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Building wealth through shares

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EMAIL NEWSLETTER No 9

Stop-Loss Orders Through Internet Stock Brokers

I am frequently asked whether I know of Internet brokers (stocks only) who accept stop-loss orders. Getting accurate information is difficult. If you are using an Internet broker who accepts stop-loss orders, it would be appreciated if you would email me who the broker is. I will then publish a list of them in the next newsletter. If possible, would you specify what type of stop-loss order they accept - in particular do they accept a market order (sell at market if hit)? If not, what type of stop-loss order is allowed?

Tendency to Fall Back on Fundamentals

A very common problem with market participants using technical analysis is to do the technical analysis work and then look for a rationale for the conclusion in fundamentals. Even some experienced technical analysts will tend to fall back on fundamentals when asked to explain their view of a market situation. This is because we all like to know why something will happen. It is natural to explain things in terms of causes. This flows from the dominance of the scientific method in modern society.

However, the problem is not the method, but its application. The technical approach assumes that prices are driven by both information and by the psychology of market participants. The reasons should be sought within the technical approach in terms of what the chart or indicator is telling us about how buyers and sellers are reacting to what is happening to them in the market. Instead, there is a tendency to fall back on the fundamentals, forgetting the unique insight that technical analysis gives into what is driving price action. The answer to this problem is to focus on behaviour of market participants and their reactions rather than the things that drive intrinsic value.

There is another way of explaining this problem: Because prices discount expectations and information that is not generally known or fully appreciated, it follows that technical analysis frequently indicates action in the absence of fundamental information to support it. The best market opportunities require us to act opposite to the 'crowd' or general view. This requires enormous discipline and faith in the technical approach. For most people, it is simply too uncomfortable to go against prevailing opinion.

There is no easy way around this problem. The only solution lies in internalising the basic conceptual difference between the technical approach and the fundamental approach. When using the technical approach, forget about the relationship of price to value and concentrate on market participant behaviour. When it is difficult to understand the action in the market, do not look for the answer in the fundamentals. Try instead to understand what is driving buyers and sellers and why they are reacting the way they do. If we can get to this level, we are well on the way to being able to anticipate their reactions. Once we can do that we can take advantage of the situation most effectively.

Planning for Profit (By Garnett Znidaric)

The theatre was quiet, the lights had dimmed. The audience sat in anticipation as the speaker's name was announced and he took up his position on the stage. He opened up his notes. Above him a PowerPoint slide is being projected onto the screen exclaiming, "Trader, know thyself!"

He stepped forward to the front of the stage and peered into the audience as he asked a question. "How many people here today have money in the markets?" More than half of the hands proudly went up.

"How many of you with your hands up have a written trading plan?" In the room of over 300 about 10 hands remained up. The room was silent as a few heads twisted to see who still had their hands up.

After pausing he spoke, starting softly, rising slowly in volume. "One last question, how many of those that have money in the markets but didn't have their hand up have heard that it is unwise to trade or invest without a plan?" Most of the missing hands made a sheepish appearance as though their owners realised that they are about to be chastised.

"Maybe I should ask all these people to leave?" The speaker challenged as he strode the stage. "Obviously they are too wealthy or foolish to benefit from what I am going to say today." He paused and moved to the other side of the stage and looked out at the sea of faces. "How on earth can you expect to know what is going on, or if you are making a reasonable profit, if you don't have a plan? Sure you may have an entry strategy, but if you don't have any means for managing your money or strategies for when things don't go as planned, what are you going to do.....? Probably lose some or all of your money!"

"Only a few days ago I was introduced to a professional person who had decided that Internet stocks were the way to pay for their children's university fees. So they sank all their savings into the high tech sector. In a matter of weeks they had turned their \$30,000 into \$180,000. A 600% return. By the time I met this person they had given back \$225,000. Once again, this trader had no plan other than an entry idea."

"Last year I had a broker suggest that a client should talk to me about creating a trading plan encompassing broad money management rules. Why? Because the broker had just found out that this client had sold one of the family vehicles to generate trading capital. Without the vehicle they had to use public transport, but they could trade. And it wasn't just equities, it was futures they were trading."

"This couple had opened up a standard minimum account with \$10,000, which was all their savings. Shortly before they were recommended to me their account was up 50% on their trading account. And then a few trades didn't go as well as planned, and I use the term loosely. They lost their profits and were back to where they had started. After talking to me they decided to close their account. I would say they had a lucky escape."

The speaker turned to a different part of the audience. "The other day a friend came to visit who is rather financially ignorant but asked whether a friend of theirs had any chance of making a living out of the stock market. I suggested that while the odds are against it, it is possible and many people make a good living out of trading and investing. The biggest challenge is that most people are under capitalised. And I asked my guest how much these people had put into their trading account. \$20,000 was the answer. Shaking my head I suggested that they would have to average around 500% return a year for them to make a basic living after tax. And that is without touching or topping up the capital."

The speaker took a deep breath. "As a thumbnail sketch for your plan, consider broadly your asset allocation or where you are going to park your various piles of money and why. Then develop a set of rules for each classification that defines what you are going to risk, when and why you are going to buy, and most importantly, when you will sell. Then look at how and when you are going to balance the allocations as the profits and losses occur."

"Also as part of your plan, consider a number of what if situations as the potential for something to go wrong in trading is quite high. Preparation is the best form of insurance."

"Trading is all about discipline and following your rules."

"One of the most ignored realities or secrets of trading and investing is to have a plan and stick to it. In short, you should have a plan and with that plan you can then practice the most secret law of trading. Plan your trade and trade your plan."

As the applause died away and the people left, some were heard to suggest that with a small account they didn't really need a plan. While others walked out realising that they had just learnt the most important lesson of their trading life.

The speaker smiled as he heard the comments, for he acknowledged that there always has to be someone to take the losing side of the trade.

Garnett Znidaric's workshop is designed for investors and traders with less than five years experience, although experienced traders have also found great benefit from attending. Over the two days you will explore more than 80 specific elements to assist you in developing a sound foundation on which to build trading strategies for various markets. Within this we will explore asset allocation, market and personal psychology, four levels of money management and multiple approaches to risk. We will also help you start a business plan including income and education goals for the next five years.

More information and additional articles are available on the Trading Plan Review Web Site <http://www.tradingplan.com.au>

Probability vs Certainty

From early in our schooling we tend to learn things in terms of 'black and white' rules. Even economics makes heroic assumptions about the real world so that we can arrive at seemingly clear conclusions about a situation.

Technical analysis does not pretend that there are any 'black and white' rules. It recognises that there is no certainty, only probabilities. All technical analysis claims is that there is a stronger possibility of one outcome than the alternatives.

Most of us spend our lives trying to control the world around us by distilling a set of rules. Many of us will be tempted to take technical analysis to the point where we find a simple rule that will direct our trades. This is fine for the trader. The trader only needs to be right about half of the time. His money management will ensure that he cuts losses and lets profits run. Over a series of trades, he only needs a few big winners, allowing all the small losses to be covered by all the small profits on trades that went nowhere. The trader understands the probability game.

However, analysts seek to be "right" about their view in each situation. When they make recommendations or give advice, it is in specific situations one by one. They can not easily just "average out" their recommendations.

The reason there are no certainties is because the real world is too complex and our understanding will always be insufficient. This is the real reason economists fail all the time when trying to forecast. Their unthinking critics condemn them as incompetent. Those who appreciate the nature of the problem recognise that it is impossible to consistently forecast future events.

The way to approach this problem is to internalise that it is not possible to forecast. However, it is possible to interpret what is happening in the market and develop an understanding of how market participants react. With much hard work and thought, it is possible to develop a feel for anticipating the reactions of market participants and to formulate plans to take advantage of the situation. However, we will never get closer than "what is most likely" as opposed to what "will" happen.

So, what technical analysis demands is that we never stop thinking. Most people are not prepared to do this and go from one theory of investment to another, trying to find the 'silver bullet' that will shoot the market. They never find it, because they do not appreciate that the nature of the problem does not lend itself to certainty.

Response to Email Newsletter No 8

I received the following response from Bernard O'Connor:

Colin

I'm bit of a rare breed in that I'm a broker who has successfully been using and teaching T.A for years and aims to make the client self sufficient from me. Instead I work on creating ideas which I send out in the form of an email and if it appeals to the client they then ring me. I'm used then as more a second opinion and fine tune the risk reward scenario and stops to suit their risk profile.

I couldn't agree more with your comment on hard work and commitment from the trader. Like the majority of people they want to transfer the responsibility factor to someone else (the broker) and will eventually find one who will do this. Very few come to the realisation that they are responsible for their actions + need to put in to get out. I get disappointed when I see clients doing well by working hard at it whilst others have an ad hoc approach then blame stops for their failures. They in turn blame T.A for their own lack of a basic trading plan and effort.

I acknowledge the problem of loneliness for your trader particularly if he is trying to avoid generally unsuccessful day trading methods. Suggest he read the market wizard books where there is good coverage on the importance of waiting.

I would add that there is another key element to trading and investing apart from being able to master fear and greed and that is patience. I'm sure that this is made easier by looking at the market after it is closed and placing stop entry orders and losses before it reopens. This then enables the investor to have a normal life at home and not get lonely or emotional as they look at live data.

"How I made \$2,000,000 trading the stock market" by Nicholas Darvas is a classic and goes over this issue superbly. The book is expected to be back on the bookshelves soon after being out of print.

Of course if the pool of funds isn't big enough then this will cause overtrading and emotional problems.

I believe that peer support is important when starting out, but it has to evolve to the degree where the client ends up just using it to bounce ideas, maths etc. I find that the good clients and I always agree when a second opinion is needed anyhow and I become a filter. If we are always disagreeing then something is not right and needs to be looked at. I find my role important in building up confidence to do the right thing ie stops, not overweighting, and generally making those hard decisions.

All the Best Bernard O'Connor 03 8643 9450 bernard.oconnor@ssmb.com.au

PS. I would like you to mention that I get all clients to read the Stan Weinstein book 'Secrets of profiting in bull and bear markets' before I am prepared to send out the nightly emails. This means that most of what I say makes sense and I don't have to spend my day explaining basic concepts. It also gives a great basis to start developing a trading plan and methodology and acts as an automatic filter for those people who are not prepared to work.

I could not agree more with these comments from Bernard. Especially the value of Darvas' book, which is a classic and even more so the value of Stan Weinstein's book. I am often asked to recommend a broker who understands technical analysis. I have no direct experience with Bernard, but if he sounds as though he may be the sort of broker you are looking for, give him a call and have a chat about how he might work with you. Try to call out of market hours for the initial contact.

Reader Comment About the Loneliness of Trading

I received the following additional comments on this subject, with which I wholly concur:

In your last newsletter, you commented that if you need peer support or a social situation in which to work, trading is not for you. However I think there is a middle course. My comments relate to the end-of-day trader, as I have minimal experience with day trading.

One of the problems for the full time trader is that it can be a lonely occupation. One does not have the interaction or repartee or social activities that occur in a work environment. Another problem is that, for an end-of-day trader, trading is not a full time occupation.

One way of overcoming feelings of isolation, is to look for other activities associated with trading. For example, belonging to the ATAA, joining a software support group eg the IT monthly meetings, attending seminars on trading. There are also the PC Users Stocks and Shares group, and various interest groups for software users eg The Northern IT group (NITS). There are probably others. If there is no support group for ones software, a useful activity would be to start one. In these activities it is possible to meet others and discuss technical analysis, trading etc, or meet people with similar interests so that one has someone to phone to discuss a problem or new development or exchange e-mails. I have found these activities ameliorate those occasional feelings of isolation.

You commented in Newsletter 7 that after the hard work of finding ones feet in trading, it may become a 2 to 4 hour per day activity plus study. My own experience is that it is not an 8 hour per day activity, or should not be if one has adequate systems in place. The problem for the full time (end-of-day) trader, is that there remains the rest of the day to fill. I suspect that this can lead to over optimising systems or over trading or both, to fill the time. I suspect also that one reason for the alleged proliferation of day traders is that day trading is an activity that fills the whole day.

So the end-of-day trader needs to have some other interest in addition to trading. This in itself may solve the problem of loneliness.

I would point to yourself, Colin, as a prime example of combining trading with associated activities and creating interaction with others and successfully filling your whole day. The actual activity of trading involves only ones self, (which I think is one of its main attractions), but it doesn't have to be a lonely existence.

On this same track of having a life other than trading, I recently read John Train's "New Money Masters". Everyone should read his short chapter titled "Envoi: Midas" in which he sets out the case that money is not everything in life. His last paragraph is:

The rational approach is to trust in a sufficiency of wealth as a by-product of useful life. Happy are those who find fulfilment in their families, their work, and their civic duties, and hope for the best."