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Colin Nicholson: Newsletter 75

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I advertise my upcoming speaking engagements on my web site www.bwts.com.au on the *Hear Colin Speak* page. The next opportunity is:

Investor Outlook 2008 Sydney and Melbourne

Hilton Hotel Sydney Monday 4th February 2008 12.15pm - 1.45pm

RACV Club Melbourne Thursday 7th February 2008 12-15pm - 1.45pm

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Recent volatility in global and Australian share markets has left many investors feeling vulnerable and confused. Investor Outlook 2008 presents expert commentary on strategies for dealing with this uncertainty and how to prepare for making difficult investment decisions.

Investor Outlook 2008 features:

David Bassanese, AFR commentator (Sydney seminar)

Barrie Dunstan, AFR commentator (Melbourne seminar)

Craig James, Chief Economist, Commsec

Colin Nicholson, Analyst and Author: *The Aggressive Investor*, *The Psychology of Investing*, *Hot Stocks 2008*

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What to do now?

Question

I have held most of my stocks through the December/January shakeout. Could you suggest what I should do now?

Answer

As you know, I cannot comment to you about specific stocks without an adviser's licence. However, I can tell you what my own strategy is right now. Most of it is in my books anyway - *The Aggressive Investor* and *Hot Stocks 2007* and *2008*.

First, because I have felt for some time that we were in the final or, rampant speculation, phase of the bull market, I had reduced my exposure before October and again coming into year end 2007. I was around 30% invested, which is my plan.

Since then, I have sold a few stocks when they hit their stops. I did not sell on the big panic sell-off day, but before that, or waited for the rally and sold into that. I am now 21% invested and the remaining holdings are above their sell stop.

Because I think we have seen the top of the bull market, I am not replacing the stocks I have sold. I now want to see a bear trend and the third phase of distress selling. Then I will start re-building my portfolio for the next bull market.

Now, it is important to stress that the above is my investment plan. Yours could, and in fact should, be different.

If you are more short-term than I am, you may have been right out of everything and shorting the January decline. Now you would have covered the shorts and be buying again.

If you are more long term than I am, you may have held stocks through the dip and still have them. You may even have bought on the final plunge.

If you are confused as to what you should be doing, you need to take a view on where you are in the bull-bear market cycle and adjust your portfolio accordingly. If it were me I would get rid of all speculative stocks on the current rally. I would also sell anything which hit its sell stop on the way down and I had been too slow to act. Bear market rallies are opportunities to take profits and cut losses on losing long positions. They will also set up shorting opportunities, but that is not part of my own plan.

Any stock I hold through a bear market on my approach to investing needs to meet two criteria. First, it must be trending up on the monthly/weekly charts. Second, it must have a margin of safety in a higher than average dividend yield and a lower than average PE ratio. I would also favour stocks which are not too vulnerable to the economic cycle.

I must stress that this is not advice. It is just my thoughts on my approach to prudent active investing. You need to take on board my thoughts just like all the other thoughts you pick up in the media and from advisers. Then you need to take your own view and act accordingly, within the rules of your investment plan. The worst thing you can do is just blindly follow my plan. It is for me and works for me, but few other people will have the same experience and knowledge that I have built up over 40 years. Nor will your risk tolerance and general temperament match mine exactly. As I have said for years, everyone must develop and test his or her own plan and follow that. I can help you with knowledge, but the experience and self-examination part, which are the tough bits, must come from you.

Hot Stocks 2008

Just over 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. The book may also be purchased through bookshops around the country, but they will not bear my signature. To order a signed copy of *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 some 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. Place your order on my web site www.bwts.com.au or phone me on 02 9439 9724 in Sydney office hours.

Learning and Testing

This is a long item. One of my readers sent me a lengthy email, which raised some important issues. I took a couple of months to reply at length to this reader, because I needed to think a lot of it through properly myself and things have been rather hectic in my life over this period. I hope you find the discussion useful.

Reader's Comment

I found my education in trading and investing was like a student turning up to class on the first day and finding there was no teacher. I knew the general subject and my end goal, but I had no idea of where to start, what books to read, how to set myself up or how to structure my learning. I was trying to learn something I simply knew nothing about and I was not even aware of what I did not know.

My Response

Your experience is not unusual. What you had set out to do was to learn a new profession. If you had no background in the financial world, it was indeed like starting school again. There was a wide range of subjects you had to master, starting with what is a share, how the market operates and so on right through to the cutting edge of investing and trading methods.

In school, as you say, we have many teachers who teach us a range of subjects. Then we graduate to university and, while there is a greater element of self-guided research, there is a set curriculum and our subject choice is often guided into core and elective elements. Having graduated, we would then find employment. We would receive training on the job and may be directed to further education specific to the industry. Above all, we will be serving an apprenticeship under the guidance of managers and mentors. It is this experience which is the often overlooked critical element before we are competent to operate on our own.

Since you had sought to teach yourself, without also working in the industry, you had an enormous task ahead of you, with little guidance. I note that at some point you realised you needed some formal education in investing and trading, which you did through FINSIA and Safety in the Markets, plus study of the late Neil Costa's course (no longer available). However, to be realistic, these can not make you ready to invest or trade for a living. You still needed the experience.

Like many before you, and many who will follow you, I suspect that you underestimated what was involved in learning a new profession and becoming proficient in it. The total process which I described above from entering university to the end of an apprenticeship usually takes at least ten years. To become proficient in investing or trading, in my experience, takes at least ten years and often longer. It took me longer and I am still learning how to improve my methods.

The key issue here is that trying to educate ourselves outside of formal education and employment is akin to reinventing the wheel. We will be going over a lot of ground which others have discovered before us and documented. I think that what you needed to find early on was a mentor. By this I do not mean someone who sits with you and teaches you. That is a teacher. I do not even mean someone you can turn to when you don't know something and who guides you in finding the answer. That is a coach. What I mean is that you needed to sit down with someone, who had experience in the industry, and who could tell you all the things you needed to learn about. That mentor might even have pointed the way in some areas. The advantage of this is that you might have become aware of the things that you did not know anything about much earlier than you did. You might also have had a better mental map of the territory, so that things could be mentally placed in their right position.

Since you sent me your email, I have given this a lot of thought. I have come up with a list of what I believe we should have ideally learned about if we are to be proficient investors and traders. Here is my list:

Knowledge for Investing

Basics

Types of securities – shares/trusts/futures/options/warrants/CFDs
Markets and how they operate – equities/commodities/currencies
Technical analysis
Security analysis – industrial and resources
Law esp. corporations
Accounting
Economics – macro and micro
Geography esp. commodities and resources
History esp. markets
Politics – national and international
Money Management
Risk – types and techniques
Portfolio management theory
Behavioural finance and psychology

Research Tools

Internet
Books – investment concepts and trends
Books – great investors and their methods. Also speculators
Magazines and feature articles
Academic research papers
AFR – company reports plus local and international affairs

Software

Charting and technical analysis
Fundamental analysis
Portfolio manager
Broker internet platform

I would stress that all of this is the knowledge areas where you need some level of competence. That is the first half of the task. The second half is gaining experience on the job. This means starting in a small way and trying not to lose too much while you learn. A very large part of this second stage in the development of an investor or trader is to develop a plan. I will talk about this more below.

Reader's Comment

I'm guessing a lot of traders start the same way, with a haphazard approach which is based on trial and error. They turn over one rock and learn a little bit which leads to something else and that something takes them in another direction and so on. Over a long period of time, they gradually begin to gather the pieces of the jigsaw puzzle and put them together. They hopefully end up

with a robust trading system that suits them as an individual. Of course, there's more to it than just ending up with a trading system.

My Response

Yes that is as you describe for most people, unfortunately. It may be a bit harsh, but I think the hard reality is that most people who come new to trading in particular think that it is easy. I have noticed in talking with many of them over the years that they have no real concept that trading and investing is a profession and a tough one at that. Most of this flows from a well known behavioural error called overconfidence. Men are worse in this respect than women, something which has been demonstrated in research. However, women also tend to be overconfident as well, just not as much as men. Interestingly, this applies to all fields. Also there is a tendency to be more overconfident the less we know about a subject.

Reader's Comment

I attended the 2007 ATAA Annual Conference. There were quite a few very good quality speakers showing a variety of ways to make money from the market. What has become clear from this conference is the need to TEST EVERYTHING, before adding to my trading plan.

My Response

I agree entirely. What I have done myself is to develop an investing plan. This took a long time to do. What took the longest was the thinking part. I learned the hard way that unless I had thought things through and understood all the relationships between the different elements, I felt I was groping in the dark. This means that when I was under pressure in the market, I did not have enough conviction about the plan to follow it in a disciplined way.

There were four things which had to be done to alleviate this problem.

One was to write down my plan. This forced me to confront the internal logic of my plan.

The next thing was to test my plan. I did this many years ago before computers. Basically it was a process of paper trading past data for many stocks, where I did not know the outcome. Then paper trading in real time until I thought my plan worked and I had faith in it.

The third thing was to rehearse the possibilities. I forced myself to list all the things I thought could happen. This included the things that are out of left field. One of them was a violent crash. In 1987, when that actually happened, I had already done a mental rehearsal over and over again. I knew exactly what to do. I was amazingly calm. I followed the plan. Today, I continue to try to envisage all the risks and to rehearse dealing with them by just following my plan. It has worked very well over the last year in particular. Not that I am ever happy that I could not do even better and keep thinking how to improve my plan.

The last thing was to keep learning. Every time I encountered something new, I assessed whether it might improve the way I do things. If I thought it would, I incorporated it and tested it. After 40 years, this does not happen very often now. I read things and decide they do not offer any advantage over what I already do. However, I have made one recent change to what I do recently, which I am still testing and therefore not ready to talk about yet. I am also continuing to study in the areas of behavioural finance and psychology. I am finding that the way we make decisions is one of the critical skills which great investors have over beginners. My book *The Psychology of Investing* is a good place for beginners to start in this area.

Of these four things, the one you highlighted was the need to test everything. This is of absolute importance. Without going through that process, you will always have a temptation to rethink the plan under pressure.

Reader's Comment

I am committed to improving myself. I am not ashamed to admit that testing is something I have not done thoroughly up till now. In the beginning, I was happy to find some gurus with many years of experience and trust that they knew what they were doing and simply follow what they do. What I realise is that their plans sound very good in theory, but without testing them myself, and seeing the results with my own eyes, it is very hard to ingrain that method into my belief system to the point where I can fully trust it. This is where, during the heat of the trade, I can find myself switching to the shorter time frame. I know the task in front of me. I can't rely on the fact that it has been tested by others and works. I have to test it myself.

My Response

This is a very perceptive point you make. Just getting to this level is a real plus and sets you up to move to the next level. It demonstrates that you have the commitment to do the hard yards between being an enthusiastic, but maybe confused amateur, to becoming a professional.

Reader's Question

What is the best way to do this testing? Do I just pick a stock, any stock, perhaps one that I've already traded, and go back to the beginning of its chart and work my way to the present, writing each individual trade in a notebook for one timeframe, then go back and do it again in the second timeframe? Then repeat for a hundred stocks? Then repeat for reversal signals, indicator's etc? Also taking note of how they perform in bull and bear markets.

My Answer

Computers have changed the way we do things in a profound way. We can now access enormous volumes of data instantly. However, it is also a dangerous tool for a few reasons.

Firstly, there is the temptation to look at the chart before we start. This is very dangerous, because it sets us up for hindsight bias. This is where we think we knew things at an earlier time, when we actually had no idea of what was coming.

Associated with this is the tendency to analyse the middle of the chart. Any fool can do this for the reason of hindsight. They know what happened, so it is now easy to see the set up that led to it. Real investing and trading takes place on the right hand edge of the chart in real time.

Thirdly, even if you step through a chart of a stock you know nothing about one bar at a time, there is a problem. Each day follows the other just as soon as you choose to hit a key and expose the next bar on the chart. However, in real trading and investing, you must wait some time before the next bar is available. This is not long for day traders with intraday real time data feeds, but for most of us it is one day or a weekend. This time can play tricks on your mind.

What I am leading up to here is that there are three key principles:

One is that you back-test your plan over a great number of stocks of the type you intend to trade or invest in, using a computer to crunch the data. It is important to test only the type of stock that you intend to conduct your campaigns on.

The next is that you ensure that this testing is over rising trends in bull markets, falling trends in bear markets and some nasty sideways markets which are essentially trendless.

The third is that having passed the past data testing, you then paper trade the plan in real time. It can also be useful to trade or invest in a small position in one stock at a time. You close each trade or investment out before opening a new one. I learned that technique from Gerald Loeb in his book *The Battle for Investment Survival*.

All that said, I have dodged one issue, haven't I? That is what plan you start with. Remember it must be a complete plan. My book *The Aggressive Investor* sets out my plan. Yours can and should be different, but it should have all the same elements in it. That is the main reason I wrote the book, to teach what a plan should be like.

There are plenty of books with lots of different plans you could start with. If you were an active investor, I would suggest starting with my plan and then adjusting it to suit what you are comfortable with. If you are a short term trader, I would get Dr Alexander Elder's book *Come into my Trading Room* and start with that. Then adjust it to suit your temperament. Although I have suggested these two plans, there are a plethora of books out there with different author's plans in them. The reason I suggested my own plan and Dr Elder's plan is that I know we both actually invest and trade with these plans, so they are not just theoretical.

However, you could just make up your own plan and test that. However, this is really starting from scratch. It seems better to me to start with plans from people who have done a lot of the tough work and modify them an element at

a time to something which you are comfortable with and which gives good results.

Reader's Question

At the end of the testing, would I look at the win/loss ratio, profit/loss ratio, largest winning and losing trade?

My Answer

You will get lots of different responses to this. An excellent book on testing systems is *Computer Analysis of the Futures Market* by Charles Le Beau and David W Lucas. Don't worry about the reference to futures, it is the concepts and methods you want, not the market. There are other excellent books on computer testing of systems, but this is not an area I can advise you on beyond the book I just mentioned.

To my way of thinking, the key issues are:

First, is the average winning trade or investment much larger than the average losing trade or investment? This is a critical test. If a system fails this one, don't go any further.

Second, assuming the system passes that test, you want to see zero large losses, or as close to zero as you can get. It is the large losses that break your system.

Third, even with zero large losses, there may be large drawdowns (paper losses on the way to the end result). You must study these situations carefully. Step through the charts of those stocks a bar at a time. Record the drawdown you would have incurred after every bar. If the drawdowns are larger than you could tolerate in real time, then you will close the trade in fear and then the testing, which assumes you hold through the drawdown, will not be a realistic test.

This last point is one reason why you should paper trade the system extensively before putting much real money behind it. It may test alright, but in reality, you can not tolerate the stresses involved. Paper trading is not as good a test as using real money, but I would do that before taking that final step using the Loeb method described above.

In doing this testing, you need to also think through what you are trying to do. If you are looking for a method which makes no losses, you do not understand what trading and investing is about. They are about assuming risk. There will always be some losing trades and investments. The trick is for your profitable trades or investments to be bigger than the losing ones.

There is a lot more to this, but in my experience, these are the first things and the critical ones to look at. The rest you can find in books.

Reader's Comment

I wonder whether my results could be distorted by the fact that when I'm paper trading, I can just say I'll enter here and exit there, when in reality, I may not execute an order till the day after the signal and could also get filled at a much different price depending on the volatility and liquidity of the market?

My Response

Yes, these are real problems. It is very valuable that you recognise them. They are why you test first on past data. When you do it, you must religiously follow the rules of your plan. These rules will spell out some of the issues you raise. Then you paper trade forward in real time, which is not real trading or investing, but is a cheap way to get as close as you can to reality. If that all works out alright, you should start to trade or invest with smallish amounts of real money and test one position at a time as described earlier.

Reader's Question

I currently use Market Analyst which has a training module allowing me to add one bar at a time. However, I still have to manually write down each trade in a book, going through the process of determining stops, position sizing and keeping notes as each trade progresses. Doing all this by hand will take literally hundreds of hours. Is there any software that you know of that is especially good for back testing data?

My Answer

The top traders and investors have put in those hundreds of hours which are worrying you. Elite performers in every field spend more time than you would believe constantly testing and practising to improve what they do. If you were at the ATAA conference for the final speech by Charles Browne, you may recall a story he told of a woman who said she would do whatever it took to play the piano like one of the masters, who had just given a recital. His answer was that he did not believe that she would really do whatever it took. He told her how many hours each day he had practised for decades and she walked away without further comment.

So, you have to make the commitment. Assuming you are prepared to make that effort, there are computer programs that can help. When you get to paper trading or investing and then later trading or investing with real money, you will be doing what you describe with Market Analyst. The best traders and investors keep good records and they also keep a diary of everything they do for research and assessment purposes. Rather than a notebook, I would keep the diary records of your testing in a Word file, pasting in the calculations from an Excel spreadsheet and screen dumps of the charts as you make each decision.

However, there are other software programs that can do the initial testing for you. I use Insight Trader charting software. It allows us to test a system in its System Testing Module. It forces us to define every aspect of the system and then runs it over the stock and period we nominate. Then we can evaluate the results. We can also then go back and step through it bar by bar to see what it was like closer to real time. There is other charting and testing software

available, but I have no first hand experience with them to advise you. You need to do your own research on them. Some of the research can be done on the Internet and by phone. After that, you need to see the software in action before you buy.

Insight Trader software also has a very comprehensive Portfolio Manager Module, which would assist you in keeping records of your paper trading. You can have as many test portfolios as you want. There is also a facility in Insight Trader to keep an electronic diary linking it to the actual stock. You can include many kinds of file in the diary including screen shots at the time of each decision in the diary.

I hope all this helps you. I spent a lot of time thinking it out and writing it. That effort is not wasted if you benefit from it and others who read it in my newsletter also benefit from passing on my experience.

Ticklish Question

Question

I am currently reading *Trading for a Living* by Dr Alexander Elder. As a part of his Triple Screen system, he suggests placing a buy order one tick above the high of the previous day. How much is one tick?

Answer

A tick is the minimum upward or downward movement in the price of a security.

In the past, US stocks did not trade in decimals. Then a stock would move in amounts of 1/8, 1/16, or 1/32 of a dollar. Thus the tick was whichever minimum amount the stock price could change by.

Of course, this changed in the US when the decimal system was brought in. Now the tick size will be a fraction of a dollar expressed as a decimal rather than as a fraction.

The term tick is not in general use in our markets. However, it is in all US books, so we have learned to mentally translate it into the terms we use in our stock market. The ASX uses the term which most of us would use, which is price step, which means what Americans call a tick.

So, what Dr Elder is saying is to place the buy order one minimum price step above the high price for the previous day.

Information about price steps (ticks) for the ASX may be found at <http://www.asx.com.au/investor/education/basics/price.htm>

The price step or tick will vary depending on the securities you are trading. Shares are different to futures or currencies, for example. Also, the terminology may change from market to market.

Results Calculation

Question

I purchased your book after hearing you speak at the 2007 ATAA Conference in Brisbane and very much enjoyed it, particularly the reference you make to being only 30% invested at present, a wise decision it seems! When calculating your annual return and comparing it to the return from the share market are, you including the cash held awaiting future opportunities in your investment capital and investment returns?

Answer

The short answer is yes.

My returns are calculated by including:

Capital gains (realised and unrealised at the end of the year)
Dividends
Interest on cash reserve
Franking credits

The best index to use for comparison is therefore the All Ordinaries Accumulation index. It is not a perfect comparison for two reasons:

It assumes reinvestment of dividends from the ex dividend date, whereas I cannot reinvest them until the payment date.

It does not include franking credits. However, for a comparison of pre-tax returns to other asset classes, I include them in my results.

Money Management

Question

I'm confused. I like to have around 20 positions, but this looks difficult with 2% rule. If I am fully invested, every new investment will involve a risk of 2% of \$5,000. Is the 2% rule preferred even with a lot of positions?

Answer

The 2% applies to the total investment capital you have. Each investment would involve a maximum risk of 2% of your \$100,000, not 2% of the \$5,000 invested in each stock.

2% of \$100,000 is \$2,000. That is your maximum risk on each position. Note I said maximum. It is not compulsory to risk this much. See below.

If you wish to have 20 positions, you will have 5% of your capital in each investment, which is \$5,000.

You will now have at risk 20 x \$2,000 or a maximum loss, if everything went bad at once, of 20 x \$2,000 = \$40,000.

This sounds fairly drastic, but the reality is that it is unlikely all 20 investments would fail with no profits on any of them, **unless you were to make all the investments at or near the top of a bull market**. If you use a market risk policy like mine, you would have begun making your investments for this bull market up to five years ago and have made very large profits, only some of which would be given back at the end of the bull market. Note that the actual stocks in the portfolio may have changed over the period of the bull market, which is why we measure results for the portfolio, not each single stock on its own.

Also, a stop is not the only way out of an investment. You should have other sell signals which will occur well before such a stop in many cases.

Finally, your positions do not have to be so large as to risk 2%. The 2% rule is a maximum risk level to avoid over trading. My risk percentage is 1% and I rarely risk over 0.5% on any one investment.

The other way this risk is ameliorated is to use an approach like Dr Alexander Elder, who never risks more than 6% of capital in total across all open positions and, including losses for the current month. This means you would put on a few positions that have a combined risk of 6%. As they move into profit, you can open new investments.

It should be noted that I would never invest 50% of my capital in one stock. Diversification is important. My maximum investment in any one stock is 6% of my capital (a different 6% rule to that mentioned above in relation to Dr Elder's approach). So, I would typically have around 16 – 20 positions when fully invested.

I have mentioned two approaches above. Mine, which is described in my book *The Aggressive Investor* and Dr Alexander Elder, which is described in his book *Come into my Trading Room*.

Winit Auto Run of Chart Arrangement

Question

In *The Aggressive Investor* you illustrate the basic screen view you use on a daily basis, which is a screen divided into four windows. Can this set-up be saved and used for any stock, or do I have to save a chart arrangement for every stock I wish to monitor?

Answer

The instructions for creating my chart arrangement are in Newsletters 53 and 64. The second specifically explains how to use any existing arrangement and clone it for a new stock.

I have a template at the top of all my saved chart categories (force that position by inserting blanks before it). To get to the template from anywhere in saved charts use the hot key Ctrl+Q. If not in saved charts: Alt+R then Enter.

I set up saved charts for stocks I own or track every day. For any other stock, I always look at them by cloning from the template. It is fast if you know the hot keys and the code or the company name.

To do an auto run, create a list of the stocks you want. See manual Chapter 5. Then open the template. Then run your Hilite list of the stocks you want to see. You can set the delay between chart arrangements, or step through them manually.

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.

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