



COLIN NICHOLSON
Building wealth through shares

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Recent Mail from Readers

Over the period from the last bulletin, I have received comments and questions from readers. Some of the more interesting ones are below, followed by my response:

Reader

I appreciated your comments to the trader in your bulletin (and the bulletin itself is a great idea - it fosters thinking and reflection!!)

All the experts I admire say that you have to have your trading plan written down. When I said to Ivan Krastins recently that I thought I was getting close to having a system in place he floored me by saying that the next step is to write it down on paper so that another trader could execute it for me! Now that would be precision!

Then I was heartened by Gordon Pelletier's comment at the President's dinner that he had been working on writing his plan for five years and by gosh he was determined to have it finished by Christmas! It may have echoed what I have found, and about which you made a helpful comment in your bulletin, which is that the subjective factor is needed for most of us but experience (and study) will teach us how to use subjectivity safely.

I am currently putting together a seminar on candlesticks and I find that my overall view of a candlestick chart, tracing the trend progressions and reversals right up to the present timeframe is my safety net - it helps me make sense of the chart and form a view of the future - this is then needed because the classic candle patterns are very often imperfect! Therefore I must use my judgement or, as you say, pass by perfectly reasonable opportunities for the sake of technically perfect signals.

But how to quantify the subjectivity in a written plan? I think the act of trying is worthwhile, however, because it forces us to be honest with ourselves and express to ourselves why we might considering a less than technically perfect signal. And then strict money management keeps it fairly safe.

Colin

Thanks for the feedback. I agree with Ivan. We must be able to write our plan so that someone else could go over our trades and say whether we had followed it or not and if we followed it, what the results were.

I do not see that subjectivity as a big problem, so long as it fits within guidelines or rules. It is always possible to rationalise. What we need is honesty with ourselves. If we keep making bad subjective calls, we need to examine what we did very carefully. Try to turn it around - could we convince someone else that our judgement call was the only reasonable or most reasonable interpretation? If not, a useful exercise before taking a trade is to try to write down what the other side of your trade might see in the chart to convince them you are wrong? If you are buying, what evidence is there for a seller?

I hope this helps. It is all a journey of self-discovery. The journey is the important part, not the final answers.

Reader

Take Keycorp as an example (which I entered at \$9.19). This had a trading range and a classic

breakout. But if you just looked at it now for the first time is it too late to enter? Do you wait for a trading range to form again and then enter the trade?

Colin

As I see this chart, it jumped upward and is now consolidating. My approach would be to take a small position now (it would be small, because of how far the stop is away from entry, by definition) and then wait for either of two developments and act on which ever occurs first:

1. If it falls back to the breakout point (resistance, now support), I would buy more. As the stop is now closer, you can work out an average risk and increase your position without risking more than 1%.
2. If it makes a new high, I would buy more, with the stop under the consolidation low, as the indication is that it may be very strong.

However, there are other quite reasonable views, including that if it goes too far for your comfort, you should let it go and look for another stock. Just do not crucify yourself later if it is a big winner.

I prefer to take a small position now, because it may be a big winner and it is better to have a small position than none at all. However, it depends upon you being comfortable with the risk.

Reader

Is there an entry point for these 'shooting stars'? Do we treat a 'retrace and rise' as a 'short lived' trading range (for setting the buy price and stop loss) and enter on the breakout above the old high?

Colin

For these stocks, I try to tolerate the risk and let them run until I see them meet some resistance. However, I sometimes find short-term trend lines useful (the only time I use trend lines). Other people find the Parabolic SAR indicator useful and I have used it sometimes.

Just remember that nothing goes straight up for long - certainly not in normal times and even in rampant speculation phases it ends sooner or later.

I am sorry I cannot give you the "right" answer, but there just isn't one to give. Instead you have to assess the risk and your tolerance for it. There is a time to take big risks - in the early part of a bull market. However, I think a more risk-averse approach is warranted the closer we get to the end of a bull market.

Student of SIA Subject E114 Technical Analysis

RE: Relative Strength of Reversal Signals

From Lecture 2, I understand (I think!) the following re relative strengths:

- Key (reversal) is stronger than closing price (reversal), which is stronger than
- open/close, island and pivot point (reversals), which are similar in strength (but variations by size of gap on the island)
- pivot point (and therefore island??) is stronger than key (& therefore closing price and open/close) given that it often starts with them and therefore confirms (strengthens?) them??

Questions

1. Is the above reasonably correct or is it not that clear cut?
2. Where does the hook reversal fit in re relative strengths? (similar to the open/close??)

Colin

I don't think it is as simple as you present it.

On a somewhat philosophical level, I worry about trying to boil it down to rules like this. Almost any discipline begins to lose its effectiveness when it is pushed too far. Also, the best practitioners in any

discipline tend to keep thinking about every case, while the mediocre practitioners need rules to guide them.

In the instance of reversal signals, I do not think there is anything to gain by trying to order them in the way you suggest and, to the contrary it might get in the way of good analysis, which comes from seeking insights into each situation.

Any reversal signal is more potent after a strong trend compared to a weak trend. Thus, while a key reversal is regarded as a strong signal, it might be a weak one if the trend was ragged, irregular and lacking in momentum generally.

On the other hand, you might generally regard a hook reversal as weaker than a key reversal. However a hook reversal at the top or bottom of a dramatic trend would be more potent than a key reversal after a weak trend.

So, you see that it is not possible to order the signals without a context, which will be different each time. In topic 10, on page 10-6, we talk about subjectivity and look at it as a problem and an opportunity. This is one example of where you can use it as an opportunity or not as you choose. I know which way I use it.

I hope this helps, even though it is not the answer you were looking for.

I wrote the following today and have also given it to Dr Alexander Elder to publish on his Books and Trades email list (to join contact him at info@elder.com . See his web site www.elder.com .

On April 4 2000, I wrote the following item for my Trendlines Column in the current issue of the Australian Shares magazine about a technology stock called Senetas:

"Senetas Corporation (SEN) has a fascinating chart, because it shows one of the most reliable technical analysis signals. This revolves around the idea that a failed signal 'very strongly suggests the possibility of a significant move in the opposite direction' (Jack Schwager, in *Schwager on Futures - Technical Analysis* page 188). This signal was also known decades earlier on Wall Street as a **bull trap**.

The pattern is formed when a stock breaks out of a trading range upwards, which normally suggests a potential uptrend will develop, but then immediately crashes down through the trading range. The daily candlestick chart of SEN shows this action in the last six candles.

In addition, the black candle immediately after the all-time high was made is very bearish. It is not a perfect example of *dark cloud cover*, but an experienced analyst who has an edge based on subjective analysis will have noticed it.

These two signals in combination suggest strongly that it is time for SEN holders to abandon ship." The price was then \$1.60. The price promptly fell to below 60c, at which point I received an email from a reader as follows:

"I have been reading your comments in Shares magazine. What is your current view on Senetas. Should I sell it now or keep it? I bought it at its highest price of \$2.38. I have lost too much. I would really appreciate if you can reply."

This is not an unusual example of the sort of email I have been getting for some time as more and more people have been sucked into the stock market bubble. You might be interested in my reply:

"I think I gave you a fairly good analysis of the bleak technical picture for Senetas in Shares May 2000 on page 16. It seems I was quite correct as judged by subsequent events and have no reason to change my analysis.

You have to bear in mind that I am not a licensed adviser and in any case I could not advise you properly without knowledge of your situation and financial plans.

So, I cannot tell you what to do. However, I can give you some general guidelines on how to make trading and investment decisions. These are the sort of ideas I teach in my seminars:

1. You must have a trading or investment plan.
2. This must spell out why you buy something and over what time frame you expect to make a profit.
3. It must also identify where you are wrong about your trade and therefore where you would cut your losses.
4. This point enables you to calculate the size of your position, such that you are not overtrading and can stay in the game.
5. It must also spell out how you are going to get out of a successful trade or investment.

As I look at the Senetas chart, any short term trader would have got out some time ago. If you are still holding it, you must either be a long term holder or, to put it bluntly, not know what you are doing.

If the latter, you have no right trading in the bubble economy, which is highly risky. In such a circumstance, my usual advice is to get out of the market until you have worked out what your plan is. You might find my seminars useful as a first step in understanding the trading problem and how to go about devising a plan that will keep you in the game and make realistic profits.

I am not sure whether this is what you wanted to hear, but it is my best advice that I can give you."

Trading without a proper plan, which imposes discipline, is based on money management, and an edge based on probabilities grounded in sound technical analysis, always leads to tears. If only more would-be traders took the time to learn from those who make the time to share their experience, more of them would be successful.