

If this newsletter appears garbled, it may be because you are viewing it in plain text. If you change your email client to view the email in HTML, it should look better and will print OK.

Colin Nicholson: Newsletter 74

28 November 2007

Hot Stocks 2008 Melbourne Book Launch

Hot Stocks 2008 will be launched in Melbourne on Thursday December 6 at 5.30pm for 6.00pm at **The Educated Investor** bookshop at 500 Collins Street Melbourne. Anyone is welcome to come, but it is necessary to book a place. To book, phone (03) 9620 0885. At the book launch, I will speak on the present situation in the stock market and suggest some appropriate strategies for 2008. After that there will be plenty of time for questions, or to talk with me.

What is Hot Stocks 2008 About?

A year ago, I wrote a new book called *Hot Stocks 2007*. It has been so successful that I have written a new book called *Hot Stocks 2008*. This 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 year. It explains at length what I believe to be the appropriate strategies to adopt for 2008, based on my investment plan as explained in my book *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 now available from me. I will sign all books ordered directly from me. Supplies are also going out to bookshops around the country. To be among the first to receive *Hot Stocks 2008*, please go to my web site www.bwts.com.au and place your order. 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.

Special Offer

I still have stocks of *Hot Stocks 2007* for sale. Mostly, it will not continue to sell in bookstores, because people will think it is out of date. However, that is not entirely true. Some of the stocks in *Hot Stocks 2007* are still in my own portfolio. Moreover, *Hot Stocks 2007* was not written as a list of stock tips, it was conceived as a teaching tool. I wanted to teach you how I analyse the markets and how I analyse individual stocks by example, which I find is the best way to teach. Obviously, I could shred the surplus books. That seems a waste to me. So, as they are effectively written off, I am offering the remaining stock for sale to anyone with an Australian address at **\$5.00 per book**. That price covers my cost of processing your order and mailing the book to you.

Copyright Colin Nicholson.

The newsletter may be reproduced and distributed in whole or in part, providing it is not altered in any way and the source is acknowledged.

Place your order on my web site www.bwts.com.au or phone me on 02 9439 9724 in Sydney office hours.

Questions on *Hot Stocks 2008*

Question

Do you have a very recent updated version of your book *Hot Stocks 2008*? I will only purchase a copy of your book if it allows for the full impact of the sub prime mortgage crisis events emanating from the USA. Was *Hot Stocks 2008* written before, or after, the recent USA/global sub prime mortgage predicament? Have you effectively factored in the sub prime mortgage crisis in the selection of your 2008 hot stocks? I have heard that the sub-prime mortgage mess will continue to impact on international and Australian markets until the end of next year 2008.

Answer

The sub-prime crisis hit the stock market in August and has continued since as various (mainly US) banks and funds admit their exposure and losses. There has been minimal direct exposure in Australia other than a few funds. I believe the news is already out, or the listed companies/funds involved will be charged with failing to observe the continuous exposure regime, for which there can be severe penalties. However, there is an indirect exposure for any company borrowing money in that interest rates have risen and in some cases lenders have withdrawn from the market. This is most severe in the area of mortgage lenders who are looking to refinance their mortgages, even though there is no sub-prime sector in Australia. Fear is often very irrational, but must be treated as an input to analysis. Sometimes it provides an opportunity, if you can see reality through the clouds of fear.

Hot Stocks 2008 was written and completed in September/October 2007, with full knowledge of the sub prime crisis. There are no later editions. That is not how book publishing works. *Hot Stocks 2008* is essentially an annual publication looking forward one year. That said, if I was writing it today, I would not change anything with respect to the sub prime crisis. I see it as only one input. It is one of the possible catalysts for the ending of the bull market, but there is no guarantee that it will be the key one at this stage. I think there are far bigger issues in the US economy generally which will impact on the rest of the world, including China, which could be a big issue for us.

Hot Stocks 2008 is not a tip sheet in a book. I have analysed the markets and suggested a strategy for someone following my investment plan in general terms. Since your plan must of necessity be different to mine, because you are a different person in terms of experience, attitudes and risk tolerance, it will be up to you to use my thoughts as you think to be appropriate for your plan.

As for the stocks I have discussed, the sub prime crisis would not today cause me to choose differently or to exclude any of them. I am not aware that there is any direct danger for any of them, but bear in mind that I have no more information than is already in the public domain. Indirectly, I feel there is no more effect to be expected on the stocks in the book than will apply to the

general market. I must repeat that the stocks discussed in the book are meant to be a teaching tool to show you how I analyse stocks by example. There is no way that I can, or have tried to, make anything in the book a recommendation for any specific investor or for investors generally. It would be against the law for me to do so. I am a teacher, not an adviser. I hope that if you study my analysis, you will learn from it so that you can do your own analysis of the stocks in the book and many more besides, in the context of your investment plan.

With respect to your last statement, what you have heard is an opinion. The people expressing their opinion are entitled to do so and it is valuable that we have their views. If we are smart, we take their views into account along with all other views and reach our own conclusions. Our own final view may or may not accord with the one you have heard. In these situations the art of contrary thinking is an invaluable tool, as discussed in another of my books *The Psychology of Investing*, along with crowd psychology generally.

In the same vein, *Hot Stocks 2008* is an expression of my views on the markets and some 30 stocks. I have tried to reach the objective of a good presentation of ideas by providing reasons for what I assess to be the situation and the appropriate strategy to follow. Why should you give what I say any credit? The only final measure is my investment record, which is published in the book and may be found in an earlier newsletter on my web site. For your convenience I have repeated the table of performance since 2000 (the last top of the market) below. I publish my portfolio in real time on my web site to meet the law with respect to disclosure of my holdings. This has the side benefit that nothing is concealed and would be available for audit if the person requiring it is prepared to meet the costs.

I hope that clarifies what the book is about for you and helps you to decide whether it is worth buying.

My Investment Record

Year	My % Return	Market % Return*	Difference
2000/01	9.69	8.85	0.84
2001/02	2.11	-4.50	6.61
2002/03	20.61	-1.08	21.69
2003/04	17.48	22.37	-4.89
2004/05	26.88	24.75	2.13
2005/06	33.62	24.20	9.42
2006/07	45.25	30.28	14.97

Discussion of Aspects of the Art of Investing

Comment

I seem to be annoying my wife with my new found knowledge as I don't shut up about our share portfolio.

Response

This is not what you asked, but your comment raised a very interesting issue. It can be both a positive and a negative to be annoying others about how our portfolio is going. I think the key is how that other person reacts to your comments.

We should be looking to learn from what we do well and what we do badly. Especially the latter, because one of the real jewels in the art of investing is to learn to cut losses quickly and to let profits run. A great way to learn is to use a tool which is strongly emphasised by Dr Alexander Elder (author of *Trading for a Living*, *Come into my Trading Room* and *Entries & Exits*) is to start to keep a trading or investing diary. In it we should keep notated charts and an explanation of the reasoning behind every decision we make. This includes decisions to do nothing and let a situation run. This needs to be done at the time, not afterwards, when hindsight bias will rob us of an opportunity to truly write down what we are thinking at the time.

This is where your wife, or an important other person, come in. Instead of just listening to us boasting about what we know, she might start to ask us questions. Firstly, have we written down what we are telling her today? Is it in line with our written trading or investing plan? Secondly, what are our reasons for the decision we have made and have we written them down? Thirdly, do we know where we would be wrong about our trade or investment and have we marked it on the chart in the diary? Also, have we written down why that is the price at which we would be wrong about our investment? Next, when we close a position out, she might ask us what we learned from the trade or investment and have we written that down? Finally, have we identified any aspect of our trading and investing which we need to learn more about and how do we intend to go about doing so?

What I have just outlined for you is what elite performers do in every field of endeavour and why they got to be where they are. It is not easy. It is hard work, both physically and emotionally. Most people will never do it, which is why they will never be great traders or investors. I hope you will find these thoughts useful.

Question

I am currently reading the 1988 book *Stan Weinstein's Secrets for Profiting in Bull and Bear Markets*. He describes riding the rise of an individual share for possibly two years. Is that a common period for a trend, or have the times changed?

Answer

Every bull market is different in terms of both its strength and its longevity. So, there is no absolute answer to your question.

The other aspect is one of the trickiest of all. This is what time frame we are intending to operate in.

We might be a swing trader, who is looking to capture each upward swing in the market and get out as soon as a correction begins. In this case two years will indeed be a very long time to expect the swing to run for.

Alternatively, we may be a medium term investor who is looking to take as much as possible out of an upward trend in a bull market. Bear in mind that we cannot consistently buy the bottom and sell the top, which is why I said take as much as possible out of the trend. The longer it runs, the more we might expect to get out of it in percentage terms, if we learn to let our profits run, which is not easy for most people. In this case, some trends may run for a year or less. Two years may not be unusual. I have found in the last couple of decades that three to five years has not been unusual. Then again, we have had some very long-running bull markets in the 1990s and again since 2003. It will not always be so, unfortunately.

Your question, is akin to asking how long is a piece of string? In fact we do not need to know the longevity of a trend and there is nobody who can tell us in advance. That is why we have sell stops and sell signals. We manage what unfolds, not try to gaze into a crystal ball and divine the future. Your question is important because, frankly it is the wrong question. It shows what you may still have to learn about the art of investing.

Comment

Most of the shares I had in my portfolio in the last few months have been sold after they hit my sell stop.

Response

That is excellent. It shows that you have good discipline to follow your plan.

Comment

I have made some poor decisions by selling shares that were still in their uptrend.

Response

This is a strange comment to make after just saying most of your sales were at sell stops. I assume that you are referring here to the ones that were not covered by the word most. This is where we can learn some important lessons. If we are trading a trend and we got out of it before our sell stop was hit, then, my friend, we are not following our plan. We need to go back over these investments and ask why we acted out of fear when the investment was still on the course we chose to exploit. Don't take this point lightly. We learn far more by studying where we did not follow our plan. Whether the investment made a profit is not relevant here. The only way to judge the success of an investment is to ask whether we followed our plan. Win or lose, an investment that followed our plan is a good one. An investment where we did not follow our plan, no matter how successful it may have been, is a really bad decision. It leads to us ingraining bad behaviours, which can be difficult to change.

Comment

Some of those shares I have sold are now trading 20% less than I sold them for so I have made some correct decisions.

Response

Please read the previous response again and again. Whether the investments went down after we sold then had nothing to do with it being a good or bad decision. The only way to judge the quality of a decision is whether it followed our plan.

Of course, if we relentlessly follow our plan and lose consistently, then it may be our plan, rather than our decisions, which require review. Stop and rethink. Then test on paper before starting again cautiously.

Comment

I think that most of my poor decisions have been that I purchased shares well after they have started a breakout. I need discover the breakouts earlier.

Response

Just thinking that is the reason is not good enough. We could be chasing the wrong thing. We need to go back over all of our investments and analyse them. Before changing what we do. We must know, not think, what the problem is. Each of us has to do this ourselves. Nobody can do it for us. It is thinking about our investment methods over many years that makes for real improvement.

Now suppose we do that work and change our comment to knowing that we bought too late after the breakout. Now comes a tough issue. Did we really see the breakout too late? Or did we act well after we first saw it? This is vital. There is a huge difference here.

If we are simply not seeing enough breakouts early enough, we need to find a way of seeing them earlier. Personally, I use a scan of the market every week looking for stocks making 52 week new highs. This suits my time frame. It finds all breakouts from sideways patterns of a year or more in length. It also finds all uptrends of a year or more in duration with no initial breakout from a sideways pattern.

The problem which I find to be far more common is that we see the breakout, but we do not act on it quickly enough. This is mainly because we do not have enough faith that our investment plan will work. There is only one way to get that faith. We must go back and test the plan on paper over hundreds of stocks using historical data. Then we must begin to act on the faith we have developed. I have done this, so I know how powerful this is.

We need to develop a mind set that if we act on a breakout straight away, then that is a good decision. If we delay, then the decision not to act on the breakout when we first saw it is a bad decision. We are simply not following our plan. This is where an investment diary can be very useful. If we see a breakout on a chart, we should ask and write down whether it is the first time

we have seen it. If we have seen it before, then we should go back in our diary to that point and look at what reason we wrote down for not acting on it. It is vital that we be looking at reasons written at the time, not later, when hindsight bias will always lead us astray, usually without realising it.

The first step to solving a problem like this is to know what the problem really is and have a method for trying to change our behaviour. It is also possible that we cannot bring ourselves to change our behaviour. There is no disgrace in this. Instead it is a very valuable lesson to have learned. The lesson is that our investment plan is unsuitable for our personal temperament. We therefore need to develop an alternative investment plan that is more compatible with who we are and the journey we have made through our life so far. It took me many years to do this. It is not a quick process. It involves a lot of very hard work, called thinking.

Question

Do you sell all of your shares when you detect the market is on the start of a downtrend or do you run with them until they eventually hit your sell stop?

Answer

In the preamble to your comments and questions, you said that you had read my book *The Aggressive Investor*. I don't doubt your honesty, but I would like to suggest that you may have read it, but have not understood everything in it. In the book, I describe EVERYTHING that I do in my investment plan. The answer to this question is in the book. You will find in the long chapter on market exposure how I invest heavily in the early and middle phases of a bull market and reduce exposure in the third phase, which we call rampant speculation. I have discussed this issue in more detail and in practical terms in my more recent book *Hot Stocks 2007* and again in *Hot Stocks 2008*.

My sell stops have nothing whatever to do with the phase of the overall market. Each stock is an individual decision. The sell stop is where I am wrong about that specific stock. It has no relevance whatever to any other stock or to my view of the market phase.

Question

I am yet to experience a bear market, so I am wondering whether the market drops suddenly, or does it tease you like the current market?

Answer

Your question is very revealing. The past is an open book. All the data is out there. Countless books have been written detailing the history of the markets. The best way to learn what usually happens is to study the past. If we do not do it that way, which is relatively cheap in money terms to buy the data and books, then we have implicitly made an unrecognised decision to let the market teach us. The market charges very high fees for tuition, which are called losses.

What you describe is happening now is perfectly normal for a bull market. The saying in the markets is that a bull market climbs a wall of worry. This is part

of a psychological process where it teaches us to buy corrections. This is a very successful strategy. But there is a trap. One of the corrections will be the start of a bear market. We will not know which one it is until it is well past. At the time, each swing high looks pretty much like all the others. This is where my market exposure strategy comes in. I will. I say I will, not I hope. I will not have much of my capital in the market at the last peak. In 1987 my exposure was only 25%. At other tops, my exposure has been smaller.

If we would like to study what has happened in the past, we can buy the books and study the data. I have some long term files of mostly monthly data for the Australian and US stock market indexes going back over 100 years. If you would like to study this, email me for the files. Tell me whether you would like it in Insight Trader format or as an ASCII file.

By the way, just as every bull market is subtly different, so is every bear market. The first step is to look at all the historical examples. Then work out in our mind and rehearse a strategy for dealing with each scenario. I had done that prior to the 1987 crash and surprised myself as to how calm I was on the day and how I knew exactly what to do.

Question

Is it possible to still find an up trending share in a bear market and obtain healthy profits without extensive risk?

Answer

This is three questions in one.

Up trending? Yes it is possible to find uptrending stocks some of the time. But usually not many of them. Towards the bottom of a bear market, more of them may start to emerge.

Healthy profits? The answer to this one is yes and no, or just maybe. What I have found, though, is that most stocks go up much faster when swimming with the tide of the market. It is very difficult for individual stocks to rise strongly in a falling market, unless they are very special situations.

Extensive risk? Maybe. However, the risk is always higher in a bear market.

What you are asking about here is whether you should try to invest against the trend of the overall market. My plan is not to try such a high risk strategy. It is always better to invest with the trend rather than against it. This is absolutely fundamental to what I do in my investment plan.

However, this is not to say that there are not other strategies. Bear markets feature strong rallies. If we are experienced enough, we can trade them. This is a very tough game to play. I strongly prefer to invest with the trend. Since I do not short the market from choice, I stay out of bear markets.

Comment

I think it will be hard to sit on the fence for a long period of time without investing in the stock market.

Response

What you seem to be saying here is that you lack the patience and discipline to follow a plan like mine. That is not a criticism. It is a very important thing to know. In time you may come to appreciate just how valuable this insight may be.

However, if we have a temperament which says we cannot accept a positive cash return in a bear market, I would question whether trying to be long in a falling market is the right approach. We now know the question, but are we exploring the wrong answer?

If we must do something in a bear market, it is far better to trade the short side. This is also a tough game. However, it is easier than trying to buy rallies against the trend. If we decide honestly that we must trade a bear market, I suggest that the time to start learning this game is now, maybe well before we need these skills. Get hold of data for some bear markets. Work out a plan and test it by paper trading the past data. We can do this easily in Insight Trader software by stepping through an historical data file one bar at a time. We must keep a diary as if we were actually trading the market, so we can look back without hindsight bias getting in the way of accurate perceptions.

I have decided not to trade the short side, so I can not teach you beyond what I have told you. You will find Dr Elder's books *Come into my Trading Room* and *Entries and Exits* of great value in your endeavour to learn shorting the market.

One word of warning, though. CFDs are probably the easiest way to short in our market. However, everyone should avoid leverage until they have a two-year successful track record and then use leverage with great caution and very gradually increase it.

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 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. 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 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.