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Building wealth through shares

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A year or so ago I spent a couple of sessions advising a new trader. Recently, he sent me a long email telling me how he had got on with his trading and some of the things he had learned from the experience. Extracts from his email are in quotation marks below, followed by some additional comments from my response to him:

Thanks for your email. I very much appreciate hearing how you got on.

“I derived a lot of benefit from the sessions I had with you a couple of years ago. I thought you might be interested in my development as trader as it probably mirrors the experiences of others.”

Many of the things you say are indeed not unexpected and, yes, I have heard them before and recognise them in my own learning over time. I thought that I might just comment specifically on some of your points:

“I keep on abandoning ideas that at first seemed axiomatic. Initially I thought that the application of some industry over a brief period should suffice for competent trading. In fact it has taken 2-3 years to acquire confidence and an adequate return.”

I think that everyone goes through the phase of trying out things and discarding what does not work. You have probably made faster progress than many because of your critical approach. I see too many people who assume anything any guru has written as being true and useful, when they should be more sceptical of everything they read until they can verify it for themselves.

Some traders have told me it took them 5 to 10 years to evolve a profitable method, so you have made remarkable progress. I guess it relates to some extent to how much effort is put into the learning phase - many learn the craft part time, whereas you have been able to give it a more full time effort.

“I next discovered that investment fundamentals or forecasts did not predict performance.”

True. Forecasts are useless. I have concluded long ago that no one can predict the future. Fundamentals are useful as indicators of value and likely performance. However, there are two problems: 1. The market discounts expectations, so much of it may already be reflected in the price. 2. Fundamentals are not useful for timing.

I use fundamentals as a way of scanning the universe of stocks for value situations, but then use technical analysis as a screen for timing and the way the market is discounting other factors.

“The next phase was a search for electronic indicators, which now seems like preferring shadows to substance.”

With indicators, you are looking at derivatives of price. I too have found it best to work with the price directly.

“Having looked at hundreds of charts daily I am now becoming acquainted with charting patterns, which seem behaviourally determined and which are reasonably reliable short-term predictor of price movements.”

This is very close to what I do. It is not fashionable, of course, but who cares if it works. One thing that annoys me is that people learn the old "Charting" techniques and then go on to regard indicators, Gann, Elliott and so on as somehow "advanced" technical analysis, to the extent that they stop looking at the

chart itself any more. They are really surprised when I tell them that I do not use many indicators and could trade quite successfully without them.

“I was surprised to find that discipline, money management and exits(in that order) were the important determinants of performance.”

So true. Everyone I have met who becomes successful at trading echoes this back to me.

“I also had to discover, although it may seem obvious, that a trading system has to be consistent with the trader's emotional make-up.”

I also agree strongly with this. It is something that I have wrestled with in deciding to teach my plan. What I found from talking to lots of people was that many simply could not start from a blank piece of paper to build up a plan, because it is difficult to appreciate what must be in it. What I have decided to do is to teach my plan as a model from which they can start. I do emphasis that they do not have to do things the way I do, but must have a mechanism that deals with each of the factors in my plan - basically management of different kinds of risk. So I tell them what is in my plan, why that element has to be in a plan and how I am dealing with the element of the trading problem. I then leave it for them to use my tools, or vary them to something they are more comfortable with.

“My trades are based on high probability, short-term signals. I do not diversify, I exit (at least partially) on first momentum pause and I compensate for .5% commission with accurate execution. I think that market risk can be expressed as product of size and duration of exposure. Most of my funds are in Bank Bills and my exposure never exceeds 35%.”

This sounds very sensible to me and as though you have evolved something you are now very comfortable and confident with.

“I do not risk more than 0.5% on any trade or 2% on related stocks.”

When I tell people how low the risk is that good traders accept, people stand there with their mouth open.

“Within these parameters exposure depends on reliability of pattern and liquidity of stock. I find that most good signals are followed by expected price moves although most price moves are not preceded by recognisable signals. I prefer high specificity at the expense of sensitivity.”

“I suspect that this method would be uncongenial for most traders. The patterns are hard to express in numerical terms and therefore hard to quantify and test.”

Yes, but I have found that after a while your brain is able to classify and grade them so much better than a computer could do. Just because everyone is moving to computerised and mathematical approaches, does not mean subjective approaches won't still work. I tell them that I could do my value scan on the computer, but do not. The reason being that the computer is too relentless - it is not easy to program it with the fuzzy logic that our brains use.

For example, there are three parameters in my scan. A stock may be well inside two of them but a fraction of a percent outside the third, The computer would reject it, but I can include it in my list, by using discretion.

I also explain that ability to be good at subjective analysis is a function of experience. Many want an approach that short-circuits the need for this experience, which takes time and work. However, just as in any other field, experience and work lead to an edge over the average practitioners. Is this not why some medical specialists are top of their field, and the same applies in almost any profession?

“ I do not manage to remain in most trends. Attempts to do so led to disproportionate loss of unrealised gains. It takes a long time to recognise and have confidence in these patterns although most are quite simple to describe and are in the public domain. Also second guessing, whilst seductive, is usually wrong.”

It sounds to me as though you have found a time frame and associated risk parameters that suit you.

“Over the last year my return was three times 10yr bond rate with only 15% average exposure to stocks. This seems adequate, though not spectacular. It combines a potential for good returns with low risk. The system reminds me of methods with 90% in government securities and 10% long options.”

It is also what the great futures traders do - they never have all of their capital in the market, but look to make high percentage gains over and over on small "bets".

“Finally, allow me again to thank you for your help both directly and through your writings.”

It has been a pleasure for me to help someone along the path to success and I appreciate your feedback very much.

The following is an article I wrote for the February 2000 issue of the ATAA Newsletter:

Is It Really Different This Time?

By Colin Nicholson

We live in interesting times. Of late many have been saying that we live in times that are unprecedented in history. The strange thing is that the longer I spend in the markets, the more things I seem to have seen before come around again. Not only that, but I also recognise them in books on the history of markets.

Much is made of the new age of information, communications, biotechnology and so on. Yet there have been similar eras in the past, some of them in my lifetime, many before. Those that spring readily to mind, in no particular order, are the internal combustion engine, electricity, radio, television, the printing press, the telephone, computers, the transistor, electronics, air travel. I am constantly struck by the similarity of the current internet boom and the age of electronics in the 1960s.

Then again much has been made of the low inflation, low interest rate environment. However, such periods have been seen many times in the past and they are always followed sooner or later by excesses that lead to inflation.

Also much is made of the ability of modern governments to manage the economy based on lessons learned in the past. As an economist by training, I am here to tell you that I have no such faith in our political masters or my fellow economists. Economics is a frightfully inexact “science” and the economic system is only vaguely understood, partly because it is incredibly complex, does not lend itself to real-time measurement of parameters and is evolving constantly.

One of the seductive untruths about the forecasters is the conviction many hold that if a person can explain the past, they are qualified to forecast the future. However, the two are completely different things. Well after the event, we have access to information and insights born of perspective that are simply not available at the time events are being formed.

Of much greater importance is the idea that markets are driven by the psychology of human beings. Even worse, especially in a stock market boom, they are acting as part of a crowd. Crowd theory tells us, among other things that we all tend to lose our capacity for individual thought and action in crowds. Instead the lowest common denominator and the opinion leaders become our guides, to our peril. The interesting thing is that humans have never so far learned from previous episodes, but continue to act the same way each time a situation occurs.

So, what can we do to avoid damage to our financial health when the bull market ends, as it most certainly will – sooner or later?

The most important thing is to be aware of history. Get the books and read them. Talk to the older traders about the 1960s, the 1970s and the 1980s. Ask how similar current conditions are, rather than seek to magnify differences – that is called rationalisation, or trying to select evidence to confirm what we want to see and hear. Stay aloof from the crowd. Question everything you read or hear, no matter how imposing the source.

Develop strategies now to ensure that you will be a survivor this time.