

# Colin Nicholson: Newsletter 83

8 November 2008

## A Very Common Question

The question which I am asked most often is what will the market do tomorrow...next week...next month...next year?

My answer to this question may seem abrupt at first. My answer is that I have no idea. I answer it this way very deliberately. Those readers who have read my book *The Aggressive Investor* should not be surprised at this answer. This is because all my 40 years of experience, plus all the research I have read about over the years, points strongly to prediction being an almost impossible art.

By prediction, I mean what the price will be at some point in the future, or what direction and how far do I think the market or a particular stock will move in that time.

Therefore, my conscious philosophy is not to even try to practise the dark arts of forecasting. For one thing it opens the forecaster up to all kinds of psychological hazards. Confirmation bias is probably the most potent.

What I do instead is two-fold:

1. I know where my entries will be triggered and where my sell stops will be triggered on every stock I am interested in or own. I simply react without hesitation to these signals if they are triggered.
2. I constantly assess which of the three phases of a bull market or a bear market we are in and implement my market exposure strategy accordingly.

Right now I see us being in the second phase of a bear market (decreasing earnings). I am therefore 100% in cash. When will that change? See the major article later in this newsletter.

My complete investment plan is set out in my book *The Aggressive Investor*.

## Please Help

Every time I send out an email that a newsletter is ready to read, over 100 of the emails bounce. An unknown number go into spam or junk mail folders. After an email address bounces three times I remove it from the list. You can help me continue to get these email notifications through to you in the following ways:

- Put [colin@bwts.com.au](mailto:colin@bwts.com.au) on the safe senders list in you junk mail and spam filters.
- Update the list when you change your email address. To do this go to [www.bwts.com.au](http://www.bwts.com.au) and on the home page, click on Newsletters. Scroll down to the link to the page where you can update your details. If you no longer wish to receive newsletters, there is also an unsubscribe link accessed in the same way or by clicking unsubscribe at the foot of every email advising you that newsletters are ready to read.

- If you are away any time and your mailbox is likely to fill, bouncing further emails, a good solution is to set your ISP's software to divert all emails directly to Gmail and not hold them in your mailbox while you are away. I do this myself and it works well. If you want to save any of the emails when you return, simply go into Gmail and send them to your email address (after undoing the diversion, of course). The added advantage of this is that you can see your emails anywhere in the world from an internet cafe or netbook if you are travelling. Gmail is free and the mailbox size seems to have no limit.

## Learn From Dr Elder

Dr Alexander Elder is a friend of mine. I have learned a great deal from him over two decades and had the pleasure of working with him at several camps. I regard him as one of the best teachers of short term trading in the world.

If you wish to learn from him there are two ways to do so:

Travel to one of his superb traders camps. The next one is in the Caribbean in January. He has a special deal going in November, which is detailed below.

Buy his books *Trading for a Living*, *Come into my Trading Room*, *Entries & Exits* and his latest book *Sell & Sell Short*. I don't sell them, but he does off his web site [www.elder.com](http://www.elder.com). Tell him in your order that I sent you and he will dispatch the books at a very cheap postage rate of \$US 6.00 for each book plus its Study Guide.

Email from Inna Feldman in Dr Elder's office:

*This bear market is now more than a year old, and it has just experienced its worst collapse in a century, while the new (US) administration is preparing to institute serious changes in the economy. Now is the best time to study - in order to be able to recognize the inevitable future bottoms in many stocks and prepare to trade their future uptrends.*

*Our Traders' Camp January 17-24 is attracting a small group of serious traders. There will be a lot of new information, in addition to the usual review of the current markets. Dr. Elder is preparing a new presentation which will include for the first time the psychological test for traders. It will help you recognize what types of trading should work especially well for you and which are better to avoid. David Weis will present new materials he has collected for the book he is writing, to be published in 2009.*

*The camp is filling fast, so please act quickly - email ([info@elder.com](mailto:info@elder.com)) or call me at +1.718.597.1033 (New York business hours).*

*Special Opportunity for my readers: When you phone, tell Inna that I sent you and ask about a free extra day – arrive a day early as a guest of Dr Elder. Also a hint - ask Inna if there are any special requests available.*

*I look forward to answering your questions and registering you for the January Camp in the Caribbean.*

*Inna Feldman (Manager)*

The above is not a paid advertisement and I personally receive no financial or other payment for it or from the sale of the books and camp. It is simply provided for your information as a service.

# Stock Market Investment Strategy for the Year Ahead

Colin Nicholson's

**Share Investment Strategy  
for the Year Ahead**

**Melbourne Investment Expo**  
Friday 10 October 2008 11.50am  
Saturday 11 October 2008 2.15pm  
Sunday 12 October 2008 12.45pm

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Over the past few months, I have been speaking around the country on the general subject of how to survive the bear market and to prepare for the next bull market, whenever it begins. The following is a summary of the latest of these presentations.

I begin by showing some history in the form of a chart of the Australian Securities Exchange All Ordinaries price index for the last 108 years:



I begin in this way for two reasons.

Firstly, many beginners do not know that there have been bear markets throughout that period and should be expected once any boom period moves into the rampant speculation phase of a bull market.

Secondly, I want to highlight that for a passive investor who is holding investment grade stocks in sound companies, the market always tends to rise higher in the ensuing bear market. So, the sky is not falling. This is normal. The key thing for passive investors to do is to hold their nerve and follow their investment plan. The strategy for active investors is different. I will come to that later.

Next, I show a chart of the ASX All Ordinaries price index, displaying what has happened in the last bull market and the bear market to date:

The key observation here is that the bear market has not so far gobbled up all of the gains which were enjoyed during the bull market. It is always possible that could happen, but our worst bear market (1973-74, NOT 1929-32) only saw a 50% decline. This time could be worse, but it has not happened yet.



I then reinforce this with some data in numerical form:

**The Bull Market and Since**

Financial Year	All Ordinaries Accumulation Index Return
2003-04	+22.37%
2004-05	+24.75%
2005-06	+24.20%
2006-07	+30.28%
2007-08	-12.12%
2008-09 so far	-16.83%

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This table shows the percentage changes in the ASX All Ordinaries **Accumulation** Index. This index is different to the price index in that it is calculated assuming dividends are reinvested. This approximates the experience of passive investors who have a broadly diversified portfolio of investment grade stocks. The table shows just how good the 2003-07 bull market was in Australia. We had not seen anything like it since the 1980s.

Much more importantly, the table shows that, so far, the bear market has not taken all that gain away from us. This table was calculated for the current year a few days before I spoke. Later in October, the market has fallen further.

I also show this data another way:

**The Bull Market and Since  
Growth of \$100,000 invested 1 July 2003**

Financial Year	All Ordinaries Accumulation Index
2003-04	<b>\$122,370</b>
2004-05	<b>\$152,657</b>
2005-06	<b>\$189,599</b>
2006-07	<b>\$247,010</b>
2007-08	<b>\$217,073</b>
2008-09 so far	<b>\$180,540</b>

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In this table I have assumed the notional investment of \$100,000 on July 1 2003. This replicates the before tax performance of a passive investor with a portfolio whose performance has tracked the market index. It shows that the \$100,000 would have increased to around \$247,000 by June 2006 and is still around \$180,000. That is not to be sneezed at for five and a quarter years. Moreover a passive investor will not have paid too much tax on the dividends, courtesy of the Australian system of allowing a tax offset for imputed credits (company tax already paid on the dividend amount).

I also show the above similar calculation from July 2000 (near the top of the tech boom bull market). This time I show a different comparison. I show what would have happened to \$100,000 if I had invested it in my active investment style and obtained the percentage increases and decreases that have been achieved on my own portfolio. Against that I show that market index outcome. The latest period is slightly different on this slide, being calculated at the end of September.

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

Year	Colin	Market
2000/01	109,690	108,845
2001/02	112,004	103,946
2002/03	135,089	102,818
2003/04	158,702	125,819
2004/05	201,361	156,955
2005/06	269,059	194,932
2006/07	390,808	253,961
2007/08	370,838	223,181
2008/09*	377,439	185,620

\*After three months

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The purpose in showing this slide is to again emphasise that the market has not taken away the previous gains, although the return over this period has not been as good as from 2003. The other reason is to introduce the rest of my talk which will focus on my active investment methods.

My method is that of a market timer. This is fully outlined in my book *The Aggressive Investor*. Using a chart of the ASX All Ordinaries index, I show what I am attempting to do:



This first chart shows the period over which I try to progressively enter the market. This is not right at the bottom. I believe that cannot be done except by sheer luck and with immense nerve.

The period often works out to be at least twelve months. I aim to begin buying in the last stages of the third phase of the bear market and complete the entry in the initial stages of the first phase of the bull market.

Then we use the same chart to add the period over which I plan to progressively exit the market:



Again, I am getting out of the market over about twelve months in the third phase of the bull market and completing my exit in the first phase of the bear market which always follows it. I do not believe it is possible to sell out right at the top except by sheer luck. Trying to do so is very difficult and very dangerous. If we wait until we think we have seen the top and then try to get out, we can be very badly hurt in a big shakeout such as we had in January 2008, and horror of horrors, 1987. My strategy of progressive disengagement once things get wild is the main reason I have survived those terrible episodes in the market.

I also lived through the dark days of 1974, when the market fell relentlessly for months, which we have just seen replayed this time around. Yes, the exact details that led up to it are different, but the result tends to be a replay. If we do not study or remember history, the market educates us in a very expensive way.

I then show where beginners buy in the next chart:



They buy in the third phase of a bull market. This is the phase called rampant speculation. Not only do they buy at the wrong time, they tend to buy many of the wrong stocks. They buy speculative stocks. These are stocks which do not make a profit and do not pay a dividend. They also bought stocks last time which were geared to the gills with debt. Some borrowed more money each year to be able to pay distributions. Some are already in the graveyard of history, helping to enrich the liquidators. Others are fighting a valiant rear guard action, prolonging

stockholders' agony.

Over the next year or two you may see many of the star players before the judiciary.

The really sad part is where the beginners sell as shown on the next chart.

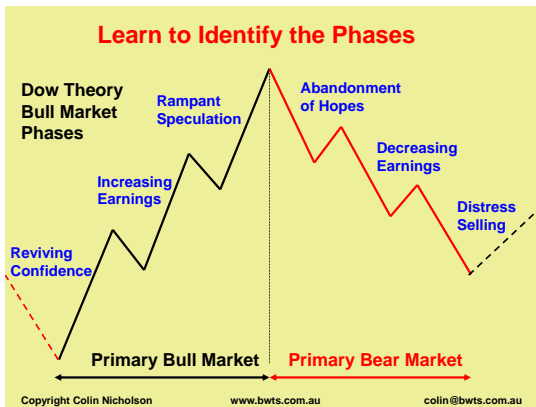


Yes, that is correct. They sell on the way down. Many may not want to realise their losses, but are forced to in the face of unemployment, falling incomes and huge debts from the good times.

This is where I tuck my tongue into my cheek and introduce the seminar indicator. Last year we were in the rampant speculation phase and the rooms I spoke in were packed to the rafters with wildly speculating beginners. This year we were in the

second phase of the bear market and the room was still reasonably full, but the numbers were down. I then explain one way to know when we get to the third phase of the bear market. At that time my seminar room will be only half full. Then, the beginners will have been massacred or have capitulated and are no longer interested in the stock market.

At that point, I move into showing how I actively time the market. I start by stressing that stock markets are cyclical. All booms lead inevitably to a bust. The severity of the bust is usually proportional to the excesses of the boom period. I exhort my listeners to learn the phases of bull and bear markets, something which has been known for over a century when Dow Theory was first developed. This next slide shows a diagrammatic representation of the cycles and phases:



Every bull market unfolds in three phases. The first is reviving confidence. The second is increasing earnings. The third is rampant speculation.

Every bear market unfolds in three phases. The first is abandonment of hopes. The second is decreasing earnings. The third is distress selling.

For a full description of what to look for in each phase, see my book *The Aggressive Investor*.

Next, I show where I judge that we are now in the bear market, shown diagrammatically below.



The reporting season which finished on August 31 saw many companies announcing reduced profits, some write downs and some losses. It was also clearly evident that chairmen and chief executives of companies were generally reluctant to forecast earnings for the current year. What is this telling us I wonder?



As the last two slides show, my analysis points strongly to us having moved into and living through the second phase of the bear market, known as decreasing earnings. We still have the remainder of that phase to pass through and then we will come the final phase, known as distress selling. Because debt was so abused throughout western economies in the boom years, I suspect that it may take some time to cleanse the system and forge a new beginning. It is unlikely to happen overnight. There are many ways in which this may play out.

There are a number of tools which may be used to indicate when we are well into the final phase of the bear market. That is when my plan calls for me to start building positions in upward trending stocks. Note that this could be many months before the ultimate bottom, which the chartists will be looking for. I have a number of tools I use for my strategy, including the charts. However, the first signal is usually from Dow Theory phase analysis. We need to know when we are in that phase. At this point I take the audience though what we need to have drop into place to know that the time is right to begin investing again.

The key indicators are in this next slide. All this information is available in the media, so long as we pay attention. Read the business newspapers, the business sections or programs of the mass media and business magazines. Do not read the froth and bubble of items just telling you what happened today or yesterday. Reading this is likely to cause you to lose perspective. Read for hard facts and expert commentary. I like to emphasise the need to read the longer in-depth articles, which few people read. Everything you need is there.

## Wait for Bear Market Phase 3

### 3. Distress Selling

Significant fundamental under valuation

Unemployment

Bad news is discounted

Low public participation

Media coverage declines

Bankruptcies and failures.

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In particular, I think we need to see real unemployment in Australia (the US is ahead of us on this one). I take no pleasure in seeing it, but as a rational investor, I know it will come. The other key indicator is bankruptcies, especially in smaller businesses and individuals who are carrying too much debt.

### My Strategy for the Year Ahead

Sell any speculative stocks still held

Sell any downward trending stocks

Diversify the portfolio

Focus on stocks with a margin of safety

Low PE ratio

High dividend yield

Low debt to equity ratio

Only buy stocks trending up...

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I then introduce the slide at the left and discuss the key points of my suggested strategy for the bear market.

If you are an intelligent and experienced passive investor with your portfolio in investment grade stocks and widely diversified, there is nothing to do. The passive approach calls for inactivity, other than perhaps to buy more of some stocks on days when we think there is panic selling. However, it may still be a bit early for that yet. Many good stocks may yet get a lot cheaper.

Diversified does not mean six to eight banks in a portfolio, unless it has 50 to 60 stocks in it. Likewise resources stocks. The cycle has turned down and this sector will shrink significantly before it grows again. The ones you hold should be big companies with several major mines and low production costs that will keep them paying dividends through the downswing.

Of course, many investors were not too smart in what they bought. They may have bought highly geared or speculative stocks (defined earlier). These often fall 90% or more (they go bust) in a bear market. Many will not pull out of their death spiral down towards the bottom

right corner of the chart. I suggest taking the medicine sooner rather than later and holding the proceeds in cash for the next bull market. In Australia, you can carry forward capital losses to future taxation periods. Meanwhile interest on the remaining capital is better than death by a thousand cuts.

The above slide sets out the three key ratios to look at if and when readers are thinking of buying again. If you have those in place, and the chart is trending upward, the odds are good you will do much better next time around. The PE ratio and dividend yield strategies are defined at length in my book *The Aggressive Investor*. The next edition will include the debt to equity ratio as well, but the key guideline is that the ratio be low. These three ratios are readily available in the media and on the internet. You do not need to be a security analyst to find and use them.

I said above that not only must those ratios be in place, but the stock should be trending up.

That means the flow of prices on the chart must be heading for the top right corner of the chart, like the one at the right.



The stocks which you should NEVER EVER buy will have charts like the one at the left.

These are the stocks whose flow of prices is sinking to the lower right corner of the chart.

This next slide does not need a lot of discussion. It is aimed at reinforcing the general philosophy I espouse for the active investing approach. We cannot make the market give us money. Instead we have to find the right conditions. This applies in any timeframe to investing and to speculation. Then we must buy the right stocks.

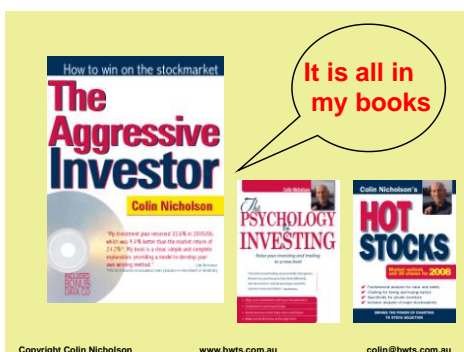
### Two Critical Traits of Good Investors

#### Patience

Wait for the last phase of the bear market

#### Discipline

Have clear criteria for which stocks to buy.



To learn more about my methods and how to make better investing decisions, my books may be purchased from [www.bwts.com.au](http://www.bwts.com.au)

I hope you enjoyed this brief discussion from my latest presentation.

## New Highs and New Lows

The web site address which was given in the last Newsletter was incorrect. I removed it from the file on the web site while the matter was clarified, so many readers may never have seen it. This incidentally is one advantage of the way I am now distributing the newsletter – corrections are possible.

The web site concerned is [www.equitiesinfo.com.au](http://www.equitiesinfo.com.au). It will be of interest to those readers looking for an up-to-date list of ASX stocks making new 52-week highs or new 52-week lows each day. It is updated during trading days, so is close to live.

## Where to Find the Coppock Indicator

I am fielding an increasing number of questions about the Coppock Indicator. It is likely to be the next signal we get after we have identified that the third phase of the bear market has begun.

### Important Caveat

It can sometimes give very premature signals. In that case there will not be many upward trending stocks. For further explanation and discussion see my book *The Aggressive Investor*.

On the Data Files page of my free web site: <http://www.bwts.com.au/text.cfm?15>, there are spreadsheets which may be downloaded with the Coppock indicator data calculated for major Australian, US, UK and Japanese indexes. The Coppock indicator is calculated on the monthly close and I update the spreadsheets shortly after the end of every month. It is possible to read the signals from the last column on the spreadsheets. I will mark them when they happen.

There are also charts of the Coppock indicator posted on my Members Only web site shortly after the end of every month. Again I will comment on signals when they occur. The Members Only web site costs \$44 to join and \$55 per year. It contains all my copyright work except my books and what is on the free section of the web site. For more information and some samples of the content, go to the home page of [www.bwts.com.au](http://www.bwts.com.au).

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