

Colin Nicholson: Newsletter 63

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Colin in AFR

I know many of my readers were as disappointed as I was that BRW changed editors and repositioned the magazine, leaving no role for me and many other writers. However, as one door closes, another opens.

From this Tuesday I am writing each week for Market Wrap in the centre of the Australian Financial Review. There will be several charts of markets and stocks with my analysis of them.

Chasing Prices and Greater Fools

This is a good series of questions because they raise some important issues.

Question

How far do you chase prices?

Answer

I need to be careful in answering this question, because you may not be asking what you appear to be asking.

First – what you appear to be asking. What I do and not what someone else might do? This is important because every part of an investment plan is related to the other parts in the sense that it is a balance of risks. What I do may be quite different to what someone else does who is also an investor. And of course someone who is a trader will probably give a quite different answer.

My answer for what I do is that there is no practical limit. This may surprise you. To understand what I am saying you need to appreciate that my investment plan calls for stocks that are undervalued (value model) or not valued much higher than the market average (growth model). So long as a stock meets those parts of my buying criteria, the price is not an issue. I know the current price is value or I would not have reached the point of buying it.

Another issue for me here is that I am happier if the stock is tending to move higher than if it is hovering. Which of those two is the strongest stock? – a no-brainer .

Second, so that is what I do. But you may have meant what should you do? I am sorry, but I cannot answer that question. I have no idea whether you are a trader or an investor and I have no knowledge of the rest of your investment or trading plan. Depending on what you are trying to do, your answer may be much different to mine.

I know this is not much help, if that was your question, but I cannot answer it for the reasons I outlined. In addition, what you would be asking for is advice and I am not licensed to advise you. So, we need to leave that question there.

Question

I think I read somewhere that you often require a share to "prove its case" by exceeding a previous high by 2%.

Answer

Yes, I have said something like that. However, it is really an unrelated issue to the first question.

I learned the art of investing before computers and used hand-drawn point and figure charts because they are so easy to quickly update hundreds of charts. One of the heuristics or rules of thumb that point and figure chart users adopt is to use a box size that is about 2% of the price. The signals those charts give is driven by the box size, in that a breakout is not recorded until the price has moved one box or 2% above the highest box in the congestion area or trading range. When I began using bar charts, the issue arose of what move constitutes a breakout. This was not my issue, mind you, because for me a move out of the congestion area is a breakout. Commonsense works fine. If it is only a fraction of a cent breakout on a \$4 stock it is maybe not significant. However, no matter what I say there are always people who want rules set in concrete. So, if they insist on having a rule, I tell them to use 2% as the test for a breakout. It has nothing to do with whether the breakout will succeed or fail. It just gives them what they crave. As they mature as traders or investors they will probably no longer need such a rule.

Question

At what level do you conclude that you've missed the boat and are now in greater fool territory?

Answer

Greater fool theory is something my friend Dr Elder talks about in his books, seminars and camps. It relates to his short-term trading method. His philosophy of buying value is very similar to mine except he uses only technical analysis, whereas I also use fundamental ratios. So, we are both looking to buy value and sell to the (greater) fools. The difference between what we do is the time frame. Dr Elder may hold a position for hours or days. I hold a position for months or years. I may even buy a stock from him if he was trading one I was interested in, because in his time frame it was above short term value, but in my time frame it was undervalued. The result may be that I hold the stock for a couple of years. Dr Elder may buy and sell it many times in that period. We would hopefully both make money.

So, if a stock is on my list to buy, greater fool theory is not relevant, because over-valued stocks never got to first base in my stock-selection method. For it to drop off my list of buys it would have to move a long way or announce some bad news. Then I would reassess.

Where I think your questions are coming from is should you chase a strong stock? As I have said earlier, the answer all depends on what you are trying to do.

However, for me, I love the ones other people will not buy. Right now we are in the fourth year of a bull market. As stock that is still undervalued and moving up strongly is a prime target for me. I will chase it and buy an initial lot. Then if it keeps racing away, I am on board and laughing. However, most likely there will be a correction, when I buy more and then a new high when I complete the building of my position.

The alternative at this stage in a bull market is that a stock is only now poking its head out of an accumulation pattern. I may buy this one too, but if it is not moving strongly and presents a turnaround story, it is a dog that has been asleep while everything is happening. Yes, you can buy it close to the lows of the chart. Yes, you may do really well with it. But unless it is a special case, dogs that wake up three years late and show little signs of life should be left to go back to sleep.

Conclusion: Buy value. Buy strength. Leave the dogs to the lesser fools.

That is my philosophy and it works for me. But you are not me and may have quite a different approach. There are many ways to make money in the markets. What you need is to find one that fits your temperament, not search for perfection. Perfectionists do not make good investors or traders, but that is an issue for another day.

What I Do and How

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 my book *The Aggressive Investor*, 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.

Managing the Bust

We are in the fourth year of a bull market which has just gone through a difficult correction and has now roared up again to test the old all-time high. This may or may not be the end of the bull market – only time will tell. However, all bull markets end sooner or later. We should be thinking through what we plan to do when it finishes well before the event. We should have mentally rehearsed our plan so that it has become instinctive and we can act on it without hesitation. If you are not already in this situation, start thinking. You may not have as much time as you think. It is too late to start thinking it through in the heat of battle. That is how you get to join in the panic. The winners will know what they intend to do and calmly execute their plan.

Since March 2003 it has been easy to make double digit returns. Ask whether you are mistaking the bull market for brains. The hard bit is keeping what you have made when the bust comes along.

All markets go through bull and bear cycles, even though there are many who swear that property only ever goes up. I have lived through many property cycles and I can tell you the carnage when the bubble bursts is not pretty unless you derive pleasure from watching the misfortune of others. This weekend's Australian Financial Review contained an article headed *A Sceptic's View of the Property Boom*, by Mathew Dunckley, which every investor should read. It is about Bill Bowness, one of Australia's most successful property investors. He has just sold out ahead of the next bust. Some of his advice for managing a bust is instructive and can be equally applied to the stockmarket.

His first golden rule is to look for warning signals. I know no better way to do that in the stockmarket than by using Dow phase analysis and basic charting. This is all explained in detail in my book *The Aggressive Investor*.

His second golden rule, which he has just invoked in the property market is not to get caught with stock when the music stops and to have plenty of capital in cash. The strategy I set out for market exposure in *The Aggressive Investor* is how I do the same thing in the stockmarket. It saved me in October 1987 and at several other important market tops.

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His third golden rule is what breaks you is not bad stock selection, but holding costs. If you are using margin lending, you will have holding costs in the stockmarket too, but the big destroyer is losses. The golden rule is to cut losses quickly and let winners run. Most people do the reverse. The best investors worry most about the losers. If you have a good plan and cut the failed choices quickly, that is the main game in a market bust.

Another of his golden rules is diversification. I agree in principle. However, if you want to beat the market you need to avoid wide diversification or you may earn a mediocre return. I am a stock-picker. I am frequently pestered for how I pick the stocks I buy. I am happy to talk about that and have outlined it in detail in *The Aggressive Investor*. The smart students read what comes after that in the book – how I manage my investments. That is where the money is really made. Nobody ever asks for a seminar on that topic.

Finally, Bill Bowness says that cash is king in a recovering market. I learned this lesson decades ago by studying Howard Hughes. He had cash at the bottom of the great crash of 1929-32. He bought great assets cheaply when nobody else had cash. I have always sought to get out of the market – entirely if necessary – around the top and be in cash when the bottom approaches. The easy money is often made at the start of the bull market, not the end of it. If you want to know my rules, read *The Aggressive Investor*. It is all there.

PE Ratios and All That

Question

Many companies do not have P/E ratios. Why is this?

Answer

The PE ratio is the earnings per share for the company divided by the price. It tells you how many years it would take for earnings to repay your investment. It is therefore a measure of how expensive the company is in relative terms. So, if a company has a PE ratio of 10 times, it means that you are paying ten times the earnings to buy its shares. If another company has a PE ratio of 20 times, it means you are paying twenty times the earnings to buy its shares. Clearly the second one is more expensive and the first one is better value.

If a company does not have a PE ratio, there are two probable reasons. One is that it does not make a profit. If it has no earnings, it has no PE ratio. The other reason is that maybe it is a more recently listed company and it has not yet released its results for its first year on the market.

In general terms, companies that have no earnings and hence no PE ratios are unproven and are more in the nature of a speculation than an investment.

Question

Even if they had a PE ratio, would it really matter, since the price of a speculative share is based on emotions rather than logic?

Answer

In general terms, investment is about the management of risk. A low PE ratio indicates one of two things. The company could be going broke. The other explanation is that the company is undervalued by the market. The value school of investing will focus on this second group because the relative cheapness of the company gives the investor a margin of safety.

Then again, if the company has no earnings it is, as you say, a speculation. The risk is high and the margin of safety is non-existent. In a bull market this can look like free money and many people mistake a bull market for brains. However, the piper has to be paid and the real test is when the speculative music stops. A bear market separates the men from the boys. Good luck.

Question

I find it confusing to see that one share is less than \$5.00 and the other is above \$30.00. Should the price of a stock have any bearing on your decisions?

Answer

The short answer is no.

The price of a share in theory is the total value of the company divided by the number of shares. So, if one company is worth \$100m and has 100m shares, its price will be \$1 per share. If a second company is worth \$100m also, but has only 10m shares, its price will be \$10 per share. All other things being equal, they are the same thing.

The difference in price should have absolutely no bearing on your decision. Instead you should look at per share ratios that enable you to make valid comparisons between the companies. The direction and strength of the trend is also important in your decision.

So, if you are thinking that, for the type of company that you are considering, the relative cost of the assets is important, you might consider the price to NTA ratio. If one company's price is 70c for every \$1 of assets it might be a better buy than another company whose price is \$1.30 for each \$1 of assets.

It Is All About How You Think

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.

My new book ***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

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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

Signed copies of *The Psychology of Investing* 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.

Price to Book Ratio

Question

Do you place any value on the price to book ratio?

Answer

This ratio is one of Benjamin Graham’s criteria for his margin of safety. I discussed it in the appendix to my book *The Aggressive Investor*. Graham’s rule was to look for a price to book ratio of 1.5 or less. In other words, do not pay more than \$1.50 for \$1 of assets. Graham had an exception involving multiplying the price to book ratio by the PE ratio, which is also discussed in my book.

We should realise when we discuss this ratio that Graham was mainly looking at industrial companies. However, it is arguable that the economy has changed a lot since then and that this particular ratio is of less value in service companies where there are low levels of physical assets. However, the general idea remains sound that we should not pay too much for assets if we are a value investor. A growth or momentum investor would probably allow far more latitude on this ratio.

I do not place a lot of stress on this ratio. I think there are far more important elements in the total picture. It is only one small part of my view of a company. I certainly do not give it any special characteristics.

Question

It is said that a price to book ratio of less than 1 may indicate a takeover target. True?

Answer

Yes, it could be one such indicator. If you are paying less than \$1 for \$1 of assets the company may be cheap. Remember though that the book value is the going concern value and if you thought just to break the company up and sell the assets, the value of the assets may be far less.

The other issue is that it is far too simple to use only one ratio for such an indication. You should consider all the other ratios and do a full fundamental analysis assessment of the company and its industry to understand whether a company may be a takeover target.

Question

If the price to book ratio is less than 1 is there a probability the price could rise, or the reverse?

Answer

One reason a price to book ratio is that low is that the company is in trouble. In that case I would want to see a lot of other things in my favour that indicate a turnaround. The most important would be an uptrend on the chart or a breakout upwards from a good accumulation pattern. These things are more likely to be in place if the company has had temporary problems and fallen out of favour. In that case you need to have the value metrics giving you a good margin of safety to take on a risky situation.

In general terms, I would need to see an outstanding opportunity. It is easier and surer to make money from good businesses that are trending upward strongly than trying to be a hero and pick a dog that may have another day in the sun if it is lucky. Remember that the heroes are the ones with the arrows in their backs.

Breadth Data and Daily Routine

Question

I was replaying an old Dial and Chart Mystery CD and was following your daily routine. Do you still follow the same routine or have you refined your routine and moved on? The reason I ask is that on the CD you use the Advance Decline line and the Hi-Lo as a sub indicator and chart the PE and DY for the All Ordinaries index. Are these indicators available in Insight Trader as I can't seem find them, if not how do you go about retrieving this information and importing it.

Answer

My daily routine is still very similar, but there are a few changes.

I still follow Advances-Declines. I find it a valuable short term indicator of possible market tops.

I have discontinued New Highs-New Lows. The reason is simple – I found the turns were mostly after the market, so it was not a part of my decision-making routine.

Other than that, everything is much the same except that I now use chart arrangements as described in my book *The Aggressive Investor*. The chart arrangement puts a monthly, weekly, daily and candle chart on the screen at once for each market and each stock. This saves key strokes and time and lets me quickly compare time frames.

I put the Advance-Decline data on my web site each month. The charts are on the Interesting Charts page in the Members Only section. The data files are on the Data Files page in the public section.

Insight Trader can plot the Advance-Decline line, providing the data file has the daily difference set as an accumulator field. I have set up the file that way, so you just need to download the file and put it in your Winit\A folder, because the file is called ASXAD. The relevant field is set also as the default field, so just charting it like a stock will bring up a cumulative line. I do not display it as a second window any more, but overlay the chart of the index and the A-D line.

I also calculate a 20-day moving average of the Advances. The ASXAD file has Advances in a separate field. I then plot that and overlay it on the index.

Instructions for creating these charts and more are on the Presentations page of the public web site.

Note: I am no longer selling the Mystery CD. It can still be purchased from BeyondInvest (Dial&Chart).

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