

Colin Nicholson: Newsletter 82

4 October 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 Melbourne

My session times

Friday 10 October 2008 11.50am

Saturday 11 October 2008 2.15pm

Sunday 12 October 2008 12.45pm

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.

For further information on the Expo click [here](#).

Friday 10 October 2008 1.10 - 2.10pm

I am one of a panel on the subject

Property Vs Shares - Where to Invest in the Current Market

For further information on the Expo click [here](#).

Australian Shareholders Association Mid North Coast (NSW)

Friday 17 October 2008 10.00-12.45

Senior Citizens' Rooms, corner William & Hay Sts Port Macquarie

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

I will assess in detail my view on where we are in the bull-bear market cycle. Out of that I 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 ifs.pmq@bigpond.net.au.

Trading and Investing Expo Sydney

Friday 24 October 8.30am to 10.00am

How to Buy a Young Bull

Over the last 40 years, Colin has seen a number of bull markets. Every time, most investors join it far too late, often by several years. The most important thing he has learned is that the best investors join a bull market while it is young and leave the scene as the bull market ages. In this session, Colin will show what to look for to know when the bull market is starting. He will then explain his strategies for joining it earlier along with the good investors.

For further information on the Expo: www.tradingandinvestingexpo.com.au

Australian Investors Association One-Day Seminar Melbourne

Making Money in 2009

Saturday 25 October

My session will be 11.20am - 12.20pm and 1.10 - 2.10pm

How to Apply Winning Strategies

Over the last 40 years, I have seen a number of bull markets. Every time, most investors join it far too late, often by several years. The most important thing that I have learned is that the best investors begin to invest in the last phase of the bear market and complete their purchases early in the first phase of the bull market. Doing this is not difficult once we have the best tools and we understand what to look for. In this session, I will teach the key tools which I have found useful in past cycles and show how to use them effectively. In doing so, I will explain my strategies for getting set for the next bull market along with the good investors.

Further information: 1300 555 061 or aia@investors.asn.au

These will be the last opportunities to hear me speak this year. I am taking a bit of a break for the hectic program over recent months to focus on some other projects.

Copyright Colin Nicholson.

The newsletter may be reproduced and distributed in whole or in part, providing it is not altered in any way and the source is acknowledged.

How to Make Better Investing Decisions

This is a write-up of the presentation which I gave at the Australian Investors Association Conference 29 July 2008.

Outline

- Introduction: My objective today
- Why behavioural finance can improve our decision-making
- The mental accounting trap
- Loss aversion
- The sunk cost fallacy
- Where to go from here

Introduction: My Objective Today

I have been investing in shares for 40 years. In that time I have learned, and gained a great deal of experience in, investing strategies, technical analysis, fundamental analysis, money management and risk management.

The way I like to look at the investing task is that it requires the development of a sound plan, which is suitable for the investor concerned, and the ability to carry out that plan. The first part, development of a plan is not easy, but the really difficult part, in my experience, is developing the skills necessary to actually carry out the plan.

Carrying out the plan involves an unending series of decisions. Sometimes investors make decisions that they do not even realise they have made. Every time a new piece of information becomes available, we have to decide what, if anything, to do about it. Of course, mostly we do nothing. This is still a decision.

So, I describe the art of investing as being a process of serial decision-making.

This means that our knowledge and experience is only a necessary foundation. What really makes the difference is the quality of our decision-making.

The longer I work and study in the investing field, the more I observe that the good investors think differently to the way most average investors think. The best investors have learned to look at the investing landscape in ways which avoid many of the quite natural thinking errors and biases that we are all subject to.

We have only a short time today, so I want to focus on some of the thinking errors and biases which I believe to be most important for investors. I know this because I am still doing my best to overcome them myself.

Why Behavioural Economics Can Improve Our Decision-Making

Economists developed their craft on the seemingly reasonable assumption that each of us would make every decision in a way that maximised our self interest. In other words, in any situation where choice is required, we will always act rationally. For centuries this idea was rarely even questioned.

However, in the last almost four decades, a new field of research has blossomed. It is called behavioural economics or behavioural finance. The basis of it was to reject the

assumption of perfect rationality and look at how we actually make decisions. A lot of this work has been done in areas that have direct application to investing.

What the behavioural economics researchers have discovered is that all human beings, male and female, old and young, are subject to a whole range of errors and biases in their thinking. These are the traps which we fall into quite unconsciously, because we are doing what seems quite natural.

I have time today to only touch on this, now enormous, body of work and will focus on a few which I think are, in my experience, among the most important for investors.

I want to show you today:

- How we value some dollars differently to other dollars
- How losses affect us far more than profits
- How investment decisions that we make now are more important than past decisions

I used to think none of these things applied to me. You probably also think they do not apply to you. I am here to tell you that they apply to every one of us. Some of us may have become more aware of them than others have. Our investing decisions will be the better for being conscious of these errors and biases and by trying to avoid them.

The essential first steps in dealing with these traps and biases are:

- Accepting that the traps are applicable to us
- Becoming conscious of how they affect our decision-making
- Working at avoiding them through alternative strategies

I will address these issues as each of the three topics are discussed today.

The Mental Accounting Trap

I will introduce this topic by relating the legend of the man in the green bathrobe...

The honeymooners in Las Vegas had spent their \$1,000 gambling allowance

That night, the groom noticed a glowing object on the dresser

It was the \$5 chip saved as a souvenir

Mysteriously, the number 17 was glowing on its face

The groom donned a green bathrobe and went down to the roulette table

He bet the \$5 chip on the number 17

The 35:1 bet paid \$175

He kept letting his winnings ride until he was about to bet \$7.5 million

The house refused the bet, so he took a taxi downtown to a casino who would accept it

*He bet the \$7.5 million and won again - \$262 million
He let those millions ride, but the ball fell on 18, wiping him out*

He walked back to his hotel

When his bride asked where he had been he simply said "playing roulette"

When she asked how he did, he said:

"Not bad. I lost five dollars"

Can you see in this fable how the groom saw the \$5 as his money and the winnings as the casino's money? He did not see his winnings as being his money, so he did not regard them as being his losses

So, the key thing to notice was how some money in that story was given a different value to other money. This is what is meant by mental accounting. It has a pervasive presence in much of our lives and causes us to make bad decisions.

To understand this fully, suppose the groom had picked up the \$262 million and gone out to spend it. No shop-keeper would have seen it as other than the groom's money. Yet in the gambling situation, he saw that money as being "house money" and so made extravagant bets with it.

Investors often indulge in mental accounting. They regard their investment capital as their money, but their paper profits as the "market's money". So, they take more risks with their profits than they would with their investment capital. The result is that they often give too much of it back to the market

Some investors walk into the trap another way. Sarah was a sound share market investor with a long term return of 11%. She inherited \$17,000 from Grandma and thought it so special, that she could not risk it on shares. She put it in a 3% bank account. Ten years later it has grown to \$22,847. In the share market it would have grown to \$48,270.

I am sure you noticed how Sarah treated the money from her Grandma as being different to her own savings.

Next, consider these two situations:

Imagine that you have bought a ticket to a concert being given by a world-famous musician. At the venue, you realise that you have lost your ticket, which cost \$150. Would you spend another \$150 to hear the performance?

Now imagine that you go to the venue intending to buy a ticket at the door. At the box office, you realise that you have lost \$150 some time after leaving home. Still, you have at least another \$150 in your wallet. Do you buy the ticket?

Most people will not buy another ticket in the first scenario. They see it as costing \$300. Most people will buy the ticket in the second scenario. They see it as costing \$150 and the lost \$150 as a separate thing.

This is pure mental accounting. We should either buy or not buy the ticket in BOTH situations.

Economists correctly regard all money as fungible. Each dollar will buy the same things. There should be no difference in the way we save or spend it. Yet these examples show that we normal human beings are extremely prone to mental accounting, where all money is not treated the same way.

Here are some common warning signs of mental accounting in action:

- We don't think that we are a reckless spender, yet we have trouble saving.
- We have savings in the bank, yet we carry credit card balances from month to month.
- We are more likely to splurge with a tax refund than with our savings.
- We seem to spend more on our credit card than we would when using cash.
- Most of our retirement savings are in fixed interest investments.
- We are more relaxed with paper profits than with a share which goes backwards from the start.

To overcome mental accounting, we need some strategies to practice:

- When about to buy something with a credit card, we should ask if we would make the same purchase with cash? If not, don't buy it.
- Break big purchases down to single items and assess each on its merits and never add small items to a very large purchase.
- Put windfall gains in the bank for a month or so before spending them.
- Use mental accounting to your advantage by setting up a specific payroll deduction to your super fund or savings account.
- Regard paper gains on investments as real money we have earned.

I strongly recommend the books written by Dr Alexander Elder. He is the best teacher of short term trading which I have heard or read. He has a special deal for my readers:

Buy any of his books and he will give you the special postage rate to Australia of US\$6.00 on the book and also US\$6.00 for the book and study guide set. However, you must say in your order that you are one of my readers.

In addition, he will sign books when you request that in your order. Order from www.elder.com

Disclaimer: Dr Elder is a friend of mine. I do not earn anything from sales made to my readers. This is not a paid advertisement.

Loss Aversion

Probably the most well known research finding in behavioural economics is what is known as prospect theory. I have spoken about it before at AIA conferences and written about it in my books.

The basic idea is that we all tend to feel more pain over a loss than we feel joy over a gain of the same amount.

The result is that most investors have a strong tendency to take profits quickly in case they slip away from them. That is a very natural thing to do.

However, the equally natural tendency for most investors is to hold on to losing investments in the desperate hope that they might one day get out even. This is even justified using the excuse that the loss is not real unless they sell the investment.

Put another way, we tend to be conservative with our profits, but very risky with our losses.

The sting here is that the best investors act in the exactly opposite way. They cut losing investments quickly and patiently allow their best investments to grow.

Consider this situation:

You need to sell some investments to pay the school fees for your children totalling \$10,000.

You hold \$10,000 of CSL shares that you bought for \$5,000 and \$10,000 of ANZ shares you bought for \$20,000.

Which would you sell, CSL or ANZ?

If we chose to sell the CSL shares, we are suffering from loss aversion. As I just pointed out, good investors will always sell losers and hold winners.

Some warning signs that we are falling into the loss aversion trap as investors are:

- We tend to sell winning investments too quickly.
- We hang on to losing investments.

Here are some strategies to help to deal with loss aversion:

- Before we make an investment, agree and write down the price below which we will have been wrong about our investment.
- Diversify, so that no single investment is so large we cannot bring ourselves to cut losses quickly.
- Always value our portfolio at the current market price and try to forget the price we paid for our investments.

- Take profits slowly and gradually. Always keep some of a rising investment in place.
- If faced with a need to release capital from investments, sell the losers first and the winners last.

Dr Elder has written a number of books:

Trading for a Living, which is one of the best-selling books on trading ever written.

Come Into My Trading Room, which took the material in *Trading for a Living* to a new level.

Entries & Exits, which takes you through actual winning and losing trades by a number of traders, with commentary by Dr Elder on the lessons to be learned.

Sell & Sell Short, which is his latest book. As its title suggests, this book focuses on an aspect of trading which is little covered in trading books, which suggest ways to buy, but skim over aspects of the all-important selling decision.

These last two books may seem a bit expensive. This is because they are printed on very good paper and all the many charts are in colour. This makes his explanation of the methods so much clearer.

Each book has an accompanying *Study Guide*, which is a paper-back book in its own right and is invaluable as a learning tool.

Dr Elder's books may be purchased from him on www.elder.com. He has recently pointed out to me that some booksellers in Australia are asking 40% more than his prices. I suggest you might like to check this out. See also the earlier notice of Dr Elder's special deal on postage.

Disclaimer: Dr Elder is a friend of mine. I do not earn anything from sales made to my readers. This is not a paid advertisement.

The Sunk Cost Fallacy

Consider this scenario:

You have paid \$200 for a ticket to hear a famous singer perform at the Sydney Opera House. The day comes and it is cold and raining. You feel that you are coming down with influenza and would rather stay home where it is warm and listen to the performance on the radio. There is no way to get a refund for your ticket. Would you go to the concert?

The choice most people make in this scenario is to go. Their rationalisation is that they have paid \$200 for the ticket and they are not going to waste it.

Now consider this famous research study, where two groups were presented with the same decision, but in different ways:

The first group were told that their company had invested \$100 million in development of a new aircraft. It was 90% complete when the company learned that a competitor had developed a much superior plane that was cheaper to make. Would you spend the last 10% of the budget to complete your aeroplane?

The second group were told the same scenario, except that no mention was made of the \$100 million investment so far.

Which group do you think were most likely to vote to finish the project?

This is a very clear illustration where focus on the sunk cost led the first group to wish to complete the project. However, the second group focussed on whether it made sense to spend anything more on a doomed project and decided against it.

The thing we can change in making any decision is the future. What has already been spent cannot be changed and that money is gone. No matter how much we have spent so far, it is irrelevant to what we do now.

In evaluating a losing investment, the only focus should be on which will be likely to yield the best return from here on:

- Sticking with the existing investment, or
- Selling it and investing in another investment which we think will do better

The key thing is that if we, even for one moment, think about the original cost of the existing investment as being a factor in the decision, then we have fallen into the trap of the sunk cost fallacy.

Here are some warning signs that we are falling for the sunk cost fallacy:

- We go through with something because we had already spent money on it, but would now prefer to do something else.
- We finish a meal in a restaurant, even though we were quite replete half way through it.
- We decide to sell our house, but refuse the best offer because it was less than what we originally paid for the house.
- We resist switching to an investment with better prospects because we would have to take a loss.

Now, some strategies to employ to counter the sunk cost fallacy:

- Try to ignore the original purchase price. In evaluating how our portfolio stands, make a list of the current worth of each of our investments and do not list the purchase cost.
- Focus on the future options. In deciding whether to sit with or switch out of a given investment, make a best estimate of the likely return from the existing investment and each available alternative. Decide how we can best maximise future returns and switch if that is indicated.

- It can help to think in terms of switching to something better, rather than taking a loss based on purchase cost. Try to always think and talk in those terms.
- It is OK to make a bad investment judgement (don't use the word "mistake"). It is **not** OK to continue with it when there are better options available.
- Sticking with poor decisions for the sake of consistency is one way that we rationalise the sunk cost fallacy. The great decision makers have shown flexibility when it is the higher virtue in a situation. It is better to be right some of the time than to be consistently wrong.

Where to from Here

Today I have only had the time to introduce you to three of the errors and biases in the way we think which have a particularly strong effect on the quality of our investment decisions.

If we can overcome these three, we will have made enormous progress. However, there is a great deal more that has been discovered in the research conducted by behavioural economists. Each trap which you learn about and try to avoid falling into will increase the quality of your investment decisions.

There are three books which I would encourage you to buy and read. They are all written in an easy to understand style:

Gary Belsky & Thomas Gilovich

Why Smart People Make Big Money Mistakes and How to Correct Them

Stephen P Robbins

Decide and Conquer - Make Winning Decisions and Take Control of your Life

Colin Nicholson

The Psychology of Investing – Raise Your Investing to a New Level (Note: My book has now sold out and we are printing a second edition). I will shortly advise how advance orders may be placed, once I have a firm publication date.

Most of the material in this talk has come from these three books. There is also a major chapter in my book *The Aggressive Investor* on the ways in which the best investors think quite differently to beginners. It may be ordered from www.bwts.com.au for \$49.95 including postage to Australian addresses.

I know most of you have a focus on investing, but these three books hold out the prospect that you will learn how to make better decisions in every aspect of your life.

Here is a strategy to start to improve our investing decisions:

- Read these books and more like them, but don't then just put them down.
- Pick a bias or error trap and go back over it in detail. Try to be aware of how we and others fall into this trap. We should be able to see at least one instance each day for the next month. As we spot each instance, take a moment to think how we or others could have made a better decision with what we now know.

- Then start studying, and watching for, another error or bias.
- Try to devise a framework for making investment decisions which utilises the strategies we have learned out of this approach.

Good luck. May you make lots of great future decisions.

Coppock Indicator

An important part of my investment plan is the market exposure strategy. One key element is when the Coppock indicator gives a signal that we are within a few months of the bottom of a bear market. Keen followers of my methods are watching for this signal at the end of each month.

The charting software I use, *Insight Trader*, calculates and displays the Coppock indicator. However, it is not absolutely necessary to chart it, so long as you can make the calculations at the end of each month. As a way of teaching the calculation of the Coppock indicator, I have a spreadsheet on the Data Files page of my web site www.bwts.com.au. I update the spreadsheet as soon as I can after the end of each month. When a signal occurs, I will mark it on the spreadsheet. However, you can easily update the spreadsheet yourself.

The signal occurs when the Coppock Indicator falls into negative territory and turns up again. Currently, all of the markets I track have negative Coppock indicator readings, as would be expected in a bear market. This is the Australian situation at end September:



I also publish a file of the Coppock indicator charts for these markets each month in the members' area of the web site. Again, I will indicate that a signal has occurred in that file.

I am asked constantly whether the Coppock indicator may be used for sector indexes and for individual stocks. The answer is two-fold:

1. Maybe it can, but I have not seen the research that would be necessary to validate such a use. The Coppock was optimised for the Dow Jones Industrial Average. I have also seen that it works over long periods in the US S&P500, NASDAQ Composite, Australian All Ordinaries, UK FTSE100 and Japanese NIKKEI225. I also supply a chart for the Shanghai All Ordinaries, but there is insufficient data on which to validate its use in that thin and underdeveloped market. Before using it on individual stocks, I would personally want to have done a great deal of testing.

2. Even if the testing comes out alright, the bigger question is whether it is the best tool available. There is a whole toolbox of indicators that have been tried and tested on individual stocks. My inclination would be to use them. The Coppock is not a magic indicator. It is simply a long term momentum oscillator that has been optimised for the Dow Jones Industrial Average and similar broad market indexes.

My Portfolio Disclosure

Because I comment on stocks from time to time in the media, I am required by law to disclose my stock holdings. I do this through the Portfolio Disclosure page on my web site www.bwts.com.au. I endeavour to post changes in my portfolio as soon as an order is completed. There is a link to this page on the bottom of every page on the web site.

Currently, I am 100% in cash, as is required by my investment plan in a bear market. There is a complete discussion of my investment plan in my book *The Aggressive Investor*.

Thank You

My thanks to the many readers who made suggestions for future improvements to the newsletter. Some of these suggestions may take some time to implement, so please bear with me.

Two immediate improvements are the addition of page numbers and a reduction in the margins to reduce the number of pages for those who wish to print the newsletter. I discourage printing in order to save a few more trees. Every little bit helps. It takes us old dogs a while to learn new tricks, but a conscious effort results in increasing comfort in reading from a screen rather than a page.

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.

My email newsletter list contains only your name and email address, which information is not used for any other purpose than to send out email newsletters.

Past issues of the email newsletter are available for downloading from my web site www.bwts.com.au. Newsletters will generally be posted to the web site when the following issue is sent out, about a month later, so my email list is the fastest way to get to see them. Join the list by going to the Newsletters page on www.bwts.com.au and clicking on the relevant link.

The newsletter is intended to be a forum for discussion of interesting ideas about technical analysis, trading and investment. It is primarily educational in nature. I have taken reasonable care in its preparation. Nevertheless, everything in it should be read as my opinion, unless otherwise stated, and requires the reader to check the accuracy of facts and test the validity of my opinions before acting upon them. My opinions are not intended to be recommendations to trade or invest in any stock or financial security. Nor are they intended to be recommendations to use any particular trading or investment method. Readers who do not have the ability to assess the relevance to them of any matter discussed in the newsletter should consult a competent and licensed adviser before acting upon them. I am not a licensed adviser.