

# Colin Nicholson's Newsletter 48

5 April 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](mailto: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.*

## How to Use a Chart

### Question

I have spent the last three years studying Technical Analysis. Yet when I look at a chart, I still cannot tell what is going to happen. How much longer will it take to reach that point?

### Answer

Some people never find the answers to their questions for the simple reason that they are asking the wrong question. How many times have you felt that there was a problem you needed to solve, but could not somehow come to grips with it? Mostly, when this happens it is not the solution that is illusive. It is the definition of the problem. If you can properly identify what your problem is, you are most of the way to solving it. Likewise, if you ask the wrong question, you will tend not get the answer to the question you should have asked.

Your question falls into this category in my opinion. Let me assure you that you are not alone. It is a common misconception that technical analysis, or fundamental analysis for that matter, is about prediction. There is a great deal of literature that suggests very strongly that it is very difficult for us to predict almost anything. If the system we are trying to predict is extremely simple, yes, it may be possible to get it right. However, as soon as the system becomes in any way complex, it is almost impossible to predict the outcome with any consistency. Moreover, the further ahead we try to predict something, the less chance we have of being consistently successful.

Does this suggest that analysis is useless then? No, not really. Benjamin Graham, the father of security analysis agreed with me that it was not possible to predict company stock market performance. His approach was to find companies that had been consistently successful in the past and which were cheap. This gave him a margin of error. Even if the company were to suffer considerable misfortune in the short term, the low price paid for it would act as a buffer against catastrophic loss.

This suggests that if we are looking for analysis to provide predictions, we are asking the wrong question of it. The correct questions we should ask of technical analysis include what is the condition of the market? What is the balance of supply and demand? Is there any evidence of a change in the balance? Is the risk relatively high or relatively low?

In other words, technical analysis is no more or less reliable than any other method in predicting the future – abysmal. Its value lies in being able to see what buyers and sellers are doing. We cannot see this with fundamental analysis, because it studies value. Technical analysis studies price. Price is determined by the interaction of buyers and sellers. If buyers are stronger, prices rise. If sellers are stronger, prices fall.

So, what we should be looking for from technical analysis is to assess how the past led to the present situation. This assessment is then the basis for developing a strategy that is appropriate for the present conditions. That means to take advantage of opportunities and to manage risks.

Thinking only in terms of prediction is a naive and unsophisticated approach. Successful investors graduate from that level to one where they learn to read the situation and develop investment strategy. In doing that, there are some basic guidelines:

1. Start with the long term and analyse down to the short term. This is a very powerful idea, even for short term traders. Trends exist in multiple time frames. Longer term trends have a powerful influence on shorter term trends within them. The key idea is that if you trade any time frame in the direction of the higher time frames, you have more chance of being in a strong trend. Short term trends that are counter to longer term trends tend to be much weaker.
2. Start your analysis of the chart in any time frame with the facts. You should first establish what information is on the chart that is not an opinion or a judgement, but a fact. Is there a trend? What direction is it in? Where are support and resistance levels in relation to the present price? And so on. In other words, you describe what you can see that is factual.
3. Then move into analysis. Analysis is when you reason from the facts to a conclusion about the balance of buyers and sellers and whether there is evidence of a change in that balance. It also involves assessing the level of risk. Is it high or low? From those assessments, you should form a view as to where any opportunities are that you might take advantage of and where there are risks that you need to manage.
4. Finally, move into developing a strategy for taking advantage of the opportunities. Are they good enough to chase? Is the risk worth taking? How much risk should you assume? What sorts of risk should you assume and what types of risk should you minimise?

This is the proper use of technical analysis. You have probably already got enough knowledge to do this. All you have to do is to start asking the correct questions.

## **The Aggressive Investor**

My book on investment methods is now complete and published on my subscription website [www.bwts.com.au](http://www.bwts.com.au). It will stay there until it is published in print in a few months time. I do not have a release date yet. When I have a date I will let you know through this newsletter.

## A Timely Warning

In *Shares* magazine April 2005 on page 58, I wrote an article titled *A Timely Warning* about a new indicator based on the new high-new low data file which is available on my website. This is how you construct the chart shown in the article in *Insight Trader charting* software:

Launch Winit  
Alt+L  
ASXHL  
Click Chart in New Window  
OK  
View  
Chartspecs  
Change second box to 2  
OK  
OK  
Ctrl+H  
A  
Tab  
20 (or whatever length of MA you want)  
Enter

You can now reset the Y axis if you wish.

You can also create a new chart in a separate window of the All Ordinaries Index for the same period and overlay them if you wish to view it like that.

## Payout Ratio

### Question

What is the payout ratio and how is it interpreted?

### Answer

The payout ratio is simply the dividend by share (DPS) as a percentage of the earnings per share (EPS):  $\text{Payout Ratio} = 100 \times \text{DPS} / \text{EPS}$ .

So, if the dividend is 50c and the earnings per share is 75c, the payout ratio is  $100 \times 50 / 75 = 66.67\%$

Interpreting the payout ratio is not quite so straight-forward. It all depends on the situation.

Firstly, though it is important to understand that by law a company can only pay dividends out of profits. To protect creditors, companies may not pay out their capital as a dividend. So, to pay a dividend, a company must have current year profits or profits retained from previous years available to cover the dividend.

If the payout ratio is more than 100%, it means that the company is paying out all of its current year profits and also some retained profits. This is not sustainable. It is often a sign of problems. In these situations, it is necessary to inquire into the circumstances and be convinced that it is a temporary measure.

The payout ratio should desirably be less than 100%. This gives some margin of safety in that the profits may fluctuate somewhat without endangering the dividend. Many companies recognise that some shareholders live off dividends and they try to give some certainty to the income flow. They will be reluctant to cut dividends. They therefore tend to pay out less than 100% in most years, so that in bad years they can hold the dividend. If the payout ratio is normally lower and then moves toward or to 100%, it is necessary to enquire further into the circumstances, to ensure that this is temporary.

Other companies have a policy of paying out a consistent proportion of earnings. They may therefore have a policy which, for example pays out 80% of earnings. In this case, the payout ratio is not as important as the earnings, because dividends will rise and fall with earnings.

Payout ratios are affected by the degree to which companies have a need to retain earnings for growth through increased business levels or through acquisitions. If a company has few growth possibilities and is throwing off lots of cash that the directors have no scope to employ in the business, the payout ratio may be high. However, if the business is growing very rapidly and there are abundant opportunities for further growth, the payout ratio may be very low.

So, in the final event, it all depends on the situation. However, if you encounter a fairly normal situation where the payout ratio is 60 to 80%, there is probably not great cause for concern.

## It's About Time

Last year my friend Sue Fraser began a business teaching people how to reduce the stress of trying to keep up with all the things they need to get done each day. I went along to see what it was about. It was so useful to me that I went back and did the course a second time and I have gone to several follow-up sessions. If you find that you can not get everything done in your day, week or month, one of Sue's seminars will help you more than you imagine.

There are two seminars to choose from. *Productivity and Accomplishment* is focused on people in business. *Managing Stress and balancing Life* is focused on anyone who needs to get control of their life and reduce stress levels. In addition, Sue can tailor special seminars for groups or businesses.

Sue's business is called *Pentagy*. The seminars are part of the *Mission Control®* program.

Upcoming seminars:

### **Productivity & Accomplishment**

Thursday 7 & Friday 8 April - North Sydney

Saturday 16 & Sunday 17 April - Carlton, Melbourne

Monday 1 & Tuesday 2 August - Ryde, Sydney

Thursday 22 & Friday 23 September - Ryde, Sydney

### **Managing Stress & Balancing Life**

Saturday 14 & Sunday 15 May - Ryde, Sydney

Saturday 12 & Sunday 13 November - Ryde, Sydney

**For more information, or to register:**

Susanne Fraser, (02) 9651-4703, [sue@pentagy.com.au](mailto:sue@pentagy.com.au), or visit [www.pentagy.com.au](http://www.pentagy.com.au)

## Starting with Borrowed Money

### Question

Having limited capital, I am thinking of starting trading with a line of credit. Am I being foolish?

### Answer

Yes, I think you are. Trading is a difficult skill set to learn. Most people take five to ten years to learn to make money consistently. Most beginners lose money and drift away disillusioned. The key is to get through the learning process without doing yourself significant financial harm.

I would NEVER start with borrowed money. You must start with money you have saved and while you would not like to lose it, it would not leave you with a debt if you did.

First you need to start learning the craft. You need to read a lot of books, and do some formal education. The two technical analysis subjects you can do through the ATAA (see [www.ataa.com.au](http://www.ataa.com.au)) are a great start in that area. The ASX also runs courses for beginners (but avoid options – that is a mug's game). The Securities Institute of Australia also offers excellent programs. Avoid get-rich-quick seminars and any software costing thousands of dollars and promising to make it easy. It isn't.

You will find lots more on my website, both on the free site and on the subscription site.

## Did You Do It?

It is an important principle of investing that investors take responsibility for their decisions. This extends beyond the obvious decisions involved in buying and selling. A recent example concerns database management. Decisions made about the integrity of your database can be important in your analysis.

A recent example centres on adjusting the database in unusual situations. In Insight Trader charting software, it is possible to automatically handle over 99% of adjustments to the database through the Database Manager service. To handle a recent adjustment, which could not be dealt with automatically, the following notice appears on the screen when you next launch Insight Trader after each time you have run the Database Manager:

*FILE MXG MERGED WITH MXGCA*

*Following the final payment of the call on MXGCA and additive adjustment has been necessary to merge this code with the fully paid MXG.*

*ONLY IF YOU HAVE NOT ALREADY DONE SO: Please copy the adjusted files MXG.DAT and MXG.B01 from your \WINIT\Files directory to your \WINIT\M directory.*

In passing, I recently asked a number of Insight Trader users what they had done about this notice. Almost universally the answer that I got was that they did not understand the message, so they clicked it off and did nothing about it. This was a

bad decision. There was a very good reason why this notice was posted. Unless the requested action is carried out, your database will not be correct.

Firstly, let me say that this notice is very cryptic and it is difficult for many users to understand. However, it is not technically incorrect or incomplete. It is assuming a certain level of computer literacy, which if the user does not possess, the user should seek further advice on what the notice means. This is not a problem that is peculiar to Insight Trader, it is endemic in the computer industry. Those who work with computers every day, including myself, have a lot of trouble appreciating how low is some users' understanding of very simple instructions and basic processes. So, let me decode this message for those Insight Trader users who have still not acted on the notice. Users of other data services that make adjustments to databases are advised to check whether the adjustment has been made by their vendor and whether it has been done correctly.

#### *FILE MXG MERGED WITH MXGCA*

What this means is that the data file for Multiplex fully paid shares, which has the ASX code MXG, needs to be merged with the data file for Multiplex contributing shares, which has the ASX code MXGCA. Why?

A fully paid share is one where all the capital has already been paid to the company. A contributing share (also known as a partly paid share or an instalment receipt) is one where some of the capital has not yet been paid by the shareholder to the company. That payment will be made at a date fixed in the future or when the company decides to call upon the shareholders to make the payment, known as a call. There may be one or several calls before the share reaches fully paid status.

A contributing share is a different security to a fully paid share. There is an outstanding liability to pay calls on the contributing share, which does not apply to the fully paid share. It is therefore necessary to allocate a different ASX code to each type of share, so investors know what they are buying and selling. Fully paid shares always have a three-letter ASX code (MXG in this case). Other types of security will have a four, five or six-letter codes. Contributing shares are usually allocated a code that comprises the fully paid three-letter code (MXG) and an additional letter C, that designates a contributing share and an additional letter A, B, C etc for each class of contributing share. As Multiplex only had one class of contributing share, its ASX code was MXGCA.

When the final call is made, the contributing shares cease to exist. However, if there have not been any fully paid shares prior to this call, there will be no historical chart for fully paid shares. We will want to join the price history for the contributing shares to the new prices for the fully paid share. So, we have to adjust the historical prices in the contributing share file so that they are comparable to the fully paid share prices and then merge the data in the contributing share file into the front of the file for the fully paid shares. In this case, we have to adjust the prices in MXGCA and then merge them into the front of the MXG file.

*Following the final payment of the call on MXGCA an additive adjustment has been necessary to merge this code with the fully paid MXG.*

The first part of this simply tells you that there has been a final call on Multiplex contributing shares (MXGCA).

The statement that an additive adjustment has been made is jargon for what sort of adjustment is necessary. If you buy a contributing share and later pay a call on it, your cost after the call is the price you paid for the contributing share plus the call you paid. So, if you bought MXGCA at \$1.00 and then paid the 97c call, your cost of the MXG fully paid share you hold after the final call is \$1.97. So, in order to make all MXGCA prices comparable to MXG prices, we have to add 97c to all past MXGCA prices.

This is called by the jargon term an “additive” adjustment (we add a constant amount to all past prices) to distinguish it from some other adjustments that are multiplicative (we multiply all past prices by a factor) or other more complex adjustments. Additive adjustments are one of the few adjustments that can not at present be handled automatically by Insight Trader Database Manager, so they have to be handled in a different way.

As already explained, the adjusted MXGCA file needs to be merged into the front of the MXG file, so that we can see the historical trading when analysing MXG.

*ONLY IF YOU HAVE NOT ALREADY DONE SO: Please copy the adjusted files MXG.DAT and MXG.B01 from your \WINIT\Files directory to your \WINIT\M directory.*  
The Insight Trader file structure is explained in the Insight Trader manual. Yes, I know that real men never read manuals, but unless you do, you will have trouble understanding this instruction.

Most charting software uses a file structure where there is a file that controls the way the data is handled etc and one or more files with the actual data in it. The file that controls the file with the actual data in it is called a “dot dat” file, which is computer speak for a file with the file extension DAT. So, the MXG file that controls the files with the actual data in it has the name MXG.DAT. The file(s) which have the actual data in them will have some other file extension, depending on the software developer’s or data vendor’s file structure. In Insight Trader, the files with the actual data in them are limited to either 16 or 32 kilobytes. When the files reach their maximum size, a new file is created. The files have the extension Bnn, where nn is a two-digit number. The first one is named B01 (B, zero, one), the next B02 and so on. So MXGCA, being a recent listing, only has one file with the actual data in it and has the name MXGCA.B01. Likewise for MXG, the file is called MXG.B01.

We therefore have two sets of files:

MXGCA.DAT and MXGCA.B01  
MXG.DAT and MXG.B01

The data in MXGCA.B01 has to be adjusted and merged into the front of MXG.B01. MXG.DAT is also changed to reflect this process having taken place.

Since this is not at present possible automatically, Insight Trader have made the adjustment and merged the files. Two new files MXG.DAT and MXG.B01 have been supplied. These are updated every week and deposited in your Winit (stands for Windows Insight Trader) folder on drive C. This is the default set up, but you may have decided to use a different location and folder name for where your Insight Trader ASX files are stored on your computer.

These new files can not be put into their correct positions, because users may not want to make the adjustment (unlikely), or want to make it a different way. They may also want to retrieve their notes and alarms in their existing MXG files before they are deleted in the next process.

It is not absolutely necessary, but it may be easier to see what you are doing in the next steps in the process if you turn on file extensions in Windows (see Windows Help for how to do this).

Note: The term "directory" is used in the notice. Directory is a term that originated in DOS, the operating system that predated the latest Windows operating system. Microsoft chose to change it to "folder" in Windows. The two terms are interchangeable.

If you have not run Database Manager for a week or more, run it now.

Before you move any files it is standard practice to backup your computer. You can skip this step if you also practice unsafe sex and similar risky behaviours. Murphy's law almost guarantees something will go wrong from which you cannot recover. Take the time to do it.

It is a good idea to adopt a "belt and braces" approach. Rename the existing MXG.DAT and MXG.B01 files as MXGOLD.DAT and MXGOLD.B01. This will be useful if you have notes or alarms in your MXG file, or want to manually transfer data from it later (see below). The quickest and safest way to do this is to load or chart MXG in the normal way in Insight Trader and then save it under the new name MXGOLD using File/Save Data File.

Next, you need to use Windows Explorer (also known as My Computer in some versions of Windows). Find it by right clicking on Start and clicking Explore, or from Start/My Computer or from Start/All Programs/Accessories/Windows Explorer.

Navigate to C drive (or wherever your Insight Trader files are kept) and then to the Winit folder (or whatever folder your Insight Trader files are in) and then to the Files folder. Select MXG.DAT and MXG.B01 (hold Ctrl and click the icon in front of these files. If you cannot see the .DAT extension, it is because you have not set Windows Explorer (My Computer) to show file extensions (See Windows Help under Show file extensions). If you cannot see the .DAT extension, don't worry, though, it will be the MXG file that does not have a file extension showing. The other file, MXG.B01, should show the file extension, but if not, just select the two MXG files. Do not confuse them with MXE, which may also be there and have a very similar name.

Once you have selected BOTH of the two files, right click on one of them and click copy. Click back or otherwise navigate to where you can see the M folder. Right click on it and then click paste. You will be asked whether you wish to overwrite the file MXG.DAT. Click YES. Likewise the MXG.B01 file. Close Windows Explorer.

Open Insight Trader. Copy and paste any notes from the F2 keypad in MXGOLD or MXGCA that you wish to transfer to the F2 keypad in MXG. If you had alarms set in MXGCA or MXGOLD, you may want to set them up again in MXG (you will have to adjust the alarms in MXGCA by adding 97c to them).

The MXG file that you have now will have data up to the last trading day in the previous week to the one you last ran Database Manager. You need to bring the file up to date if you have already updated your database since you last ran Database Manager. You can manually insert the data from MXGOLD (slow and prone to human error), or distribute the data from your vendor for the days absent from the MXG file again. How you do this will depend on what data vendor you have and how their downloading utility program is set up. You could also do it using the Datacapt utility in the Utilities menu in Insight Trader.

Load and chart MXG as daily bars. It should begin on 021203. If it does not begin on that date, you have done something wrong. Copy MXG.DAT and MXG.B01 from the Files folder to the M folder again until it is correct.

If you are not confident about doing this, you need to find someone to help you do it. Dial & Chart have a pay-per-use helpline for Insight Trader users for this purpose. The notice will appear again after each time you run Database Manager for some time. You can now ignore it.

The lesson: Do not ignore notice or warning boxes. If you see one, read it and follow what it asks you to do. If you do not understand it, write down what is on it and ask someone to explain it to you.

## CFDs – Did You Know?

It has recently come to my notice that there may be more than a few clients of Contract For Difference (CFD) issuers that do not fully understand who they are dealing with. The bottom line is that CFD issuers are finance companies operating in the so called "over the counter" market. They make their money from you by lending you money at a price, called interest and from the spread between buying and selling quotes offered to you. CFD issuers are not bound by the stock or futures exchanges. In Australia, they are regulated by the Australian Securities and Investments Commission (ASIC).

An over the counter market is one conducted off the floor of an exchange. Essentially, the CFD issuer is running a private market as a market maker. A market maker is someone who offers a buying quote and a selling quote at all times, which you may accept or reject. The exchange traded options market also operates this way. While prices quoted will be set in relation to prices on stock and futures exchanges, there will at times be differences, particularly if the market is thinly traded, your order is large relative to the volumes on the market, or the market is disorderly for some reason.

The other thing to understand about this is what is called in the industry as "counter party risk". If you trade on the Australian Stock Exchange (ASX), your transactions and certain money held by brokers pending transaction completion are guaranteed by the ASX National Guarantee Fund. So, the credit worthiness of the person on the other side of your trade (the counter party) is not relevant. However, with CFDs, there is no such guarantee fund and the credit risk is dependent on the financial strength of the CFD issuer. I am not suggesting that these companies are an immediate credit risk. However, it is something that clients should be aware of and take steps to monitor the financial health of the issuer, say by tracking annual and half-year financial reports if they are available publicly.

## **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](http://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).
- 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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