Colin Nicholson: Newsletter 72

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Dealing with a Market Downturn

Question

(This question was sent late July 2007)
My wife is a buy-and-hold investor and I have been arguing with her over your methods in a market downturn. She agrees with your strategy on a single company basis where if you buy a stock which promptly goes down through the stop loss you have made the wrong decision and you should get rid of it. However, she cannot agree on this process when the whole market goes down. Is there a difference? My wife says after a couple of more days of correction, the market will go up and therefore I will have sold out unnecessarily. My opposite view is that I don't know where the market will turn. It could just as easily go down another 200 points in which case I have put some money in the bank to buy back at a lower price.

In a total market downturn do you rigorously stick to selling out at the stop-loss point or does my wife have a point that it is not a stock specific event?

Answer

I think there are two things here to think carefully about:

Firstly, if a stock violates its stop loss you should always sell without hesitating. Your stop should be where you are wrong about the trade, therefore it should be sold. There are many ways to determine where you are wrong, but they should all be based on the logic of your investment plan. My plan calls for trading a trend, so if the trend is violated by making a lower trough, I am out.

Secondly, when faced with a major peak there are two possibilities - that it is just a correction and that it is the last peak in the trend. You can only know which it is in hindsight. To manage this risk, I reduce my exposure to the market using my market exposure strategy as set out in my book *The Aggressive Investor*. I have known from the chart that the downturn was coming for more than a few weeks, So, I have reduced my exposure to the market to just below 50%. I will now also sell any holding that has its stop violated. If it turns out to be a correction only, I will begin rebuilding my portfolio. It can be healthy to purge the poor performers in these situations and when it is over decide whether to buy them back. Often it will be that you do not wish to buy some of them back and have only kept holding them because you already had them.

Issue of New Shares

Question

There is a stock I am interested in for a short term trade and the company has released an announcement saying that they are issuing more shares (1 500

000 ordinary fully paid shares). How does this action usually affect the share price?

Answer
This is a good question. It raises interesting issues.

The impact of a new issue of shares depends a lot on how many there are being issued and at what price.

With respect to how many shares are being issued, we should look at it like this. If the company has already listed 100 million shares, issue of an additional 1.5 million is probably insignificant. However, if the company has only 10 million shares issued now, then the issue of 1.5 million more may be very significant.

The easiest way to find how many shares are already issued is to use the ASX web site to access announcements for the company concerned and look in its last annual report. That should show towards the end of the notes to the accounts how many shares were issued at the last balance date. It should also show how many shares were held by the top 20 shareholders, which can be interesting.

With respect to the issue price, if it is close to the market price, it will be not very significant in terms of how it might affect the share price. However, if the price at which the new shares are issued is substantially lower than the present market price, it will tend to depress the market price after the issue of the new shares.

It is usually possible to find the issue price of the new shares in the announcements section of the ASX web site.

In the event that you can not find the relevant announcements (rare - all such things must be reported to the ASX) on the ASX web site, look also on the company web site. If you have made every effort to find the information yourself, or if you think things have changed since the last report (again there should be announcements) and you cannot find them, an email or a phone call to the company should get you some help. If a small company, ask to speak to the company secretary. If a large company, ask to speak to the shareholder relations person.

Another important concern with the issue of new shares is that unless the issue is a pro rata rights issue, the interest of the existing shareholders will tend to be diluted. This is a little complicated. Assuming the shares were issued for cash, new funds have come into the business. This cash should generate more earnings, but there could be a lag before that occurs. In the interim, the earnings of the company are spread over more shares and the earnings per share will fall - and maybe the dividend. This may or may not be significant, again depending on how many shares are issued, at what price and how the money is invested. If the new funds are used to buy a new business, the earnings purchased may be greater than the cost, which may actually increase the earnings per share. Quite often the company announcement will indicate the use of the funds and whether the company thinks it will improve or dilute earnings per share.

Again, this information should be advised in announcements unless it is only a smallish issue to raise general working capital. If you can't work it out and the issue is a large one relative to the existing issued capital, you could ask the company.

However, asking the company for information is one thing. Asking for opinions is another. For one thing, the company is not a disinterested party. For another, there can be all kinds of reasons, both legal and competitive, why they can not or will not give you opinions. It would be better to address those questions to a stock broking analyst, if you use a full service broker. Another useful source is media reports and services like Aspect Huntley (though it is frequently not sufficiently up to date).

Note that ASX rules restrict what proportion of the capital may be issued without a vote of shareholders. So, if there is a vote required, the new issue will tend to be significant. In this case, the material sent to shareholders for the vote will usually tell you what you need to know. When the material is sent out to shareholders for the vote, it should also be on the ASX web site as an announcement.

The calculations for the effect on earnings per share are quite complicated and technical. I have tried to answer your question in simple language. Remember that the expert analysts make all sorts of complex calculations, but we probably only need the big picture impact to make most investment decisions.

Finally, you refer to short term trading rather than investing. In a short term trading environment the fundamentals are probably less relevant. Instead, the share price should tell you what the market thinks. If the price is trending up, then the market thinks the news is positive. If the price is trending down, the market does not like the news. The market could be wrong, but you cannot make money buying a downward trending price chart. You must either short the market, so you are trading with the trend, or wait until the market gets it right and the trend turns up and then buy.

Sell Stops in a General Downturn

Question

My spouse and I have debated your stop-loss strategy. The issue is whether to act on a stop-loss signal for a stock when the market is in decline. I can understand your stop-loss strategy for individual stocks which go into decline when the rest of the market is booming. Do you rigorously stick to your stop-loss strategy if the whole market is in a downturn?

Answer

In my investment plan I exploit an uptrend. The uptrend is defined as a series of higher troughs. If a stock falls through the last trough in the uptrend, then on my plan, I am wrong about that stock. That is where I position my sell stop. Just below the last confirmed trough in the uptrend. A trough is confirmed when the price rises above the previous peak in the trend.

Since my sell stop is where I am wrong about the investment, there is no question in my mind about whether to act on the sell stop. I do it without a moment's hesitation and usually offer the holding at market. Only if the stock is very thinly traded might I have to manage the sell order somewhat.

The direction of the market is irrelevant for me in this situation. If I am wrong, looking for a way out of a difficult decision by reference to the market is an example of a very human trait to seek ways to rationalise poor decisions.

I also start building a position on a breakout upwards from an accumulation or consolidation pattern. In this case, there is not an existing uptrend, but the strong likelihood of one unfolding. As it unfolds, I will build my position as described in my book *The Aggressive Investor*. On both the models I base my plan on – the value model and the growth model – the price should not fall back through the pattern from which it has broken out upwards. If it does, then I am wrong and that is where I position my sell stop – just below the lows of the pattern.

As in the case of a sell stop in an uptrend, I execute my sell stop below an accumulation or consolidation pattern without hesitation.

You asked about my sell stops and that is how I have answered you above.

However, there are three other aspects of my investment plan which also have relevance. My sell stop is not the only reason for me to sell out of a stock.

The first of these other considerations is the only one that is related to the condition of the overall market and that is my market exposure strategy. This overrides everything else. When the risk is low I am fully exposed to the market. When the risk level is higher, I systematically reduce my exposure to the market. The detail of why and how I do this is set out in detail in my book *The Aggressive Investor*. It should be noted that I only describe my own method in the book. There are other ways market exposure may be managed. The main point here is that every investor should have a strategy for market exposure, whether to remain fully invested at all times through the spectrum of possible plans to one that is very active. My plan tends strongly to the active end of the spectrum. However, while I have found this works well for me, it is one of the reasons I titled the book the *Aggressive* investor. Market timing is an aggressive and difficult skill.

The second of the other considerations is that I also have a strategy for taking profits progressively on successful investments. This is partly a way of rebalancing my diversification strategy. It is also a way to reduce risk. Perhaps more importantly it is a way to deal with the psychology of dealing with very large profits that swing the total portfolio result around in a way that is difficult to handle.

The final one of the other considerations is that I have three basic sell signals, as described in *The Aggressive Investor*. The sell stop level is only one of them. If I find that one of the other sell signals occurs, then it is a signal that the trend is probably finished. I act on these sell signals without hesitation.

Sometimes I will be shaken out of an uptrend prematurely. If that happens and the price then makes a new high for the trend, I will consider buying back into that stock, providing it meets all the other requirements I have in my investment plan which indicate the stock still represents good value.

Comment by Reader
I know you will tell me I should have been getting out of the market due to the volatility - difficult to do if you have just put more money into an SMSF earlier in the year.

My Response
Increased price volatility is one of the markers of the third phase of a bull market. This is called the rampant speculation phase. This is when I begin to reduce exposure to the market. I do not act on increased volatility alone. I would look for other confirming evidence. The things I look for are all set out in my book *The Aggressive Investor* and there is a further detailed current example in my book *Hot Stocks*, which looked at the general strategy for the present market.

I do not understand why the recent movement of funds into a SMSF has anything to do with market exposure strategy, sell stops or sell signals. My view is that we should put our money in the most tax-effective vehicle we have access to and then manage it according to our plan.

Could I suggest that your comment suggests that you may not have internally accepted the implications of my investment plan? This is not surprising. Every one of us is different. I expect that most readers of my books will use my plan as a model of what should be in a plan and why. Trying to copy my plan precisely will present problems like the one you may be implying. I suggest you need to think through what you are comfortable with. It sounds as though my market exposure strategy is too aggressive for your temperament. There is nothing wrong with that. All it says is that you need to have a different way of managing market risk. I cannot do this thinking for you, because I am not you. Only you can take that difficult intellectual journey. I can do no more than help you to see the task ahead of you.

Comment by Reader
The All Ordinaries index chart had being going up and down between 6200 and 6450 (approx) from mid-May onwards. I expected it to break out downwards like April/May 2006. Like most people I took no notice of it. In hindsight, I should have sold. But all the expert analysts were saying the

fundamentals were OK and there might be a correction, but not until late 2007 early 2008. Some people were talking of 7000 by Christmas.

My Response
You may not regard me as an expert analyst, but I had been warning of a correction since late 2006. It is all set out in my book Hot Stocks and I further developed those ideas in talks all around the country from late 2006 through to July 2007. A lot of those who read or heard my thoughts on this reduced their exposure to the market and re-focussed their portfolios on more defensive stocks with adequate diversification.

You are quite correct that most commentators will have been telling you everything was fine. There are a number of reasons for this. Most people talk up their own book. All humans like company. Journalists are required to report the news. If the market is rising, they find reasons for it. If it is falling, they find reasons for that. Their job is not to forecast the market. Most forecasters have a strong tendency to see a continuation of the present trend. So if the trend is up, they see higher prices ahead. Then there are analysts who are employed to sell stocks. It is unlawful for them to tell you lies, but there is no law against them simply presenting a favourable story backed up with facts. The best example of this is a company's annual report. It is a sales brochure for the company. Again, they should not tell you lies, but they may present the company in as favourable a light as possible.

In this environment, it is best to make your own decisions. Ignore the crystal ball gazers and the salesmen. Adopt the philosophy of contrarian thinking, which is introduced in my book *The Psychology of Investing*. Learn to set out the pros and cons of any situation, based as far as you can on hard facts. Where there are only opinions to work with, learn to test those opinions by looking for both sides of the issue. The clearest example of this is when everything looks positive for buying a share. If it is so clear, why would there be any sellers? There must be an alternative view of some kind. Or the seller has a different time frame or a quite different strategy to you. If you can't see why anyone would sell, you need to find someone who can help you see the other side of the picture.

You also said that you could see a correction was due. So did I. The index had been hugging the trend channel line for some months. It was an accident waiting to happen. That is why, in a rampant speculation phase, I had been reducing my exposure to the market. You too say you knew you should sell. However, you were not alone in being sucked into the psychology of a bull market. Most people in a rampant speculation phase seem to forget about risk. They think that the risk is low because all the other lemmings around them are also racing blindly towards the top of the cliff. This was a time to stand aside from the crowd. It is not easy. It can be very lonely. But the result is worth the pain.

Comment by Reader
On Monday 6th Aug, two of my stocks went through their stop losses, so I sold. By Thursday 9th Aug, one stock had risen 10% and I was wondering why I had sold.

My Response
There are two reasons why you would be wondering why you sold. Remember that a stop loss level should be where you were wrong about the investment.

One reason could be that you do not have a clear conceptual basis to your investment plan. If you do, then you would never be wondering in hindsight why you sold. You should have an investment diary in which you have written down where your stop-loss was. Ideally, you would print out a chart with the stop-loss marked on it and pasted it into your diary. Then, when the stop-loss was hit, you should have printed out another chart, which should show that the stop-loss was hit and where you sold. So, it should be there in black and white. Your stop-loss level was violated, so you sold. You should not be wondering why you sold.

What you may be wondering about in hindsight is why you had your stop-loss where you did. If you cannot justify its position using the logic of your investment plan, then maybe your plan is the problem, not why you sold. It would be suggesting that you have not internally accepted and totally understood the logic of your investment plan. It is also possible that you might be blindly following my plan, but you have difficulty doing so. This is again because we are all different. If you are finding yourself double-guessing placement of stop-loss levels, it is suggesting that you need to rethink this whole area of your investment plan. You need to do the hard thinking needed to understand the problems in depth and to also have faith, from much testing and experience, that your plan is one you can work with.

Question
Can you differentiate between when a stock is falling for reasons specific to that stock and a when the stock is only falling because the overall market is falling?

Answer
We humans always seem to want a reason for everything. It is one of the quite natural impulses that have to be dealt with in investing. The problem is one that bedevils technical analysts. It arises because people generally invest based not so much on what has just happened, but on their expectations for what will happen in the future. This means that by the time that reason is available to us, it will be too late to have acted on it. The chart tells us what is happening now. What buyers and sellers are doing and what the interplay of supply and demand is creating by way of patterns on the chart. We can interpret what this may mean in terms of investment strategy, but the chart can not tell us the reasons for what is happening. For that we need to look for news, but as I said, the chart tends to move well ahead of the news in most cases.

Once this is understood, the problem changes. Searching for reasons is not a useful exercise. Instead, what we need to do is to assess what action to take based on the chart patterns generated by buyers and sellers acting on their expectations.

Our investment plan should be based on some kind of model. The model will imply that an uptrend should unfold, remembering that most investment plans will be based on exploiting a rising trend. The investment plan should include a way of defining that trend. There is a wide range of tools that might be used. The way I do this in my investment plan is only one of the many ways you might choose.

Suppose that, instead of using peaks and troughs as I do, you use a daily moving average of a particular length, tested on past data. Your use of this moving average might be that the price bars should always close above a rising moving average. Therefore your sell signal and your stop-loss level would be if the price were to close below the moving average on any day. So, now you do not need any reason for what is happening. Instead, it is only necessary that, using the logic of your investment plan, you know that you are wrong about the investment. Once you make this shift in thinking from news-based reasons to the logic of an investment plan, the whole task becomes much easier.

To answer your questions in these terms, I do not look for reasons. I focus on my sell stops. If a sell stop is hit I sell. I do not care what the overall market is doing. The last thing I would ever do is to take the market condition into account in deciding whether to act on a sell stop for a specific stock.

Instead, market condition is a quite separate issue and impacts on my investment plan at the level of market exposure strategy. This overrides any stock-specific decision in the sense that I will sell a stock that has not hit a sell stop or given a selling signal if the condition of the market indicates that I should reduce my exposure. Full discussion of this is to be found in my book *The Aggressive Investor*.

Dividends and Buy-backs

Question

If I buy a share on the market from another shareholder rather than the company in a float, how am I entitled to dividends?

Answer

A share is a financial asset. It represents part ownership of the company. Shareholders take a risk in owning shares because the company could fail and their shares become worthless. As a part owner, the holder of the share is rewarded for assuming that risk through receiving dividends. Dividends are after-tax profits which are distributed by the board of the company so that each shareholder receives so many cents per share. In other words, they share in the risk of providing finance for the business and are rewarded for doing so by sharing in any profits that are earned.

When a company floats, it sells shares to the public. This is a primary market. The risk and the right to dividends attaches to the owner of the shares when the dividend is paid, not to the person who originally bought the shares in perpetuity.

The original shareholder may at some time wish to sell the shares in order to use the proceeds for some other purpose. This is why the stock market provides what is called a secondary market. The shareholder can sell the financial asset that is no longer required to someone who is willing to pay for it. The price is set by bids made on the stock market.

When you buy a share from someone, you exchange your money for the share which means you now assume the risk of loss and in return you acquire the right to distributed profits in the form of dividends.

Question

Since I am buying the share from another person, rather than the company, how is my purchase of benefit to the company?

Answer

What you are doing is helping to create a secondary market. If there was no organised secondary market, a shareholder would find it difficult to sell the shares, should the shareholder need cash in the future. This would greatly increase the risk and therefore the company would have to make the original sale price much more attractive and maybe pay higher dividends too. This would increase the cost of capital for the company.

Because a secondary market enables shareholders to either sell down or to buy more as they wish, the price of the shares will tend to be higher and dividends lower. This reduces the cost of capital for the company, both in the original float, to service that capital and if it needs to raise more capital later by selling more shares.

What is happening here is that you are part of the process known by the jargon term of providing liquidity. Liquidity simply means that there is a ready market for buyers and sellers. The more liquid the market is for a share, the lower the risk. On the other hand, the less liquid the market is for a share, the higher the risk. You will have heard people talk of less liquid shares. This is what they mean - it is difficult to find buyers or sellers, so the risk is higher. The higher the risk, the lower the price you will pay and the higher the dividend you will require.

Question

How does a share buy-back benefit the company?

Answer

A buy-back usually occurs when a company has surplus capital, with no identifiable use for it for expansion or acquisition of another business in the near future.

Leaving aside the question of franking credits, The company will have reduced its cost of servicing capital. If it had not bought the shares back and cancelled them, it would have still had to pay dividends on the surplus capital. Through the buy-back, it has exchanged surplus cash for shares, which are cancelled and no longer need to be serviced through future dividends.

There is a lot more to this than my simple explanation. For one thing, it may be that, rather than having surplus capital, it is cheaper to service additional debt than service the share capital, So, some shares are bought back with additional borrowings. However, my explanation will provide you with the basic idea.

When Are You Speaking?

Question
Are you likely to give any talks in Canberra in the near future?

Answer
I have no immediate plans to speak in Canberra. I spoke there to the ATAA a few months back. All my speaking engagements are listed on my web site www.bwts.com.au on the Hear Colin Speak page.

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