Colin Nicholson: Newsletter 67

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I must apologise for the elapse of time since the previous newsletter. I have been very busy preparing presentations, travelling and presenting them.

Interesting Times in the Markets

I am often asked by readers to give my views on the markets in this newsletter and on my web site. Unfortunately, it is not legal for me to do so. I have no wish to be a financial adviser, so I have chosen not to seek a financial adviser's licence. I do not give financial advice. What I am about is teaching people what I have learned over almost 40 years of trading and investing. The only thing I sell is educational books and access to my copyright work that has been published in magazines, newspapers and newsletters. In the past I have also done some face-to-face teaching, but this is a low priority for me at present because of the workload of other commitments.

As well as being an author, I write currently for *AFR Smart Investor* magazine and in *The Australian Financial Review* – mostly in Tuesday's *Market Wrap* section, but occasionally for the *Smart Money* section in the Weekend edition.

In *AFR Smart Investor* magazine I am now writing a column that deals in detail with a single stock, showing how I analyse it from a fundamental analysis and technical analysis viewpoint. I hope that readers who follow my column will be able to improve their analysis skills by studying the examples of my methods of analysis.

In *The Australian Financial Review Market Wrap* columns I discuss markets and individual stocks mainly as a chartist, although I touch on investment strategy and tactics along the way. On Tuesday March 6, I departed somewhat from this model to deal in more depth with what has been happening in the markets recently and what strategies I think investors should adopt going forward. Key failure points on the chart were highlighted. I am not able to supply copies of this column directly for legal and copyright reasons. However, you can access my work through public libraries or www.afraccess.com, though that source is not free. I also publish my work on my members' web site, but under my agreement with Fairfax, I can not do this until three months have elapsed after initial publication. For information about what is on my members web site see www.bwts.com.au

In addition, my book *Hot Stocks*, which I wrote in early November 2006, I provides a detailed analysis showing how I reached a view about where we were in the bull market cycle. I then discussed my strategies for 2007. This analysis and strategy suggestions, which are based on my investment plan as outlined in my book *The Aggressive Investor,* are still very relevant in the present situation. For details of what is in my books, see my web site www.bwts.com.au, which also allows you to order a signed copy directly from me.

Inconvenient Truth

(Originally published in the BeyondInvest December newsletter)

Earlier this year some interesting research was published on an aspect of technical analysis that is widely used in the markets. The work was by the academic Roy Batchelor, HSBC Professor of Banking and Finance at Sir John Cass Business School, City of London and PhD researcher Richard Ramyar and has the somewhat provocative title *Magic Numbers in the Dow.*

Batchelor and Ramyar point out in their introduction that although technical analysis is widely used, it has been regarded with suspicion by academics. They observe that:

The root of the problem is in the failure of technical analysts to specify their trading rules and report trading results in a scientifically acceptable way.

This is an issue that has concerned me personally for a long time. I have spent a great deal of time and effort trying to promote the use of technical analysis, despite the suspicion of academia and outright condemnation by fundamental analysts. It would be much easier if there was a great deal more academic testing of technical analysis concepts that could be used to substantiate the claims by technical analysts.

Batchelor and Ramyar point it that a great deal of academic research has been done in recent decades on various aspects of technical analysis that lend themselves to testing. By no means have all of the results been negative. Batchelor and Ramyar are in fact receptive to the idea that much of technical analysis may well be able to be proven of real value. Nevertheless, there is also a large body of beliefs in technical analysis that are so subjective and lacking in specificity that it is difficult to test them.

Batchelor and Ramyar chose to research an aspect of technical analysis that is widely used and believed with an almost religious fervour:

This paper tests a popular but previously untested proposition about the behaviour of the stock market. The proposition is that when the market changes direction after a period of trending prices, the magnitude and duration of the next trend is not random, but depends on the magnitude and duration of the previous trend. Specifically we are interested in whether the ratios of successive trends cluster around Fibonacci ratios or ***round numbers****.*

They chose for the purpose of testing Fibonacci and round number beliefs a data set of daily values for the Dow Jones Industrial Average (DJIA) from January 1915 through June 2003.

A great deal of the paper is taken up with a review of the previous research that has relevance to the methodology they chose to use. The specific problem they were faced with was determining an objective method of defining peaks and troughs in the DJIA. They take the reader through a very detailed discussion of the pros and cons of the alternative methods used for similar purposes and work towards a clear explanation of the method they chose. It should be noted that:

1. Having run their chosen method over the data set and arrived at defined peaks and troughs, they ran the results past a competent technical analyst, who attested to them being realistic in terms of general market practice.

2. They were concerned that there may have been some bias caused by the sensitivity of the parameters they used. They tested other parameters either side of their chosen set and the results were essentially the same.

They made a point of testing daily highs and lows, rather than closing prices. This is clearly realistic in terms of market practice. They also tested a range of different applications of the ratios, recognising that, for example, some technical analysts work in terms of percentages rather than absolute DJIA values.

Considering the widespread use and support for the utility of Fibonacci ratios and round numbers in determining where support and resistance might be expected, their results were surprising:

A few significant ratios appear, but no more than would be expected by chance given the large number of tests we conduct.

Their conclusion:

Our conclusion must be that there is no significant difference between the frequencies with which price and time ratios occur in cycles in the Dow Jones Industrial Average, and frequencies which we would expect to occur at random in such a time series. In our introduction, we noted that empirical evidence from academic studies suggests that not all of technical analysis can be dismissed prima facie. The evidence from this paper suggests that the idea that round fractions and Fibonacci ratios occur in the Dow can be dismissed.

Many technical analysts are going to find this an inconvenient truth in the sense that it will challenge their beliefs about part of what they do in analysis and trading. There will be those who want to know which ratios appeared at all and try to clutch at straws that represent no more than chance. There will be others who are even more deeply in denial and try to explain it all away by saying that is fine for the Dow, but what about other markets? This is a good point. However, Batchelor and Ramyar have set a standard of research that should be undertaken before relying on Fibonacci ratios or round number ratios in serious trading and investing.

I must say that I had myself believed there was some utility in these ratios, but no longer. I thank Batchelor and Ramyar for their excellent work in establishing that these ratios are no more than something akin to mysticism.

Upcoming Speaking Engagements

I am often asked when I will be speaking around the country. After my accident last year I have not been able to travel, nor did I have the stamina to speak for long. I am feeling stronger now and I have a number of speaking engagements lined up over the next few months. Most of the talks will be on the market outlook, what strategy is appropriate for the conditions and how to find interesting stocks for 2007. I have set up a new page on my web site which details where and when I am speaking and what the topic will be. Please go to www.bwts.com.au and look on the left hand side of the home page for the link to the Hear Colin Speak page.

Each entry on the web site will give a web site or other source for information on the time and place of the meeting.

All Australian Technical Analysts Association (ATAA) meetings are free for members and first time visitors. Repeat visitors pay a small fee. Visitors will be very welcome.

One or two of the other meetings may not be open to visitors. I will advise this on my web site.

There is an entry fee for the Investment Expo and there is a registration charge for the Australian Investors Association (AIA) conference.

I will advise the dates as far ahead as possible. Details may not be available until later. However, put the dates in your diary and check the web sites closer to the day.

Timeliness of PE Ratios

Question
How up-to-date are the price earnings (PE) ratio numbers in the *Australian Financial Review* and elsewhere?

Answer
As stated at the top of the table each day in the *Australian Financial Review*, the earnings figures used are historical rolling 12 month totals based on company provided data in interim and annual reports.

It is my understanding that most historical ratios would be calculated this way. The only time you need to be a bit careful is around the reporting season when the rush of results sometimes means there is a delay of a week or more in updating the data in the tables. Just as at any other time, the tables are a useful starting point in arriving at a short list of prospects, but you need to check the figures against the company reports before acting on them.

Some analysts do not use historical earnings data for their PE ratios, they use prospective, which means forecast, earnings. You might feel that these would be more up-to-date at first glance. However, they are only going to be as good as the analyst's ability to forecast. Such forecast may also have other motives if the analyst works for the company's house broker or his/her firm is trying to promote the company's shares.

A halfway house is Aspect Huntley, whose PE ratios are based on the last six month's actual earnings and their forecast earnings for the next six months. The same caveats apply to the forecast component as in the previous paragraph.

Entries & Exits Winners

As announced in the last newsletter, everyone who ordered one of my books, joined my members only web site or renewed their membership in February had an entry to a draw for one of two signed copies of Dr Alexander Elder's book *Entries & Exits* plus the study guide that complements it. The two books and study guides were kindly donated by Dr Elder. His generosity is greatly appreciated.

The two winners were:

Richard Wood (New Zealand)

Peter Galov (Tasmania)

Their book and study guide set is on its way to them.

Some readers may not be familiar with *Entries & Exits*. In it, Dr Elder visits sixteen trading rooms. Dr Elder interviewed each trader about their trading methods and general approach to trading. Then he dissects two trades for each of the sixteen traders. One is a winning trade and the other is a losing trade. Losing trades can be every bit as instructive as winning trades. Dr Elder shows you the set-up on a chart and explains the reasoning. You can then form a view before Dr Elder tells you what happened. Most importantly, Dr Elder discusses his views on what can be learned from the trade and its outcome. The book is beautifully presented in hard back form in large format with colour charts.

Readers who did not win may buy a copy from Dr Elder through his web site www.elder.com. Don't forget to ask Dr Elder to sign the book for you when you place your order.

It is perfectly safe to order by credit card from Dr Elder's secure web site. However, if it still worries you, send your order by fax or telephone Inna Feldman in New York office hours. All contact details are on Dr Elder's web site.

I do not accept any monetary reward from sales of Dr Elder's book, all of which I strongly recommend because I think he is the world's best writer and educator on short term trading.

Some Feedback on *The Aggressive Investor*

I recently received this feedback from a reader:

*I have just read **The Aggressive Investor**, borrowed from the local library and have decided I need to own a copy as my guide. Well done! It is excellent. Clear, simple and honest.*

You can purchase a signed copy of *The Aggressive Investor* from me for the recommended retail price of $49.95 including GST and postage to Australian addresses. Use the safe online order facility on my web site www.bwts.com.au or phone me on 02 9439 9724 in Sydney office hours.

The Market’s Money

Question

What do you think of the idea of selling some of a holding to cover the purchase price and letting the rest ride for nothing?

Answer

My personal opinion is that this is one of the main mistakes people make. I discussed it at some length in The Aggressive Investor under the heading of The Market’s Money (page 17).

My view is based on the idea that you are investing YOUR money. THE MARKET is not a person and it does not trade or invest, so it cannot have any money. It is YOUR money that you are risking, whether it is your initial invested amount or paper profits that you have not yet realised. In the book I explain this at some length using an example. Here is another attempt to explain it:

The idea that your profits are not yours is a psychological crutch that allows you to avoid responsibility for your decisions.

If you invest $7,000 and sell out for $6,000, you have lost $1,000 of YOUR money. I am sure you will agree with this.

If, on the other hand, you invest $5,000 and your shares increase in value to $7,000 and then fall to $6,000 before you take your profits, you have lost $1,000 of YOUR money, not somebody’s money called THE MARKET. If you had sold at $7,000, that additional $1,000 would have been YOURS. If, instead, you had sold at $7,000, would you consider that you should send a $1,000 cheque to the market, because it was not your money, but the market’s money?

The whole idea that unrealised profits are somehow free money that you can take risks with and not have to take responsibility for giving back is a very dangerous mindset to have. You will be a much better investor once you get this idea right out of your vocabulary and start to take total responsibility for running the same risks with every dollar of capital, whether it is in the bank or is an unrealised profit in the market.

Some Feedback on *Hot Stocks*

I recently received this feedback from a reader:

I really enjoyed reading your recently published book, Hot Stocks*.*

It is the perfect follow up to The Aggressive Investor*, elaborating on strategy, & especially relevant at this crucial juncture in the market.*

The stocks you discuss are both interesting & thought provoking, giving the reader an insight into the decision-making process of some unusual circumstances.

I found the layout & highlighted sections made the book really easy to read & appreciate your concise simple use of language.

It forms an important addition to my library of trading books.

You can purchase a signed copy of *Hot Stocks* from me for the recommended retail price of $29.95 including GST and postage to Australian addresses. Use the safe online order facility on my web site www.bwts.com.au or phone me on 02 9439 9724 in Sydney office hours.

Arbitrary Stops

Question
Should I set my trailing stops to sell out on a 10% drop from the previous day's closing price?

Answer
I am not sure how to really answer this one. I do not understand the logic of using an arbitrary stop of 10% below the last closing price. Does the logic of your trading plan and your back testing substantiate 10% as a valid arbitrary rule? If so, I would be interested to see your research.

My idea is that, assuming that you are trading on technical analysis, a stop should be situated where your trade has gone wrong based on what your technical analysis trading model suggests should happen. Without full knowledge of the logic of your trading plan, I am unable to comment on how valid a 10% arbitrary stop would be. Instead let me try to use an example of my reasoning.

Let's assume that your method is to trade an uptrend using a 22-day exponential moving average (EMA). This implies that your model would be that while the price stays (or closes) above the EMA, the trade is proceeding to plan. However, if the price falls (or closes) below the EMA, then the uptrend has failed.

If this was your plan, a 10% arbitrary stop would make no sense at all.

If the EMA was only 5% below your last closing price, then a 10% stop would be far too late to act on the logic of your plan.

If the EMA was 15% below your last closing price then a 10% stop would close you out while your trade was still on perfect track.

As I said at the start, to assess the idea of a 10% arbitrary stop, I would have to know the logic of your plan and see the research that supports it. I do not even pretend to know everything, but I have never been shown any system where an arbitrary percentage stop makes any sense in terms of the logic of the trading plan or which is based on researching many past situations.

I will say, though, that a 10% arbitrary stop might be better than having no stop at all.

However, it seems to me that arbitrary stops can result in late decisions on failed trades, such that the loss is greater than it should be, or premature decisions on successful trades that miss out on potential additional profits.

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.