

Colin Nicholson: Newsletter 65

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3 January 2007

Hot Stocks Sydney Book Launch

My new book *Hot Stocks* – market outlook and 30 shares for 2007 – was launched in Melbourne on 22 December. I started sending it out against advance orders on 28 December. I am launching the book in Sydney on

Saturday 13 January 2007 from 10am to 12 noon at
Best Western Twin Towers Inn
260 Pacific Highway Artarmon (opposite Campbell Street)

I will speak briefly on the book.

I will outline the strategies I think may be appropriate for this stage of the market cycle

This will be followed by a general question and answer session on any topic

Bookings are not necessary.

My books will be available for purchase on the day, or immediately from my web site www.bwts.com.au.

Auckland Talk and Seminar

In February I will be in Auckland. I will be speaking at a STANZ meeting and also giving a one-day seminar.

STANZ Meeting

7.15pm Thursday 15 February 2007

Topic: A strategy for the Times

In the talk, I will introduce a unique aspect of my investment approach, which is centred on the management of risk. The starting point is market risk – the risk inherent in where we are in the cycle of bull-bear market phases. I will go through a workshop-style examination of where we are now and from that derive a strategy for dealing with the opportunities and challenges for 2007. This will centre on my market exposure strategy, but will also touch on stock selection policy.

STANZ welcomes visitors.

For details of place and cost see

http://www.stanz.co.nz/auckland_meeting.php

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Auckland One-Day Seminar

Saturday 17 February

Topic: Hot Stocks for 2007

I will present in detail the material in my new book *Hot Stocks* – market outlook and 30 (Australian) shares for 2007. The detailed program for the day is:

- 8.00-9.00 Registration, welcome refreshments and book sales
- 9.00-10.30 **Where are we in the bull/bear cycle? What strategy?**
- 10.30-11.00 Morning break and refreshments
- 11.00-12.30 **The two models and how to find the hot stocks**
- 12.30-1.30 Lunch break
- 1.30-3.00 **Scanning the market and selecting potential hot stocks**
- 3.00-3.30 Afternoon break and refreshments
- 3.30-5.00 **Analysis of the more interesting potential hot stocks**

Only the first hour and a half will partly overlap the STANZ talk. I will also be updating some of the material in the book, which will reflect what has happened in the last couple of months.

The cost is NZ\$280. STANZ members, members of my web site and subscribers to my free email newsletter may claim a NZ\$30 discount making the cost NZ\$250, including lunch and refreshments.

For a copy of the seminar flyer, further information and to book, please phone

Phyllis Bergquist in Auckland 09 625 8425.

Places are strictly limited to 30 and over a third of them have already been taken, so don't delay if you wish to come.

A Thought for the Times

Recently, one of my readers sent some kind feedback:

I have just completed my annual business plan/trading plan review and included this year a 6 month 'Time Weighted Average Capital' (TWAC) analysis as per your newsletter of sometime ago. I am happy to report that my 6 months to December 30th have returned 36.685% for the 6 months.

I owe 90% of my success to your teachings. I would never have completed the trading plan without your video series, and your book helped refine the plan further. I am very grateful for your newsletters and the many articles which have helped me overcome many of the emotions which trading invokes. I am deeply indebted to you.

This is one of several similar messages recently. My response:

Thanks for the feedback on your success. What I think important is that for anyone to learn, they have to be ready. And strangely, the right teacher often

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appears when the time is right. If you were not receptive, it would not matter much what I wrote. So, most of what you have achieved is due as much to you as a student as to me as a guide. That said, I am very glad to have been of service to many people like yourself. Thank you for taking the time to convey your thoughts.

It is my view that we are heading into more dangerous times. No bull market goes on forever. While bull markets also seem to often last longer and rise further than we imagine, the psychology is brutal. The market slowly conditions us to expect it will just go on and on. Which is what we hope will happen, but is not reality. I think that, as we approach the end of the fourth year of the bull market, we are most likely to be closer to the end than to the beginning. The name of the game now is to make sure that we take away most of what we have made, not give most of it back.

In *The Aggressive Investor*, I outline my strategy for market exposure towards the end of a bull market. Some of this is discussed in specific detail in *Hot Stocks*. In a bull market, we make money by running with the bulls. However, a stampede is a dangerous place to be if the herd is running towards a cliff. The smart thing is to try to see where we are, whether the risk is any higher, and to move towards the edge of the stampede, ready to step aside.

It will be lonely. Both success and failure loves company. The psychological trap here is that most people would prefer to earn \$100,000 when most others are earning \$70,000 than to be earning \$120,000 when most others are earning \$150,000. Even though the weather looks fine, it is time to start carrying some rain gear. You will hear me saying this quite a lot from now on. If the bull market continues for some time, you will also hear much laughter at my attitude. Let's see who is laughing six months or a year after the bull market ends.

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.

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.

What is an Equity Curve?

Question

How do you plot an equity curve of a portfolio?

Answer

This is an issue that is more complicated than it appears on the surface.

Assume that you start the year with a certain quantum of investment capital. It will be either invested in shares or held in cash as a reserve. You value the portfolio at the closing market price on June 30 and add the cash reserve. That is your starting capital for the year.

Now assume that during the year you do not take any capital out of the investment portfolio and neither do you add new capital to the portfolio.

In this situation it is easy. You value your shares again at the closing price each day, week or month (whatever is your preference). Weekly or monthly would be fine. Daily is probably a lot of work for little reward.

If you are using the Insight Trader Portfolio Manager, it will update your portfolio each day and, providing your record keeping is up to date, that will give you your total equity (shares at market value plus cash reserve). If you want to go back to an earlier starting point or to calculate points in between, just change the current date in Portfolio Manager and it will value the portfolio at those dates.

If you do not use Portfolio Manager, you will need to generate the same equity numbers using your own records. Going backwards is difficult unless your software allows you to reference to past dates as Portfolio Manager does.

You manually enter these data into an Insight Trader file that you might title Equity Curve. This is one number per week or per month and is not a big task. If you have a lot of past data you want to input, it is possible to create a data file and use Datacapt to input it.

That is all easy enough. However, the real world does not always respect the assumptions. You might want to add capital to the portfolio. This is fine for Portfolio Manager, but the Equity Curve will jump at that point reflecting the addition. You might want to take capital out of the portfolio – say to pay tax. That is also fine in Portfolio Manager, but will cause the Equity Curve to fall sharply reflecting the withdrawal.

Assuming again that these changes are only occasional, this probably presents little problem. You will know why it jumped or dropped. However, you may be adding or subtracting capital frequently. A good example is the receipt of dividends. I regard dividends as part of the total return, so it is not a problem, but it can be in some circumstances. Somewhat worse would be if you were in a retirement phase and took regular amounts out for living expenses. This would have nothing to do with investment results and would be a problem. You could deal with it though by taking out living expenses at the start of the year and keeping that money separate to the portfolio. Then again, that may not suit you.

There are other things that may create problems, which may or may not affect you.

An equity curve on its own is not a big problem. Where it can get difficult is that you need to compare it to something. I use my target return and the All Ordinaries Accumulation Index. If you have additions and withdrawals in your equity curve, which you recognise, that is fine, but they will not be reflected in the other two curves, so comparison is difficult.

It is possible to create two theoretical portfolios in Portfolio Manager – one for your target return and one for the Accumulation Index. If you put the same capital into each at the start of the year and do the same additions and subtractions through the year, you will have three curves that can be compared. However, there are some tricky underlying assumptions here.

The alternative to plotting the dollar value of the portfolio is to plot the rate of return. This is not an easy subject. It is dependent on the starting point and the method of calculating return. I use a quick-and-dirty method that suits my objective. I don't plot the curve, but I look at the data every day. My target return is to average 12.5%pa over all market cycles. This is the long term return of the All Ordinaries Accumulation index. So, what I need to do is to try to match or beat the index most of the time. If I am ahead of the index through the year, I am ahead of my objective.

I calculate my return as a percentage of the starting capital for the year. I do not annualise it. I just calculate that growth percentage through the year for the portfolio and for the index and compare the two numbers. The only time it is a true annualised return is at the end of the year.

The issue for me is that I sometimes take capital out or put more capital into the portfolio. I deal with this by calculating my growth number on a time weighted average capital (this is described in one of my past Newsletters). This is also a quick-and-dirty method during the year, but it serves my purpose and is conceptually acceptable, though not perfect at the end of the year.

So, what I look at each day is that my portfolio has grown $x\%$ since the start of the year and the index has grown $y\%$. If $x\%$ is greater than $y\%$, I am on target. The only other concern is if the difference between $x\%$ and $y\%$ starts to narrow. In that case I need to consider whether I have a problem. This is where plotting it on a chart might help many people. They can see visually what I am visualising in my head.

Note that I do not annualise the two growth percentages, but this could be done if you wish. It is not conceptually easy to do in all situations and can be a very complex calculation.

Another issue I have not touched upon is whether you allow for exit costs in valuing your portfolio (I do and so does Portfolio Manager). Yet another issue is whether you value the stocks you hold at market value or at the stop-loss level for each stock. This has some merit, because you are more likely to realise the stop-loss price than the current price. Then again, if you are a long term buy-and-hold investor, the stop-loss level may or may not be relevant - some investors never sell any stock they have bought.

I am sure this is a far longer answer than you expected. However, while it is a simple concept, it has many methodological and conceptual wrinkles that may be more or less relevant depending on your situation.

I can also tell you that it is on a long list of projects to implement this in Insight Trader Portfolio Manager. However, there it is a very big problem, because it needs to deal with all possible situations. My own situation is relatively simple in comparison.

Who is More Accurate?

Question

I find that there are differences in fundamental data between Commsec and the Financial Review. Which is more accurate?

Answer

There is no simple answer to your question. The first problem is that it is not only a question of accuracy, but let's start with that. Accuracy to me is a question of whether the data is correct or not. In the most simple terms, this

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means is it the same as the data produced by the company in its accounts? If calculations are involved in presenting the data, are they mathematically correct? While all human beings make mistakes, I am not sure that this is a significant problem. Sure, there will be the occasional transcription or calculation error, but I think this is a minor issue.

I think that what you are alluding to is not accuracy. It is whether the data is current, or is it out of date? This is a big problem. It is especially a problem around the semi-annual reporting seasons. A lot of new results data pours into the ASX. It sometimes takes days or even weeks for the providers of data to the Financial Review and Commsec to catch up with it all. This is particularly a problem when hundreds of companies release data in a single week. Actually, I think they do a pretty good job in the circumstances. The trick is to be very wary about data around the times that companies are reporting. There is a lag between announcement and publication in these media.

In some ways a trickier problem is a question of accuracy. I recently myself queried a report in the Financial Review. It showed a very high dividend yield for a company. I happened to know that it had recently split its shares. A quick check showed that the reporter had been given a dividend yield based on the old dividend per share before they were split, but the yield was calculated on the latest price, which was for the split shares. I am certain that both Commsec and Financial Review have wrongly-based data in this situation. Share splits and reconstructions are not all that unusual, but I have noticed that most data services do not deal with them well. The lesson is to never accept data that looks too good or too bad to be true. It may be this issue is involved.

A far more subtle issue is that of definition. Before you use any data service, try to look up the glossary of terms to get at the definitions they are using. Take Price Earnings (PE) ratios. The Financial Review provides historical data. In other words, they take the last two half year earnings per share data, add them together and divide the total into the price. Commsec uses Aspect Huntley as a data provider. Aspect Huntley mostly uses an average of historical and forecast earnings in their calculation. Both will almost always be mathematically accurate. Neither is wrong in the sense that they have done what they have said they do. So the problem is not which one is more accurate. The problem is that they are designed to be different. Some people, like me, prefer to use historical data and make our own projections. Others prefer to use pure projections. A middle path is the Aspect Huntley average of historical and forecast data.

So you see it is not just a question of accuracy, it is a far more complex problem. And it is not a problem that has a single correct answer, because it depends on what you are trying to do and how you are trying to do it.

How do you deal with this? I think there are four guidelines:

First: Always find out what it is you are using, before you use it. If they do not give definitions and you cannot cross check for yourself, don't be afraid to ask. Getting answers, or finding the right person to ask, of course is another thing.

Second: Once you find a source that is providing data the way you want it try to use that source consistently.

Third: Once you have got to the point where you are ready to commit real money, go to the source data and do your own checks and calculations. It is not difficult. The ASX web site (Announcements) and company web sites (links are on the ASX web site) will have company reports you can use in digital form.

Finally: If something does not look right, don't accept it – prove to your own satisfaction that it is correct. Don't be afraid to phone the company and ask questions, but do your homework first so you don't waste their time rather than use yours first.

Neil Costa's Course Wanted

One of Neil Costa's earliest students is wanting to purchase a copy of Neil's Market Masters course. If you have a copy of Neil's course, which you are interested in selling, please contact Ian Littlejohn 0427 910 195 or igl910@bigpond.com.au.

Charting on the Apple Mac

Question

Do you know of good charting software for the Apple Mac?

Answer

I find that there are a few industries that use the Apple Mac and many others that use the PC. The finance/securities industry seems to use the PC almost exclusively. I am not aware personally of any charting software for the Apple Mac. If any reader has had experience with any such software or knows of some, it would be appreciated if you would let me know.

There is software on the Internet that you can use on any computer, but not download. For example www.bigcharts.com. Yahoo Finance also has charting ability. There are more, which you could find using Google.

Tricks of the Trade

(Originally published in BeyondInvest September 2006 Newsletter)

I recently changed my address. A little later, I changed my banking arrangements for taxation reasons. I would like to warn readers who are share investors to be extremely careful if they do either of those things. It is very important to know how the trade works to avoid significant and ongoing problems.

For taxation reasons I needed to change the account into which dividends were paid by direct credit. The logical thing was to simply change the name of the account, but the bank I was with would not do that, even though some of its competitors do allow that action. The convenient time to do that was 30 June, so I closed the account and opened another account in the names I needed it to be in. At the same time, I advised the share registries of each holding I had of the revised account details for direct credit of dividends. I had been quite meticulous about this and thought the problem was fixed. Not so. It turned out to be a nightmare because of the way share registries work.

Although you can instruct your broker to change your address details and tax file numbers, which are then revised in the CHESS database and advised to share registries, there is no provision to also advise direct credit details the same way. That would seem to be easy, cheap and relatively foolproof, because the details would be attached to your HIN and therefore share registries would be updated automatically. But that is not the way it works.

In the mean while, I had sold some shares and bought others. Each time I received a welcome pack from a share registry for a new holding I returned the direct credit instructions for it immediately. Even this turned out to be a nightmare.

I received a dividend direct credit advice sent to my old address and paid into the old account, which by then was closed. I checked and I had some weeks before advised the registry of my new address and direct credit details. On enquiry, I was told that the registry acts on the address and direct credit details that were in their database on the Record Date. I was amazed. Since the Record Date, but well before the payment date I had advised the new address and direct credit details, and had a written confirmation from the registry. Their answer was that they do not take any notice of information supplied after the Record Date. So, although they have new information and know they have it, they ignore it. Clever country we live in, isn't it? In the twenty-first century, it should not be too difficult to use computers to apply the latest information on address and direct credit quite close to the payment date.

Things you need to know:

The **Record Date** is set by the company paying the dividend. You can find it in their announcement and on the ASX web site. However, many other lists of dividends do not show the Record Date, only the Ex Dividend Date and the Payment Date.

The **Ex Dividend Date** is readily available on lists of upcoming dividends and is four business days before the Record Date, so you can work out the Record Date from that. Watch out for public holidays when the ASX trades – for example the recent Labour Day holiday in NSW.

So, I had to wait weeks while the bank refused to accept the credit to a non-existent account and then the registry sent me a cheque. They will not make

the payment using direct credit, even though this information is known to them at this time. They did accept the new address to send the cheque to, but somewhat reluctantly.

Realising this situation would apply to other shareholdings, I then researched the Record Date for every other holding I had and established that no other holding had been bought after a Record Date. There were some new purchases since the Record Date, but they had my new address from the CHESSE database and I had not advised them direct credit instructions. So, my assumption was that they would send me a cheque in the absence of direct credit instructions. That was a stupid assumption.

Some weeks later I received another dividend payment advice that had been sent to my new address (from the CHESSE database), but paid into the old direct credit account. This mystified me because I had not been sent a welcome pack for this shareholding. So I had not given them direct credit instructions for it and assumed they would therefore send me a cheque. A call to the share registrar explained that this was my mistake. I had owned shares, and sold all of them some years earlier. Since they had direct credit details from that previous investment, they did not send me a welcome pack and just used the old details. Again I had to wait weeks while they awaited the bank refusing credit to a non-existing account and then they sent me a cheque.

This last problem was a big one. I have owned shares in hundreds of companies over the years and there are many registries. Also there are name changes and changes of registry, I do not keep records longer than five years after sale, so it was unlikely I could ever fix the problem. I might buy something in two years time that I had forgotten I owned six years ago and the dividend would be credited to the old account.

After discussing this with my broker, the only solution I could see was to start afresh. I opened a new account with the broker and transferred all my holdings to it. I cancelled the old HIN and transferred all holdings to a new HIN. This resulted in an avalanche of paper, but at last I have a clean starting point.

The moral of this story is that if you change your bank account, change your HIN at the same time to remove the problems from legacy details in registries for previous holdings you had sold and finished with years ago.

I asked the registries if I could change my direct credit details globally and they apply it to any legacy records of old holdings. The answer was no. The only solution I can see for this problem is the bleeding obvious: Direct credit details should be part of the CHESSE database, so one instruction to your broker changes everything after that date. It seems that politicians have no interest in passing the appropriate law. Registries also have no motive to change because it would reduce the work they charge for and the interest they earn on failed direct credits and unrepresented cheques. I am not suggesting they do this deliberately, but simply that the failures of the present system work to their advantage.

ASX Purge

No, I am not referring to the dumping of the chief executive and replacement with the chief executive of the ASX takeover target. I am referring to another trick of the trade. One of the innovations of recent years has been the ability to place contingent orders – often loosely referred to as stop-loss orders – in the market. This has been useful for many investors, especially those who travel and wish to leave stop-loss orders in the market to protect their positions while they may be out of touch with the market.

The problem is that if a company pays a dividend or makes some other action like a capital return, split or consolidation, on the day the shares start trading "ex" the corporate action e.g. the ex-dividend date, the ASX purges all buy orders, sell orders and conditional orders like stop-losses from the system. The reason for this is obvious, but the result is that one day you have protection and the next day you are wide open to sharp falls in the price with no stop-loss order in position.

The moral of this one is that you need to have someone monitor your positions for corporate actions while you are travelling and give them authority to re-establish your conditional order, or other order awaiting a movement in price towards it, after adjusting for the corporate action.

The back of the doors in airport toilets have warnings about unprotected sex. Maybe there is a case for a warning about travelling with unprotected investments.

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.

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