

Colin Nicholson's Newsletter 54

December 10 2005

I am speaking at the Adelaide meeting of the ATAA next week – details on www.bwts.com.au and www.ataa.com.au

Reader Comment on *The Aggressive Investor*

On the subject of your excellent book-The case studies in the book & on disk really brought your trading plan "alive" for me. I am generally quite familiar with your style of trading, as a regular reader of BRW, Shares and now Smart Investor, as well as viewing your videotapes numerous times & hearing quite a few of your presentations, but I felt the book's case studies had something extra, in that you described your thought processes at the time in considerable detail. Any subtle changes in your plan compared with earlier years were also evident and very interesting, and clearly illustrate the progressive "work in progress" nature of a trading plan.

Buy Now for Christmas – Special Offer

With only two weeks for Christmas, readers might like to consider buying a signed copy of *The Aggressive Investor* for someone in their family (or suggesting to someone in their family that they buy it for you). I have **two special offers which will expire on Christmas Eve**:

Offer One: Buy two copies (one for yourself and one as a gift for someone else) and I will include free of charge a copy of a book about the markets that I no longer wish to keep. I will also include the CD-ROM while stocks last – see Offer Two below.

Offer Two: Buy one copy and I will include free of charge a CD-ROM of Dan Gramza talking about building a trading strategy, while stocks last. Dan produced the CD-ROM for the Chicago Mercantile Exchange and gave them away at a recent meeting in Sydney. He left me the remaining stock of 38. They will go to the first 35 orders for either offer. I am hoping he may be able to send me some more. If so, I will first send the new stock to anyone who missed out on the first 38.

If Dan does manage to send me more, I will make them available to readers who have already purchased my book from me. I will advise how to obtain them in a later newsletter.

Tough Week in the Market

Question

Last week (mid October 2005) I was looking at a large unrealised profit. This week I am looking at less than half that unrealised profit. How do you stay calm, when you see over 50% of your profits walk away?

Answer

This is an interesting question. The short answer is experience combined with rehearsal of your investment plan.

Experience is being there many times before. There is no real substitute for experience in any profession or in sport for example. If you have been there before, felt the emotions and dealt with them, taken action (or froze) and learned the lessons from the experience, you are better equipped to deal with the situation next time.

However, it is not possible to have experienced everything that could happen many times. Life is too short and some events are rare or unique. All athletes use rehearsal. They visualise all the possible situations that could occur and then visualise how they deal with them. They do this over and over again. Then when one of these things actually happens, they know instinctively what to do.

I had never lived through a 25% overnight fall in the market as happened in October 1987. Yet I was surprised how well I handled it. I think it was because I had rehearsed what it is like and what to do in a sudden drop in the market. I had previously had that unhappy experience in one stock (which I should have sold, but didn't), so I guess I had some experience. But essentially the key was that I had rehearsed what had to be done. I then sat there calmly and did what I had to do over the next two days.

Most people have trouble imagining alternative futures. It is a good skill to develop. Try to postulate all the things that could happen - likely or otherwise - and work out what you would do. Try to imagine it clearly and feel the emotions. Try to list the alternative options you have and weigh them up - see my article in AFR Smart Investor November 2005. Ask what is the best or worst you might expect. Then check out one stage worse that you think is possible.

You have arrived as an investor when you know instinctively what to do in any situation. Experience and rehearsal of your plan will get you there.

The other thing is to have a good investment plan that provides guidelines for decisions, of course. You need to have studied how it works over hundreds of previous situations. For example, my investment plan involves a sell stop which will always be somewhat below the absolute high of the trend. It will mean giving back a fair bit of the paper profit at the end in order to capture the meat of the trend. If you do not understand the implications of your investment plan, and

have rehearsed it over and over, then these things will continue to be a challenge.

Your plan has to know whether you are trying to capture most of every swing up in the market - in which case your recent experience is a failure of the plan. Or are you intending to sit through the corrections and capture a big part of the bigger trend. In this case you must have rehearsed and internalised the sort of situation you have just experienced. The market was up 10% or so in a few months. You must know that cannot continue. Your plan must be the result of you thinking through what you will do in such a situation. Will you grab the profits and run or will you hold. If you hold, you must have rehearsed how it feels like and internalised the balance between the regret and the ultimate aim of your plan.

What Happened to the Advance-Decline Line?

Question

I have your video tapes and your book *The Aggressive Investor*. Both have been extremely helpful to my development as an "Aggressive Investor". In your tapes you tended to use the Advance-Decline Line to help identify a possible downturn in the overall market. In the book I didn't notice it mentioned at all, I was wondering why you seem to have stopped using it in your market risk assessment?

Answer

When I wrote the book, I decided to leave the advance-decline line out of it. I did this for several reasons:

1. I became increasingly concerned about the utility of the Australian advance-decline line because of the marked downward bias it has. There are many pet theories people have for why this is, and I have ideas of my own. However, nobody including me has yet produced and evidence to substantiate the hypotheses. It is in fact such a difficult phenomenon to prove reasons, and there may in fact be multiple contributing factors, that it seems more productive to put the effort into developing indicators that do the job better.
2. Because of the downward bias, The advance-decline line is only usable in my opinion in the short term. Its main use is to warn of a potential turn in the current market upswing. In any bull market, one of those upswings will be the final one, but we have no way to know this until afterwards. Nevertheless, the advance-decline line is often useful in warning of the potential end of a swing. However, my method is to stay in the market through bull market corrections except when we seem to be in the very late stages of a bull market. Then, I will reduce my exposure to the market.
3. The advance-decline line is only one of several observations that will drive my market exposure reduction towards the end of a bull market. It is not

even the most important one for me. After much thought, I considered that it was such a small additional part of what I do that I would leave it out of the book.

Since finishing the book, I have been doing some additional work on the problem of the pronounced downward bias in the advance-decline line. I am now favouring the 20-day moving average of advances as a better measure. It seems to partly eliminate the downward bias problem. I have also applied this idea to New Highs-New Lows and my article in April 2005 Shares magazine reported on this. I am now publishing charts each month of the 20-day moving averages of Advances, Declines, New Highs and New Lows on the Breadth Charts page in my Members Only website, with comments, which are a kind of rolling commentary on my assessment of these and the standard breadth tools. I have also shown and discussed the new 20-day moving average of advances line in my weekly BRW columns.

I have more work in mind on breath indicators, as well as needing to monitor how the new tools work going forward. Depending on results, I may decide to include them in a second edition of the book down the track. I will also consider including them in a possible reprint of the Shares Charting Guide articles in the form of a Charting Guide book. However, this is still only a project in planning at this stage.

Where to Place Stops?

Question

I am a trend trader using weekly charts. If my share price goes through my stop during the week should I exit or should I base my exit on the close of the week? I often find I get stopped out during the week only to find that by the end of the week it closes above my stop. Or do I do whatever my trading plan says?

Answer

The quick answer to your question is that you should always follow your trading plan. You should do this through to the end of your trade. If you start trying to re-think your plan during a trade, you will be taking a step on a very slippery slope. It is very easy for you to fall into several psychological traps, such as availability bias, where you make decisions based only on most recent observations, which may represent an atypical sample. What you are obviously asking is whether you ought to change your trading plan. If you think that you want to review your plan, this is best done while you are out of the market. That is why I suggested the quick answer was to follow your plan.

You seem to have observed some situations where, if your trading plan rules had been different, the result may have been better. These ideas should occur to thinking traders all the time. They should then test them. That means going back through past data for the sort of stocks you trade in rising, falling and flat markets. You need to find hundreds of situations that you may have traded on your selection and entry rules and then compare the results from your current

stop placement rule versus the new idea. That is the only way you will be able to know whether the new idea would have worked in the past. This gives you some basis then for whether you might want to change that aspect of your trading plan.

This can be painstaking work, but the best traders got to be where they are by doing the hard work, rather than guessing. The alternative to testing on lots of past data is to test it going forward with real money. Most people do it that way and they get an answer one way or the other eventually. However, the market can charge very high tuition fees which it hides from you by labelling them trading losses. It is much smarter to do the testing on paper on past data. You can get part of the way with software that lets you test trading rules. However, it is only a partial solution. Testing in this way gives you some quantifiable data, but it does not deal with the psychological aspect. Ideally, you need to set up the charts and step through them by adding one bar at a time and try to experience the emotional pressures. For example, your testing may show that your new method works well over time. It is easy to gloss over some of the software testing results like the maximum drawdown (paper loss) during the trade and the number of consecutive losing trades. In reality you may not be able to stand these levels of heat or pain in the trade, so no matter how good the system over lots of stocks and lots of time, you would have stopped using the method before it paid off, or maybe skipped some trades that turned out to have been the big ones.

As for my experience of closing prices versus intra-day or intra-week lows, I do not have what you are looking for. I don't know how you place your stops and I don't know which kinds of stock you trade in. My own method is based on intra-day/week lows (they are the same thing) because the logic of my method is to trade the trend, which is defined by troughs. However, in thinly traded stocks I will carefully examine very large downward intra-day spikes that occur on low volume because of cascading automatic stop-loss orders. Notice that I said that I will carefully examine them, not that I ignore them. I treat every case on its merits and will be closely monitoring daily and even intra-day data for whether there is follow through on the fall or that it was a system anomaly caused by beginners using automatic stops in an unsuitable stock to apply such a tool.

If you told me what sort of stock you trade and your present and proposed stop rules, I could test them for you. However, I have neither the time nor the motive to do so. Even more importantly, it would be a bad idea because you would not have lived your way through the hundreds of situations that ultimately build up faith in your method in your mind.

A couple of years ago I discussed with a very good trader how he came up with a new signal that he used. His answer was what I have told you above. When I asked him how long it took, he said about 80 hours of intensive work. This is actually a short time, because it was a short term signal that set up in and was resolved in about ten periods. If you are trading a longer time frame, more time will be needed in testing. That is the shape of the territory if you want to be a

good trader. These are the people you are competing with to take profits out of the market. If you don't have the answers on these issues and they do then money will flow from your bank account to theirs. I am sorry to be a bit brutal about this, but it is better I tell you than the market teach you.

Some Thoughts of Chairman Buffett

(Originally published in Dial & Chart Newsletter September 2005)

If you want to write a best-selling investment book, you might do worse than to write one about Warren Buffett, Chairman of Berkshire Hathaway. After all, he has been one of the most successful investors in the last half century. Except you would be a bit late, there is already a plethora of books on his life and methods along with software that purports to let you invest like he does.

So why are there not a swag of investors out there replicating his results? I think there two main reasons.

Firstly, he is a product of his education. His teacher was Benjamin Graham. Many of Graham's other students have also done very well. Maybe not as well as Buffett, but they are near the top of the rankings. They are all value investors. They are highly disciplined and very patient. They play a long-term game. Unfortunately, many of the readers of the Buffett books have no time, no patience and no discipline. Value investing does not yield the instant gratification demanded these days. In short it is just not sexy.

Secondly, he is a product not of what he knows, but how he thinks. Buffett may not be one of a kind, but he is of a rare type. He thinks differently to other people. Not all of them, but most of them. If you think of an investment rule, Buffett invariably succeeds by turning it on its head. Recently I have come across some interesting insights into this different mode of thinking employed by Buffett.

On Timing the Market

Almost all funds managers and especially value investors like Buffett tell us it is disastrous to try to time the market. In the case of many funds managers, this is generally self-serving advice, in that they want us to leave our money with them through thick and thin. Value investors like Buffett have a more honest position. They really seem to believe that timing the market does not work and that they do not do it. Really?

Take this quote of the words of Chairman Buffett at the recent Berkshire Hathaway annual meeting, reported in Barrie Dunstan's Smart Investor column AFR August 20-21 2005: *We try to price, rather than time, purchases.*

Sounds cute doesn't it? But think about it. If you only buy a stock AT THE TIME that it is cheap, aren't you timing the market? I would maintain that Warren Buffett is one of the great market timers. He just doesn't realise that he is a

market timer. Doesn't he repeat Benjamin Graham's fable of Mr Market who some TIMES offers you ridiculously high prices and at other TIMES offers you ridiculously low prices? Doesn't he tell us we can ignore the TIME when the price is high and wait for the TIME when the price is low? So it is all semantics – buy at the right price, or the right time – same thing really.

On Ignoring the Market

Barrie Dunstan's column goes on to report that Buffett added something very profound on this issue of timing purchases. A common excuse I hear a lot after two and a half years of bull market is that the market is too high. It is too late to buy now. It is best to wait until the next bear market. What these inexperienced investors do not tell you is why they did not buy in the first half of 2003.

This idea of buying only at the perfect time is very pervasive in the investment community. It has even been trotted out in recent times in the media by value funds managers, who are bemoaning that there is no value left in the recent market. Now read what Barrie Dunstan reports Buffett as adding to his earlier quote:

In our view, it is folly to forgo buying shares in an outstanding business whose long-term future is predictable because of worries about an economy or a stock market that we know to be unpredictable.

So, again, we see Buffett turning on its head the idea that you do not buy because the market has become expensive. This is because he does not buy the market. He buys stocks. And he only buys a few stocks. Compare this to most funds managers who basically hold a diversified index-related portfolio. Of course they need to look at how expensive the market is – they are effectively buying the whole market. Buffett does not buy the whole market. He buys only a few outstanding stocks.

The remark quoted above demonstrates that he ignores the market. Mr Market is a madman. He is there to be taken advantage of, but his views are never to be listened to. Buffett looks at all Mr Market's offerings and WHEN he offers to sell a great stock at an incredibly low price, Buffett pounces on it, regardless of what the overall market is doing.

So Buffett's secret is that he knows the right price and waits for the TIME when it is available. Then he acts fearlessly. This lack of fear, born of absolute conviction, is what most investors lack. There are always doubts. Great investment decisions are always the most difficult. Unless, that is, you have a clarity of focus on price and time, the like of which Warren Buffet has demonstrated over the last half century. As Shakespeare wrote in *Julius Caesar*:

*There is a tide in the affairs of men,
Which, taken at the flood, leads on to fortune;*

Open Interest and OBV

Question

Can I get open interest data for equities market, or is open interest data only available for futures? Is open interest in equities market the same as on balance Volume?

Answer

There is an essential difference between share markets and derivative markets. In the share market, what are traded are pieces of paper that represent assets. Companies are formed when the promoters raise money from the public. In proportion to the money contributed, pieces of paper called shares are issued to these investors that evidence ownership of the company. These shares can be traded on or off a stock market, which is known as a secondary market, because it allows trading between people other than the primary or original investors in the company.

A derivative market is totally different in the way what is traded is created. What is being traded is a contract that specifies a right or obligation to perform some action in the future. Each contract has two parties to it who are undertaking to take the opposite side of the transaction that is the subject of the contract. To understand this, imagine that you are a manufacturer of gold products, and that you want to lock in the current price of gold for a big contract. You can buy from a gold miner the right to buy gold at the current price on a future date, which is when you have to make the products. In effect this is a contract. To make it easy for miners and manufacturers to lock in price certainty, standard contracts are created and traded on a futures market with speculators and others providing liquidity. You can buy a contract or sell a contract. If you buy it you are long and have to take delivery of the gold at the end of the period. If you sell it you are short and have to make delivery at the end of the period. At any time you can take the opposite action to cancel out your position.

In a share market, no matter what trades are made, there is always the same number of shares in existence. However, in a derivatives market, if you sell a contract you hold to someone who was short, then it is of no effect any more and ceases to exist. In a formal derivatives market the matching of opposite sides of contracts is achieved through a clearing house. So, the number of contracts goes up and down depending on whether the net effect of trading is to cancel contracts or open new ones.

Open interest is the number of open contracts in a futures or exchange traded options market. It goes up or down depending on whether market participants are generally expanding or contracting their exposure to, or if you like, their interest in, the market involved. If open interest is rising, then both sides are increasing their exposure to their positions. If open interest is falling, then both sides are unwinding their exposure.

Open interest is quite different to On Balance Volume. On Balance Volume is a volume indicator invented by Joseph Granville. It relies on the rule that if prices rise on a day (close today > close yesterday) then the day's volume is given a plus sign. If prices fall on the day, it is given a minus sign and if the price is unchanged, volume is ignored. The idea is that buyers drive prices up and sellers drive prices down. All the volumes, plus and minus, are accumulated and the resulting number is plotted as a line. If the line rises it tells us that buyers are increasing their commitment to that stock. If the line is falling, they are unwinding their commitment. We should also be very wary when price move the opposite way to On Balance Volume. Rising or steady prices with falling On Balance Volume suggests distribution. Falling or steady prices with rising On Balance Volume suggests accumulation. In either case a change in trend or breakout may be indicated.

My Portfolio

Question

Where on your website do I find your portfolio?

Answer

There is a link to Portfolio Disclosure at the bottom of every page on www.bwts.com.au.

You can also save this link to your Favourites folder:

<http://www.bwts.com.au/text.cfm?7>

On Learning to Trade

Question

I am a beginning trader and have read many books on trading. I have also been subscribing to some newsletters/reports to help me learn trading. The only seminar I have ever been to was one at the Traders Expo. Although I have found the presenter's newsletters and trading books to be good, I found at his seminar that he didn't really say anything that wasn't already in his books/newsletter. Is it really necessary to pay large fees to attend seminars to learn how to trade? Just about all seminars are very expensive in my opinion. Wouldn't it be enough to read books/magazines extensively and learn from personal experience through trading on a fairly small scale?

Answer

This is a very interesting question.

I learned most of what I know about trading from reading books and magazines and also from hard experience and much testing of ideas. However in the early 1980s I paid what was then a lot of money to attend David Fuller's Chart Seminar in Sydney. I learned a great deal from this two-day seminar. David has never written a book with this material in it, so there was no other way to have

accessed it. I think it paid for itself many times over by increasing my insights into the market.

Having just written a book with my complete investment plan fully described and illustrated with case studies, I wonder like you what the real benefit would be to run seminars teaching the same material. Yet I am constantly asked to run seminars. When I point out it is all in the book, people tell me they don't like books and only learn from seminars. This is strange to me because I would prefer to buy a book anytime over a seminar. However, I guess that we are all made up differently, so there needs to be various channels for people to access ideas depending on their attitudes to learning.

There is one aspect to attending seminars as against reading a book and that is that the seminar makes you listen, whereas there is nobody to make you read the book. The seminar drags you out of your busy life and imposes the discipline that would be required to make time to read and study a book.

One thing I will say though is that if I teach seminars again, and I have no plan at present to do so, I would not be charging the fees that some seminar promoters are asking. I believe that a fair fee is a maximum of \$500 plus GST per day. My saying this may upset some people in the industry, but they are just going to have to live with my opinion. However, I think you have criticised Traders Expo a little unfairly – the prices they charge seem very reasonable to me.

So, if you like learning from books, it is all there for you and it will probably run out cheaper than taking seminars. If you want to learn trading the best book by far in my opinion is Dr Alexander Elder's *Come Into my Trading Room*. However, this is just a starting point and you will need to read widely beyond that to develop your own style.

The best way to learn Technical Analysis is through the ATAA/FINSIA by taking their subjects E114 Technical Analysis and E171 Specialised Techniques in Technical Analysis. You can do the lectures if you want, or do it by distance education. The subject notes are extensive and you will use them as a reference for years to come.

The only seminars I have attended in recent years are those run by Dan Gramza. His material is excellent and not so far available in a book. His idea of a fair price for seminars is closely in line with mine. He is one of the best teachers of trading who is regularly available in Australia in my opinion. You have just missed his latest seminar, but I hope he will be back next year. I publicise his seminars through my newsletters and on my website.

US Fundamental Data

In the previous newsletter I fielded a question on New York Stock Exchange fundamental data. The question related to the overall market average ratios (PE

and Dividend Yield), but two readers have volunteered sources for individual US company fundamentals:

In your most recent newsletter (very interesting, as usual), one of your readers had asked where to get fundamental data for US companies. I use TD Waterhouse brokerage (www.tdwaterhouse.ca or www.tdwaterhouse.com) and once on their site you can get S&P data sheets for many US companies (NYSE, AMEX, NASDAQ) which give 10 years of data.

This site may help your reader: http://advfnus.ar.wilink.com/asp/A563_search_ENG.asp

Adjusting for Dividends

Following the item in the last newsletter, a reader has advised:

Just Data (Bodhi) has the facility to include or exclude the dividend adjustment at the users choice by ticking a box.

ASX All Ordinaries Accumulation Index

Another reader has kindly advised a source of the ASX All Ordinaries Accumulation Index on the Internet:

Regarding your reply about where one can get the ASX All Ordinaries Accumulation Index, it's also available for free on Standard & Poor's website, at this page:

<http://www2.standardandpoors.com/servlet/Satellite?pagename=sp/Page/Indices/IndexPg&r=7&l=EN&b=4&s=6&ig=42&i=5&xcd=ASXALLO>

Look for the number alongside the label TR (Total Return). The number for any date seems to be published by the following morning. Change the date in the drop-down box to see the figure for any other date.

This is a free email newsletter for people interested in investment and trading.

I only record your name and email address, which information is used for no other purpose than to send out email newsletters.

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 subscribe by going to the Newsletters page on www.bwts.com.au and clicking on the relevant link. My only proviso is that the newsletter be sent in full and unchanged.

Past issues of the email newsletter are available for downloading from my 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 them.

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*