

Colin Nicholson: Newsletter 66

29 January 2007

Auckland Seminar

In two weeks time I am spending some time catching up with friends in Auckland. I am speaking at the STANZ meeting on the evening of Thursday 15 February. My topic is: A Strategy for the Times. Visitors are welcome. For details of time and place see http://www.stanz.co.nz/auckland_meeting.php

On Saturday February 17 I am doing a one-day seminar covering the market outlook for 2007 and an update of my new book Hot Stocks. This will go into far more detail than I have the time for at the STANZ meeting. Space is limited and there are only 12 places left. For full details and to book to avoid disappointment, phone: **Phyllis Bergquist in Auckland 09 625 8425.**

Upcoming Speaking Engagements

I am often asked when can you hear me speaking on the market outlook and how to find interesting stocks for 2007. After my accident last year I have not been able to travel, nor did I have the stamina to speak for long. I am now much stronger and have a program of speaking engagement over the next five months:

Melbourne March 15 ATAA meeting. For details see www.ataa.com.au

Sydney March 19 ATAA meeting. For details see www.ataa.com.au

Canberra March 20 ATAA meeting. For details see www.ataa.com.au

Sydney March 23-25 Investment Expo. For details see www.investmentexpo.com.au

Toowoomba April 18 ATAA meeting. For details see www.ataa.com.au

Brisbane April 19 ATAA meeting. For details see www.ataa.com.au

Brisbane May 8 Qld Investors Club. Details later.

Sunshine Coast May 10 ATAA meeting. For details see www.ataa.com.au

Perth June 21 ATAA Meeting. To be confirmed. For details see www.ataa.com.au

Gold Coast July 23 AIA Conference. For details see www.investors.asn.au

This is an early advice. In most cases the details are not yet on the web sites listed. However, put the dates in your diary and check the web sites closer to the day. I will also advise more details in later newsletters.

Takeover Tactics

Question

How do you handle takeovers and potential takeover situations?

Answer

Takeovers are a rather different situation to normal. This is because there are some very specific laws which govern them. There are also two basic types of takeover and the situation for each is different.

One type of takeover is where the bidder offers to buy all the shares. There may be a level of acceptance the bidder sets before the takeover is unconditional – i.e. the

bidder can walk away if it is not met. There is also provision to later declare the bid unconditional before that level is met. Unconditional means you get your money by accepting the bid, no matter what happens afterwards. The other key issue is that 90% acceptance is critical. Once it is reached the bidder can compulsorily acquire the remaining shares. So, a 10+% holding is a blocking stake and can be used to extract a higher price. Note too that the definition of 90% is not a simple one.

The other type of takeover is more a merger. It is done by a Scheme of Arrangement. It is easier to effect if there is a blocking stakeholder, because it only requires a 51% vote of the target shareholders. If it passes the vote it is a done deal. There are some conditions on who can vote, though, that disallow some parties who have a conflict of interest of various kinds.

My tactics are to take each situation on its merits. The issues as far as laws and procedures are concerned are usually well canvassed in the AFR. They will also discuss tactics of bidders and targets plus potential bidders. There are some broad guidelines I use, but I stress that each situation can be different:

If the deal is accepted by the target board and they sell their shares, and there is little likelihood of a competing bid, I will sell into the market and move on. An exception might be if there was a large tax advantage in accepting the bid, in which case I may sell into the bid. As I say, take each situation on its merits.

If there is some reasonable likelihood of a competing bid emerging or if the target is playing hard to get and may negotiate a higher price to get its approval, I may wait and see. A good guide in this situation is if the market is paying more than the bid price, a higher bid is the expectation of the smart money. They may be wrong, of course, but that is where they are putting their money.

One reason I get involved in these situations from time to time is that I focus on buying undervalued companies. They are also attractive to predator companies. It is frustrating sometimes to buy a good company cheaply and find you get taken over before the potential is realised in the price. A pity, but that is how the world works.

The final situation is the trickiest of all. Where a bid is foreshadowed, but does not yet exist – e.g. Coles, Multiplex and Qantas (before the Qantas board forced their hand). Here the decision is a tricky one because if you don't hang in there, you may miss a bid at even higher prices than the initial spike on the rumours/news. On the other hand, it may all come to nought and the bid never eventuates as happened with Coles. My inclination is to read all the comment and watch the price. If your judgement is that there is much doubt the bid will emerge and the price is sliding down from the spike, it may pay to take the money and run. You have to make a choice between the bird in the hand and the bird in the bush that may be bigger, but you may not catch it. Regret is a powerful emotion when you act too soon and miss an opportunity that always looks far more likely in hindsight than foresight. My philosophy is that you make your best call and know that you will never catch them all perfectly, no matter how good you are.

Are You Prepared?

We have been enjoying a very strong bull market now for almost four years. Things are getting a little more wild than they were, which is suggesting that we are closer to the end than we might hope. I don't know when that will be, but I have changed my strategy as set out in detail in my book *The Aggressive Investor*. I have also brought my thinking up to date in my new book *Hot Stocks*. Are you making preparations for a sudden unexpected turn in events, or are you just hoping the fun will go on forever? Do you have the knowledge to have the right mindset to deal with the tough decisions you will have to make sooner or later. My other book *The Psychology of Investing* will help you to recognise and avoid many of the common biases and errors to which we are all subject.

Signed copies of all three books may be purchased from my web site www.bwts.com.au. In addition, I have a special offer: Dr Alexander Elder has given me two signed copies of his new book *Entries and Exits*. In it Dr Elder takes you into 16 trading rooms, looks at the methods used by those traders and dissects two trades by each trader – a winning trade and a losing trade. This is a superbly produced book with full-colour charts and comes with a separate study guide. Anyone buying any one of my three books, or joining or renewing membership of my web site (which may be done in advance) **before the end of February 2006** will be in the draw to win one of the two *Entries and Exits* plus study guide sets. You already have my books? Why not buy one and give it to someone as a gift? You might be really lucky as well as doing a friend a good turn.

Pulling the Trigger

Question

I am a bit confused as to how far should I let a stocks price run after I believe it has made a break out. What is your philosophy on this? I will give an example of a stock I had listed, but got away from me.

Amalgamated Holding (AHD) was earmarked so that if it should breakout above 505 then I would pay very close attention with the view of purchasing. It closed above this price on 7/11/06. To see if the breakout was the real thing (for the use of better words) I let it run and it closed at 525 on the 9/11/07. It stayed at this price until 13/11/07 where it closed at 553, which is approx. 10% gain and has been rising ever since. Is this too much of a gain to get on board if I believed the breakout has been established? The 260 day moving average was still heading up.

I know that there is no hard and fast rule as to when to get in and buy, but I have watched other stocks to the same thing, but in saying that, I have also seen other stocks fall as well.

Answer

My investment method is to buy upward breakouts or new highs in an uptrend. This is not the only method or even the right one. Many people find it hard to buy new highs like this. It is also not a good method for short term traders. Remember that I am an investor and my time frame is months to years. If you cannot buy upward breakouts or new highs in an uptrend, or you are a short term trader, you need to develop a different approach. I do not teach one, because I do not use such an approach except

to the extent that I also buy pull-backs that find support in an uptrend or after an initial breakout. This is described in detail in *The Aggressive Investor*. If you want a short term approach to consider, I could not more highly recommend Dr Alexander Elder's book *Come into my Trading Room*.

As for Amalgamated Holdings (AHD) I had no problem with it. There was a clear breakout on 7 November. I bought it on 10 November at \$5.20. I cannot recall why I took a couple of days to act – maybe I was busy. It had nothing to do with waiting to see what happened. My plan is to see a breakout and buy it. I do not even think about the percentage breakout. I am looking for a big move over months to years. A few percent is irrelevant. However, if you were trading short term, you could have bought it that day or the next day at up to \$5.10. It sounds to me as though the problem is three-fold:

First, how clear are you about your trading plan? Do you know your timeframe and do you have clear written rules for your entry? If you do, and you believe in them, it is easy – you just follow them. Good traders and investors do not agonise over decisions, they see the entry signal and they act without hesitation according to their plan.

Second, you may be looking for a guarantee that the breakout will succeed. I am sorry to bring you a dose of reality, but there is no such thing as a guarantee. I have never found a way to pick the ones that fail from the ones that succeed except using hindsight. The idea is that a breakout has a better than even chance of leading to a trend in the direction of the breakout, but there are no guarantees. Upward breakouts will tend to succeed more often in a bull market than a bear market, but there will always be some that fail. If it were not so, there would be no risk and you would not be able to buy the stock, because everyone else would also want to buy it and there would be few if any sellers.

Third, you may be trying to get a sort of a guarantee by waiting and watching it going up. If this is your plan, fine, but then what is the problem? I suspect that it is not a plan as such, but lack of an entry plan and conviction in following it. In fact, you may be actually increasing the pressure on yourself in a perverse way – the more it goes up, the more you worry about how far it has gone and find it even harder to buy it.

To get out of this bind, you need a clear plan, believed in with conviction. If you lack the conviction, go back and do more testing until you KNOW that it works more often than it fails. That is the best you can do. Then just follow the plan. The danger you have is not in the decision to buy. If you have good money management and trade management, it is not intellectually very difficult. The difficult stuff is the psychology of decision making. Here, my book *The Psychology of Investing* may help you a lot.

Tightening Up Stops

Question

My stops are normally placed under the trough of a weekly trend. This has worked well for me. I now see a time for extra vigilance in stop setting, and the reduction of market exposure. I am therefore currently using one of the following stop methods to tighten stops:

Sell any stock that has been going sideways for the last few months.

Sell any stock that breaks a trend line.

Set the stop 2% under the last trough on the daily chart.

Set the stop under a daily moving average.

I believe I am really changing time scales to daily with most of the methods, but if the stocks are in a bubble situation I feel the above is still appropriate.

Response

I think you are correct that you are to a large extent shifting timeframes. In other words, you are investing and then managing the investments as though they were short term trades. I am not sure that this is sound and is a common mistake people make.

It seems from what you have said that your concern is giving back your paper profits. I agree this is an important issue. My thinking is that it is better to sell part of your holdings, so taking some profits out of the market, than breaking the logic of your plan by shifting time frames. Just as it reduces risk to stage into a position, the same can be done on the way out.

You can do this in two ways. One is my method of selling out of the weakest stocks you own. The other is to sell part of several holdings. Of, course, you can also use both methods at the same time.

More on Administration of Shareholdings

Question

What is the best way to handle the administration of shareholdings.

Answer

All share registries are now electronic. They run off the CHESS system.

There are two ways you can hold your shares:

As a broker sponsored shareholder or

As an issuer sponsored shareholder (an issuer is each company whose shares you own)

It makes no difference whether your broker is internet or phone or both.

I use ONE broker only to keep things simple. That broker also sponsors all of my CHESS holdings. This also keeps it simple.

Your broker can put your tax file number(s) into CHESS and share registries should therefore not need to ask for them. However, in practice, some still ask you to fill out a form and return it.

Your broker can also put your address into CHES and that is how the registry will send you the paperwork. However, if you have owned a share before at a different address, the system does not work – they send the paperwork to your old address. See the Tricks of the Trade article in Newsletter 65.

Your broker can not put your banking details into CHES for direct credit of dividends (some companies make this compulsory). That is why the registry will send you a form to fill out. However, this also does not work properly. If you owned a share before and supplied different banking details, they will use the old details and not ask you or give you a chance to update them.

I found the only way out of these last two issues after I changed address and bank details was to move all my holdings to a new HIN number and start again. It is a pain, but at least the problems stop.

So long as you avoid the address and bank details changes problem, it works quite smoothly. It is just a matter of filling out the forms when they arrive and sending them back. Each one only takes a few minutes.

Some share registries also have facilities to put details into their web site. However, it is a pain because you have to do it for each and every company and the web sites are none too user friendly in my experience. Some things cannot be done on the web sites and have to be done by mail anyway. I avoid the web sites to keep sane in the process.

One day we will actually become a clever country and be able to put everything into CHES and it all flow through to the share registries. Don't hold your breath waiting, though.

Investing with Borrowed Money

Question

Why do you not advocate gearing as a wealth creation tool?

Answer

I think you are misrepresenting my views on gearing. I have never said that I do not advocate the use of borrowed money for trading or investing. What I have tried to say it two things:

Firstly, that I do not consider it appropriate for me. There are several reasons for this. One is that I am an aggressive investor. I try to time the market, which is difficult and dangerous, but can be rewarding if you are good at it. I also focus my portfolio in a few large holdings, which is also more risky than a diversified portfolio. Finally and more importantly, I focus on smaller companies which are more volatile and carry a liquidity risk. Investing is about the balance of all the risks you have to manage. Because I am taking a very risky course in my plan in these areas, I take lower risks in other areas of the plan. One of those is to not use borrowed funds.

Secondly, while not completely discounting its use by some investors and traders, I do stress that the risk in the investment or trading plan is increased by using borrowed money. Of, course, the risk level is directly related to the size of the borrowings relative to the equity. So, if you have equity of \$100,000 and borrow

Copyright Colin Nicholson.

The newsletter may be reproduced and distributed in whole or in part, providing you do not alter it in any way and acknowledge its source.

\$40,000 dollars, you have less financial risk than if you have equity of \$100,000 and borrowings of another \$300,000.

Using this last example, the issues become clear. If your portfolio goes up by 50% (\$200,000), then your return is 200% of your equity. However, if your portfolio falls by 25% in a crash (one day in 1987) or a bad bear market, you will have a loss of 100% of your equity. This is why gearing is dangerous. It works savagely in both directions.

Another aspect I like to stress is that there is gearing at many levels and they all add to risk. It becomes clear if you take an extreme example (which is not as rare as you might think):

Your equity is \$10,000. You borrow another \$10,000. You use CFDs on a conservative 10% margin, so your portfolio is now \$200,000. The companies you invest in are geared between 50% and 70%. You now have three levels of gearing. The big danger is that now, if your \$200,000 portfolio falls by 5%, you have a 100% loss on your equity. This I find very scary. As I said, this is an extreme example, but even if you are not as aggressive as this in your gearing level, it is still very risky. Try playing with the numbers for yourself.

Question

I am not sure what to do with trading profits when my portfolio is geared. I usually reinvest all of the profits along with my own capital in new positions. I don't pay off any of the debt. This is fine with a rising market, but if the market turns down, paying interest on borrowed money does not seem appealing.

Answer

I think this is an easy one. The logic of using borrowed money (sensibly) is that if you can earn 12%pa on your trading and you can borrow money at 8%pa, it makes some sense to trade the borrowed money. However, if the market falls and you can no longer make in excess of 8%pa on your trades, it makes no sense to borrow the money any longer until the market improves.

To understand this another way, suppose you are a toy retailer. Christmas is your big season. You borrow against your overdraft to acquire the stocks for the season. After Christmas you will hopefully have sold most of the additional seasonal stock and you reduce your overdraft until next Christmas. Every business does this to some extent where the business has seasonal or cyclical peaks and troughs.

What I suggest you might do is to make a quarterly assessment of your return versus the costs of borrowing. If you are not making more than the cost of borrowing, maybe you should cut back the borrowed funds until you can find the conditions favourable to trading with results in excess of the borrowing cost.

You said you were a trader, so I have answered in those terms. The time frame for an investor would be much longer. An investor may more sensibly make annual assessments and look at a three or five year average return. However, the principle still remains true. Investing borrowed funds makes no sense unless you make more than the cost of the credit, and the risk of loss is greater if you do not achieve that objective.

Overseas Market Data

A reader has suggested that a good early data source for overseas markets, not restricted to stocks, is the Wall Street Journal Market Data Centre:

http://online.wsj.com/mdc/public/page/marketsdata.html?mod=djm_eMailMDCMW

Charting Software for the Apple Mac

In the previous newsletter, I asked for readers to provide any information they were aware of about charting software for the Apple Mac. Several readers sent me information and I would like to thank them for their time and effort. I have summarised the information provided below. I have not checked its accuracy. Readers intending to investigate it should make their own evaluation and not treat any of this as a recommendation, because I have not made any evaluation of the information or the software.

From a reader who has been in the beta test group for ProTA for Mac OS X:

This is a fully featured charting application for the latest Mac OS (Mac equivalent of XP). It is a complete rewrite of an earlier Mac OS 9 version (equivalent Windows 95). Visit <http://www.beesoft.net/> for details.

The retail version of ProTA for Mac OS X costs US\$299 for the fully featured version and US\$129 for a reduced features version.

The full User Manual is available for free download so you can assess the features and capabilities of the program in detail.

The reader adds that for several years he has used MetaStock but he is now generally using ProTA because it is easier to use.

The reader also supplied some useful information on data for Pro TA:

In terms of data, ProTA can be configured to import any comma or tab separated data file. Personally he has been using history data from National Online Trading because this goes back to 1990 but other beta testers have been using similar data from Commsec which he is told goes back about 5 years. There is a third party application called StockXloader from <http://invest.bragit.com/stockxloader.html> which will take the data from yahoo with up to 5 years history and with an intraday 20 minute delay. Of course you have to look after your own stock splits etc with this type of raw data (ProTA is very helpful in this regard), I'm sure that ProTA could be configured to take 'processed' data from one of the recognised Australian data vendors too as it already does with US data vendors.

Another reader says that ProTA is somewhat similar to MetaStock in terms of capabilities, programmability etc.

He also believes that the new version released by Beesoft is a major update to make it work correctly with the most recent computers.

From a former TradeStation user:

He uses TradeStation, but believes that Behold is very similar to TradeStation and has the same language/syntax etc. He also believes that it also allowed for portfolio testing of strategies.

Contact Investors' Technical Services

(commonly known by a shortened version of their name: NTech).

P.O. Box 164075, Austin Texas 78716-4075

Email info@bhld.com or through <http://www.bhld.com>

Phone (512) 347-8472

From a Personal Hotline user:

She uses Mac charting software called Personal Hotline from Trendsetter. Website is <http://www.trendsoft.com/>

She suggests contacting them to get an Australian distributor, or deal directly with them (she found that very easy).

They will provide an Aussie contact for a historical data CD. I get my daily data emailed from Paritech - after midnight data is quite reasonable.

The reader has been using Personal Hotline for about 6 years - it has all the indicators, etc she wants. She also finds the support excellent.

From two Mac and MetaStock users:

The new MAC which uses the Intel chip and operating OSX can run a virtual PC within the MAC. Software to do this can be bought from <http://www.parallels.com/>. Another reader says it costs \$US50.

The virtual PC can be set up with different operating systems. He uses Windows XP and runs Metastock as well as other Windows programs such as Office and COMMSEC Professional Trader. The virtual PC networks with the MAC and thus has normal internet functions .

Both the Mac and the virtual PC can be running together and you switch between with the click of the mouse in that part of the screen which has the system you want.

The other reader describes that charting on a Mac is easy. He has a Mac laptop (with the Intel chip) and runs MetaStock. He installed parallels and then WindowsXP and then MetaStock. It runs at full speed just like a PC.

One added advantage is that he can easily make a copy of the Windows environment (which takes about 2 minutes) as a backup. If he does get a Windows virus, he just deletes that copy of the Windows environment and starts the copy he made.

Some other information from readers:

There are other Mac charting applications. The other commonly used Mac program is the Personal Analyst series from <http://www.trendsoft.com>. Paritech used to market Trendsoft products for the Mac in Australia but I don't know if this is still the case.

Copyright Colin Nicholson.

The newsletter may be reproduced and distributed in whole or in part, providing you do not alter it in any way and acknowledge its source.

MarketAnalyst <http://www.market-analyst.com/>

Investor/RT <http://www.linnsoft.com/>

A summary list of Mac stockmarket applications is given at <http://www.pure-mac.com/ticker.html>.

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.