

Colin Nicholson: Newsletter 62

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29 September 2006

Stop Losses and Dividends

This question is one of the most common ones I am asked.

Question

If a stock goes ex-dividend, do you give some tolerance to its stop loss point?

Answer

The short answer to this question is no. However, I need to explain why the answer is no.

A stop-loss point is defined in my mind as the price level which, if the stock fell through it, I am wrong about the investment. So, if my stop-loss level is violated I sell without hesitation, because the investment has failed.

This sounds easy, but it is far from simple. I have made it simple because I have a very clear concept of what I am trying to do in my investing. I am trying to capture an uptrend. I build a position into a developing uptrend. An uptrend requires that each trough is higher than the last one. So, my investment has failed if the trend fails. The trend has failed if a correction falls lower than the previous correction. So, you can see that the stop-loss method I use is a logical outgrowth of the investment plan itself.

A good trend will extend over several years and there will be two dividends a year. Good trends are rarely ended by a dividend payment causing an unusual drop in price. If it does occasionally, it does not worry me. That is the nature of investing. If the trend reasserts itself later, I can always buy it back. However, as I said I this is a very rare situation. I can't remember the last one.

Many people do not have a clear idea of what they are trying to do. Also, it follows that their stop-loss level may be unconnected logically with the objective of their investment. Mostly it is quite arbitrary. This is not conducive to sound investing.

The reason that I have no trouble with my stop-loss levels is that I define the first one before I put on the order. Indeed, I need to define it in order to measure my risk and calculate the initial position size. I then have clear rules for how I move the stop-loss level up as the trend unfolds. I will always have that stop-loss level decided and marked on the chart before the price action happens that triggers it.

There are two exceptions to this. I have two sell-stops that can be higher than my stop-loss level. These are alternative ways the trend can fail before it falls

to my stop-loss level. I also mark these on my chart before the price action happens.

So, it really is easy. I decide where I am wrong and mark it on the chart well before it happens. Then if the price falls through one of the levels, I sell without having to think about it. I feel good about that, even if it is a losing investment. The only time I would feel bad is if I hesitated and did not execute my stop-loss. I don't like to feel bad, so I always execute the stop-loss immediately – the easy way out.

You asked me about a specific stock. I do not discuss specific stocks because of the law, which requires I have a licence to give general advice. Unfortunately, the law does not allow you to excuse me from its provisions, even in a teaching situation. In addition, you have not told me your situation, your investment plans or anything, so I could not advise you even if I wanted to.

However, if you study my investment plan as set out in my book *The Aggressive Investor*, you should have no trouble working out what I would have done. If you cannot work it out, find an example that is at least a year old and I will address that as an exercise in teaching my method.

I don't like the law, but I have to obey it. If you think it is wrong, please agitate with your federal member of parliament to change the law. But good luck – the law is about investor protection and there are no brownie points for politicians who want to relax investor protection.

More on a Similar Issue

Email from a Friend

A friend rang me this morning and said that he urgently wanted to see the charts of XXX and YYY (ASX codes concealed to satisfy the law). I did not make any recommendations. I simply supplied the two charts which displayed some similarities and explained what I see from my chartist's point of view. They both made lower highs and lower lows. XXX is down nearly a third from its high and YYY a quarter. They could be both very cheap, but I would not dare to buy any.

My Response

I have spent some time this morning looking at those charts trying to work out some reason based on the charts whereby I could agree that either was a good buy at the present. The charts are frightening. On the fundamentals, the dividend yield is abysmal, though the earnings yield is there. The PE ratio is low, but I suspect it is because it is not sustainable. My conclusion – your friend is buying near the top of a boom. It is a hope trade. It will probably end in tears. There are points on the charts where, if the price went back there, I would buy. There is lots of time to do that if it happens.

I think the most important point you can make now, if your friend is listening to you, which I doubt, is to ask where he would know he is wrong about the trade and get out. Sad as it is, I doubt he has any idea. This one point separates

successful investors from the rest. We will all get it wrong lots of times in the future, but the trick is not how good your crystal ball is, but whether you know what you are trying to do and where you are wrong and will cut your losses.

A Later Email from my Friend

He just rang me this evening, to report that he rang his broker, and on the broker's recommendation he bought them both.

Thank you for your comments. I also asked myself the same question. Stop-loss does not appear in my friend's vocabulary.

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.

Discussion with a Reader

Comment

When I first started buying shares I intended to turn \$20,000 into \$1,000,000 in 5 years by making 10% in 10 weeks on every trade. Boy, did I have a learning curve to climb.

Response

Your expectations as a beginner are far from unusual. Most people come into investing and speculating with a totally unreal expectation of the likely returns. Warren Buffett is the best there is and his average return is between 20 and 25%pa. Most major companies would give their eye teeth to average 15%pa return on capital. Just think why would they put in all that effort if the returns you thought to make were possible. The reality is that most investors and speculators struggle to beat the market return over the long term, which in Australia is about 12.5%pa using the accumulation index.

Comment

I bought my first share four days before September 11 2001, what you could call impeccable timing.

Response

Ouch! Why? The most basic look at a chart would have screamed downtrend to you – the US since May 2001 and the ASX since late June 2001. If you want to go north, get on a bus heading north, not one heading south and hope it turns around (massacred allusion to Welles Wilder's famous advice). If you have to do anything in a downtrend, you should go short. Otherwise you are trading against the trend - not a good policy.

Comment

You can encourage the shareholding public to keep good records of their share activities then thousands of tax preparers across Australia will worship you.

Response

Never mind the tax preparer. One of the most important things I have learned over many years is that good businesses always have good records and bad businesses always fail with their records in a mess. There is no effective way to learn and improve unless you keep good records and evaluate how you went and why with a view to improving your methods and execution over time. I encourage all investors and speculators to keep up-to-date records so they know where they are for the year at any time. Also to keep a diary of some kind that records at the time why they did something and include charts if they have been part of the decision.

Comment

I have never used a 'stop loss' regime. I felt that a rule saying 'If the price falls to this level, sell no matter what' was too much like Black Box Trading.

Response

Yes – the famous boast that real men don't use stops. I am sorry, but all successful investors and speculators have some kind of stop-loss rules in their plan. Even Warren Buffett, who says he will hold something forever, will sell if the situation changes significantly and he cannot fix it (he fully owns many companies he invests in). The way to set a stop loss level is very varied. It should relate logically to what you expect to happen when you buy the share. So, it is simple, your stop loss should be the price level where, if the share fell to it, you would be wrong about your initial decision. My method is not the only one, but the logic of my investments is that the share price will trend upward. This means that each correction in the trend should finish higher than the last one. If the price falls below the last correction, the uptrend has been violated and my investment has gone wrong, for the time being anyway. I sell without hesitation or emotion and look elsewhere or wait for a resumption of the trend to emerge. As I said, this is not the only way to do it and may not be the best one either, but I have tested it over a long time and it works for me.

Comment

I have (now) introduced a crude stop-loss calculated weekly as 90% of the lowest close of the previous week, with only upward changes made. The share has to trade below the stop for two consecutive days before I shall think of exiting. This newfangled idea will be monitored closely from now on.

Response

Good luck, my friend, but I fear for you. What is the logic of this stop? It sounds quite arbitrary to me. However, a good arbitrary stop, which has been tested thoroughly, is better than none. Maybe you have tested it and not said so. However, I doubt it. Why 10%? Maybe another percentage works better over time. You cannot know unless you test it. Before you put real money behind any part of your plan you should test it over a large number of stocks over 15 or 20 years of data if you can get it. Yes, seriously, this is what the pros do. They will often be on the other side of your trades. If they have tested and know what they are doing, and you have not, they are going to eat your lunch. You have done well in a bull market. The real test is a sideways or down market. When the going gets tough, the tough guys tend to prevail. For your sake, test your idea soon. Computers make it relatively easy to do. Yes, the software costs money. However, the alternative is to let the pros teach you the hard way. Their tuition fees are called losses.

Comment

In your book you say to set realistic targets. There is no such thing. My advice is to decide what you want, then figure out how to achieve it, regardless of whether other people think it is unrealistic.

Response

While your sentiment is positive and good, so is motherhood and we are all in favour of both ideas. However, I can set an objective of being a mother and there is no way medical science will make that possible in my life time. Seriously, some objectives are really impossible. What I was talking about in

the book was the rate of return you should aim for. There is a great deal of statistical data available. There is also a very wide range of achieved results. However, over the long term, it is very difficult to beat the market. If you are planning your future, it is better to set realistic targets. If you do not have enough capital to earn the income you want, you may have to make up the difference outside of investing. Yes, you can take greater risks. Up to a point and in a bull market, you may get away with it for a while. However, remember what happened to Icarus. If you set unrealistic objectives and fall short, you may end up with a problem that you can not redress somehow. Would it not be better to plan ahead on reasonable assumptions and know what the problems are in advance? Then you can assess your options and maybe do something about them before they happen. David decided to fight Goliath with a sling-shot. He did not have many other options open to him. We all admire his bravery in the situation. However, Dubya would not have tried to change the regime in Iraq with soldiers armed with sling-shots. He had other options and used most of them.

Comment

Knowing when to sell seems to be my biggest problem.

Response

I am not surprised. You are not alone. Most people do not want to know this skill until the market has bludgeoned them into recognising the problem. You are well advanced on the journey, if you are at this point. Most beginners are nowhere near it. If I run a seminar teaching people how to decide what to buy, I can fill the room to overflowing. If I run another seminar teaching what to sell and when, the room will be half full if I am lucky. The truth is that no matter how well you make your buying decisions, it is all wasted if you cannot make selling decisions of the same quality. Just quietly, the second seminar is the one to go to.

Conclusion

Thank you for sending your thoughts. I have been a bit rough on you in several places above. This is simply to make important points. Your achievements at university and your investment results over the last five years are very commendable and I take my hat off to you for what you have achieved. I hope my thoughts assist you and others who read them to move on from where you are now to even better things.

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.

Differing Views

Originally published in the BeyondInvest Newsletter June 2006.

I recently received a question from one of my web site users, which is of wide general interest to *Insight Trader* users:

Question

I've just read *Come Into My Trading Room* by Dr. Alexander Elder and am currently going through the areas of the book which I don't fully understand.

In the section of the book that describes Triple Screen (p132), Dr. Elder mentions weekly trend following indicators. i.e. weekly MACD-Histogram and weekly EMA.

What does the weekly refer to here? Is it settings of the indicators (i.e. 26-week EMA and a 22-day EMA), or the data from which the indicators are derived (i.e. weekly prices, daily prices, etc)? I believe that it is the latter, and if so, how can I get *Insight Trader* to plot indicators according to monthly/weekly/daily data?

Answer

This is an excellent question. To answer it fully, we need to go back to first principles and work up from there.

Setting aside those who use intra-day data in *Insight Trader*, the vast majority of users will be using a daily data stream. There are several forms this may take, but the most common one is the summary of the day's price action by recording in the database the four key prices and the number of shares traded in the day. The key prices are:

The Open: The price of the first trade of the day.

The High: The price of the highest-priced trade of the day.

The Low: The price of the lowest-priced trade of the day.

The Close: The price of the last trade of the day.

Opening and closing prices on the ASX are determined in a very special way, which is quite different to the bid and offer system that operates once the market is open. There is detailed explanation of the opening and closing procedures on the ASX web site. Go to www.asx.com.au and search for Market Phases.

To see the data you have in *Insight Trader*, load any stock into memory

Launch Insight Trader

Y

Alt+C

N

BHP

Enter

and then

Alt+E

Alt+B

to browse the data file for that stock. It will show the date, Open, High, Low, Close and Volume in columns. I have described the hot-key method because it is much easier to record and faster to use than the mouse and menus, but you can do it that way if you prefer. Just watch where the hot-keys are taking you and then use the mouse instead.

So, the first important thing to appreciate about *Insight Trader* is that the data is collected and stored in the data base in daily summary form. This is important because almost all indicators and chart forms by default use the daily data. This is most unfortunate, because it would be far better if intending traders and investors began with the longest available time frame and progressed their analysis down to the time frame in which they intend to trade or invest. However, that is how it is and it is unlikely to change.

Fortunately, it is easy to switch timeframes in *Insight Trader*. The way you should start your analysis is to buy at least ten years of historical data and load it into *Insight Trader*. You should then ensure that it is correctly adjusted for corporate activity by running the *Insight Trader DataBase Manager* or equivalent service. You should then study the long-term picture. To do this using a line chart and Telstra (TLS) as the example:

Launch Insight Trader

Y

Alt +C

N

TLS

Enter

L

You can toggle the chart between arithmetic and semi-log scaling using the F key.

You can toggle the chart from Line to Bar using the B key, then return using the L key. There are hot keys for other chart forms in the *Insight Trader* manual.

Now, bring your chart back to a common starting point of an arithmetically scaled bar chart using the B and F keys. Then ensure you have all history still showing by using the Alt+F3 hotkey combination. Where you should start your analysis is from the daily line chart we created a moment ago and/or the monthly bar chart. This is where I need to explain to you the second really important idea in using *Insight Trader*.

When you load a stock data file in *Insight Trader*, with some exceptions, you will be loading a daily data file. To check that your Telstra file is a daily data file, press the D key. You should now see D@D in the top right corner of its chart window. If you have M or W @ M or W, you have loaded a compressed file, which no longer contains daily data.

I have just covered a lot of territory in a few words. Let's step back and break it down. *Insight Trader* is extremely flexible in that it allows you to plot data or make calculations in daily, weekly or monthly format. This is very useful as we will see, but it can lead unwary users into serious error, so pay attention here.

The standard data file is in daily summary (Date, Open, High, Low, Close and Volume) format:

230606 245 246 241 243 5678

If you are plotting this daily data as a daily chart display, the top right corner of your chart window will show D@D. The first D means Daily display and the second D means Daily data file. You may think the second D is superfluous. But it isn't with other uses of the software.

You might decide that you want a weekly bar chart. To switch from a Daily display of a Daily data file (D@D) to a Weekly display of a Daily data file (W@D), press the W key. You now have a weekly bar chart. Now, what is really important here is that W tells you the bar chart is weekly, but @D tells you that the underlying file is Daily data. This is vital information because it tells you what calculation *Insight Trader* will use if you draw an indicator on the chart. Say you want a ten period exponential moving average. You would add this to your chart with these hot keys:

A
E
Tab
10
Enter

I just said "ten period". This is the key point to grasp. Because the data file in use is daily, the moving average has a look-back period of ten DAYS. If instead you wanted a ten WEEK look-back period for your moving average, you need to use the closing prices of the last ten WEEKS, rather than the closing prices of the last ten DAYS. In order to do this, you need to compress the underlying data file in memory. This is not permanent unless you subsequently re-save the file, file but even then your original file remains intact as the compressed file will be saved under another name..

A daily data file for five consecutive days Monday to Friday will look like this:

190606	245	246	241	243	5678
200606	248	248	240	244	4321
210606	246	249	237	239	6543
220606	255	253	248	250	2345
230606	256	255	254	254	4345
240606	258	258	251	251	7890

When the data file is condensed, it takes the last date in the week and selects:

- The price of the first sale in the week as the Open
- The price of the highest high in the week as the High
- The price of the lowest low of the week as the Low
- The price of the last sale in the week as the Close
- The sum of all the volume for the week as the Volume

Our sample week above would be compressed to look like this:

240606	245	258	237	251	31122
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Insight Trader makes it really easy to compress a file. To compress a daily file to weekly, use the hot key combination Shift+W. If you now do this on your Telstra chart, W@D will change to W@W and the moving average will change from a ten-DAY moving average to a ten-WEEK moving average. It is as easy as that.

Not unsurprisingly, *Insight Trader* makes it just as simple to compress the file to Monthly summary data. Just press Shift+M on your Telstra chart and it will change to M@M and the bar chart will be monthly and the moving average will be a ten-MONTH moving average.

You can just as easily go back from a monthly or weekly compressed file using Shift+W or Shift+D.

Now you might think this is more complicated than it needs to be. Not so. The complication is necessary to give flexibility. For example, I like to use a 260-day moving average on all of my charts, whether the bar chart is daily display (D@D), weekly display (W@D) or monthly display (M@D). The reason I do this is so that I am always looking at exactly the same moving average line on

every chart. If the software did not allow me to change both the display and the compression of the file, I would lose this important advantage.

Now to return to my questioner. When Dr Elder says he has put a 22-period WEEKLY EMA on his chart, in *Insight Trader*, you need to create a chart that is weekly display and weekly compression (W@W). You will have a weekly bar chart with a 22-week EMA.

Likewise, when he says he is using a WEEKLY MACD Histogram, you need to create a W@W chart, so the MACD Histogram is calculated and displayed on a file compressed to weekly summary.

So, the simple answer is that a weekly chart means a weekly display of a weekly calculation. In *Insight Trader* the built-in flexibility means that you need to be aware of the need to compress the data file in order to get the correct calculation and display.

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.