

Colin Nicholson: Newsletter 64

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13 December 2006

There has been an unusually long interval since my last newsletter. This is because I have been busy writing a new book, which will be launched next week:

Hot Stocks Book Launch

My new book is called *Hot Stocks*. It will be hot off the press in Melbourne next Wednesday evening 20 December 2006 and delivered to me in Sydney straight after Christmas. Details are already on my web site www.bwts.com.au. See also details later in this newsletter.

There are two ways to get one of the first copies:

- Come to the Melbourne book launches next Wednesday and Thursday evenings. Space is limited, so you need to book – details below. I will arrange a Sydney book launch in the New Year.
- Order it from my web site before Christmas and I will post a signed copy to you between Christmas and New Year. Go to www.bwts.com.au it is already set up for advance orders.

Melbourne Book Launch

There will be two sessions:

- Wednesday 20 December 2006 at 6pm
- Thursday 21 December 2006 at 6pm

The book launch functions will be at **The Educated Investor** bookshop at 500 Collins Street Melbourne. I will speak for 15-20 minutes and then be available to sign books and answer questions.

Space is limited, so you need to book. Phone Janene Murdoch between 9.30am and 5.30pm weekdays on (03) 9620-0885 or email her at info@educatedinvestor.com.au.

Colin in AFR

From Tuesday October 24, I have been writing for the Tuesday edition of Market Wrap in the centre of the *Australian Financial Review*. Each week, there will be several charts of markets and stocks with my analysis of them.

Size Does Matter

Question

I have a portfolio of about \$5 million. I struggle to keep the number of stocks I hold below about 40-50. I seem to have a comfort zone of around \$80,000-\$100,000 per stock. I have one or two that I hold around \$200,000, but in the

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main that's the size of the parcel I can't seem to pluck up courage to buy more of. So I end up with about 45-50 stocks which I feel is too many. Yet there are few I want to let go.

Answer

First, let me make two general observations:

Observation One: You have asked an important question. It is one that I am asked from time to time. It is also one that I have personally wrestled with, especially when, a year or so ago, I switched additional funds from selling other assets into my share portfolio. What you describe is a very real problem. To quote an old joke, size does matter. If you want to climb mountains, you do not start with Everest, you work your way up to it by trying smaller peaks first. Let's say that you and I were betting on something between us. We might be having real fun betting \$100 on who would win the next cricket test. But suppose I offered to bet you \$1 million on the next test. Size does matter.

Observation Two: There are few absolutely right or wrong answers in investing. At the extremes there are possibly some right and wrong answers. Say you put the whole \$5 million on one stock. Or that you only put \$5,000 of your \$5 million on 1,000 stocks. Both of those could be said to be wrong. But at the margins in the middle somewhere, it is not so easy to make absolute judgements. If we were to discuss whether you should stretch from \$100,000 to \$150,000 per stock I don't think there is an absolute right or wrong judgement that can be made about that.

When I wrote my book *The Aggressive Investor*, one of the problems to solve was the name of the book. I decided that *Aggressive* was the right word. Yes, it has a double meaning. That added to its appeal, because it made people stop and think. The important meaning of *aggressive* is the antonym of *passive*. I am not a passive investor. I have an aggressive or active management style. Some people say that I am a conservative investor. I argue that an investment plan is a balance of factors. Yes, there are some areas that I am conservative about – no leverage – but this just balances the aggressive areas. One of the aggressive areas is the concentration of my portfolio into 15-20 stocks when fully invested.

The reason for this very aggressive style element is that I am trying to match or beat the market index. That is not as easy as it sounds. If I have a broadly diversified portfolio, it will be difficult for me to even match the market index. To beat the market index, I have to be holding fewer stocks than the index. I am not big enough that I must hold most of them, but overweight some, which is what a big funds manager must do to try to beat the index. My strategy is to focus narrowly on very strong stocks. I hold them while they are trending up, but am ruthless in cutting them if they fall out of their trend. I have another advantage over a big funds manager. I can move very quickly from cash to fully invested and back into cash again. It is rare to make such a big move, but I have recently reduced my exposure to the market significantly on this strategy.

The proportion of the portfolio that is invested in any one stock is not the only place in the investment plan where this issue of size crops up. When my portfolio was much smaller, I used to risk up to 2% of it on any one stock. As the portfolio became larger, I reduced this level of maximum risk to 1%. However, although I have left the plan at 1% maximum risk, I very rarely go near that level – 0.5% is a more normal risk for me and it is often even less than that. If you have a \$5 million portfolio, then 1% risk is \$50,000. If your position size is \$80,000 - \$100,000, that is a big hit and I doubt if you will be risking that much on one stock.

So, what it comes down to I think is this:

On the one hand, as your portfolio grows, I would expect you to risk a lower percentage of the portfolio and to also invest a lower percentage on any one stock. I do not see a problem with 45-50 stocks, so long as you have the time to devote to managing them and do not become lazy in your decision-making because one seems not to matter that much in the total scheme of things. This is a common problem in a bull market.

On the other hand, if you extrapolate this into the future, when you have a \$10 million portfolio, you would be holding 90-100 stocks. That could be a problem. Do you have the time to manage them? Would you be content then with close to the index return, because that is what you would be simulating, give or take a bit? I suspect not.

In summary then, I don't think what you are doing is wrong in any absolute sense. However, the fact that you sent me this question is suggesting that you are not entirely comfortable with it. I don't think it would be wise to change what you are doing in a sudden jump. In other words, to move in one step from \$100,000 in 50 stocks to \$300,000 in 17 stocks would not be smart. But I think you should consciously try to move. Right now you are at about 2% of capital invested in each stock. Try to move that up in slow steps. Consciously set yourself 2.25% of capital (\$112,500) for the next year. Then move it to 2.5% of capital (\$125,000) the next year. As the portfolio grows these percentages should be the guide, rather than the dollar amounts. That way, over time, you will focus your portfolio more than it is now. You will also avoid it becoming more and more diversified, which tends to bias the results to mediocrity. How big these steps are is up to you. Also how far you take the process is also up to you. Maybe you aim to get from 40-50 stocks down to 35-40 stocks and hold it there. This might be as far as you ever want to reduce it. Because I am more aggressive does not make me right or wrong – just that my plan is different. Remember too that as your portfolio grows, working with a percentage of capital means the position size increases each year. So, once you are at 35-40 stocks (say), you will still be increasing the size of your average position each year.

One aside is that all stocks are not the same. I have a maximum of 6% of capital going into any one stock and a minimum of 2% of capital. Part of my plan is to exploit some small and thinly traded stocks. For some of these 2% or 4% may be all I ever put into them because of the liquidity risk. Nothing is

cast in stone in this game of investing. Each case must be considered on its merits.

Hot Stocks

Market Outlook and 30 Shares for 2007

My approach to investing uniquely combines:

- Fundamental analysis for value and safety
- With charting for timing and buying tactics
- And is specially designed for private investors

Do you want to know which of the bull and bear market phases I think we are in now? It is in the book. I will take you through a detailed analysis of the situation, not just giving you an answer, but showing you how you can do this for yourself. From the analysis I suggest the market exposure strategy I am adopting as we go into 2007.

I have recently scanned the market looking for stocks that are looking strong or promising as we go into 2007. Some are already in my portfolio, others may be there soon. By the way, at 13 December my portfolio was 26% ahead of where it was on June 30. The All Ordinaries Accumulation index is only up 10.7%. Past performance is no guarantee of future results, but you might like to read *Hot Stocks* to add practical depth and richness to my book *The Aggressive Investor*, which went into reprint less than 12 months from launch and continues to sell very well.

In *Hot Stocks*, I take each of the 30 stocks and look at them in depth, showing you some ideas, but more importantly, building your skills by example in following my basic methods – adapted for your own investment plan, of course.

Hot Stocks will sell in bookstores at a recommended price of \$29.95. I will mail you a signed copy for that price to any Australian address. Overseas addresses will attract a small additional postage charge. To buy a signed copy from me go to www.bwts.com.au and fill out the online order form. Or phone me on 02 9439 9724 in business hours. My office will not be manned 20-23 December, while I am in Melbourne, but you can leave a message and I will return your call.

Online Security: My web site is quite safe to use to order using a credit card. It is an SSL connection. Orders are removed from the web site as soon as possible and I do not keep credit card details on a computer.

Determining Opening Prices on the ASX

Question

How are opening prices determined on the ASX?

Answer

The ASX web site has excellent descriptions of the process.

For a general overview of ASX market phases/trading hours go to http://www.asx.com.au/investor/education/basics/trading_hours.htm

There are some other links at the right hand side of that page. One of them takes you to a page describing calculation of opening and closing prices. The direct link is http://www.asx.com.au/investor/education/basics/open_Close.htm

Calculating Position Size

Question

From reading your book *The Aggressive Investor*, I seem to be getting two conflicting messages. On the one hand, you are saying that you need to make allowance for price fluctuation, and not set too tight a stop loss. On the other hand, you are saying to set a stop loss to avoid losing more than 1% of capital. Could you resolve this issue for me?

Answer

From your question I think you may be not quite understanding what I have been trying to say in the book. You may not have got to the case studies section yet. It may become clearer at that point. The major part of the book is spent explaining my investment plan. This is the theory, if you like to put it that way. However many people do not always find that the easiest way to learn. It was for that reason that I included the major section on case studies and included more case studies on the compact disk that comes with the book. Many readers have given me feedback that the case studies brought the whole thing to life for them. This was my intention. Most of us find actual practical examples resolve a lot of the issues we may not have fully grasped from the discussion in theory terms.

What you have described me as saying is not correct. I was not trying to say either of these things. Of course, it is my responsibility as the writer to make myself clear to you. So, I will try to make up for that in the simplest terms that I can as follows:

I am not saying that you should set a tight or a loose stop loss. I don't recall saying that at any point. My whole method is based on trading a trend. A trend is a series of higher peaks and higher troughs on the price chart. I buy into an upward breakout on the assumption that a trend will unfold. Or I buy into an existing uptrend. I hold while the trend is intact. The key feature of a trend for this purpose is that each trough in the trend forms at a higher price than the previous trough. If the price falls through the previous trough, then the trend has failed by definition. This is therefore where my stop-loss is – under the accumulation or consolidation pattern for the breakout and under the last trough in the trend once it begins to unfold. This is really simple. So simple, in fact, that some people have actually asked me if I run an advanced course where I say what I really do. The good news is that this is what I actually do and all that I do. There are no undisclosed secrets. In *The Aggressive Investor* I have disclosed everything that I do.

So, that is how I set where my stop-loss will be. Under the lows of the accumulation or consolidation pattern at breakout and under the last trough in the trend once the price is trending.

The remaining issue is where 1% of capital comes in. I can not stress highly enough, and I hoped that I had made clear in *The Aggressive Investor*, that I set my stops based on the trend. I do not, repeat not, ever for one moment set the stop any other way. In particular, I do not buy a quantity of shares and set the stop at a price that means my loss would be 1% of capital. This is getting it all the wrong way about. Even worse, that is a recipe for disaster. If you set a stop above the last trough in the trend you are inviting normal price action to take you out and then the trend carries on without you. The result is that by setting the stop in this way, you have increased the risk of making a loss. If this is what you have been doing, for heavens sake stop doing it. It is not right and it is not what I am teaching.

What I do is this:

I look at the bid-offer spread and decide my buying price.

I work out where my stop-loss should be as described above.

I subtract the stop-loss level from the entry price.

That difference is my risk per share

I take 1% of my capital (all holdings at market price plus cash reserve).

I divide that number by the risk per share.

The result is the number of shares that I can buy and only lose 1% of capital if I am wrong and my stop-loss is hit.

Example:

Entry price \$3.00

Stop-loss level \$2.10

Risk (\$3.00 - \$2.10) 90c

Assume my capital is \$100,000

1% of capital is \$1,000

$\$1,000 \div 0.90 = 1,111$ is how many shares my method allows me to buy, holding my potential loss to no more than 1% of capital.

Please study this simple example. Then work your way through the case studies in *The Aggressive Investor*. Once you have mastered this concept I think you will improve what you are doing now.

Thank you for asking this question. You are not the first to ask it. I appreciate the opportunity to try to explain it to you better. I hope I have succeeded.

Create My Chart Arrangement

Question

How do you create the four-chart Chart Arrangement in Insight Trader, which you showed in *The Aggressive Investor*?

Answer

The instructions for creating my chart arrangement are in Newsletter 53 on my web site. Since then, I have made one small change – setting the X axis in the monthly chart window. Here are the updated instructions incorporating that change.

My four-chart Chart Arrangement consists:

Upper Left Window

A monthly semi-log bar chart with a running time window displaying the last 5500 days of data (about 15 years)

Lower Left Window

A weekly semi-log bar chart with a running time window displaying the last 1500 days of data (about 4 years)

Upper Right Window

A daily linear bar chart with a running time window displaying the last 365 days of data (one year)

Lower Right Window

A daily linear candlestick chart with a running time window displaying the last 100 days of data (about 3 months)

All four charts have a 260-day simple moving average on them.

I create, and save as a Saved Chart, a template using St George Bank (SGB) [it could be any stock listed for about five years or more]. To create a chart arrangement for any stock I simply retrieve the template Chart Arrangement from Saved Charts and press Ctrl+N followed by the stock code. When I then press enter, all four windows are replaced with the new stock. I can then save this new Chart arrangement if I need to.

The key to having a running time window is to set the X Axis to From – n, [minus n], where n is the number of days to be in the running time window. What this setting does is tell the software to start the X axis from n days before the date on the computer clock (ie today). The running time window

therefore automatically ensures that the software will always display the last n days only and requires no adjustment by the user.

The keystrokes to create my chart arrangement are:

Note: I will use hot keys, but you can do the same things with the relevant icons or menus in many cases.

Launch Winit

Alt+C

V

If your standard configuration is semi-log, press F

N

SGB

Enter

A

Tab

260

Enter

X

S

-100

Enter

C

+/= (the plus/equals key)

SGB

If not already checked, tick Close Dialog on Acceptance

Enter

X

S

-365

Enter

B

+/=

Enter

F

X

S

-1500

Enter

+/=

Enter

X

S

-5500

Horizontal tile

By the way, you could also have learned these elements of the operation of Insight Trader and much more from Bernard Chapman's Interactive Seminar

on CD. I could not recommend it too highly to anyone who is learning Insight Trader (who does not have more to learn?).

My Fundamental Analysis Filter

Question

I noticed in *The Aggressive Investor* that you have moved away from your earlier method of finding value with fundamental analysis using a PER < 12 and DY > 5% and now use the market average. Can these be found easily on the Internet or is it best using AFR for more up to date values?

Answer

I used to use PER<10. However, in the low inflation environment of the 1990s, I changed to PER<12. This was a quick and dirty method and is quite alright, because this is not an exact science we are dealing with. Later, I made the whole thing much more rigorous. I tied the PER limit to the bond rate and incorporated an explicit risk premium. This gave me a target earnings yield, which is the inverse of the PE ratio. This is the PE ratio I now use. The main reason I do it this way is that it is self adjusting to the bond rate.

I also stopped screening for both variables. This was after I read the research in several books – Dreman and O’Shaughnessy mainly – that suggested price to cash ratio was the best indicator, closely followed by PER and Dividend yield was a bit less effective. Since price to cash is not easy to get, I use PER as my screen filter.

However, I still use dividend yield once I have the output of the system screen, as described in the book. I check the dividend yield manually; because I want also to see the trend of dividends (I also check the trend of profits or EPS). I use the market average dividend yield as the yardstick, but again this is not a precise test. Using the market average rather than an arbitrary number also adjusts roughly for the bond rate. The caveat is to be careful in overheated markets.

If you wish, you can filter for both PER and dividend yield, but I find that this cuts out some interesting companies, which just miss out on what is an approximate test. Filtering on PER is all that I need to trim the full ASX list to a manageable size.

Market average PER and dividend yield may be on the Internet somewhere, but I get the AFR every day, so I take it from the weekly table, which appears on Saturdays and again on Mondays.

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