Colin Nicholson: Newsletter 68

4 May 2007

The interval between newsletters has been a bit stretched out this year. I have been very busy travelling and speaking to groups around the country.

Starting Out

Question

I am a beginner at share trading and starting out with small capital. Therefore, I was thinking of either taking a margin loan or trading in CFDs. Do you have an opinion for or against either?

Answer

I have learned the hard way to be a conservative trader and investor. I have found that it takes most of us at least ten years to become a good trader or investor. This is the same time rule that applies to most professions. The name of the game is to try not to lose too much while you are learning.

The most dangerous gambler is the guy who bets on the first race he attends and wins. He then thinks it is easy and is hooked. Usually he then learns the hard way that it is not easy and loses as he learns. A similar thing applies in trading. In a strong bull market it is not too hard to make some money quite quickly and the new trader thinks it is easy. Wall Street notoriously calls this mistaking the bull market for brains. Then the market gets a bit tougher – either by ranging for a while or even falling in a correction. Then the beginner finds out how hard it is to make money except in a strong bull market. And even in a strong bull market, many beginners can lose money.

Both margin loans and CFDs involve borrowing money, which increases financial risk. All my experience suggests that while learning the craft, we should avoid borrowing money. Once we have a good track record of making consistent profits for a few years in different types of markets, then we can consider using borrowed money, also called using leverage.

My view of the way to come into trading is this:

1. Go to school and learn the knowledge. The best place for this in Australia is FINSIA. If you are not a graduate, you can do the Graduate Diploma subjects *E114 Technical Analysis* and *E171 Specialised Techniques in Technical Analysis* by joining the Australian Technical Analysts Association (ATAA). See the ATAA web site www.ataa.com.au and FINSIA at www.securities.edu.au.

2. Develop a trading plan and paper trade it until you have established that it works. You can also test it on past data, which is good, but not a substitute for paper trading in real time going forward.

3. Start to trade real money that you own and could afford to lose. Ideally do one trade at a time (you only need limited capital to do this). Close that trade before you

do another one. Continue one trade at a time until you rack up a series of profitable months.

4. Then start to trade more than one position at a time and again rack up a track record before you think of borrowing any money.

5. Once you have a couple of profitable years, then and only then, think of borrowing some money to trade with. Don't borrow too much in relation to your own capital. Then try to run up a profitable year before borrowing greater sums.

6. Use CFDs to borrow money if you must, but use stops. Before you start CFDs, make sure you understand how the CFD provider and their web site works. Know all the rules in all the situations. Give preference to a CFD provider who has a facility for you to paper trade on their system for a few months before you start. If you don't learn the ropes before you use real money, the market will teach you the ropes the hard and expensive way.

There is one other caveat I would make. You say you have small capital. I am not sure what you mean by small. Most experienced traders will tell you that if you try trading with less than $50,000, you will tend to be taking risks that make it highly probable you will lose money. Some people put the amount of capital required higher than this at $70,000 or $100,000. The key point is that the more capital you have the lower your risk level. Big experienced traders take smaller risks than beginners with small capital. That is why they are successful. If you do not yet have enough capital to trade safely, I suggest that you start saving while you are learning. You have quite a few years to save the required amount. Borrowing money is not really solving the problem of insufficient capital. It is actually increasing the pressure on you and will magnify losses, just as it magnifies profits.

I know this is not what you want to hear and that there are lots of people out there in the market place telling beginners what they want to hear. I am trying to tell you how it is in the real world, not a wishful paradise. Just remember that you will be competing in the market with highly intelligent, highly educated and experienced people. If you come in as neophyte with no knowledge and experience, they will eat your lunch.

When Can I Hear You Speak?

Question
How often do you give talks in Canberra and to what organisations?

Answer
There is no regular pattern, but I have spoken in Canberra few times. Only the Australian Technical Analysts Association (ATAA) has asked me to speak in Canberra. I last spoke in Canberra to the ATAA on March 20 this year.

I am speaking at all ATAA meetings this year between January and June (Brisbane, Toowoomba, Sunshine Coast, Newcastle, Sydney, Canberra, Melbourne, Adelaide and Perth). I also get invitations to speak from time to time by The Australian Investors Association (AIA), the Australian Shareholders Association (ASA) and various other associations and bodies. Also I spoke at the Investors Expo in Sydney last year and again this year.

I am speaking at the AIA Annual Conference this year (Gold Coast July) and giving the same talk in Perth in June.

I am speaking at the ATAA Annual Conference in Brisbane in October.

All my speaking engagements are listed on my web site www.bwts.com.au on the Hear Colin Speak page. I indicate when visitors are welcome (some meetings have no space for visitors or their policy precludes visitors).

Decisions, Decisions

Question

I've very much enjoyed studying your trading plan as outlined in The Aggressive Investor. You are very careful to put in protective stops as insurance against a market trend change. Do you have some kind of corrective measure if your analysis of the current phase of the market turns out to be wrong or premature? For example, if you've reduced your shareholdings because of a mistaken belief that we are in the final phase of the current bull market, how do you identify the mistake and what steps do you take to rectify it?

Answer

This is a very perceptive question. It is in fact not an easy question to answer briefly, because there are a number of issues that are involved.

In your question you made a statement as preamble to your question:

'You are very careful to put in protective stops as insurance against a market trend change.'

Let me address this first. It is a statement that I have encountered from many people recently as I have been speaking to groups around the country. Some of those questions have been rather more argumentative than yours. For example, when I teach how I manage market risk by varying my exposure to the market I am greeted with the proposition that surely I only need my sell stops to protect me.

I would not deny that sell stops are a key part of my investment plan. However, the sell stops apply to individual stocks. They are a measure to control specific risk, which is the risk inherent in each individual investment. Your preamble was about sell stops dealing with a market trend change. They do not do that, sell stops mainly deal with trend change in specific stocks. Only very indirectly do they approach the problem of trend change in the overall market.

I do not have a sell stop for the market as a whole. If you think about it, a sell stop on the whole market would not make much sense. I would be either in the market or out of it, with nothing in between. I would also be in the position of selling individual stocks because the market sell stop had been violated, even though the uptrend in that stock was still quite intact.

So, what I do is to separate these two things in my mind and in my plan. I manage market risk through the level of exposure to the market and I limit specific risk using money management, diversification and sell stops. I think it is very important to see these two distinct elements of my investment plan quite clearly and separately based on the primary risk element they are there to manage.

There is an important aspect to not relying on sell stops for management of market risk. Suppose that I had 16 positions, with an average risk to my stops of 1%. Then suppose we had a really sharp fall at the end of the bull market. 1987 was an exception, which if it was repeated would devastate the portfolio. Instead, just consider an ordinary sharp fall of about 10%, which triggered all the stops and with slippage cost me 20% of capital. It would then take a 25% gain on my remaining capital to recover the losses. This might easily mean I miss out on two years or more of potential gains.

This is why I think an investor has to have a strategy to manage market risk. A trader might use Dr Elder's method of never risking more than 6% of total capital. Most good traders may rarely have all their capital in the market and no matter how much they have at risk, the 6% rule Dr Elder uses will manage that issue. However, an investor using a plan like mine will be quite aggressive in wanting to have 100% of capital in the market in the first two phases of a bull market when the risk is relatively low. When the market moves into the third phase, rampant speculation, I drop my exposure initially to 70% of capital and then as low as 30% if the market is very hot or comes off a strong peak (which could be the last peak in the bull market). This achieves something like Dr Elder's approach in terms of how much of my capital might still be at risk at the end of the bull market. It is not the same exactly and will tend to be a bit more aggressive, but it is a similar outcome, using a different method.

Having discussed that very important issue, I will now address your main question.

The superficial answer is the same one John Maynard Keynes gave to an interviewer when asked what he would do if what he wrote in the *General Theory of Employment Interest and Money* turned out to be wrong. His reply was along the lines that if he was wrong, he changed his mind!

The problem with that answer is that it conceals as many aspects of the problem as it illuminates. This is because in economics and investing, there are many issues for which there are no absolute right and wrong answers. There are many ways to make money in the markets. Some work out better than others at a particular time and place. Consider value investing. It will work really well for long periods. However, there may be equally long periods when investing in growth stocks gives a better result. Nothing I just said proves anything is absolutely right or wrong.

Your question relates to market phase analysis. What you are asking is what I do if I am premature in my judgement of the phase we are in. I think that is what you really wish to examine. Let's leave being right or wrong out of the discussion.

Phase analysis is carried out by looking at all the things that are happening in the market and the economy around us. There is no one single judgement to be made. The process is to take each of the markers of each phase (these are outlined in my book *The Aggressive Investor*). We make a judgement on each relevant aspect. Then we form an overall view of where we are on the balance of available evidence.

Take as an example the last phase of a bear market – distress selling. When I detect that we are in that phase I want to begin to move up to 20% of my capital into the market. I look for uptrending stocks and buy some of them. If I can't find any uptrending stocks, I am indeed premature and wait till they appear. If they appear and I buy them and then their uptrend fails, my sell stops take me out of those stocks as usual.

Now consider the present market. As I explain in detail in my book *Hot Stocks*, I have formed the opinion that we are in the rampant speculation phase of the present bull market. This overall judgement rests on a range of factors, some of which are far more definite than others. It is therefore an overall balance. As time goes on, some of these factors will vary – for example the likelihood of inflation rising and resulting in further interest rate rises. So, I may be more certain about my judgement, or less sure about it as time passes. I don't see this as a problem. My market exposure strategy calls for me to be between 70% and 30% invested. That is a wide range. So, I may think we have entered the rampant speculation phase, but that it is still early days. In that case I might sell down to 70% invested. Then if the market rises into a strong speculative peak, I might shift quite quickly towards 30% invested.

Now, comes the point I think you are asking about. Suppose that the market comes off that strong peak. Then it falls in a sharp correction. The move down to 30% will have been a good one. If it is the final peak I will have been very happy with that strategic decision. Now suppose instead that after the correction, the market starts rising again. I might now form the view that there is more to come of the rampant speculation phase and increase my exposure to any level between 30% and 70% as I think is appropriate and also assuming I find the opportunities within the rules of my investment plan.

What I am explaining here is that investment decisions are not on/off choices, but are judgements that can vary in their level of conviction from time to time. My strategy allows me enormous scope to vary my exposure depending on my current judgement.

There is one big risk in all of this and that is in the area of psychology. We humans are very adept at rationalising what we want to believe. We have a strong tendency to decide something and then assemble the evidence that backs that conclusion, while subconsciously ignoring the contrary evidence. I try to deal with this by breaking down the judgement into a series of factors and looking in each area at the pros and cons of the view I am reaching. I am far from perfect at this, but I do my best.

In conclusion, I would adapt Keynes' answer to say that as my views change I modify my strategic response accordingly, within the parameters of my investment plan. Even so, in everything I am basically a sceptic and I try to challenge every strongly held belief using the techniques of contrary thinking. There is a good basic discussion of contrary thinking techniques in my book *The Psychology of Investing*. This is in many ways the most important book I have written because it deals with the biases and errors all humans fall into in making investment decisions.

Special Offer

In the last newsletter I was remiss in not mentioning the special offer by Dr Alexander Elder if you wish to buy a signed copy from him of his brilliant book *Entries & Exits*. The offer is that he will mail it to you from New York at the special postage rate of only US$6.00. This is much cheaper than Amazon and most Australian booksellers.

Dr Elder's price is US$55.00 for *Entries and Exits* and US$75.00 for both *Entries & Exits* plus the *Study Guide.* The US$6.00 postage applies whether *Entries & Exits* is purchased alone or if you buy both the *Entries & Exits* and *Study Guide* in one lot.

Important

To buy a copy from Dr Elder, go to his web site www.elder.com. **Don't forget to ask Dr Elder to sign the book for you when you place your order and also say you are a reader of my newsletter and request the US$6.00 postage offer.**

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.

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.

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

To Hedge or not to Hedge

Question

Do you use put options as a protective measure in your investment plan?

Answer

No, I do not use put options for any reason at all in my investment plan. For a full explanation of my investment plan plus case studies and examples of how it operates in practice, please see my book *The Aggressive Investor*, which may be bought off my web site www.bwts.com.au or through good bookshops.

Question

Why do you not use put options as a protective measure in your investment plan?

Answer

When you ask about using put options as a protective measure, I assume you mean as a hedge against the price of a share falling. In very simple terms, this would be achieved by either buying an at the money put option for the number of shares held to lock in the current profit or an out of the money put option for the number of shares held to lock in a stop-loss situation. The advantage of this would be that for a small cost (the option premium), a guaranteed result could be achieved, without selling the shares.

There are three likely outcomes.

The first is that the price of the shares moves sideways during the life of the option. In this case, the result will have been to have reduced the current profit by the amount of the option premium.

The second is that the price of the shares rises. In this case also, the result will have been to have reduced the future profit by the amount of the option premium.

The third is that the price of the shares falls. In the case of the at the money option, the effect will be to have locked in the current profit less the cost of the option premium, by exercising the put option. You could also sell the put option for a similar, but not necessarily the same result. In the case of the out of the money put option, its result will vary depending on how far the price of the share falls relative to the strike price of the option.

This seems a lot of trouble to me. It only makes any sense if your tax rate on your investing is very high, so that you might want to avoid crystallising a capital gain, even if it is discounted 50% for holding more than 12 months (or if you bought the shares before capital gains tax started). If you are able to invest through a self managed superannuation fund, your tax rate should be quite low, or even non existent if you are 60 after June 30 this year.

There is also the issue of opportunity cost. If you spend a lot of time holding onto an at risk position by hedging, you reduce your profit and also forgo the profit you might have made by switching to a share with better prospects.

So, the big psychological trap in this hedging approach is that you avoid making a decision and it ends up costing you missed opportunities. To my mind, it is better to say that, if I am worried about a stock, I should take the profit and reinvest the money elsewhere while I see what happens. When the doubts dissipate, I can always buy the stock back again. Brokerage is cheap these days.

As asked, I have explained my thinking, but as always in investing there is no single right or wrong answer. Every one of us is different and we need to work out an investment plan that we are comfortable with. Hedging may well be right for your situation and temperament. I have considered it and come to the conclusion that it is not my optimal approach. A big element in that for me is the fear that it would make me lazy by the hedge being a psychological crutch to avoid making hard decisions. It has worked better for me so far to take a strictly logical and cold-blooded decision on each case and then move on.

By the way, there are other ways to hedge, but they are outside the scope of your question. My attitude to the alternatives would be the same as for put options.

Feedback from the reader who asked the question
I appreciate the time you have taken to answer my question. I am the proud owner of two of your books – I have read **The Aggressive Investor** *twice. You will be pleased to know that both my brothers bought it and they both read it and found it extremely valuable reading. One, like me, has also read it twice.*

A Clarification

Question
In newsletter 64 you discussed the question of how many stocks in a portfolio, but I am struggling with your reply. You say that you used to risk 2% and gradually reduced it to 0.5%.

Are you indicating that you used to risk 2% (50 stocks in a portfolio) and now you only risk 0.5% (250 stocks in a portfolio)?

Or are you saying that you set stop losses and bail out of stocks if 0.5% of the portfolio is lost by one of them?

Answer
I am sorry that I failed to explain this clearly for you. I will try to clarify it all for you now. As an aside, if you read my book *The Aggressive Investor*, and particularly the case studies, it would all be much clearer. The person I was replying to, as I recall, had read the book already, so I was addressing the question on that assumption.

Your question suggests that you seem to be confusing two quite separate concepts - position sizing and diversification - and applying the percentages to the wrong numbers.

Every percentage in your question relates to the total value of my portfolio - the market value of all holdings, plus the cash reserve.

Diversification is simple. I will not bother to put less than 2% of the portfolio into any stock. That is my meaningful minimum. So, if my portfolio is $1,000,000, I would not invest less than $20,000 in a stock. I also have a maximum of 6% that I will invest in a stock, or $60,000 for the same portfolio.

Position sizing is the other issue. First, you need to define risk. Risk in this context is the purchase price less the price I use for my sell stop (or stop loss). So, if I buy a share at $5.00 and my sell stop is at $4.50, my risk is 50c per share. In practice there will be some slippage on the way out. For example, the sell stop may be at $4.50, but I actually only get $4.38 on the way out.

Now, as I said in newsletter 64, I used to risk 2%. This means 2% of my total portfolio value. Say that my total capital is $1,000,000. A 2% risk would be to risk no more than $20,000. A 1% risk would be $10,000 and a 0.5% (my current plan) would be $5,000. The important thing to note is that the amount I risk is not the total value of the amount I invest in each stock; it is the amount I would lose if my sell stop was hit.

As to the size of my position, the calculation is simple: maximum number of shares I can buy risking 0.5%:

Buy price $5.00
Sell stop $4.50
Risk $0.50

0.5% of capital is $5,000

5,000 divided by 0.50 is 10,000 shares.

Then I decide if I am looking to move to 2%, 4% or 6% of capital in that share. Assuming it is 2%, I am looking to invest a minimum of $1,000,000 x 0.02 = $20,000.

If I invested $20,000 at the present price of $5, I would buy 4,000 shares (20,000 divided by 5). This is less than the number of shares I could buy at my maximum risk (10,000), so I could proceed.

You will be able to see now that moving to 4% would also be OK (8,000 shares), but moving to 6% would not (12,000 shares). In that case I would not buy more than the 10,000 I can buy at my maximum risk.

I hope this has clarified this element of my investment plan for you. It is all in my book *The Aggressive Investor* and a great deal more besides. I would commend the book to you, because it is dangerous to act on only part of the plan. You can buy a signed copy of the book from my web site www.bwts.com.au. It is also kept by good bookstores, but the copy will not be signed in that case. My price matches good bookstores and is post free to Australian addresses.

Accumulation Index

Question
What is the All Ordinaries Accumulation Index?

Answer
It is not easy to get a precise definition of how the All Ordinaries Accumulation index is calculated.

The All Ordinaries price index is a capitalisation weighted index of price for the 500 stocks in the index. It measures the overall price movement of the market, or if you like, the overall capital gain or capital loss over a period.

However, investing in shares is about the total return, not just the capital gain or loss. The total return is the stream of dividends plus the capital gain or loss. The All Ordinaries Accumulation index tries to measure the total return. As I understand it, it is calculated by assuming that the cash dividend is reinvested on the ex date for each dividend. This is unreal, in my opinion, because you can not reinvest the dividend on the ex date, only on the payment date, or as soon after the payment date that the dividend hits your bank account and is cleared if it is received by cheque. So, it would seem that the accumulation index slightly overstates the total return. However, it does not assume the reinvestment of franking credits. This is a difficult one conceptually, and is best left at that for this question.

I compare my investment results to the All Ordinaries Accumulation index because it is the closest measure we have of total return from investing in shares.

Data Files Change

From the end of March 2007, I have changed the files that are available on the Data Files page of www.bwts.com.au. The files ASXPEDY and AUS1090 have been replaced with a single file AUSYIELDSAFR, which now also contains ASX All Ordinaries Earnings Yield data.

Question
How do I plot the Insight Trader data files from your web site?

Answer
When you download the files from the Data Files page on the web site, you must put then in the correct folders. Which folders you put them in will depend on your set-up.

In a typical set-up you will have a Winit folder on your C drive.

If you do not have your folders (directories) split (see the manual) all your data files will be in a folder called Data. So, you would put the files from the web site into C:Winit\Data.

However, much more commonly, you will have spilt folders (directories). You can tell whether you have this set-up in Windows Explorer (My Computer) by looking for folders called C:Winit\#, C:Winit\A, C:Winit\B etc. In this case, you copy the files into the folder with the letter that starts the file name. So:

Into C:Winit/A you put ASXAD and AUSYIELDAFR

Into C:Winit/N you put NEWFLOATS and NYSEAD

Then open Insight Trader and plot the filename you want:

ASXAD is ASX Advance - Decline line. The default field in this file is the cumulative difference between advances and declines and should be displayed as a line chart.

NYSEAD is New York Stock Exchange Advance-Decline line. The default field in this file is the cumulative difference between advances and declines and should be displayed as a line chart.

NEWFLOATS is the monthly number of new floats on the ASX. There is only one data field in this file, which is the default. It is the monthly number of new floats on the ASX. The new floats data is seasonal with a peak at the end of the calendar year. I get around this by suppressing the plot of the default field (Ctrl+H). I then plot a 12 month simple moving average, which eliminates the seasonality. The key strokes to do this are: A, Tab, 12, Enter. If your default plot was semi-log, change it to linear by pressing F. Then rescale the Y axis with the keystrokes Y, S, 0 (the number zero), Tab, 30, Enter. If the line goes above 30 in the future, use a larger number than 30 as is appropriate.

AUSYIELDAFR contains various monthly yield and PE ratio data.

The fields in this file are:
Field No 2 10YBY - Australian monthly 10-year bond yield.
Field No 3 90DBY - Australian monthly 90-day bill yield.
Field No 4 ORDSDY - ASX monthly All Ordinaries dividend yield.
Field No 5 ORDSPE - ASX monthly Price Earnings (PE) ratio.
Field No 6 ORDSEY - ASX Monthly earnings yield (100/Field No 5)

Field No 2 is the default field in this file, so it will be plotted automatically. It is best displayed as a line chart (press L) and on a linear scale (if displayed as a semi-log chart, press F).

To plot the other fields the keystrokes are Alt+V, C, Tab, (number of the field you want to plot), Enter, Enter.

In Ask Colin\Insight Trader are instructions for overlaying the lines on a bar chart of the index.

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