

Colin Nicholson: Newsletter 58

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23 May 2006

Thank You

Late in March I suffered a fall while bushwalking in the Blue Mountains. I spent some time in hospital and at home confined to bed. I am now recovering slowly and my doctor expects I may be able to start writing for the magazines again in July, but I have to take it very easy for the rest of the year. In particular, I should not travel again until 2007.

I would like to express a big thank you to the many web site members, newsletter subscribers and magazine readers who have sent me messages of concern and encouragement. It has given me a tremendous lift.

Although I am not supposed to be working, as I am recovering I have tried to catch up on some of my reading and to write this newsletter. It has taken me much longer than usual to get it done, but it has helped pass the time rather than doing nothing. It also allows me to tell you about two pieces of news – the launch of my second book, on investing psychology, and also Dr Elder's new book. Details are in the newsletter below.

Market Correction Tactics

Question

What do you do if a correction in the market seems imminent?

Answer

I have a two-pronged approach to this situation.

The first is to apply my market exposure strategy. The idea here is simple. When risk is low at the start and in the middle stages of a bull market, I will have my portfolio fully invested. Then, as I detect that we are possibly in the rampant speculation phase, I cut my exposure back. For example, as the sharp US correction began in the week ended 12 May 2006, I was sitting at about 80% in stocks and 20% in cash. This exposure to stocks is a little on the high side for my strategy, but all my holdings are still in strong uptrends.

The second and most important aspect to my approach is to have a clear sell-stop level marked on the charts of every stock that I hold. Over the weekend of 13-14 May, I carefully reviewed every holding and marked its sell-stop on the chart. This makes the decision, so if a bar appears that cuts the sell-stop line, I can execute a sell order without the need for any emotion or agonising.

If I am expecting a sharp fall, I may monitor the market during the day and execute my sell-stop then. However, I am essentially an end-of-day investor and would usually execute my sell order after the opening of the market next day.

There is one other minor aspect of my investment plan. That is to take profits if a stock has doubled in price.

All of these aspects of my investment plan are fully described in my book *The Aggressive Investor*, which may be purchased from my web site www.bwts.com.au or by telephoning me on 02 9439 9724.

Learn to Think Like a Winner

My new book is now available for purchase:

The Psychology of Investing

Raise your investing and trading to a new level

Investment and trading are essentially mind games. Winners succeed because they think differently. Join the winners' circle by learning to avoid the common errors and biases.

Align your investments with your temperament
Understand crowd psychology
Avoid common mind traps, errors and biases
Make sound decisions at the right time

If the greatest living investor, Warren Buffett, stresses the importance of psychology, it should cause us to pay attention. This is what he wrote in his famous preface to Benjamin Graham's investment classic *The Intelligent Investor* –

To invest successfully over a lifetime does not require a stratospheric IQ, unusual insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.

So, to master the market we have to learn to master ourselves. Investing and trading involve what I call serial decision-making. Every piece of new information causes us to make decisions, whether to buy, sell or do nothing. We make decisions using our mind and it is here that the battle is fought and won or lost, between investment success and failure.

The Psychology of Investing is organised into four distinct parts –

- Know Yourself - How to align your investments and your temperament
- In the Avalanche - Psychology of the market,
- Stretching our Mind - Common biases and errors in decision-making
- Catching the Tide – Practical applications of psychology.

Reading this book will make you a better investor or trader. The ideas and methods in it will improve your investing and trading decision-making. No prior knowledge of psychology is needed. Everything is explained in a clear, simple

style. Technical terms and jargon are avoided or clearly explained in plain English.

The book is to be released in June/July, but a few book stores already have it. Autographed copies may be purchased now directly from me through my web site www.bwts.com.au via the *Psychology of Investing* page or by using this direct link <http://www.bwts.com.au/text.cfm?50> or by phoning me on 02 9439 9724 in business hours. My price is the Recommended Retail Price of \$39.95 including GST and is postage free to Australia, New Zealand and Asia. There is a small additional postage charge for North America (\$4.75) and Europe (\$5.25), calculated after removing the GST component in the price.

Is Volume Important?

Question

I re-read your book *The Aggressive Investor* recently, also *Stan Weinstein's Secrets for Profiting in Bull and Bear Markets*. They are both excellent books, in my opinion.

I note at page 161 of your book you said "...my experience with the Australian stock market is that many good breakouts occur without an increase in volume, so I no longer worry about the volume."

Stan Weinstein at page 103 of his above book states "...never trust a breakout that isn't accompanied by a significant increase in volume"

I am puzzled about these differing views on volume. Admittedly, Stan's book was published in 1988 and the US market may have changed in this regard. I would appreciate your comments on the above differing views about the importance of volume in breakouts.

Answer

I don't think there is cause to be puzzled and I am sorry if I have been the cause of your difficulty here. There are several issues I would raise in this matter.

Firstly, volume is a very minor part of charting. I would put it at less than 10% of the data on which a chartist would make a decision. I will readily admit that some chartists would give it greater importance, but that is my opinion born of my experience.

Secondly, I think there is a possibility that the US and Australian stock markets are different. This would be likely especially with regard to the NYSE, where all the stocks are large and trade in deep liquid markets. The same is not true of the ASX, where this might be true of less than 100 of the 1600-odd traded securities. This might explain why my experience and Stan's is different. I do not think this is something that has changed over time, but I have not studied it and I may well be wrong.

Thirdly, I have no argument with Stan's investment plan with respect to volume. I think it is very sound and I would trust his judgement with respect to

his market. There is no reason why you should not extend it to your plan in the local market, so long as you recognise that it is based on another market rather than your own. As such my feeling is that it would be overly conservative and lead you to miss quite a lot of good opportunities. Then again, I am an aggressive investor and you may be more conservative. What should you do about this? I suggest that you define the Australian stocks that you trade or invest in. Then study at least 10 years of history for them looking for the proportion of winners and losers that was confirmed by a volume spike on the breakout. You need to record both the winners which were confirmed by volume and the ones that were not. You also need to record the failures that also had or did not have confirming volume on their breakout. Once you have the complete picture in this way, you will be able to form your own opinion on what works for the stocks and time frame in which you trade or invest.

Feedback on the Aggressive Investor

*I am basically new in the share market over the last 2 - 3 years. I have just purchased **The Aggressive Investor**. I have found that the majority of share books are boring or repetitive. I compliment you on publishing a book on shares which is honest, concise, easy to read and with precisely the subject matter for people such as myself. You said it, "it's all there".*

Colin, all I can say is thank you for imparting your knowledge in your book. I have learned to refine my risk management strategy where I have adjusted my trading plan. Previously I was finding that I was exiting a trade too early on a dollar value stop loss. I would then find that the trade would go about face and increase in value. Now I take into account the previous low on a weekly chart before exiting a trade and the results are now starting to show.

oooOooo

I must say that I felt the beginning of the book was written about my own recent experience since starting to invest 9 months ago. Especially about buying shares then not knowing how to manage them. I feel confident I'll be building it much more quickly now once I have an investment plan to guide me.

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 9439 9724. My price is the Recommended Retail Price of \$49.95 and includes postage and GST, except for a small additional postage charge to North America and Europe, calculated after removing the GST component in the price.

Daily or Weekly?

Question

As a novice share market investor, I really enjoy reading your articles in *Smart Investor* magazine.

A question relating to your April magazine article "Home on the Range", if I could please - What benefits and/or advantages are gained by reviewing the weekly bar chart instead of, or in addition to, the daily bar chart for a stock?

Answer

This is one of the often-asked questions I receive. I have already addressed it in previous issues of my newsletter, which can be accessed on my web site www.bwts.com.au. However, let's look at it again.

One of the most important and difficult decisions an investor or trader has to make before he or she starts is the time frame in which they plan to trade or invest. You would then make your buying or selling decisions from the chart that is relevant to your time frame. Perhaps the single fastest way to lose money is to invest on a time frame that demands a weekly chart and then sell based on something that happens in the short term on the daily chart.

However, it is not as simple as this. There is something even more important to know and use in your analysis. This is that what happens in any time frame may be influenced most strongly by something that is happening in a longer time frame. So, let's suppose you are investing off a weekly chart. You find a nice upward breakout and buy it. Then it fails on you. This may often be just part of the game. However, it may also be that you have bought an upward breakout in a longer term down trend and as soon as the rise got near the long term trend line, it failed.

The lesson is that you should begin your analysis of any market or share from the long term monthly chart with as much history as you can get – ten years or more if possible. You should be looking for good charts in the long time frame. Then you work your way down to the time frame you intend to trade or invest in where you will make your tactical entry decisions. Ideally, even a short term trader should be looking for an uptrend on the monthly chart, the weekly chart and then buy an upward breakout or similar signal on a daily chart.

As shown in my book *The Aggressive Investor*, I have my screen set up in four windows. One is the monthly chart with up to a decade of history, another is a weekly chart with about four years of history, another is a daily chart with about a year of history and the last is a daily chart with only recent history shown. I decide what shares to buy off the monthly and weekly charts and time my entries off the daily charts. Likewise the selling decision is made off the monthly and weekly charts, but the fine timing is helped by seeing the daily price action.

New Phone Number

Please note that my phone number has changed. It is now 02 9439 9724. My postal address will also change soon, but remains PO Box 5121 Greenwich NSW 2065 for the time being. I will notify any change in a newsletter and change all references to it on the web site. Even so, the old address will remain current for an overlap period.

Sit With Some Real Traders

I am often asked whether I act as a mentor for beginners and allow them to sit with them and coach them in trading while the market is operating.

Unfortunately, Australian law does not allow traders to do this unless they are licensed to give advice, which I choose not to do, because I am focussed on teaching investing and trading skills, not giving advice. That is the bad news. The good news is that Dr Alexander elder has written a new book and associated study guide called *Entries & Exits*. In the book, he interviews real traders including real case studies of their trades. This is next best to sitting down with these traders while they trade. This is an excellent book, which I highly recommend. Here is a review from the Amazon web site and also information from the inside flap:

Come behind closed doors and see real trades made by real traders.

Dr. Alexander Elder leads you into 16 trading rooms where you meet traders who open up their diaries and show you their trades. Some of them manage money, others trade for themselves; some trade for a living, others are on the semi-professional level. All are totally serious and honest in sharing their trades with those who would like to learn. You will meet American and international traders who trade stocks, futures, and options using a variety of methods. All are normally very private, but now, thanks to their relationships with Dr. Elder, you can see exactly how these traders decide to enter and exit trades. Each chapter illustrates an entry and an exit for two trades, with comments by Dr. Elder. With this book as your guide, you can get closer to mastering the key themes of trading—psychology, tactics, risk control, record keeping, and the decision-making process.

The companion Study Guide is filled with striking insights and practical advice allowing you to test your knowledge and reinforce the principles outlined in Entries & Exits.

From the Inside Flap

You are about to visit the trading rooms of sixteen men and women. These traders live in different countries, follow different markets, and use different methods, but all share several traits—most importantly, their dedication to trading. They are utterly serious about their work, while most of the amateurs who supply the bulk of their winnings are chasing the excitement of an adrenaline rush.

Why would a person who is trading for a living talk about his or her method instead of grinding out profits in silence? Winners know full well that success in trading does not depend on knowing "the secret." There is no secret—only hard work, focus, attention to detail, being careful and long-term oriented with money, and having a bit of flair.

Trading is a vast field, and like a doctor, you must specialize. Many beginners spread themselves painfully thin by investing in and day-trading stocks, futures, and options. Each trader in this book concentrates on an area that appeals to him or her, be it buying breakouts, writing puts, or trolling for dull stocks ready to explode from consolidation zones.

People become successful when they focus on what they love to do. In reading this book, you will probably come across a trading vehicle you like or a concept that appeals to you. Once you find it, stay with it and mine that area for its rich deposits.

There are massive differences between traders at various stages of development. Beginners look for tips, while intermediate traders keep asking about indicator settings. Experienced traders love to watch others make decisions and explain them. Traders in this book will share a wealth of information with you; what you take home is entirely up to you.

Trading can give you money, which can buy many good things—freedom from a boss, the ability to travel wherever and whenever you like, and much more. Still, when the chips are down, it is not money that determines the quality of your life. Your goal in trading should be to become the best professional you can be.

We owe a debt of gratitude to the sixteen traders who opened their trading rooms—helping all of us become better traders and serving as examples of kindness, generosity, and drive. They show us that there is more to life than money, even in a trader's life. This book is designed to help you break out of isolation, learn from others, pick up ideas that suit your style, and return to your trading room a better, more confident trader.

The book and study guide can be purchased from regular book stores. However, I recommend that you purchase it from Dr Elder directly. There are three advantages by doing this. Firstly, Dr Elder's price is a 60% discount on the recommended retail price and less that you will pay on Amazon:

Entries & Exits US\$55 (Recommended price US\$95)

Both the book and the Study Guide US\$75 (Recommended price US\$135)

Secondly, if you request it, Dr Elder will autograph the book for you. Allow for a possible slight delay, because Dr Elder travels frequently. Finally, Dr Elder will airmail either the book, or the book plus the study guide, to you for only US\$6.00, which is a very special deal.

To order, go to www.elder.com and fill out the usual order form. In the comments box, say you are one of my newsletter subscribers and request the special airmail rate of \$6 and (if you want it) for Dr Elder to autograph the book. If you do not wish to place a credit card order online, you can fax (anytime) or telephone (in New York office hours) your order to the numbers (not the 800 number) provided on Dr Elder's website.

Learning the Trade

Question

When you started to invest in the stock market what it was like for you? Did you start off dumbly trading until you got confident using some of your

concepts? Did you have some big losses to start with, miss you stop loss points etc?

Answer

I began investing in the late 1960s. That is a long time ago now and the way stock market operated was different to the way it works today. The one thing that was similar was that we were in the late stages of a resources-driven bubble market in which we saw some amazing things.

I will try to answer your question. However memory is a tricky thing. We all tend to re-write history to some extent, magnifying our achievements and minimising or erasing our failures.

I had left university at the end of 1965 and got married. In the next few years I was able to save a couple of thousand dollars to start investing. This was insufficient to exercise any real money and risk management, not that I was really aware of those ideas at that stage. I had prepared myself by reading. I had read the Australian Financial review every day since I left school, a habit I still follow today. I had studied economics, which included a major in government and excursions into accounting and economic history. These were more useful over time than I thought at the time. There were not a lot of books about on investing in those days and were difficult to get hold of. I had closely studied three books, all closely focussed on charting. The first was Edwards and Magee's classic *Technical Analysis of Stock Trends*. In my opinion, all investors and traders should start with this book today. Then I read Wheelan's book *Study Helps in Point and Figure Technique*, which is still the best book on the art of point and figure charting. Finally, I read Phillip Rennie's book *Share Price Charting*, which you will not find today, but gave me an insight into the basic strategy which I still follow today.

So, I had some money and some knowledge. I had a basic strategy of buying stocks breaking out from an accumulation zone, following the trend, but cutting losses quickly if things went wrong. The real problem was that I had way too little money, so I was reluctant to start. Then a group I was working with decided to form an investment club. I joined and in time ended up basically managing it as others lost interest, but left their money in the club. Since it was a bull market, it was easy to make money, but there was still plenty of opportunity to lose. The key was to buy uptrends, something I have never forgotten. Eventually, the bull market ended and we closed the club down making a moderate profit overall. What I learned was more important than the profits.

I have only hesitated once to sell on a stop-loss. I bought a share at \$1.23. My stop loss was if it fell below \$1. It did. It drifted a few cents below \$1 and I gave it some room to move. A few days later it opened at about 20c, with the management declaring huge losses. I sold immediately and have never made that mistake again.

I did not learn money management until the 1980s, but I always tried to give my portfolio some diversification to lessen the specific risk. The other critical

strategy was to vary market exposure inversely to risk. This saved me in 1987, when I had only 25% of my money still in the market and that year was my biggest losing year ever in percentage terms. I sold everything the day after the crash.

As well as investing, I delved into trading for many years. In those days we got the prices out of the newspaper and in the call of the board on the radio at lunch time. Charts were maintained by hand. The only other way was to sit in the public gallery, which was small and up a flight of stairs. You had to watch the chalkies changing the prices and keep your charts from that. To place an order, you had to leave the gallery and make a phone call to your broker. One year I took some holidays and spent every day in the gallery for a couple of weeks. How things have changed today.

Over the years I have read hundreds of books on trading and investing. I learned how important fundamental analysis is and that money management is critical. I did not have a complete approach until I reached this stage. I also learned that the big money is made from investing, not trading. All of this is now set out in my book *The Aggressive Investor*.

MetaStock Formulas

Question

Having read your interesting book *The Aggressive Investor*, I can not seem to make the appropriate scans with my existing software (MetaStock and Stex Charting). Would you kindly let me have a contact for Insight Trader?

Answer

Insight Trader – Contact Bernard Chapman 02 4751 2932 or info@insighttrading.com.au. Website is www.insighttrading.com.au

However, before you do, the set-up for most of my scans in MetaStock are in Newsletter No 30 on the Newsletters page of my web site www.bwts.com.au.

Dow's Theory

One of the most influential thinkers about the markets was Charles Dow. He was the founder, owner and first editor of *The Wall Street Journal*. He developed something which we all tend to take for granted today in the form of a market index, which measures the direction of the overall market. Dow did it in the days before calculators and computers by collecting the closing prices of a basket of stocks and averaging their price. This series developed through time as the Dow Jones Industrial average and is still the most watched indicator of the US market to this day.

Unfortunately, Dow never wrote the book he was encouraged to write by his contemporaries. However, in the years immediately before his death in 1902, he wrote a series of editorials that set out his ideas on markets and sensible speculation. S.A. Nelson gave them the name "Dow's Theory" and they were incorporated in Nelson's book *The ABC of Stock Speculation*. These ideas form a body of knowledge that has been developed over the ensuing century

into what we know today as technical analysis. On them rests the assertion that Dow was the father of technical analysis.

The following are notes which I have made from Dow's editorials and which discuss his principal ideas. Where I have used italics, I am quoting directly from Dow's editorials. The chapter numbers and titles refer to Nelson's book in which the editorials were reprinted.

Chapter 5 Scientific Speculation

Dow begins by asking *whether there is such a thing as scientific speculation*. While he thought that it may legitimately be open to doubt, he thought that there were *some general rules worth heeding*.

Rule 1: *The maxim "buy cheap and sell dear" is as old as speculation itself, but it leaves unsolved the question of when a security ... is cheap and when it is dear, and this is the vital point.*

The elder Rothschilds are said to have acted on the principle that it was well to buy ... when others wanted to sell and to sell when others wanted to buy. There is a great deal of sound wisdom in this. The public, as a whole, buys at the wrong time and sells at the wrong time.

Dow goes on to qualify this by saying: *There are of course exceptions to this rule. ... When the market has an extraordinary rise, the public makes money, in spite of beginning its purchases at what would ordinarily be the wrong time...*

I was at first loath to include this qualification, but decided to do so in the interests of fully representing Dow's thoughts. What he is saying is the equivalent of the market saw that the inexperienced public speculators mistake a bull market for brains. They are sucked into this rise and may take good profits out. However, they re-invest them and at the end of the bull market, Dow's assertion will generally be correct – that they sell at the wrong time and at large losses.

In my view, this rule is not given any where near enough prominence in the markets, except perhaps by the value investors who follow Benjamin Graham's approach, which is exactly as described by Dow above and ascribed to the elder Rothchilds. I have always thought that the key to successful investing was to buy strongly in the early stages of a bull market and get out in stages as it matures. This is not easy, but it is the opposite of what the general public still do today and is far more successful. I devoted a large chapter of my book *The Aggressive Investor* to setting out how to determine where we are in the market cycle and how to follow my strategy of early entry and early departure in a bull market.

Rule 2: *Daniel Drew used to say "cut your losses short, but let your profits run." ... The thought here is unquestionably one of the sound principles in trading. It means that if a stock has been purchased and it goes up, it is well*

to wait; but if it goes down, it is well to stop the loss quickly on the ground that the theory on which the purchase was made was wrong.

Again, Dow goes on to speak specifically about the general public: *The public, as a whole, exactly reverses this rule. The average operator, when he sees two or three points profit, takes it; but if a stock goes against him two or three points, he holds on waiting for the price to recover, with, oftentimes, the result of seeing a loss of two or three points run into a loss of ten points. He then becomes discouraged and sells out near the bottom...* (a "point" is US market jargon for a dollar. Most US stocks trade at much higher values than in Australia. A rough guide would be to use a factor of ten. So an Australian stock trading for \$5 would be equivalent to a US stock trading for \$50).

Anyone who is trading shares and has not had to learn this lesson the hard way is very unusual. What is more, the lesson often has to be learned over again when we become overly confident of our ability and neglect this rule.

Dow goes on to state one of his most telling observations that still applies today to everyone who is learning to trade:

*How many operators in looking over their books find a considerable number of small profits swept away by one large loss? **When a trader finds by his accounts that his profits have been relatively large and his losses relatively small, he can make up his mind that he is learning how to trade.** Ask yourself whether you can meet Dow's rule. If you don't know, you need to find out. This prompts me to remember a corollary - a good trader will know the answer to this question at all times, because good traders always keep good records and constantly monitor their performance.*

The trouble with carrying out this plan is that a series of losses of from one and a half to two points are very discouraging. A trader who sees that he has taken twice or three times a loss of two points when, if he had waited a few days he need not have taken any loss, is very apt to decide that he will not cut his losses short any more, but wait, and this is the time when the recovery does not come.

I am struck by the authenticity of Dow's comments and description of the process. Clearly, he had been there and had practical experience of what the general public do. He had also learned the essential lessons, either from his own experience or from the wisdom of other traders of his time.

The other thing that strikes me about some of Dow's writing is that he sets out these clear rules, yet he is realistic enough to qualify them in many ways. In this respect, he goes on to qualify what he has just said above as follows:

Mr Jay Gould said his policy was to endeavour to foresee future conditions in a property [stock] and then, having made his commitments carefully, to exercise great patience in awaiting results. This is a sound doctrine, but proceeds along different lines. Assuming the ability to foresee the future, it is the wisest of all courses; but many who have tried this method have found

that the omission of essential factors made their forecast valueless, and both their courage and their patience of little avail. Nevertheless, this method should not be discarded on account of the difficulties involved. Within limitations, the future can be foreseen. The present is always tending toward the future and there are always in existing conditions signals of danger or encouragement for those who read with care.

Again, I was tempted to leave this last paragraph out. Although I am primarily a chart-based investor, I agree strongly with the father of fundamental analysis, Benjamin Graham, that it is practically impossible to foresee the future. My own approach could not be further from this one and is firmly fixed in cutting losses and letting profits run. Of course, mankind has a huge fault in its makeup that it is overly confident in being able to foresee the future. Personally, I see it as a fool's errand and moreover that it is not a necessary ability in order to make good money from trading and investing. If you find yourself strongly pulled to this approach of being able to forecast the future, please be very careful. It is not for one moment something that I would personally recommend.

There is another reason why I do not advocate trying to forecast the market. This is that it opens us up to psychological traps. In particular, once we make a forecast, we are reluctant to admit we are wrong. Even more deadly is the tendency to ignore adverse information and focus only on evidence that supports our forecast. In my experience, it is far better to not have a view and just follow the plan.

The one element of Dow's last paragraph that I do think is very powerful lies in Dow's last sentence above. This is that price throws a shadow ahead of the news. This is the very powerful observation that underlies charting and technical analysis – that the action of buyers and sellers can help us detect changes in the balance of supply and demand in the market as a whole or for an individual stock.

In future newsletters I will cover more of Dow's editorials.

Apology

The Unsubscribe and Change Profile links at the foot of the last newsletter did not work unfortunately due to a software bug. This has now been fixed. My apology for any inconvenience this caused.

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.

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