

Colin Nicholson: Newsletter 69

31 May 2007

A reminder – the opportunities to hear me speak are on the Ask Colin page of my web site www.bwts.com.au. This includes a half-day seminar in Perth in June, which may be of particular interest.

Hot Stocks - Update

I wrote my third book *Hot Stocks* in early November 2006. It was then printed and went on sale a few days before Christmas. *Hot Stocks* was not written as a book of stock tips. Rather, it was intended as a teaching tool. I set out to do two things:

Firstly, I tried to provide a practical example of how I analyse the market and decide on my market exposure strategy. The view I took in the book is still current as I write – if I were writing that important chapter today, I would change very little.

Secondly, I selected 30 stocks that had come out of my stock selection methods and showed in detail how I analysed the fundamentals and the chart for each stock. I selected the 30 stocks subjectively, not to be a list of my top recommendations, but instead to provide a wide range of different stocks and how they might be analysed.

Some readers may nevertheless be interested in how those 30 stocks have fared so far in 2007. There are several problems to deal with in making an assessment:

1. A starting date. *Hot Stocks* was printed and went on sale a few days before last Christmas. Allowing for the early buyers to read it over the holidays, it should have been possible to have acted on any relevant stocks that were discussed in it by the first trading day on the ASX in 2007. I have therefore arbitrarily assumed that the starting point was the opening price for each stock on the first day it traded in January 2007.
2. The stocks to include. A few of the stocks have not achieved the breakout which I indicated might trigger a decision to buy. I have left all 30 stocks in the calculations. One stock was taken over. I used the last sale price on the ASX instead of 30 May. One stock made a rights issue. I used the adjusted prices for the calculation. Some stocks I would have sold before 30 May. I left them all in the calculations.
3. Dividends. All but one of the 30 stocks were dividend payers, but for simplification I have left dividends out of the calculations and only assessed capital gains and losses. I have therefore compared the 30 stocks with the All Ordinaries price index, rather than the accumulation index.

So, my method has been to assume all thirty were bought at the start of the year and held until May 30. Further, I have assumed that \$1,000 was invested in each of the 30 stocks, in order to get an overall result. The results to 30 May 2007 look like this:

Stock No	Jan-07	30-May-07	% Change	\$1,000
1	0.65	0.81	25	1246
2	3.25	4.08	26	1255
3	6.20	5.95	-4	960
4	1.81	2.58	43	1425
5	4.26	4.66	9	1094
6	1.15	1.61	40	1398
7	18.00	21.80	21	1211
8	0.32	0.45	41	1406
9	5.47	6.00	10	1097
10	13.30	16.40	23	1233
11	4.76	5.91	24	1242
12	6.95	6.27	-10	902
13	1.88	2.60	39	1387
14	0.87	1.68	93	1931
15	0.50	0.48	-4	960
16	3.63	3.86	6	1063
17	1.20	1.29	8	1075
18	0.60	0.55	-8	917
19	0.32	0.29	-9	906
20	18.44	19.82	7	1075
21	2.83	3.42	21	1208
22	2.80	3.82	36	1364
23	3.96	4.75	20	1199
24	1.22	1.11	-9	910
25	4.97	5.78	16	1163
26	28.85	31.60	10	1095
27	1.02	1.20	18	1176
28	20.15	27.08	34	1344
29	1.96	2.55	30	1301
30	16.81	18.00	7	1071
Total	30,000		19	35,616
XAO	5647	6272	11	

I have not identified the stocks above for obvious reasons. However, they are numbered in the order they appeared in *Hot Stocks*, so those who have bought the book will have no trouble identifying them. The stock that changed its name is numbered in its original position in *Hot Stocks*.

If the 30 stocks had been considered as a portfolio and all purchased in equal dollar lots, the portfolio would have returned 19% for 5 months. The index only increased 11% in the same five months.

Readers may wonder why I should talk about this now the year is five months over. It is not to boast about the result. It is rather to suggest that it may still be worth buying *Hot Stocks*, not for the specific stocks but to learn how I go about finding and evaluating which stocks to buy to try to beat the market index. I am not an adviser, so the book was never intended to be a tip sheet. I am about teaching people to be

better investors and I do this by showing examples from which readers might see my methods in practice.

Handling Increased Risk

Question

I have built two investment positions to around 6% of my capital. Because their prices have increased, both investments now exceed 6% of my capital. What troubles me is that the distance back to my sell stop is now greater than 1% of my portfolio. The prices have not, however, doubled so I have not reached the position of selling 50% using your investment plan. How would you resolve this dilemma?

Answer

This is a problem I like to have. Your sell stop is protecting profits rather than cutting losses, which is a far worse problem.

At one level, your discomfort is part of the nature of investing. In order to make good profits on investments you need to assume some risk. If everybody knew what was going to happen, there would be no profit to be made because everyone would want to buy those stocks and few holders would want to sell to them. The price bid and offered would quickly move to a level that left little opportunity for further price increases.

As explained in my book *The Aggressive Investor* and illustrated in the case studies in particular, the initial sell stop is to cut losses and is limited to no more than 1% of capital in my plan. In fact it is often lower than this – 0.5% is not unusual for me and is now closer to my norm. So, when the investment doubles in price, the risk back to my sell stop may be less than 1% sometimes and greater at other times. It will sometimes be a sell stop which cuts a loss, but later is more likely to be a sell stop that protects a profit. In both cases, it is important to develop the mindset that you have to risk some of your paper profit or your investment capital to let your profits build. It is not easy, because behavioural finance research has shown that we humans tolerate loss far more readily than we tolerate risk to our profits. We tend to have an impulse to snatch profits quickly and to let losses run, hoping things will come good if we hold on. This natural impulse is the exact opposite to what a successful investor must do. It should be branded into our forehead that we should try to let profits run, but cut losses quickly.

I hope this explains your discomfort and that you realise that it is both natural and also something you need to deal with.

I can offer some ideas that may help you to manage your situation.

The first idea, and I think the best approach, is what I do. I always situate my sell stop where the logic of my investment plan says that it should be. I continue like that until I get a sell signal. My sell stop is moved up under the last significant trough in the trend every time a new high is made above the last significant peak in the trend. However, as explained in *The Aggressive Investor*, this is only one of three sell signals I use. What tends to happen quite often in these situations is that I get one of the other two sell signals occur at higher prices than my sell stop. I then sell on that signal. This is

the approach that I would commend to you if you are able to follow it. I am the first to acknowledge that it is not easy and that it may take you some years of experience to start to trust that it will work.

The second idea is that you mentioned that the prices of your two investments had risen sharply, but had not yet doubled in price. At that point, you indicate that you would follow my investment plan of selling half your holdings. This is my approach, but it is not carved quite so much in stone as you seem to imply in your question. The key for me is that a doubling in price is a guideline. 100% is not a rule set in concrete. What I did not perhaps explain well enough in *The Aggressive Investor* is that it is a guideline, not a rule. What I do in practice is to use it as a guideline level, but I still use some judgement in applying it. If the price rises sharply to, say, 185% of my purchase price and then comes off a sharp peak, I would most likely sell half the position at that point. In like vein, if it gets to 200% of my purchase price and is still moving up strongly, I would not sell automatically on it having doubled in price. What I would most likely do is to allow it to keep rising strongly until it comes off a strong peak and act at that point to sell half of my position.

I hope this clarifies something important for you, but of course it may not resolve your discomfort. If your two shares keep rising strongly, your discomfort may in fact increase.

That brings me to the third idea, which may help you while you are still learning the craft, but which I feel is my least preferred resolution. There is an old saying on Wall Street, which I have repeated many times over the years, that if your position is so large that it causes you to lose sleep, you should sell it down to the sleeping point. Let's assume from your question, that at the present stage of your journey to investment skill, you are uncomfortable with a risk back to your sell stop being greater than 1% of your capital. What you can do is to sell as much of your position as brings the risk on the investment back inside 1% of capital. If it keeps rising inexorably, you may have to do this more than once on some rare occasions.

This approach to your discomfort is not ideal, as I have explained, but is far better than selling all of your holding and not having any of it continuing to build if the price just increases for some time.

The one thing that you might consider, but which I think is very incorrect, is to break the rules of your investment plan by moving your sell stop up closer than the logic of your plan says it should be. This is often called **tightening** your stop. It makes no logical sense within your investment plan, if you have a tested level that works on the probabilities, to move the stop closer, where a price movement that is normal for your plan would hit the stop. You would then likely sell the whole holding and maybe miss a long sustained move to the higher prices that your original plan envisaged with the normal sell stop.

Here We Go Again

Comment from a Reader

I was watching the business finance section on the ABC after Lateline tonight and listened intently to the interviewed analysts who were commenting on the resources boom with emphasis on the RIO/BHP take over possibility.

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The part that rang alarm bells for me was the constant confirmation being given of the magnificent resource boom which was going to continue for the next 12 to 18 years, without doubt and that it was basically an etched-in fact, no argument.

I then knew that replacement of the 1990s dot com bubble had found its new identity.

I decided to distance myself and examine a bit of history.

If someone had said at the height of the dot com euphoria that resource stocks would be the better way to go back then and that we should be picking them up while they were so cheap, one would have been expected to be directed to the nut house to be frank.

So at the conclusion of the ABC program, after listening to such euphoric bias, I immediately knew where and at about what stage we must be in the current market.

I intend to basically stay in quality non-resources shares that show reasonable chart strength and strong fundamentals, but that is all.

It really is cash time for me and plenty of patience for some of the stocks that have been ignored, with the idea that they too will have their day when all this clears. Cycles come and cycles go. I like bull markets but I prefer the opportunity offered in bear markets better.

My Response

Your comments are full of commonsense and echo my feeling almost exactly. I have been speaking around the country on this theme. This is a time to become far more defensive in preparation to survive the end of the bull market and the ensuing bear market.

Price Earnings Ratio

Question

You suggest looking for stocks with a low PE ratio. Yet William O'Neil and Stan Weinstein both warn against buying low PE ratio stocks because they could be weak-inferior stocks. How can we be more certain of good value?

Answer

I agree entirely with O'Neil and Weinstein. To simply buy low PE ratio stocks is asking for trouble. Stocks can have a low PE ratio for several reasons. One is the obvious – that the market has sold them off (which lowers the PE ratio) because it does not expect that they will repeat their last earnings numbers. However, it can also be because the company or its industry is out of fashion. It can also be because the company has been in some trouble and is still recovering, something the market has not entirely recognised yet in the price. These are the potential gems that we are looking for.

Cast your mind back to what I said. I suggested that we look for well-managed companies that were cheap. Cheapness could be found initially by looking for low PE ratios and high dividend yields. However, this is a two-edged sword, because it also

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finds potential failures which are on the way out. The secret, if there is one, is to look at the charts and use what I teach as Charting 101. Unless the chart is heading upwards to the right hand top corner of the chart, or is breaking out upward from a broad trading range, it is a failure on the way out, or we are too early and should wait for those signs.

In other words, use the fundamental ratios to find a group of companies that may be interesting and then use charting to winnow the grain from the chaff. Nothing is foolproof, but this should give you a short-list of stocks to be researched in depth and maybe you will want to build a position in them if they continue to trend upward.

This approach is described in detail in my book *The Aggressive Investor* with many examples and case studies.

Sector Ratios

Question

Where do I find the PE ratio for a sector?

Answer

This data is published in the *Australian Financial Review* in the weekend edition and in the Monday edition. The table they publish also has the market average PE ratio and dividend yield in it.

What Does Defensive Mean?

Question

In your talk the other night, you said that it is now time to buy more defensive stocks because they are likely to fall less in a bear market. I can't find a reference to defensive stocks in your books or elsewhere. What do you mean?

Answer

Defensive in investing is a rather general term. It means roughly the opposite to aggressive or speculative. My main book is called *The Aggressive Investor* because my approach is aggressive in important respects around timing the market, active management and a focus on mid-cap and small-cap companies that are more risky than slower-moving blue chip companies. For this reason, my investment plan needs to balance its basically aggressive posture with some elements that are more defensive in nature. This has to do with the stocks I select to buy.

In *The Aggressive Investor*, I describe in detail how I go about selecting stocks. The very basics of this I covered the other night when I said it was a time to be more defensive. I suggested that it was the market season in which we should avoid speculative stocks and those laden with debt. Instead I suggested that we should focus on well-managed companies that were still good value. This is what I mean by defensive, in that these companies should generally be less vulnerable to price declines in a bear market.

In *The Aggressive Investor* and again in *Hot Stocks*, I explain my two models for stock selection – value model stocks and growth model stocks. In both cases I am looking for relatively low PE ratios and relatively high dividend yields. In the case of

value model stocks, this means a PE ratio that is significantly lower than the market average and a dividend yield which is significantly higher than the market average. It is not easy to do the same with growth stocks, but I am defensive in that I seek PE ratios that are not too far above the market average and dividend yields that are not too much lower than the market average.

Once I find these companies, the job is not complete. I then have a short list for further research and a final decision. In looking for defensive situations I will generally try to avoid cyclical industries like construction and banking. If possible I want the portfolio to be strongly focussed on companies that are in non-cyclical industries and are relatively cheap in value terms.

Be Wary of High Debt Levels

Question

What do you mean when you say to avoid debt-laden securities?

Answer

Your longer version of this question, which I have summarised above, seemed to be looking for some decision rules in terms of absolute and universal numbers. I am sorry, but this is not the way to address this issue.

Debt is a marker of financial risk. Financial risk is basically the ability of the company to meet debt service payments and debt repayments on time, even in difficult times. If a business is in a cyclical industry (one whose revenue and profits rises and falls with the level of economic activity), then it has more financial risk with a given debt to equity ratio than a company in a non-cyclical industry.

The other aspect is that if a company finds itself in trouble for a while, a high debt to equity ratio is a marker of more risk than a low debt to equity ratio. If debt is low, there is borrowing capacity unused in a difficult time, but if the debt level is already high, there is no fall-back borrowing capacity.

So, the first step is to look at the debt to equity ratio. The lower it is the better in financial risk terms. Certainly it is also a safety valve in hard times. Then you have to assess it against its competitors as discussed above.

It should also be noted that I said securities, not shares in my talk. There are quite a range of securities you can buy these days. A trust and a company are different beasts. You need to know that and what the implications are. Also, there are stapled securities, which are a trust unit plus a share. This is a different animal again. I personally avoid these securities and confine myself mainly to companies, because they have more growth potential from retained earnings. Trusts can not retain earnings because of the way the tax law works. There are many more wrinkles to these securities, about which I am not an expert, so I cannot comment in detail. I follow Warren Buffett's dictum of not investing in businesses that I do not totally understand.

I Can't Always Follow You

Comment

I have looked at your portfolio in relation to their charts. The buys, mostly I can see, but a lot of the sells I can't work out.

Response

I publish my portfolio on my web site for only one reason. This is so that anyone reading my work in the *Australian Financial Review* or *AFR Smart Investor* magazine is aware of what I do or do not hold myself. This is required by law if I am commenting on stocks. Putting my portfolio on my web site overcomes a problem of just tacking a notice on the end of the article or column, in that my position may have changed by the time you read the article or column.

I would hope that my buys are explicable in terms of my method as explained in my books *The Aggressive Investor* and *Hot Stocks*. If not, I am not following my investment plan. I am therefore not surprised that you worked most of them out OK.

Sells are a little more complicated to follow at times. The ones that hit a sell stop level, or gave one of my three sell signals, should also be fairly easy to work out. However on top of this, there are other considerations.

The most important one relates to my market exposure strategy. At times I make decisions to vary my market exposure. The general rules for this strategy are set out in my book *The Aggressive Investor*. However, what is unstated is what I might be thinking. My current position is fairly much discussed in detail in my book *Hot Stocks*.

At other times I may make some other moves, which are driven by my personal situation. I might need to sell something to pay a tax bill. I may need to liquidate some investments to shift some assets from one tax-driven structure to another. And so on. These things will probably remain hidden from your thinking. I am sorry about that, but I can not legally give a running commentary on my actions in the market without crossing the line on not being able to give a view about the market without an adviser's licence. The best I can offer is that if you ask me I will answer if I am legally able to do so at the time. I know this may sound like an evasion, but it is not. I simply cannot take the risk of breaking this important law which is aimed at investor protection, even if it is rather heavy-handed.

In this respect, I dare not answer your questions with any reference to the stocks you mention that you hold, because that could easily be seen as expressing a view about them.

Where Should My Stop-Loss Be?

Question

The real problem I am having is trying work out where to set a stop-loss for skyrocketing stocks where there has been little sign of a plateau or minor downturn.

Answer

With the greatest respect, I would like to suggest that you are tackling the problem the wrong way. Let me answer your question in two ways.

First, if a stock rises so far without any correction that you are uncomfortable with your sell stop, I think the best approach is not to try to **tighten** up your sell stop somehow. That could be inviting a normal market movement to take you out of a good investment. I think that your sell stop should be always where the logic of your investment plan says it should be. Then, if you find that the result is that too large a percentage of your capital is then at risk, the logical course is to sell your position down to a size where less of your capital is at risk. Say you started with a risk of 2% of your capital and the stop is now 4% of your capital away. It makes sense to me for you to halve the position. Remember that you can always rebuild it again later when the logic of your plan allows a closer sell stop.

The other way, and in many respects the better way, to answer your question is by reference to my investment plan as set out in my book *The Aggressive Investor*. The way I set my sell stop is only one of my three sell signals. My sell stop may be a long way away after a strong rise. That is part of the dictum to let your profits run. However, if the rise runs out of steam and the whole trend fails, I find that I am likely to get one of my other two sell signals well above the sell stop level.

I think that the answer to your question is a combination of these two approaches. Wait for a sell signal, but if you cannot stand the pain, sell down to a level of risk you can tolerate. Resist the temptation to **tighten** the stop in a way that is contrary to your established and tested investment plan.

Where the Money Is

Comment

In a mining boom, just like the 19th century gold rush, it wasn't only the miners who made money, but the people selling the picks and shovels so companies which supply the resources companies have produced fantastic returns.

Response

I agree entirely. I had to delete the codes of the companies you listed to avoid breaking the law. If you peruse my portfolio and the companies I have held in the last year you will see that I have followed that general approach with great success.

Another Scam

Question

I had a phone call from (name withheld) about their amazing grey box that automatically browses 1200 stocks picking the best 10 stocks each day using no less than 250 indicators. It's yours to keep for life, gives an average 18% per month and you can obtain your data feed from any source you like. They also sell a professional version that returns 30% per month. They say they are only selling 250 licences Australia wide and there is only a couple left. I also received their glossy brochure with a lot of glossy pictures but little else about what you are actually getting for your money. They are asking \$8,500 and the professional version costs \$30,000. Should I

hang out for the steak knives or put the brochure in the bin where it belongs with all the other too good to be true scams?

Answer

This is an all too familiar marketing story and sounds like any one of several similar scams over the last ten years or so. Bin it.

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