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Colin Nicholson: Newsletter 79

2 July 2008

Please accept my apology for the two-month delay between newsletters. I was overseas all of May. I intended to do another newsletter a month ago. However, unfortunately my father passed away in mid June and family responsibilities have consumed all my time. Because some of these responsibilities are ongoing, I have found that I have had to cut back on something. I have reluctantly decided to quit writing the weekly column in the Australian Financial Review Market Wrap section on Tuesdays and also the monthly column in the AFR Smart Investor magazine. I hope to be able to continue the newsletters and adding to the web site going forward. Once things settle down for me I will have a better idea what I will be able to continue in the future.

My Speaking Program

I advertise my upcoming speaking engagements on my web site www.bwts.com.au on the *Hear Colin Speak* page. I have had to defer the Port Macquarie presentation until October. I will do my best to fulfil all other existing engagements. The next opportunities to hear me speak are:

Australian Technical Analysts Association

Monday 21 July 5.15pm - 7.30pm
Bowlers Club York Street Sydney

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 www.ataa.com.au

Australian Investors Association Conference

Gold Coast Queensland 27-30 July 2008
I am speaking at 4pm Tuesday 29 July

How to Make Better Investing Decisions

The great investors think differently. They have learned to avoid some of the natural errors and biases, to which we all fall victim by doing what seems natural. It is not easy to change the habits of a lifetime. The first step is to become aware of the mistakes we are making. Colin will take us through some of the key findings from the relatively new field of behavioural finance and suggest practical strategies we can use to improve our investment decision-making ability. Much of the academic work in this area of study is relatively difficult for investors to understand. Colin will strip away the jargon and explain the key ideas in everyday language.

Further information is at <http://www.investors.asn.au/G700GoldConf.asp>

There is More than One Way to Invest

I recently received two long emails from a reader, which raised what I think is a very important issue and one of general interest in these difficult times in the market. Below I have set out the reader's comments and my response.

Comment

It seems to me that most of the problems people have with investing are of their own making and are highlighted in your book *The Psychology of Investing*. It is your brain getting in the way of making rational decisions.

Response

Yes, you are spot on there. None of us are immune from acting in very natural ways. We have learned this thinking from the people around us, or by just doing what seems to be the obvious thing to do. There are two things which I think we should bear in mind here.

First, most of our human thinking is driven by our need to somehow, often unconsciously, defend our ego. Nobody likes to be wrong. We humans are very good at rationalising and restating facts to put us in the best light. This is definitely a form of unconscious self-deception and one of the aims of my book was to make you aware of common errors and biases in thinking so you might try to avoid them.

Second, it is very difficult to effect lasting change in the way we think. The older we get, the more difficult it seems to be. Elsewhere in your emails you said:

For me, reading your books was a bit of an eye opener and education. I know what I should do. I just lack the discipline to carry it out. Probably 50% of the time I take the right decision at the right time, the other 50% I pontificate, dither, delay, succumb to greed, fear, and other emotions but I imagine a lot of people are like that especially if they have only been investing for the past 5 years of bull market. Hopefully, given time, I will improve my percentage in the correct decision direction.

This is a good description of the way common errors and biases manifest themselves.

Although it is difficult to change the way we think, it can be done. The first step is to be aware of what we may be doing. That is why I have written *The Psychology of Investing* and why many others have also written books on the subject.

One of the most important ways which I try to change my poor thinking is something I described in an earlier newsletter. I have a detailed written investment plan. This is my book *The Aggressive Investor*. The key section is the Executive Summary. Most of the time I know instinctively what to do to follow my plan if a critical chart level is breached. I act without hesitation. Nevertheless, being as human as everyone else, sometimes I hesitate. When that happens now, I pull down my own book off the bookshelf above my desk

and go to the Executive Summary of the plan. The answer, in terms of the correct thinking, is always there for me to read. Then I act on it.

I can not stress too highly the importance of having a detailed written plan. It should contain the answer to every situation you encounter. If it does not, then the plan needs further work to make it so.

Comment

When the market was falling, I watched most of my stocks go through their stop losses and dithered whilst they went lower but eventually bit the bullet and sold. Most of them, particularly banks and other financials, kept going south. The old adage that the stocks will come back kept me from selling. At a meeting of Australian Shareholders Association I suggested people read your books to (a) set stop losses; and (b) understand the psychology of selling and holding on to losing stocks. There were some 80 people there and I think I was alone in suggesting selling stocks before the loss gets bigger. 79 said they were in for the long haul and what went down will come back and they hadn't made a loss until they sold.

Response

While what you are saying makes sense in terms of my investment plan and yours, assuming it is similar to mine, I think you are missing something very important here. There are a great many ways to make money in the markets. Yours and mine are only two of them. Speaking for myself here, I am an active investor. I try to time the big swings in the markets. That is, to be in the market strongly in the first two thirds of a bull market and then phase my way out so that I sit in cash in bear markets. This is a market timing approach. It is not easy to do. It is not a proposition for big funds managers, because they would destroy the market, and their clients' wealth, if they tried to sell out and go completely into cash. That aside, market timing is difficult and very risky. It takes many years to learn the ropes and I fear that it is an art for very few people with the aptitude and perseverance to master it. Most people lose money trying to learn and mercifully give up before they lose too much.

From my method you can go in two directions.

One is to short term trading and day trading. Here the plan is one of speculation and most people fail at it. Nevertheless, there is a small group with the aptitude and application which can learn to be good at it. The best teacher of short term trading that I know is Dr Alexander Elder. I commend his books to any reader who wishes to go down this route, especially *Come into my Trading Room*. Dr Elder has recently written a new book called *Sell and Sell Short*. I have not had time to read it yet, but will report my impressions in a later newsletter. This book is clearly relevant to a bear market, such as we have now. Readers who wish to buy it may do so from Dr Elder's web site www.elder.com. If you mention that you are one of my readers, he will post it to you at a special low rate. For the maximum value, also order the *Study Guide*, which will help to deepen your grasp of the material in the book.

The other direction you can go is what your friends in the Australian Shareholders Association are talking about. This is the long term buy and hold approach. This is the most common method of investing. It can be remarkably successful. However, it can also be poorly executed and result in less than good results for the same kind of psychological reasons as beset active investing or short term trading. These revolve around lack of a plan and failure to follow the plan.

What these investors have said to you is self-evident if you look at a long term chart of the stock market. If you save money all your working life and invest it as you go, and stay the course, you will do very well. The long term total return from Australian shares is 12.5%. If you can get near that and allow it to compound, you will retire very rich. The worst thing one of these investors can do is to panic and sell when prices fall. That defeats the whole purpose of what they are doing.

However, that said, there are some mistakes these investors can fall into:

They can have waited too long and invested late in the bull market. This is very common. Then they try to ride it out, but eventually they are forced to liquidate their portfolio when they lose their job and need the money to pay the mortgage. Or they lose patience and panic.

They can have bought speculative companies. An investment grade company should make consistent profits year after year and pay dividends likewise. I would argue that companies which do not satisfy these requirements should not be in a buy and hold portfolio and should be treated as speculations.

They can have chased yield in heavily indebted securities. We have recently seen how devastating this can be, just as it was in the 1980s. These are highly risky situations. One or two in a big portfolio may be alright, but a lot of the portfolio exposed to them is inviting disaster.

They can have a far too concentrated portfolio. I have seen some with eight or ten banks in a portfolio of twenty stocks. Likewise a concentration on resources. Diversification is one of the most powerful strategies for long term investors.

Assuming that your Australian Shareholders Association friends hold portfolios with the features I described, you have little to argue with them about. It would be far more fruitful for you to ask the questions I have just addressed, and if they meet them, what they will be doing is approximating the return from an index fund. It is very difficult for most people to do better than that. Indeed, if an investor does not have either the time or the skills to make their own investment decisions, a low fee index fund is the way for them to go.

Comment

The majority were retired or near retirement and I tried to argue that maintaining their capital is the prime objective, not dividends from falling stocks.

Response

This is an excellent point and a very important one. If they need cash over the next year or so, shares will not be a good place to be. The usual way to deal with this is to always have some cash in reserve. If they have enough in cash to cover their needs for the next two to three years, you have no argument with them. If not, it is a good point for you to make.

Comment

At the same meeting I pointed out that there were sectors and stocks that were bucking the down trend, mainly resources and the health sector. This is where psychology rears its ugly head again. Just as it proved difficult to sell losing stocks as they went through stop losses, it proved equally difficult to buy into rising stocks.

Response

Yes, you are correct that there are often a few good stocks which are rising even in a bear market. If they are sound investment grade stocks, as I described above, my guess is that they will already be in these investors' portfolios. If so, fine. If not, one could argue whether taking losses in another long term holding in order to buy into them is a good suggestion to make. It cuts right across their investment plan by introducing an element of market timing. Long term investors should be looking to put additional savings into these kinds of companies, but possibly not now, when they are overvalued, but by choosing a time when their prices represent good value. In short, you are trying to convince these investors to change their plan to yours. I think this would be a mistake.

Comment

However, I then found my brain had a problem with buying into an uptrend. I didn't want to pay too much and never bought the stock. I kept waiting for a down day to get in, but have missed every time because I was too concerned not to pay too much in case it fell back. Now it is up 37% since I identified it and have missed out on a nice gain. Is this a problem that is normal? Instead of just worrying about a few cents in the share price, I should have bought at market on day one. It could be that the stock will continue to rise, but my brain says I have missed the boat. So we have, not only the psychology of selling out of losing stocks, but also the opposite problem of trying to get into rising stocks.

Response

What you describe is very typical. As I said earlier, market timing is a tough game. You must have a clear plan. Then like me, when you see an opportunity, your plan should tell you what you should do. It sounds to me as though you either do not have a plan, or more likely, you do not have enough faith in it to follow it. You must test your plan over and over again on past

markets and by paper trading going forward. Continue this until you just know deep inside you that it will work if you stick to it. In doing this, remember that all plans involve losses. The key is that you cut all losses quickly and let the good investments run.

What I suggest you do is what Dr Elder teaches for traders. It works just as well for investors. At the time you make any investment decision, write down what you are thinking. Put down what evidence you had and what decision you made and why. Include a copy of the chart or charts as they were at that time. Then do the same when you add, reduce or close the investment. This kind of investment diary is invaluable in learning what you did right and why. More importantly you will see what you did wrong and why you decided to act differently to your plan. This takes a lot of work. However, as Dr Elder said in one of his recent newsletters: show me a trader with good records, and I will show you a good trader.

Question

Why has there been nothing in the financial magazines suggesting that you actively manage your portfolio, change your shares held into other sectors, sell shares and put more into cash for the recovery day?

Answer

Your question went on to list a whole lot of possible reasons. Most of them miss the point that I have been making above. Most investors should not be trying to do what I do and try to time the market. They do not have the time, the aptitude or the skills to do that. They have other things to do in their lives. Most of the commentators will be talking to this kind of investor, for whom the worst possible advice is to panic and sell in a bear market. Their time horizon should be many decades away and they should be investing sensibly in that time frame. Buy and hold is a very sound way of achieving their objectives.

However, we all make some judgements which do not work out as we hope. This calls for some fine tuning over time. However, one of the smartest investors I personally know has the perfect approach here. Each year she sits down at tax time with her adviser and they review her portfolio. If something needs changing they do it. Interestingly, they rarely change much at all.

This is not to say that some of the commentators will be talking their book, or at least representing the views of their employer. This is normal. We all talk our book most of the time to some extent. Nevertheless, we should try to make comments that are relevant to the investor we are speaking to, not try to sell our own ideas, which may be unsuitable for them. In order to assess the worth of any advice, you need to look firstly at who the audience may be and then assess the advice you give in terms of what is appropriate for that audience. We all like to convert others to our approach to investing, but that may not always be a responsible thing to do.

Comment

For me, reading your books was a bit of an eye opener and education. I know what I should do. I just lack the discipline to carry it out. Mostly, I pontificate,

dither, delay, succumb to greed, fear, and other emotions but I imagine a lot of people are like that especially if they have only been investing for the past 5 years of bull market. Hopefully, given time, I will improve my percentage in the correct decision direction.

Response

Yes, I hope so too. Earlier, I gave you some suggestions as to how you might go about that task.

Special Offer

I still have a small stock 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 simply covers my cost of processing your order and mailing the book. To order, go to www.bwts.com.au

Why not do it Yourself?

Question

I read in a previous newsletter that you have only managed your total portfolio in recent years. This concerns me, as it suggests that it is harder to manage a portfolio than one might imagine. Could you please indicate why a person with all your experience did not manage your total portfolio well before you did?

Answer

This is a very good question. As I discussed in *The Aggressive Investor*, it takes a long time to gain the knowledge and build up the experience. For me, it took longer than the minimum that I suggest is normal of at least ten years. In large part this was because I had a demanding full time job, so time was not always there to read and study. In fact I did not study investing formally until I quit my employment in 1987 and devoted 1988 and 1989 to full-time study.

Another aspect to this is something I teach, which is that because it takes time to gain the knowledge and experience, the smart thing to do is have most of your capital with professional investors. I suggest taking no more than 10% of it and managing that yourself. Once you can demonstrate that you can beat the professionals, gradually start to manage more of your capital yourself.

This is essentially what I did, except that there was another complication. That is superannuation. It was not easy to get money out of the superannuation system until 55 and 60 on the old rules. Looking at a self managed superannuation fund was for many reasons not practical then because the amount involved did not make good sense. Current thinking is that you need

at least \$200,000 and probably more. So it stayed with the professionals and I even made more deductible contributions in later years.

Once I got to 55 and 60, I took the money out of the super funds and managed it myself. Then last year, I set up a SMSF under the new rules and moved everything back into super, because the new rules are too attractive to ignore.

There is another reason why I took my time. You know it is interesting how everyone is in such a hurry these days. They have one or two good years, usually in a bull market, and think they know it all. I take the view that all the research I have ever seen is saying that it is very difficult to consistently beat the market. Anyone can have a good run in a bull market. If there are enough investors in the sample, someone will beat the market every year for ten years and yet it might all be just good luck.

If we think we are experts and it turns out we are not, the long term penalty can be very great in lost opportunity. So, for all these reasons I wanted to be sure I could consistently rack up returns better than the market. In *The Aggressive Investor* I set out my results from 2000, which was at the top of the market, then down the bear market slope and back up to a top this year. Now we have six months of the next bear market. Only in one of those years have I not beat the All Ordinaries Accumulation index and that includes 2007-08 (final numbers will be a few weeks away). So, I still could be very lucky, but the longer the streak lasts the more comfort I can draw that I am doing something right most of the time and can justify the risk of managing it all myself.

You may regard all this as extremely cautious and overly timid. If so, I am guilty as charged, but knowing what I do today, I would not have changed very much of what I have done.

My Portfolio

I publish my portfolio in close to real time on my web site. The link to the portfolio disclosure page is at the bottom of every page on my web site www.bwts.com.au. In 2007-08 my portfolio (including cash reserve) outperformed the market by a good margin. I will not have a final number for a few weeks yet when all the paperwork is available. I will publish the 2007-08 result in a future newsletter, just as I have published all my results since 2000.

I have been asked recently why there are currently no stocks at all in my portfolio. The answer is that I am following my investment plan, which keeps me out of bear markets. What will be far more important is when I believe the time has come to go back in for the next bull market. My investment plan has a very clear strategy for this, which has served me well over several bull-bear cycles. My complete investment plan is set out in my book *The Aggressive Investor*. You may order it from my web site www.bwts.com.au.

What Starting Point?

Question

At the beginning of each financial year do you start with the opening stock at your original purchase price or at the unrealised capital gain/loss price that you closed the portfolio for the end of the previous financial year?

Answer

I start each year with the holdings at 30 June valued at the market price plus my cash reserve. Since I mark my portfolio to market every evening, this will also be the value at the end of the previous year. This gives a result that is based on the real value of my holdings at the start of the year. The original cost is not a relevant figure. Once you buy something, its value is then determined at any time by the market. Your holding is worth what you could sell it for. This gives an accurate value for your gain or loss for the year.

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