Market Indices

Question

You say that over time most indices have risen and therefore the long term trend is up. However, this is not the case with the majority of individual stocks, I think?

Answer

The main reason most indices rise in the long term is that they measure prices in current dollars. Inflation almost guarantees that the index will rise longer term.

However, the real index may in fact fall when the nominal index is flat or rising. Robert Shiller in *Irrational Exuberance*, showed that the real US S&P 500 index fell through most of the high inflation 1970s even though the nominal index went essentially sideways.

The other reason relates to the changing composition of the indices, which you have asked about, and I will address, in a separate question.

You are correct that individual stocks can move quite differently to the index. It seems that the old Wall Street Adage that all boats rise and fall with the tide is true from my observation. However, I have also noticed that there are always some that fall in rising markets and a few that continue to rise in a falling market. An important observation that I have made and spoken about twice in recent years at Australian Technical Analysis Association conferences is that quite a few stocks that rise in a bull market rise far more than the index. This I see is the promise in my approach which is to find the best stocks and focus the portfolio on them, in order to beat the index.

The converse is that we should aim to avoid the ones that fall or make no appreciable progress in a bull market.

The point about markets rising in the long term is part of my reasoning behind having a focus on buying for capital gain in bull markets and not short-selling in bear markets. In the big picture, my approach is trading with the long-term trend.

Question

Because underperforming stocks are replaced from time to time by stronger stocks, do the indices give a full picture of the how the market is performing?

Answer

This is a contributing reason why indices rise over the long term. There are several reasons for replacing stocks in the index:

Firstly, companies are taken over or merge. They disappear and need to be replaced with another company.

Secondly, companies go through a life cycle of growth, maturity and decline. Sometimes this is due to the life cycle of their industry. So, industries can die and new ones are born. If the dying companies are not removed from time to time and the new industries included, then the index would cease to represent the market.

Thirdly, indices are not created to measure the market as a primary purpose. They are created for funds managers to use as a benchmark. So, certain companies are excluded and parts of other companies are excluded because there is not enough shares being traded for fund managers to have them in their portfolios. There are also other artificial or arbitrary exclusions like the recent S&P announcement that News Corp. could not be in both the Australian and Us indices and would be dropped from the Australian indices if it was included in the US indices at some point.

Indices were originally created to measure the market in the days before computers and even calculators. That was the origin of the Dow Jones Industrial Average and all its modern counterparts. This purpose has now been subsumed into the benchmarking objective, which makes them a little less valuable to technical analysts.

My own view is that computers now allow us to measure the whole market. We do not need to use a sampling method, if we can easily measure the whole. It would be possible for the ASX and/or S&P to calculate the total value (capitalisation) of the market in real time. The only reason this is not happening, I feel, is because technical analysts are not the prime client base. While institutions are paying for the indices, they will get what they want. He who pays the piper calls the tune as always.

Question

Since the downward bias in the Advance-Decline line indicates more stocks fall over time than rise, how can you support your strategy of investing only on the long side, based on the index rising over the long term?

Answer

I needed to abbreviate your question for the web site. Your full question was:

The Advance-Divide line has a negative bias (which you have previously pointed out). This is saying that, over time, more stocks go down than up (unless I have missed something). The last few months highlight this. Since the first Advance-Divide divergence appeared, significantly more stocks have gone down than up although the All Ordinaries index continued to rise. Perhaps the majority of fundamentally sound companies, which start trending up, continue to trend up, but that is different to using the indices to support your reasoning for trading the long side. Your comment would be most welcome.

I found it rather hard to get my mind around the point you were making. After long thought, I think that the problem is that you are not making a logical comparison. Let me try to explain:

My claim is that stock markets have a long term upward bias and this is ONE REASON for confining my operations to the long side.

You evidence that the advance decline line has a long term downward bias, which I agree with. You then suggest that this means more stocks go down than up. I am not so sure this is true, because I can easily imagine situations where stocks can go up quickly and correct slowly and still be up overall, leaving more declining days than advancing days.

You then suggest that a minority of stocks can take the market higher. I don't disagree with this. In fact that is what advance decline theory says happens at the end of a bull market. I think, though that you are suggesting that it may be the case all the time. I am not so sure you are right here. I tested the period you evidenced and the falling stocks were 58% and the rising ones 42%. However, for an earlier and longer period in last year's uptrend the figures were 80% rising stocks to 20% falling stocks. This is again exactly what advance decline theory suggests.

However, let us assume that you are right. Your proposition is that, over a long period, the stock market rises strongly, but the downward bias in the advance decline line suggests that more stocks fall than rise over the period. I agree this could be the case, especially when you think of the number of companies that are listed and subsequently fail.

Nevertheless, I am not sure that this logically means that a rising stock market can not be used as evidence for the strategy of investing on the long side. The index is a rough proxy for capitalisation. So if the index is strongly up over the last 100 years, it suggests that the winners increased in value as a group by far more than the losers lost value.

The only complication is that dying companies are removed from the index and growing companies replace them from time to time. The question to ponder is whether this effect is enough to make fictitious the strong long term upward trend of the market. In other words, is the removal of losers and inclusion of winners in the index over time the main thing creating the long term upward trend in the index? My feeling is that because the losers can only decline to zero (100% loss), while the winners can keep rising (more than 100% gain), it is unlikely that the index minders could fix things to such an extent. They would have to make far more changes than they do to the composition of the indices.

I am not saying that you could not make money by shorting the losers. I am sure that is right. I am simply saying that the enormous growth in value of the winners, which far outweighs the value destroyed by the losers, is a reason to invest in them rather than short the losers. I am far from convinced that the minders of the index have been able to bias the index so much that the strong long term upward trend in index is a complete fiction.

In other words, it is not a question of how many stocks go up or down, but which side it is best to bet on. Since the value created by the winners far outweighs the value destroyed by the losers, I think it is better to be on the long side.

New Charting Guide on Sale

Shares Charting Guide No 4 is on sale from 25 June 2004. Most of it is my work. It covers indicators in ten chapters. Andrew Doig has also contributed chapters on CFDs and Futures.

Fairfax has sold all stocks of *Shares Charting Guides No 1, 2 and 3*. At last report, *The Educated Investor* Bookshop in Melbourne (500 Collins St 03 9620 0885) still has some copies of Issue No 2. My chapters from Issues 1, 2 and 3 are now available on my subscription web site www.bwts.com.au.

Discussion about Research and Analysis

Question

Do you do any fundamental research apart from reading the Financial Review and the margin of safety checks mentioned in *Shares Charting Guide No 1*?

Answer

I am always looking for ideas. I read *Shares* magazine and *anything in BRW* that pertains to listed companies and investing in general.

I study the annual reports of companies I invest in or am thinking of investing in. In particular, I want to make sure that I understand their business. The Internet has made it far easier to get hold of annual reports than in the old days when we had to phone the company and wait for them to come by mail. In most cases now we can download annual reports from the company website. Links to company websites can be found on the ASX website and on the Aspect Financial website. Company websites also provide other information about the company and its business.

I also research any announcements or news items about a company I am interested in using a range of websites - my broker, ASX, Aspect Financial, F2, and so on.

Question

Do you do any research in the Philip Fisher style "Scuttlebutt"?

Answer

This refers to Philip's book *Common Stocks and Uncommon Profits*. I talk to the company or to other insiders only occasionally. This is partly a question of time and partly a question of my investment plan, which is strongly based on technical analysis and only on fundamental analysis in basic terms. However, I sometimes find that I meet an insider socially and will pick up what I can from them.

Question

Do you do any research in the Peter Lynch style "kicking the tyres"?

Answer

This refers to Peter's book *One Up on Wall Street*. Yes I do whenever I can. It is easy with retailers and businesses that we deal with in everyday life. I always have my eyes open for information or insights on how a business is travelling. However, I rarely go far out of my way to do this unless I am very seriously interested in investing in a company. This is partly a question of time and partly a question of my investment plan, which is strongly based on technical analysis and only on fundamental analysis in basic terms.

Question

Do you attend annual meetings of companies?

Answer

Sometimes I attend the meetings of companies I invest in if they are in Sydney. However, I used to do this more in the past than I do now. This is partly a question of time and partly a question of my investment plan, which is strongly based on technical analysis and only on fundamental analysis in basic terms.

Question

Do you talk to independent analysts such as your colleague Trevor Hoey at Shares magazine?

Answer

To Trevor, no, I do not know him. However, I read his work in Shares magazine. We often agree about the same companies.

I have had some discussion with one independent analyst, but it has been basically a sharing of notes on a company we were both already interested in independently. This is not often though.

In general terms, I try to do my own work and avoid being influenced by others. I never seek peer approval of ideas and prefer to work independently and be confident about my own judgement. This is basic to successful investing in that one of the traits of good investors is that they take total responsibility for their decisions.

Question

Do you think that technical analysis is more reliable than fundamental analysis?

Answer

I really find this difficult to answer, because I do not think of them in terms of reliability. However, it is an interesting idea.

First, I thought that I had better look up what reliable means to make sure I am talking about what you are asking about. According to the Shorter Oxford Dictionary, reliable means "of sound and consistent character or quality".

My first thought was to consider the data. Clearly both fundamental and technical analysis rely on reasonably reliable data, though there are problems areas in both of them. However, you are asking about analysis, not the data on which the analysis is made.

I wondered what makes analysis reliable? My thought is that reliable analysis should give valuable insights into the subject of the analysis. It is my experience that both fundamental and technical analysis give good insights. Fundamental analysis gives useful insights into the value of a security, while technical analysis gives similarly valuable insights into the ever changing strength of supply and demand in the secondary market.

This is the real problem in your question. Since fundamental and technical analysis are concerned with different aspects of the investment process, it is difficult to make a direct comparison. Indeed, a comparison may not be of meaning in such a situation. It is a bit like asking whether the egg or the flour are more important in the making of a cake.

I would therefore say that I don't know how to answer your question. I know that both are useful. I also know that using both together is better than relying only on one. As to which is more reliable I don't know and I don't think it is really relevant.

Stressed, No Time to Get Everything Done?

Have you ever felt that you have too much to do and not enough time to do it in? I know that I do. Late last year, my good friend Susanne Fraser told me she was taking up a partnership with *Mission Control*[®], a new approach to managing and organising everything there is to do in life that leaves your mind free to focus on what you are doing now, without nagging thoughts about other things you need to do or may have forgotten.

This sounded too good to be true, but I could not walk away from it without looking at it. So, early this year I attended one of the weekend programs. I had been to time management seminars and read the books, but I found that *Mission Control*[™] is quite different. Sure, there is a time management method at the heart of it, but no time management method will work unless we change the way we think about how we manage all the competing demands in our lives. Having done the seminar, I think differently and believe that I am getting more done with less stress.

There is a unique opportunity coming up. *Mission Control*[™] CEO, Brian Stuhlmuller, will visit Australia in July and August to lead two two-day *Productivity & Accomplishment* workshops in Sydney, and one in Melbourne. For more information about these opportunities, visit www.pentagy.com.au, or phone Susanne Fraser on 02-9651-4703.

Why Haven't You Sold?

Question

You wrote an article in *Shares* magazine on 5 and 22-day moving averages. In your portfolio you have purchased ABC Learning Centres (ABS) on 10 March 2004. However, applying the moving averages, the trend has failed. What is the reason for holding those shares?

Answer

I am glad you have asked this question because it poses several important issues.

Firstly, I write about many techniques, but that does not mean that I use them myself. What I use is clearly explained in my video *Building Wealth Through Shares* and in the book *The Aggressive Investor*, which I am publishing progressively on my

website. You may then ask why I write about other techniques. I do that because there are many ways to trade and to invest and each trader and investor has to find the tools that most suit their personality and needs. There is no single "right" way to trade or to invest.

Secondly, there is the very important question of time frame. You are judging my investment against 5 and 22-day moving averages which are appropriate for a trader with a far shorter time frame than mine. I am not sure what moving average time frame would be appropriate for my portfolio. In the case of ABS, 5 and 22-weeks would still have had me sell, but that combination looks a bit too short-term for my style. 5 and 22-months might be closer, but this combination looks a bit too long-term for my portfolio. So, I am not sure how I could respond in terms of moving averages, except to say that I use the 260-day (52-week or 12-month) moving average to identify trend direction and for ABS it is still up. However, I do not make my decisions based on this moving average. It is an aide only.

Thirdly, you can only appropriately judge my portfolio on the basis of whether or not I follow my investment plan. This is fairly easy to do from my video or book, except that I reserve the right over time to do two things. First, to make changes in the plan if I think I can improve the plan. I am constantly reviewing the plan, though I change it infrequently. Second, to make occasional small investments on bases other than my plan in unusual situations. I have one such investment in my portfolio as of early July 2004, but it is not ABS.

Fourthly, my portfolio is published on my website to meet legal requirements of disclosure in the context that I write about stocks in both educational articles and market comment columns. There is insufficient information on the website portfolio disclosure for you to evaluate my portfolio. I would like to make additional disclosures, but I am not permitted to by law. The FSRA allows me to state facts, but I cannot give information that might be construed as advice. For that reason I do not disclose the quantities I hold or the stop-loss or protect-profit stops on my positions.

Finally, the reason that I am still holding ABS is that it has not hit my stop-loss. As I just said, I have decided that a stop-loss level could be seen as advice, even though it could be argued that it is a fact. However, that would be difficult for me to prove, unlike what stocks I hold and the dates that I bought and sold them, which can be documented absolutely.

The best I can do is to offer to explain the decisions I made and the reasons for them, after the investment is completely sold and some further time has elapsed, so that there is no possibility that I am inadvertently giving advice in teaching my methods. If you like to ask me again at such a time, I will be happy to answer candidly. I will be including some of my actual completed investments as case studies in my book. My subscription website will be the first place to read about them, because I am publishing the book progressively there.

Fleetwood Revisited

I have received several questions about thinly traded stocks that have fallen a long way quite abruptly asking if it was like the Fleetwood situation that I discussed in Newsletter No 37. I have difficulty in answering these questions because they are about current charts – see the statement about questions on the *Ask Colin* page on

my website www.bwts.com.au. The problem in a nutshell is that I am not licensed to give advice. If I talk about current charts, I could be seen to be giving advice. This is especially perilous for me in these cases because the point that I made about Fleetwood was that it seemed to fall as if it had hit an air pocket as stop-loss orders sitting in the market with wide limits were progressively triggered and executed. Once the process had been completed the price quickly sprung back to near the price before the stops were hit. If those asking the questions are holding a stock that has fallen abruptly, they must be wondering whether it is a situation like Fleetwood or not. I cannot risk expressing an opinion on this, but I can try to better explain the Fleetwood situation, which is now well in the past. Readers will then have to apply these ideas themselves to other stocks.

A candlestick chart will show quite graphically what happened on January 29 2004. Fleetwood had been slowly falling for some time. The day opened fairly normally, but the price slipped lower. At some point it seems to have set off the progressive execution of stop-loss orders with wide limits and the price plunged. It then returned just as quickly and closed back where we might have expected it to. If we look only at the real body of the candle and ignore the lower shadow, the day looks quite normal in the context of the trading before and after it.

So, for those readers who might be looking at another chart and wondering if the same process is at work, I suggest that you need to analyse the chart very carefully from first principles as I have done. Only if you are sure that the situation is identical, might you venture to draw the same conclusion, which was to ignore the lower shadow on the candle. If the fall takes place slowly over several days, I would suggest that you may be looking at something different.

Are You Seeking a Mortgage?

Vera Krasnova is my webmaster. In her other life she sells mortgages through *Aussie Mortgage Market*, one of the top firms in the field. If you are in the market for a mortgage in the Sydney area, please give her a call on 0402 382 727.

Advance-Dcline Data on the Web

Question

Where can I find ASX advances and declines on the Internet?

Answer

I did not know, but a reader of my website found a site through a friend of his: <http://www2.tradingroom.com.au/apps/mkt/movers.ac>. Scroll down to the line under the section heading "Top 20 of Whole Market".

There is always the question of accuracy of advance-decline data, because different sources differ widely depending on their (usually undisclosed) methodology. I checked the data from this source for Friday July 9 2004 against my own calculations. The data shown on the site was: $395 - 371 = +24$. This is quite close to my calculations which show $406 - 389 = +17$.

Question

Why are the advances and declines numbers on the *Trading Room* website different to yours?

Answer

I don't know and have no way of working it out unless I could get a list of the stocks in their list to compare to mine or if I could get a detailed and exact description of their methodology.

Both their advances number and their declines number were less than my calculation on the day I checked them.

The advance decline data are quite sensitive to new listings. If they only update the list of stocks periodically, that would explain why their numbers are less than mine.

Likewise the numbers are sensitive to name changes. If they do not combine the old and new data files, there will be a day on which they do not record an advance or decline that I do. This would be very minor, but could contribute to their numbers being less than mine.

Likewise changes for splits, reconstructions and issues of new shares could give a difference if they do not adjust the data prior to the split, reconstruction or issue.

In the last analysis, I think that their data is not too bad. So long as you use the one source consistently, it should give reasonably useful results.

Their data looks far more accurate than the *Australian Financial Review* (AFR) data, which always produces much larger numbers than I calculate. I suspect the AFR do a lot of double counting because they include several security types for the same company. I don't know for sure though, because the AFR will not disclose its methodology either.

Question

Is there a website where I can see the Advance-Divide line for Australia and the US?

Answer

I do not know of a site that actually shows charts of the Advance-Divide lines for Australia and the US.

However, the data is available for Australia at <http://www2.tradingroom.com.au/apps/mkt/movers.ac>.

For the US, it is available at <http://finance.yahoo.com/advances?u>.

I put the complete historical data file up on the *Data Files* page of my website www.bwts.com.au at the end of every month. It is quite easy to download this and chart it in Excel. You could keep it up to date during the month from the sites above. However, maybe just a monthly view would be fine for an investor.

Exponential Moving Average Envelopes

Question

Dr Elder uses an exponential moving average as the base for his envelopes. I can't seem to do this in *Insight Trader*? Is there a way?

Answer

Yes there is.

You have to change the setting in Default Parameters for Indicators.

There are three ways to get to this screen:

Click the sixth icon (the yellow clock face)

Alt +T

View/Time Constants

When you get there, tick the Expon. button in the Envelopes section

Save as default

Force Index and Elder Ray

Question

Is there a way to chart Dr Elder's Force Index and Elder Ray in *Insight Trader*?

Answer

Both of these indicators have been added to *Insight Trader* version 14, which is being released in July 2004.

Old Idea, New Face

Question

What is your opinion of multiple moving averages?

Answer

In general terms, I think they are an interesting technique. They do give some insights into both short and long-term trends. Quite whether all of the psychological explanations given for them based on traders and investors are useful, I am not so sure.

Actually they are capturing ideas about market behaviour that have been known and used for many years and are also captured in other indicators.

Clearly Bollinger bands are revealing similar insights. However, there is a much older technique that I feel does a better job, at least for me. This might be called *Father of Multiple Moving Averages*. I refer of course to the triple moving average method that has been taught in Australia by Dawn Bolton-Smith since before the proponents of multiple moving averages were out of nappies. Multiple moving averages seem to be simply another expression of the same ideas on which the triple moving average method is based. The big advantage of the triple moving average method to my mind is the more precise buy and sell signals.

Trading Full Time

Question

How much experience do you think I should have before trading my own account full time?

Answer

I think that you should have a couple of years of experience during which you actually made the level of return that you need to achieve to trade full time.

The one problem with such a short period is that you may not have developed experience in different types of markets. It would be good if you has traded rising, falling and ranging markets in the timeframe you intend to trade.

Most people take between five and ten years to get to this level.

Question

How much risk capital do you think I need to trade my own account full time?

Answer

If you are going to trade your own account full time, then you have to work out what annual income you need to generate to live off your trading. Subtract any other income streams you will have in addition to trading.

From your experience to date you should know the annual rate of return that you can achieve from trading. If you don't have such a track record, use 5% for the first three years and pray you make that.

Then it is a simple calculation. Assuming that you can make 15% pa from trading (an excellent return), and you need \$100,000 before tax to live the way you want to, you need to have 100,000 divided by .15 or \$667,000.

Bear in mind that this is not allowing anything for capital growth to maintain your purchasing power. If you assume inflation at 4%, the above calculation would be 100,000 divided by (.15 - .04) or \$909,000.

Just plug in your own numbers and you will have the capital you need.

My Journey

Question

How did you get started in trading?

Answer

I began with a few thousand dollars as an investor when I left University. Later I got involved in an investment club where I worked and ended up running the fund when other lost interest with the end of a bull market in 1970-71.

For many years I traded small capital actively - I had not much money to trade with as I had a family and a mortgage to feed. However, I never stopped following the market daily and trading here and there in all sorts of companies. I learned from books, experience.

Once the mortgage was paid off and my wife went back to work, we had more funds to invest. I developed a position trading approach that is really active investing, which was suitable for execution on end of day data and allowed me to focus on my job during the day, which also involved a lot of travelling.

My trading education was completed from David Fuller's *Chart Seminar* in the mid 1980s, which took me to another level. Shortly after, I found Dr Elder's work, which took me to another level again.

In 1987, I had accumulated enough capital to chuck in the job and live off my wife's salary and my writing income and invest our capital to grow it into a retirement fund. My wife has now retired and we live off my writing and teaching income.

With the changes in the law on capital gains, I find it is more rewarding to be taxed as an investor, so I closed out my share trading fund and switched to being an active investor.

The retirement fund is still growing and is large enough to retire anytime I want - though I doubt I will, because I turned my great loves, which were previously pursued as hobbies - writing, teaching and investing - into my occupation. So retirement is an oxymoron for me because I am paid to do what I would want to do if I retired. The only question is how many hours I work.

At Odds with Dr Elder?

Question

You seem to have an unfavourable view of short term trading as opposed to investment style trading and you cite studies which show that few people make any money at it. I've recently read Dr Elder's *Come into my Trading Room*, which actually encourages novices to start with short term swing trading, and here is his reasoning: *because profit targets and stops are clearer, feedback comes faster and money management is easier* (p189) and his own trading diary shows trades averaging one to two weeks. Whereas of trend trading he says that *people who can do it successfully are few and far between*. I know that you endorse his methods, so could you please comment on any misunderstanding I have with what seems to be a contradiction between your views and his?

Answer

My experience is that it is difficult to make money on short term trading. The prime reason is that you have to overcome what Dr Elder describes as the three external barriers to success - transaction costs, slippage and trading infrastructure costs. So, we are agreed on that. You have to develop your skills to beat these handicaps. It is possible, but not easy. I thoroughly endorse his methods as an excellent education in trading and as a starting point to developing your own style.

Short term trading also requires a lot of time. Once you are very experienced and in markets where you can place stop-loss orders (only really possible here recently), the time can be reduced using Dr Elder's method of setting buy orders in advance at the levels you want to buy. However, until you develop a lot of skill, it is quite time-consuming. Investing, which can be done with end-of-day data, is much easier for people with a day job or who do not want to spend a lot of time watching the market.

We are agreed on much more too. This is a passage from *Come into my Trading Room*:

Early in your trading career, it is safer to concentrate on the swings. As your level of expertise rises, allocate a portion of your capital to trading trends. Major trends offer

spectacular profit opportunities - the big money is in the big moves. You owe it to yourself to learn to trade them. (page 193)

So, we are definitely agreed on trend trading, or active investing, whatever you want to call it. Dr Elder mostly teaches swing trading. I teach trend trading, which is what I do. I think we are agreed that trend trading is where the big money is. We are definitely agreed that it is not easy for beginners. One important reason for this is that it requires incredible discipline. The other factor is that it is best done with larger capital than most traders start with.

I hope this clarifies this issue for you.

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. 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 and Yahoo.*
- 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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