Colin Nicholson's Newsletter 49

29 June 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.

Apology Department: Newsletter

The last newsletter went out at the beginning of April. Since then I have completed the manuscript of my book and taken a much-needed break trekking in Nepal for a month. Since I returned, I have been totally absorbed in the editing phase of the book. This has meant little time to work on a newsletter. However, at last I have one ready and here it is. I will try to make up for the long gap between newsletters by doing an extra one or two in the second half of 2005.

Apology Department: Website

There should have been an update of the subscription website at the end of May. It did not happen. I don't know why at this stage. I have only just discovered this. The next update was due at the end of June. My webmaster should have done this before she went overseas, but it did not happen. To say that I am unhappy about this would be an understatement.

My webmaster will not be back until the end of July. There is nothing I can do about this until then. As soon as possible after the end of July, the website – free and subscription – will be updated. Longer term, I will ensure that this should not happen again.

Other than apologising for this, what I can think to do about it is:

Subscriptions: I will extend all current subscriptions by two months. It will take me a little while to do this. If your subscription is due soon, it may not appear to be extended initially, but it will be as soon as I can edit the database.

Free Website: Data file updates will not take place again until early August. In the interim, anyone who wants the end of June files should email me for them after 2 July. Specify whether you want ASCII or Insight Trader format and I will only send you that zip file.

Subscription Website: New articles will not go up until early August. Likewise the next update of the Breadth charts. However, any subscriber who would like the end June Breadth charts, may email me for them in a pdf file after 2 July.

If these problems cause any other inconvenience, please do not hesitate to email me and I will do what I can to alleviate the situation.

Update: The Aggressive Investor

At this stage I am expecting my book *The Aggressive Investor* to go on sale in bookshops in August. As soon as I have more precise information, I will advise it in the newsletter. I will be selling copies of the book directly. Details will be published in future newsletters.

Trading and Investing using Intuition

Question

If highly experienced traders and investors quote trading as more of an art than a science, is it possible for you to explain where an experienced trader and investor would incorporate their creative intuition into their trading plan? Would and do experienced traders use their feel (creative intuition) for the market to step outside their trading plan at times, therefore breaking trading plan rules?

Answer

This is a fascinating area of study. There is a huge literature available on decision theory and the role of intuition. As it happens, I am currently reading Malcolm Gladwell's book *Blink*, which is a very easy read in this area, though not specifically on trading. There is also a lot you can find on the Internet. Important writers in this field include Klein and Snowden.

Most successful traders move through a process where they have developed a trading plan (this may take many years) and then developed the discipline to follow it. They become good traders when they see a set up or a break down on a chart and know instinctively what they have to do and do it without agonising over the decision. This is very close to being intuitive traders. However, it should be seen that they have so internalised their trading plan that it has become easy to follow. This is not the same as the idea you are suggesting where they break the rules of their plan. I think this leads to disaster.

They key to successful trading and investing lies in having a sound plan and following it. Following it is the hard part. The plan may have subjective analysis as part of the method, and intuition may play an important part here in the area of interpretation. However, taking that to the point where a trader actually breaks a rule in his or her trading plan is a first step down a slippery slope.

I said a moment ago that analysis could be subjective. This is something that many people shy away from. The big danger is that you see in the chart what you want to see. However, we never have all the information we would like. Instead we have a chart and other information that gives us insights into what buyers and sellers are thinking and doing. Experienced analysts are always going to tend to be better at reading the scene and drawing sound conclusions. In some cases this process can involve intuition in the sense that they FEEL what is happening or that something is not quite right. In this they will be ahead of the beginner. This is the art part of analysis and trading. It is not action on an irrational gut feeling.

I hope this helps – and I recommend that you read further in this fascinating area of study, which I will also be doing. My objectives in further studying this subject are to better understand how I and others make decisions and beyond that to find the best ways to teach people to develop those skills.

Tight Registers

Question

Why does a stock like Flight Centre (FLT) have a large spread between the buy and sell prices and why is there not a large volume traded on a daily basis? Could it be due to a tightly held share register, as I understand employees hold a large amount of the stock and therefore aren't buyers or sellers?

Answer

The reason that the market in Flight Centre shares is so thin is because the shares are very tightly held. The holdings of the original owners will be far larger than the employees and even less likely to be traded. You can easily research how tight a share register is for yourself. If you go to www.asx.com.au and then Prices Research and Announcements, then either:

- Announcements and follow your nose to the Flight Centre announcements in the last 12 months you should find the annual report. Many online broker websites also provide access to ASX announcements.

- Company Research, then the link to "all companies listed on asx" and follow your nose to the company’s page, you will usually find a link to the company’s website. There you will usually find the annual report.

In the annual report you will find basic information on the spread of shareholders. For Flight Centre it confirmed that the 20 largest shareholders owned 85% of the shares on issue.

You can do this research for yourself on any company.

Trading Penny Dreadfuls

Question

How do people earn money on low priced shares such as OPM, which mostly falls in price?

Answer

It may be an incorrect assumption that very many people are earning money in any share that is falling in price. When a share falls in price consistently, in my view most investors would be losing money on it. There may be some traders who sell short, if that is possible with the sort of share you have in mind, which I doubt, but I have no information on that. See the article on short selling on the Articles page of www.bwts.com.au for the theory of short selling.

However, that said, it is quite possible that some traders, rather than investors, could make money on very low priced shares, because the low price creates a significantly large percentage spread. It is therefore possible in theory to make money by buying at the bid and selling at the offer. At the close of trading today, there were 23 million OPM bid at 0.3c and 41 million offered at 0.4c. During the day most of the transactions were done at 0.3c. However, the last transaction of the day was done at 0.4c. That transaction was 300,000 shares. If the seller had bought the shares earlier in the day, she would have paid $900 for them. She would then have sold them for $1200. This would have provided a handy profit after brokerage. So, that is how it can be done. However, as already pointed out, this is very risky, because many others active in the OPM market will probably be trying to do the same thing and if the price is generally falling (it has fallen steadily from a high of 2.4c in October 2003 to 0.3c recently), most of them will lose money.

More likely, people are trying to make money buying OPM, because they hope the price will go up. Not a fraction of a cent here and there in a falling trend, but that the trend changes from down to up. This has happened before, as inspection of the OPM chart will show. In February and March 2003 OPM changed hands as low as 0.16c.A month later it had leaped to 1.2c. Although only a few shares changed hands at these prices, there were more sales in between and the percentage gain if you were really lucky was fantastic. However, it seems to me that this is a game rather like buying lottery tickets. You can outlay a relatively small sum and if you get lucky, you win big, but mostly you get locked into a shareholding.

You mention that there are a lot of people involved. That is true and interesting. At the close of business today there were 22 buyers at the bid and 50 sellers at the offer. There were similar numbers either side of the spread. I have no insight into this, but I assume that there are quite a few people who are playing the game described above. However, this is just a guess. It seems the most likely explanation.

You also mention that there are millions of shares traded each day. This is simply a function of the price. As I mentioned above, the last transaction today was 300,000 shares, but this parcel was only worth $1200. That is really a small transaction on the ASX.

You ask why the shares do not go up. This is surely a matter of the prospects for the company. I know nothing about OPM, but one glance at the chart sends off alarm bells for me that its shares are like casino chips. This does not look to me like an investment grade share which one might start to appraise using security analysis. However, I could easily be wrong. I really don't know anything about the company or its prospects.

Finally, you ask what will happen if the shares go down to 0.1c, is there somewhere to go after that? Well, that is the lowest price the shares may be quoted at on the ASX. I suppose that an optimist would suggest that the only way they can go is up. However, my guess is that the company may have become history by then. If not, and it does fall to that price, I am sure there will be someone out there who will buy 1 million of them for $1000 and hope to double their money selling them to someone for 0.2c. Hope springs eternal.

I would like to stress that I know nothing about OPM and my comments use its prices and chart as an example only without any implication that my theoretical comments have any basis of fact in OPM. I would not recommend to anyone that they try to trade such shares to scalp the spread. It looks to me like a loser's game.

Maybe one of my newsletter or web site readers has better insights than I have into the game of trading such low priced shares. I welcome any contributions on this subject.

Correction to MXG Instructions

In the previous newsletter, I gave instructions for dealing with the adjustment of Multiplex (MXG) in Insight Trader subsequent to the call on the contributing shares.

The fourth from last paragraph read like this:

Load and chart MXG as daily bars. It should begin on 090304. 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.

Unfortunately, I got the date wrong. **The date in that paragraph should have been 021203**, not 090304. My apology for this mistake. Also, thanks to Chris Horsfall for bringing it to my attention.

Importance of Dividend Yield

Question

Regarding your investing and stop loss philosophy where dividends are concerned: As retirees, we are interested in shares with a good yield. Since a good yield makes up for some lost ground if the share price drops, do you factor it into your calculations in purchasing or in setting stops at all? Or do you avoid high yield stocks entirely in favour of growth stocks? If so what would your advice be to a little ole retiree regarding an alternative investment strategy?

Answer

I would question your statement that you are interested in shares with a good yield. There is nothing wrong with that per se, but there are some traps.

Firstly, a company which is failing will seem to have a good yield, because the market has dropped its price in expectation that it will not be able to continue to pay dividends at the present rate.

Secondly, dividends are only one part of the total return on an investment. The other, usually larger, part is capital gain. Some stocks or other securities like trusts have very little growth expectations, so they sell at high yields to attract investors. This is fine, but you may do better if you focus on total return than yield alone. In other words, a stock that has a yield of 4% (a long term average for the market) with a capital gain expectation of 8% (also a long term average for the market) may be a better investment that a stock with 6% dividend yield, but little if any capital gain expectation.

I hear what you say about being retirees. However, are you familiar with the life expectancy tables? Many people, who get to say 70, do not realise that their life expectancy is well into their 80s. It may be important to have a part of your assets in growth investments - especially if inflation returns, which is inevitable. There are many views on this, but a common conservative one is that you consider 100 minus your age as the percentage of your investment capital that you have in growth assets like shares.

In terms of whether I factor in yield in my purchasing decision - yes I do as explained in my book (on sale by end August 2005 and on my subscription website until then). However, what I do is relevant to my investment plan, but not necessarily to yours. A yield above the market average can indicate a margin of safety, all other things being positive - especially that the share price is trending up. I help a retiree personal friend with her investments and I do most definitely focus on uptrends with above average yields for her because income flow is important. However, her situation may be quite different to yours, as may be her age.

As described in my book, I invest in both value and growth stocks. However, that is what is appropriate for me. Your requirements may be different.

As for setting stops, the yield plays no part at all. Likewise the payment of a dividend, which usually sees a fall in the price, plays no part in the placement or exercising of my stop-loss level. I make no adjustment for dividends.

As for advising you on an alternative investment strategy, I am sorry but I can not do that legally and have no wish to be an investment adviser. My focus is on teaching people to be their own advisers. I hope that the discussion of some of the issues above helps you in fining the right strategy for your situation.

Further Question
Also, would you say in setting a stop loss level and exit strategy that one should consider the yield of the stock, in terms of its current price, or the yield you are now getting on the original purchase price?

Answer
I always look at every decision in terms of the current price. What you paid is not relevant and worrying about it is one of the biggest traps in investing, as described in my book.

Pre-Opening Price on the ASX

Question
Regarding the ASX Market Depth screen: How do they calculate the "Estimated Price"? Before the market opens, this varies, presumably, as pre-market orders are placed.

Answer
This is fully explained on the ASX website www.asx.com.au. In Search ASX, enter opening price and you will find how the opening price is calculated. The estimated price is simply the dynamic calculation in the pre-opening period, based on orders as they are placed on the SEATS system.

Question
After the market opens The Estimated Price usually goes blank, but lately for some stocks, it retains a value all day?

Answer
It goes blank because the market has opened and is trading. Estimated price is no longer relevant, because there is an actual price.

A stock can be suspended from trading by the ASX or at the request of the company, say pending an announcement. One way this is done is to place the stock in the pre-opening sequence beyond the normal opening time. It can sometimes stay this way for some hours or some days. You can check if this is the case by looking at the announcements on your broker's website or on the ASX website. If trading is taking place and there is still an estimated price showing, it would suggest a bug in your broker's or the ASX software. The latter is unlikely.

50% Rule and Divergences

Question

Some stocks have retraced 50% from their highs but the index has not. What do you think of this rule in the current market situation where many stocks have given up all of the gains since August 04.Some are also showing divergence on a daily basis.

Answer

I am not allowed by law to comment to you on the current market, because I am not a licensed adviser. Also, I do not want to be an adviser anyway. I prefer to focus on teaching people to be their own adviser.

I am not at all surprised that some stocks have retraced 50%, but the index has not. It is totally consistent with the idea of an index, which was originally an "average" as in "Dow Jones Industrial Average". Individual stocks will be both more volatile and less volatile than the index. Some will even move in the opposite direction. The index summarises all these disparate movements, so it would be amazing if it were not as you describe.

The 50% rule has been around your about a century. It is one of those rules where people can find lots of near-perfect textbook examples, but I have never seen a proper statistical analysis of many markets over a long period. If you know of one, please let me know.

I am at a loss to know how to trade the 50% rule. The problem is that it is "woolly". By that I mean that sometimes the examples people quote show the market turning anywhere between say 45% and 55%. I don't know which point to rely on. The problem in short is that the rule is aiming at finding the exact top or bottom of moves. This is not possible at all except with luck and with consistency except by telling lies after the event.

I much prefer the percentage bands approach taught by Dr Alexander Elder in his book *Come into my Trading Room*. There is a logic to placing buying orders near the moving average and selling near the upper band. Or selling short near the moving average and covering near the lower band. You could apply the same approach to 50% retracements to enter trades, except, I do not understand the logic of the magic number 50%. It sounds and feels like Holy Grail territory, if you will let me mix a metaphor for effect.

I am not an expert on divergences. The problem with them is that there is often a divergence before a turn, but all divergences are not followed by a turn. Just blindly buying and selling divergences will be premature most of the time in good trends. Martin Pring advocates confirmation from a trend-following indicator, which is sound logically. Dr Elder has a more subtle approach involving multiple time-frames, which I suggest you study in detail if you want to use divergences.

Darvas the Dancer Again

Question

I have been studying the Darvas Box technique of late and I notice that I can't find any mention of this in your articles. It looks from your trading plans that you are doing the same thing anyway. Could you please tell me if this is so and whether Darvis Boxes are necessary to confirm a strong trend?

Answer

I have read both of Darvas' books (many years ago). I am not aware of any other explanation given by Darvas himself.

The basic description of what he wrote is that he observed that in strong trends at the time, stocks seemed to rise, then hover on a range before rising again and so on. If the breakout from the range was upward, he bought or held on and if the breakout was down, he sold. I think this is a useful idea. It picks up the concept of a "line" from Dow theory. It seems that the market when he was active in the 1970s formed lots of "lines". However, "lines" were described in Dow theory as only an alternative to secondary reactions which involve a more significant retracement, rather than just a pause in a range.

Much later and more recently, some people have tried to give Darvas' basic idea far more precision than he ever described and turned it into an algorithm that becomes a trading system. My view is that this is fraught with danger. Firstly, the whole thing is based on a market condition that is an exception. It was apparently very common at a specific time when Darvas was active and profitable (he later did much worse in different conditions). That means that it is not a robust method that will work in other market conditions. Secondly, I have learned from long experience that general tendencies are useful and exploitable in the market. However, taking them too far and attempting to make them too precise renders them unprofitable. In jargon, this tendency to precise algorithms simplifies the problem to the point where it breaks down by pushing the edge of the envelope to far.

Regarding the second part of your question, I use the concept of "lines" from Dow theory. I recognize that Darvas "re-discovered the wheel" or found a time when it was more common rather than an occasional exception. I rely mainly on peak and trough analysis, but recognize that a trough can sometimes take the form of a "line" or trading range in strong uptrends and weak downtrends. However, this does not mean the reverse – that a strong uptrend means lots of "lines". I have not done any statistical work on that proposition and my gut feel is that I do not see persuasive evidence of it. I also see "lines" in weak uptrends and strong downtrends often end in a trading range.

Volume Indicators

Comment

I have a concerns about reading the volume histogram, I do not think I interpret it very well.

Response

I agree that volume histograms are difficult to analyse. They require quite a bit of practice. I also find that they are not as reliable in the smaller thinner Australian market than the textbooks present them with US market examples.

Question
I can access On Balance Volume and Price% and Volume, and Money Flow. Could you please tell me the difference between these indicators?

Answer
On Balance Volume is a way to see whether volume is flowing into (buying) or out of(selling) a stock. If the price closes up on a day the volume is given a positive sign. If the price closes down for a day the volume is given a negative sign. On Balance Volume is simply the cumulative volume drawn as a line. There are articles about it on my subscription website from Shares magazine and Stockwatch/Technical analysis Articles.

I do not know Price% and Volume. Maybe you mean Price and Volume trend? It is like On Balance Volume, except that the amount of volume added or subtracted depends on the amount of price movement.

Money Flow is simply volume multiplied by the high + low + close prices divided by three. It is a rough estimate of the value of trading. It can be plotted as such, but it is also used as an input for the Money Flow Index, which is essentially RSI using Money Flow instead of price. I have written an article in Shares magazine on Money Flow Index.

Question
I tend to use OBV. Could you tell me if the indicator is valid for all daily, weekly and monthly scales?

Answer
It is most commonly used on daily data. There is no reason why you can not use it on weekly and daily data, but that will tend to hide some of the information conveyed by the daily line. For example, suppose a stock trades down all month till the last day. The daily line will be strongly negative. But if the price jumps on the last day to just one cent higher than the close of the previous month, the line will rise. Yet the trading on the one up day may have been relatively small. I personally prefer to always use daily data.

Question
I have the impression that you described OBV as a rough indicator some time ago in the newsletter. If this is so could you tell me why you think this and what are the implications of this roughness.

Answer
This is simply the same point as the previous one. If a stock makes big upside trades on a day, but happens to finish slightly down, it is all negative volume for the day. Ideally you would use course of sales data and create the indicator trade by trade. However, that data is not always available and it requires a huge data base.

Some of the variations on On Balance Volume, like Price and Volume trend try to improve on it. However, in practice I find the original indicator usually tells the story well enough.

Point and Figure Charting

Question

I read an article of yours where you use Point & Figure charting. Did you use this for day trading, or for longer term trading? I am using a trading style using P&F which I need an expert to confirm if I am on the right track as on occasions the system fails(about 20% of the time), or am I being to greedy?

Answer

I was overseas for a month and since then have been totally absorbed in the final proofs for my book.

The article must be some time ago because I now only write about bar and candlestick charts and have moved away from using point and figure charts. I changed my focus to bar charts because they are more easily understood when I am teaching or writing.

I used Point and Figure many years ago for short term trading and even day trading for times when I could sit in the public gallery and chart off the board. However, mostly I used it for swing trading, because I had a full-time job.

If you have a system that "fails" 20% of the time, you are doing very well. Many of the best traders are only around 50% winning trades. Of course, their winning trades make more than they lose on their bad trades, which is the real test.

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).*
- *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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