

Colin Nicholson: Newsletter 71

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My Results

I know there is great interest in my investment results. I disclose my results for only one reason – if I presume to try to teach something, you the readers should know whether I have a practical track record as an investor, or am I just teaching theory.

In the financial year to 30 June 2007, my return on capital was +45.26%*. The ASX All Ordinaries Accumulation index for the same period was up 30.28%, so my outperformance was +14.98%.

I must stress that past results are no guarantee of future returns, by me or anyone seeking to follow similar methods. 2006-07 was in many ways a remarkable year.

* This is subject to very minor adjustment for some data I am awaiting on one investment.

Mining Stocks

Comment by a Reader

You seem to confine yourself to industrials and avoid mining stocks because you consider that your method is not suitable where metals prices can be volatile and PE ratios are therefore not a good indicator of value. Also, there is higher risk due to exploration surprises etc.

My Response

This is not quite right. In *The Aggressive Investor*, I tried to make two things clear:

Firstly, that price earnings ratios were not really an appropriate method for valuing miners. The idea behind a PE ratio is that the E number is the maintainable earnings of the business. This is fine for industrials like manufacturing and services companies, but is inappropriate for some sectors. Among the ones that are inappropriate are miners. They are, in general terms, exploiting a wasting asset. Therefore, they do not have maintainable earnings unless they are very large and diversified, with long-term mines. Also, metal prices are more volatile, along with currencies than the prices in industrial markets. For this reason, it is better to use a discounted cash flow analysis based on estimates of mine life, prices and currencies.

That said, I did point out in *The Aggressive Investor* that I do invest in producing miners. I had some in my portfolio last financial year. I also had a number of companies that supply goods and services to this sector, with which I did very well. This leads into the second point. I do not invest in explorers. I see them as speculations and class them with technology hopefuls and other new businesses trying to prove up a new business model.

Comment by the Reader

Unfortunately, in Australia we have only a small number of industrial stocks to choose from and these are diminishing due to mergers and acquisitions.

My Response

I am sorry, but I do not agree with this observation. Of course, it depends on what you mean by a small number. Compared to the US, yes we have relatively few. However, I have no problem finding hundreds of them to choose from. You may find some of them by following my weekly column in the Market Wrap section of the Australian Financial Review on Tuesdays.

Nor do I agree the number is diminishing. The last three years have seen a great number of new companies joining the list. Although many are mining speculations, there have also been many industrials.

Question

I notice from your books that you are happy to consider recent floats, especially if they are currently moving to new historical highs. This was food for thought for me because I had always favoured something with a longer history (I look for institutional participation, hence inclusion in the ASX200). Do you have any observations on how successful your trading in recently floated stocks has been in comparison to more established stocks?

Answer

Generally, I prefer, like you, to invest in a business that has a successful track record. However, size is not as important as it is for you. One of my first screens on finding a company is whether it makes a profit and pays a dividend. If not, I will not touch it until it does. There is one exception to this – if it has a history of profits, but has held off paying dividends to fund expansion, I may invest if I form a judgement that it is likely to start paying dividends soon. Imdex is one like this in my current portfolio.

What I think you may be missing here is that there is a difference between a newly floated company with no existing business and one that has been around and made profits for many years before it was listed. Quite often the prospectus will give you a clue on this score. I think the example you have in mind from my books is Funtastic. I have explained how I researched that one – retained earnings were a strong clue to its profitability prior to listing. That it was good value and had a rising trend finished the story off nicely.

Your specific question is a comparison between newly floated stocks and ones that have been long-established on the market. I cannot answer this – I have not done any analysis of it. It is not an issue that is all that important to what I do. There are two things I like about newly floated companies:

Firstly, if they are making new highs in an uptrend, there is no overhead resistance from past trading.

Secondly, if they are floated in a bear market, or very early in a bull market, they are often somewhat under-priced to get the float away. The clue to this is usually when they start trending upwards.

Question

It seems to me that the miners can have phenomenal capital gains under the right conditions and are worth thinking about very carefully. I propose that most of the steps in your method could be modified to deal with the miners. Forgetting PE and DY, you could still look for stocks either in a turnaround situation and breaking out from the accumulation phase, or those with prospects of profit growth and breaking out from consolidation. Some different skills may be necessary to deal with the revised fundamental filters. Now that the resources bull market is well along it would probably be safer to trade shorter moves (i.e. to use smaller order lows to set stops and look for re-entry if the correction proves to be minor). It's less like investment and more like trading (therefore more demanding time-wise) I know, but the profits may be astounding. I have done very well doing this over the last year. Do you have any comments or warnings?

Answer

Actually, as I said above, I do invest in producing miners. So, you are to some extent misunderstanding what I do. The point is that, as you propose in your question, reliance on the PE ratio is not the best way to analyse them. You are correct that the chart can be more important than for an industrial stock. I love companies in any sector that have been through tough times or are out of favour in the market. If I see a value model chart, I am very interested. The only point here is that miners require a lot more work in analysis and they can be much more tricky than an industrial. If I have to make a choice between an outstanding chart for a miner and an outstanding chart for an industrial I will prefer the latter. The last three years have been a bit like that – so many great opportunities in industrials that I did not need to wade deep into analysis of mining companies. I do not have enough money to buy them all and I don't need to. What I have done very well with, as mentioned above, are the companies that supply the booming mining industry.

What you seem to be asking is stated as wanting me to change what I do, but seems also to be seeking my approval for what you have been doing. If you have the runs on the board, then you have it. Well done. There are many ways to make money in the markets. I do not pretend to teach the only way, or that my methods are the best way – however you define best. The reason that I wrote *The Aggressive Investor* was to teach how to create an investment plan. I did that by showing you my plan as a model. I said in the book that you need to define your plan to suit you. Each of us is very different in our total make-up and experience.

There is one caveat I would make though. You used the term miners. I hope we are talking about the same thing. A miner for me is a company that mines something and makes profits and pays dividends. If you mean by miners companies that are exploring, or who may have found something, but not yet got a mine working, then it is way outside what I do. Even the great BHP has

failed to get a mine working after finding a resource. Mining technology is a difficult art, made very risky by the varying properties of ore from one mine to another. I am an aggressive investor, but these are speculative situations that are outside my plan by definition. As I said, I may be missing something by this, but that is the choice I make in my plan. I am beating the market at acceptable risk, which is fine for me and not screaming at me to reconsider what I am about.

The last part of your question raises the issue of trading rather than investing. In almost 40 years in the markets I have tried everything from day trading (even before the internet, computers and mobile phones) to investing. I have found that the big money is in the big moves – the trends that run for years. I have therefore become an investor – albeit an active and aggressive one. If anything, I am moving towards lengthening rather than shortening my time frame. This is overlaid, though, with my market risk strategy, which is what makes my approach diametrically opposed to professional fund managers. They have to (no choice because of size) aim to profit from time in the market and asset allocation is therefore critical. I am trying to time the market. That is not easy and is not low risk.

Overseas Markets

Question

Have you tried investing internationally? Now that the internet and global economy are part of everyday life, it seems to me that very soon more online brokers will start to offer a platform to trade international shares from a local account. I read recently that the number of Australians directly holding international shares is skyrocketing. I receive market news as it happens on the internet. A buy or sell order is just a UK phone call away. It would be better to be able to trade it locally though and that made me think about being able to trade international shares from a local account. Macquarie can organise it, do you know of any other brokers?

Answer

No, I do not invest overseas. I thought I made this very clear in *The Aggressive Investor*. The prime reason is that all my long term liabilities are in Australian dollars, so I have no need for a natural hedge by having assets in another currency.

I also find that I have my work cut out to follow about 1900 securities on our market.

There are some real problems investing overseas:

Information Risk

Yes the Internet is better than things used to be, but it is not a perfect solution. One problem is that there is information there, but can you trust it?

Transaction Costs

They are usually higher – especially through funds, which is the only way you can access some markets realistically. Fees tend to be lower in many

overseas markets, but you have to be able to establish an account in those places. There can then be taxation complications, which also involve costs.

Regulation Risk

I would have little problem with New Zealand, but even the UK and the US have many varied differences between our reporting systems and theirs. Even the way their markets operate. Smaller markets would be far more hazardous.

Currency Risk

Yes you can hedge, but that also has a cost.

Sovereign Risk

Australia is a very stable place, though that, too, is changing. Maybe the US and the UK are OK. Or are they longer term? Smaller markets can have extreme sovereign risk.

Economic Risk

Remember Mexico, Brazil, Argentina, Israel, Germany, and Russia. Most of them may be OK now, but at one point investors were wiped out. The US may be heading for economic trouble unless they turn around the twin deficits fast. This can play back into currency risk, of course.

So, I wonder whether that green grass on the other side of the fence is worth straining for – especially since risk and cost is higher.

The above is my point of view. There are many who will disagree. That is as it should be. I am not trying to convince you of anything, just laying out my take on the territory.

I do not know which, if any, local brokers allow you to buy on overseas markets. As I said, it is outside the area I work in.

Stop Loss Levels in a Strong Move

Discussion of a recent email from a different reader follows.

Comment from the Reader

During a trade, my thoughts vary between **letting your profits run** and, as the market begins to turn, **never let a good profit turn into a loss**. In one trade, the market had travelled some distance without a retracement. I had a tidy paper profit, but the technical level for my stop loss was still my original stop loss level. Then the market moved down. My stop loss was hit and I took a loss after showing a good profit. I felt that I needed a clear rule to deal with this situation and the conclusion is this - when a market rises for a considerable way without a retracement, I should sell on the confirmation of a reversal signal. But, in keeping with the mantra of letting my profits run, I should buy again if the trend reasserts itself.

My Response

In my mind, the key issue is that you described your **trade**. You did not describe your **investment**. This suggests that you saw what you were doing

as trading, not investing. These two words are difficult to define. The more difficulty you have defining them precisely will be a clue to how deeply you have thought about the issues involved in the process of trading and investing.

In the present context of your comments above, it seems to me that by describing what you were doing as a trade tells me something about your timeframe. The problem of having a clear definition on timeframe is one of the most difficult ideas to come to grips with in trading or investing. It can be one of the final keys to becoming good at what you are doing.

It is really a very simple problem to define, but also one that is very difficult to come to grips with. Yet it is vital. Unless you know very clearly what you are trying to do, and here I mean in terms of timeframe, you have only a slim chance of succeeding consistently. Of course, a bull market may lead us to believe for a while that it is easy and we do not seem to need to confront the problem. Eventually, the bull market changes character and there are days of reckoning before those who have not adequately mastered this issue.

Before going any further, let me say that this is not something you can fix in a few minutes. It takes a lot of thought and testing and experience to develop a clear view of timeframe and to ingrain it into your psyche until it is instinctive.

From your description of the trade, it seems to me that you had got on board one of the upward swings in a medium to long term upward trend. What you have not said is whether you were intending to trade that big trend, or whether you were only intending to trade that one immediate upward swing of the uptrend. Yet there is ambivalence in what you say. Suppose you were intending to trade the big uptrend, and got stopped out when the trend failed in that timeframe. That should probably be seen as something that is to be expected in trading. Often our trades will not be successful. This is not a great problem if our winning trades make far larger profits in total than our losing ones make losses in total. It is part of the nature of trading.

However, your solution to the problem sounds to me as though you may be using hindsight to fix something that was not a problem. In essence, you have switched timeframes. You set out to trade a big trend, through multiple upswings and corrections. However, when that one trend failed, and you were stopped out, you have found a way to have avoided the loss by changing your plan. I think that could be dangerous unless you are doing it very consciously.

If you want to change your plan - so that you do not trade the big uptrends through multiple upswings and corrections, but instead try to capture only one of the upswings – then your proposed approach may be fine. So long, that is, that you do two things. One is to recognise and be comfortable with your new shorter timeframe and everything that it involves in analysis, time required, cost and taxation implications etc. The other is to test that what you are now proposing to do will work. This means that you should test the idea on hundreds of charts to see how well it may have worked in the past and the

type of markets in which it worked best. You may also need to test the various reversal signals you choose to use.

There is another issue here that I think is important to note and understand. There is a difference between a stop loss and a sell signal. The stop loss may be only one of your sell signals. Indeed, in your new plan, you have now defined a sell signal in relation to a reversal signal. So, in effect, you have two sell signals and would act on whichever happened first. The big difference is that a stop loss is a sell signal to protect you, first and foremost, from catastrophic loss in a failed trade, while a sell signal may be to protect a profit.

Short Selling

Comment from the Reader

There were some aspects of your plan that differ from mine and I don't use. As you said in your book, a trading plan should be personalised to the individual. For instance, your views on short selling are very valid and make perfect sense, but I allow myself to sell short. I'm a positive person by nature myself but as a trader, I am a small fish in a big ocean. I read the general conditions and attempt to see things as they are. If the market is set to fall, it will do so with or without me. If the charts say that the market and individual stocks are falling, I feel that I am entitled and compelled to sell that stock short and be rewarded for my insight. This is not being negative, but seeing things as they are and taking positive action to exploit a good trading opportunity.

My Response

My book *The Aggressive Investor* was written as a model of what an investment plan should look like. I could have written it as a theory document, but I chose instead to teach by showing and bringing to life my methods as a model, with practical examples. As you acknowledge, I made the point strongly that my model is for me and is unlikely to suit anyone else exactly, because they are not me and do not have the specific experience I have had.

I do not use short selling as a strategy or a tactic. I explained why. You have a different view. You explained why above. That is as it should be. But there is one big proviso. This is that you have tested your strategy and tactics for short selling and find they work. You will have done this, I hope, over hundreds of stocks in varying markets, so you will know when the approach you have devised tends to work and when it tends not to. This is far more important than the arguments you proposed above.

I am not opposed to short selling in principle. However, I have chosen not to use it as a strategy or a tactic. That is not intended to be an argument that you should not do it.

It is amazing that as I go around the country speaking to groups, I frequently get questions like this. Colin, how do you deal with such-and-such a situation? I answer it in the terms I was asked – what I would do. However, the questioner often then tries to argue that it is alright for them to do something different and why. This is the problem. I was asked what I do. What they were

really wanting was for me to tell them what they should do. These are two totally different questions.

I am now becoming a bit pedantic about this type of question and asking my own question back – which is it that they are wanting? They usually say both, of course. That is useful, because I can frame my answer to both questions inside a general point that there are really two separate questions being asked.

Stops and the Percentage Risked

Question

On page 174 of **The Aggressive Investor**, an example showed a buying price of \$9.55 with a sell stop of \$4.40. My question is: does the price need to fall by over 50% to know that something is not looking good with that investment?

My Response

With the greatest respect, you are misunderstanding that page in the book. I was illustrating by example a calculation where my money management rules would not let me buy the stock because the maximum number I can buy is less than the minimum investment called for by my plan. It was not a real situation, just an illustration of a point.

I have developed a method over almost 40 years. I have tested it over many hundreds of charts. I did this by paper trading them as I constructed the chart by hand from pages I saved from back issues of the newspaper over many years. I did not know what the chart would look like until I drew it. You can do this in the modern age of computers by taking a stock whose chart you have never seen and building the chart up by adding one bar at a time to the chart, making a decision before exposing the next bar. I have done seminars like this using *Insight Trader* charting software, which has this very useful feature.

So, I know it works most of the time in my timeframe – which is an investor looking to capture trends that run for months to years, preferably years, with multiple upswings and corrections in the uptrend.

What I am NOT saying here is:

1. That it is the only way to do it
2. That it is the best way to do it
3. That it is what you should do

Remember, the book is to show and explain a model. It does not set out or pretend to tell you what you should do.

However, that said, I also realise that you are raising an issue that bothers you, but does not bother me anymore, using those numbers for the purpose.

Now comes the tricky bit – do you want to know what I do and think or what you should do and think?

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What I Do and Think

If the chart on which this theoretical example was based indicated that was where my sell-stop should be then that is where it will be. I am utterly indifferent to what percentage the sell-stop is of my buying price because that is irrelevant to me. I am an investor. My aim is to make a return on my capital – for the total gains from my portfolio to exceed the total losses over a period. I never, ever, risk more than 1% of my capital on a stock and rarely that much. One half of one percent or less is more common in practice.

What You Should Do and Think

That is up to you. I could give you some advice, but the problem is that I am not you, so it is not going to be necessarily correct. It may in fact be dangerous. The nature of investing and trading is that you have to think these issues out for yourself. I have told you what I do and why I do it, but that is only as a means to show and explain by example how you should go about developing the plan that suits you.

Question

... and if I was still holding it at \$4.50, how long could it take just to get back to even?

Answer

I am sorry, but there is no answer to this. It is like asking how long a piece of string is. It may take days, weeks, months or years, who knows?

I think you are asking the wrong question here.

How long to get back to even is a strange question anyway - are you intending to then cut your losses? If not, why are you asking that question instead of how low before the anticipated uptrend starts? Remember it has not hit the sell-stop, so it is still within my plan.

I think the question you should be asking is a totally different one – if the stock sinks back into the accumulation pattern, what would I do about it?

I would hold the stock. However, I doubt I would be doing so forever. I have no concept of a time-stop in my plan, but many traders and some investors do. Instead, I use an idea that I did not discuss in the book – I guess I took it for granted, being an economist by training – and that is opportunity cost. If I held a stock that was languishing back in an accumulation pattern and there was another good breakout to buy, with no funds to buy it without selling something, I would be likely to sell the languishing stock.

Where to Place a Stop-Loss

Comment by the Reader

In buying a breakout, your placement of a stop was below the lowest low of the trading range. I understand the theory upon which the placement of the stop is based ...

My Response

Correct. No problem.

Further Comment by the Reader

... and below the trading range is the absolute point where the investment is wrong.

My Response

That is not part of my concept. I do not recall ever introducing an idea that my sell stop was there for the reason you have implied in your comment by introducing an idea of an absolute point. I think you have misunderstood what I have written.

Further Comment by the Reader

I also understand your desire to place the stop where it won't be hit by the normal fluctuations of the market.

My Response

Again, you are misunderstanding me and have ascribed a motive to me that is not my method.

In the specific theoretical example you pointed to, that level was where the logic of my investment plan indicated that I would be wrong about the investment. In choosing that level, I have no motive to avoid normal fluctuations. The theory behind that level is that the lows of the accumulation or consolidation pattern are where support has been manifested before. If it falls through that level later, then something important has changed. It is that simple.

Further Comment by the Reader

When we buy a breakout, we are buying a stock which is showing strength in being able to break through the confines of the range. I'm buying it on the basis of it continuing to show strength and keep rising... in the hope it will be one of those that continue a long way. Now if it doesn't perform in this way and trades back into the range, do we need to allow the price to fall below the low of the range to know that the stock is not as strong as we first thought? We didn't want to own the stock when it was in the range. We wanted to wait till it broke above. If it trades significantly back into the range, then it is back where it was when we didn't want to own it.

My Response

What you say sounds logical and fine in theory. However, are you not ignoring that the breakout has taken place? Before the breakout it was a potential accumulation or consolidation pattern. The breakout confirmed it. All my testing work and experience shows that it pays much of the time to be patient. It is based on my two models – value and growth.

Question

Do you think the trade would be looking weak if it traded significantly back into the range...say the mid point of the range ...?

Answer

I am aware that David Fuller uses the mid point for his stop-loss. My work and experience has shown me that it is not a reliable solution. Mid-points are just an expression of magic numbers – see the earlier newsletter on the research on Fibonacci and Gann magic numbers.

Question

... or below a trough around that level?

Answer

That is quite different.

Firstly, it has nothing to do with the mid point of the pattern for me. It has to do with support levels.

Sometimes a trend will start within the pattern. I may therefore use the most recent trough in that trend as a sell stop rather than the low of the pattern. Likewise if there is a very clear – and I stress very clear – support level in the pattern, I would use that. The danger is wishful thinking - finding what you want to find (called rationalisation). If in any doubt, I use the lows of the pattern.

Question

Or in terms of support and resistance...the resistance that was at the top of the range that has now been broken through should act as support on the retest. If it doesn't hold up and price goes through it back into the range, would that be reason enough to say the stock is not as strong as I first thought or hoped and on that basis get out and look for a stronger stock with a view that the time is not yet right for that particular stock, but continue to watch ready to buy again if it begins to move?

Answer

That is not what I do. As I said before, my testing and experience has shown that many stocks, which went on to make lovely trends, first pulled back into the pattern before moving higher.

However, I am aware that some people use the method you propose. It is logical. There is nothing wrong with logical reasoning to establish ideas that should be tested.

So, if you want to use this proposition, you need to test it.

Go back over twenty years and define when there was a bull market and when there was a bear market. This is important because I find more breakouts fail in bear markets than in bull markets.

Then you need to find hundreds of stocks with breakouts and tabulate how many failed after pulling back into the pattern and how many went on to trend much higher.

Only when you have this data can you know the answer to your question.

I have not done my research as thoroughly as this, but I wish I knew thirty years ago what I know now, and I would have done it as rigorously as that. The only reason I am not going back and doing it is that the way I am investing is working well, so I think I have something that works for me. If you need something different, then you need to do the work before risking too much money on the idea.

I hope this discussion is of use on your trading journey.

Many Roads Lead to Rome

(Originally published in the BeyondInvest April Newsletter)

Introduction

Learning to be a good investor tends to start the same way for many people. Quite unlike most other professions, they believe that investing is easy and that anyone can do it, providing they find the secret. Their journey in search for the secret is colloquially known as the search for the Holy Grail. There are two realities, which conflict with this approach.

First, learning to be a good investor is not easy. Experience indicates that it takes about ten years to gain the education and work experience that leads to the development of sound judgement in any similar profession. It took me longer than that. I rarely hear of many investors who have been able to establish a consistent track record in much a shorter time. However, many claim such a feat after a year or so of a bull market. Wall Street has an aphorism for this – it is called mistaking a bull market for brains. A consistent track record can only be demonstrated over a full bull and bear market cycle or two.

Second, many roads lead to Rome, which means that there are many ways to make money investing. There is no single secret or right way to do it. One powerful reason why there can not be any single secret is that each one of us is different in every respect that makes us the person we are. This includes our upbringing, education, experience, attitudes and beliefs, tolerance for risk and much more. In short, everything which has happened to us since the day we were born. Each of us will have taken many diverse decisions in the journey of life that makes us different to everyone else. The key is not to find the one secret, but to find a method which suits who we are and which will work for us.

My book *The Psychology of Investing* was written as a tool to help investors with two things. One was to help them to understand what their own temperament type is and therefore what investments to focus on and what methods are likely to be appropriate. The other is to explain the common traps and biases that we all fall victim to as we try to make investment decisions. If you feel you need to develop your knowledge in this area, you may buy a signed copy from my web site for \$39.95 including postage to Australian addresses.

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Let's move on from there and assume that we are already on our journey to investment competence. Some of us will be just starting and others will be well advanced. I put myself in this second category. I have been investing for almost 40 years. I have learned a great deal, but I have found that there are always new investing ideas to investigate and test. I fear the day that I ever think I know everything there is to know about investing, because then I will have stopped growing as an investor.

What I want to discuss now is something that I have become more and more conscious of over the last few years. This is the need to realise that many roads lead to Rome. I find that one of the most difficult parts of investing is to be able to see how many alternatives there are. This requires imagination. Imagination is not a quality that is often seen as a necessary trait in a good investor.

This is a very big subject. What I want to do is to briefly explore what I see as the three areas in which to look for more than a few roads to take to get to Rome.

The Light Switch Approach

We are all familiar with a simple light switch on a wall. It has only two settings – on and off. There is nothing else we can do with it but flick it to one of those two options. There is no dimmer switch on it. There is no other setting that is neither on nor off.

At this point you might wonder what I am talking about a light switch for. The reason is that I find many investors see their investing decisions like a light switch – a yes or no decision. Do I buy or not? Do I sell or not? Do I do something, or do nothing?

Take what might sound like a simple question – XYZ Corp has a breakout from a continuation pattern on its chart – should I buy it or not?

Wrong question! Instead, the question should be to ask - what are all the options open to me?

The moment I ask the right kind of question, the whole landscape is different. What might be some of the answers to that question?

Some options I can think of:

- Wait for more evidence a trend is developing.
- Wait to buy a pull-back to the breakout point.
- Buy a small lot now and build a position over time.
- Buy a full position right now.
- Buy a call option and exercise it if a trend develops.
- Look at other shares with an even better chart prognosis.

I am sure you can think of more options available. There are also many other questions we should probably ask and investigate.

Sticking to this question and this list of options, the task is then to assess the pros and cons of each alternative. Only then can we start to make a good decision.

The lesson from this is that, if we think that we have only two options open to us in a situation, remember that this is light switch thinking. We should try to broaden the question until we come up with all the options. We should not try to assess them as we go. Instead, use the brainstorming method of listing all the options. Then set out some criteria to make a judgement and assess each one against those same criteria. Then we should be able to make a better decision.

Perfectionism

One group of people who find investing difficult are the ones who seek the perfect answer to a question. In some life circumstances there are perfect answers, but not in investing. We all have some elements of the perfectionist in us and that character trait makes investing more difficult for us.

I am often sent a question about investing and asked what is the right thing to do? This is another example of asking the wrong question. In investing there are very few absolute right and wrong answers. To try to find which answer to a problem is more correct than any other answer is an exercise in frustration. This is because we are dealing with a question, the answer to which depends on what happens in the future. The future is largely unpredictable, so it is nonsense to think there is a best answer, except in hindsight, which is too late. Trying to find perfect answers is to misunderstand the nature of investing.

I have lost count of how many times I have had to choose between buying one of two stocks. Many times the decision may have come down to stock A having a near textbook perfect chart pattern and stock B a less than perfect one. I may have decided to buy stock A, because it had the better pattern, but looking back afterwards, it was stock B that did much better. The way to look at this is that again I have made a decision based on the wrong question – which stock had the better chart pattern? What determined the outcome may have been something different altogether. It may even have been unknowable at the time the decision was made.

This question of what is the right decision to make is another example of many roads leading to Rome. The reality of investing is that there is more than one effective decision we could have made and there were also several ineffective decision we could have made. I prefer this idea of effectiveness, rather than using the terms right or wrong.

The advantage of using effectiveness as the criteria has two advantages. First, it focuses us on the idea that there are many possible answers, more than one of which may have a positive outcome. Second, it focuses on the

idea that the outcome is unknowable, no matter how much information we have. The only way we will know which of the answers that would have yielded a positive outcome gave the **best** result is in hindsight.

The other thing this way of looking at the issue exposes is that there is no point trying to reach perfection. Instead there are several courses of action, which may give a satisfactory outcome. Since we cannot know which is best until afterwards, trying to judge in advance which course of action is best is another case of asking the wrong question. Instead our investment plan should provide some criteria for assessing the options into two categories – options that have a good probability of a positive outcome and options that do not. Once we have a small number of options that should have a positive outcome, we can take a different approach to the problem. We can take a small position in each stock and let the market decide. The positions that start to work well can be built into full positions. The ones that do less well can be left as small positions, in case they are late developers, or closed out.

Too Available

The third situation where many roads lead to Rome, but only one or two are seen is in imagining a range of different scenarios for how the future might unfold. This is where our human weakness of limited or distorted imagination can lead us astray.

The psychological trap here is known as availability bias. The easy way to understand this is that our memory is an unreliable instrument. It tends to give great prominence to a previous happening that was the most recent example, the most vivid example or the example that affected us personally. This is a real problem in trying to imagine a range of possible scenarios. One or two past events may stick in our mind to the exclusion of other possibilities. This can cause us to think that they are the most probable outcomes, when an objective examination shows that other scenarios are just as likely or even more likely.

The key to seeing all the many roads that lead to Rome in a situation is to assemble as many possible outcomes as we can. This is where knowledge of history is very valuable. It can alert us to how wide the range of possibilities really is. It can also help in putting them in a truer perspective. If we do not know the full range of things that have happened before and can not imagine them for ourselves, we can find other people who can help us do so. Ask them to play devil's advocate with our scenarios. Ask them to help us to imagine other ways the future may unfold.

Once we have a list of the roads to Rome, we can seek out objective information on each road and arrange them in a rough order of likelihood. Again, don't attempt to put them in a perfect rank order because that is simply not possible. Only one can actually happen, so all the others can not be ranked accurately even in hindsight.

The other thing is to realise that we don't need them in a perfect rank order. We just need as complete a list as we can dream up. Then, we can take each

one in turn and analyse how it would affect us if it came to pass. We then try to work out a strategy to follow if it does happen. This way, for each possibility, we should have a contingency plan. Then the easy bit is to watch what unfolds and put the appropriate strategy into practice.

Conclusion

One technique that is very helpful in this whole area of seeing all the alternatives is known as the art of contrary thinking. This is also covered in my book *The Psychology of Investing*. It is an art well worth cultivating if we aspire to be good investors.

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