

Colin Nicholson: Newsletter 57

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13 March 2006

Speaking Engagements

My speaking engagements are notified on the Hear Colin Speak page on my web site www.bwts.com.au.

Next weekend I am speaking at the Investors Expo in Sydney on the subject *How to Avoid Giving it all Back*. I will be giving the presentation at 12.30 on Saturday 18 March and repeating it at 2.45 on Sunday. It will be possible to buy signed copies of my book *The Aggressive Investor* at the Educated Investor Book Shop stand after each presentation.

Two Typical Journeys

First Reader Comment

I talked with you several years ago, and took your advice. I now have a diploma in technical analysis and have about 2.5 metres of books on my shelf, not including videos and DVD's. I have studied just about every form of technical analysis there is. And traded many different styles including many of your methods, but it is only in the last 6 months that I realise I have found the style that suits my character. I remember listening to Neil Costa once describing how you have to find what suits your make up. My problem was how to find my method. Well, I guess it's like getting married. You just know when it's right. I was looking at Tony Plummer's video a couple of days ago for the first time in a few years, and realised my methods are very similar to his, the mind works in mysterious ways.

Colin's Comment

You are describing a typical journey through reading, seminars/courses and experience. Most people describe how things become more confusing along the road until the point is reached where they work out which methods fit with their temperament. Many give up before they find it, or because they are unsettled by the need to embark on discovering who they are and what drives their temperament.

This is the reason I wrote my book *The Aggressive Investor*, to show what an investment plan looks like. Readers are advised not to copy it, but to adapt it to their temperament. Most of my other writing is to help them find what suits their temperament and how to make sound decisions (the psychology articles, which will soon be published in book form) and the other tools they may use, in place of the ones I use, in developing their own plan (the charting articles, technical analysis articles and the Charting Guides).

Second Reader Comment

I have now worked through your book *The Aggressive Investor* in detail and as a result, have now gone and re-read Alex Elder's *Trading for a Living* and

Come into my Trading Room again. I have also developed a **proper trading plan**, reconfigured my data screens and started a disciplined time management plan based on daily, weekly, and monthly action items. In other words I have a robust **plan** and an **organized purpose** which I previously did not have. So thank you for providing me the wherewithal to achieve that! I have now started managing my share trading investments and process as a **business**, whereas before it was merely a buy and sell process with a goal of growth, but not of wealth protection and a return on capital employed!

What to Sell?

Question

In *The Aggressive Investor* p80: *Strategy for getting out of the market*, you say you sort your holdings in *descending order by percentage gain on cost*. This is logical if you bought them early in the bull market, as you do, but if they were bought well through the run, as many of mine are, would it not be better to sort them according to percentage gain from their price as it was near the beginning of the bull market?

Answer

You are not correct that I have bought all my holdings early in the bull market. The reality is that many that I bought then will have failed and been replaced. Others might have shaken me out of the trend, but I bought them back later when the trend resumed. In the ideal situation I would be a brilliant stock picker and bought the lot at the start of the bull market and still hold them all. Unfortunately, I am only human and it is in the nature of investing that most holdings show mediocre gains and losses. About a fifth will make the real money. It is important to let these run as long as their trends persist, subject only to my tactic of taking profits progressively in the absolutely outstanding ones.

Even if I had bought all my shares only a month ago, if my market exposure strategy indicated a reduction in exposure, I would first sell any on which I have not yet made a profit. The logic to this is simple. If I am reducing exposure because I think the risk is high that the bull market could end, any share that is not making a profit in my portfolio is probably a dog and should go first. Most people find it difficult to take losses, so they take profits. This is the wrong thing to do. We want to ride profits and cut losses, not the reverse. My discipline, then is to cut losing holdings first. Remember, you can buy them back later if the situation changes. Nothing is final, the market keeps operating continuously.

After the losing holdings are gone, if I need to reduce further, I sell the least successful ones first. If I have to choose between winners, I want to keep riding the best ones, not the weaker ones. This is a variation on the idea that it is tempting to lock in profits by taking them early and letting weaker ones run. If you were allowed to switch bets on runners during a race, would you move bets from the leaders to the ones falling back, or from the laggards to the ones moving up in the field?

I know the point you are making is that it depends on how long the share has been held as to how much profit it could build up. However, the best stocks are the ones which start running earlier in the bull market. If I have a choice between selling a stock held for two years with a 50% gain and a stock held for two months with a 5% gain, I will always sell the second one. If it started later, it is to be preferred less than the one that started earlier. If I bought it towards the top of a great run, I may be buying it too late anyway.

I will not deny that this is an arbitrary approach. It is mechanical for the simple reason that we all have a strong tendency to take profits rather than sell losers.

Do you have to do what I do? No, most definitely not. My investment plan is what suits my temperament and objectives. Your investment plan should be different, to suit your temperament and objectives. In my book I tell you that you should only use my plan as a model for what should be in your plan, not slavishly follow me. The reason I wrote the book was to show what a plan might look like and to explain why my plan was as it is.

So, since your email indicates that you are uncomfortable with following me, you need to think out carefully what is right for you. Make sure you are not simply being pulled toward the tendency to sell winners and hold losers. If you are sure you are not, then you need to work out another method of assessing which ones to sell. For example, your argument that you should take each of your holdings back to the start of the bull market in March 2003 and work out the price gain since then is a good one. You could use this as your method. You could sell the worst ones and keep the best ones. I am not suggesting you do this, merely trying to get you thinking. Another possibility is to use Dr Elder's greater fool theory and sell the ones that are trending up and currently most stretched above their moving average. Again, I am not suggesting you do this, merely trying to get you thinking. Maybe you could incorporate both of these ideas into your final decision. There are infinite possibilities, none absolutely wrong or right. You need to work out what makes sense in terms of the issues and is sufficiently comfortable for you to be able to follow your plan. Only you can work out what you should do.

Feedback on the Aggressive Investor

... your book has been a great help to me in finally setting out a plan after 15 years of trading (profitably). How much better it would have been with a plan set down and not just something in my head buzzing around and changing.

oooOooo

I have just finished reading your book and would like to congratulate and thank you for writing such a worthwhile text.

I have read many books, including some written by the other Australian based authors, however, most of the books available are written by US based authors. Many of the books I have read are based on your recommended list, and I find that each book provides additional perspectives to assist me in my

journey of becoming a better investor. Yours has provided a valuable Australian perspective.

In your book I really valued the examples that you provided in your disk, and it was pleasing to read so many examples of companies that I am familiar with. In particular, I found the explanation and application of your investment plan very useful, even though I don't intend to use all your methods.

A signed copy of my book *The Aggressive Investor* may be purchased through my web site www.bwts.com.au on the Aggressive Investor page <http://www.bwts.com.au/text.cfm?42> or by telephoning me on 02 9436 1610. My price is the Recommended Retail Price of \$49.95 and includes postage and GST.

Where is Taxation?

Question

I have read your book *The Aggressive Investor* and have found it most useful. However there is no mention of income tax. In my case I watch the income tax implications of all disposals before I take any action. Do you consider that all income tax implications should be ignored?

Answer

There are several reasons why I did not mention tax in the book:

- I am neither licensed nor qualified to discuss taxation issues. I prefer to stick to things where I think I have real knowledge or experience.
- The taxation situation of every reader will be different and there are so many possibilities, it would have complicated things enormously. You will notice that
- I expressed my returns on a pre-tax basis. It is then up to each reader to apply that to their tax situation.

There is one policy that I have, though, that I did not spell out in the book. That is to set a strategy on taxation before starting investing. So, we should decide what we want to be doing from a tax point of view and structure the way we invest to meet taxation imperatives. Thereafter I think it is wise to keep taxation out of investment decisions. It is difficult enough to make good decisions without complicating them with taxation issues.

However, I would like to stress that this is my point of view and it is eminently arguable. There is room for many different approaches to this question. The aim of my book was to provide a model of an investment plan and show how it might be implemented in practice. The aim of supplying and explaining the model is to assist you in developing your own plan, which will necessarily be different to mine. There is absolutely no reason why you might not bring taxation into your investment plan. My feeling is that it will complicate things, as I explained. However, there is scope to maybe fix some other aspects of

the plan that are decision points for me, but will be given for you the way tax is for me. The key think is to try to understand the full implications of your plan. This takes time, and experience.

Fundamental Filters

Question

Like you, I believe using both technical and fundamental indicators is a valuable approach to filter opportunities. I am aware that you use Insight Trader software for its ability to filter both technical and fundamental information. However, in your book *The Aggressive Investor*, you make reference to the Aspect Huntley Equity Review service (AHER), which also provides a fundamental filter screen in addition to other valuable fundamental information.

What have you found to be the differences or advantages between what Insight Trader and AHER can offer an investor seeking a fundamental filter tool?

Answer

I have not used the fundamental filters in AHER for two reasons:

Insight Trader does what I need. I filter on PE ratios (plus dividend payers) to find the charts. Then check the charts and make a short list. Then I use AHER data to make my assessment of the fundamentals.

Insight Trader uses historical PE ratios. AHER uses a mix of historical and estimated earnings. I prefer to use only historical data, because I know they are real. Estimates are just someone's guess.

Ben Graham took a view, which I subscribe to. This is that nobody can consistently forecast prices or earnings or most other things either. The only sound foundation is what has been actually achieved in the past. This is the best guide into the future. So, if you find a good performer and buy it cheaply, giving a margin of safety, that is about a good as you can and need to do.

If you decide to use AHER PE ratios, be careful that you are happy with what each ratio implies in terms of earnings growth. If it looks as though it demands a heroic increase in earnings, there may be no margin of safety.

The KISS of Death

Originally published in the *Dial&Chart* Newsletter December 2005.

The KISS principle in engineering seems to have originated around the time of the Apollo project in the 1960s. The idea of Keep It Simple, Stupid has spread widely through many disciplines, including trading and investing.

The basic idea, which is to eschew unnecessary complexity is a sound one for engineering and largely ignored by developers of mobile phones and software, which become more complex every day while the user is demanding simplicity.

I often hear investors refer to the KISS principle and it worries me a lot. I think there is a strong case for using only easily understood ideas in analysis and avoiding complexity that renders the analysis almost unintelligible. It is, after all the basic ideas that account for most of the return we try to achieve and those ideas are not difficult to get our mind around. Basic ideas like diversification and financial risk management are the cornerstones of a robust investment plan.

What worries me is when I hear the KISS principle used as an excuse to simplify things so much that it is an excuse for proper analysis and risk management. The users often disclose an appalling lack of knowledge and thought, excusing it as KISS.

The extreme examples of the KISS principle in action are the traders and investors who openly admit that they have no idea what company they are investing in. All they know is its code and the price. At this stage in a bull market, it is difficult to warn them that they are accidents waiting to happen, but they may learn the hard way when the music stops.

The sad thing is that they would be better traders and investors if they learned some of the important things about the companies they are investing in that may save them from being bitten badly down the track. The basic ideas in analysis that give you a reading on the risks you are taking are not difficult to implement. The minimum things I believe that a trader or investor should find out and assess before placing their buy order are set out below.

What phase is the market in?

Dow theory sets out the six phases of bull and bear markets. Different strategies are appropriate for each phase. I teach this from time to time and after explaining the phases, most of my audience identify where they are in the phases within one phase of the consensus view.

Is your stock in an uptrend?

I am amazed at how many traders and investors buy into stocks that are in downtrends. You should know how to analyse a chart for trend without any indicators. If you are going to buy it then you should see an uptrend or at least an upward breakout from a broad accumulation or consolidation pattern that promises to turn into an uptrend.

Is the trend too extended?

While buying any uptrend is better than buying into a downtrend, you should know when your trend is in "greater fool" territory. This is when the only way you can profit is by selling it at an even higher price to an even greater fool than you are. Your purchase should be situated in a trend that is not accelerating steeply upward.

What does the company do?

Unless you know what sort of business the company is in, how can you have any idea of the level of risk you are taking on and whether you should treat it as a speculation or an investment? Even if you are looking to be a speculator,

you need to pick the right sort of company and structure. This information is readily available on the internet.

What are the dynamics of the industry?

Ideally you need to be buying companies in industries that are in growth phases or in upward swings in their cycle. If not, you need to find a very special company that can make progress against the tide. To recognise those special cases, you need to understand what drives profit in the industry and ensure that your company offers something special in that respect. In an ideal case you will be an insider in such an industry. If you aren't, then you need to read widely about it and/or consult people who understand that industry.

Who is running the company?

In the past I have knowingly speculated (never invested) in companies run by crooks. If you are going to speculate, you must have your eyes open. If you are playing a game against crooks, and you don't know it, you are likely to become a victim. You can find the CV for directors and chief executives in annual reports. Then ask around about them if you do not know their track record from your study of the markets.

Does the company make a profit?

You can see up to a ten year profit record of any company that has been listed that long on the Aspect Huntley website, carried free on many internet broking sites. If the company has never made a profit, you need to know a lot more about it and its industry dynamics, or you are speculating. Likewise if was profitable and has recently fallen into losses.

Things to watch for

Favour companies whose net profit is growing faster than its sales. This means its margins are increasing. Be wary of any company whose receipts from customers on the cash flow statement are significantly less than the sales figure on the statement of financial performance. This may indicate some creative accounting is being practiced.

Does the company pay a dividend?

If the company has never paid a dividend you are relying totally on capital gain unless you have inside knowledge that suggests the situation will change. Likewise, be wary of any company that has passed recent dividends and is not making good profits. Be very wary of a company whose dividend per share is greater than its earnings per share. Ideally the dividend yield should be greater than the average yield for the market.

How much are you paying?

The much maligned price earnings (PE) ratio is the most readily available information. While you can adjust the calculation to the rate of inflation as I show in my book, the quick-and-dirty rule of thumb is that over 20 times earnings, you need a very strong reason to be buying. The higher the PE ratio over 20 times, the further you may be into greater fool country. Look for strongly growing companies with PE ratios less than 15 times and recovery situations below 10 times earnings.

Why are you buying?

You should be able to write down why you are buying the stock, listing the internal or industry dynamics that are going to produce the result you are looking for. Then the important bit – write down why someone would be prepared to sell the stock to you at the current price. This will record the risks that you need to monitor going forward. If you cannot write down why someone would sell to you, then you may be well into greater fool altitudes.

Dial&Chart (www.dialchart.com.au) is my data supplier. If you are looking for a data supplier, I recommend their excellent service.

Please Help

Every time I send out a newsletter I get dozens of messages back asking me to click on links and fill out questionnaires before my message will go through the recipient's spam blocker. I know spam is a problem, but it will only take you a moment to put colin@bwts.com.au on your white list and I would rather spend time writing answers to readers than filling out spam blocker questionnaires. If you install a spam blocker, please put colin@bwts.com.au on your white list. Thanks.

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