

## Colin Nicholson: Newsletter 55

4 January 2006

### Help Wanted – Commodity Prices

From 16 January the London Metals Exchange will only provide price information by paid subscription. I have a reader who is looking for new free sources on the internet for commodity prices especially for aluminium, copper, lead, nickel, tin, zinc, silver, coffee and crude oil. This is outside my area, but any reader contributions of appropriate URLs would be helpful. Please email me at [colin@bwts.com.au](mailto:colin@bwts.com.au). I will put the URLs contributed on my web site progressively in the Ask Colin section under the keyword **Commodity Prices**.

### Time Frame Revisited

#### Question

I recently bought your book. I have been doing some paper trading to learn the system. Once one has identified appropriate shares on the monthly charts and the filters does one make decisions about position building and, if necessary, selling, on daily or weekly charts?

#### Answer

I am asked this question all the time. It rather mystifies me that so many people are troubled by it, because daily, weekly and monthly charts are all showing the same price action. The same peaks and troughs in a trend will be visible on all three.

The one aspect that we need to be careful about is is timeframe. However, this is not really an issue of what chart you use, but the time period that you have on the screen. If you are looking at a trend that began in early 2003, and you are looking at a daily bar chart a year and a half later that shows only the last four months (Sept to Dec 2005), then you cannot see the whole trend in perspective and will be apt to acting on a shorter time frame than the one you are trying to capture. For this reason, I prefer to have a monthly, weekly and daily chart on my screen at the same time as described in my book *The Aggressive Investor* and apply the rule that if you cannot see the daily chart's peaks and troughs as significant on the weekly chart, you may be looking at too short a time frame.

### Taking Profits

#### Question

I have read about a strategy on taking profits on fast trending stocks. The proposal is that when the profit gets to the 50% level you sell 1/3 of your position therefore cashing in some profit and reducing your stake back to the starting value. This would also have the benefit of keeping your portfolio in balance. i.e. a 10% position that gets out to 15% is reduced back to 10%.

**Response**

I have seen this approach and many others like it. I think it is fine for traders, but it does not really achieve what I want to do which is capture the big trend rather than just one upward swing. In my case it would be breaking the important rule of letting your profits run.

However, just as I find it helps psychologically to sell half if my investment doubles, this will work well for a trader who finds it difficult to stay with fast-moving positions. The key though is to be sure of what you are trying to do. If you are trying to be an investor, it will be very corrosive to your plan. The danger is that the investor never learns to stick with the trend, but jumps out too quickly.

In summary, it could be a good idea for a trader, but I have some reservations for an investor.

**Learning Fundamental Analysis****Question**

I have steadily been building my knowledge of fundamental analysis, but still feel that it is somewhat superficial. Since you were involved with the Securities Institute is there a unit(s) you would recommend, or maybe a book to fill this gap? I would like to be able to take a company report and do an analysis where I feel I have actually gained valuable information to make a decision whether to invest or not, i.e. believe I have extracted the essentials and not just kid myself I have.

I am looking for interpretive/practical meaning and not just mechanics of financials. e.g. Not only what depreciation is, but how it can be interpreted and used in analysis. I want to be able to read an annual report and get to the essential information, so I feel I have a grip on a company's health and prospects for the future.

Is there something you can recommend?

**Answer**

Ten years ago in my opinion, there were very few really accessible books on fundamental analysis. The best thing I did was the core subject on Financial Statement Analysis and Valuation in the FINSIA Graduate Diploma in Applied Finance and Investment. That would still be my first choice. However, not everyone will be able to do it (you must be a graduate) or like that kind of learning. In the book area, these are my recommendations:

Trevor Sykes *The Numbers Game*. Excellent and readable guide to what really matters.

Benjamin Graham *The Intelligent Investor*. Graham's most accessible book. Note that I had a go at an example of his margin of safety analysis in the appendix of my book *The Aggressive Investor*.

Michael Thomsett *Mastering Fundamental Analysis*. Very easy to grasp and very sound.

## ASX 200 Earnings Chart

### Question

I have recently seen a chart, I believe in *The Australian*, showing company profits versus the ASX 200. The chart had a base index of 100 as at March 1990. Is it possible for a user to construct this chart in Insight trader? How or where would company profits be obtained in Insight Trader or MetaStock format?

### Answer

I am not aware of where you could get this data. However, I will put your question in my next newsletter and some reader may let us know.

It would not be very difficult to chart a proxy for it. Assuming you have two data series in addition to the ASX 200 price index - the ASX All Ordinaries price index and the ASX All Ordinaries PE ratio, you can put them in a spreadsheet. You can then manipulate them so that you have an earnings number ( $100/PE \times P = E$ ).

Then you can import the data into Insight Trader and plot both the ASX 200 price index and the Earnings number rebased to 100 at any date you choose in the data series. The two charts can then be overlaid and you have what I imagine you saw in the newspaper.

The ASX All Ordinaries PE ratio data may be downloaded in an ASCII file from my website [www.bwts.com.au](http://www.bwts.com.au) on the Data Files page. Much of the series is monthly, but more recently weekly. Monthly All Ordinaries Index data is also in the Coppock Indicator spreadsheet also on the Data Files page.

## How I Find Good Shares

### Question

How do you determine which stocks offer the best potential to buy out of all the stocks listed on the ASX?

### Answer

What you are asking is a large part of my book *The Aggressive Investor*. In the book I describe the two models I work with, the value model and the growth model. I have written about these in several other places - for example in the Shares Charting Guides - and these are also available in back issues of the articles or on my members only web site. However, the book has my entire method in one place.

You are quite right to identify one of the problems with share investment being to scan through the 1700-odd stocks listed on the ASX. This is actually quite an easy task once you have decided what you are looking for.

I do it with charting software, with two basic screens. One is a technical analysis screen that looks for stocks making new 52-week new highs. It is possible to do this without charting software as the list is published every day in the Australian Financial review. The other is a fundamental analysis screen that looks for stocks with low PE ratios. The software lets me do this, but I used to do it by hand from the list of stocks in the Australian Financial Review. It does not take long that way. However, the next step is a bit longer to do without software.

The basic screens usually give me up to 200 stocks that satisfy the initial criteria. I then go through them, which is really easy using the software to look for stocks that are trending up, or breaking out of accumulation or consolidation zones on the two models. I then further assess them looking for a margin of safety, which is somewhat different for each of the models.

If you would like to follow this up, as I said the most complete description with hundreds of actual examples in my book.

*The Aggressive Investor* may be purchased for \$49.95 including postage from my web site [www.bwts.com.au](http://www.bwts.com.au) at <http://www.bwts.com.au/text.cfm?42> or by telephoning me on 02 9436 1610.

## Who Can You Trust with Breadth Data?

### Question

Yahoo's breadth data varies from what is published at:

<http://www2.tradingroom.com.au/apps/mkt/movers.ac>

(see rises vs falls in 'Top 20 of Whole Market' section). Who do you trust?

### Answer

Breadth data is very difficult to calculate accurately. Some of the problems are:

1. What to include. Some methods include every listed security. However, this tends to count companies, which have more than one type of security listed, more than once. One approach is to include only the three-letter ASX codes. However, even this is not perfect because some companies do not trade as a three-letter code.
2. You have to be meticulous with adjustments. If there is any change that requires adjustment of past data, say due to a split or consolidation, you need to be very careful that the adjustment is done before calculating the breadth data for the ex date and subsequent dates. There are also areas of disagreement about adjustments. Different vendors may make different adjustments. Right, wrong and trust are tricky concepts in this area.

3. You have to be meticulous with name changes. If there is a name change, you need to be careful to join the old file onto the front of the new data file before calculating the breadth data for the ex date and subsequent dates.
4. Likewise with code changes.
5. Likewise with calls and instalments that create a fully paid share. Many vendors do not make this adjustment correctly in my opinion.
6. Back-door listings are a tricky subject. Some of us disregard the old data, but many vendors retain it. This will give different breadth data between vendors.
7. Demergers are also very tricky. Each one needs to be considered on its merits. There is a lot of room for different approaches to joining or not joining old data to the front of the new file (and which file?) as well as what adjustment to make.

Conclusion: The breadth data will vary from source to source. It is not so much a matter of trust, although some may be more meticulous than others in maintaining their database. Putting aside incompetence, there are genuine and eminently arguable reasons why different vendors will use different methodology. The key I think is to use a consistent source.

## Time Frame Conundrum

One of the most difficult areas of technical analysis and technical analysis-based trading and investing is the time frame issue. There are many possible ways to approach this. One of the strongest methods is that of Dr Alexander Elder in *Trading for a Living* and *Come into my Trading Room*. This is of particular reference to traders, but can easily be applied to investing. As far as my own approach to it, this recent question from a reader echoes the most common question I am asked:

### Question

On pages 67 - 69 of *The Aggressive Investor*, you give examples of charts showing the start of bull and bear markets. Should I be looking for these signs on daily, weekly or monthly?

### Answer

The quick answer is that the peaks and troughs can be seen on daily, weekly or monthly charts. However, it is easy to lose perspective when looking at daily charts that only cover a few months. The useful check that I use is that if you cannot see the peaks and troughs that appear on the daily chart also on a four to five year weekly chart, they are probably in a shorter time frame than I use.

The particular pages referred to showed conceptual diagrams of trends. When I continued on with specific examples of market charts, I used daily line charts.

These are better mostly than weekly line charts because they better capture the full extent of the peaks and troughs which could be missed on a weekly chart where the absolute peak or trough high or low occurred during the week. To see what I mean, compare a five-year daily line chart with a five-year weekly line chart.

A weekly bar chart, of course, is alright, because it captures exactly the lows and highs of the troughs and peaks. I used line charts because they simplify the picture and show what I needed to bring out of the particular discussion.

The key thing is that the daily line charts cover a few years in each case – enough to show the big picture. Try to have enough data on the daily line chart screen to show the whole of the trend, rather than just a part of it. You may need first to consult a chart with a few decades of data on it and then work down to the trend you are studying.

## Comparison to the Accumulation Index

I compare my results to the All Ordinaries Accumulation index. This is not perfect, but is better for an investor than the price index, which is more applicable to short term traders. There are two problems with comparison to the Accumulation index:

1. I include the imputed credits attaching to dividends in my total return. This gives a correct comparison on a pre-tax basis with other asset classes. However, the accumulation index does not gross up their dividends, so it tends to somewhat overstate my return by comparison.
2. I include dividends when they are paid, which is when I can reinvest them. However, the accumulation index includes dividends from when they are declared. This can be a month or more before they are paid. This tends to overstate the true return from reinvestment of dividends and my return looks worse by comparison.

Readers should be aware of this when looking at my reported returns and also if they are using a similar method for calculating and referencing their own returns.

## More Feedback on my Book

*I just want to let you know that I have not only received your book, *The Aggressive Investor*, but have also read it from cover to cover. I started out with an initial investment of only \$10K and what I thought was a sound investment plan. But, as with all things new, it took a bit of time to show up all the flaws, each one resulting in a loss or a near miss. Since then I have tried to correct the faults as they appeared, or if things were not fixable, completely re-write that part of the plan. Although I have read many books on investing and trading, none actually lay down sound guidelines, and to make things worse, there seems to be a lot of*

*contradiction. Your book resolved a lot of my confusion. I feel I have learned a lot from your way of looking at the market.*

The Aggressive Investor may be purchased for \$49.95 including postage from my web site [www.bwts.com.au](http://www.bwts.com.au) at <http://www.bwts.com.au/text.cfm?42> or by telephoning me on 02 9436 1610.

## Do you Use Candlesticks?

### Question

I note that in *The Aggressive Investor* you state that you only use candles to more easily see the OHLC levels (top p183) and yet there is considerable discussion of candles on [www.bwts.com.au](http://www.bwts.com.au) and reference to a candle course on your members' only site. Was this section of the book written before your interest in candles?

### Answer

The book was written later than the candlestick material on the web site. The mini-course on candlesticks was written in 1999. The other material was written mostly prior to 2005.

I wrote the Candlesticks mini course as a topic for the subject E171 at the SIA (now FINSIA). The other material was mostly written in response to Q&As like yours.

You need to bear in mind that I teach technical analysis in general as well as the techniques that I personally use. The book is what I use in my own investing.

## Identifying Troughs

### Comment

As you state in 'The Aggressive Investor' it can be difficult to determine where the trough occurs on some charts. From limited experience in applying it I find that the weekly Parabolic SAR is helpful. The judgement is that a trough is not significant unless the Parabolic generates more than 5 dots, thus the line drawn bypasses such pauses in trend and continues on to the next peak.

### Response

This is an interesting approach and maybe worth researching further on a large number of stocks. I do not use indicators to identify troughs on the basis that if I cannot see them on a weekly chart, they probably are not there.

Rather than Parabolic, I think momentum oscillators like RSI, MACD and perhaps Stochastic may also be very useful.

This is an interesting subject. Perhaps some readers may like to contribute to a discussion on the subject?

## Upcoming Dividends

The previous two newsletters have discussed online sources of upcoming dividend information. Another reader has supplied this source:

*Go to [www.egoli.com.au](http://www.egoli.com.au), click on the Shaw Online tab, it takes you to the Free Dividend Schedule, which is just below the Welcome to Shaw Online heading. You don't need to be registered with Shaw to access this, and I find it helpful as it covers a longer time frame than others I use.*

## Coppock Indicator

### Question

Your *Research Report No 2* included a write-up on the Coppock Indicator. Is it still available?

### Answer

No, the *Research Report No 2* is no longer available.

There is quite a lot of discussion of the Coppock Indicator on my web site in the Ask Colin section. In addition there are some articles about it in the members only section of the web site. I also included the key material in my book *The Aggressive Investor*, with discussion of recent examples.

There was some additional material in the *research Report No 2*. I have provided the material from the research report below.

### The Coppock Indicator

This indicator was invented by Edwin Coppock, a US investment adviser and the founder of Trendex. He designed the index to do only one thing – indicate the time to buy long term holdings at the bottom of a bear market. It is a little cumbersome to calculate, but it can be done by hand, which is how Coppock did it in the days before the PC. It is now built into most computer charting packages and can also be easily calculated on a spreadsheet.

Coppock outlined the philosophy behind his view of the markets, leading to showing the calculation of the indicator and describing its use, in his paper ***Realistic Stock Market Speculation***. It was published for a Trendex conference in 1967 and has been long out of print. The indicator was designed for the DJIA and is calculated monthly. It has been found to work on almost any stock market index.

### Principal Ideas from Realistic Stock Market Speculation:

Coppock begins his paper with the proposition that the most difficult aspect of realistic speculation is to resist the urge to act in ways that seem most natural and logical to the untrained speculator. He therefore suggests that to be successful, we must change our behaviour from the apparently logical approach that has caused past losses from trading.

It soon becomes obvious to the beginner that success in stock market trading does not come easily. It also becomes obvious that stock markets are driven by forces other than rational people acting on known information. Thus the first step is to acknowledge this fact and realise that an approach other than simple study of the news is needed to succeed.

This is but one example of how each of the accepted principles of security analysis must be questioned and tested to see whether it works in the real world. Coppock suggests that, if the minority seem to be more successful than the majority, then the minority may be using different strategies than those commonly accepted. The reason that the commonly accepted principles remain current and continue to be promoted is because of their reasonableness. Those who may be brought to book if their advice does not turn out to be sound will protect themselves by hiding behind what is easily defended as widely accepted, rather than what they might believe actually works. This may sound cynical, but it is important to understand that speculation is a pursuit where cynicism pays off.

A good example of this trap is the way stocks are sometimes touted to us as being undervalued because they are selling for less than book value. While it might be true, it also may be that there is good reason for the low price, say because the company is sliding toward liquidation.

We are taught to achieve by hard work and persistence. However, mere hard work and persistence in the face of market trends is a recipe for disaster. Likewise, faith and natural courtesy are admirable qualities. However, relying upon them when an adviser is well-meaning but unqualified can also lead to disaster.

Beginners also tend to be naive about company profit reports, assuming that they are seeing them at the same time as everyone else. However the facts are that some people get the news faster. Even of more importance, some are able to estimate or anticipate the results and have already acted in the market well before the news is released. Thus stock prices do not only reflect known facts, but they also discount possibilities. There is even a saying on Wall Street that earnings are usually at their best just before a price decline begins. Coppock suggests that speculators watch prices before an earnings announcement is due, to gain an indication of what insiders think will be announced.

The realist does not bother to ask why prices are moving contrary to that expected from the known information. Rather, he learns to act upon what prices are telling him and expects the news to confirm it sometime later. He will then often sell to the beginners after that news is announced.

Another way that the uninitiated lose in the market is through greed. They unthinkingly buy the stock with the highest dividend yield. All too often they do not realise that the rest of the market has seen that yield and not tried to take

advantage of it. Why? Often it will be because the initiated and the insiders know that the dividend on which the yield is based is very likely to be cut when the next earnings announcement is made.

Contrary to what the beginner thinks, it has been observed that many of the greatest percentage increases in stock prices have started from a situation where the company paid no dividend at all, or an insignificant one. This seems to be because the contrast between zero dividend and good growth prospects drives keen anticipation.

In learning the new concepts that are useful in speculation, we need to become used to the idea of considering effect, without worrying about what the cause is. We are taught to think in terms of cause and effect and moving away from this method is bound to cause us to feel uncomfortable at first. So uncomfortable, that some people refuse to grapple with it and reject it out of hand. They prefer the comfortable losing strategy to the discomfort that has to be overcome in order to succeed.

The first thing to realise is that announced and disseminated news is out of date and can have no further effect on stock prices. Prices are driven by expectations of the future, not facts about the past. This is why stock prices can sometimes fall even in the face of generally good economic conditions and rising profits. Often this is quite reasonable, if it is appreciated that prices had already been driven too high by unreal expectations about what is now the present. The realist acts on the reality of falling prices, not the known facts of buoyant present conditions.

Coppock uses the analogy of a general who studies the information about his enemy in order to time his own strategy. Likewise, it is important for speculators to get their timing right. Yet few who are brought up on a basically fundamental approach place very much importance on timing. It pays to stay aware of the actual movements in prices, as well as the underlying story.

Another area where beginners are misled is the idea that there are 'normal' levels for PE ratios. Whereas it soon becomes clear to the initiated that PE ratios are related to levels of inflation and interest rates on the one hand and to expected growth rates for the company on the other. So-called 'normal' rates may have applied in times of stability in prices and a stagnant economy, but students of history know that this is rarely a normal situation for long.

On the other hand, there is some relationship between earnings and prices, though not as much as many people believe. However, this does not justify using earnings in the form of a PE ratio to justify stock prices. Any chart of PE ratios over time will show that they vary widely for the market as a whole and for individual stocks.

Reactions to news is markedly different between beginners and the initiated. Beginners tend to buy good news and sell bad news. The initiated take a different tack by considering first whether the news was expected or unexpected. Expected news is ignored. Unexpected news will impact the market in the short term, but will not tend to disturb a strong trend for long. Unexpected bad news therefore can be expected to finish off a tired trend, but it will be shaken off by a young vigorous trend.

Next, Coppock turns his attention to dealing with tips and tipsters. The beginner is usually eager for inside information and pounces on tips in a most trusting way based on wishful thinking. Instead he should ask questions about how likely it is that he is the first to hear the tip, whether the tipster stands to gain from it, whether the stock has already gone up in price and how qualified the tipster is. Since the average chief executive is so often wrong about the direction of his company's stock, the beginner should ask how an outside tipster would know any better. Sure, the tipster may be a stock market genius, but experience suggests otherwise. The real experts rarely talk about what they are doing and know that the best bargains are never the subject of rumour and have not yet started to become active price movers.

Another common mistake is to follow reports of the portfolio moves of fund managers on the assumption that they know the future. Yet most fund managers do not do as well as the market index. Moreover, they took the portfolio decision some time ago and, by the time it becomes known, the situation may have changed.

*Every student of the behaviour of unrealistic novice speculators eventually reaches one important conclusion: the average novice wants success without work, he wants shortcuts and he is intellectually lazy.*

*If it is agreed that success doesn't come easily and that among speculators, the minority wins more often than the majority, then a step toward reality has been taken. Further steps depend on open-mindedness, a willingness to accept a change of method and a continuing willingness to work hard at the business of making your money work hard for you. This paper will now start presenting a realistic program that overcomes many of the weaknesses outlined in the criticism of orthodox concepts.*

Edwin Coppock at page 19 of *Realistic Stock Market Speculation*

Coppock suggests that there are four elements to be dealt with: the problem, the participant, the media (eg stocks, bonds etc) and the method.

The problem is firstly a manifestation of greed and the thrill that comes from winning. There are always emotions involved and this is why the losers outnumber the winners.

There is also the matter of time. Everyone's objective for how long is needed to make a certain profit tends to be different. Some are more realistic than others.

Some can carry out a plan with courage and others cannot.

Some understand the risk of speculative stocks and the differences in liquidity and others do not.

This short list combines all four elements. They are inter-related. The point is that there is no point learning method and strategy if you do not understand the role played by your emotions in the process.

Most speculators concentrate almost exclusively on method. Yet all methods will fail in some markets. Thus different methods must be used in parallel as a means of reducing risk.

Earlier, there was discussion of the need to consider the reality of price movement without being concerned about the cause. Yet if we give a beginner any sort of reasonable explanation for price movement, he becomes more assured. This points out that the average beginner is driven very largely by fear and craves reassurance. This makes them vulnerable.

The way around this is to concentrate on the one reality, which is the trend of prices. We need to consider such facts as its direction, rate of change and probable duration.

We also need to consider that there are trends within trends and that short term traders may be trading an opposite trend to the larger picture being considered by a long term investor. Yet investors, who have bought stocks with a view to holding for months, continue to call brokers to find out how the market is going within a day.

Emotions drive prices, the emotions of buyers and sellers. Thus the human factor of psychology must be considered in a complete analysis of a situation. And it is not that difficult, because people are predictable, in the sense that they tend to react in a similar way each time they encounter a given situation.

Even a superficial look at a series of long term price charts will show that from time to time there are deep valleys in price, at which time it would have been perfect to buy. Beginners never do this, but some professionals calmly wait for these times and take advantage of them.

Coppock then describes how to calculate the indicator to which his name is most often associated.

## Calculation of the Coppock Indicator

Although some books suggest the indicator is calculated from average monthly values of an index, it is clear from Coppock's paper that the closing value is used. The steps in its calculation are as follows:

- ❖ Calculate the percentage change between the index value in the current month and its value 14 months earlier.
- ❖ Calculate the percentage change between the index value in the current month and its value 11 months earlier.
- ❖ Total the two percentages.
- ❖ Calculate a 10 month weighted moving average of the total of the two percentages.

This is the indicator, which is plotted on a chart.

The historical values for, and the calculation of, the Coppock indicator for the ASX All Ordinaries Index is shown in the spreadsheet in Appendix A. This spreadsheet may be updated by hand. Readers who would like the Excel file may download it from the data Files page on [www.bwts.com.au](http://www.bwts.com.au).

The Coppock indicator will swing between positive and negative values. The signal for long term investors to begin buying is when the indicator turns up from below the zero line. In other words, when it becomes less negative than it has been. At this point, the market will often be some months past its extreme low, but the risk for a long term investor entering now is quite low.

Coppock's advice at this point is very interesting. He suggests dividing our capital into three equal parts and investing it in only three stocks. He pays some attention to diversification, though, by insisting that each of the stocks be from a different industrial group.

His next advice is absolutely critical. He says to buy three of the strongest stocks you can find, based on recent price increase - those making new highs for the last few months. Do not worry that you may be paying too much for them.

If this last advice worries you, then you still have much to learn. A basic observation that all experienced speculators have internalised is that the leaders at the start of a bull market will tend to be the strongest throughout its course. This is often advocated today with the fancy name of relative strength. It comes to the same thing – buy the strongest stocks, they tend to stay that way.

Other commentators have suggested that long term investors should complete their buying before the indicator reaches the zero line. That is, before it turns

positive. However, Coppock clearly intended that purchase should be immediate upon the indicator turning up.

Another common question is whether the indicator works as well for sectors of the market or for individual stocks. His answer was in the negative – the indicator only works really well for the overall market. This is not to say it will not work for sectors and stocks some of the time, it will, but it is not as reliable.

Nor did he claim that it was a precise timing tool, simply that it signals a period of low risk for taking new positions.

Coppock claimed his indicator was only for entering the market. He used other means to exit, which were not really dealt with in the paper, because he went on to discuss techniques for dealing with the medium term. These have never obtained the popularity and following of the indicator described above and are beyond the scope of our current research paper.

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