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Colin Nicholson: Newsletter 76

18 February 2008

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

Bulls and Bears Sunday Traders Club Sydney
Sunday, 24th February 2008 at 10.00am Harbord Diggers Club (Sydney)

Part 1: Selecting Stop Levels Colin will discuss the theory behind setting sell stop levels. He will explain how his sell stops are generated based on the logic of his investment plan. Along the way, he will show how an inappropriate stop can actually increase risk of a losing trade or investment.

Part 2: Outlook and Investment Strategy for 2008 Many investors and traders focus too much on individual stocks in the short term. One of the important aspects of successful investing and trading is to have a broad overall strategy. Colin will analyse the Australian and major world market index charts. Colin will explain his view of the situation and what strategy he thinks is appropriate for 2008. There will be time for questions.

For Further Information see <http://www.bullsandbearsnetwork.com.au>

A Common Mistake

The Background

A reader recently emailed me somewhat distraught because most of the reader's paper profits had evaporated in the August 2007 and January 2008 shakeouts. It seemed that the reader had made most investments in late 2006 and early 2007. A key remark by the reader was a common refrain of recent times: *...after being in the market for a short period, it is difficult to see all your gains evaporate.*

My Response

There is a hugely important issue here which you do seem to be recognising. What has hurt your investments is that you have not followed my plan with respect to when to get into a bull market. With respect, you seem to have done what most beginners do. That is to buy near the end instead of near the start of the bull market. I have heard a lot of these stories in recent days – especially at the AFR seminar last Monday (February 4 2008).

While you said you followed my rules on one aspect of your investment plan, you seem to have overlooked something vital. This is that all the aspects of my investment plan are inter-related. While you can validly vary the methods of implementing the strategy, you cannot get away with turning an important aspect on its head. It seems that you were entering the markets as I was scaling back to 70% invested (It is in print in my book *Hot Stocks 2007*, which I wrote late 2006). Then you stayed in too long as I scaled back to 30%

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invested (there is more discussion of this in my book *Hot Stocks 2008*, which I wrote late in 2007).

This timing strategy aspect of my method is worth making more explicit than I have perhaps done: If we enter in the first 20% of the bull market and get out at the end giving up 20% of the gains, we will have taken away 60+% of the bull market. By scaling in early and scaling out early, this number can be improved.

However, if you turn it around and enter in the last 20% of the bull market and give back the last 20% on the way out, the result is very different.

This is worth pondering. This element of my strategy alone will make a huge difference to your results. The two key words are:

Patience to wait for the right time

You cannot make the market give you money when you want to make it. You make money by exploiting the market at the appropriate times and using the appropriate strategies. There are many ways to do this. Mine is only one.

Discipline to act in difficult times when everyone around you is doing the opposite

The crowd is right most of the time in a bull market. But it is usually wrong at the start and again at the end.

This is just one important aspect of the way the best investors think differently to beginners and why their results are so much better.

Learn my Methods

A full explanation of my methods is set out with examples and case studies in my book *The Aggressive Investor*. A signed copy may be purchased from my web site at <http://www.bwts.com.au/text.cfm?42> for the recommended retail price of \$49.95, including postage to Australian addresses. Orders may also be placed by telephone at 02 9439 9724 during Sydney office hours. For overseas destinations there are small postage charges, which are set out on the web site.

Recent Discussion with a Reader

You may be interested to read some comments and questions which a reader sent me around the end of last year and which I replied to late in January 2008.

Reader's Question

Your investment plan and investment record during the FY 2000/01 to 2002/03 was given as 2000/01: 9.96%, 2001/02: 2.11% and 2002/03: 20.61%. Are these returns the total returns on your portfolio, including interest on cash reserves? My assumption is that you did not have 100% invested in shares during the period.

My Answer

I have actually answered the same question in the previous newsletter. That answer was that 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.

Some people will only calculate their returns on the amount they have invested in shares. However, my investment plan is to be in cash and shares and my target is a return on the total investment portfolio.

We must be very careful in calculating returns that we do not give a wrong impression of performance. For example, let's say that in a given year you only invested 5% of your investment capital in one share and that you doubled your money in six months and then sat out the rest of the year. I have seen people use a situation like this to claim an annual return on their investments of 200%. It is not legitimate to compare results using such a method to my returns, because my returns are shares plus cash and this return is shares only. To compare it to my returns you have to add up all the asset classes, which in this case might be shares plus cash. Then you can make a comparison.

Further to that answer, and the last two paragraphs, which add to the previous answer, you are correct that I was not fully invested during that period.

Reader's Question

Are you able to say what percentage of your portfolio was invested during these financial years? I have assumed it was 30%.

My Answer

I have not kept records of the level I was invested during that period. I could go back and calculate it, but it would now be relatively tedious and I think of little value. I do track it constantly through the year, but only keep the end of year situation. At 30 June in those years my exposure was:

2000/1 38.7%

2001/2 27.8%

2002/3 54.8%

Note that June 2002/3 was after we had passed the bottom of the bear market. The Coppock has given a marginal signal at the end of May and was

clearly going to confirm it in June. I had therefore started building my exposure and was slightly ahead of my plan guideline of 40%.

Reader's Question

A return of 20.61% on your total portfolio for 30% of the portfolio invested is an excellent return during the FY 02/03. Was this return mainly due to your investment in the company Funtastic at the time?

My Answer

The 2002/3 result was driven primarily by Funtastic, but there was also a big contribution from McPherson's and a consistent contribution from Hills Industries, Integrated Group, Noni B and Sims Group.

Reader's Question

Will you be outlining in your newsletter during 2008 when the market phase analysis evidence indicates that the bull market has ended and the evidence suggests that phase one or phase two of a bear market has developed?

My Answer

I will not be doing that in the newsletters. This is because their aim is to educate. This means to teach people to do this analysis for themselves. I am a teacher, not an adviser. This last issue is also important, because I don't believe I can do that kind of current market analysis in the newsletter without risking that ASIC may consider that I am publishing advice without an AFS licence. I could get a licence and do it, but that is not what I am about.

However, when I write each week in the *Australian Financial Review Market Wrap* section on Tuesdays (and recently some other days as a special request by the editor), I can go so far as to make that kind of analysis within the media exemption to the legislation on advice. Whether I do this specifically in terms of phase analysis is a good question. My brief is the title of my column, which is *What the Charts Say*, so I am mainly writing as a chart analyst. I do make general non-chart observations and suggestions for investors from time to time though.

Reader's Comment

You may well do so in another *Hot Stocks* book in October/November 2008 for 2009, however a bear market will be obvious to most by June 2008, if one begins in March 2008.

My Response

Whether I do another *Hot Stocks* book may depend on how well *Hot Stocks 2008* sells. We will assess that around the middle of 2008.

As I have recently written in the *AFR Market Wrap* column, my analysis is that the bear market began this month. I would not revise my analysis on this point unless the market made a very convincing new high. Even so, we would still be in the Rampant Speculation phase of a bull market and I would be very cautious and defensive.

One of the more important ways I look at investing is that I do not believe we can forecast the future with any certainty or consistency. Indeed it is very dangerous to our decision-making skills from a psychological perspective. I find that a far more productive approach is to assess where we are in the bull and bear market cycle and adopt a strategy appropriate to where we are. All of this is described in detail in my book *The Aggressive Investor*, so should be no surprise to anyone.

Reader's Comment

I can see elements of phase one and phase two of a bear market occurring quite often in the ASX market already (during the past 4 months of 2007), so I am trying to clarify for myself how much evidence is needed so that one can say phase one or phase two of a bear market is in place. From reading your books I gather you make a subjective assessment on this based on your experience.

My Response

My reading of the situation is that the bear market may have begun in the decline in January 2008. This is contentious, because it relies on the market taking out the last major trough in the bull market. Some analysts will dispute that point and say that they must first see a lower peak and then a move below the previous trough before there is a valid signal. I do not think this argument can ever be resolved and I am frankly not that interested in trying to win any arguments. My plan calls for me to act on the signal we have seen and I have done that. For me, my current view is that the bull market is finished. I am expecting a bear market to unfold. We may, of course, see the signal the Dow purists demand before very long. Time will tell.

Bear markets usually run a year or more. I do not see what you are seeing, however, you should never regard my views as infallible or that I am a guru. I can be wrong quite often. Like Keynes, when the facts change, I change my mind.

You are right that Dow Theory phase analysis is subjective. I see that as a real strength because it requires us to think seriously about what is happening around us. Good subjective analysis requires a lot of sound experience, as you suggest. There is no getting away from that. Most professions require some element of subjective decision-making simply because we rarely have all the facts. Experienced professionals tend to make better subjective decisions than inexperienced people in any field.

In *The Aggressive Investor*, I set out the common markers to look for in each phase of bull and bear markets. This should help less experienced people to know what to look for. When I teach Dow Theory phase analysis at FINSIA, I go through all these markers, trying to explain them, but not give too many clues to my personal assessment. Then I take a poll of the class as to which phase we are in. Last week (late January 2008), most students thought we were in either bull market phase three (rampant speculation) or bear market phase one (abandonment of hopes). So, even newcomers can mostly get it

fairly right most of the time. They can certainly get it close enough to be adopting the right general strategy for the times.

Detailed Discussion

In both *Hot Stocks 2007* and *Hot Stocks 2008*, I discussed in some detail how I was seeing the situation using the markers for those phases that were set out in *The Aggressive Investor*. I then went on to discuss the general investment strategy which I thought to be appropriate for where we were in the bull-bear market cycle.

A signed copy of *Hot Stocks 2008* may be purchased from my web site at <http://www.bwts.com.au/text.cfm?53> for the recommended retail price of \$29.95, including postage to Australian addresses. Orders may also be placed by telephone at 02 9439 9724 during Sydney office hours. For overseas destinations there are small postage charges, which are set out on the web site.

Some copies of *Hot Stocks 2007* are still available for the special price of \$5 including postage to Australian addresses. Why not order both at the same time?

A few overseas readers have also asked about *Hot Stocks 2007*. Postage costs add considerably to the price. I will provide a price on application to me by email at colin@bwts.com.au.

Interesting Questions

In mid December I received an email from a reader asking about a stock the reader held. To answer this reader would have put me in great danger legally. Unless I have an AFS licence, I can not give specific advice, which is advice about the affairs of a specific investor. Nor can I give general advice about the stock in question. I have made this perfectly clear on my web site www.bwts.com.au on the Ask Colin page. I do not make the law in Australia, but I am obliged to obey it. The law says I cannot give advice without a licence. I would ask that readers please take note of this issue. It rears its head every time we have a shakeout in the market. I get a rash of emails asking what to do with reader's holdings. I cannot legally answer these questions. I do not wish to give advice. I am interested only in educating investors, not advising them.

If you are still reading, there is another point here. As it happens, the questions which that reader asked about a specific stock which the reader owned were of great general interest to me in terms of investment education. After agonising over this for six weeks, I have decided to address those questions here. However, I must emphasise that this discussion is totally educational. Although it was asked in the context of a specific stock, I am going to address it in educational terms only. This is absolutely not a wink and a nod answer. I have made a point in addressing these questions of not even looking at the chart of the stock the reader held.

Preamble

Assume that you buy a stock and the company comes out with a downward revision of its forecast profit for the next half year. The price falls very significantly overnight, so to speak. The reader thought that he or she had three options:

Option One

Follow the rules [of my investment plan] and sell because the stop loss has been passed.

My Response

I am often asked this kind of question. For me it is a non-question. If an investor is still asking this kind of question, he or she lacks the necessary faith in their plan. Let me explain.

I have an investment plan, every aspect of which follows logically from the other. My sell stop is located where I am wrong about my investment in the terms of the logic of my investment plan. So, if my sell stop is violated, I know instinctively what I have to do. I sell. I don't agonise over it. Just once in a while I hesitate. That is when I pull down my own book *The Aggressive Investor* and flick to the executive summary of my own plan. That reminds me what my own plan is. After doing that I have no doubts and put in the sell order.

This certainty comes from years of testing my method and from experience in executing my plan. It took me a long time to reach the point where I always know instinctively what to do when I see the latest bar on a price chart. I have written that the usual time to reach this point is ten years, from which most people recoil in disbelief. It took me longer than that. I have been in the game for forty years now. It took me at least twenty years to reach the point of instinctive reaction in following my plan. Then again, maybe I am a slow learner.

The general answer I would suggest here is that, if we have an investment in the market and we need to ask what our options are, then I doubt two things. Firstly, that we do not have a written and complete investment plan. Second, if we do, then we have not yet tested it on past data and actual experience to the point where there are no options about what we should do.

Option Two

Wait a while in the belief that the market has over reacted and the stock will rally a bit and there may be a better price to get out at.

My Response

If a politician said that, we might unkindly say they were weasel words. It is saying that the investor does not want to face reality.

Now, it is possible to have an investment plan where, if a sell stop is violated, we might wait for a rally to get out at a better price. In this case, it should have

been written into our investment plan before we took the investment position. If it was, then that is the plan and we should follow it. In that case, the investor would not be asking me the question, because there would not be any other options.

However, if it was not in our written plan before we started the investment, then we are clutching at straws to avoid reality. The investment has gone wrong. We know that because it went down through our sell stop. So, there is no option here. We sell.

Maybe later, we could consider revising the plan. However, that should be after extensive testing of the new idea against the original plan. If it tests out as better, then we might change our plan. However, even thinking of changing the plan in the heat of battle is a fatal idea.

There is one caveat I would make here. In my own experience, I have encountered two or three very unusual situations where the whole market was in freefall. I have rehearsed this mentally many times over the years. It is not in my written plan, but it should be and will be next time I revise my book. In these very rare situations, which means two or three times in forty years, I will wait for a rally before selling all stocks which have violated their sell stop. This rule is for a severe market shakeout. However, I must stress that it is not for the general situation I was asked about, which was a profit downgrade on one stock. That already falls squarely into my written plan. If it violates the sell stop, I sell it.

Option Three

Buy more at the bottom to average my price down.

My Response

I have read several hundred books about investing and trading over the years. This idea of averaging down has almost universally been the subject of warnings not to do it. In its simplest terms, it is throwing good money after bad.

The issue here comes down to something economists refer to by the jargon term of opportunity cost. If we keep holding a bad investment, the best outcome may be that it recovers a bit. However, while this is happening, there will be other stocks which are moving up nicely. The difference between the return from these strong stocks, and the lower return on the dog we bought and will not sell, is the opportunity cost. It is the extra return we might have made if we had not held onto the troubled stock.

So, the rational decision is to sell the investment which has failed and move the remaining funds into something that may return more than sitting in the failed investment. It follows that if it is right to sell the failed stock, it is also a mistake to average down by buying more of it.

You might ask why we would even contemplate doing this. The answer is simple. We would be trying to rationalise a decision that has not worked out to

avoid admitting that we were wrong. We are trying to protect our ego. However if we put \$10,000 into a stock trading at \$1 and it falls to 50c, we have lost \$5,000. The only question at that point is whether the \$5,000 will give a better return than moving it into another stock that is trending upwards.

To think that putting in more money will make it look good by lowering the average cost is an exercise in self delusion.

If the facts change, I change my mind. What do you do, sir? John Maynard Keynes

Common Errors and Biases

After *The Aggressive Investor*, the most important book which I have written is *The Psychology of Investing*. This book is all about the ways in which we human beings make less than optimal decisions in investing. This is important, because investing is about making decisions in situations in which there is risk and uncertainty. If we learn how to avoid common errors and biases in making investment decisions, we will be bound to become better investors. I have been investing for forty years. This area of decision making is now the prime focus of my own personal reading and study. It is far more important than stock selection. It is the key to managing investments, which is the difficult part of the art of investing.

A signed copy of *The Psychology of Investing* may be purchased from my web site at <http://www.bwts.com.au/text.cfm?50> for the recommended retail price of \$39.95, including postage to Australian addresses. Orders may also be placed by telephone at 02 9439 9724 during Sydney office hours. For overseas destinations there are small postage charges, which are set out on the web site.

Advice about a Trading Method

Question

Is this the basic ground rules [for a trading method]: Check shares daily at the close of trading? If there is an uptrend leave it alone. If the first day closes with a lower high and lower low is that a warning sign? Then watch more closely on the second day and if it closes again with a lower high and a lower low, is it time to get out on the following morning?

Answer

You may not realise it, but you are effectively asking me for advice on a trading method.

This method is different to what I do, so I have never tested it.

If you ask about my method, I can explain whether you have it correct. However, without an AFS licence I can not advise on other methods, even if I had tested them.

All I can do is tell you that what you need to do now is to test it on lots of stocks in uptrends, downtrends and sideways periods. If you have an entry signal, you can short-cut the testing by only looking at stocks which give that signal.

It is only by doing the testing yourself that you will develop the conviction that it works and be able to follow the method under pressure in the market.

After testing it on past data for lots of stocks, I would suggest paper trading it going forward so that you have a good idea of what it will feel like with real money on it. It is never the same, but it is as close as you can get.

Which Software to Buy

Question

Should a beginner buy MetaStock, Insight Trader or something else?

Answer

MetaStock is the most popular charting software on the market. This is partly because it has been around a long time, but also it is widely advertised and promoted. You need to be aware that it originates in the US and getting support is not easy. One of the big selling points for Insight Trader for me is that there is local support available at a reasonable price.

All software takes time to learn, a lot of time. MetaStock and Insight trader would probably be similar in this respect. However, there may be rather more learning tools available for Insight Trader in the form of CD and DVD seminars and tutorials. These are sold by BeyondInvest and Insight Trading.

If I had no prior knowledge of either software, and you held a gun to my head to decide which to buy, it would be very difficult to give a clear answer. It just is not a simple question to answer.

If it were me, I would not buy either of them initially. I would learn technical analysis at Kaplan Education (previously FINSIA) and while doing so, rely on free internet charting like Bigcharts.com, Incredible charts, Yahoo finance. There is also a free charting facility on my broker's web site.

Then you need to devise an investment or speculation plan. This will determine what functions you need in the software, what indicators you are going to want and what level of support you need. You should end up with a list of the things you require to be in the software.

Then you need to survey the market. There is a lot on the internet, so start there. Then go to investment expos and things like the AIA annual conference, where you can see software being used and ask all the questions you need to ask. Score each software package against your checklist of requirements.

My best advice is not to rush this. It may be five years down the track before you will be ready to make a sensible choice. You can do everything you need

in the meanwhile on the internet using free tools. Using them will help you to develop your wish list for the software you eventually buy. Just remember the old adage about marriage – what you decide in haste, you may regret at leisure. Learning the software is a big task. I would not start the buying campaign until you know what you need.

Education Rather than Advice

Reader's Question

I have just ordered your *Hot Stocks 2008* and *2007*. Which of the *Hot Stocks 2007* stocks do you still favour?

My Answer

I don't want to sound unco-operative, but I am not legally able to make recommendations to individual investors without an AFS licence. I could seek a licence and then give general advice, but I have chosen to be an educator, to teach people to make their own investment decisions, rather than to just advise them.

In my last two newsletters, I said some stocks in *Hot Stocks 2007* were still in my portfolio. That is a factual statement, which by definition is not advice. You can check what stocks I am holding at any time by going to my portfolio disclosure page, a link to which is on the bottom of every page on my web site www.bwts.com.au.

My main motivation for writing the *Hot Stocks* books is stated therein. It is to teach people to do their own analysis by providing examples. The books are not tip sheets in a book. Instead, I demonstrate how I research stocks and how I assess the data.

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.

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.