

# Colin Nicholson: Newsletter 73

5 November 2007

I must apologise for the length of time since the last newsletter. I have been busy writing a new book and it has consumed all my spare time and then some. I will endeavour to make up for it over the next few months.

## **Hot Stocks 2008**

A year ago, I wrote a new book called *Hot Stocks 2007*. It has been so successful, thanks to orders from my newsletter readers, that I have written a new book called *Hot Stocks 2008*. The new edition is a completely new book. I have updated my view of where we are in the bull/bear market cycle. Far more importantly, I have written a new chapter for this edition. It explains at length what I believe to be the appropriate strategies to adopt for 2008, based on my investment plan as explained in *The Aggressive Investor*.

Again, there are 30 stocks discussed in *Hot Stocks 2008*. I have deliberately not covered again the stocks discussed in *Hot Stocks 2007*. Because both books are teaching by example how to analyse stocks, I am assuming you will have learned from them how to update the analysis of the stocks discussed last year, some of which are still in my own portfolio.

*Hot Stocks 2008* is expected to be delivered to me by mid to late November. Within 24 hours of me receiving the book, I will post any advance orders. I will sign all books ordered directly from me. Also, these advance orders will get to you before supplies arrive in bookshops. So, to be among the first to receive *Hot Stocks 2008*, please go to my web site [www.bwts.com.au](http://www.bwts.com.au) and place your order. I will not process your credit card until just before the books are sent out. You may also phone orders to me on 02 9439 9724 in Sydney office hours, but it is much easier for me if you would please place your orders on my web site. The web site is totally secure with SSL encryption and I remove orders from the web site as soon as possible after they are received.

## **A Thought for Beginners**

*Benjamin Graham suggested that every investor should spend a year running a paper portfolio – devising strategies, making stock picks and testing the results – before venturing any real money...is like learning how to pilot a plane in a flight simulator. (Jason Zweig *Your Money & Your Brain*).*

## **Knowing the Right Time**

### **Question**

Is it my imagination, or is this reality? Now that our stock market has made new highs, and price earnings ratios are around 16, why can't I buy anything? I tried to get into some of my old favourites, which I had sold during the August correction, but I can't. The difference between this correction and the previous ones is that the price of most of them seems to be too high. If I limit

my risk to half a percent of my capital, then I cannot buy enough shares to get to the minimum investment of 2% of my capital. Is this normal?

### **Answer**

The fact that you have encountered this problem is a good indicator that you are sticking to the discipline of your investing plan. As Edwin Lefevre said in *Reminiscences of a Stock Operator*, sometimes it is best to sit on our hands. There is a terrible temptation to do something all the time. However, there is a time to be aggressive and there is a time to be defensive. Said another way, this means that we should be aggressive in the early part of a bull market, while the risk is low. However, in the final phase, it is even more important to be defensive and wait for the right time.

I have discussed what you are alluding to in my new book *Hot Stocks 2008*. Specifically, I pointed to the problem that the average price earnings ratio for our market at late October is 14.86 times. That is around about the long term average level. There are two points to be made from this. First, if the current ratio is at the long term average, then the market is not cheap. It is saying that we are probably at least in the second, if not the third Dow Theory phase of the bull market. So, clearly the best of the bull market is now behind us. Second, I scan the market all the time looking for stocks with low price earnings ratios and up trends on their charts. They are very difficult to find now, as you say. To me this is emphasising that we are well into the last half of the bull market. Both these points suggest that we should be much more lightly exposed to the market and defensive because the risk is higher than it used to be. This is in stark contrast to the almost universal absence of fear in the crowds around us. That is time to be even more fearful ourselves.

Now, that does not mean that we cringe under the bed. What it does mean is that we must stick to our investment plan with the dogged determination of a long distance runner. The investing race is a long one. This section has many traps for the unwary. To win the race you must avoid injury in this passage of the course and still be there at the end.

Everything you say is screaming that the risk level is high. Stick to the plan. If it says you cannot buy, then wait. The market is telling you something very important. Only a gambler must bet on every turn of the wheel.

## **A Thought for All Investors**

*In a rising market, enough of your bad ideas will pay off so that you'll never learn that you should have fewer ideas.* (Daniel Kahneman, quoted in *Your Money & Your Brain* by Jason Zweig). Zweig suggests comparing your own results, no matter how good it appears to be in isolation, to the base rate. The base rate is what the overall market did, or what the sector that you invested in did.

## **Be Prepared**

### **Question**

I have followed your market exposure strategy. As of September 2007, I have

the majority of my investment capital in cash waiting for signals to re-enter the market. I don't know when the market will give a re-entry signal, or which stocks will give a buy signal. How can I best prepare myself so that I am well researched and ready to act decisively when the time comes?

### **Answer**

I need to begin by pointing out to readers for my newsletter what you mean when you say that you have been following my market exposure strategy. This refers to my main book *The Aggressive Investor*, in which I set out my entire investment plan. This was followed up by my book *Hot Stocks 2007*, in which I updated my view of the market and suggested what strategy I thought was appropriate and which I intended to follow myself. What I said then (October 2007) is still relevant today and I still hold some of the stocks discussed in that book. In a few weeks, my latest book *Hot Stocks 2008* will be printed. *Hot Stocks 2008* updates my view of the market at more length than the previous book. There is also a new chapter discussing my strategy suggestions which flow from that analysis.

This is not the place to regurgitate what is in the books, so you will need to read them. However, the general thrust of my thoughts in *Hot Stocks 2007* was that we were in the early stages of the third and final phase of the bull market, which is now four and a half years old. This phase is known as rampant speculation. It is when many beginners join the bull market and I start to leave the scene along with many professional investors. By leave the scene, I mean that we reduce our exposure to the market. By New Year 2007, I had taken 30% of my money out of the market.

My strategy after that was to take another 40% of my investment capital out of the market if the rampant speculation phase heated up. Things did become a bit more wild leading up to the shakeout in August 2007. By that time, I had only 50% of my capital still in the market. There had been no sign of a climax rally, which would have prompted me to reduce urgently to no more than 30% invested. However, the market had been hugging the upper channel line of a trend channel which was then over four years in duration. Every time the market had reached or approached that channel line in those four years we had seen a correction. For fifteen weeks the market crawled up the channel line. A correction was waiting to happen. There were other chart and technical analysis signals too, but this was the key one for me. That was why I had shrunk my exposure to 50% invested.

Once the correction came, I dropped to just under 30% invested as some of my portfolio hit sell stops. I was in the UK at the time and I was a bit slower acting than if I had been at home, but I acted as soon as I was able to.

Once the correction had held at the trend line, (there is a more detailed look at that in *Hot Stocks 2008*), I began to look to rebuild my portfolio. I am now about 35% invested and may move up another 5-15%, but absolutely no higher. I will reduce my exposure again quickly if I see a potentially dangerous peak fail. I may never move much higher than I am now, of course, because the market has very quickly reached the channel line again. Time will tell.

So, when you say that you have followed my strategy, I am assuming that you too took your money out as I described for myself. However, it seems you had not rebuilt the portfolio at all in September. You may have done so by now, or maybe not, depending on how you see the situation. There are no right or wrong answers in this game. The only correct approach is to have a clear investment plan and follow it relentlessly. Patience and discipline are everything in difficult times.

For me, there is unlikely to be a signal to pile aggressively back into the market until we have seen the next bear market. In the meanwhile, there is lots of money to be made using a conservative 30 – 50% of capital in a defensive posture. What this involves is discussed in detail in *Hot Stocks 2008*.

Now I have come to your precise question of what to do in preparation for the next bull market. I think there are several basic strategies:

First, we need to carefully assess our existing portfolio. Does each stock we hold still meet our investment plan criteria? If the stocks we hold have moved up strongly, is their up trend still intact? Where is the current failure point for their up trend, which is where our sell stop should be? If any stock we hold has not moved into profit now, would we buy it again today on the criteria of our investment plan? If not, we should clean out the rubbish and look for better opportunities.

Second, we need to think through very deeply and carefully what we think is the right level of exposure to the market for us. I have my approach, but each reader is different. That is fine. Each of us should have a different plan in some respects at least. So, we should clean out the rubbish and set a target exposure. Then we should work to build to that exposure, if good stocks can be located. If they can't be found, that in itself is telling us something very important. It may be saying that we can only find stocks to buy which are outside of our investment plan criteria. If so, maybe the situation is more risky than we thought.

Third, we need to think out and write down what would cause us to change our market exposure. It is too late to start thinking about this when the market becomes turbulent. We must have thought through all the scenarios we can come up with and rehearsed mentally how we will react to them. I have written elsewhere that this is exactly what I did in 1987. I did not predict the day, but when it came, I knew exactly what to do and carried it out very calmly. Every elite sports person knows the power of mental rehearsal. It is a skill I learned on the playing fields, but have applied just as successfully in investing.

Fourth, we should be using the time when we are mostly or entirely out of the market to keep exercising our analytical skills. Although some people may believe that it is not important, I have found through my experience that it is important to know what we are investing in. A good strategy here is to schedule time in our diary every week to learn about a new company. It does

not matter that much which one you choose each week. However, you might like to use some of the criteria in your investment plan to make the choice. Then at least the work you do will have some relevance for your investment plan. The important thing is to pick companies about which you know absolutely nothing, and maybe had not even heard of before. As a model for how you might do this, look at how I have analysed companies in *Hot Stocks 2007* and *Hot Stocks 2008*. When I wrote those books, those stocks came up on my market scans. Although I read the Australian Financial Review every day, and have done so for 40 years, there are always companies I do not know much or anything about, some of which I found myself researching and analysing to write those books. It is a very valuable exercise to analyse a new company. This is especially so if you do not intend to invest in it now and have no preconceived ideas about it. The process of research and analysis can hone very valuable skills which will be primed for when you need them in the future. Everything in the analysis in the two Hot Stocks books was found in the internet. It is a marvellous resource. Learn to use it.

Fifth, none of us knows everything. There is always more to learn. Elite investors will be looking all the time to improve their skills and knowledge. In *The Aggressive Investor*, I made the suggestion that we try to read one book about the markets, investing, trading or analysis every month. This is not difficult. Just read 10-20 pages, or a chapter, each night before you go to sleep. You will get through a book each month easily like that. I always take a book everywhere I go and take every spare moment to read some of it. This is far more productive than sitting in a trance listening mindlessly to an ipod. If I don't have a book with me, I think about what I last read in the book I am currently reading. Often it is how deeply and thoroughly we ponder what we have read that is even more powerful than just reading and forgetting.

So there is a program that will prepare you for the future markets.

## How Do You Get Out?

### Question

What method do you use to get out at the end of bull markets?

### Answer

My methods are described in full in my book *The Aggressive Investor*. I have updated my specific view of the market in my book *Hot Stocks 2007*. As I answer your question, I am checking the proofs of the book which will update my view in detail, *Hot Stocks 2008*. It will be available in a few weeks time.

To answer your question in full would necessitate me regurgitating a great deal of *The Aggressive Investor* and significant sections of the two *Hot Stocks* books. However, in general terms, my method is formed around these ideas:

I use Dow Theory phase analysis to analyse where I think we are in the bull/bear market cycle. This is my primary tool for devising my strategy for how exposed I want to be to the stock market. The general strategy is to be heavily exposed in the first two stages of the bull market. The Coppock indicator is one of the few indicators I use. It has a place in this process in that

it tells me when we are somewhere near the bottom of the cycle. This is its only use. It has no other proven benefits. Once I think that we are in the third and final phase of the bull market, which is called rampant speculation, I begin reducing my exposure to the market. I first made this judgement in late 2006 and described my analysis of the salient issues in *Hot Stocks 2007* and had put the first steps in place by New Year 2007.

I also use basic trend analysis. This is the identification of the direction and integrity of a trend using peaks and troughs. I will use other charting tools as appropriate to the situation. The 2003-2007 unfinished bull market lends itself brilliantly to trend channel analysis. I have used that to reduce exposure to the market when that analysis indicated we were in the vulnerable zones. The last instance lead into July-August 2007, when I progressively took more and more of my capital out of the market before the break came or soon after it began. Since the trend channel held, I have since rebuilt my exposure somewhat, but nowhere as high as it was a year ago. There is a detailed description of my strategy for market exposure in *The Aggressive Investor* and the recent situation, including the trend channel analysis, is discussed in detail in *Hot Stocks 2008*.

This approach has been very effective for me in the past. In 1987, I only had 25% of my funds in the market on the evening of the crash. My exposure was similar through the 2000-2002 period, which was somewhat different in character and much more difficult to manage.

So, that is what I do in general terms and it is all there for you in detail in my books.

## Looking Back is Vital

*If you have never lived through a bear market like ... 1973-74, it's easy to delude yourself into thinking you have nerves of steel. Every novice investor should study enough financial history to know that booms always end in busts – and that the cockiest traders die first. (Jason Zweig in *Your Money and Your Brain*).*

## New Series of Articles

You may know Xinc, which is a mortgage broker. I have begun to write a series of short articles for their monthly newsletter. The topic is shares and share investing. The target audience is property investors, so the articles are pitched for beginners. The first few articles are now on my Members' web site. I will add new articles in this series at the end of the month in which they appear.

All of my copyright work, other than my books, is on the Members' web site. You are invited to peruse its contents in the form of sample articles on the home page of my free web site [www.bwts.com.au](http://www.bwts.com.au). You may also access a full listing of the material from the links on the home page. The cost of the members' web site is \$44 to join and \$55 per year. Membership enables you to access the material at any time, tho download it, or to print it.

## Overseas Markets - More

I answered a question about trading shares on overseas markets in Newsletter No 71. A reader, who has some experience trading overseas markets, has kindly offered to share some of his thoughts with us. I have lightly edited some of his comments, so they flow a little better in the context of the newsletter:

### **Reader's Comments**

*My comments below are based on experience gained over more than 20 years investing on overseas stocks markets.*

*Investors considering spreading their investment risk by investing offshore might be wise to carefully consider currency risk. As an investor looking to optimise returns, it is not been profitable to invest in economies which have a soft currency, particularly if this that currency is expected to decline over a 12+ month time frame. It has been my experience that investors are unlikely to compensate for currency weakness when investing in weak economies.*

*Consequently, any investor holding a well balanced portfolio of shares, which out-performs the local Index (remembering that 85% of retail investors fail to do so over 10+ years) is still likely to under perform stock markets in stronger economies.*

*The US markets are a good point in case. In recent years, the ASX has out-performed the US markets in Australian dollars by a significant margin. For the 12 months ended September 2007, the US S&P500 lost 4% (in Australian dollars), whereas the ASX200 gained 28.5%.*

*Over the past 2 years the US S&P500 made a capital gain of 3.3% per annum (in Australian dollars) and the ASX200 returned a capital gain of 21.5%. That's the power of being in the right economy and strengthening currency.*

*There are a number of other very bright spots like many of the Asian markets, Canada and Brazil. However, I would agree with you that investors should look to generating sound returns on the ASX rather than diluting their time unless that so happens to include Asia and in particular India. However, there are quite a number of restrictions on foreign investment into India. Investors like me might prefer to invest via listed investment companies and Exchange Traded Funds (ETF's) on other exchanges including the London Stock Exchange.*

*A domestic on-line broker who provides investors with access to many global markets is Melbourne-based Sonray Capital Markets ([www.sonray.com.au](http://www.sonray.com.au)). However, in my opinion, offshore brokerage is still on the high side. Investors need to take into account the costs of exchanging Australian dollars into other currencies.*

*There are ways to reduce the costs, but it needs thorough research. Global broking is the way of the future but like all new innovations, it requires volumes to increase and competition to drive costs down.*

*Currency hedging can be considered but not recommended for investors who are not proficient in trading in the foreign exchange markets, which looks easier than it is sometimes.*

*The bottom line is that global investors should continue to pour funds into the ASX, based on our positive economic outlook, strength in currency and many world class companies to choose from with undemanding share prices. Domestic investors may continue to be hard pressed to find a better investment destination for many years to come.*

### **Colin's Comments**

The view above are those of my reader. While I agree with them in general, he obviously has more practical experience to draw on than I have. I thank him for sharing his thoughts with us.

I have absolutely no experience with Sonray Capital Markets. You are advised to make their own inquiries before acting on the reader's views, just as you should if those views were mine.

*If you have friends or clients who you think would like to receive the newsletter, please email it on to them and invite them to join the list by going to the Newsletters page on [www.bwts.com.au](http://www.bwts.com.au) and clicking on the relevant link. My only proviso is that the newsletter be sent in full and unchanged.*

*My email newsletter list contains only your name and email address, which information is not used for any other purpose than to send out email newsletters.*

*Past issues of the email newsletter are available for downloading from my web site [www.bwts.com.au](http://www.bwts.com.au). Newsletters will generally be posted to the web site when the following issue is sent out, about a month later, so my email list is the fastest way to get to see them. Join the list by going to the Newsletters page on [www.bwts.com.au](http://www.bwts.com.au) and clicking on the relevant link.*

*The newsletter is intended to be a forum for discussion of interesting ideas about technical analysis, trading and investment. It is primarily educational in nature. I have taken reasonable care in its preparation. Nevertheless, everything in it should be read as my opinion, unless otherwise stated, and requires the reader to check the accuracy of facts and test the validity of my opinions before acting upon them. My opinions are not intended to be recommendations to trade or invest in any stock or financial security. Nor are they intended to be recommendations to use any particular trading or investment method. Readers who do not have the ability to assess the relevance to them of any matter discussed in the newsletter should consult a competent and licensed adviser before acting upon them. I am not a licensed adviser.*