

# Colin Nicholson: Newsletter 70

11 July 2007

## Discussion of Breakouts and Stops

### Comment

Over the years, false breakouts have been very damaging to me as a trend trader.

### Response

I must be a pedant for a moment on an issue that I think is important. I do not believe that a breakout can be somehow false. There is either a breakout or there is not a breakout. Assuming the most generally agreed definition of an upward breakout is a move above the highs of whatever pattern we are looking at, the price either broke above those highs – a real breakout – or it did not. The only issue may be how far the price must move above the high of the pattern for it to be defined as a breakout. Further, some analysts may also define a breakout as needing to close above the high of the pattern. If the move above the high of the pattern does not meet those conditions, then it might be seen as not being a breakout. However, if a move does not meet the definition of a breakout it is simply not a breakout, not a false breakout.

This is important because I think what you mean by false is that it was an unsuccessful or failed breakout. This is a totally different thing. Some breakouts succeed. An upward trend develops. Other breakouts do not succeed. The price falls back through the pattern and out the other side of the pattern in a downward trend. In between, are failed breakouts that drop back into the pattern and the pattern continues to develop for a future breakout to occur in either an upward or downward direction.

However, there is an important observation we can make. In a strong bull market, particularly in its early and middle stages, a high proportion of breakouts do lead to an upward trend of varying extent. Towards the end of the bull market, or in a bear market, a much higher proportion of breakouts will tend to fail to lead to an uptrend. I have no trouble with this, because it is normal and it is an important piece of information. It tells me something valuable, namely that I need to be somewhat more selective and careful about breakouts and to expect more of them to fail than in better conditions.

### Comment

A long time ago I decided that stops were the critical thing in trading, but that I just could not find a way to optimise them.

### Response

Yes, this is a very profound conclusion. It shows that you have developed as an investor beyond the raw beginner stage. Raw beginners are usually still looking for the Holy Grail – a method of investing that works every time. I am assuming that by optimising, you mean that the stops are perfect. They take

you out of every losing position cheaply and keep you in all winning positions right to near the end of the trend.

In reality, this level of perfection is quite impossible. All investing involves losses and also it involves some premature stops. That is the nature of investing, which involves the management of risk in an unpredictable market. When the trend is strong, our batting average is higher than when the trend is weak or fickle and turns against us quite quickly.

### **Comment**

The problem with trading a breakout from an accumulation pattern is that a stop under the lows of the pattern is a long way away from the buying price and therefore costly when the breakout fails.

### **Response**

I could not disagree with a statement more than with this one. In my book *The Aggressive Investor*, I go to some lengths to explain how to calculate the position size so that no matter how far away in cents the stop level is, I always risk up to the same percentage of my capital. This is reinforced in the book in the case studies to the point of maybe labouring it.

I never, ever, risk more than 1% of my capital on an investment. So, if the stop is 10c away, my rule would allow me to buy more shares than if the stop was \$1 away. The whole point is that I am quite indifferent to how far away my stop is from my buy price – I am always risking up to the same percentage of my capital. Therefore, if my capital is \$100,000, and my maximum risk is 1%, both the 10c stop and the \$1 stop would be risking no more than \$1,000 in total.

I can not emphasise this enough. It is absolutely basic to becoming a good investor and your comment shows that you have not yet internalised this issue. When each investor completely understands and accepts it, they will be able to move to the next level on their climb to investment expertise.

### **Comment**

Psychologically it is very taxing waiting for the stop signal to be triggered under these conditions.

### **Response**

If you take on board the issue I discussed in the previous response, this problem will go away. No matter how close or distant the stop, the amount at risk is always the same. Sure, there is psychological pressure when an investment is under water, but it should be no different, no matter where the stop is, because your risk should always be the same total dollar amount.

### **Comment**

Tighter stops only throw you out of good positions.

**Response**

Exactly. I could not agree with you more on this one. If you have an investment plan, which has been thoroughly tested and indicates where the most effective place is to set your stops based on the logic of your plan, then if you move the stops any closer, a normal movement in prices will stop you out prematurely and maybe at a loss. The whole idea of **tightening** stops is a big mistake in investing - assuming that you have tested your method and it works a good proportion of the time.

**Comment**

Professionals know where every trend trader's stops are and deliberately trigger them to sucker them into or out of a position.

**Response**

Of course. Don't you also know where most stops will be? I do, give or take a cent or two. Your use of the description *professionals* suggests that you have a bit of a complex about this. I would re-phrase it and say that all experienced investors have a good idea where the majority of stops will be.

So, it makes perfect sense to sell a share down to where the stops are likely to be and then buy as the stops become sell orders. This is a good way to get set at lower prices and just under a pattern or support level. It enables you to have a stop-loss just a bit lower in case the downward breakout turns into a downtrend. This is also a reason why support levels are not that precise. There is some level of overshooting or undershooting at times. So, a stop should not be too close to the absolute low of the old support level.

Now put yourself in the shoes of the experienced investor. You buy a position. Why would you put your stop where everyone else does and where any experienced investor will know where to trigger them if they want to? My policy would be to put my stop below that level, so the chances of it being hit are reduced, but the stop still protects me from a failure of my investment.

**Comment**

On the other hand I have recently been very successful entering after a decline, on critical support and fading downward momentum...

**Response**

Exactly. This is one of my three entries as I build a position. This is described in detail in my book *The Aggressive Investor*.

**Comment**

At least if I'm wrong the stop isn't far away.

**Response**

See the previous discussion of this point above.

**Comment**

Yesterday I speed read one of your books and noted with interest your three stage entry technique for breakouts. That system overcomes the problem of

the magnitude of the stop by gradual adjustment of position size (importantly to me it is not pyramiding). So, now I intend to try trend trading again using your techniques.

### **Response**

Whoa, hold on there. Please read more slowly and carefully. As discussed above several times, you are missing the most important point which is that it is not how far away your stop is in cents. It is using the position sizing rule to always risk the same maximum number of dollars. If you take the time to study the examples in the case studies in *The Aggressive Investor*, this will become very meaningful to you.

### **Question**

Once you get an entry signal, do you wait for a certain time to elapse? Or wait for a certain volume to trade? Or refuse to enter during the first hour or so of trading, to avoid a bull trap caused by professionals taking out traders buy stops? Or do you just take a position and rely on your position size to limit risk?

### **Answer**

When I get an entry signal I act on it. I do not do any of the other things you suggest, or I would have put them in *The Aggressive Investor*, which seeks to set down everything that I do.

Something I do that is counter-intuitive to most beginners is worth saying though. The stronger the breakout move the happier I am to join it. Most beginners will not chase rising prices, however that is the time when I am most confident that I may be onto a good one. A share that has broken out and is continuing to rise is much stronger than one that breaks out and then hovers.

There is one situation where I will wait. If the price breaks out and then retreats into the pattern, I will tend to wait for a confirming second breakout. This partially recognises your situation where traders have faded the buy stops and the move has failed, at least for the time being.

### **Question**

Many growth stocks have long upward trends with only minor pullbacks to the relevant moving average. Do you ever enter after a trough on one of these pullbacks (more or less like your second entry point in the three-stage system for the accumulation phase breakout) rather than wait for the recent top to be taken out?

### **Answer**

In *The Aggressive Investor*, I described how I enter after an accumulation phase breakout for a value model stock and how I enter after a consolidation phase breakout for a growth model stock. In both cases, my method is the same. I buy some on the breakout, some on the pullback and complete building the investment on the next move above the peak following the

breakout. In other words, I buy in expectation of a trend and build the position as the trend is confirmed.

You seem to have confused the value model and the growth model a bit. *The Aggressive Investor* was written to be studied slowly and carefully – especially the case studies in the book and on the CD to really reinforce the concepts.

Then, quite separately, I find that with both value model and growth model stocks, for all sorts of reasons, I may not take a breakout entry. I will then consider entering the uptrend. Again, I have a three-stage entry tactic, which is explained in detail in the book. It is important to get these two basic entry tactics clearly in mind and it will totally resolve your question. In the trend entry I buy a new high above the last peak, build the position on a pullback and complete building it on the next new high above the last peak.

### **Question**

On exit from a trend you use the intraday low rather than the close as the trigger. My chart analysis would suggest that intraday lows often breach the last significant trough providing misleading signals. It is probably some professional trying to sucker technical traders out of their position. Do you ever change policy and wait for a close that breaches support if you think that the fundamentals don't justify a new down trend?

### **Answer**

In *The Aggressive Investor* I described my definition of a trend and my two models that I use to take money from the market. My trend definition is that each trough in the trend is higher than the last one. If a trough is taken out by any price – open, low, close or intraday, then the trend is no longer intact by definition. This is what I mean by the logic of my investment plan. So, I will sell as soon as I am aware of the stop being hit – same day, next day, whenever. Sometimes my exit price will be below my stop, sometimes it is above it and even above the last trough. As I said, the trend is no longer intact, so I am out of there. As described in *The Aggressive Investor*, I have a re-entry tactic, but the trend must make a new high to trigger my consideration of re-entering.

The fundamentals have absolutely zero role in this decision. I use the fundamentals to select stocks to invest in, but all timing decisions are made totally on the chart evidence. Fundamentals can be used as a crutch to rationalise not taking a chart signal. This is very seductive and highly injurious to your account.

One of the hazards of investing in thinly traded stocks is not the professionals as you call them – they will not bother with these stocks – but the mug punters who use pre-set stop loss levels in stocks that are unsuitable for that method. Stop-losses are meant for deep liquid stocks. On thinly traded stocks, one triggered stop-loss order can trigger a whole cascade of others. That is one reason so many mug punters lose, by the way. It is unfortunate that this happens, but that is life. I move on and consider re-entry if the trend reasserts itself later.

You say that you have analysed charts and that often intraday lows give bad signals. Have you looked at hundreds of charts over many years in both bull, bear and sideways markets? And have you compiled statistics of how many times the intraday lows gave good and bad signals? If so, I would be interested to see your research results. If not, then I am afraid that your statement is simply a belief and I would not put my money behind it, sorry. I spent years doing what I described in *The Aggressive Investor*, both in actual investing and on hundreds of charts I paper traded. While I did not know enough then to compile statistics, I established confidence that the trend definition works most of the time. Sure, sometimes it does not, but it is easy to keep trying to find the perfect method, when no perfect method exists.

### **Question**

After years of experience you would have built up a feel for the market that affects your success without you realising what you are doing different to others. Do you think that your system would be as effective for anyone with little experience but the discipline to apply the system consistently?

### **Answer**

It seems that speed reading misses some important material. In *The Aggressive Investor*, I explained why I wrote the book. Everyone is different and has to develop their own investment plan that fits comfortably with their temperament, risk tolerance, knowledge and experience. I wrote up my investment plan to provide a model of what should be in a plan, but each reader needs to vary it to suit who they are and where they have come from. It will take up to ten years to reach the point where you have enough knowledge and experience to do that and be comfortable with it. I cannot emphasise enough that I am not expecting many readers to just adopt my plan without any modification to some elements. If they try, they will probably fail, because they are not me and do not have my experience. You can not avoid the serious contemplation of the issues and the testing of them until you have grown confident in your approach. I am still learning myself and I have been at it for almost 40 years. There are always new things to consider and then accept/reject. Some things that I am comfortable with, I have thought deeply about later and become even more confident of my conclusions.

The issue of my feel for the market is critical. That is called experience. It takes time at the coalface over a long time and requires a lot of post mortem assessment, research and modification. One of the problems in writing *The Aggressive Investor* was to try my best to get down everything I was doing. It took a long time and the process I used was to teach seminars where I fielded questions that probed everything I do. There may be some things I could have explained better. There may be some really minor things I left out, but nothing that is really material.

I often explain that I can teach knowledge and hope I am good at it, but I cannot teach my experience. It is the nature of experience that you have to have made the journey and thought it out as and after you go there. Experience and deep contemplation gives confidence and the result is almost automatic execution of the plan without emotion getting in the way. I am sorry

therefore to tell you that you are going to have to make the experience journey. Otherwise, you will not have the confidence to execute the plan under the intense pressure the market puts us all under. You will tend to try to rethink the plan at the worst time. It is a recipe for losses.

My best advice is to take it slowly. Develop a plan. Test it on past data and going forward on paper in real time. Then make one investment and complete it before making another. When you have a good track record, think about making more than one investment at a time. The key advice is not to lose too much money while you are learning. An apprentice surgeon learns the same way – he or she tries very hard not to lose or damage too many patients in the learning process.

## Reliability of Chart Patterns and More

### Comment

I would like to get a better understanding in reading the market by analysing price patterns (i.e. bar charts OHLC)

### Response

Price patterns is a broad subject and, to some extent, what you mean depends on your definition of a pattern.

There are two large groups of patterns. One is the general area of reversal and continuation patterns. These can be very large patterns on weekly and monthly charts. They can also be shorter-term patterns on daily or intra-day data charts. However, in their time frame they have essentially the same use. The other general area is short-term price patterns that comprise only a few bars, such as a key reversal day or an open-close reversal. These can also be used in various time frames, so that you can see them on daily, weekly and monthly charts. Candlestick charting also has a range of these patterns.

There are also unique patterns in point and figure charting, Market Profile and Elliott Wave Theory.

### Comment

I would like to get a better understanding of how traders and investors make decisions based on these patterns.

### Response

Patterns are important because they help us to understand what is happening in the interplay of buyers and investors. This is particularly so when a pattern shows us that the supply and demand balance may be changing. Some people use the simplistic approach of memorising the patterns and try to then interpret them mechanically. This can be a useful place to start, but is really not, in my experience, all that helpful. What is far more useful is an understanding of what the pattern is telling us and in being able to see subtle differences in each situation. Seeing what everyone else sees gives little opportunity to be ahead of the crowd. Being able to see and understand aspects of the pattern, that others have not taken the time and made the intellectual effort to analyse, can be very valuable. The difference between

these two approaches is what differentiates a beginner from an experienced analyst.

However, you did not ask about analysts. You asked only about traders and investors. Analysts are people who spend a lot of time trying to understand any situation and who are usually paid to have a view one way or the other on any chart. A trader or an investor has a different objective altogether. An analyst seeks to be right about almost every situation. A trader or an investor is seeking only to make a profit out of a series of transactions. A trader or an investor knows they cannot be successful every time and don't expect to be. What they do try to achieve though is a profitable outcome over a period of time and series of transactions.

A trader or investor therefore comes at chart patterns very differently. They seek to exploit a small number of set-ups. When they don't see the set-up on the chart, they leave it for analysts to deal with for their purposes. Then, when they do see the set-up they are looking for, they act on it as set out in their trading or investing plan. So, as you can see, a trader or investor has a totally different approach to chart patterns, with a different objective and different expectation of the outcome.

Of course, many private investors and traders need to be part analyst and part trader. This is because they do not have the luxury or scale to separate these two different activities and give the two roles to different people. Where private investors and traders get into difficulty is that they often fail to see the two separate activities they are carrying out. They mix them up. They try to be two partially incompatible things at the same time. A trader might not give a chart a second glance. An analyst may spend hours on it. The trader is looking for opportunities. The analyst is looking to make accurate comment on any situation. Private traders and investors need, if possible, to have a very clear idea of what they are about. A good trader or investor will have little time for detailed, difficult and often arcane analysis. They cut to the chase – if the opportunity is not there, forget it and move on to the next chart. This requires great patience and discipline, but is what separates the good traders and investors from those who do not understand what they should be trying to do.

### **Comment**

I have read a few of your articles in *Smart Investor* in the past that covered the topic.

### **Response**

The articles I wrote on charting for *Smart Investor* did not cover the topic. There were only a few articles and they went nowhere near covering the topic. Also, my brief is to keep it very simple, because that is how the editor sees the readership (and I do not disagree with her view). This year we have changed the brief and I am now writing columns that are a more holistic approach to investing. This is what I really do for a living – combine fundamental and technical analysis into an investment plan. You will notice from these more recent columns that the analysis I use – fundamental and technical – is not difficult and is focussed on making money, not having a

correct view. In part this is because I adopt an opinion, based on experience, that it is impossible to accurately and consistently forecast the future. So, I consciously do not try. Instead I look for situations that are set-ups based on either the value model or the growth model I use to make money from the market.

Before *Smart Investor*, I wrote many more charting articles for *Shares* magazine (and for the four *Shares Charting Guides*). Like *Smart Investor*, the target was fairly unsophisticated in charting, so they were at basically the same level as the *Smart Investor* charting articles.

Concurrently, I published a series of articles, initially for the *Stockwatch* web site, but after that failed, for my own web site. These articles are heavily based on the course notes for the subject E114 Technical Analysis, which I wrote for what was then the Securities Institute of Australia's Graduate Diploma program.

If you would like to get a good general education in the main aspects of mainstream technical analysis, a study of the technical analysis articles will comprise a textbook, which uses Australian examples. The charting articles for *Shares*, *Shares Charting Guides* and *Smart Investor* will add value to them with more examples and a generally less technical explanation.

### **Comment**

I would like to read up extensively on this subject.

### **Response**

Good. I encourage would-be traders and investors to read widely. In my book *The Aggressive Investor*, I suggest aiming to read one book about the markets every month. This is not difficult if you want to succeed.

Since the thrust of your comments have been focussed on trading and investing rather than just being an analyst, your aim should be to read histories of the markets, biographies of great traders and investors as well as books on chart patterns. I have strongly recommended all of Jack Schwager's *Market Wizards* books in this regard.

### **Question**

Would you be able to recommend any books, articles etc preferably for the Australian market?

### **Answer**

Yes, and in fact I already have. On my web site there are 59 separate questions and answers on books. Some of those questions are the same as yours now, so I will leave you to read them.

On Australian examples I have two comments:

Firstly, the best sources with Australian examples are Ivan Krastins book, and my articles on technical analysis which I described above. They will one day

be a book, but that will take a lot of time and effort. It is on the drawing boards, but not for the immediate future. In the meanwhile it is all there in article form.

All of my articles on charting are on my web site in the Members' section. There are hundreds of articles. The cost to join is \$44 plus \$55 per year and you can read them all, download them or print them out.

Secondly, in my experience it does not matter what market the chart belongs to. Every traded market represents the actions of buyers and sellers and most human beings react to situations the same way, no matter what their cultural or ethnic background. I know from experience that if I put in front of you twenty charts from different markets for different types of securities, but concealed from you the name of the security and the price scale, you would be lucky to guess correctly which market they were from. Any you got right would be sheer luck. The point here is that Australian examples don't matter. What you need to learn is how to trade or invest and the basics are the same in any market. We could take a good traders from Chicago and give them money to trade in Shanghai or Istanbul and they should have no trouble getting similar results to what they got back home. Investing is a bit different, but not from the point of view of technical analysis, but the relatively greater impact of fundamentals on the task, and here local knowledge is far more relevant. Then again, you asked about principles, not details, so an investor would tend to use the same methodology in a different country's market.

### **Question**

Do you use patterns when making your investment decisions?

### **Answer**

No, not really. They are for analysts. I generalise. I am looking for accumulation patterns (value model) and consolidation patterns (growth model). They are both essentially similar in shape – sideways price action over a year and often much longer. What is more important is what has led up to them, so that I can distinguish them from likely distribution patterns (both models). However, that is easier to do for the value model than the growth model.

### **Question**

How reliable are these patterns for trading the Australian share market?

### **Answer**

I don't know. I have never had the time or the motivation to do the research. Life is too short when it is not germane to what I do which is invest. I have taught myself a lot of analysis, but I am not an analyst. I thought knowing more about analysis would make me a better investor. Knowing the basics does help, but looking back, a lot of it was not of much use. However, it was a journey I needed to make and I don't regret it. Unless we go down a path and investigate and assess what is there, we will not know whether it was important or not.

What I am trying to say here follows from my earlier comments. If you want to be an analyst, then you just have to know and deeply understand that material. But I am not an analyst, I am an investor. You have also asked me questions in terms of investing and trading. What I have found from my reading and experience, is that the keys lie elsewhere in a total approach. Analysis is a small part. The big things are having a sound and logically complete investment plan, having good money management and understanding the way we think (psychology), so that we can effectively manage our investments. I have written my investment plan up completely in my book *The Aggressive Investor* and my book *The Psychology of Investing* is a start on the biggest challenge of all – effective decision-making and avoiding common and largely unconscious errors and biases.

If you are concerned to do some research on chart patterns, I don't want to discourage you and I would be interested in your results. Technical Analysis will never obtain mainstream acceptance until it applies scientific methods to testing its knowledge. However, you should start with your eyes open. The big issue is definition. Just take one of the main reversal patterns and try to define it in mathematical terms so that a computer could find all the patterns of that type over decades for hundreds of stocks in different time frames. It is not an easy task, because a lot of chart patterns are identified very subjectively and people have faith in them not from any testing, but from falling into the psychological trap called confirmation bias.

Then, when you have defined your patterns, if you ever do, you have to define what you mean by reliable. How big a move do you require to happen before you call it reliable? Over what time frame will you require the move to happen for it to be termed reliable?

The reason I have not tackled any of this is because I don't see that, even if I succeeded it, would make me a better investor (or trader, which I am not anymore).

### **Question**

Do you have any statistical evidence of these patterns?

### **Answer**

No, I don't. However, there has been quite a bit of work done by analysts and academics overseas. Only some of it has been particularly encouraging. I would not expect Australian research to show markedly different results.

## **Data Source for Market Screens**

### **Question**

Some of your writings refer to the Australian Financial Review (AFR) Monday edition to do your fundamental ratio screens of the market. Where is the price to Net Tangible Assets (NTA) ratio?

### **Answer**

These days mostly I refer people to the Monday edition (or the Saturday edition) of AFR in the context of market scans, because they need the market

average PE ratio and dividend yield as benchmarks. These are the only two editions in which the AFR publishes the market averages.

That is not what you are asking, I know, but I thought it best to start by clarifying the point, because it is related to the task of market scans.

These days, I do my market scans using Insight Trader charting software. It has the ability to screen stocks based, among other things, on PE Ratio, dividend yield and Price to NTA. I describe what I do in my book *The Aggressive Investor*, which is to scan on PE ratio only and at that only if the stock pays a dividend (DY>zero), but when I find candidate stocks that also have an uptrend or breakout on their chart, I will check the actual dividend yield. I no longer worry about price to NTA, but some people do, so I often include how that can be done. It is easy in Insight Trader.

The problem with this is that you need to have charting software which will screen on those ratios, or subscribe to Aspect Huntley, which allows it to be done, albeit on a PE ratio that is based on earnings per share which is part historical and part forecast).

The question then is what does an investor do who does not have, or cannot afford, the appropriate charting software? I have probably answered it in the article you refer to in terms of what I did before I had that facility in Insight Trader and the tables were available on the AFR web sites. In fact it is not difficult to do even if you do not have a computer at all - the scans can be done manually from AFR tables, providing the tables have the ratios you need.

Since I now only use the PE Ratio and dividend yield, I can do it from the tables on any day Monday through Saturday. However, if price to NTA is required, I would need to use an AFR table that has that ratio in it.

I have been using AFR tables for almost 40 years. Over that time, the composition of the tables has changed many times and there has been a need to adjust accordingly. Before the weekend edition came into existence, the price to NTA ratio, the PE ratio and the dividend yield for industrial stocks were all in the Monday AFR tables, which were the only tables each week to carry all three ratios. When the Saturday edition was created, the price to NTA ratio was only shown there and dropped from Monday except for the top 150 stocks. So, now if I wanted to screen on price to NTA, it is the Saturday edition, not the Monday edition, which I would use.

Between using charting software and not having a computer and doing it manually, will be those who have a computer, but not the charting software. Providing the computer has spreadsheet software like Excel which can sort on columns in a CSV file, it is possible to do the screen using the Weekly AFR tables from [www.afr.com](http://www.afr.com) or [www.smartinvestor.com.au](http://www.smartinvestor.com.au). These tables also allow screening on the debt to equity ratio, if so desired. This is very simple, with minimal skills, by just sorting on one ratio at a time and saving only those that pass each sort. If you have database skills, you could import the tables

and screen them on then the way Insight Trader does it, but this will be beyond the competence of most investors.

So, the problem is that what I have written in the past may have related to AFR tables which have since been changed. I hope this brings it up-to-date for you.

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