

# Colin Nicholson's Newsletter 50

2 August 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 Information statement at the end of the newsletter.*

## Latest on the Book

My book *The Aggressive Investor* is now at the printer. It should be available in the second half of August. I will advise how you may order it in the next newsletter.

## New Website

Following on from the problems I explained in the last newsletter, I have had the website completely re-designed so that the problems will not recur. You will notice some new features. Articles and Questions and Answers will have dates on them as well as a prominent list of recent additions. Many of you asked for this. It will also be possible to search the site for anything on a subject. Other features, including the search function will be added either when the new site is launched or soon afterwards. The new site will be put in place very shortly. I would appreciate feedback on anything that does not seem to work properly.

## More on Stop-Losses

### Question

My broker allows automatic stop loss points. I don't usually use them because I got sick of stocks having an intraday (probably at the open) down spike, and then rising back above. During the present situation (April/May 2005) I have only been caught twice. I didn't sell either of them because it happened so fast, but I now have automatic stops in place on them both.

### Answer

I have discussed this issue before in my newsletter. Automatic stop-loss levels can be a trap, giving false security to investors. Stop-loss levels are only really effective in deep liquid markets. Thinly traded secondary stocks, like the two you quoted to me, are arguably unsuitable for automatic stop-loss orders. They are accidents waiting to happen. Stop-loss orders only work properly if there are bids available in enough volume near the last price. If there are few or no buyers, the price falls through your limit and the stop-loss order is never activated. That is bad enough, but if there are some bids inside your limit price, the stop-loss order will find them, even if they are a long way away from the last price and where subsequent trading takes place. Hence the huge slippage and the big lower shadow on the day's candle – created by you. So, in fact you might be lucky if the spike happens so fast and goes so far that your stop-loss order is not activated. It gives you a chance to act

rationality after the panic created by stop-loss orders in inappropriate stocks is finished.

I take the view that one of the things that should be thought through and written down in our investment plan is what we do if the price spikes a long way below our stop-loss level.

My own rule is that I sell at market if my sell stop is violated. It means I am wrong about the investment. In thinly traded stocks I will have to manage the order carefully. A lot of judgement is needed. It is very difficult and complicated to write down. However, in principle what I do is to accept the best bid if it is reasonably close to the last sale and there is enough volume there. If not, I place my order at the last price, if it is in the spread (which may be quite wide). If there are offers lower than the last price, I will position my order one price point below the best offer. If other offers come in lower than that in any volume, I will keep moving in front of them until my order is done. However, if there is volume bid nearby I will accept the bid. It is easy to try to save a cent and end up giving away 10c in these situations. The only time I do not hit the bid is if there is no volume there, or if it is a long, long way away from the last price. Sometimes there are no bids at all in these stocks.

That is what I do, but it is not necessarily correct for anyone else. Each investor needs to think this through in relation to what they are trying to do. I trade uptrends. If the uptrend is violated I sell at market, because I am wrong about my trade. What I have described above is what I do when there is no liquid market. But if there is, I do not hesitate to accept the bid. There is no law that says you have to do what I do. Many very successful investors will wait for a rally and sell into that. I think that is fine, except I see stop-losses as disaster protection. Losses are inevitable in investing. They are part of the territory. What will destroy your portfolio are huge losers. Waiting for a rally that never comes may be a recipe for big losers from time to time. Whether all the money saved on the rallies is enough to offset the big losers is your judgement and should be researched.

You also mentioned that sometimes prices spike down through your stop-loss and then rebound above it. Since I trade trends and the trend is violated, I sell. This is what I call positive slippage – aka good luck. However, that is the logic of my investment plan. There are many other possible plans and rules – such as only selling if a close violates a stop. That makes no sense in the logic of my investment plan, because trends are defined by peaks and troughs, highs and lows, not closes. Many other investors trade other models where the close is the relevant thing - e.g. a closing price filter on a moving average or trend line. The key thing is not what the rule is, but that you have one that is consistent with the logic of the market model you are trading and that you execute it faultlessly.

### **Comment**

However I am leaking value on just about everything else I own. Nothing else has hit a stop, but because they are all falling with the rest of the market, my portfolio is losing value. And some are looking precarious with ominous chart patterns. I have very close automatic stops on them now too.

### **Answer**

My definition of a stop-loss is where I am wrong about my trade. In my case, I am perfectly relaxed about stocks trading near my sell stop. If the stop level is violated,

I sell, otherwise I hold. Since the levels I set my stops at will be just below support levels, it is very likely they will often be tested in the way you describe and hold. That is what I expect. I also expect that some will not hold at support and those I will sell without hesitation.

You wrote this in early May 2005. The market had been falling for over a month. So, if the portfolio was not leaking value, it would be a miracle. Prior to that the market went up for seven months and it was still well above the starting point in August 2004. The nature of bull markets is that they do not go up forever in a straight line. There will be big corrections at times. The bull market will also end at some point and you will give some of your profit back. An investor accepts this, knowing that we cannot ever consistently get 100% of a trend. 50-75% of a trend is good.

What each investor has to think through is what stops are for and what loss they can tolerate. They then need to study decades of data in hundreds of stocks and check whether their stop-loss rule would have worked to get them out at the tolerable level. If so, it has a good chance of working going forward. If not, the investor has a basic contradiction in their investment plan that must be resolved. They are trying to follow a plan that involves greater drawdowns (paper losses) than they can tolerate. The result is predictable – they will not follow the plan.

You say you have close stops on these stocks now. You do not say if those stops are still consistent with your original investment plan. If they are higher than the logic of your investment plan suggests, then they are accidents waiting to happen.

#### **Question**

I am concerned that in the present situation I am just hanging on for the inevitable, and when my stops are hit, I will be sold out at even lower values than now. Would you ever consider selling everything, and not buying anything again until the chart of the market showed positive signs of recovery?

#### **Answer**

You ask what I would do. But that is the wrong question. It is only relevant to your problem if you are trading an identical investment plan and have my risk tolerance embedded in your psyche. I would be unconcerned about the situation you describe. And yes, I do sometimes quit the market completely in the situation described in my investment plan – a bear market and all my holdings have hit their sell-stops.

Then again, Warren Buffett is a pretty good investor. His plan is totally different. He might sell none of his stocks, no matter how far the market falls. What he does is consistent with the logic of his investment plan – if a stock is outstanding value and an outstanding business that has not deteriorated, he will hold it forever and maybe buy more when most people are selling.

So, you need to decide what you are trying to do. Buy-and-hold outstanding stocks, or trade short term swings, or anything in between. You need to define the methods you are going to employ to find stocks, buy them, place stop-losses, how many shares to buy and in how many lots, where you take profits, where you sell and so on. I suspect from your questions that you have not read my book *The Aggressive Investor*. I wrote it, not so that others should imitate my investment plan. That generally won't work. Rather, I wrote down what I do, and why, as a model of what should be in an investment plan. Readers can then use the model to construct their

own plan. My book has been on my subscription web site for some time. It will soon be available in bookshops and directly from me.

## Shares Charting Guide No 4

My articles from *Shares Charting Guide No 4* will be available on the members section of my website [www.bwts.com.au](http://www.bwts.com.au) as soon as the new design website is launched (very soon).

## Even More on Stop-losses

### Question

What you do if you miss a sell stop signal and by the time you pick it up the share has moved up out of danger?

### Answer

Your question is a good one. However, you should not be asking what I do. You should be telling me what your investment plan is and asking me what I think you should do.

Nevertheless, let me answer what you asked first. I check the market every day after it closes. If my sell-stop has been violated I sell next day. If I could not track the market for some reason, I would sell as soon as I saw the signal. Usually I have someone watch my sell-stops when I can't do it myself, say because I am travelling.

The reason I do this is because I trade uptrends. My stops are below the last trough in the trend. That is where I am wrong about my trade. So I sell if the stop is violated. If the sale is at a price above the stop, it does not matter - the trend is no longer there, so I am wrong about the trade and I get out.

Next, I will consider what you should have asked me. That is what I think you should do. You should act on the logic of your investment plan. If you buy something it should be on the basis of what you think will happen based on one of the many models of how the markets operate. Your investment plan should therefore be able to define the price level, which if reached, indicates that you are wrong about your trade. If that happens you sell.

However, it is possible that some trading plans could call for you to hold if the price rises back above your stop by the time you see the violation. In the logic of my investment plan, there is no justification to hold. In others, there might be.

In order for me to express a more specific opinion, you will have to send me your investment plan - preferably in a form similar to mine as described in my book on the subscription section of [www.bwts.com.au](http://www.bwts.com.au) and shortly (August 2005) to be released in print.

## Learning New Software

### Question

I have heard that Insight Trader charting software is not very user friendly and takes a while to learn. Should I consider it or look for something else?

## **Answer**

Learning Insight Trader is no different to any other software. Learning a new piece of software is like learning a new language. It takes time and effort. You need to assess whether your priorities in life allow you the time and effort necessary. The comments about Insight Trader being hard to learn are in my opinion unfounded. Yes there are some things that are not standard for Windows. However, there are good reasons for them to do with the functionality of the software application. Things like minimising the need to fill out endless dialog boxes which drives most people crazy in some Windows applications.

If you decide to go ahead with Insight Trader, I suggest you do this:

Buy the software.

Buy the series of CD-ROM videos from Dial & Chart that will teach you how to use Insight Trader

Devote some weeks or months to studying them and embedding the information into your investment plan.

Use the Help Line at Dial & Chart if there are things you want to do that are not covered in the manual that comes with the software or on the CD-ROMs (fairly unlikely)

That should do the job assuming that you already know how to invest successfully. If not, then you have some 5 to 10 years of further study ahead of you to learn a new profession and gain experience and hone your new skills. You might find my website helpful in that regard [www.bwts.com.au](http://www.bwts.com.au). If this is the case, you really ought to learn technical analysis and investing before you worry about the software. You will need the software when you start developing your investment plan and begin investing.

As far as other software alternatives are concerned, if it is charting software, rather than a trading system (see my web site articles page for definitions) it will take you the same time to learn as Insight Trader or any other charting software. If you are looking for something that is simple and easy, it will be a toy like the Internet based charting facilities that most people tire of quite quickly and end up buying charting software or drift away from direct investing because the time requirement is too onerous.

## **Advance Decline Line**

### **Question**

I am a shares subscriber and am trying to put together an advance decline line for the ASX200 that Colin Nicholson talked about recently but can't find the information anywhere. Can you point me in the right direction please?

### **Answer**

Firstly, I have never, ever talked about an advance-decline line on the ASX200. My advance-decline line is the total market, not just the top 200 hundred stocks. This is because we are trying to measure the whole market, not just the big stocks. We want to compare what the big stocks are doing with the totality of all stocks to see differences. I use the All Ordinaries Index for my index comparison to the advance-decline line, but it will make no real difference if you use the ASX200 or ASX300. Some people do construct an advance-decline line for only the stocks in the ASX200 (and other indexes), but I think this is logically unsound considering the concept of a breadth indicator.

I think that everything you are after is already on my website. Go to [www.bwts.com.au](http://www.bwts.com.au) and enter the free site. Then go to the Ask Colin page and look for the keywords Advance-Decline Line.

## My Results – An Update

### Question

Your published results for the four years to June 2004 are hardly exceptional. Investing in Argo Investment Company, an index fund or the Aussie Dogs may have been competitive with your approach, probably outperforming you. Also these approaches might be less risky and easier for the average investor.

### Answer

My track record from July 2000 to June 2005 compares to the index as follows:

Year	% Return	Market%	Difference
2000/01	9.69	8.85	+0.84
2001/02	2.11	- 4.50	+6.61
2002/03	20.61	- 1.08	+21.69
2003/04	17.48	22.37	-4.89
2004/05	26.88	24.75	+2.13

The index comparison is to the ASX All Ordinaries Accumulation Index.

The best way to understand the impact of my returns compared to the All Ordinaries Accumulation index is to show how \$1,000 would have grown in my portfolio, compared to how \$1,000 would have grown if it had been notionally invested in the index. This is shown in the following table:

Year	Colin	Market
2000/01	1,097	1,088
2001/02	1,120	1,039
2002/03	1,351	1,028
2003/04	1,587	1,258
2004/05	2,014	1,570

Since my return is higher than the accumulation index over the period, I will have a substantially higher return than the index funds, which match the price index less fees. The statistics that I have seen show that most managers struggle to beat the price index, let alone the accumulation index, over five-year or longer periods after fees.

My rationale for managing my own money is to do better than the professionals. I feel I am doing that and having a lot of fun along the way.

I am also convinced from observation that many private investors, especially beginners, do not match the professionals over five-year or longer periods. Therefore I think that I have something to offer.

You will have to form your own judgement on that.

## Search Insight Trader Manual

### Question

How can I search the on line Insight Trader v14.1 manual for a specific word?

### Answer

First you need to download the latest (2005) digital manual for v14.1 into the software:

Go to [www.insighttrader.com.au](http://www.insighttrader.com.au)

Log into the members area and download the manual (~6MB)

To log in enter the **Username** and **Password** under **Help/About** from the Insight Trader v 14.1 main menu

Click Downloads in the **Members Options box** on the left (not Downloads on the main menu bar at the top)

Download the file into your main WINIT folder.

**This step may be necessary** depending on the security settings and version of Windows:

Open Windows Explorer (My Computer) and navigate to your Winit folder

Right Click Winit32.chm

If there is this statement at the bottom of the General tab:

*Security: This File came from another computer and might be blocked to help protect this computer.*

Click Unblock

Click Apply

Click OK

To search the digital manual:

Click **Help** from the main Insight Trader menu

Click the option **Search for Help on...**

Click the **Search** tab on the Help dialog box that appears. See Note below.

At **Type in word(s) to search for** enter what you are looking for eg RSI

Click **List topics**

Double Click any topic that is subsequently listed and the display will jump to that page in the manual.

All occurrences of the word that was searched for will appear highlighted

If you cannot see the Search tab, go back to **This step may be necessary...** above.

## Renting Shares

### Question

I hear it is possible to rent shares? Is renting shares a new method of trading or just a different term?

### Answer

Unless there is something new that I am not aware of, renting shares refers to a long-standing facility established so that institutions can lend shares to each other to facilitate short selling.

There is a detailed article on short selling on the Articles page of my website [www.bwts.com.au](http://www.bwts.com.au). However, the renting aspect is simply this: Short selling means that you sell shares first and buy them back later, hoping to make a profit if the price

falls. In order to sell share that you do not own, you need to rent them from someone so that you can deliver them to the buyer. When you close out the short sale by buying them back, you return the shares to their owner. You pay a fee to the owner for the privilege of renting them.

Any broker can give you more information on this. However, they may be reluctant, because this is not a game for inexperienced and especially small investors. Brokers therefore tend to not want to waste time informing small clients about something that is not relevant to them. Small investors who are interested in trading falling markets might use futures, CFDs, warrants or options. However, be warned that, like short selling, these methods may involve high levels of risk and leverage and are not to be undertaken without fully understanding how they function and the risks involved. (Written 4.7.05)

## Insider Trading Suspicions

Readers may be interested in some recent comments from a reader and my response:

### Comment

If insider trading is so difficult to prove that ASIC and the Public Prosecutor are reluctant to go after Vizard for (what appears to be) such a clear-cut case, imagine how much insider trading goes on unchallenged and unnoticed.

### Response

I think that you need to be careful in judging ASIC and the Public Prosecutor based only on what is written in the newspapers. I am sure that ASIC, for one, is very keen to prosecute insider traders, but to do so requires evidence that will stand scrutiny in court. Sometimes they will know something, but not be able to prove it. Insider trading is a crime that is very difficult to prove unless one of the parties to the crime is prepared to give evidence or the person who does the trading is incredibly careless. Some of ASIC's successes in this area have been when people plead guilty.

Having said this, I am in agreement with you that insider trading takes place. However, much of it may not be illegal. It may be that insiders are acting on information which they have come by in the ordinary course of business and is not proscribed by law. For example, I retailer notices that a particular product is selling much better this year and draws the conclusion that the manufacturer may therefore earn higher profits. This is clearly insider information, but it is not illegal to act on it in my understanding.

### Comment

Indeed as you mention in your writings, one of the reasons why technical analysis and buying breakouts works, is that the "smart money" (i.e. people close to the company) know things which the general public doesn't.

### Response

Yes, that is true. I have expressed this view in the past. People, who study the activities of a company closely, like broking analysts, will often have superior insights to the general run of investors. We can benefit as chartists by watching their actions and their clients' actions as far as they affect price. However, I am not suggesting that this is illegal activity, though it may be occasionally.

## Comment

A good example is a trade which you did on 11 July 2005 and which I did about 10 days ago. We both bought Allied Finance Corporation (AFC) for purely technical reasons when it rose above its March high. Of course, neither of us had the slightest idea about the announcement today of the company merging with a competitor, but I think there is a probability that some of the people buying over the last few weeks did.

## Response

You may be right, but as I see it, there was no really unusual activity. The trading through June was very light and irregular. There was hardly evidence that some insiders were buying up AFC ahead of news. If they did, they did not make much out of it to warrant the risk they took of being caught. Then again, you may know something that I don't. I just don't see evidence for your claim on the chart.

## Correction: Money Flow Index

In the last issue I said:

*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 MACD using Money Flow instead of price. I have written an article in Shares magazine on Money Flow Index.*

I should have said that the Money Flow Index is essentially RSI, using Money Flow instead of price, not MACD.

## Latest Credit Card Scam

I was recently alerted to this by one of my readers. I verified with my bank that this is not a hoax and that the scam is real and being investigated by the banks:

By understanding how the VISA and MasterCard Telephone Credit Card Scam works, you'll be better prepared to protect yourself.

My husband was called on Wednesday from "VISA", and I was called on Thursday from "MasterCard". The scam works like this: Person calling says, "This is (name), and I'm calling from the Security and Fraud Department at VISA. My Badge number is 12460 your card has been flagged for an unusual purchase pattern, and I'm calling to verify. This would be on your VISA card which was issued by (name of bank). Did you purchase an Anti-Telemarketing Device for \$497.99 from a Marketing company based in Arizona?"

When you say "No", the caller continues with, "Then we will be issuing a credit to your account. This is a company we have been watching and the charges range from \$297 to \$497, just under the \$500 purchase pattern that flags most cards. Before your next statement, the credit will be sent to (gives you your address), is that correct? "You say "yes". The caller continues - "I will be starting a Fraud investigation. If you have any questions, you should call the 1-800 number listed on the back of your card (1-800-VISA) and ask for Security. You will need to refer to this Control Number.

The caller then gives you a 6 digit number. "Do you need me to read it again?"

Here's the IMPORTANT part on how the scam works The caller then says, "I need to verify you are in possession of your card". He'll ask you to "turn your card over and look for some numbers". There are 7 numbers; the first 4 are part of your card number, the next 3 are the security numbers that verify you are the possessor of the card. These are the numbers you sometimes use to make Internet purchases to prove you have the card.

The caller will ask you to read the 3 numbers to him. After you tell the caller the 3 numbers, he'll say, "That is correct, I just needed to verify that the card has not been lost or stolen, and that you still have your card. Do you have any other questions?" After you say No, the caller then thanks you and states, "Don't hesitate to call back if you do", and hangs up.

You actually say very little, and they never ask for or tell you the Card number. But after we were called on Wednesday, we called back within 20 minutes to ask a question. Are we glad we did! The REAL VISA Security Department told us it was a scam and in the last 15 minutes a new purchase of \$497.99 was charged to our card.

Long story made short - we made a real fraud report and closed the VISA account. VISA is reissuing us a new number. What the scammers want is the 3-digit PIN number on the back of the card. Don't give it to them. Instead, tell them you'll call VISA or Master card directly for verification of their conversation.

The real VISA told us that they will never ask for anything on the card as they already know the information since they issued the card! If you give the scammers your 3 Digit PIN Number, you think you're receiving a credit. However, by the time you get your statement you'll see charges for purchases you didn't make, and by then it's almost too late and/or more difficult to actually file a fraud report.

What makes this more remarkable is that on Thursday, I got a call from a "Jason Richardson of MasterCard" with a word-for-word repeat of the VISA scam. This time I didn't let him finish. I hung up! We filed a police report, as instructed by VISA. The police said they are taking several of these reports daily! They also urged us to tell everybody we know that this scam is happening.

Please pass this on to all your family and friends. By informing each other, we protect each other.

## **No Simple Answer**

### **Question**

For the last two months I have been reading books, internet information and lots more on trading shares. I have managed to save \$10K and want to start buying shares, problem is, I am very unsure which ones to buy! I have read so much that I think I am confused! Do you have a simple answer to my question?

### **Answer**

There is no simple answer to your question. It depends on many things which you need to provide the input for – your age, risk tolerance, personality, attitudes and beliefs. Then you need to develop an investment plan. It will take you some time to

do this – maybe a few years of reading and study and then more time gaining experience to understand yourself in an investment context. Remember that you are embarking on learning a new profession. Most professions take up to 10 years of study and experience before you are proficient.

Two months is a small fraction of the time you will need. Indeed, I am not surprised that you are confused. The initial learning curve is steep and clear. Then it gets more complicated as you learn more and you tend to go backwards for some time before things start to fall into place. All learning tends to this model.

The reason you have to develop your own investment plan is because it has to suit you and only you will know if it feels right. Also in the process of developing and testing the plan, you will develop the faith in it necessary to be able to follow it under pressure.

I am unable to advise you specifically for many reasons. The main one is that I am not a licensed investment adviser and do not wish to become one. My focus is on teaching people how to manage their own investments, not provide advice.

You may find my book *The Aggressive Investor* is useful in your journey, because it contains my investment plan for use as a model for what should be in your plan. The book is already published on the members section of my web site. In the second half of August 2005, it will come off the website and be available in print.

There is also a great deal of material available free and to members on my website.

### **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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