Colin Nicholson's Newsletter 46

20 January 2005

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.

Gaps and Stop-losses

Question

If a share drops suddenly with no chance to exercise my stop loss, should I sell the next day, or wait for a rally, closing the gap, and then sell?

Answer

You have raised several issues in this question:

There is no chance to exercise my stop-loss

I know what you mean – that you were unable to act at the price level at which you set your stop-loss. Instead the price has gapped through that price level. I think that you are misunderstanding what a stop-loss level is. If it is placed with a broker, it is usually an instruction to sell at the best price if the level is breached. The broker would therefore sell at the market even though that level is well below the trigger level for the stop-loss. However, in some markets you may be able to place an order that has limits on the execution price, such that you would have no chance to exercise the stop-loss if a price gapped down quickly and significantly. Since you have said that you were unable to exercise your stop-loss, I am assuming that your stop-loss was not placed with a broker, but you were intending to exercise the stop-loss yourself manually. So, it comes back to what you mean in your mind or in your investment plan by a stop-loss level. Perhaps you have not thought this out carefully enough. Perhaps you are unrealistically expecting that you will always be able to get out at your stop-loss level or close to it. However, this is only likely to be the case for large liquid shares and in the absence of unexpected news. In the case of thinly traded smaller shares, it is more likely that you will suffer some slippage on your stop-loss. This will also be the case where unexpected news has come out on a large share, such that it has gapped down.

Should I sell the next day?

You should not be asking me this question. Your investment plan should tell you. You should know beforehand what you will do, without hesitation, if a stop-loss level is breached. If you are asking me what should be in your investment plan, then the thing to understand is that there is no simple answer to this question that is always right, except to say that you should act according to the logic and rules of your investment plan.

There are several points of view about what someone should do if their stop-loss is triggered. My view is a simple one. My stop-loss level is where I am wrong about my investment. If the price falls to that price, then I am wrong and should cut my losses. I always sell without hesitation on the next day. For me not to do this, something very unusual would have to have happened after the stop-loss was triggered.

However, my view is not the only one that can be taken. Some people may place stop-loss levels on a different logic to me and their reaction may be different. Also, I will sell even if the price has recovered back above my stop-loss level, whereas other people may not sell in that circumstance. My logic is that I am trading a trend. If the price falls below the last trough, the trend has failed, so I sell, even if there is a subsequent rally. The only exception would be if something really unusual happened – such as a rally so strong that it established a new high for the trend. This is highly unusual and would probably only happen in a takeover situation.

The most usual alternative to my approach is if the person's investment plan requires the closing price to have violated the stop-loss level. This would be where the logic for the investment plan was different to mine – say based on a trend line or a moving average crossover.

Wait for a rally to close the gap
I know some people will do this, but I think it is fraught with danger. Exhaustion gaps are never closed by definition. Other gaps may be closed. You could wait to see what happens, but it has then become a "hope" investment. If it is an exhaustion gap, it will be costly. However, if you sell and it turns out to be a common gap, you can always buy the share back. This seems to me to be a far better way to deal with the situation.

Question
If a drop in a share price, which hit a stop-loss, was larger than at any time previously, does this alter the situation?

Answer
One of David Fuller's three signals for the end of a trend is a larger than usual correction. It is therefore possible that a large drop at the top of a consistent trend is very significant. Of course, there is no guarantee that it will always be one of the David Fuller signals, but my thinking is to treat it as being one until there is evidence to the contrary. So, I would sell when the stop-loss is hit and see what happens. If the share recovers to a new high for the trend, I would consider buying it back. This seems a better way to deal with the situation.

Building Wealth Through Shares DVD Seminar

In the second half of last year I sold all my stock of the *Building Wealth Through Shares* seminar on videotape. I have now sold all of my stock of the seminar on DVD. I do not have any immediate plan to produce more of these DVDs or to make a new DVD seminar. My book *The Aggressive Investor* replaces the older videotapes and DVDs and is the latest complete version of what I taught in the videotapes and DVDs.

Which Moving average?

Question
What is the best moving average or group of moving averages to use for a market index?

Answer
I do not use moving averages for timing myself, so I have not done the work necessary to be able to answer your question.

For individual stocks, I use the direction of the 260-day moving average only as an indicator of the existence of and the speed of the trend as described in my book on my subscription website. However, I find it a bit too fast for indexes. I notice that Dr Alexander Elder mentioned using a 2-year moving average (520 days) in one of his newsletters. That would have worked fairly well on the Dow Jones Industrial Average in the 1990s. Then again, it all depends. In Australia in 1993-4 and in 2003-5, 260 days has been fine. However, from 1995 onwards, 520 days saw several serious penetrations of that line. Instead of a moving average, I prefer to use the trend itself as my timing mechanism, as described in my writings.

The other issue is that investments should be managed form the chart of each stock, not from the market index. So, if the market swings from bull to bear, you should be taken out of each stock you hold when its trend fails. That is how I do it.

My Teaching Plans

Question
Where would I find details about your upcoming investment camps?

Answer
At the present (early 2005), I am not doing any teaching, because I am focused on finishing my book and then making a new DVD seminar from it. At this stage I think it will be well into 2005 before I am ready to start teaching again. When I have a clear idea of my available time and the timing of the book, the DVD and other commitments, I will advertise my teaching program on my website www.bwts.com.au and in my newsletter. Until then the only access to my methods is through my book, which is being progressively published on my subscription website. I am leaning toward teaching my methods in a camp format rather than the exhausting (for me and the students) two-day seminars. However, what they will be called and the final format is yet to be decided.

My Book

Question
When do you anticipate finishing your book?

Answer
Most of it is already on my subscription website as at the end of 2004. I think the final version should be there by the end of February 2005. It will then be some months before it is published in printed form. I will keep everyone informed on my website www.bwts.com.au and in my email newsletter.

Learning to be a Trader

Question

I am interested in looking at share trading. What would you suggest I do in terms of study, research, books, DVD's etc in order to equip myself to make a start?

Answer

You need to learn a new profession. It is going to take you some time. The key is not to lose too much money while you are learning. Here are some things to start the learning process. Other avenues will open up as you work through them.

1. Read the article *Becoming a Full Time Trader* on the *Articles* page of my free access website www.bwts.com.au. There is more in the *Ask Colin* section of my free access website under *Trader* and similar keywords.
2. Read Dr Elder's books *Trading for a Living* and *Come Into my Trading Room*. You may then want to do one of his Traders Camps before you make a serious start.
3. Read my book, which is being published on my subscription website and will be in print later in 2005. What you need to read is already there, even though the book may not be finished on the website until February 2005. Although I am an active investor rather than a short term trader, my book will help you in developing your trading plan (see point 6 below) and in generally understanding the risks to be managed in the stock market.
4. Do the SIA *Graduate Diploma in Applied Finance and Investment*. It was the first thing I did when I went full time in 1987 (I did not have time before that). Pick the electives that will help you depending on what you want to trade.
5. Start reading the *Australian Financial Review* every day. Read everything about the market, the economy etc. If you don't understand something, research it on the Internet and in libraries until you teach yourself what you don't already know.
6. Develop a complete written trading plan and test it thoroughly on past data and going forward in real time on paper.
7. Start trading with very tight risk control. Dr Elder's method of limiting risk per trade and per month are excellent.

This is the minimum I see to get started. If it sounds like more than you are willing to do, forget trading as a profession and get yourself another day job using the skills you already possess. Sounds savage, but trading full time is real job with real money. Your money. It is not a game. It is not easy. However, it can be learned.

Question

How can I assess if I am suited to share trading as a full -time or part -time job?

Answer

I doubt there is any simple answer to this or any simple test that can be applied. I suggest you read widely about trading, traders and psychology, to get a feel for what trading requires and all of the different types of people who have been successful.

There are, I think some key ingredients, without which you might struggle, or even fail:

1. No fear of hard work and a preparedness to do whatever it takes to succeed. It will be harder and take longer to learn that you ever imagined.
2. An ability to think things out for yourself and to question and assess everything you read or hear. Nobody is going to be able to do it for you. You must do the thinking for yourself and be comfortable that you can work out the answers for yourself.
3. An ability to be comfortable making decisions by yourself without reference to anyone else. If you have been in a profession where this has been required over many years, you will have a flying start. Some people simply never learn to make decisions for themselves because they were brought up to be consensus people.
4. A very deep knowledge of yourself in terms of attitudes, beliefs, risk tolerance and your general psychological makeup. Your trading method must be comfortable with you as a total person or you will fail. If you do not know who you are, you cannot devise a plan to suit you. If you try to hide from yourself in the market, the market will hone in on your weaknesses and make you pay dearly. It may take you several years of introspection and study to come to a clear and honest view of yourself.

These are probably not what you expected and you may not see these points elsewhere. They are my personal view based on my experience. In particular, you will see lots of advertisements telling you how easy it is and how quickly you can learn to trade. They are very good at telling people what they want to hear, rather than the reality. Remember that if it sounds too good to be true, it usually is and that a fool is quickly parted from his money by rogues. Good luck.

My Market View

Question

On 15.01.00 you wrote an article titled *Australian Share Market 15 Jan 2000 Review & Suggested Strategy* where you suggested an impending bear market. Where can I read your current view of the markets?

Answer

This was an address that I made to the ATAA in Sydney on 17 January 2000. Unfortunately, in some ways, the law has been changed by the parliament since then. As from 2004, it is necessary to have a license as an investment adviser in order to give a view about the market in public. I have no desire to give investment advice. I am more interested in teaching investment skills and methods. I have therefore not sought a licence and have no plan to do so. This means that I am no longer able to give that kind of address to the ATAA or to any other public forum in person or in print.

However, the law allows me to write my views in the media in certain defined circumstances. I am writing a regular weekly column in *BRW* magazine. It is published most weeks, except when there are special issues, the editor asks me to write a special column on specific stocks only, or when I am travelling or on holidays and unable to follow the market and file a column. If you wish to follow my view of the market, the only way to do so regularly is through my weekly column in *BRW*.

Anti-Spam Software

Every month, a few more of the recipients of this newsletter install anti-spam software or use filters set in place by their ISP. They forget to put colin@bwts.com.au on their white list, so my newsletters bounce. I have no option but to delete these addresses from the list. If you have such software in place or are thinking of installing it, please put me on your white list, if you wish to continue receiving the newsletters.

Correction: Volume Weighted Average Price

Several readers have been kind enough to advise me that I had a typo in the last issue. I used an example and said that if the VWAP was $4.71… Here is the full item again with the correct VWAP of $4.53, not $4.71 in the example:

Question

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

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 $4.53, 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.

Questions on my DVD Seminar

Question

What minimum amount of capital do I need to start trading? Would $10,000 be too little? I have estimated that I could get 7 to 8 positions using up to 2% of my trading capital as my maximum position, placed in one order. This would limit the position size to approx. $1200.00, brokerage approx. $20.00 with Commsec.

Answer

My standard answer to this question is that at least $50,000 is needed. The main reasons for this are:

1. Risk. The larger the capital you have, the less risk you can take effectively. With $50,000, you might just be able to get away with risking 2% of capital on a trade and have a realistic sell stop. Probably you would need to creep it up a bit and the more that you do so, the more likely that you will lose. Once you get to $100,000, you should be able to operate on 1% risk. Even higher capital would enable you to get well below 1%. With $10,000, you are going to have to risk more than 2-3%, perhaps up to 5%, or else you will have to be extremely disciplined and only take trades that have really close sell stops.

2. Diversification. 7-8 positions are not enough. This would be the very minimum suggested by portfolio management theory if the positions are truly uncorrelated. However, all stocks are to some extent correlated. My own feeling is that you ideally need twice this number of positions.

3. Costs. On a $1200 trade, $20 brokerage is 1.7% in and 1.7% out. The first 3.3% you make goes to the broker (and GST). This is a very high hurdle. Compare this to 16 positions from $50,000 capital, or $3,125 per stock. $20 brokerage is .64% in and .64% out. So the hurdle is now only $1.28 or only half as high.

That remains my standard answer. However, I do not want to discourage you totally from getting into trading. However, if you go ahead with only $10,000, you must realise that the chances of succeeding are smaller than for someone with larger capital. I think you should therefore accept the high risk, with your eyes open. What you need to do is to conserve your capital and try to make it grow by trading and saving, while accepting high risk. I think that until you have something approaching $50,000, my investment plan is not going to work for you. I think you should look at something more like the approach taught by Dr Alexander Elder in his book *Come Into my Trading Room.* In particular, you have got to take trades that are low risk and have close stops. You should only risk 2% on each trade, but limit the number of trades on at any one time to three, until one or more are in profit and you have been able to move your sell stop up to above break even. You also must use his rule that if you lose 6% of your capital in a month, then you stop trading that month. Once you have grown your capital to $50,000 or above, you can start to reduce the risks you are taking by moving towards my sort of investment approach.

Question
You scan your database for stocks making new 52 week to find breakouts. How does this work when the market is seen as coming to the end of its run. Is this a sit and wait situation?

Answer
In my investment plan the proximity of the end of a bull market is dealt with by my strategy on market exposure. If I think we are in the third phase of a bull market, I will reduce the amount of my capital that I have in the market as described in my book (on my subscription website) and previously in my seminars and videotapes/DVDs. So, yes in that respect it is a sit and wait situation.

The more advanced a bull market becomes, fewer breakouts from accumulation phases on the value model will occur. Those that do occur need to be considered carefully. They may be dog stocks that are only rising on the backwash of the main wave. However, there may be a few genuine value situations where a non-cyclical company is recovering from bad management or ill-fortune.

There is two other situations that the 52-week new high finds:

1. A growth model chart that is breaking higher from a consolidation zone. If it is still reasonable value, these are very prospective situation for investment.

2. A value model or growth model chart that shows an ongoing strong uptrend. If these also still represent reasonable value, they are also highly prospective situations.

The beauty of the 52-week new high scan is that it keeps you looking at the charts that are in uptrends or breaking out. It keeps you away from charts in downtrends.

Question
You mentioned that when the market opens, this is normally a time when the public trade and the Professional Fund Managers sit back and wait till I assume the market settles. The beginning of trading has always fascinated me by its volatility either bearish or bullish and I had never realised that it is people like me that cause it to be bullish or bearish. Would you estimate that the market takes about 1/3 of its trading time for the ordinary folk to have completed there trading and prices settle?

Answer
No, the professionals do not sit on their hands. They fade the emotional trades by the public. In other words, when the public panics, they drive the market down, but it is the professionals who buy the bargains and take their profits when the panic is over. When the public rushes in and buys anything, the professionals accommodate them and buy the stock back lower once the greedy rush is over.

I remember watching a big fund manager operating on a panic opening. He had his shopping list with his brokers. They just snapped up anything at his price or lower and added it to the long term portfolio.

As to how long it takes a market to settle, I don't think there is any rule. It may take minutes in one situation and hours in another. It all depends on the circumstances. Much of the time there is quite an orderly market even at the opening, because there are no real issues around to create fear or greed.

Maybe you are talking about the pre-opening on the ASX, where some rather strange orders get placed. This is to do with the ASX opening procedure, which is complex. Investors and traders place orders across the spread to ensure they get a fill on the open by knowing how the opening procedure works. If you don't understand this, I suggest you study the very clear explanation of it on the ASX website.

Question
You talked about a parabolic stop that you use to set you stop profit when a stock rockets up. Can you please explain how this is executed?

Answer
The Parabolic indicator calculates a sell stop level for the next day. If you have a broker who takes sell stop orders, you can use that to place your stop order in the

market. Otherwise, you need to watch the market and execute your sell order manually if the market trades at or below the Parabolic stop level.

For more details see my free access and subscription website and also Dr Elder's book *Trading for a Living.*

Question
You mentioned a channel line. What do you mean by this?

Answer
I cannot remember the exact context for this. However, a channel line is generally a line drawn parallel to a rising trendline through the highs of the rallies or parallel to a falling trendline through the troughs of the declines. Channel lines are also commonly drawn above and below moving averages. In this case, the correct description is an envelope line. They are usually drawn a certain percentage above or below the moving average.

The most basic use of these channel or envelope lines is to identify when the price is stretched on the upside or the downside. On the upside the cannel and envelope lines are what Dr Elder calls greater fool prices – prices which are so far from value that the only hope in buying is to find a greater fool to sell to in order to make a profit. Value, of course is near the moving average or trendline.

With channel lines on a trend, it has also been observed that if a move is so strong as to burst through the channel line, the next correction back to the trend line is often the one that ends the trend.

Question
When you sell a position, do you normally do it by calling your broker to do the trade or do you do it online?

Answer
Most of the time, I do it online, because it is cheaper. However, if there is something very difficult about the trade or if I do not have the time to finesse the order myself, I will instruct a broker to do it for me by telephone.

Decisions, Decisions

The following is a discussion with one of my readers, which should be of general interest:

Reader
I am happy with my progress in studying and investing in the market over the past three years. At all times I continue to work on my weaknesses. There are two outstanding issues which I still have some trouble with though:

My first issue: Being Decisive
I find I am still not decisive enough to trade when I see opportunities that fit my strategy. I believe it is related to feeling there are too many opportunities and I can't decide which one(s) to trade. The usual simplistic advice is to be told to trade the best ones. Easy to say, but how do you define the best, e.g. based on technicals and fundamentals if they all appear strong? Of course, this scenario is prevalent in a bull market as we have had for the past year or so. I guess there is no easy answer, and

it requires us to bite the bullet and make a choice, rather than dither. Has this ever been an issue for you and if so, how do you deal with it?

My second issue: Biased mindset when assessing opportunities
This relates to the previous issue as well. I feel a bias sometimes when assessing the prospects of a share. I think this can lead to missing some very good opportunities, e.g. ALL, BSL, COA and CTX to name a few. Who would have thought ALL could turn around so quickly and make multiple gains with no current earnings? I was well aware that its technicals were starting to look good, but rejected it because of its previous poor fundamentals. Who would have thought a steel company would make multiple gains quickly? I was influenced into thinking COA was a cyclical and maybe all the gains were on the table. It has continued to be a strong performer. Who would have thought CTX would make multiple gains after being criticised so much for its poor performance?

It is difficult to see shares purely as a vehicle for profit without bias in any way. Part of a strategy may eliminate certain shares for trading, e.g. ones with no earnings. The irony can be that they are often the ones showing the best moves. A well-known investment newsletter had strong buy recommendations on MRL all the way down into the doghouse, based on the time-worn belief that it is undervalued and only needs the market to recognise this fact. Please! What is the point in arguing with the market to prove a point while other shares are booming? It is a similar scenario with people obsessing over shares like TLS, NAB and AMP, banking on a big turnaround. Meanwhile the rest of the market has stolen a march and left them for dust. These biases are not easily overcome, but thankfully I am getting better all the time. We do get attached to our shares whether we like it or not.

I guess trading without bias comes back to our strategy and being comfortable with it e.g. if we are happy to trade unprofitable shares with the associated risks, and manage to make money, so be it. At the end of the day it's about taking profit from the market and increasing our equity, how ever that may be achieved. Do you perceive this bias in traders or experience it yourself?

Colin
Yes, both of these things have been and to some extent continue to be issues for me. I think they are issues for most people. In fact, they can cause a kind of paralysis as you describe, where there are so many choices that you end up doing nothing on the one hand and where we all feel this incredible regret that we din not buy into risky situations that paid off handsomely.

For me the breakthrough was the insight that I was trying to be a perfectionist. I was analysing and analysing, trying to find the best ones somehow, so that I had the perfect approach. However, in investing and in life, seeking perfection is ultimately a futile exercise. It is especially the case in investing. I learned the hard way over quite a long time that the most textbook-perfect chart could end up as a loss, while a less-than-perfect chart that I had discarded ended up being one of the winners.

What I am saying is that there is no way to absolutely know which ones will be the best and which ones will not. The best you can do is to have some criteria, rank your shares on those criteria and go with the best ones in the ranking. Then evaluate how it works out and if necessary revise your criteria based on what you learned. The only problem with this is that the market conditions may have changed.

Above all, do not have regrets that you missed some. I have missed many great investments over the years. In some cases a look back at them has caused me to revise my criteria. However, in a surprising number of them, I ended up concluding that the risk at the time was greater than I wanted to take on and that even though they were ones that would have been great to invest in, out of consciousness were lots of others, that had the same risk characteristics and which were investment disasters. It is a bit like horse racing. Everyone remembers the few long shots that came home at huge odds. However, quite forgotten are myriad others like them that finished where most long shots finish – at the tail of the field. Investing is about probabilities. We try to keep the odds in our favour by having a margin of safety and clear criteria for selection. You can't buy them all. Hindsight is the only perfect way to pick shares.

At the start of a bull market I tend to invest in good shares as they come to my attention. Then, when there are more coming up than I have money for, I rank them on PE ratio, dividend yield and trend strength. It will never be perfect, but it seems to work fairly well. I also tend to try to avoid having too many shares in the one sector, but I do not try to have something in every sector. Finally, like everyone I have prejudices against certain companies, managers and industries from time to time. I think this is unavoidable and part of the facet of investing that says we should have a plan that we are comfortable with. There are some that I could never be comfortable with. I have stopped apologising for this.

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.*

Published by
Colin Nicholson
ABN 95 911 284 126
PO Box 5121
Greenwich NSW 2065
Phone +61 2 9436 1610
colin@bwts.com.au