

## Colin Nicholson's Newsletter 52

30 September 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.*

### Meet me in Melbourne

I will be in Melbourne next week. I would love to meet my readers. This is where you will find me:

Thursday 6 October

12 noon - 2pm Educated Investor Bookshop 500 Collins St.

Friday 7 October

11am – 2pm Educated Investor Bookshop stand at The Investment Expo  
Melbourne Exhibition Centre

Saturday 8 October

11am – 2pm Educated Investor Bookshop stand at The Investment Expo  
Melbourne Exhibition Centre

On each of these occasions, you will be able to buy my book *The Aggressive Investor* and I will sign it for you. If you have already bought it elsewhere, bring it along and I will still be happy to sign it for you.

There are also a very limited number of places at a talk I am giving in the Educated Investor Bookshop at 6 – 7.30 pm on Wednesday 5 October. Please call Janene Murdoch on 9620 0885 to ascertain availability before coming along.

### Outperforming the Market

#### Question

Has your investment plan tended to outperform the market the most in the first stage of bull markets, as it did in 2002-03?

**Answer**

No, not necessarily. My portfolio outperformed the market in 2002-03, but there were only three months of bull market in that year. Quite a bit of the gain was made in the first nine months of that year, before the bull market began in March 2003. My investment plan calls for me to start getting involved in the terminal stages of a bear market. This I did, by buying strong stocks (stocks making new highs). In the first full year of the bull market, 2003-04, my portfolio slightly underperformed the market.

Thinking back over earlier cycles, I am not sure that I could claim to outperform the market in the early stages of bull markets. The early stages are often very strong and I will typically not be fully invested until after the bull market is confirmed. My expectation is that I would somewhat underperform the market in the early stages of a bull market.

I sense, though, that my portfolio will do better than many investors, especially the inexperienced ones, because they tend to be much later getting into the bull market, or of even knowing it is happening. Inexperienced investors are always slow getting into bull markets and this is one thing my plan is actively slanted towards – forcing early exposure.

The end of a bull market is also interesting. I will hopefully have cut back my exposure as the last wild days come. My expectation is that my portfolio will underperform the market in the last stages of the bull market. However, the key comes after the turn when the market falls. Then, my expectation is to make a positive return from interest on cash, with only the strongest stocks still being held, while the market falls over all.

The aim of my plan is to get in early and build exposure when the risk is low and also to get out early as the risk increases. My objective is first of all not to lose money – make a positive return – and then to at least match the long term market performance. That will give outperformance in some periods, but will underperform when risk is high. The only valid assessment of a plan must be over the full cycle.

**Complexity and Prediction****Question**

I have been following your website and newsletters for a number of years. I have learnt a great deal on how to minimise my losses and thank you for this. It seems to me the simple way that you teach of buying and selling on trends and breakouts works well as long as you follow stop loss rules. Do you believe that people make this far too complicated with all their theories etc?

**Answer**

I think there is an element of truth in what you say. Investing is not really that difficult if you have a sound method, discipline and patience to let the plan work.

My plan in its essence is to manage risk, while buying up trending stocks that have a margin of safety. It is all in my book. However, as I remarked in the book, despite me saying that this is all I do, they keep failing to believe me and ask when I am going to run the advanced seminar where I teach the real secrets, or perhaps write another book with the rest of what I do in it. I guess no matter how many times I protest that there is no advanced seminar and no secrets I have held back, they will not believe me.

The thing is that so many people believe that complex is better than simple methods, the reality is otherwise. The way I like to think about it is this: Most of the ideas we have to exploit in the market are somewhat inexact. They work on the balance of probabilities. However, these ideas seem to resist all efforts to refine them by adding complexity. It becomes difficult to understand what is actually happening with these complex indicators and systems.

The other issue is that all beginners seem to have the totally mistaken idea that it is possible to predict the future with any accuracy or consistency. I have read widely in this area and all the evidence points to it being impossible to predict the future. It is interesting that Benjamin Graham reached this same conclusion by observation 70 odd years ago and devised a method that was independent of any prediction. My methods are different to his in some respects, but not in others. However the one thing we do absolutely share is to invest in a way that makes absolutely no attempt to predict the future.

Many of the gurus and theories you refer to are attempts to predict the future and are bound to fail. When one of their theories fails to predict accurately, they make it more complex in an attempt to make it work. In some things it is possible to refine methods and make something work. However, that thing has first to be possible. Nobody has yet demonstrated that it is possible to predict market prices.

The sad thing about all this enormous waste of energy in trying to make predictions is that it is not necessary. Ben Graham and his acolytes, the best known of which is Warren Buffett, showed you can succeed without predicting anything. I am not aware of anyone who has shown that methods relying on prediction come anywhere near their results.

### **Feedback on *The Aggressive Investor***

*Bought your book "The Aggressive Investor" this afternoon, and read the first quarter of it tonight. Already you have got me thinking differently about my Telstra holding – ie, winning attitude: I must focus on the value of the 4,500 shares **today** and where to with that wealth from **today**. As opposed to losing attitude: getting angry at the loss on those shares to date, or blaming the govt, or Telstra management, or the weather, or....*

ooooOoooo

*I have read your book (more than a few pages per night!). It is EXCELLENT. It is just what we needed to review and revivify our SUPER FUND strategy, which has eluded us for a while. Thank you very much for sharing your unique style with us. Thank you also for your transparency. We wish everyone in this game were as open about what they do as you are. There is a lot of hype in this industry. But you really put it all into a very balanced, rational and realistic frame. We very much appreciate your candour. And, I think you ARE an aggressive investor, as you say.*

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*I have read your book, "The Aggressive Investor" and have found it to be the most concise and practical book on the stockmarket I have read to date.*

ooooOoooo

*Thanks for the writing Aggressive Investor... It should be mandatory for anyone investing in shares for the first time to read this book.*

ooooOoooo

To buy *The Aggressive Investor*, go to <http://www.bwts.com.au/text.cfm?42>. The purchase options are at the bottom of the page. I will sign all books purchased from me unless requested otherwise.

## **Discovering the Internet**

For many people nearing retirement or already in that phase, the Internet is something forbidding and mysterious that young people use. The reality is that the Internet is simply a big repository of information. While investors can sometimes drown in a sea of information, more commonly they get into trouble because they did not have access to enough information. The Internet is a tool that is well on the way to removing the excuse that you got caught because you did not know something.

Recently a friend of mine got caught by not knowing the law about something. He angrily argued with me that life was not fair – how could he know what he didn't know? My reply was simple – when the issue came to my attention, it took me about five minutes to find what the requirements were on the Internet.

I would suggest to all of my readers who have regarded the Internet as something too difficult and have hoped it would just go away, that they need to get involved with it. For investors, a useful starting point is a book called *Online Investing* by Roger Kinsky, published by Wrightbooks. It is now in its second edition. It must be a sound book, because the excellent chapter on Website You Can Access mentions my website! But seriously, this book is easy to read and will be a relatively painless way to get into the Internet.

Just one warning – once your mind has been expanded by access to the Internet, it will never go back to its original size and shape. Enjoy the experience.

## Quicker and Easier

### Question

Apart from sticking to the big companies which have good liquidity, and scanning them in search of a profitable trade, is there any easy way, or faster way, to find where the good trades are?

### Answer

The specific answer to your question is going to depend upon what you are trying to do. In other words, your trading plan should specify the set-ups that you are looking for. The scanning method you use will then be driven by what those set-up situations are. For example, my investment plan is looking for upward breakouts from broad trading ranges or ongoing strong trends. I have found that one of the best scans for this is to filter the database of stocks for those that are making 52-week new highs. A stock on that list will have broken upward from a trading range that was at least 12 months in duration, or it will be trending up. It also finds a few double-top situations, but these are easily discarded if they are not interesting. So, what you need to do is to design a scan that filters out the kinds of stocks you are looking for.

Another approach is to create a watch list. When you go through your list of stocks, keep track of which ones are actually or potentially interesting. You can put these into a shorter list and review it each day. Insight Trader makes it really easy to add stocks to a watch list as you go through your scan, for later review.

An even better method might be to use something like the alarm system in Insight Trader to alert you when a stock has moved to a level that interests you.

## Questions from a Struggling Beginner

### Question

Could you explain how to read the Advance-Decline, New Highs-New Lows and Arms Index indicators?

### Answer

I have written several articles on these for Shares magazine, all of which are now on my members only website. Please look again. The articles are listed by title and under that is what they are about. The website now has a search function. We are working on improving it, but it will find these topics if you persevere with it. If you really can't find them after another look, get back to me.

### Question

With these indicators, are we just looking for a divergence between them and the index?

**Answer**

Basically yes. If a rising market is sound, then the breadth indicators should confirm the uptrend. If they do not, then the integrity of the rise may be in doubt. However, this is a very simple answer, and it is a bit more complicated than this. There are also several ways to chart the same data, some of which may be more revealing.

**Question**

What importance would you apply to the different time charts?

**Answer**

The market unfolds in trends in different time frames. This question of time frame is one of the most difficult if issues in technical analysis. While there is no simple answer to it, in practice it is not too difficult. You can get a long way along the track with the three most common views of the market - daily, weekly and monthly bars charts.

If you find moving averages and other indicators useful, you can vary the look-back period to give you insights into time frames. Since you asked this question in relation to breadth indicators, I would mention that Dick Arms uses a 200-day for long term, 55-day for medium term and 10-day for short term moving averages of the Arms index.

**Question**

I have been charting the rises, falls and steadies with the ASX200 industrials for a couple of months. (Chap suggests this on the Egoli web site) Is this similar?

**Answer**

I have not looked at Egoli, but I would not do this. I would plot the rises minus the falls cumulative line, not the separate lines. Having said that, the two individual lines are useful on their own, but not the raw data, which is too volatile. As I explained in my Shares articles, I use a 20-day moving average of the advances.

I would also not compare those lines with the ASX200 Industrials. I would use the complete ASX200 index, not just the industrials sector index for preference. However, I use neither. I prefer the ASX All Ordinaries index, because it is the broadest and most representative index of the overall market. The ASX200 was created for other purposes, like creating an index the funds managers might find easier to beat than the ASX All Ordinaries index.

**Question**

I have looked on your web site but can't find specific instructions on how read the breadth indicators or an example. I love examples.

**Answer**

As I have already said the explanations are in the members section. There are some examples in the articles. I also comment on these indicators from time to time in my BRW columns, which are also on the members website. They make interesting case studies because I write them in real time - the right hand edge of the chart, rather than the centre of the chart.

### **Question**

I started investing in November 2004 using the Alan Hull method but kept getting stopped out (losing \$200 a pop with my \$10,000 and 2% money management) In retrospect the market was weakening and then the correction. If I had the breadth indicator charts possibly I could have stood aside or tightened my stops instead of blindly following Actvests stops ATR. I have just managed to break even this week (10 months later). Jumping on and off stocks quickly but such a lot of work and adrenalin. Oh well I have learnt a lot.

### **Answer**

Why start in November 2004? The bull market began in March 2003 and was evident beyond doubt before the end of that year. My method teaches to get in early. What you have done is get in late with the mug punters. You therefore did not have fat profits on paper to act as a buffer. I hope this is one of the unspecified things you have learned, because I think it is a basic idea.

Breadth charts might have helped you be aware of the risk. But the real problem was that you got in so late you were an accident waiting to happen.

\$10,000 is about a fifth of the minimum you need to be a speculator - you are a speculator or trader, not an investor. You are taking on too much risk. You have zero diversification with only one stock at a time. Specific risk is going to come and get you not every time, but sooner rather than later.

Yes, standing aside may have helped, but greed is powerful isn't it? Breadth indicators are not a precise timing tool. Rather than standing aside, you could have cut back exposure - that is what I would have done. This actually happened naturally for me as sell stops on stocks were hit. However, you had only one stock and you obviously went back in when stopped out of one.

I would not like to comment on Alan Hull's methods, which I have not studied in detail. However, when I have heard him speak, he seemed eminently sensible. I don't recall him suggesting the kind of speculation you have been engaging in, though. He promotes active investment. You would be better to study the methods of Dr Alexander Elder, who is a trader, but you need much more capital before you could start safely with any method of trading.

### **Question**

I have also read every book in the library Elder, Weinstein etc and now have an information overload and not sure who to follow and what to use. I definitely want to be more relaxed investor and check the charts at end of day.

### **Answer**

What you need is an investment plan that is appropriate to your resources, abilities, risk tolerance, personality etc. It will take you time and more study. The process invariably takes you through a long period of turmoil as you sort out all the options, test them and learn about yourself. So you can tailor a method to the person you are.

### **Question**

I have a Mac and hence not much charting abilities, but E-Trade seems to have enough gadgets. Someone suggested using the Parabolic SAR and to ignore its signs except when the DMI crossed over and then sell.

### **Answer**

The Mac is a nice computer, but finance is a PC world. You don't need gadgets, you need a clear investment plan.

There are articles on Parabolic SAR and DMI on the members website (Stockwatch and Technical Analysis articles). They are tools. You need to understand them. Then you can decide if they have a place in your plan. Parabolic only works in strongly trending markets. It is also dangerous as a SAR (Stop-and-Reverse) method if the market does not trend strongly. DMI tries to tell you if the market is trending, so it can be a useful filter on when to use Parabolic SAR.

## **More on Downward Spikes**

A reader offered this first-hand account of the situation I discussed in Newsletter No 50:

*I am assured by a broker that some of these spikes have been triggered by the market falling to a point where some system traders have a common sell stop order in place. I triggered one spike by placing a sell order, meeting the bid, one cent below the previous market price. This triggered an immediate 35cent drop, some 15% of the share price. The price recovered as soon as the sell stops had all been executed. I feel sorry for the poor people who were late in the queue. This stock was one that was not too thinly traded. It had just for a while run out of potential buyers, a problem of the thin Australian market for a system trader in many stocks.*

## **Lessons from a Winner**

I received this email from one of my readers. It contains some hard-earned wisdom:

*I have recently completed my first full financial year of trading successfully. I want to thank you for the valuable information I gained from your website and email newsletters. My annualised IRR for the year was 70.4% and that included some mistakes I do not intend to repeat. My trading plan was mostly derived from Weinstein's Profiting in Bull and Bear Markets which I adapted to suit my own strategy. For instance I use support levels rather than moving averages to determine sell points. My money management discipline came from your guidelines.*

*I learnt the following key lessons, many of which you stress:*

- (1) Develop a plan and stick to it, but do not be afraid to adapt it if you can see improvements.*
- (2) Do not be afraid to take small losses when your plan says sell. Two of my mistakes were holding on when the chart said sell but I thought the fundamentals were good. Instead of getting out with 6-8% losses I ended up with 20-25% losses.*
- (3) Let your winners run. Do not be tempted to take small profits when your plan says hold.*
- (4) You can afford to be aggressive if you have a good plan, you stick to your plan, you remove emotion from the equation, you always have a stop loss in place and you never risk too much on a single trade.*

*I now look forward to many years of trading without having to worry a broker again.*

## **Returns and Franking Credits**

### **Question**

The Accumulation Index does not include franking credits, yet they are in your results which are compared to the accumulation index. Is this the correct comparison?

### **Answer**

You are correct that I include franking credits in my returns figures. I do this because I am trying to present a true before tax return, which can be compared to before tax returns from other asset classes. It would be better perhaps to show an after tax return, but that is quite complicated and there are many alternatives. Although Vanguard have started showing after tax returns, the industry generally shows before tax returns.

I have compared my return to the Accumulation index, with the full knowledge that it is not a strict comparison and that it is even slightly in my favour, in the sense that it may tend to make my return look better than it is. There is no index that gives a direct comparison. The straight price index is only applicable to a pure trader, because it only measures capital gain. The accumulation index is as

close as I can get to an index that measures what I do as an investor harvesting total return (capital gain plus dividends).

So, the choice is an unsatisfactory one. Exclude franking credits and have a direct comparison to the index, but not a direct comparison to other asset classes. Or have a direct comparison to other asset classes with the disadvantage of having a less than satisfactory comparison to the index. Since I am not explicitly aiming to beat the index – rather I am aiming to match the long term return for the index over decades – you should regard the comparison to the index as imperfect, but a rough guide as to how I have gone. Nothing more. The real decision we have to make is to invest in shares, or in something else. The return I am showing is a good guide to what I am getting from shares, which can be compared to other types of investments.

## Technical Analysis of Commodities

### Question

There has been much comment and speculation recently about the price of oil and where it is going. Whatever the fundamentals might be, the chart shows that oil has been in a strong uptrend/bull market. Do you think that technical analysis and trends are as valid for trading commodities as they are for trading stocks?

### Answer

This question can be addressed on several levels.

Firstly, I believe that any freely traded market, for which accurate and complete price information is available, is susceptible to analysis by technical analysis. The reason is a basic one. The price data reflects the actions of humans as they trade. So long as there is a free market, people will tend to react in predictable ways when placed under the same stresses. The same patterns will tend to form on the charts and have the same implications.

Secondly, commodity markets tend to be highly leveraged and this means that most speculators will have no alternative, but to trade short term rather than hold longer term. That is what the hedgers do. However, while the actions of hedgers are vital, price discovery tends to take place through the action of speculators. This is their role and why they are encouraged to be there. The shorter the term in which we trade, the more important will be technical analysis, which tries to discern changes in the balance of supply and demand in the market. News shocks will also be important, but the charts will often throw a shadow ahead of the news as the smart money gets set or gets out.

Thirdly, technical analysis has always been a factor in commodity markets. In fact there is evidence of it centuries earlier in Japan, than when it came to be used in Wall Street. Also, many of the techniques that we call technical analysis, rather than charting, seem to have been developed for the commodities markets

and later utilised in the stock markets. Everyone has been trading stocks in the 1990s and 2000s, but before that futures and commodities were a big game and where the real action was.

## Point and Figure RIP

### Question

In your book you say you used to keep point and figure charts, but no longer. What do you think of them now?

### Answer

If I did not have a computer, I would still be using point and figure charts, because they are the easiest and fastest way to keep track of lots of stocks.

However, the computer enables us to utilise any form of chart almost instantly created for any number of stocks.

Point and Figure charts also have a great advantage in that they cut out some detail and show the basic price picture. For that they are still valuable.

However, most charting packages do not display point and figure charts very well and some even draw them incorrectly. The problem is similar to candlestick charts – as soon as you need to display a lot of data, the chart form takes up too many pixels. The candles run into each other and the point and figure charts run along the bottom of the chart trying to keep the boxes square. Some have solved this by distorting the boxes – a compromise that is unsatisfactory.

There is also much more information on bar chart than a point and figure chart. This is not always an advantage, but switching to weekly and monthly formats does go a long way towards comparability to the filtering aspect of point and figure.

As I said in the book, the factors that swung it for me were that bar charts are easier to teach from and I found that I could still see the same patterns on the bar charts as I saw on point and figure charts.

## Out of Date

### Question

The BRW and Shares articles on your website are out of date. Is there any other way to access to your market commentary without having to buy the magazines?

### Answer

My agreement with Fairfax is that I do not publish columns and articles on the website until 3 months after publication in print form.

I can not publish my market views while I do not choose to become a licensed adviser. My focus is on education rather than advice.

### **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.

*Published by*  
**Colin Nicholson**  
**ABN 95 911 284 126**  
**PO Box 5121**  
**Greenwich NSW 2065**  
**Phone +61 2 9436 1610**  
[colin@bwts.com.au](mailto:colin@bwts.com.au)