



COLIN NICHOLSON

Building wealth through shares

7 October 2000

EMAIL NEWSLETTER No 8

Finding Good Fundamental Information on Stocks

Many of my readers will wonder why I have a heading about fundamental analysis. However, if they do, they have not been to my seminars. I am a strong believer that we should not rely only on technical analysis, even if it is our primary method and is 95% of the decision making process.

Fundamental analysis can add value to the technical approach in many ways. The most important relates to assessment of risk. Risk is what we are assuming in order to make a profit from trading. The whole point is to manage that risk. So, we must know what it is we are trading. All companies are not the same. Some are pure speculations and others are blue chip icons. The risk is much higher with the speculative vehicles. On the other hand, there may not be enough volatility in blue chips to yield a trading profit. The best share traders find a good balance between these two extremes.

This raises the question of where to get fundamental information. The problem is that it is everywhere, in broker research, magazines, newspapers, newsletters and so on, but all of it has a bias or a point of view.

Therefore, we really should try to do our own work. We should read everything we can, but with a sceptical mind, questioning everything. Get to recognise a fact from an opinion. Then develop a feeling for what facts imply.

There is no substitute for experience here, and hard work. "Too hard" I hear people say all the time. As soon as I hear this, I know I am listening to a potential loser at trading. In what other profession can you succeed without doing the work? Why would trading be different?

It can be done and it can be great fun. I love it. I have along term love affair with the share market and companies and the way business leaders build successes or failures. If you don't have this passion, it will always be only hard work. I really recommend these people find a profession they have a passion for. That is where they will make their fortune, not in avoiding the hard work in trading.

Did You Get the Last Newsletter?

About 100 of my readers missed the last newsletter because they were over quota, their mail box was full, their ISP server was down, their company server was down or they had changed their address. If possible, let me have an address that is not subject to quotas and keep your mailbox clear. I do not try to resend rejected messages. If you missed the last newsletter and get this one, see how you can get back issues at the end of this newsletter.

Disappearing Bids on SEATS

Thank you to those readers who responded on the question put in the previous newsletter about bids that appear on SEATS depth of market screens before the opening of trading and then are cancelled prior to the market opening.

An interesting suggestion is that these buyers may be expecting news and are using the bids to reserve a space in the queue. When the news is not announced prior to the market opening, the bids are withdrawn. While this sounds reasonable, most news seems to be announced during market hours, because that gives the professional investors with instant access to news an advantage over the smaller investors.

The most plausible suggestion may be the original one that someone is trying to create a false impression of market depth. I am not an expert in corporate and securities law, but I understand that

creating a false market by manipulating the market through actual trading is illegal. However, it may be that the law only covers actual trades and that there is nothing to stop misleading the market through bids and offers, providing the trades are not actually done in the market. Maybe an interested reader could write to the ASIC suggesting an investigation and recommendation to the government to amend the law. However, my view is that like insider trading, it will be so difficult to prove as to be not worth the effort.

I never bother to look at market depth before the market opens and the feedback I have had confirms my great suspicions about its value. Even during the day, I only use it to consider whether to trade "at the market" (hit the bids or offers) and not as an analysis tool. I have the greatest reservations about its use as a tool for analysis because it changes so quickly, many bids/offers may be undisclosed and some traders never put bids/offers up at all - they just hit bids/offers made. On this last point, I have a number of times easily bought stocks where there was no offer at a price, yet my bids were hit almost instantaneously, without any change to the depth of market quantities offered at other prices.

Take Care with Volume

Technical analysis textbooks spend some time explaining the importance of volume confirmation. Indeed it seems to work quite well when reviewing the examples cited from the US market. However, some of us have been very wary over quite a long time about using volume on the ASX.

For one thing, the volume data for exchange traded options stocks is contaminated with options related volume - rather like the old example of adding apples and pears and calling it a total of apples.

However, the other area of difficulty is large transactions. A piece that appeared in Andrew Main's "Street Talk" column in the AFR 8 September 2000 reminded me of the problem.

Andrew identified that Victorian Funds Management Corporation recently did a review of its \$2.9 billion Australian equity portfolio, with Maple-Brown Abbott picking up \$550m, CS Funds Management \$600m and Deutsche \$290m. Fund managers to lose out included Macquarie Investment Management and Portfolio Partners which both shed \$600m and Colonial First State Fund Managers lost \$290m. He then commented:

"Such shake-ups are a boon for brokers since in most cases the shares have to be sold in the market and the proceeds passed to the new manager."

He could have added that these transactions affect volume, yet do not represent a real change of ownership, so distorting the picture for technical analysts.

Where large transactions involve a shedding of a large holding, such as Kerry Packer's recent sell down in OTT, the price is also often below the price in the free market, representing the discount necessary to sell such a large holding.

Technical analysts should therefore be careful on the ASX when there are large volume spikes, especially if there is an apparent breakout downwards on such a volume spike. Look for confirmation the next day. It was there the following day on OTT, but is not always so.

Loneliness and Crowds

I recently had an interesting email from one of my seminar students. He had decided to trade from home and was putting a great effort into learning and gaining experience. However, he has now decided to become an investor rather than a trader. The reason: he found it very lonely trading from home. I have heard this same story many times. This student is a lucky man to have identified this problem rather quickly and be prepared to deal with it. This is just one of the many ways in which the market can teach you about your attitudes, personality and character.

Interestingly, he tried to get a small group of traders together to support each other, but they were not interested. He has also looked at trading room situations with some brokers. He has rejected this approach for good reason that I also agree with entirely. This is that once you trade in a group, you are subject to group dynamics, which are really just a crowd situation. Crowd psychology is very detrimental to trading and is the reason most good traders work alone. It is also the reason why some professional analysts do not also trade - because of the crowd psychology in the dealing room.

The lesson behind all this is that if you need peer support and/or a social situation in which to work comfortably, then trading is not for you.