

Colin Nicholson: Newsletter 61

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Thanks again to all the readers who have sent me encouragement as I recover from the fall I experienced while bushwalking in March. I am now much better and my doctors have allowed me more exercise, which is rebuilding my strength. I have now gone back to bushwalking, though cautiously.

I am writing again for *AFR Smart Investor*. My next articles on investment psychology and charting will appear in the October issue, which will be on sale in mid September.

Unfortunately, with a change of editor, my columns in BRW are no longer required. I enjoyed writing them and will miss doing them, but change is a part of life.

The Art of Trading

Question

What do you do if you have a small profit in front of you and there is the possibility of a larger one?

Answer

This is a very important question. It is absolutely basic to the whole idea of trading.

If there is one guideline that should always be top-of-mind for every trader it is to cut losses short and let profits run.

So, the quick and dirty answer to your question is to let the profit build. Let it run.

The idea behind this is that if you pick the direction of a stock correctly around half the time, cut losses short and let profits run, then your average profits should be larger than your average losses. You should do OK and could with good fortune and enough capital become quite rich.

Most trades should result in small losses or small gains. Over time they should roughly cancel out at worst, but put you in front in a bull market. However, there are then some outliers at the extremes of the bell curve. Remember the Pareto principle or 80:20 rule. 20% of trades make 80% of the profits. But there is another 20% which make 80% of the losses. The aim of the game is to cut off the 20% of losses that are large, while letting the 20% of profits grow as far as possible.

That is simple isn't it?

Simple it is, but easy it isn't. What it requires is a discipline that is exactly opposite to your natural impulse, which is to grab profits quickly before they get away from you, but let losses run in the hope they turn back into a break-even situation. This is what almost all losing traders do.

So, in the situation you describe, you should do two things. First, you make sure that you know where your sell-stop is so that if it goes wrong, the loss is small. Notice I put the sell-stop requirement first. The first aim is not to lose big. Second, you let the profit run and move your sell-stop up as your method allows, which will lock in profits if the trend fails.

The problem with this is that the bigger the profit that builds, the more difficult it is to hang in there allowing it to build and build. Indeed, I don't believe it is smart to just let it get too big. This is especially true if the profit becomes many times your initial investment and the price starts to rise almost straight up into greater fool territory.

It sounds contradictory, but my policy is to take some profits progressively. My plan is to sell half of my position every time the price doubles. This works because it is better to let half of your position keep growing than to have taken it all off prematurely. Suppose you get on to a ten-bagger. You invest \$5,000. It doubles to \$10,000 and you take the profit and take your mates out for dinner to celebrate. Good. But how will you feel when it keeps rising – eventually, to \$50,000 without you? Not good, I suspect.

So the way I do it is to put in the \$5,000. When it gets to \$10,000, I take out \$5,000. Then every time it gets to \$10,000 again, I take out another \$5,000. Now you will feel better.

Of course, if you just left it all there you would have made more. Or would you? Could you have left it there? It takes a lot of intestinal fortitude. My experience has been that most of us are more likely to stay with a great trade if we take profits progressively and keep the growing position underneath our sleeping point.

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 specific plan may also be inappropriate for some readers. Instead, 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.

Capital Gains Tax Dilemma

Question

How do you factor capital gains tax into your thinking?

Answer

This is not an easy question for me to answer for you for a number of reasons. I have no expert knowledge in this field. I am not qualified or licensed to advise you. I am therefore not legally able to give you any advice in this area. The incidence of capital gains tax can be different, depending upon how your tax affairs are structured. I have no knowledge of your situation, so I would not have enough information to give you any advice in this area, even if I was allowed to.

My own investment plan is set out in my book *The Aggressive Investor*. I have devised my approach based on two ideas:

First, it is better to be taxed on a capital gain than on a profit. I therefore try to select investments that have the potential to be held for more than 12 months.

Second, it is better to pay capital gains tax than incur a loss by holding a failing investment. I therefore always sell out of any share that violates one of my three sell signals. This may seem a bad policy if you are shaken out of something and the trend reasserts itself. That is called evaluating the quality of an investment decision with hindsight and is a good way to screw up your mind. I am a trend investor. If a trend fails, I therefore get out. Investing is about minimising losses first and foremost. If I am sold out of something and the trend reasserts itself, I consider buying it back.

My general philosophy is to maximise the total return, but being an investor rather than a speculator, I try to pay tax on half the capital gain rather than all of a profit made within 12 months.

The only time that hindsight is useful is when you sit down to analyse your investment performance. Then, you might ponder how you might change your investment plan to improve your results. Having come up with something that would have given a better outcome on some of your investments, you have to be very careful that you are not fitting the rules to only a small number of situations. You need to see what would have happened across all of your past investments and also test the new rules across many years for many stocks and include both bull and bear markets. If it proves up OK, you might then change your plan.

It is most important that you realise much of what I have said above applies to my circumstances and may not apply to yours. You should seek advice on your situation from someone with the expertise and a licence to advise you on taxation matters. You should also be aware that the law is being changed with respect to taxation of superannuation.

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.

Sector Rotation

Question

To follow one of your suggestions regarding sector rotation, I would like to construct a saved chart arrangement in Insight Trader of all of the GICS indices, to show the relative strength of each index.

Answer

I am going to be a bit pedantic about this aspect of your question. This is not to be clever, but to bring out some points that I believe are very important and not well understood.

Firstly, you refer to one of my suggestions. This could be just loose language, but I did not intend that my reference in *The Aggressive Investor* on page 59 to sector rotation was a suggestion. It was intended as no more than an interesting observation on the second phase of a bull market. What I said was:

Another interesting phenomenon will appear in this phase. This is called sector rotation. As its name suggests, different sectors in the market tend to take their turn in leading the advance, while the previous leading sectors tend to take a breather. Thus, banks will run upward for a while, then chemical manufacturers, then insurance companies, then retailers and so on.

So, I said it was an interesting phenomenon, not a suggestion. This is pedantic, but important. If it was a suggestion, it would be explicitly in my investment plan. As an interesting phenomenon, it is no more than one rough

marker that is useful in reading where the market might be, and how it may be behaving, in the phases of the bull market.

Secondly, I used the word **tend** twice. This choice of word was very deliberate. Sector rotation is not something that can easily be measured objectively. It is no more than a general tendency and an inconsistent one at that. It requires years of reading and study of the financial press, analysts reports and company reports to develop the experience and judgement to recognise the various sectors and to know which companies fit into them. Also, some companies operate in multiple sectors. Moreover the activities of companies change over time. Finally, the sectors themselves change over time with technology and other changes in the economy. I used the word tend, because sector rotation is not an easily defined or measured concept and I do not have any evidence that it is well defined or can be easily measured using GICS indexes or any other sector charts.

Thirdly, GICS indexes are not indexes of single industry sectors. They indexes of very broad groupings of industries, each of which industries contain many industry sectors. They were originally set up for the US stock market and applied to Australia with only slight variations. The US stock market has a different structure to our market. I do not use them, because they are so broad and also because I am a bottom-up analyst or stock picker, rather than a mechanical top-down analyst. Above all, remember why these indexes are produced. The ASX sold out to S&P, who produce indexes that funds managers can use as benchmarks based, not on industry sectors, but on broad industry groupings. They are therefore not optimised tools to measure the market, though they are the best tools we have for that purpose. Think about the exclusion of News Corp as an example of the way they are twisted and distorted. I tend to only use the ASX All Ordinaries index, as it is the best broad measure of the market.

To summarise the discussion above:

- Sector rotation is not part of my investment plan. It is only a tool mentioned in passing and part of analysis as an art rather than a science.
- Sector rotation is not susceptible to study using GICS indexes. They are too broad.
- Sector rotation is something best observed through depth of knowledge of what industry sector or sub-sector a company fits into.
- I have never seen or done any work on how sector rotation can be objectively measured.

If you feel you need to develop the concept of sector rotation into something that could be objectively measured, you need to do some research. The task will not be helped by the short history of these indexes that is available. The other thing I believe you would need would be sub-indexes of the industries

and industry sub-sectors that make up the GICS indexes. The GICS system comprised eight digit numbers – there are four levels, each with a two-digit code. Only the first two levels are publicly available. You need at least the next level, and possibly the fourth level. Then you need to research it and see if there is a way to objectively measure sector rotation using indexes. Until you or someone else does this work, trying to use the idea with GICS indexes has no proven validity. It is a general idea that is being pushed further than there is evidence to support it. This lack of research is endemic in technical analysis and one of the things that most dismays me when I see people putting real money behind unproven and probably unsupportable ideas.

On the other hand, I have no problem with using GICS sectors for top-down analysis. This is not something I suggest. However, I understand the logic of it. The basic idea is that you start with scanning for the strongest national markets. Then within the strongest national markets, you scan for the strongest sectors. This would be a more precise process if we had true industry sector and sub-sector indexes, but GICS indexes are the best we have. You then scan within the strongest GICS indexes for the strongest stocks. It can also be done scanning at each level for value rather than relative strength. This is a totally different idea to sector rotation.

Relative Strength Chart Arrangement

Question

Using Insight Trader, how do I construct a saved chart arrangement of the relative strength of all GICS indices to the All Ordinaries index, rebased to 100, with a regression line and with each chart ordered by the slope of its regression line?

Answer

STEP ONE: Create a list of GICS indexes

Launch Insight Trader

Alt+F

G

Click twice on the heading Industry Sector (the various GICS indexes should now be at the top of the list)

The indexes all have dashed lines before and after their names

The first one should be already selected, but if not, click on it

Hold Shift and press Down Arrow repeatedly until you have selected all the GICS indexes

Hold down Ctrl and click Other Index

Still holding down Ctrl, click Unclassified Index

Alt+S

Type in GICS INDEXES

OK

OK

ESC (if necessary to close the dialog box where you have not ticked the box to Close Dialog on Acceptance).

STEP TWO: Select a GICS index for your template

If you know the ASX codes, choose one

If you don't know the ASX codes:

Alt+J

Enter

Write down one of the codes (I will use the first one, XFJ, in this explanation)

XAO is the ASX code for the ASX All Ordinaries Index

ESC to close the dialog box

STEP THREE: Create your template

Alt+C

N

XFJ\XAO

Enter

STEP FOUR: Set the running time window you want for your chart arrangement

(Note: You can instead set a specific starting date, but this has implications for comparing the results at different times, or else you have to keep resetting the starting date each time and re-creating the chart arrangement.)

X

S

-365

Enter

This sets the running time window at one calendar year. Vary this number as you require.

STEP FIVE: Add a regression line to your template

Ctrl+G

If you wish to hide the regression line parameters:

H

STEP SIX: Create your chart arrangement

Ctrl+Shift+A

If the File to Load is not GICS INDEXES:

Click the button with three dots

Double click on GICS INDEXES.LST

Alt+O (or click OK)

Enter (to confirm that you want the charts ordered by the slope of the regression line)

STEP SEVEN: Save the Chart Arrangement

Alt+R

If you need to change the Saved Chart Category:

Alt+G

Use the up or down arrow keys to navigate to the required Saved Chart Category

Alt+H

ESC

Ctrl+S and type in a title for the saved chart arrangement

Enter to save

STEP EIGHT (optional): Rescale the Chart Arrangement

If you just want the GICS indexes in descending order of the slope of the regression line, then these next two steps are unnecessary, but they will allow you at a glance to compare the relative slopes of the regression lines.

However, close inspection of the charts (Up arrow, then right arrow will take you through them as full screen charts) will show that the Y-axis range varies from chart to chart.

Depending on the period you have chosen for your running time window and what has happened in that time, there may be a wide range of maximum and minimum Y-axis values.

If the range is not great, a solution is to go through the charts and note the lowest and highest Y-Axis value. Then set the Y-axis to these values in step five like this:

Y
S
60
Tab
130
Enter

If the range is significant, this may be unsatisfactory for you. Instead you may want to create several versions of the chart arrangement with the Y-axis range appropriate to your various purposes.

STEP NINE: Regenerate and save the chart arrangement

Ctrl+Shift+A

Enter

Enter

Ctrl+S and type in a title for the chart arrangement

Enter

N or A to save as a New chart arrangement or Alter the old one

Enter after editing as necessary

IMPORTANT CAVEAT

The above answers your question, which was how to create the chart arrangement in order of the slope of the regression line. However, this is a frequently misunderstood and misused chart arrangement. The order of the charts in the chart arrangement and the slopes of the regression lines will vary depending upon the length of the running time window you choose. This is not a problem if you use the chart arrangement correctly. The slope of the regression line is only a first indication. It tells you in hindsight which sectors have grown faster or declined slower over the period of the running time window AS A WHOLE.

What is also important and possibly more important is the slope of the recent action on the relative strength line. Imagine for a moment that the chart with the steepest regression line had a relative strength line that was trending

down steeply through the regression line in the last month of the one-year running time window. Then imagine that the chart with a much shallower regression line had a relative strength line that was rising steeply through the regression line in the last month of the one-year chart. Clearly, the slope of the regression line is telling you what happened over the last year as a whole, but the recent slope of the relative strength line is telling you something about what is happening now. It may well be telling you that something may be changing.

To parody a well-known expression: make sure you know what to do with what you asked for.

I Cannot Give Investment Advice

Question

On the portfolio disclosure page on your web site, would it be possible or feasible to include a percentage invested figure? This would complete the picture.

Answer

I think you are misunderstanding the purpose of the portfolio disclosure page. This concerns me because you are not the first. I am concerned, because it puts me at risk and is the reason I created the entry page asking visitors to read the page and agree that they understand its purpose before accessing the portfolio disclosure. I carefully considered whether it would be better to delete the portfolio disclosure page altogether and meet my disclosure obligations in another way. Please, for my sake, read the page again.

The key part of the portfolio disclosure entry page is:

*From time to time, I may own stocks discussed in these columns and articles. **I hold these stocks to meet my financial objectives and circumstances. My personal ownership of these stocks is never intended to suggest to any reader that these stocks are suitable for them to trade or invest in.***

*Everything found on this web site has been written for the sole purpose of teaching analysis, investing and trading techniques. **This page is slightly different. It exists for no other reason than to meet my obligation to advise readers of any interest I have in a stock which I write about. It therefore follows that the material on this page neither purports to be, nor is intended to be, advice to trade or to invest in any specific financial instrument or to use any particular methods of trading or investing.***

As for disclosing my percentage invested figure, this involves other issues altogether and I think would be breaking the law. I am obliged to tell you what stocks I own if I write about them. This is NOT a cunning ploy to avoid the law on giving investment advice without a licence.

The law says that I need a licence if I give investment advice. This is the way the law defines advice:

... a recommendation, a statement of opinion, or a report of either of those things, which is intended to influence, or which could be reasonably regarded as being intended to influence, a person in making a decision in relation to a particular financial product, a class of products or an interest in such products

This has been on the Ask Colin page of my web site for several years. Again, I hoped that it would make my legal position clear.

It would be possible to argue that a percentage invested figure is a fact and a fact is not an opinion. However, what would be its purpose on the web site? The disclosure of holdings is so you know whether I have any interest in a stock I discuss. A percentage invested figure has no similar purpose. I feel that it would have no other purpose for a reasonable person that to summarise my view about the market. This is giving advice according to the law. To do that, I need a licence. So, I don't think I could defend its disclosure and it would therefore put me at risk of prosecution.

You might also ask why I don't get a licence. There are many reasons, but the key one is that it is not what I want to do. I love writing and teaching. Advising does not attract me. I am more interested in teaching you to make your own decisions than to make decisions for you or advise you as to what your decisions might be.

Many of us find this law overly restrictive, but it was devised in order to protect investors. It is a difficult balance to strike. You will be aware of the outcry over poor advice given in connection with a recent high-profile failure. If you think the law is wrong, please raise the issue with your federal parliamentarian. The only way the law can be changed is if the parliament amends the act.

Until the law is changed, I am doing what I can to teach people investing skills so that they do not need advice, but can learn to make their own decisions, or to better assess advice given to them.

I hope this makes the situation clear for you.

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.

Past issues of the email newsletter are available for downloading from my web site www.bwts.com.au. Newsletters will generally be posted to the web site when the following issue is sent out, about a month later, so my email list is the fastest way to get to see them. Subscribe by going to the Newsletters page on www.bwts.com.au and clicking on the relevant link.

The newsletter is intended to be a forum for discussion of interesting ideas about technical analysis, trading and investment. It is primarily educational in nature. I have taken reasonable care in its preparation. Nevertheless, everything in it should be read as my opinion, unless otherwise stated, and requires the reader to check the accuracy of facts and test the validity of my opinions before acting upon them. My opinions are not intended to be recommendations to trade or invest in any stock or financial security. Nor are they intended to be recommendations to use any particular trading or investment method. Readers who do not have the ability to assess the relevance to them of any matter discussed in the newsletter should consult a competent and licensed adviser before acting upon them. I am not a licensed adviser.