

Colin Nicholson's Newsletter 44

6 November 2004

This is a free 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.

Sad News

It is with the greatest sadness that I advise that my dear friend Neil Costa passed away suddenly on 27 October 2004. Along with all those whose lives he has touched, I am still finding it difficult to come to terms with the loss of such a wonderful person.

Only days before he died, I had spoken on the telephone with Neil about a special price for Christmas on his videotape set *Mastering the Markets*. My first instinct was not to go ahead with the sale price out of respect for Neil. However, I have discussed it with his wife Carol and agreed that we should go ahead with Neil's plan.

The mutual arrangement that I had with Neil was that we would sell each other's videotapes of the Traders Camp on the traditional reseller terms that the seller bought the tapes at a 40% discount off the retail price. The special sale price that I agreed with Neil was \$295 and you will see later in the newsletter that I am selling my DVD set at that price.

However, I am concerned to turn the stock of Neil's videotapes into cash, which I can remit to Neil's family, as soon as possible. I have therefore decided to make their sale more attractive by forgoing my profit and send the entire proceeds after postage to Neil's family. Accordingly, I am selling Neil's videotapes for \$195 including postage and GST while stocks last.

Full details of what Neil's videotapes contain can be found on my website www.bwts.com.au. Orders may be placed on the secure order form online, by telephone to me on 02 9436 1610, or by downloading the order form from the website and posting it to me.

What Volume?

Question

Recently I received some market comment from my data vendor about the All Ordinaries Index (XAO) and associated trading volumes. My data vendor does not supply volume on the Indices. When I inquired about why volume is not supplied with their data I received this reply: *Officially the Indices do not carry any volume, as they are not something that trades on the ASX, from a buy and sell sense. Also S&P Comstock who now own the indices from the ASX, do not permit vendors to*

change the data in anyway. Other vendors that add volume data to the indices would be in breach of this arrangement with both S&P and the ASX. So to answer your question, can you we add volume for the XAO, the answer is no. I find this difficult to believe. Is there any information on this, as I understand you have done considerable work in this?

Answer

It is not true that I have done considerable work in this area, but I have tried to follow what is going on and to talk to some of the participants. I can tell you what I think is the case.

Firstly, I have no reason to believe that it is not true that S&P Comstock do not provide volume for indices. If you think about it for a while, it will be appreciated that there are very real conceptual problems in doing it. For one thing, the number of stocks in the S&P indices varies from time to time (I refer to all of their indices here – the All Ordinaries may be an exception in being always 500 stocks). So, the S&P 200 may have 200 stocks sometimes, but other times may have 195 or 205. I would wonder about the value of volume data when the number of stocks was different. Is a comparison valid? In the same vein, the stocks that comprise the indices change all the time. This introduces other issues of validity of comparisons. Finally, as you know, the stocks in S&P indices are to be weighted not only by market capitalisation, but also by free float. This means that all sorts of other complicated adjustments would need to be made to the number of shares traded in a stock before a number that was to be included in the index could be calculated.

Secondly, unless you were going to trade the index, what value would the volume be? The only index that is close to tradeable is the one that the SPI futures contract is based on. There I would suggest that the SPI volume is more relevant than a concocted volume for the physical index.

Thirdly, technical analysts are studying the market as a whole. The All Ordinaries Index is the best, though flawed, index we have. If we were to do any volume work on the market, I would think that it was more appropriate to use the total volume traded on the market, which is readily available. It is also worth considering whether total value of trades would not be an even better measure than total volume in numbers of shares where shares trading for \$30 are added to shares trading for 0.1c.

Christmas Special

Between now and Christmas eve, I am reducing the price of the DVD set of my *Building Wealth through Shares* seminar from \$440 to \$295 including postage and GST. The DVD set contains the full two-day weekend seminar, recorded at a camp. There are three DVDs running over 8 hours in total. There is also a CD-ROM that comes with it, which contains the full 148 pages of notes in a pdf file and also files containing update articles. All the videotape versions have been sold.

Full details of the contents of my DVD set are on my website www.bwts.com.au. It may be ordered online securely from my website, or by phoning me on 02 9436 1610. There is also an order form on my website, which may be printed out and mailed to me with a cheque.

What Equity?

Question

We have about \$240,000 in super - this includes both shares and managed funds, and is in a wrap style account, so we have some say in how it is invested. On top of that we have about \$80 000 in direct shares. I am just starting to do the stock choosing etc myself, and clearly want to preserve my capital whilst I learn. When calculating how many shares to buy whilst only risking, say, 1% of capital, should I be considering just the \$80 000 as capital (as that is really what I am "playing" with, or should I be using the full \$320 000 in the calculation?

Answer

This is an excellent and very practical question. I am not sure that there is a right or wrong answer to it. There are many possible complications including what the composition of the managed funds portfolios are and how they change over time.

In general terms, if you were managing all of your assets yourself, you would first do a global asset allocation to broad categories like Shares, Bonds, Property and Cash. Each would then be managed under a separate investment plan in a similar way that funds managers would give separate mandates to managers of each of the asset classes.

So, one thing you could do, especially as you are able to switch asset classes for your managed funds is to split them out into these four asset classes. That would give you a total for Shares, which would be \$80,000 managed yourself, and \$xxx,xxx which is being managed professionally. You could then use the total for your position size calculations. The problems with this are that it may be difficult to know what the managers are doing within, say, a balanced fund. It would also mean you have to contemplate rebalancing everything if you make a switch in your asset classes in the managed funds.

On balance, I think it would be much easier if you considered the \$80,000 that you are managing yourself as being your total equity for position size calculations. That is what I have done in the past, though, that does not make it right or wrong. The big advantage in doing this is that you can compare your investment plan results to those of the professional managers in a way that you should be able to scale up if you can outdo the professionals and decide to manage more of the money yourself in the future.

My Book

Question

In Ask Colin, you mention your book. Have you published a book?

Answer

I am publishing progressively on my subscription website a book that describes my investment methods. About 80% of it is finished and I am working towards having it completed by Christmas 2004. The book's working title is The Aggressive Investor. When it is finished it will be published in book form and available in bookshops throughout the country. My publisher has estimated the launch of the book for at around Easter 2005.

Which is Beta?

Question

Could you please explain what is meant by a stock's beta and whether it is better to be above or below 1.0?

Answer

Beta is a calculation, based on the past, of the volatility of the price of a share compared to the volatility of the total market. So, if a share tends to rise or fall by the same percentage as the market, it would have a beta of 1.0. If the share tends to rise or fall by 7% while the market rises or falls by 4%, the beta ratio would be 7:4 or 1.75. If the share tends to rise or fall by 3%, while the market tends to rise and fall by 6%, the beta ratio is 3:6 or 0.5.

So, what the beta tells you is that if beta is above 1.0, the share tends to be more volatile than the market. If the beta is less than 1.0, the share tends to be less volatile than the market.

Whether it is better to be above or below 1.0 all depends on what you are trying to do. A conservative and defensive portfolio that was focused on capital preservation might favour stocks with a beta less than 1.0. However, that would be sacrificing potential return for safety.

On the other hand a trader, who is sacrificing safety for return, would favour shares with a beta greater than 1.0.

Of course, it is not as simple as this. A strategy based on beta might change over time as the market conditions change.

Arms Index

Arms index (TRIN) data is now available from Almax.

More on TWAC and Returns

Question

Following your Newsletter article on Time Weighted Average Capital (TWAC), using the example:

Start the year with 100,000
Take out \$50,000 after two months
Add 300,000 after eight months

At the end of the year portfolio is 375,000

1. What is your starting sum for next year - is it the 300,000 last invested, or the new portfolio total of 375,000?
2. What about interest received during the year?
3. Assuming we are not adding dividends, would this average be comparable to All Ordinaries index?

Answer

Taking your questions in turn:

1. What we are trying to do in the calculation is calculate our return based on the capital we have invested. In the simplest case, we start with an amount and we neither add nor subtract capital during the year. However, in reality, we sometimes want to take some money out, or have additional savings to add to the portfolio. The idea behind the time weighted average capital calculation is to recognize the changing amount of capital and to do it in such a way that we recognize also the portion of the year for which the capital was employed. So, in the example, we have had \$100,000 invested for two months, \$50,000 invested for six months and \$350,000 invested for four months. The aim of the exercise is to calculate the return for the year recognizing the changing capital amount invested. Once the year is finished, we start again. There was a \$25,000 gain in value, so the capital available for the next year is \$375,000.

It should be noted that this calculation is a simple form of the ideal calculation. In the ideal calculation, there will have been some capital growth after the first two months, so the capital for the second period in the year will actually be $\$100,000 - \$50,000 + \text{\$(capital growth)}$. Again, after eight months the capital growth for the year to date should be recognized. In the extreme example, you should make a daily compounding calculation. However, the simplified time weighted average capital method that I showed is a practical calculation that will give a good approximation (probably understated) of the return and will be all most people are wanting to do.

2. There will be three forms of income on a share portfolio. Firstly, there is capital growth, which was discussed in the previous newsletter article and in the answer to your first question above. Then there are dividends paid during the year. Some of these dividends will attract franking credits, which are also income if you are calculating a pre-tax return. Finally, there is income on invested cash held during the year awaiting investment into shares. This might be negligible, or it might be considerable. To calculate the total return from a share portfolio, you should include capital gain, plus dividends, plus franking credits, plus interest. This will enable you to make a direct comparison of your return from shares with other pre-tax returns like bonds, cash or property.
3. Comparison with the All Ordinaries index will only be appropriate if you are only including capital gains in your calculation, but not dividends and interest. If you are including dividends and interest, it means you are reinvesting them and the appropriate comparison will be to the All Ordinaries Accumulation index. This assumes the reinvestment of dividends. It is published in the *Australian Financial Review* each day and also available from some data vendors in electronic form. If you are living off your investments and spending the dividends and income, then you should simply add them to the capital gain return and again compare the total return to the All Ordinaries Index Accumulation index. The All Ordinaries index measure capital gain only. Franking credits should also be added, but even in the case of reinvestment of dividends, they are not internally compounded within the year, because they are realized in the next year when you file your tax return.

My Returns Revised Again

The discussion in the previous item, with respect to franking credits was influenced by conversations with several people over the last couple of months. In the past, I have not included franking credits (also called imputed credits) in my return calculations. This was not very well thought out on my part and my decision was not logical. There are two ways to measure return – before tax and after tax. It can be argued that before tax is the best way if you want to compare your results with others and with other asset classes. This separates the contribution from investment strategy and skill from taxation effects, which while very important, are best looked at separately.

Franking credits are added to income before tax is calculated. Franking credits are simply the tax that the company has already paid on the profits that generated the dividend. Since we get a tax offset for that tax already paid, it is really before tax income from the investments.

The above discussion also clarifies that the comparison for an investor, who is looking to gather a total return, should be compared to the All Ordinaries Accumulation index only. Comparison to the All Ordinaries price index is only appropriate for a trader, and the trader should not include dividends or interest in the calculation.

Accordingly, I have recalculated my returns that were stated in previous newsletters as follows:

Year	My Return %	Change in All Ords. Accum. %
2000-01	+9.69	+8.85
2001-02	+2.11	-4.50
2002-03	+20.61	-1.08
2003-04	+17.48	+22.37

Investing versus Trading

There is no completely satisfactory answer to the question of what is trading as apart from investing. At the extremes, we can be sure that a full-blown trader is a trader and that a very conservative investor is an investor. However, there is a large grey area where the two overlap. Perhaps it is not vital that we distinguish between them. Traders will focus almost entirely on capital gain. Investors also have capital gains as a very important source of return, but also try to harvest dividends and/or interest.

This is by way of an introduction to discussion of this very interesting email I received recently:

The last two years have been very interesting for me. My husband and I both set up portfolios at the same time. Because my husband works mainly overseas, I manage both portfolios. Because our taxation situation is very different I packed my husband's portfolio with stocks that we really hoped to ride until his retirement (only a few years away) or for at least twelve months. Although I use stops in my husband's portfolio they are very wide and, looking back, this portfolio has tended to ride the monthly trends. In my portfolio I ride weekly trends and because I don't have paid employment my taxation concerns are not so high.

At the end of our first two years both portfolios have done well but my husband's has done best. After assessing the performance of our two portfolios the longer hold perspective has been the most profitable and I am now reassessing the plan behind my portfolio, with a view to taking a longer term approach for about two thirds of it and a shorter term approach for the other third. There are a couple of problems with this that I need to overcome.

The first is that we entered the market October 2002 when there were lots of cheap value stocks.

The second is that I have to be able to keep a clear picture in my head of what stocks are for what plan.

The third is that I need to teach myself more skills.

Last week I visited a chat room (as a fly on the wall). I just wanted to see what they were all about. That day everyone on the site was in ecstasy over Chemeq, but I don't think that there will be a Chemeq every day.

One person was sort of boasting about how he had recently bought into a stock for the 2.5% fully franked dividend and when he sold ex-dividend he only lost 1% capital...so all up he was 1.5% up on the deal as well as associated tax implications.

*While I would like to gain the skills to swing or position trade using daily charts for that third of my portfolio (and I have just bought *Trading for a Living* by Dr Alexander Elder) I have no intentions of day-trading or doing clever things with dividends anything like the above.*

My question is what type of a return do these guys work for? I can only imagine that they must take huge positions to make 1.5% worth the effort or else they aim to make so many trades each day that such a small percentage per trade has a cumulative effect.

Thank-you for all your help to date. This is a very solitary activity and while I have no problems with that, it's nice sometimes to have a sounding board.

My Response

Dr Alexander Elder's book *Trading for a Living* has been a best-seller for the last decade. Every would-be trader should read it. They should also read his new book *Come into my Trading Room*, which is even better. In it you will find an interesting discussion of short term trading versus longer term trading on pages 187 to 193. This was the subject of brief discussion in an earlier newsletter.

I am of the belief based on experience that the big money is made on the big moves in the market. If you have the right aptitude and personality for it and can develop the skills, active investing will bring consistently good returns, with a lot less work than short term trading.

Then again, there are those gun traders out there who can make far more money from active short term trading, though they may have to work harder at it. So long as time and capital are on your side, trading the big moves is the sure, but slow way to get rich from shares.

There are many reasons why people trade rather than invest. One is a belief that they can be good at it. If they are, then there is a rapid compounding of returns and small capital can be grown very quickly. Of course, most people who start out think it is easy and/or that they are the exception. But the likelihood is that they will not be good at it and they lose their capital, large or small. That leaves the few who have survived long enough to develop the skills or who had a natural aptitude. They can make a great deal of money and will have no trouble finding even more capital to trade for other people for a fee plus a big share in the profits.

Many people trade because they only have small capital, so they think that they cannot be investors. They also tend to trade options, which is a mug's game unless you study and work very hard at it and have an aptitude for it. Read Dr Elder's comments on options trading in *Come into my Trading Room* before you start, because it will save you a great deal of angst.

The problem with investing is that it looks easy, but it isn't. It demands iron discipline and above all patience, which is a rare trait these days. However, it sounds to me as though you have it. By all means study short term trading and try it with a small part of your capital (less than a third). Give it a good try and if you can do better than investing, then put more money into it. However, it would not surprise me if you found that investing works out better and for less effort – especially emotional.

One thing that you need to take into account is the market environment. Since March 2003, you have been in a bull market in Australia. Many people mistake a bull market for brains. Investing will always tend to give the best results in a bull market, unless you are an outstanding trader. It certainly involves less effort. When the market environment changes – to a sideways market or to a bear market - the game will change. Investors may find the going gets much harder and only the very best traders will stay in the business. When you study my investing plan, you will find that I get out of the market when it is in a bear phase – cash returns are invariably better than being invested in falling shares.

On the matter of cheap value stocks, you are right that there are not so many around. The fishing in that pool is always best at the bottom of a bear market or early days of a bull market. However, it is still possible to find strongly trending stocks that provide a margin of safety. Also as the bull market moves on, you need to consider growth stocks, but again always looking for a margin of safety if you can. Please study my methods on this – in my videotape/DVD seminar and my book, which is being progressively published on my subscription website. I am currently completing the stock selection part of the book.

The next issue you raise is that of managing to keep the investing and trading stocks clear in your mind. It is difficult enough when they are different stocks, but if you find a good stock, it will tend to be in both your trading and your investing portfolios. It is extremely difficult to keep holding a stock in the investment portfolio, while selling it in the trading portfolio. It is not impossible, I did not say that, just very difficult. I know people are going to write to me in response to this, saying that they see no problem trading in and out of a stock in their investment portfolio. If they have actually done that successfully, I salute them. But if they only think they would have no problem doing it, well, good luck to them. It requires a great deal of discipline and very clear thinking. Possible it is, but easy it isn't.

Finally, keep away from the lunatic fringe in the chat rooms. This is a place where the ignorant talk to the ignorant, where the big egos get their thrills, where the sharp guys try to fool the punters and so on.

The guy trading the fully franked dividend stock – I am trying very hard not to go there. It is a complicated subject. For a start you must hold the stock at risk for 45 days to be able to use the franking credit. If he sold ex-dividend, he must have bought at least 45 days beforehand. That is along time for a trader to be locked in. It is more complicated than that too. You need a very good knowledge of the rules in this complicated part of the tax law. Suffice to say, the guy is either ignorant, only telling you part of the story, or a complete liar. Trading franking credits is a really complicated and dangerous game.

If you are making money as an investor, try straight-forward trading in fully paid shares with a small part of your capital and prove to yourself that you can do better than you are doing investing. You may need a couple of years at least to prove that. If you can prove it, then add some capital to your trading account. If not, you are better off as an investor. Do not be tempted by options or any other sophisticated instrument that you do not understand. Good luck.

Playing Away

Question

What should I do about my portfolio while I am on holiday? Sell, place stop-loss orders or just hold?

Answer

My answer to traders is to sell everything and go on holiday. That is what holidays are for.

However, you are not a trader, so my suggestions are different.

What I have done the last few times I have been away for up to a month have been:

1. If I am going somewhere where I can work (i.e. have contact with the Internet), I take my light laptop and monitor the portfolio myself.
2. If I am going somewhere where I cannot use the computer (e.g. Nepal), I give someone all my stop-loss levels and authority to sell my positions if the stop-loss levels are violated. I have had several people do this for me and it is no problem, so long as you give clear instructions and accept responsibility for what they do in response to your instructions. I always tell them to sell at market. Period. No argument, no finessing – just sell.

Nevertheless there are a number of options for an investor:

1. You can do what I do.
2. You can use a broker who allows you to set stop-loss orders.
3. You can monitor it yourself from Internet cafes, if you are traveling in appropriate places.
4. You can sell out and take a holiday.
5. You can just go away and keep holding your positions.

What you decide to do is going to depend a lot on what your investment plan is. It will also depend a lot on your personality and risk tolerance. It will also depend on your partner – you have indicated to me that your partner would prefer that you sold everything. You must take this into account as a serious issue. Will you be happy on your holiday if your partner is unhappy about your decision on your portfolio?

Placements

Question

What is a placement?

Answer

A placement is when a company sells new shares to existing or new shareholders. The shareholders who it offers the shares to must be what are defined in the Corporations law as sophisticated investors. They are deemed to be large enough and experienced enough to be capable of deciding to buy shares without a formal prospectus. However, there is usually a formal document called an information memorandum given to them and which contains key facts.

In recent times, when a large placement is made, companies also offer new shares to existing small shareholders. They are required to give them a prospectus. The number of shares so issued is limited and if demand is high, shareholders may only get relatively few shares. The number they receive is not always related to the number of shares they already own.

Question

Why do companies make a placement?

Answer

The quick answer is that placements can be done quickly and cheaply.

However, there can be other reasons, the most important of which might be to bring in particular new shareholders, who may be of strategic value.

Question

How will a placement affect the price of the company's shares?

Answer

Most placements are made at a slight discount to the market price, in order to make them attractive to sophisticated investors. This means that the placement should theoretically result in a reduction in the price, the fall being greater, the greater the discount at which the placement is made.

The reasoning here is simple. If the shares were worth, say, \$5 yesterday and a placement is made at a discount to \$5 overnight, today the average share will be worth less than \$5. Part of the capitalization of the company has been redistributed from the existing shareholders to the recipients of the placement. This is why the shareholders who do not participate in the placement are wont to object to the placement and why in some large placements, companies also offer some new shares to existing shareholders.

The reason companies get away with this form of wealth redistribution is that the placement is seen as being advantageous to all the shareholders in the longer term.

There can be some value in this argument. In a simple case where the costs of a rights issue would have been greater than the discount offered in the placement, the benefit to all is quite clear. However, in other situations the strategic value perceived from the placement can actually cause the share price to rise rather than fall after the placement is made.

News Corp Data

Question

My data vendor has not combined the old News Corp (NCP) data and the new News Corp (NWS) data. Should they not be combined?

Answer

As I read the terms of the announcements to the ASX, NCP shareholders were given 1 NWS share for each two NCP shares they held. In other words, it was effectively a 1 for 2 reconstruction (reverse split).

I use the Insight Trader Data Base Manager Service. It has treated the NCP to NWS change as a 1 for 2 reconstruction and merged the two files accordingly, so we have complete and comparable history that can be charted.

However, while this is the practical approach for a chartist, it is not the legal situation, where NCP and NWS are two separate legal entities. So it is technically a delisting and a new float. This is how the ASX has treated it and how some data vendors will do it. It is the legally correct solution, but not the practical solution. It seems to me that data vendors should give their users a choice, for which they take responsibility, to make the practical adjustments if they so wish.

It looks as though you are going to have to adjust the old NCP file and combine it with the new NWS file yourself.

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 their email 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 follow up these situations. If the newsletter bounces, I delete the address from my list. If you stop getting newsletters, or hear anyone complain they did not receive the Newsletter from me, please get in touch with me to reinstate the 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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