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## **Colin Nicholson: Newsletter 77**

**27 March 2008**

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

### **Investment Expo**

Sydney Exhibition Centre Darling Harbour

Friday 28 March 11.15 to 11.45

Saturday 29 March 12.00 to 12.30

Sunday 30 March 12.00 to 12.30

Topic: ***Share Investment Strategy for the Year Ahead***

A discussion of where we are in the bull-bear market cycle and what strategy is appropriate for investors in the year ahead to preserve capital and be ready to take advantage of opportunities.

## **Using My Money Management Rules**

### **Question**

With \$50,000 capital, when would it not be feasible to buy a share costing \$35.00?

### **Answer**

First, a caveat: \$50,000 is a very small capital to use my methods. I generally regard \$100,000 as a more reasonable minimum.

However, it is not impossible to use my basic method, providing that you understand that with such a small investment capital, you may have to choose your investments carefully to stay within my rules. More likely, though, it will not be possible to observe every rule and guideline and in order to work with that capital limit, you will need to clearly understand that you need to take more risk. Let me explain:

Capital is \$50,000

1% maximum risk is \$500

Buying price is \$35.00

Assume the sell stop is at \$30.00

Therefore the risk is \$5.00 per share

Limiting your risk to 1% (\$500) lets you buy 100 shares.

However, 100 shares will cost \$3,500, which is 7% of your capital.

My rule is not to invest more than 6% of capital.

6% of your capital is \$3,000

This is the operable limit here, so you could only buy 86 shares.

This would be fine. You would only be risking \$430 or 0.86% of capital, which would be essentially what I do most of the time.

The only thing you have not been able to do on my plan is to enter in three stages, which would be possible, but the brokerage might not be an acceptable cost.

Some options for you to consider if this is not to your liking:

**The sell stop is a variable**, depending on your method of setting it. In my case, if I was not happy with the size of this position, I would find another investment which had a smaller risk per share. Closing up the sell stop contrary to my investment plan rules is **not an option** as it destroys the entire logic of what my investment plan is about.

**The percentage risked is a variable.** With small capital, most investors will use a higher percentage than I do. 2% is very common as popularised by Dr Alexander Elder in his books *Trading for a Living* and *Come into my Trading Room*. There is nothing set in concrete here, so long as you realise that the higher the percentage risked, the closer you are moving to the risk of ruin threshold. Be especially careful if you are tempted to move the percentage risked towards 5%. That is like playing Russian roulette in the stock market. Be aware too, that my risk of 1% is based on the buying and sell stop prices without any allowance for slippage or brokerage. Dr Elder's number of 2% does include both slippage and brokerage. The end result is that we are both a lot closer than the raw numbers would suggest.

**The percentage invested is also a variable.** I use 6%, which I regard as rather aggressive for an investor. Warren Buffett would laugh at that rule, because his portfolio is even more concentrated than mine. However, do not take comfort from that until you are as good an investor as Warren Buffett. He is close to the best living investor. Nevertheless, this is something you could vary cautiously and consciously without undue risk. What is involved here is diversification. This is the main way we deal with specific risk in our portfolios. The higher the percentage invested in each stock, the less diversified we are and the closer we come to having all our eggs in one basket.

**Brokerage is a variable to some extent.** You could look around for the cheapest online broker to keep control of this issue. If it is an online broker, the skill level in managing the order rests with you and is not a variable, as it would be if you use a full service broker.

I hope these thoughts are of value. What I have tried to do is outline for you the issues you need to think carefully and deeply about. Remember that they are all connected and it is the totality of the risks that you need to manage as much as each individual type of risk.

*My money management rules are described in detail with many examples in the case studies in my book *The Aggressive Investor*. Cost is \$49.95 including postage to Australian addresses. There is a small postage surcharge for overseas addresses. To buy it online, go to <http://www.bwts.com.au/text.cfm?42> on my secure web site, or phone me in Sydney business hours on 02 9439 9724.*

## Using Fundamental and Technical Analysis

I recently received a great email from a reader, which I thought to share with all my other readers. I have edited it only very slightly:

*During my earlier years I was basically a professional fundamental analyst. I had little use for charts. Now I can confirm that this was where I went wrong.*

*Since the last bear market, I had decided to study at least some basics in charting (probably so as not to appear totally ignorant in conversation if it ever arose). Over the next several years I started to put certain aspects of this technical learning phase to some use. Then it started to get more than interesting.*

*I now use both fundamental and technical analysis.*

*Before using charting I had viewed it as simply something similar to a horoscope or to tea leaves in a cup. At best, charts were a lovely graphic display in order to seek one's own approval to act, with about as much faith as some sort of medieval ritual. I had seen charting as hocus-pocus that had no effective function in the real world of making investment decisions. Perhaps it was an easy way or even a lazy way of justifying myself and dismissing it as all too hard and thus diminishing it in my own mind. I now see that it was an act of ignorance.*

*Looking over my last six investing years I am now able to scan and analyse every investment for my buying and selling decisions and also to compare the timing issues of each.*

*I have concluded today that my fundamental analysis was excellent, but it was skewing my profits indifferently.*

*What cost me big time in so many of my transactions, in fact almost all examples, is that I failed to execute what the charts were telling me. I kept referring to and alluding to the favourable fundamentals in times of both buying or selling decision making and believing them so often, when the charting data was telling me otherwise. I was my own weakness in a good 90% of these decisions.*

*I've been in the share market for 20 years (came in straight after the 1987 crash). I am pretty much out of shares today - have been for several months. This time around I had learned much more about charting. So, even though the fundamentals were still looking good (perhaps a little stretched, but the profits were increasing too and all looked so rosy), alas the charts this time around were starting to tell me otherwise.*

*My conclusion is that one must use as much knowledge as you can get your hands on and if one hasn't some skill in charting then I feel you may be a weapon short.*

*Also never under estimate the importance of Market Psychology, without this all may still be to no avail.*

*I am just talking aloud some thoughts - I'm probably just writing a short letter of reflection to myself really but anyway I will share it. Kindest regards from one very grateful to you Colin for much of your teachings - your books are classics.*

### **My Comment**

I came at trading and investing the opposite way to my reader. I began with charts and thought they were all I needed. I have learned over the years that by adding a fundamental analysis overlay, I was investing with both eyes open instead of just one. My results improved dramatically. So, both of us learned the same lesson, but from different starting points.

My reader also alluded to psychology. My book *The Psychology of Investing* is about how we can learn to make investing decisions and identifies errors and biases to which we are all subject. I have been studying this area for the last few years and it has made a big difference to my results. It adds to the discussion in *The Aggressive Investor* on the general topic of the way good investors think differently to beginners. My price is \$39.95 including postage to Australian addresses. There is a small postage surcharge for overseas addresses. To buy it online, go to <http://www.bwts.com.au/text.cfm?42> on my secure web site, or phone me in Sydney business hours on 02 9439 9724.

## **What to do with Cash Holdings**

### **Question**

I now have a large portion of my equity fund in cash with one institution. I am therefore highly exposed to the credit quality of this single institution. How do you manage this risk? Do you diversify your holdings among a number of institutions or are you comfortable with the credit quality of say the four big Australian banks? What other steps do you take to reduce this risk?

### **Answer**

There are two types of risk we are exposed to here. One is general risk of a complete collapse of the banking system. The other is the specific risk of failure of one bank.

General risk to the banking system is the harder one to deal with, but also the less likely. One approach would be to hold cash in interest bearing securities rather than cash, as such. However, this may only be a partial solution, because in a banking system failure, the issuers of such securities may themselves be at risk. There will also be a liquidity risk, no matter what we do in this kind of situation. Another approach might be to invest part of the cash holding in banks in another country. However, again in a general failure, the problems may not be confined to one country. There is also an added currency risk in moving off shore. A partial solution there would be foreign banks operating in our own country.

Specific risk is much easier to deal with. The classical answer is diversification. We should spread significant cash holdings across several banks. I have dealt with this one by having my current cash holdings in four different banks – two of them based in two overseas countries, but operating in Australia.

There is a third risk in holding large cash holdings, which is not strictly a banking security issue. This is potentially the biggest risk of all, which is inflation. If we see an increase in inflation, interest rates on cash holdings may stay at levels greater than inflation, but this is no certainty. The other issue is taxation on interest. The after tax return from interest is rarely greater than the rate of inflation. In a high inflation environment, we should be in real assets, if at all possible.

As an interesting aside, I once worked for a white Russian who was in Shanghai during the 1930s hyper inflation. I recall him telling me that they were paid at lunch time. They then went out and bought almost anything with the cash because by the end of the day the cash was worth only half what it was at lunch time. Just hope we never get to live in such interesting times.

## Special Offer

I still have some stocks of *Hot Stocks 2007* for sale. *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](http://www.bwts.com.au) or phone me on 02 9439 9724 in Sydney office hours.

## Understanding the Nature of Investing

### Question

I see from your portfolio disclosure page on your web site that you sold several stocks from 11 to 18 January 2008 on a downward slope of the ASX and several more on 23 January 2008, the day after the free fall. What was the strategy in your model that caused you to sell that late? To have confidence to follow your advice I need to understand why this loss happened and what can be done to minimize this result in the future.

### Answer

My entire investment plan is in my book *The Aggressive Investor*. There are many parts to the plan and they are all logically interconnected. For you to understand my investment plan, you will need to read the book and work through the examples and case studies in the book and on the CD which comes with the book.

According to my plan, my sales were not late, except that I avoided selling on the final panic day and sold into the ensuing rally.

When I turned 60, our share investments were worth a seven figure sum. I am now 64 and the worth of our investments is now double what it was four years ago. My returns on capital before tax since 2000 are as follows:

Year	My Return%	Market %	Diff
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
2007/08	-7.42	-11.38	3.96

The 2007/08 return is to 16.03.08.

Value of \$100,000 invested 1 July 2000:

Year	Colin	Market
2000/01	109,690	108,845
2001/02	112,004	103,946
2002/03	135,089	102,818
2003/04	158,702	125,819
2004/05	201,361	156,955
2005/06	269,059	194,932
2006/07	390,808	253,961
2007/08	361,810	225,060

As you can see, 2002/03 is the only year since 2000 in which I did not beat the market.

So, I don't think I am looking at unusual losses as your question assumes. Nor were the sales in January especially late on my investment plan as you have suggested in your question. To explain this, there are three issues here which I think are important:

First, it is never useful to judge an investment plan by looking at individual investments. All investing involves investments, which do not work out. That is part of the nature of the art of investing. The aim is not to try to win on every investment, because that is totally unrealistic. Instead, we should focus on the return on capital over an accounting period (I use the Australian financial year). To make a positive return, this means that the total gains from successful investments must be larger than the total losses on unsuccessful investments.

Second, my investment plan is an aggressive one, in that I am attempting to time the market. This is not something which I recommend to inexperienced investors. I have been learning the craft for 40 years and it is only in the last five years that I have managed our entire portfolio. Prior to that, some part of

it was with professional managers within the superannuation system. The returns shown above are for the capital which I was personally managing.

My recommendation to beginners is that they should start with only a small part of their assets under their own management. The rest should be with professionals. When we can show that we can match or beat the professional managers, then we can progressively take more assets away from the professionals and manage it ourselves. It could take a decade or more to develop the skills and experience. It took me longer. Many people will find they lack the time, energy, and temperament to learn a new profession, because that is what is involved. As explained in detail in my book *The Aggressive Investor*, I try to get fully into a bull market as early as possible and then scale out as we approach and pass the top. Reducing my exposure dramatically in the third phase of a bull market helps considerably, but since we never know when the top will be, only its proximity, there will always be some unsuccessful investments once the top is passed and sell signals are encountered.

Third, one of the most important aspects of investing is the management of risk. There are many parts to this, but one of the more important is the use of what is called money management to limit the risk on each investment as a proportion of the portfolio total. In the preamble to your question, you mention the stocks I have sold in January. These were:

Retail Food Group (loss of 0.66% of portfolio)  
Cardno (loss of 0.63% of portfolio)  
Wesfarmers (loss of 0.33% of portfolio)  
Amalgamated Holdings (loss of 0.29% of portfolio)  
David Jones (loss of 0.34% of portfolio)  
Fosters Group (loss of 0.29% of portfolio)

I try to limit risk to 1% of the portfolio on any one investment and 0.5% is closer to what I aim at most of the time. Allowing for some slippage in selling the first two, you can see that these sales were not out of the ordinary and did not involve big losses in terms of my investment plan.

I hope this helps you to understand the nature of the issues in learning to be a successful investor and maybe it will encourage you to look further into what I do as set out in *The Aggressive Investor*. I wrote that book to show what an investment plan should be like. I did that because I have found over the years that most investors do not have a complete or logically consistent plan. The intention is not for you to copy my plan, but to use it as a model of what should be in a plan and why. We are all different. We will have different plans either in terms of the risk elements or in terms of the time frame and analysis tools that we are comfortable with.

In both my books *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](mailto:colin@bwts.com.au).

## Questions about my Methods

### Question

Do the resource companies pop up in your PE ratio and dividend yield scans of the market?

### Answer

Yes they do. Remember that I am only looking for producing miners. Some of them will have a PE ratio low enough to appear on the scan. Although, I do not scan on dividend yield, some of them will also satisfy the criteria, though maybe not all that often.

However, the key point is that PE ratio is not really appropriate for assessing producing miners, because they are exploiting a wasting asset and are better analysed using a discounted cash flow or discounted dividend flow basis. I tend to rely on other analysts for this work, which is highly skilled.

Producing miners will also come up very frequently in a boom on my main scan which is looking for stocks with a new 52-week new high. Once they appear there, I will look at them on a PE ratio and dividend basis, because it is a quick and dirty first cut at the issues. Nevertheless, those which are still of interest require further research as mentioned above.

### Question

Have you considered setting up a list of all stocks other than trusts and foreign companies so as to exclude them from your scan results?

### Answer

Yes I have. Some people I know do this, however, they tend to be very focused on a small group of stocks. My focus is much wider.

I have not done it because it is a very time-consuming exercise to maintain such a list. Every week there will be a number of new listings and name

changes, which mean the list requires quite a lot of time to maintain its integrity.

I use *Insight Trader* charting software and its *System Module* will create a list of all stocks each week after *Database Manager* has done its update in a few keystrokes. I then run the scan and simply quickly go past any trusts and foreign companies. This is easy because I know most of them and if I don't, I can quickly check them on my broker's web site using the *Aspect Huntley* research facility. Most broker web sites seem to have this. I welcome the opportunity to expand my knowledge of what companies do and where they are domiciled.

So, it is basically a matter of doing it in a way that is most efficient in terms of time and effort, as well as being part of a process of better informing myself as an investor.

### **Question**

Do you back up your assessment of the bull-bear market phases with a chart to make the final decision to withdraw from the market into cash and time your exit?

### **Answer**

In my book *The Aggressive Investor*, I teach Dow Theory phase analysis, which is my primary tool. Included in that discussion are the various things I look at. I have given examples of this analysis in that book and in my books *Hot Stocks 2007* and *Hot Stocks 2008*. I look at everything that is going on in the markets and I am flexible in that the relative weighting of the factors can vary somewhat with every cycle. This is part of a discipline called contrary thinking, which I deal with in my book *The Psychology of Investing*. There are no fixed formulas and rules. We have to think deeply, meditate if you like, about the situation. This is where experience comes in. I have been at this game for 40 years now and I naturally have more experience than a beginner. However, anyone can do it if they make the effort. Much of the past can be learned and vicariously experienced in the many market history books.

As for charts, yes of course. I show examples of this analysis in *The Aggressive Investor* and again in *Hot Stocks 2007* and *Hot Stocks 2008*. These analyses were written and published to give you examples of my approach. Charts tell us a great deal. The main ones to start with are the key market indexes, but I also track charts of PE ratios, dividend yields and new floats. These are shown and discussed in the same three books. The data is available from my web site [www.bwts.com.au](http://www.bwts.com.au) on the *Data Files* page. In addition, every individual stock chart I monitor or look at over the years of the bull market will be building a composite picture of what is happening and how it is changing. Volatility changes are a very important issue. So will be the general behaviour of the various sectors and industry groupings in the market.

## **Please Help**

Every time I send out a newsletter, I get back many bounce messages. The most common reasons for newsletters being bounced are:

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## Spam Filters

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## Mailbox Full, Over Quota, etc

If you are going away, please arrange for someone to clear your mailbox regularly. You would be surprised how many of you do not get newsletters every month for this reason. **My policy is to remove addresses from the newsletter list if three consecutive newsletters are bounced because the mailbox is full or over quota.**

## New Email Address not advised to me

I get many bounce messages saying the recipient is not known. Probably, the readers have changed their email address and not let me know. **I have no choice but to immediately remove these addresses from the email list.**

I hope readers do not think I am being unreasonable here. Many readers would be surprised that after sending out a newsletter I get a hundred or more bounce messages and it may take many hours just sifting through them and maintaining the list. I would prefer to spend this time writing more newsletters, books, articles and columns. **Please help me to keep helping you.**

## Charting the Coppock Indicator

### Question

How do I convert the Coppock spreadsheet from the Data Files page of your web site into a chart?

### Answer

Firstly, you do not need to chart the data to read the spreadsheet. The signal comes when the last column has gone negative and then ticks up to less negative than it was. I usually make a comment alongside the signals – see May-June 2003 on the ASX All Ordinaries spreadsheet.

I have not provided instructions for creating a chart, because it will depend on what spreadsheet software and what version you have. I have Excel 2003 and to find instructions on how to insert a chart, go to Help/Microsoft Excel Help and in Search, type in Create a chart.

By the way, on the members' web site I publish a chart which is updated every month. That chart is not created in Excel, but in my *Insight Trader* charting software. The underlying calculations for the chart from *Insight Trader* are the same as for the spreadsheet. The spreadsheet was really only

intended to teach the calculation. However, you can read the signals from it as explained above.

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