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Colin Nicholson: Newsletter 78

30 April 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:

Australian Shareholders Association Mid North Coast (NSW)

Friday 13 June 2008 10.00-12.45

Senior Citizens' Rooms, corner William and Hay Streets Port Macquarie

Living with the Bear Market and Preparing for the Next Bull Market

Colin will assess in detail his view on where we are in the bull-bear market cycle. Out of that he will suggest strategies for successfully negotiating the bear market and the strategies that will prepare us to take early advantage of the bull market which will inevitably follow it.

For further information contact Les Smith lfs.pmq@bigpond.net.au

Broking Failures

Question

Do you have more than one stockbroker in case your broker fails?

Answer

Over the years very few brokers have failed. The recent failures in the case of Tricom and Opes Prime did not lie in the traditional stockbroking areas that are regulated by the ASX. They lay in margin lending, albeit in two different manifestations.

The ASX, the two regulators involved and the government are looking at updating the law appropriately and have also taken the issues to international forums, as you will have read in the news.

I only have one broker. I used to have two, but there was a great problem of having to be very careful to act through the right one all the time. After I sold some shares through the wrong broker a couple of times, I simplified things by having only one account with one broker.

Many people have more than one broking account. One may be dormant and is there just in case the main broker's internet platform goes down. However, in that case, there is a need to move cash and/or shares, which is a nuisance if you can avoid it. I can operate with my broker either by internet or telephone. I have never had a problem getting to them, but there is always a first time for everything.

The other issue here is that I am an investor. Buying or selling on a specific day is not an issue for me. Orders can wait a day or so if there is a problem.

However, if you are a short term trader, this is a far more important issue and it might well serve you well to have more than one broker in case of emergencies.

Usually, when brokers start to get into trouble, they sell out to another firm, which wants the client base and which assumes the liabilities (for a price). The ASX is also likely to force a sale or merger in the case of a broker with problems. Nevertheless, it is always possible that the firm goes down because of something other than broking, like Tricom and Opes Prime. Even in this case, my expectation would be that the broking client base would be of value and could be sold to another firm, even though the rest of the business was bad. There may be some small delay, but the essence of the problem is that it must be done quickly in order to do it before the clients have made other arrangements.

The need for a second broker would be far more critical here for a short term trader. You will have to make your own judgement on this. However, do remember that with cash you could open a new account with another broker in hours. Likewise, in these days of electronic registers, it might take one or two days at most to get the sponsorship of your CHES account switched. If a new broker wants your business, he will usually be helpful here in my experience.

Praise for *The Psychology of Investing*

I received this unsolicited feedback from a reader:

Your *Psychology of Investing* is the book I have been searching for. It is interesting that many of the experts who offer education or training on how to trade the markets make comments like the only hindrance to success is the nut in front of the computer. You are the first person I have read that has explained to me how my nut is affecting my trading. Now that my wife has also read the book, and we both acknowledge that we have different personalities and aversion to risk etc, we understand each other's assessment of the decision process much better.

On Learning to be a Good Investor

Some comments I recently made to a beginner:

No matter how good your teacher, you will never have the confidence in the method to stick with it under fire in the market unless you have thought about it long and hard and done a lot of testing on past data and paper trading on live data. It is just not possible to get the necessary experience from a teacher – knowledge yes, but experience, never. So, I can guide you with where to look and what to think through, but from there, it is important that you do the rest.

I comment in *The Aggressive Investor* that it will take at least ten years to become good at it. It actually took me longer, but I had a big day job and

travelled a lot. Investing was a hobby only. I would love a dollar for every hour I have spent learning and gaining experience.

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. Please place your order on my web site www.bwts.com.au.

Bear Market Phases and Crystal Balls

Reader's Comment

I see that you have greatly reduced your exposure (at February 2008) to the market based on your assessment that the bull market is over. As I understand it, you will now wait for an indication of distress selling and the Coppock turning negative and then turning up again before you start to rebuild your portfolio.

My Response

Yes, that is basically a correct reading of my investment plan as set out in detail in my book *The Aggressive Investor*. I find that on my aggressive investment approach, it generally pays to be out of bear markets and in cash.

Nevertheless, every bear market can be different. The resources sector is still generally trending up. However, there are real difficulties of finding good value stocks to buy – resource prices are very high, which suggests low PE ratios. However, those prices are unlikely to last forever. On my investment plan, I am staying away.

Of course, this is my investment approach. Very long term passive investors will have gone fishing and take little heed of the inevitable bull-bear cycles.

Speculators would have a very different plan. Each to his or her own.

Question

What will you do if the market rallies from here (February 2008)? Suppose you could find some value somewhere and the required breakout. Would you go for it and forget that the Coppock had not given a signal?

Answer

In short, I will follow my plan. My analysis indicates that we are in the first phase of a bear market. There should be two phases still to play out. They are decreasing earnings and distress selling. In my book *The Aggressive Investor*, I describe what to look for to know which phase you are in.

I expected the market to rally. All bear markets have rallies. They are often called sucker rallies. They are frequently quite strong and sometimes they are both short and sharp, caused by short covering. So, I am not seeing anything unexpected so far.

It is possible for the market to rally really strongly back to the all-time peak as it did in 2001-2. That did not change my view then and would not now.

The one scenario that would challenge my view is if the market passed the all-time peak strongly and began rising well above it. In that case, I might start to look for stocks to buy on the basis that:

The bear market was unusually short and had ended.

Or it was not a bear market, just a very big correction. In that case, the real pain is still to come and I would be very wary of building beyond 30% of capital exposed to the market until the other signs of a bull market were in place.

The Coppock could have done a number of things in this scenario, short of giving a signal. As happened in the US markets in 2005, it may have turned up from near zero. This might persuade me, along with all the other evidence to expand exposure beyond 30%.

However, this is all sheer speculation. I don't even think it is very useful. I am devoting my energies to analysing where we are and adopting the appropriate strategy on my plan. I leave the crystal ball stuff to others who amuse the punters with their frequently changing wild guesses.

I am also very sceptical of the *Stronger For Longer* thesis – it has never happened before, so I place it as a new paradigm theory trap.

The other new paradigm theory trap is that China (or BRIC) will de-couple from the world economy. As Lenin once said, everything is connected to everything else. Globalisation has made that even more true than it was in 1917.

Both these traps fall into the *Its Different This Time* basket. When I hear that, I become very cautious. Remember when the Internet was going to change the world? The NASDAQ was a great place not to be invested a la Warren Buffett.

Peaks and Troughs

I was recently asked to give an example of the way I see peaks and troughs on a chart, using Woolworths as an example.

First, I defined my methodology:

When I am talking about individual bars, I refer to **highs** and **lows** of those bars.

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When I am talking about the swings in a larger trend, I refer to the **peaks** and **troughs** formed by those swings.

I try to avoid ambiguity by using different terms for bars and swings.

I then prepared an example using a chart of Woolworths. I do not wish to include this in the newsletter, because it will cause too much spam blocking with my current method of sending it. So, you need to go to my web site, where you will find it in the answer at this URL:
<http://www.bwts.com.au/download/ga/1154.pdf>

If that does not take you there, navigate to the keyword Trend in the Ask Colin section of my web site and open the question reading: Could you give an example of your analysis of peaks and troughs?

Coppock Above Zero

Question

Do you have a view on the significance of the Coppock turning up without having first been in negative territory?

Answer

This is a good question. The way Coppock described his indicator it only gives a signal if it turns up after having fallen into negative territory. It seems to me that these would be the best signals. It has also been my experience that shallow signals, which occur not very deeply into negative values, are the most likely to be premature signals. Often, a better signal occurs after the Coppock has subsequently fallen deeper into negative values.

All of that said, we should not lose sight of what the Coppock indicator is. It is a very specific example of a long term momentum oscillator. It does not have fixed boundaries like the Relative Strength Index (RSI). This suggests that there is scope for some flexibility in interpretation. One example (noting that exceptions do not prove anything) is the US market in 2005, when the Dow Jones Industrial Average turned up from near zero, but still at positive values. It can be argued in hindsight that this was a valuable indication, even though it was not technically a signal.

So, the rule for me is to keep thinking through what the indicator does and be flexible if necessary. However, there are two vital caveats. The first is that if there are few or no upward trending stocks at the time the Coppock turns up, it may be a premature signal. The second is to be far more risk averse if you are acting on a turn up from above zero or if the turn was very shallow in the negative scale.

No Big Stocks?

Question

It appears to me that your investment plan does not trade the shares in the ASX 50. I have had a look at the list on your website and would be interested in the reasons.

Answer

My method is totally bottom-up stock picking. I don't even know, though I could guess, which stocks are in the ASX 50 index. It is not important to me. I will invest in any company which is cheap and trending up (though it must make profits and pay dividends, or I regard it as a speculative stock).

However, as I said in *The Aggressive Investor*, I tend to focus on second rank industrial stocks. This is partly because they get mispriced more often than the heavily researched big stocks. The other even more important issue is that smaller companies can grow earnings far more rapidly than bigger companies. A small company could triple or quadruple in price in two to three years, but this is unlikely for a very large company.

Closing Price Versus Intraday Low to Trigger Sell Stops?

Question

Is your sell stop triggered by an intraday violation of your stop level or by a close below your stop level?

Answer

My investment plan calls for me to exploit an upward trend.

An upward trend demands that each trough in the trend be higher than the last one (with up to 2% slippage).

Each trough is determined by the lowest price in the swing down, which means that my sell stop will be triggered if an intraday low violates it.

However, you should understand that this is my method, based on the logic of the definition of a trend. There are many other possible and profitable investment plans. There is no right or wrong method.

There is an argument that the advent of automatic stops in our market sometimes results in waterfall declines on light volume as each sale triggers more stops. I am in two minds about this, but have yet to be convinced to change my plan.

This does not mean that I ignore the evidence and may look at the course of sales for that day to try to work out what may have been happening. Rules and guidelines are there to stop us doing what we might instinctively want to do, but which is against the plan. On the very, very odd occasion that I have formed a view that the situation is unusual, I may give the stock a little more

time. However, if the next bar starts to follow through on the downside, I will be out of there very quickly.

In other words, nothing which I do is unthinking and mechanical. However, I have had a lot of experience and believe that I have become very disciplined. It took me more than a decade to get to that level. Until you get to that level, I suggest you test your plan and then follow it mechanically until you have a good track record and develop a lot of experience.

It is better to sell one or two stocks too quickly and have to buy them back, than to ignore one sell stop and be badly burned.

Valuing Resources Companies

Question

On page 126 of *The Aggressive Investor* you comment on the difficulty of using PER or DY for producing miners. Won't the discounted cash flow method be equally as difficult? It is affected by fluctuations in interest rates, prices obtained for the commodities, total ore / mineral available, terminal value after 10 years etc.

Answer

The difficulties you refer to are different.

Using price earnings ratios has an underlying assumption that the earnings per share are maintainable. This is generally so for industrial and services companies and is therefore a reasonable assumption.

However, a resources company is exploiting a wasting asset, so there is no maintainable earnings stream unless the resource is extremely large and long term. It may also be a reasonable assumption for a very large diversified miner with long-term resources. Therefore, it is better to use a discounted cash flow or discounted dividend model to value resources companies.

So, I do not see any great difficulty using the price earnings ratio for industrial and services companies. Discounted cash flow valuations for resources companies involves a much higher level of difficulty for all the reasons you mention. Also gearing, currency and hedging risks need to be considered.

Peaks and Troughs Again

Question

Would it be possible for you to email me a copy of a chart from Insight Trader where you have marked the support / stop levels so that I can have a closer look at exactly how you 'do the trade'? Also whether you use a daily or weekly or monthly chart for that?

Answer

Yes, I could, but preparing it takes some time. There are quite a few charts like that already in *The Aggressive Investor*, in the case studies. Perhaps you might study those first and see if they answer your questions.

I have, though, recently prepared one chart to illustrate a similar point earlier in this newsletter. It is already on my web site at <http://www.bwts.com.au/download/qa/1154.pdf>. If that does not take you there, navigate to the keyword Trend in the Ask Colin section of my web site and open the question reading: Could you give an example of your analysis of peaks and troughs?

In *The Aggressive Investor* I used mainly daily and some weekly charts. They show essentially the same picture. However, since I wrote the book I have been focussing my first look at stocks in my portfolio or on my hot list on weekly bar charts. Then monthly bar charts and occasionally I need to look at the daily bar charts for close analysis, entries and exits or writing about stocks in a time frame different to my own for *AFR Market Wrap* or *Smart Investor* magazine. The reason I have done this is because an audit of my past investments showed that I had sometimes acted on signals that were shorter than my time frame. In a single sentence – if you cannot see the peaks and troughs on the weekly chart, they are not my time frame.

What to do about a Capital Return

Question

I bought some shares and the company made a very large capital return. Now the chart has a great gap on it. How should I reset my sell stop?

Answer

The key issue here is that a capital return requires an adjustment to the chart so that the data pre capital return is adjusted for the capital return.

I use Insight Trader charting software and take the database manager service which makes all the adjustments for me. If you use charting software, there may be a similar service from your data vendor. Otherwise you will have to make the adjustment manually.

Once you have adjusted the chart, the gap will be gone and you can use the chart to set your sell stops in the normal way for your investment or speculation plan.

Taking Profits

Question

A share I bought has risen substantially in price and it is now a large part of my portfolio. Should I be taking some profits, or letting it all run?

Answer

In general, it is important to let your profits run. However, if you get an investment right and it makes a big move it can unbalance your portfolio eroding the diversification aspect of the management of specific risk.

There are also psychological issues with managing a position which has become a large part of your portfolio and is jerking about the total value of the portfolio. The risk is that you sell it all too soon and miss an even larger move.

My approach is to let a position double in size and then I bring it back to 6% of the portfolio. I do this every time it doubles. For a fuller discussion of this, see my book *The Aggressive Investor* pages 179-181.

This makes it easier psychologically to let a good part of your profits run. At the same time it reduces how much of your paper profit is given back to the market when the trend eventually ends.

You should bear in mind that my approach is only one of many alternative ways to deal with these issues. There are many ways you can arrive at a similar result. Then again, you may prefer to let the lot run as far as possible and live with the additional risk issues. Only you can decide this because every one of us is different and a different investment or speculation plan will be appropriate for us.

Pyramiding Raises its Head Again

Question

Capital allocation – initial 2% then add another 2% etc. This is effectively pyramiding a trade as I can interpret. Have you considered going 3%, 1.5%, then 0.75% to reduce the chance of an increased loss if the more expensive shares (2nd or 3rd trade) are sold at a loss if the price should drop? That would effectively reduce the specific risk that is possibly occurring

Answer

I addressed the issue of pyramiding in Newsletter 53. I cannot think of anything I would add to that answer now:

My approach is to enter a position ideally in three stages. When I buy into a breakout, it means one third on the breakout, one third on the subsequent correction and one third on a new high for the now evident trend. When I buy into an existing trend, it means one third on a new high for the trend, one third on the subsequent correction and one third on a new high for the now confirmed trend. This is a three-stage entry to a trend. It is not pyramiding. Let me explain the difference.

Pyramiding is defined as using unrealised profits ... as security to borrow funds to buy ... additional positions. (Edna Carew *The Language of Money*)

Pyramiding is most common in the futures markets. Using a margin, a position is purchased. If the contract rises in price substantially, the balance in the margin account grows to the extent of the paper gains. If the margin account grows sufficiently, there will be enough there to enable the speculator to buy another contract. This continues so long as the price of the contract continues to rise, with more contracts being purchased using the paper gains as margin for the new positions.

To the extent that my position size calculations reflect any growth in the size of the portfolio when I buy the second and third parcels, there is a very small element of reinvestment of paper profits. However, it is nothing like the enormous leverage being used in true pyramiding.

Pyramiding is the explicit use of leverage and I do not use any leverage in my investment plan by choice. I do not choose to do so because there is quite aggressive assumption of risk in other areas of the plan as explained in my book.

The variation on my entry strategy you suggest is exactly what you should do if you were pyramiding. But I am not pyramiding, so I don't think it is that relevant. That said, there are many ways to make money in the markets and each of may arrive at different methods of managing the various risks involved in investing. If you think it is the way with which you would be more comfortable, that is fine. I suggest you test it on past data for many stocks and if it seems to work for you, build it into your investment plan. Each of us is different and we will balance the range of risks differently to suit who we are.

Using My Money Management Rules Redux

In Newsletter 77 I offered a table of calculations under the heading of Using My Money Management Rules. Unfortunately, I made a silly error. The correct table of calculations is as follows:

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.

Although it does not excuse the mistake, at least the final answer was essentially correct.

Understanding RSI

Question

What time period should I use for Relative Strength Index (RSI)?

Answer

RSI is a momentum oscillator. It is used to trade sideways markets.

I also believe it can be used to find entries to an upward trend, but my approach on this point may not be accepted by most people. You will have to make you own mind up on that.

The period you choose for RSI is related to your time frame. If you are a speculator, you would use daily data. If you were an investor, you would use weekly data. The number of days or weeks will also be driven by your speculation or investment plan. You need first to decide what time frame you want to exploit and then test different numbers of days or weeks, to see what seems to give the best results for your plan. I don't use RSI, except to teach and write educational articles. However, I find 5 or 7 days or weeks seems to be a good starting point. From there you need to adjust it by eye to match the character of the market or stock you are dealing with.

What you need to realise is that technical analysis is like a big toolbox. You don't use all the tools for every job. You use the most appropriate tool for the job at hand. That will also depend on your whole psychological make-up. If you struggle because you don't understand something, then keep working on it. But if you understand it and are still uncomfortable, it is probably suggesting that the tool does not suit your temperament and you should look elsewhere.

To understand your temperament, read the early chapters in my book *The Psychology of Investing*. They will help you to understand what your temperament is and what kind of investing or speculation is most suitable for you.

Videotapes and DVDs

Question

Can I still get the videotapes and/or DVDs of your investment plan?

Answer

I originally taught my investment plan in a two-day seminar. This was very exhausting, but it was great for making sure I was talking at the right level and addressing typical questions from the participants. Later I did it as an investment camp. I videotaped the camp presentations. When the videotapes were all gone, I transferred it to DVD. Alas they have also all gone long ago. I have spent some time today trying to take references to the videotapes and DVDs off my web site. I hope I got them all, but time will tell.

The reason I did not continue with the DVDs was because the book *The Aggressive Investor* had everything in it and there was quite an improvement in many ways in the manner of presenting my material. So, what you have in the book is the full plan in its latest form. One day I might do it again as a DVD, but I have no immediate time or plan to do that. I will update the book (maybe next year) and that will be a good time to consider a DVD. That is all in the future.

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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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