Colin Nicholson: Newsletter 59

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20 June 2006

Thanks again to all my readers who have sent me encouraging messages as I recover from the fall I suffered late in March. I still have many months of recuperation in front of me which are frustrating because there is nothing that can be done to hurry up mother nature. However, my recovery is on track and I hope soon to have medical clearance to write again for the magazines. This newsletter is rather shorter than usual because of my health problems.

New Contact Details

Please note that my telephone number has changed to

02 9439 9724

and that my postal address is now

PO Box 440
St Leonards NSW 1590

Evaluating a Stock price

Question
What is the best way to evaluate a stock price to see whether it reflects fair value?

Answer
In a weekend seminar, I would spend a fair part of two days dealing with this. In my book *The Aggressive Investor*, I discuss it at length and have included an appendix on the application of Benjamin Graham's Margin of Safety approach to our market. Since there is a lot to cover and it is already available in print, I will just summarise the key points here.

I invest in industrial stocks and producing miners.

I do not invest in stocks that do not make a profit. I have no method to teach you for these.

I do not invest in explorers or technology start-ups. I have no method to teach you for these either. I regard them as speculations or casino chips.

I do not invest in foreign companies or trusts or investment companies. I have nothing to teach you on these.

Now to return to what I invest in:

Industrial companies

They must have a PE ratio below the market average.
They must have a dividend yield above the market average.
They must have a history of profit growth.
There must be an uptrend on their chart.
Alternatively, there must be a value or growth model breakout.
If all this is in place, I research them further with a view to investing in them.

Producing Miners
If they are large, diversified and with long term mines, they can be treated like industrial stocks.
PE ratios and dividend yields are inappropriate because they are exploiting a wasting asset. Discounted cash flow analysis is the way to go.
I treat most of them more as growth model than value model stocks (see my book for a definition of the two models). As such, I am essentially a chart investor.

This is a big subject and I have given you no more than a taste because I have already done a thorough job of teaching it in my book *The Aggressive Investor*, which you can buy through my web site at http://www.bwts.com.au/text.cfm?42

Website Member Comment

Your return of 28% (assuming equal weighting of purchases, which would not be the case), since June 30 2005, plus dividends, plus interest on money not in the market is very good compared to the All Ordinaries plus average dividends.

I will disclose my return for the year at the end of June 2006. However, this is not a bad estimate so far.

What Chart Pattern is That?

Question
(Asked in May 2006) It looks to me like Alinta could be potentially a double top situation. How far apart should a double top occur and what do you make of Alinta chart this last 12 months or so?

Answer
As explained on the Ask Colin page of my web site www.bwts.com.au, I am not a licensed adviser and as such I am not able legally, nor do I wish, to comment on specific stocks.

All I will do is to address your question with respect to the pattern on the Alinta chart. This is not intended in any way to express an opinion about the investment merits of the stock.

Chart patterns develop in all time frames. You can see them on intra-day charts with one or five minute bars, on daily charts, weekly charts or monthly charts. Their relevance depends on you first defining what your time frame is. Mine is weekly and monthly charts as an active investor. On my weekly and

monthly charts, I am not seeing anything that looks like a double top on the Alinta chart. It looks more like a rectangle pattern to me. If I go down to the daily chart, it still looks like a rectangle, but could also be classified as a potential triple top pattern. I see on the daily chart what you refer to as a double top pattern, but I think the subsequent price action has formed a larger pattern of the nature that I have just described.

Aggressive Investor Reader Comment

Thank God we read the Aggressive Investor. You have taught us so much about stop-losses – and boy is it happening NOW!

oooOooo

Thank you for your excellent book. I started to invest in the market about four years ago and have tried to read as many books as I can. Your book is with out a doubt the best book I have read so far. I also look forward to reading your newsletters and learning from your opinions. One thing that has concerned me in recent publications is I feel many of the contributors, may have recently read your book, and are looking to put into practice these new skills. I can't help but think they are missing the most important part of your book regarding phases of the market, which by my understanding we are currently in the third phase of the bull market (rampant speculation) I have followed your recommendation and reduced my holdings to 70 % (early May 2006). My concern is some readers may have missed this and are keen to jump into a dangerous market. The important message from your book is that investing is a game of patience.

I feel that this reader makes an interesting and valuable observation. One of the difficult things to do in investing is to time the market. It takes great patience and discipline to stay away from an overheated market and await a right time to start investing. There is no easy answer to this, but I hope my book gives some ideas. In particular, the emphasis I place on having a margin of safety should give a portfolio some defensive characteristics and keep us out of the last stages of a bull market.

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.

Peaks and Sell-Stops

Question

In determining when a new significant trough has been established, do you wait for the price to surpass the previous peak, before raising your stop to a new level?

Answer

Your question said "the previous high", but I like to be specific in my terms. A high and a low I use to describe a bar. For trends, I use peak and trough. This cuts out some possible ambiguity as to what "high" means - i.e. the high of the last bar or the high of the highest bar in the last upswing.

The answer is that yes I do. The idea here is simple. A nice trend will unfold in a series of higher peaks and higher troughs. However, sometimes the peaks and troughs are formed in a somewhat tortuous process, so there are some false starts that do not turn out in hindsight to be the ultimate extent of the latest upward or downward move.

So, once the price moves above the last peak, I move my sell-stop up to just below the previous trough. I then await the formation of a new trough above my sell stop and then for the price to again rise above the last peak. As soon as it does that, I move my sell-stop up to just below the last trough. Hopefully, this process continues in a good trend, but if it does not, I will be stopped out of the investment.

Question
Can a new significant trough occur before the price goes beyond its last peak?

Answer
The answer again is yes. I have three sell signals. The first one was described in the previous answer. The second one is when a peak forms, then the price slips back to form a trough higher than the one before the last peak. The ensuing rally then forms a peak that is lower than the last peak. If, and not until, the price then falls away below the last higher trough, I sell without waiting for my sell-stop to be triggered. The reasoning here is that a lower peak and a lower trough mean the trend has changed from upward to downward. As I am a trend trader, my investment has gone wrong and I cut losses, or take profit, quickly.

There is an important note of caution here. This is the trickiest of the three sell signals to identify. It is important that the lower peak be of a size consistent with the rest of the trend. Otherwise, it may only be a rally within a normal correction in the trend. What you do here is up to your investment plan. I am inclined when in doubt to await triggering of the usual sell-stop. However, it can be argued that we might better stand aside until things clarify, or maybe take partial profits.

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 being released in June/July, but good 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.

Comment by Dr Elder

Just finished reading The Psychology of Investing – thank you very much, a remarkable accomplishment! Thank you for sending it to me. I liked both the

contents and the format. This book should go a long way towards firming up your reputation.

To buy a signed copy, at $39.95 including postage, go to www.bwts.com.au or phone me on 02 9439 9724 in business hours.

White List Please

Every time I send out a newsletter I get bounce messages that it did not reach readers because it was stopped by their anti-spam filters. Unfortunately I have no alternative but to delete those readers from the list. Please take a moment to put www.bwts.com.au on the white list for you anti-spam filters whether maintained by you, your employer or your ISP. Thanks.

New Address?

Every time I send out a newsletter I get over a hundred bounce messages that the address is no longer valid. I have no alternative but to remove those bad addresses from the list. If you change your email address, please remember to change it using the Change Profile link at the bottom of the last newsletter, the Change Profile facility on www.bwts.com.au, or by emailing me at colin@bwts.com.au. That will ensure yu continue receiving newsletters.

Thoughts on CFDs

A reader sent me these thoughts on his investigation of Contracts For Difference (CFDs), which other readers may find interesting:

At an Insight Trader users group meeting in Sydney not too long ago, I asked for your comment about CFDs . I have since investigated CFDs further and thought you might be interested in the following comments.

I have registered with a provider of CFDs, but have not yet done any trades, because my first objective is to learn as much as I can, not only about the technical aspects of trading CFDs, but also the different psychological environment that it presents. My incentive for registering was to provide the opportunity potentially to make short trades in a falling market that I imagined might come sometime this year. It seems to me that CFDs provide minimal advantage for long trades, unless one desires to take greater risk. That is not my desire. However, by taking the same level of risk as I do with (long) share trading, that is by trading much smaller amounts and probably always placing a reverse order at my designated stop level, I have the opportunity to trade falling markets in a manner almost identical to my trading rising markets using share trading. One significant difference is that I can lose a lot more than the amount that I invest in the trade, whether short or long. That is the reason that I plan to place reversing trades to automatically activate stops, whenever I place a trade.

However, it has become apparent that there are significant potential traps, of which only become obvious only after taking some time examining the process and the trading platform. The first is that the trading platform provides highly detailed and live information. For one used to end of day trading this

can present a temptation to change ones trading timescale, or at least to monitor markets more frequently. Simple though it might appear to deal with that, it is a new psychological consideration that you have to be sure that you come to grips with. The second potential trap is that being a highly leveraged product, the analysis from a money management perspective is quite different, even though in principle the process is simple. I am taking time to develop a routine and recording system that I will be entirely comfortable with before I begin any trading. My third thought is that many people entering the CFD arena will go there without prior non-leveraged trading experience, with all the psychological conditioning, as well as technical aspects such as stock selection and entry and exit strategies, that one learns over time in that non-leveraged, and therefore significantly safer environment. The people selling the CFD product, not surprisingly, appear to gloss over this issue. Another consideration is that I am not used to trading short. Although, technically, you can trade CFDs short as easily as you can trade long, and you follow an identical process, this inverse process takes time to become comfortable with, as does anything that you do in reverse when used to doing it in only one direction. I fear that undertaking short trading without significant dummy practice to make sure you are completely comfortable with it, from stock selection through to completion of the trade, could be asking for trouble.

My conclusion is that CFDs provide considerable potential in a falling market, but without good preparation, one's bank balance might fall faster than the market.

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.

Will We Ever Learn?

Originally written for the BeyondInvest March 2006 newsletter

Every year brings stories of investors who have been somehow relieved of their wealth by the dishonesty or incompetence of those who they entrusted to look after their investments. In some cases these people will be advisers and managers and in other cases they will be businessmen running the enterprises into which their funds have been invested.

It is a long time ago now, but I recall as if it was yesterday, that Estate Mortgage failed spectacularly. For days afterwards there were TV current affairs programs parading investors who had lost everything. This is exactly what I am talking about. These investors had chased the highest yielding investment in town. And they had put all – that's right, all - of their capital; into it. This is really dumb. In fact how much dumber can you get? Or should we say how much more greedy and dumb can you get?

I can also remember Pyramid Building Society in Victoria, where again we saw interviews of investors who claimed to have lost "everything". Luckily for them, the Victorian Government bailed them out. More recently, we have had similar stories of losing everything in the Westpoint failure. Moreover, there is a steady stream of stories every year of investors losing everything in a corporate failure or fraud situation.

It is my contention that to a large extent, investors who lose everything in corporate failures and frauds have largely themselves to blame for their predicament, yet they will be crying out that it is not their fault.

Just a moment though. I said one of the causes was dishonesty. Surely, I am being too harsh in blaming the investor when their adviser or manager has been dishonest? But no, I said investors who lose "everything" have only themselves to blame, because it is true that all investors have the chance to protect themselves to a large extent from losing everything even when fraud and dishonesty are involved.

The widely publicised situations I referred to above should have taught every adult Australian two simple but important lessons. The first one is that you should never, ever, put all of your capital into one investment. No matter how safe it seems to be. In my lifetime a number of banks have failed in Australia and so long as I live another decade or so, I am sure it will happen again. "Safe as a bank?" Nothing could be more wrong. Any business can fail, no matter how big, if incompetent managers get to run it. The very first lesson in investing is to spread your capital over a number of investments, such that if one of them goes belly up you are not ruined.

The second lesson is that risk and reward are inversely related. Not perfectly, but in general terms. Whenever someone is offering a yield that is higher than anyone else, you can be pretty certain that it is one of the riskiest investments in town. Riskiest here means something special. The academics define risk as the variation in returns. This sounds nice – returns can vary in any one year, say between +60% and -20%. So, even if you have a bad year, there will be good years to make up for it. But the risk we are talking about in the highest yielding investment in town is not a variation in return like this, but risk of total and absolute loss of capital. If you have all your money in such an investment there is a real risk that you could lose "everything".

This does not mean that we might not invest in high-yielding investments from time to time. But the combination of the two lessons is that if we do invest in one of them, it should be only with a small part of our capital and there not be too many such high-risk investments in our portfolio.

In the Weekend Australian Financial Review December 23-27 2005 Mungo MacCallum wrote an article describing his experience in losing much of his capital. In short, the story he told was that he had found an adviser/manager who he personally got on very well with. Over the years this adviser managed his capital for him and grew it substantially. Then he changed employer suddenly. Then the adviser's behaviour started to change. Finally, late in 2005 Mungo found out that the adviser had gone off the rails and lost a large part of Mungo's capital playing options unsuccessfully.

Mungo drew two lessons from this story. The first was what he called the obvious one, which was to trust nobody. Good lesson Mungo, you have hit the nail right on the head. Money is like blood in the water, it attracts sharks. Sooner or later anyone can let you down if they find themselves under enough pressure.

The other lesson Mungo drew was that "those entrusted with the money of others should be careful and responsible". Yes, sure. And motherhood should

be respected too. This, in my humble opinion is rubbish. It is rubbish because Mungo seems unable to fully recognise that he is totally complicit in his own financial demise. For one thing he had all of his wealth with the one adviser/manager. More importantly, at one point in the story he says "Every so often [the adviser's firm] would send a sheaf of paper covered with lines of figures, which I forwarded straight to my tax accountant." Then "the irony in this is that I … boast to my colleagues that my training meant that politicians and bureaucrats couldn't bluff me with figures and statistics and that I could recognise bullshit at 40 paces." Surely this is the real lesson – that he had taken his eye off the ball. Why was this not one of the lessons listed at the conclusion of the article? Was it too painful to accept and admit that he was responsible for the size of the loss he suffered?

Over the years I have read countless accounts of how advisers had defrauded investors. The common thread through many of them is that the investor left the paperwork to the adviser. Maybe they did not look at it, as Mungo admits. More insidiously, many stories involve the adviser suggesting to the investor that they have the paperwork come direct to the adviser. The most important lesson to understand when allowing an adviser or manager to run your affairs is that every single piece of paperwork about the investment should come directly to the investor. The investor has the responsibility to examine it and understand what is happening. If they do not understand it, they should keep asking questions until it is explained to them. If they cannot get a satisfactory answer, they should seek another adviser who can explain it.

Alright, that is clear, but what if the investor simply cannot understand the investment, because it is too complicated? Should they just trust their adviser? Absolutely not. Warren Buffett has some good advice here – never invest in anything you do not understand. He did it himself in the 1990s. He could not understand how a company could sell at a huge price, yet it had not made a profit and its losses were growing year after year. He kept right away from these technology and internet start-ups and survived the great bubble market. The key lesson is to stay right away from complex investments or investments that seem to you to defy commonsense.

So, it comes back to the investor. All Investors ultimately get the results they deserve. If they follow the simple rules from the lessons that are given in the newspapers and on TV all the time, they should succeed. However, the penalty for breaking the rules can be catastrophic, especially the rules about diversification and monitoring your financial affairs.

The key point here is that the investor who loses everything by dishonesty or incompetence is as much to blame as the incompetent or dishonest person. If an investor sticks to the rules, particularly to diversify and watch the eggs in their basket carefully and responsibly, even a dishonest or criminally incompetent adviser or manager should not be able to steal or lose "everything" you have.

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.

My email newsletter list contains only your name and email address, which information is not used for any other purpose than to send out email newsletters.

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