

Colin Nicholson's Newsletter 45

7 December 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.

Identifying MACD Lines

Question

People use different colours for the MACD line and the Signal line in the Moving Average Convergence Divergence (MACD) indicator. How can I tell which line is which?

Answer

There is absolutely no standard colour coding used for MACD in charting software or in publications. Further, when a coloured chart is photocopied or reproduced in black and white, there will often be two lines that are drawn identically except for their shape.

The key to understanding which line is which on a chart where there is no key to the colours lies in understanding how the MACD is calculated. Once you understand this, you will never have trouble knowing which is which again.

The MACD line is the difference between a 26-period exponential moving average and a 12-period exponential moving average.

The Signal line is simply a 9-period exponential moving average of the MACD line.

Now, when we calculate a moving average of a line, the effect is always to smooth out the fluctuations in the line. So, the Signal line will always be a smoother line than the MACD line. In other words, the signal line will not be as volatile. Another way to look at this is that the MACD line will move faster and swing more widely than the Signal line. So, there are two easy ways to determine which is the MACD line:

At important peaks in the indicator, the MACD line will be at the top and turn down across the signal line. Likewise, at important troughs, the MACD line will be at the bottom and turn up across the Signal line. These are the key signals given by the indicator.

If the indicator is rising strongly, the MACD line will be above the Signal line. Likewise, if the indicator is falling strongly, the MACD line will be below the Signal line.

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.

Ratios for Resources Stocks

Question

What PE ratio and Dividend Yield would represent a margin of safety in Resources stocks?

Answer

It is my view that price earnings (PE) multiples and dividend yields are not a good way to value resources stocks.

In simple terms, in an industrial company, there is an implicit assumption that the earnings can be maintained into the future. The whole focus of security analysis (fundamental analysis) is to calculate the maintainable earnings of an industrial company. Because it makes things or supplies services to meet an ongoing need and it is assumed that the profit is maintainable almost indefinitely. This makes use of a heuristic (rule of thumb) like PE multiple or dividend yield a valid way to get a measure of relative value and hence the margin of safety.

However, resources companies are quite different. In general terms, they are exploiting a wasting asset. Also, demand for most resources tends to be very cyclical. This means that there is not a level of earnings that we can confidently expect to extend into the future almost infinitely like an industrial company. It is more appropriate with a resources company to forecast, not the maintainable earnings, but the future cash flow, earnings or dividend streams. To arrive at a present value, we would then discount that cash flow, earnings or dividend streams. This is quite a different proposition.

Put it this way: If you buy an industrial company for 10 times earnings, you can expect to get your money back in earnings in ten years. However, if a resources company is mining a deposit which will be exhausted in three years, paying ten times earnings for it might be speculative to say the least. Of course, it may find more deposits or lots of other things, but There are many more "ifs" and "buts" that make the task far more difficult and speculative.

Trading through Internet Cafes

Further to the item in the last newsletter about what to do about your portfolio while travelling, I received this additional insight from a reader:

Shortly after I started buying shares I went on holiday. I didn't have a laptop and thought I could use internet cafes. However, when I started with Etrade I had to change the security settings on my computer. The security settings on internet cafe computers aren't so high and I couldn't access my portfolio. The attendant wouldn't allow me to change the setting. It took the carefree edge off my holiday. Now, because I still don't have a laptop I put my portfolio onto a watch list at the trading room website (which I can access at a cafe) and if I need to sell, I can telephone my order through to Etrade.

Too Simplistic?

Question

At the moment (early November 2004) it feels as if this market is living on borrowed time. I've not experienced a bear market so I'm not sure what to expect. I have read your articles about the Coppock Indicator and also the Advance Decline line but I don't have access to these tools. I am assuming that as the market falls I will be acting on my stops which will be getting me out of the market and the general financial news will be letting me know the shape of the bigger picture. Is this too simplistic?

Answer

You have raised some quite interesting issues here. Let me discuss them in turn.

The market is living on borrowed time

I have been pointing out in my BRW columns that the breadth indicators – primarily the Arms Index, which combined volume with the advance-decline information – are suggesting that a correction of the strong upward move is overdue. However, that does not necessarily mean that the bull market will finish with the next correction. I have no way of knowing whether that will happen or not. My experience is that bull markets often go further and for longer than we imagine. People worry about them ending all the time. Instead they should be letting their profits run.

Coppock Indicator

The Coppock indicator is not designed to give a signal at the end of a bull market, so you are not missing anything there. It only gives a signal at the bottom of a bear market. I have a spreadsheet of the Coppock indicator on the data files page of my website (in fact the spreadsheet covers the Australian, US [Dow, S&P and Nasdaq], UK and Japanese markets). You can read the signals off the spreadsheets, which I update at the end of every month.

Advance- Decline line

I also put this data up on the data files page of my website at the end of every month. You could easily put the ASCII file into Excel and construct the cumulative line and chart it in Excel. You could then compare it with a chart of the index from the Internet. Better though, might be to chart the index and the Advance-decline line by hand.

Stops

You are absolutely right that your stop-loss or protect profit stops are what will take you out of the market when the bull market is over. Some stocks will finish their runs early and others later, but they should take you out with a fair bit of your profits intact providing you have been participating in the whole bull market, rather than just buying in at the end.

General Financial News

This is very important. It is the source of the information you need to know which of the Dow Theory phases you are in. If you detect signs of a rampant speculation phase, and stops start being hit, do not reinvest the money but sit awaiting developments. However, if everything seems normal in an increasing earnings phase like we have now, look to reinvest money freed up if the odd stock hits a stop.

The thing to remember is not to believe as gospel everything you read. You have to realize that journalists are paid to explain what is happening even if they have no idea. They find reasons. Often from people who are talking their book. So, you have to consider what you are reading and whether it makes sense. The most dangerous views are from the people who tell you that it is different this time. The same basic cycles of boom and bust have repeated through history. It pays to know what has happened before by reading the history books. Start with Charles Mackay *Extraordinary Delusions and the Madness of Crowds*.

Too Simplistic?

Far from it I think. Most people like to make investing too complicated, believing that complicated is better. It isn't. It is the big simple ideas that make most of the money. Get the big things right and everything else falls into place. Avoid irrational fear that tempts you to take profits when the trend is still upward. Avoid irrational greed that tempts you to buy at the wrong time and hang on when the evidence is screaming danger.

You Must do it Yourself

Recently, I had this exchange with a student of my DVD seminar *Building Wealth through Shares*:

Student

Your *Building Wealth through Shares* Seminar Notes have been really informative and interesting reading. Although I am only half way through, I have pick up some really good advice. I must admit though I am a bit lost when it comes to writing a trading plan. I have in my mind what I believe needs to be done, but I just can't put it on paper, because there are a few grey areas that I am not sure of.

My Response

Actually framing your investment plan will take you some time and a great deal of mental and emotional effort. It is probably the most difficult thing you will do as a trader or investor. My *Building Wealth through Shares* DVD seminar is my explanation of my plan, which I teach to help you by showing you a model. However, there is only so much I can do for you, because the plan that you come up with must suit your whole personality. Only you can provide the necessary introspection and come to a point where you have internalised the thinking behind it and so matched it to your personality or temperament that you will be able to stick to it under pressure in the market. Feel free to ask me questions about my plan, but I can never know enough about the person that is you to develop a plan for you. Even if I did and somehow "get it right for you", you would probably not follow it because you have not taken the thought journey to the point where you believe in the plan.

A Recent Exchange

I have recently replied at some length to an email from a reader who raised issues that I think are very important:

Reader

(1) Regarding your portfolio disclosure, does your web site explain the technical trigger which instigates your decision to sell (or buy) a stock?

Colin

No it does not. I have considered whether I could do it. I have been asked to do so by others. My belief is that to do so would cross the line between fact (what I bought or sold and when) and advice (what I think should be done). For that reason I decided that I can not advise my stop-loss levels or the reasons for changes in my portfolio without an investment adviser licence, which I am not interested in obtaining because I do not want to give advice, only teach and write. It should be remembered that my portfolio is on my web site for one reason only – so that I meet the requirement for a journalist to disclose my interest in any stock that I discuss.

Reader

Taking the example of Sonnet(SNN) which you sold on 27 October:

(a) Maybe, in your investment plan, it breached a trailing stop-loss that you had set?

Colin

No, I do not use trailing stop-losses in the usual sense. My stop-losses are raised progressively to the failure point in the trend I am investing in as it unfolds. My method is fully described in my DVD seminar, in articles on my subscription website and in my book which is being progressively published on my subscription website. I have recently (November 2004) posted that chapter.

Reader

(b) Or perhaps you considered it had receded too near your buying price?

Colin

No, that is not part of my investment plan.

Reader

(c) Perhaps you thought the risk/return equation was more balanced on the risk side due to the possibility that Sonnet may lose a major client?

Colin

No, that is not part of my investment plan. I did not know of this situation, in fact. Even if I had known, it would have played no part in my decision.

Reader

(d) Or perhaps there was a major technical breach that I missed?

Colin

Yes- it gave one of my three selling signals (as described in my DVD seminar, Shares Charting Guide No 1 and my book which is being published progressively on my subscription website) on 26 October, so I sold it next day. It was as simple as that.

My selling signal is one of the three situations where the trend has failed. If the trend fails, I sell.

Reader

(e) Possibly your investment plan considers, in the case of this chart, the perceived risk of loss outweighs the possibility of missing out on a possible return.

Colin

No – that is not a part of my investment plan.

Reader

(f) I drew a channel approximately between the highs and lows of Sonnet's closing price chart between January and August 2004. The price spiked after that (presumably after the declaration of an unexpected dividend) but has since receded to within the projected ascending channel since it went ex-dividend.

Colin

This is not my method. It is interesting, but it is not what I do. As a matter of interest, I see the Sonnet chart differently to the way you describe it: It went through the top of its trend channel (a classical warning of the end of a trend) and then fell through the trend line. It has now returned to the trend line (a classical sell signal). It is all very untidy. However, I say this only in the interests of saying that I am seeing the chart differently to you. I repeat – it is not my method, so I had not even done this analysis until I got your email. By the way, I am using a semi-log chart, which is correct for trend channel work. It looks even worse on a linear chart.

Reader

(g) Although I may yet find myself to have made a mistake, I have kept my shares (bought at \$0.285) on the basis of this thinking: (i) the price is still within the ascending channel; (ii) Chairman, Eugene Kopp, sold some shares but exercised 600,000 options; (iii) there has not yet been any bad news released in the company announcements; (iv) if Sonnet had lost their major client they should have already announced rather than withheld price-sensitive news; and (v) so far the company's new management has had a tendency to under-promise. The Annual General Meeting is Tuesday, 30 November, so I am hoping after the Chairman's address I don't get an email alert from my internet broker that I'm out-of-pocket.

Colin

I cannot comment on this unless I know your investment plan. It is clearly different to mine. I followed my plan precisely. Your task is to follow the rules of your own investment plan.

Reader

(2) I notice your recent article in BRW showed a semi-logarithmic chart of the All Ords after 1988 with the current level of the index in the middle of the channel. However the other day I saw a non-logarithmic chart from 1988 onwards showing the All Ords currently at the top of the channel. Any comments about the differences?

Colin

If there is a large dynamic range on a chart, it is inappropriate to use a linear price scale. This is fully explained in the *Stockwatch* articles on trend lines on my subscription website and in the SIA subject *E114 Technical Analysis*.

Reader

(3) Correct me if I am wrong, but in a couple of your recent BRW charting articles you seemed to indicate that your comments about negative signs in a chart (I think it may have been Foodland) may not apply to a long term investor who bought some time ago. I vaguely recall you also mentioned anytime in the past has been a rewarding time for a long term investor to buy BHP. I am therefore not sure whether your comments about long term investors apply just to these two stocks only or others in your articles.

Colin

Foodland: What I said was that "... readers with this stock in their long-term buy-and-hold portfolio might well ignore the rest of this week's column." This is because I am writing to a very general business audience in BRW and have to consider all the possible investment approaches of readers. Since I was talking about a market timing issue, it was not relevant to a buy-and-hold portfolio. Having made this clear, I then commented on the stock from the viewpoint of a market timer. In other words, my comments were not directed at a long-term investor *per se*, but to a buy-and-hold investor. By that, I mean someone whose investment plan is to buy and continue to hold. They do not buy and sell, like a market timer. Your comment points out how easy it is for whatever I say to be misunderstood. I keep trying, with the help of my editors, to make comments unambiguous.

BHP: Here, I think you are misinterpreting my remarks. What I said was "The most rewarding approach has been to buy BHP Billiton (formerly BHP) when it seemed to be in trouble and hold it forever." I am not sure that I know how to say this in a way that was less ambiguous. Maybe you think BHP Billiton is always in trouble?

The two comments were in a discussion of the stocks mentioned. If I am making general comments, I will try to flag this, rather than putting them in the middle of a discussion of a specific stock.

I spend a lot of time carefully wording what I write in BRW and it is in turn closely edited by the editorial team. We try very hard to make my columns say what I mean. I feel that you may have been a bit careless in reading what I have written.

I hope that everything that I write and teach is helping you and others to reach this level. I am sorry if my comments may come across as a bit harsh and critical. It is only that you have touched on things that are very important to me. It pains me to see people investing without the knowledge and skills needed to succeed.

Volume Weighted Average Price

Question

What does the Volume Weighted Average Price data mean on Comsec Professional and how is it analysed?

Answer

I am not a Comsec user. I am told that the Comsec Professional web site does not have a definition. They just tell you that VWAP means Volume Weighted Average Price. I suspect the lack of a definition is because it so obvious, in that the title of the column explains what it is.

If I were calculating a volume weighted average price for a day, I would take all of the transactions. I would then multiply each number of shares by the price to get the value of the transaction. I would then total the value and total the number of shares. If you then divide the total value by the total number of shares, you get an average that will be weighted according to the number of shares transacted at each price. You could verify that this is what Comsec are doing by finding a share that only does a few transactions in a day. You could then make the calculations from the course of sales screen by hand. If you get something different, I suggest you ask the Comsec Help Line for a definition.

Analysing the data is fairly well common sense. The volume weighted average price tells you where the greater part of the day's volume went through. For example, if a day had a range of \$4.50 to \$4.70 and the volume weighted average price was \$4.71, you could assume that most of the business was done near the low. If the day closed near the low, you could be fairly sure that sellers had control of the market at the close. Whereas, if the close was near the high, then something may have changed late in the day to take the price away from where the business had mostly been done, because buyers were in control at the close.

Volume weighted average prices might also be more relevant for some indicators than the closing price. However, I have never done any work on this.

Why Split?

Question

If a company has significant fluctuations in price, and liquidity is thought to be a contributing factor, would a share split (say 5 for 1) be a possible solution?

Answer

Yes it would. Share splits seem to have two main objectives:

1. To reduce the price of the shares to the range that most investors feel comfortable with in our market. Once prices go over about \$10, a lot of investors think they are too expensive, even when they are clearly undervalued on fundamental measures. It is a purely psychological issue or effect.
2. To increase the number of shares available for trading. It seems that people are more prepared to sell part of a large number of shares, say 10,000, but not a smaller number of shares, say 800, even though the actual value is the same. Again it is purely a psychological effect. This increases the liquidity. Liquidity tends also to reduce volatility, because there are more buyers and sellers to aid price discovery.

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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