

Colin Nicholson: Newsletter 81

10 September 2008

My Speaking Program

I advertise my upcoming speaking engagements on my web site www.bwts.com.au on the *Hear Colin Speak* page. The next opportunities to hear me speak are:

Investment Expo Brisbane

Friday 12 September 12.30-1.00pm

Saturday 13 September 12.30-1.00pm

Sunday 14 September 10.15-10.45am

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.

Further information: http://www.investmentexpo.com.au/page/brisbane_visitor_home.html

ASX Investor Hour

1 October 2008 12 noon

RMIT Storey Hall, Building 16, 342 Swanston Street, Melbourne

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.asx.com.au

New Method of Delivering the Newsletter

In the past, I have delivered newsletters to you in an email. The format will have been HTML or plain text depending on how your email client is set up.

For a number of reasons, I will now deliver the newsletter to you in a different way. I will send you an email advising that the next newsletter is available. The email will provide a link to the newsletter on my web site. If your email client is set to HTML, you will only need to click on that link. If your email client is set to plain text, you will need to copy and paste that link into your internet browser.

In both cases, that will take you to the newsletter, which will open in a PDF file, provided that you have the Adobe Reader on your computer. If you do not, you may download this free program from www.adobe.com. You will be able to then read that file, or save it to your hard drive for later perusal.

I have done this in large part because it will deliver to you a better product and will open up more options for formatting and to show and discuss charts.

Constructive suggestions and feedback is always welcome. Just email me at colin@bwts.com.au

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Alpha versus Index

In the Australian Financial Review August 23-24 Barrie Dunstan reported on some new academic research on managed funds. Those who are interested in studying the full research paper will find it at

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=869748

The paper is titled *False Discoveries in Mutual Fund Performance: Measuring Luck in Estimating Alphas* by Laurent Barras and Oliver Scaillet of the Swiss Finance Institute and Russ Wermers of the University of Maryland.

The paper sought to identify what the authors call false discoveries. This is simply a term for mutual funds that deliver significant alpha which is solely due to luck. Alpha is a jargon term for the part of returns which is in excess of the market benchmark and claimed to be due to fund manager ability.

The paper found that 75.4% of the funds studied did manage to report some alpha return from their stock selections. However, there is a nasty rider to this. These managers then captured the alpha return for themselves, rather than investors, through the fees they charge to manage the funds. Yes, that means that the investors in the funds do not receive any of the benefit of the managers' stock selections net of fees.

You might ask what about the remaining 24% of funds? Simple, the study finds that they are simply unskilled. In trying to produce alpha, they actually produced returns which were lower than the benchmark index.

However, the more interesting insight from the study concerns the other 0.6% of managers. This was 12 out of the 2,076 funds studied. The study found that these were the only funds to produce alpha in excess of fees for their investors. These were the only fund managers who were able to demonstrate real skill in producing alpha returns and passing some of them through to investors after fees.

Interestingly, the number of funds in this category had fallen from 14% in 1990. At the same time, the percentage of unskilled managers had risen from 9.2% in 1990 to 24% in the study. Clearly this is partly attributable to greater competition in funds management, which has in effect acted to arbitrage away much of the after fees alpha available to fund investors.

This study provides great comfort and support for the low fee index funds. By the same token, it should increase the discomfort of individual speculators and investors, who should question whether their field of endeavour has not also suffered from a reduction in the number who are producing alpha, after costs, through true skill. It behoves all individual speculators and investors to maintain good records and to track their true performance against an appropriate benchmark index.

Advertisement

An *Insight Trader* charting software licence for sale

One of my readers, Henry Luk, is interested in selling his *Insight Trader* charting software licence. This is a legitimate offer of a valid licence, which may be purchased for A\$150. The licence enables you to run version 9.1 and register it with *Insight Trader*, who are aware of this offer.

Version 9 is not the latest version. The latest version is 17.1. Now, version 9.1 is fine and may suit many beginners because all the basic functions are there.

If a reader wishes to buy this licence for version 9.1 and upgrade it to version 17.1, the cost will be an additional A\$264 paid to *Insight Trader*. In addition, it is possible to buy from *Insight Trader* the latest historical data file for the ASX for A\$55. If a reader did this, the all up cost for the latest software would be $\$A150 + 264 + 55 = A\469 . This is over A\$100 cheaper than the list price for version 17.1, which is A\$595.

Interested readers should email the seller on henrypluk@gmail.com

This is a free advertisement provided as a service to readers

Preparing for the Next Bull Market

I am invited to speak on varying subjects around the country. Whenever I do, I find myself fielding emails from people in other parts of the country who want to know what I said. Although I speak in many cities, I cannot be everywhere. This means that, to hear me, readers will need to watch the *Hear Colin Speak* page on my web site and come to where I am. This is really cheap these days, with budget-priced airlines offering fares that are often less than the cost of a seminar.

The previous format of the newsletter rather restricted me in what I could show in the way of charts. This is one reason for the change in the way of delivering the newsletter. Now, I can deliver a better product, including charts.

As time permits, I will try to write up briefly some of my presentations. I will start in this issue with the recent free 30-minute presentation I gave at the recent Melbourne *Trading and Investing Expo* in the subject of preparing for the next Bull Market.

I chose this topic because many investors who I meet seem devastated by the present bear market. There are several main reasons for this:

1. They had not read the history books, or lived through previous cycles, to know and expect that every bull market leads into a bear market. This has been happening for a long time and is unlikely ever to change very much.
2. They focus too much on changes in capital value rather than income streams, which are the prime focus of investment for retirement.

3. They are agonising over the short term losses instead of seeing a bear market for what it is. Bear markets are a form of cleansing of the excesses of the prior boom. They set the stage for the next bull market.

So, a positive, rather than negative, view of what has been happening this year is that some great opportunities are being created. What we do in a bear market may well determine how well we perform as investors next time around the cycle.

In speaking about investment, we should always start by being absolutely clear on two things:

1. What kind of investor are we?
2. What is our investment method?

Of course, most people dive into whatever is being said without stopping to think whether what is being said is relevant to them or not.

The way I see the investing world, there are four basic types of investor:

1. Short term speculators (hours to days)
2. Swing speculators (days to months)
3. Active investors (months to years)
4. Buy-and-hold investors (a lifetime)

You will notice that I have not mentioned “traders” or “trading”. I have done this deliberately. Trader is a polite term for speculator. It has been so debased with a huge range of meanings, that it has lost its usefulness. I prefer the somewhat older, but solid terms speculating and investing.

Speculation is where we seek to buy something which we think will rise in price and we can sell later at a profit. While a dividend may be received, almost by accident for a stock, in many markets there is no equivalent income stream. That is not the only way though. The other way a speculator profits is to sell short something which he or she thinks will fall in price and can buy back later at a profit. My friend Dr Alexander Elder has recently published a fascinating new book called *Sell & Sell Short*, which discusses this important method of speculating in many markets.

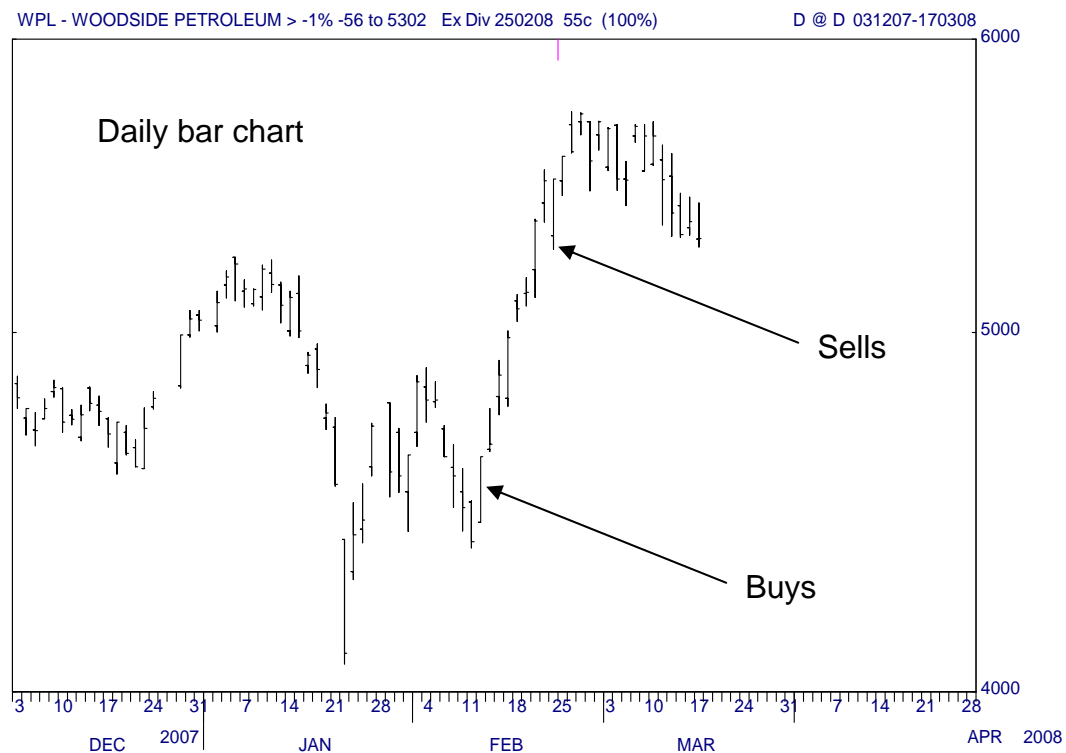
Investment is a different pursuit altogether because it relates mostly to the stock and bond markets, where the prime focus is on total return. In the case of bonds held to redemption, this may be entirely an income stream, much like the buy-and-hold investor who holds stocks through a lifetime. However, for the active investor, the focus is clearly on both the income stream and the capital gain components of the total return.

Of course, there is always a grey area. Some speculators think they are investors, but focus primarily on capital gain. To the extent that this is the prime objective, I would class them as swing speculators.

We can argue about this forever, but I hope I have made it clear how I am seeing speculation as apart from investment.

To illustrate what I have just been discussing, these charts may assist:

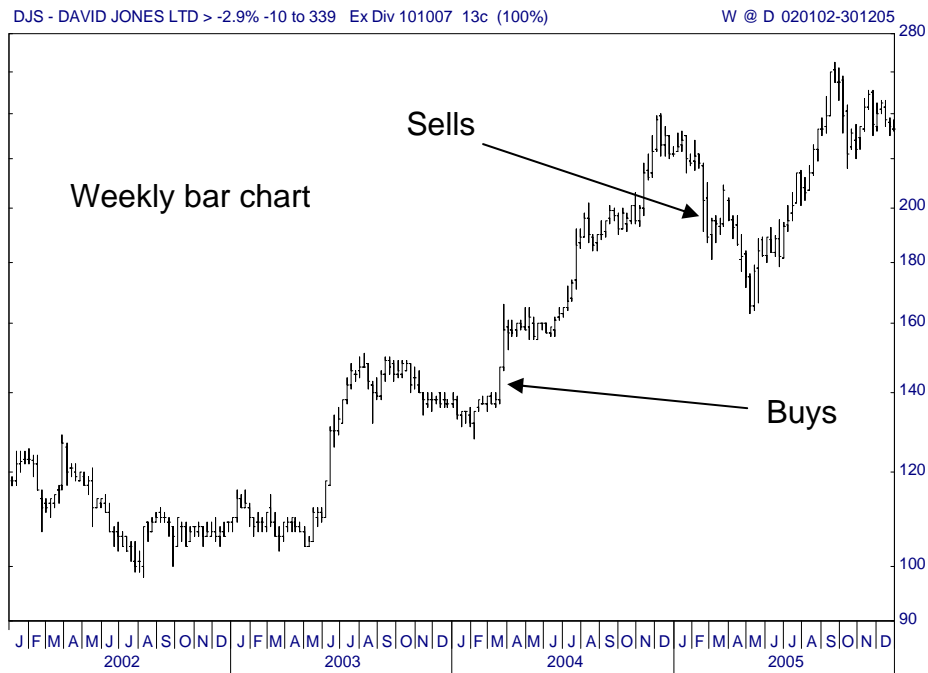
First, the short term speculator:



This campaign took nine days.

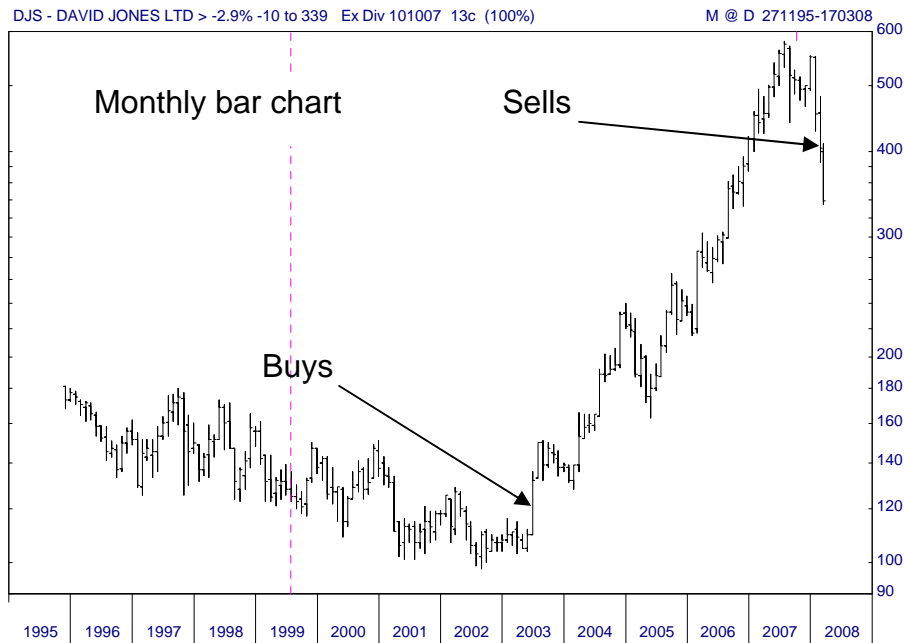
However, a day trader might have held the stock for nine minutes or nine hours. The key to the definition is that it tries to profit from one short-term swing in the price.

Second, a swing speculator:



This campaign ran for about a year, from early 2004 to early 2005.

Next an active investor:

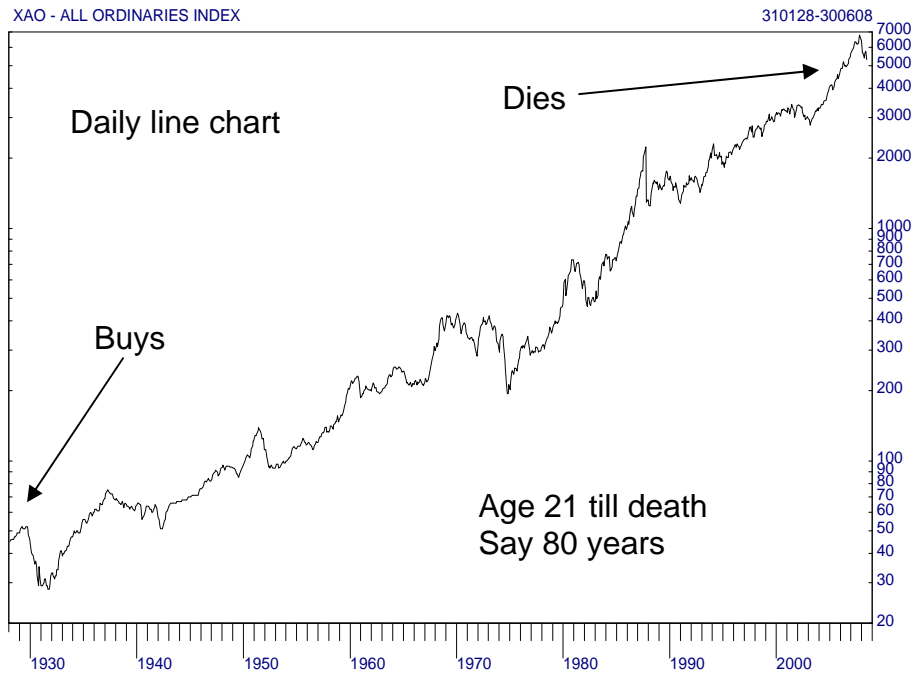


This campaign ran for four and a half years from mid 2003 to early 2008.

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Finally, the buy-and-hold investor:



This campaign took an entire adult lifetime. While there may have been a few switches over the years and more than a few takeovers, mostly the investor simply reinvested the dividends after tax.

Bear Market Strategies

On this basis, the strategy for each of these groups in a bear market might be:

Short Term Speculators

Actively long and short as usual.

Swing Speculators

Primarily short because that is the direction of the major trend. Only very experienced speculators should consider being long in sucker rallies during a bear market.

Active Investors

Primarily sitting in cash and waiting for the final phase of the bear market. This may sound boring, but at least the sign in front of the rate of return is a plus, not a minus.

Buy-and-hold Investors

Sitting on their holdings, or buying very cautiously in very extreme sell-offs of high quality stocks.

An Aside

In the last few months I have encountered a lot of very negative comment from speculators about the “idiots who did not sell in time”. I would like to say that I think this kind of sentiment is particularly ill-informed, because it fails to take into account what these “idiots” investment plan was.

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If they were speculators, then yes, they did not know what they should have been doing.

However, if they were buy-and-hold investors following their plan, they may actually be some of the smartest investors around the market. In fact I know a few who have beaten the index over many years and have lived comfortably off an ever-growing income stream from dividends. That is the **Accumulation** index, not the **price** index, which the speculators use. The lesson here is to judge others on how well they follow their plan, not yours.

Having set the scene, the rest of what I will discuss will focus entirely on active investors. This is my own investment method and the one I am most competent to discuss.

Active Investing Strategy

Active investment is an exercise in market timing. The basic strategy is:

1. Enter in the last phase of the bear market (distress selling) and complete buying during the first phase of the bull market (reviving confidence).
2. Stay fully invested through the second phase of the bull market (increasing earnings) and into the final phase of the bull market (rampant speculation).
3. Begin reducing exposure once the final phase of the bull market (rampant speculation) is obvious and exit completely once the first phase of the bear market (abandonment of hopes) begins.
4. Stay out through the second phase of the bear market (decreasing earnings) and into the final phase of the bear market (distress selling).

Then we start over again in the next cycle.

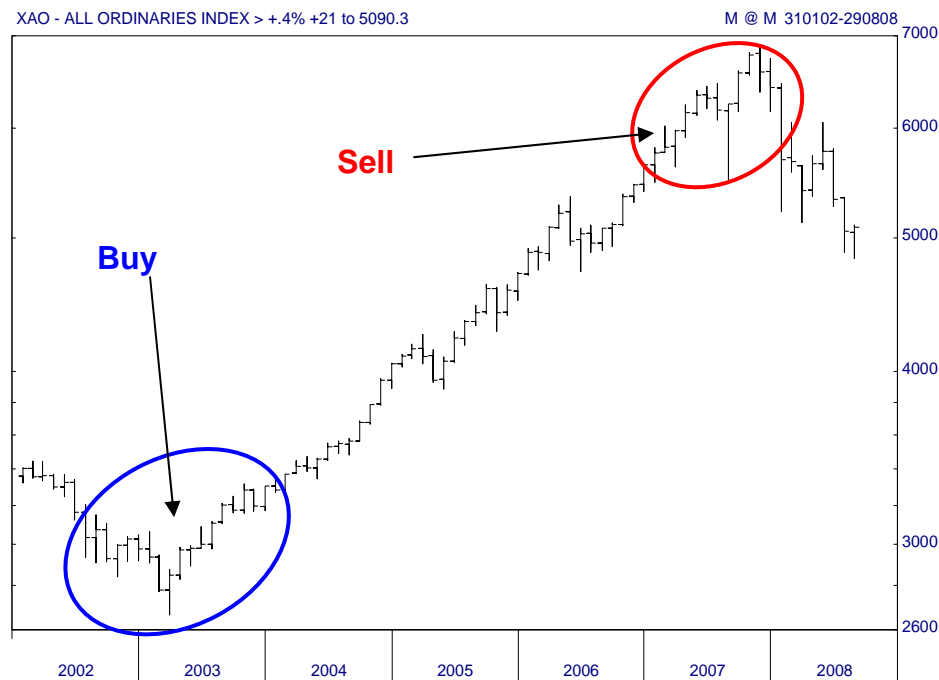
Many people dismiss this kind of phase analysis of the stock market, but it is not difficult to do and is very powerful. This is fully explained, including what sort of indications to watch for, in my book *The Aggressive Investor*. You may buy it from www.bwts.com.au.

I have been using this methodology for many years now. Anyone can say afterwards that they acted perfectly. I never claim to be perfect, but I do try to get my basic strategy roughly in tune with the market phases.

In late 2006, I wrote *Hot Stocks 2007*, in which I called the start of rampant speculation. I explained why and what I was doing myself. A year later, I wrote *Hot Stocks 2008*, in which I brought my view up to date, explaining again why and what I was doing about the situation with my own investing. Yes, I warned readers rather early, but I make no apology. I would only apologise if I had failed to warn of what was coming much too late to take action.

Hot Stocks 2007 and *Hot Stocks 2008* are still available from www.bwts.com.au at the special prices of \$5 and \$6 respectively. These prices include postage and are designed to put a teaching tool into your hands rather than pay to pulp the stock.

To visualise how the strategy works, here is a monthly bar chart of the ASX All Ordinaries Index:



As you can see, there is plenty of time to get in and then to get out, if you know what to do. The entry takes many months, the exit likewise.

There are those who say this is all rubbish and who demand to know where the bottom is and where the top is. They seek perfection. This is understandable, but unfortunately it is at complete odds with the nature of the art of investing. A far better method is to start to assemble a portfolio of good stocks, then weed out those which fail to perform and build the positions in those which do perform.

Look again at this chart. We should have been able to take away a great chunk of the bull market, not all of it, but around 70-80% of it. That can generate a great return. See my last newsletter for a statement of my results since 2000.

Summary of What We Should Be Doing in the Bear Market

There are two key words I keep repeating to myself as we bide our time though the bear market:

1. **Patience.** This is a virtue largely lost in modern society. We cannot make the market give us money. Instead we need the patience to wait for the bull market to come to us. It may be only a matter of months away, but more likely a year or more. Only time will tell.
2. **Discipline.** This is at many levels. First, there is the discipline through the bear market to keep our hands away from the order screen simply out of boredom and impatience. Second, there is the discipline to buy the right stocks when the time comes. This is not difficult intellectually, but it is tough because we have to deal with our emotions.

My own activity in a bear market can be set out under some simple headings:

Review our Written Investment Plan

This is very difficult to do in the heat of an investment campaign. It is best done when things are quiet and we have little or no money in the market. It requires reading, study, research and a great deal of thinking time. The answers are not easy to find. Moreover they are different for each of us.

The pivot here is that we should have written down in detail exactly when we should act, in terms of what is happening around us. Then the plan should spell out a precise strategy. Mine is all in my book. I am always reviewing it in a bear market, even though, after 40 years of experience, I now rarely change it. This review process makes me more confident about following my plan when I come again to put it into action.

Develop a Hot List of Stocks to Buy at the Right Time

It is too late to start our research when the bull market has started. I have just spent a lot of time studying results in the reporting season and putting some stocks into a hot list. I have charts set up for each stock, so that I can monitor them every day. There is no action to take at the moment, but one day the all-important breakouts will occur and I will be ready.

Most people will have read about these stocks and promptly forgotten about them because the time did not seem to be right. Then, one day a few years later, they notice how far they rose. That is why it is so important to have a list of candidates to buy and to keep monitoring them.

In selecting stocks for the hot list, the main thing is that our investment plan should have clear and precise criteria for what we are interested in. This is all in my book. I am just following my plan.

Read Books, Take Courses

People ask why do this? Surely, they say, I must know it all already. Not so. Once we stop learning, we stop growing. Nobody knows it all. I know that there are always things I should seek to improve, so I am constantly trying to fine-tune my methods.

I spent many years learning and then teaching both technical analysis and fundamental analysis. Teaching, by the way, is the best way to master your

material. Along the way, I found myself exposed to the history of markets and how they work. I was trained at university in economics, but if you have a different background, you will need this too.

More recently, my prime focus of study has been on decision making skills. I read this material whenever I can and have written one book about it: *The Psychology of Investing*. You can buy this book from www.bwts.com.au. I have also started to teach this material when the opportunity arises. I have further to go with it yet, but already I am seeing concrete results in my investing decisions.

That is a brief summary of the main ideas I talked about at the expo. If the feedback is positive, I will try to write up some more presentations.

Bear Market Indicator

I recently conducted a seminar in Melbourne at the Trading and Investing Expo on the topic of how to know when the bear market is finishing and a new bull market is starting. This was an hour and a half extension of the 30 minute presentation which was written up above.

One of the indicators that a bear market is heading into the second (decreasing earnings) and especially the third (distress selling) phases is a rise in the level of bankruptcies. While large corporate failures will attract headlines, the really large group to watch for are small businesses and individuals.

One question I received from the audience was how to know what the level of bankruptcies is at any time. For those who wish to see the official statistics in detail, they may be viewed at <http://www.itsa.gov.au/dir228/itsaweb.nsf/docindex/about+us-%3Estatistics-%3Estatistics?opendocument>

I know that most readers will be content to watch for press reports rather than study the statistics. While I concede that bankruptcies are not given a lot of publicity, attentive reading of the *Australian Financial Review* and general newspapers (especially financial sections) will throw up some of the numbers from time to time.

Only just over a week after the seminar, I came across an article *Exit with Strings* in the *Money* section of the *Sydney Morning Herald* 27 August 2008. This was most likely to have also appeared in the corresponding section in the *Melbourne Age*. What the article was about concerned Debt Agreements, which for some people are a viable alternative to bankruptcy. The article stated that, based on figures for June and July 2008, the annual rate was now about 10,000 agreements. This compared to only 6,619 agreements which had been signed in the past year.

This is the kind of report I was talking about in Melbourne. I feel that it is suggesting clearly that the bear market is starting to bite for individuals with

too much debt. It is just one small glimpse of what is happening in our economy. We should expect to see further reports of a similar increase in bankruptcies as the bear market unfolds.

If you have friends or clients who you think would like to receive the newsletter, please email this file to them and invite them to join the list by going to the Newsletters page on www.bwts.com.au and clicking on the relevant link. My only proviso is that the newsletter be sent in full and unchanged.

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