

Colin Nicholson: Newsletter 60

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Thank you again to all the readers who have sent me encouraging messages as I recover from the fall I suffered in March. My recovery is on schedule, but has many months to go before I am 100% again. I have this month begun writing my column in BRW magazine. In August, I plan to again write for Smart Investor magazine. The first articles will appear in mid September in the October issue.

My Investment Results

Now that the latest financial year has closed, I can update my investment results:

Year	My Return %	Market %	Difference
2000/01	9.69	8.85	+0.84
2001/02	2.11	-4.50	+6.61
2002/03	20.61	-1.08	+21.69
2003/04	17.48	22.37	-4.89
2004/05	26.88	24.75	+2.13
2005/06	33.62	24.20	+9.42

This is a comparison of my results with the ASX All Ordinaries Accumulation Index (includes re-investment of dividends).

These results have been achieved following the investment approach outlined in my book *The Aggressive Investor*. I should warn you, though, that past results are no guarantee of future performance. My approach may also be inappropriate for some readers. The book is intended to provide a model for you to develop your own investment plan.

The Aggressive Investor

Have you ever wondered why some people win on the stockmarket while others always seem to lose? After watching the Stockmarket almost every day for 40 years, teaching thousands of students and writing hundreds of articles, I have learned that there is a simple answer:

Winners think differently. Losers adopt the wrong approach.

In this book, I set out a better way. I will teach you:

- How winners think differently
- How to succeed in the share market
- The Simple Big Idea in share investing
- The risks to be managed
- How to select shares combining fundamental and technical analysis

- When to buy
- How to build a position
- When to cut losses
- When to take profits
- When to sell

The book is written with a minimum of jargon terms. I have put in it everything I do. There are no secrets that have been kept concealed.

“Those who succeed in the stock market have a sound and complete investment plan. This book sets out my proven approach clearly, simply and in full detail. It provides a model for you to develop your own winning investment plan.” Colin Nicholson

If you would like to learn my methods, please go to my web site www.bwts.com.au and buy a signed copy of the book. You can also order it by phoning me on 02 9439 9724 in business hours. I charge \$49.95, which is what you will pay in a bookstore. My price includes postage to Australia, New Zealand and Asia. There is a small additional postage charge for North America and Europe, calculated after removing the GST component in the price.

Starting Out on the Journey

I recently answered an interesting question from a beginner:

Question

I am about to enter the stock market for the first time and have read up on the stock market and the main impression i have come up with is to always follow the trend. But it still confuses me. There are so many stocks to buy and i tried to read up what's going on with the economy and the market but there are so many things to read. I have saved really hard for my little amount hoping that i can invest for the future. How do you come up with choosing a quality stock because there are so many stocks to monitor?

Answer

I do not want to discourage you. To the contrary, what I do is to encourage and teach people to invest. However, I need to start with a caution. The general thrust of your question is that there is a lot of reading and study to do. I am afraid that this is true and that it will not go away with time. You will get better at it and maybe it will take you less time, but it is just as probable that it won't.

I would like you to remember that what you are taking on is a job that is normally carried out by a professional funds manager. He or she will have at least one university degree and probably a higher degree as well. He or she will also have post-graduate learning behind them. Even more important, they will have many years experience. There is no way to short-cut this learning and experience task. So, if the work fazes you, think again and consider letting trained people invest your money for you.

Having told you the downside, let me pick you up again by saying that my experience is that investing in shares is one of the most endlessly fascinating occupations. I never expect to stop learning. I read the Financial Review in detail every day, read articles from several magazines and the Internet and try to read one book about investing every month. If you find this game as fascinating as I do, then it will not seem like work, because you will be motivated to do it as though it was your hobby – it was mine before it became my main source of income and capital appreciation.

Now, to comment on some of the things you said and asked:

Question

I am about to enter the stock market for the first time

Answer

Alright. So, why have you chosen this time? Is it because you have at last saved some money? Or is it because your study of the Dow Theory market phases has indicated that it is a good time to start? Unless it is the second of these, I suggest you study the six phases of bull and bear markets before you start.

Question

The main impression I have come up with is to always follow the trend.

Answer

This is good. The old saying that the trend is your friend will keep you out of a lot of trouble. But it is not enough. You need to know when to buy. You also need to know when to cut losses and when to take profits. You need to know money management, which is just as important as analysis. You also need to understand investing psychology. Investing is a process of decision-making and the decisions are made in your mind, which is open to psychological traps and biases.

Question

But it still confuses me.

Answer

Yes, because, as I just explained, you only have some of the picture. In fact the more you read and learn the more confused you are likely to become. Everyone goes through this. It is only with study and experience that the confusion starts to settle into a clear investment plan to which you are committed. In my experience it will take you about 10 years to get to the stage where you become a good and successful investor.

Question

There are so many stocks to buy and i tried to read up what's going on with the economy and the market but there are so many things to read.

Answer

I see this as one of the great things about investing. If you find it to be a burden, then you may be in danger of not being prepared to put in the hard yards needed to match the professionals. If you don't, they are likely to eat your lunch.

Question

How do you come up with choosing a quality stock because there are so many stocks to monitor?

Answer

I have explained this completely and in great detail in my book *The Aggressive Investor*. If you would like to learn my methods, please go to my web site www.bwts.com.au and buy a signed copy of the book. You can also order it by phoning me on 02 9439 9724 in business hours. I charge \$49.95, which is what you will pay in a bookstore. My price includes postage to Australia and New Zealand. My objective in writing the book was to pass on what I have learned over 35 years. Hopefully it will save you some time, and some effort.

In particular, in the book, I explain how to use investment software to deal with the amount of data. However, if your investment funds are small, it may be best for you to use free or low-cost internet tools until you have more capital saved. I did it without software for fifteen years. It can be done.

Finally, please be aware that what I do is the exact opposite to what the marketers of courses on trading do. They tell you what you want to believe. I tell you how it really is and try to help you on your investment journey.

Finding the Right Path

Comment

Being totally new to investing I hope that the book and regular reading of your articles will give me the right tools and the right attitude to investing in the share market. My goal is to be fluent or should I say risk aware in most aspect within 5 to 7 years.

Response

You are being very realistic about the learning curve, which comprises knowledge and experience.

Comment

I already have two subscriptions the first one to *Conscious Investors* lead by Mr John Price and the 2nd source is *Aspect Huntley*.

Response

These are both very worthwhile.

Question

Where should I now go to source my initial approach to technical analysis?

Answer

By joining my members only web site, you will have at your fingertips all my articles on Technical Analysis, which comprise a text book on the subject. Also the charting articles I wrote for Shares magazine and Smart Investor magazine will add another dimension to your learning. If you would prefer to study in a more formal environment, you could do the subjects E114 Technical Analysis and E171 Specialised Techniques in Technical Analysis at the Financial Services Institute of Australasia (FINSIA). The articles I mentioned above cover almost all of E114, the course notes for which I wrote. If you are not a graduate, you can get into those two subjects as a member of the Australian Technical Analysts Association (ATAA) www.ataa.com.au. You are welcome to come to one meeting without charge as a visitor.

When Do You Sell?

Question

Do you make decisions during the week, or only at weekends from your weekly charts?

Answer

My method, as described in my book *The Aggressive Investor* is that of an end-of-day trader. This means that most often I only check the market when the data comes down after it has closed. I make my decisions then and act on them next morning.

That is the norm. However, the reality can sometimes be different. If I see one night that the price has already fallen very close to my sell-stop, I may check the market next day mid morning and mid afternoon and act on the sell-stop immediately if it has been violated. The same thing may apply if overseas markets have fallen very heavily overnight. That said, it would be rare for me to check the market during the day – maybe a dozen or so times a year.

The reason I act in this way is that I trade trends, as described in the book. I have three sell-stop signals. These are based on the intra-day low, so once a sell-stop has been violated, I am bound to sell, no matter where it closes. I mean that too- I sometimes execute a sell-stop above the sell-stop level. The logic for this is what drives my investment plan. I am a trend trader. My three sell-stop signals indicate that the trend may be ended. So, I act on it. If the trend re-asserts itself later, as sometimes happens, I will consider re-entry as a new trade on its merits.

The Psychology of Investing

Raise your investing to a new level.

Investing is a process of what I call serial decision-making. The quality of those decisions is in large part what determines the quality of the investment results.

We make decisions using our mind and it is here that the battle is fought and won or lost.

The psychology of Investing is organised in four parts:

Know Yourself – How to align your investments and your temperament.

In the Avalanche – Understand crowd psychology

Stretching our Mind – Avoid common mind traps, biases and errors

Catching the Tide – Making sound decisions at the right time

“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.” Colin Nicholson

The book was released in June/July and good book stores will have it in stock. Autographed copies may be purchased 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 and Europe , calculated after removing the GST component in the price.

When to Buy Software

Question

I purchased Dr Elder’s latest book *Entries & Exits*, which i have begun to read. I am learning and using sites like Comsec, *Incredible Charts* and the like. I am trying to prepare for being able to capably invest and/or trade within a couple of years. I only currently have about \$30,000.00 to use. Is it worth paying for a computerised system or keep going as is?

Answer

Firstly, I would like to commend you on your approach of trying to learn the knowledge and skills before jumping in. So many people do it the other way around and pay rather high tuition fees to the market, called losses.

One of the most important things I learned about business was to minimise capital overhead costs until you can show some profits. So, your question is an excellent one. I think the answer is to continue to use the free or low cost tools available on the Internet until you have built up your capital and have proven you can invest and/or trade profitably. By then you will have a better idea of what tools you need and can select the appropriate software.

With regard to software, it really depends on what you are trying to do and what tools you have found to be best or most comfortable to you. *Insight Trader* charting software does the job for me, but everyone is different. Without full knowledge of you and your approach, I could not responsibly make a recommendation for you on software any more than I could on which stocks to buy.

Dow's Theory Part 2

The first part of this series was in Newsletter 58, which may be accessed on the Newsletters page of my web site www.bwts.com.au. Over time I intend to discuss each of Charles Dow's famous editorials, which outline 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 6 The Two General Methods of Trading

Dow believed that in general terms there were two methods of trading.

Method One is ... *to deal in active stocks in comparatively large amounts, relying for protection upon stop orders.*

Dow's key caveat in this statement was that the stock be actively traded. By this, he meant that it was a deep liquid market. Deep means that there are a lot of buyers and sellers who are active in the stock in big volume. This makes it liquid, because the trader can always find a buyer or a seller very close to the last traded price.

This idea is completely overlooked by many beginners, now that stop-loss orders are readily available to small investors in the Australian market e.g. through Comsec. Stop orders only work effectively in deep liquid markets, because they will be executed close to the stop level unless something very unusual happens. However, I hear constant complaints from beginners that their stop orders are executed near their limits. Or not executed at all because there were no close buying orders in sufficient volume, such that the avalanche of stop orders caused the price to fall like a stone, triggering even more stop orders. Quite often, the price spikes down on low volume, cleaning out our tyro investors and then springing back like a stretched rubber band. In almost every instance, the stock concerned was not even remotely liquid enough to be using automatic stop-loss orders. The lesson is not to use stop orders in stocks that are not deep and liquid markets. It is better, in these cases to use a price alert system and then manage the stop manually.

In this method, Dow stresses that the trader has no need to know very much about the intrinsic value of the stock. It is only necessary that the market allow the stop order to be done close to the required level, as discussed above.

Dow believed that it was only necessary for the trader to form an opinion as to the direction a stock is likely to go. The trader then puts on an order and if the opinion about direction is correct, the profits are allowed to run. If the opinion about direction is incorrect, the market will trigger the stop order, taking the trader out at a small loss. Of course, the secret here is to use and execute a stop-loss order. One big loss can wipe out most of the profits from many successful trades.

Dow's conclusion: *If he can guess right as often as he can guess wrong, he is fairly sure of profits.*

This is a very important observation. It implies that trading can be profitable when the trader does no more than get the direction right half the time. This is because, by cutting the losses quickly and letting the profits run, the average profitable trade should be larger than the average losing trade. It should be noted that this is where it is important to trade only in deep liquid markets. In thinly traded markets, it may not be possible to execute stops close to the entry price, destroying the underlying assumption.

Method Two is ... *he will buy his first lot of stock at what he considers the right price and the right time, and will then buy an equal amount every 1 per cent down as far as the decline may go.*

What you have just read is the exact opposite of the first method. Averaging down the entry price is anathema to the first method, which is to cut losses quickly. The essential difference between the two methods is that the first method requires no knowledge of value, but it is critical for the second method. Timing is also important, because even if you buy at a good price at the wrong time, this method can be fatal to your account.

Dow stressed the essential assumptions underlying this method. *It starts with the assumption that the operator knows approximately the value of the stock in which he proposes to deal. It [also] assumes that he has considered the tendency of the general market; that he realises whether the stock in which he proposes to deal is relatively up or down, and that he feels sure of its value for at least months to come.*

Clearly, the second method requires greater skills in stock valuation and timing of the stock and the general market than does the first method. For this reason: *This method of trading is the one generally employed by large operators: They know the value of the stock ... and are therefore reasonably secure in the following decline.*

Dow stresses that this method is not suitable for small traders. He might well have added that it is entirely unsuitable for beginners. This is a game for exceptionally experienced traders who have very deep pockets. Dow was also writing at a time when there was a great deal of insider trading and manipulation, which is no longer possible to anywhere near the same extent with modern communications and regulations.

In underlining its unsuitability for small traders, Dow set out the two principal disadvantages:

He does not absolutely know the value of the stock.

... he seldom [has] sufficient capital

In the first case, where the stock continues to fall, the small trader may worry that there is something not known to him or her and is tempted to sell out at a big loss before the strategy has worked.

In the second case, in Dow's day as now, most small traders have far too little capital and over trade it. That is, they have positions that are too large. The result is inevitable – losses.

Dow explains this by putting forward a situation in which the annual range in price for a stock is \$30. If the stock is bought \$5 off the high, the trader needs to have enough capital to cover the possibility of the stock falling a further \$25 before the method starts to work. Think carefully about that – this is a different game entirely to the first method.

Of course, beginners have a strong tendency to overconfidence. They believe they can get the value and the timing right. Experienced hands have learned how wrong this is the hard way. The market runs classes in this discipline every day, if you want to take them. The tuition fees are called losses.

Dow then makes the interesting assertion that *Such campaigns require time, patience, and the pursuance of a fixed policy, but whoever will follow this policy will find himself able to get a high rate of interest on the capital invested.*

Notice that he said a *high rate of interest*. He did not say that huge speculative profits were possible. Dow then makes a statement that every would-be speculator (sorry, the polite word these days is trader) might well print out and attach to their computer screen:

It is an old saying in Wall Street that the man who begins to speculate in stocks with the intention of making a fortune, usually goes broke, whereas the man who trades with a view of getting a good interest on his money, sometimes gets rich.

Note the use of *sometimes*. There is no certainty to speculation.

Dow explains the saying this way: *This is only another way of saying that money is made by conservative trading rather than the effort to get large profits by taking large risks.* How true that is. One thing that struck me most forcibly when reading Jack Schwager's Market wizard books was how small were the risks taken by the great traders. Trading is more about managing risks than focussing on the rewards.

Dow rounds out his editorial with: *After allowing for all the risks involved, we think the outsider who wants to trade in stocks has a better chance working in small lots on a scale than in any other way, provided he will pay attention to certain essential points:*

1. *Bull and bear markets run four or five years at a time. Determine by the average prices, which one is under way.* What Dow meant by the average prices was what is now known as the Dow Jones Industrial Average. This is the average price of 30 of the largest capitalisation stocks on Wall Street. Today we can still do this with the average he invented, or with the more sophisticated indexes that are available.

2. *Determine the ... stocks to trade in. They should be railroad stocks, dividend payers, not too low, nor too high, fairly active, and for the bull side below their value; for the bear side above their value. Values are determined roughly by the earnings available for dividends.* Dow crunched a lot of wisdom into this point. The mention of railroad stocks was because they were a heavily traded market segment in his time and there was a separate market average for them, rather like a sector index today. More important, though, is his focus on what we call fundamentals. He specifies dividend paying stocks. In other words, real businesses that actually make profits, not casino chips. Likewise the focus on earnings, which is what drives dividend payouts. Finally, his emphasis on value, pre-dating the value investing school founded by Benjamin Graham, whose most famous acolyte is Warren Buffett.
3. *Observe the position of your stock with relation to recent fluctuations. In a bull market, the time to begin to buy is when a stock has had four or five points decline from the previous top. In a bear market, the time to sell is when such a stock has had three or four points rally from the bottom.* In US terminology, a point is a dollar. US stocks are generally priced roughly ten times the normal price of Australian stocks. What Dow is suggesting is somewhat similar to the method taught by Dr Alexander Elder. He advocates buying near fair value, not on extremes, which he calls the greater fool theory – to make a profit, you need to find a greater fool to take the other side at your exit.
4. *Stick to the stock bought until a fair profit or until there is good reason for deciding that the first estimate of value is wrong.*
5. *Have money enough to see a decline through.* This is very important with this approach. If you do not have enough capital, you will be easily shaken out of situations that would ultimately have been profitable if you had been well enough financed to see the declines through. Then Dow's universal words of wisdom: *In a bull market it is better to always work on the bull side; in a bear market, on the bear side.* Amen. In today's terms – always trade with the larger trend. This is essential wisdom behind most successful trading methods. It is integral to my investment approach set out in my book *The Aggressive Investor*. It is also the philosophy underlying Dr Alexander Elder's Triple Screen trading method. I learned this truth years ago from his writings and I regard it as the most important principle underlying what I do.
6. *Do not let success in making money in [small] lots create a belief that a bolder policy will be wiser and begin to trade in [larger] lots with inadequate capital.* He is referring to the common tendency of beginners to overtrade. This refers to the size of their risks, not to the number of trades. As Dow points out, the losses from a few large trades will wipe out the gains from many small trades. Those of us who have been fortunate enough to attend one of Dr Alexander Elder's seminars will never forget the way he explains this – size does matter.

7. *There is not usually much difficulty in dealing in [small] lots on the short side... especially for a customer who amply protects his account and who seems to understand what he is doing.* Short selling has always been easier to do on Wall Street than in Australia. Still today, many brokers will not do it for small accounts. Perhaps that implies wise council for the beginners. However, once a beginner has learned to invest successfully and stepped up to profitable trading on the long side, they should be ready to trade the short side as Dow suggests. This is possible today through some brokers, or by using derivatives like CFDs or options. I would stress, though, that this is the last thing to learn. If you read the foregoing too quickly you might have missed the qualifications you need before even thinking about short selling. First you learn to invest successfully – two years minimum. Then learn to trade the long side successfully – again two years minimum. Then try short selling, but remember that it is wise to use it only in a bear market. Always trade with the trend, not against it.

In this editorial, Dow spent a lot of time on the second method. This is important, because trying it without enough capital or enough experience is how many small beginners lose heavily. I cannot stress strongly enough Dow's point that this is a game for very experienced investors with very deep pockets, plus the discipline and patience to pick the right stocks at the right time.

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