Colin Nicholson: Newsletter 84

14 January 2009

Firstly, I offer my apology for the long delay between newsletters. For the last three months, I have been almost totally focused on updating my book *The Aggressive Investor*. The new book will have a different title and be published in May 2009. Closer to that time, I will advise what has been changed in the book and its new title. Please don't ask me for details in the meanwhile.

The Coppock Indicator

Over the last few months I have begun to think that I have created a monster. One of the tools which I use in my market exposure strategy is the Coppock indicator. Since mid last year, I have had more questions about it that anything else. Why I say that I fear that I have created a monster is that it seems many people are totally focused on it. I think this is taking one tool as being a standalone method.

I use the Coppock indicator because it is a very useful long term momentum oscillator. It was designed by Edwin Coppock to provide a signal for when we are close to the bottom of a bear market. It calls for accumulation of upward trending stocks for long term appreciation.

The really important thing to understand here is that this tool has three caveats:

1. It is usually late, in the sense that it gives a signal after the bottom of the market is in place for a few months.
2. It does give premature signals. This tends to happen in rallies that go on to a re-test of the bear market low some months later. This is not a problem providing we only buy upward trending stocks and that we are rigorous in executing sell stops if the trend fails.
3. The signals from the Coppock indicator are really just a wake-up call. In my strategy, the first action signal is given when the third phase of the bear market begins. This phase is called *distress selling*. The Coppock signal is generally after that action signal. If readers wait just for the Coppock signal and ignore Dow Theory phase analysis, they will be missing a more important signal. I will discuss this earlier action signal in a later section of this newsletter.

To wind this discussion up, let's examine the Coppock indicator for the Australian stock market. As readers will know, the Coppock indicator is calculated on the monthly closing price for the ASX All Ordinaries index. The last plot was at the end of December 2008. At that time the chart showed the picture on the next page.

Can you help?

One of my readers is looking for historical daily data for new 52-week highs and lows for the ASX. For preference, it should be in *Insight Trader* format. If you could assist, please email me the relevant files at colin@bwts.com.au and I will pass them on to the reader. Many thanks.

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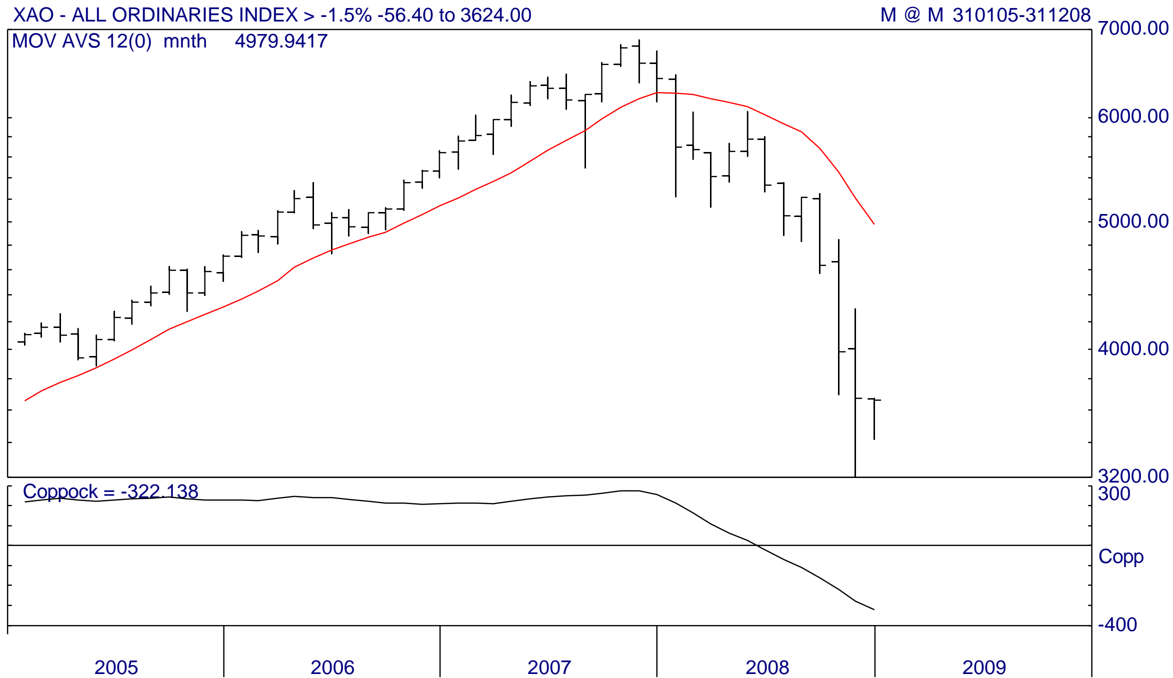

Clearly, the Coppock indicator is still in a steady downtrend. What is interesting is how the plunging Coppock indicator line has opened up the negative scale from -100, to -200, to -300 and now to -400. It has now become one of the deepest readings that we have seen for a long time. Without being too pessimistic, it is worth pointing out two things:

1. There is no limit to how far the Coppock indicator line can fall.
2. The deeper in negative territory that the signal comes, the better the signal. **Except** that, in the past, there have been premature signals that were quite deep.

My own inclination in this situation is in fact to expect a premature signal if we get a strong rally. My reason for saying this is that there are precious few stocks which are building much in the way of accumulation or consolidation patterns so far. There are even fewer stocks which could be described as trending upward.

My take on this is to be suspicious of an early Coppock indicator signal unless we can see that some stocks have formed platforms for a new upward trend or are starting to trend upwards.

For readers who are curious as to what kind of rally would be needed to trigger a Coppock indicator signal, please download the spreadsheet from the Resources page of www.bwts.com.au and play at inserting guesses of the next month's index value which would generate a signal.

The Coppock Spreadsheets file on the website also shows calculations for the three main US indexes and also the UK and Japanese stock markets.

On the Members Only section of the website (requires a paid membership), I upload at the end of each month charts for those markets and also the Shanghai market.

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Book Review

Dr Alexander Elder *Sell & Sell Short*

Over the years, I have noticed that when I speak about what stocks to buy and when to buy them, I invariably attract a full house. However, when I speak on how to sell stocks, the audience is substantially smaller. This is an important observation, because it says a great deal about where the audience is currently on the learning curve to becoming a good trader.

At least half of the audience at the presentation on buying are still at the start of the journey of learning the craft. These would be traders are still at the point where they mistakenly think all they need is to find the right stock to buy and profits will fall into their lap. Very unfortunately, many of them may not reach the level of mastery of the art of trading.

On the other hand, the people who come to the presentation on selling have reached the point where they understand that the selling decision is critical to the process of making successful forays into the market. It is for these operators, and those of the first audience who will listen, that Dr Alexander Elder has written his latest book *Sell & Sell Short* (Wiley 2008).

I have just had a short period of convalescence after some minor surgery. I thought that it was a good time to catch up on some reading. The first book on my pile of books to read was Dr Elder's new book. Right from the start, I could not put it down. Also the further I got into it, the more fascinating it became.

It has been written in three parts:

Part One

Dr Elder first brings the reader up to speed on how to buy, manage risk and keep records. While the buying method summary and the risk management to a large extent summarise and refer to his previous works (*Trading for a Living, Come into my Trading Room* and *Entries & Exits*), the discussion about keeping records provides important new insights. Indeed Dr Elder makes the strong claim, which I would echo from my own experience, that the best traders will be those who keep good records. The reverse also applies. Poor traders tend to have no records. This is because investing is not simply a matter of acting in the market and making money. It is a voyage from ignorance to mastery. They key to this voyage is that you know where you want to go, how you intend to go there and learn from every attempt, so improving your skills.

Part Two

Here Dr Elder takes us deep into the question of how to sell. He has divided this part of the book into three chapters, dealing with each of the three types of selling.

The first chapter deals with selling at a target. He shows how he does this with a moving average, envelopes or channels, and resistance levels. Dr Elder does a marvellous job here, explaining the logic of his trading plan and how the various selling points derive from that logic. This is no academic exercise. Here, and throughout the book, he shows actual trades, often showing what he learned from the ones that went well and the ones which did not work out.

The second chapter deals with selling on a stop. This is one of the best chapters in the book, particularly because it is one of the questions which beginners ask me most often.

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Dr Elder's discussion explores every aspect of setting stops from a very practical point of view and with many examples. I would have paid the price of the book for this chapter alone.

The third chapter deals with selling on what Dr Elder calls "engine noise". This addresses a very common issue that neophyte traders agonise over: wait till the stop is hit, or bail out early. This chapter includes some anecdotes on how the market can ring a bell near the top and introduces the idea of a decision tree for selling, not as a theoretical idea, but what it means in practice, based on Dr Elder's own experience working on his own trading decision tree over many years.

Part Three

This year, we are living through a bear market. One way traders can profit in a bear market is by short selling. This involves a basic idea of trading: trade with the trend, which is down. Short selling is an easy concept to grasp. You borrow some shares, sell them and later buy them back at a lower price, before returning the borrowed shares. There are some complications in this, compared to going long, which are discussed from a practical perspective based on Dr Elder's extensive personal experience with short selling.

While short selling was banned for a while in Australia recently, as in the US for financial stocks, it is an important part of the trader's skill set. In this respect *Sell & Sell Short* has been published at the perfect time. I am asked all the time about short selling. Dr Elder has written for me an answer to those questions, to which I will point traders for years to come.

Short selling is a skill which may be employed in falling markets. However, even in upward trends, there are counter trend moves which are exploitable using Dr Elder's methods. He shows examples in the stock market and also discusses the particular characteristics of shorting futures, option and forex.

Conclusion

This book is beautifully printed in colour on glossy paper. This is necessary to fully explain the methods and bring the charts to life in an easily understood way. It also explains why it is not the cheapest book in the bookstore. This reminds me of the trader who years ago asked me for a good book on trading. When I suggested he buy and read *Trading for a Living* (Dr Elder's first book), the trader admonished me for suggesting a book which then sold for about $100.00 Australian. I asked him how he was faring in the market that year, to which he told me he was down $15,000 to date. I was impertinent enough to suggest that $15,000 was a high price for tuition, compared to what was available for only $100. He walked away. However, this story focuses on a philosophy of mine that has paid great dividends. I have read several hundred books on the markets. From almost every one, I learned at least one thing which was worth far more than the price of the book.

The current weakness in the Australian dollar makes *Sell & Sell Short* relatively expensive in local bookshops. I suggest those interested in the book look at the price on Dr Elder's web site www.elder.com. His prices are in US dollars as are his postage rates. However, if you note clearly on your order that I sent you, Dr Elder will give you a special postage rate of US$6.00 for the book and its Study Guide, if ordered at the same time. You may also request Dr Elder sign the book for you.

Please note that I receive no money or other personal gain from Dr Elder for publicising his work. I do it because he is a long-time friend and I regard him as the best teacher of short term trading in the world. *Sell & Sell Short* has only reinforced my view.

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The Real Game – Dow Theory Phase Analysis

My primary tool for timing the market is Dow Theory phase analysis. This is the tool which gets me into the market as we approach the bottom and begin the next bull market. It is also a tool which took me partly into cash in 2007 and took me right out of the market by early 2008. These two decisions have a great deal to do with the returns that I have been able to take out of the market and deposit in the bank over many market cycles since I began in the late 1960s.

Bear markets unfold in three phases. This is explained in detail in my book *The Aggressive Investor* (currently out of print, but the new book will be published in May 2009).

The first phase of the bear market is the *Abandonment of Hopes*. This phase is now well behind us.

The second phase of the bear market is *Decreases in Earnings*. In my judgement, this is the phase we are in now in Australia. We are now going into the Australian reporting season. Between now and the end of February, I will be surprised if we do not see a lot of earnings decreases announced. I also expect chief executives and chairmen to be reticent about predicting results for 2009.

I have no idea how long the second phase will last. However, I fear that it may take some time. I do not need to remind readers of the extensive levels of debt right through the system – trusts, companies, investors, speculators, home owners and individuals. Now, it seems that governments are joining those groups in borrowing to fund budget deficits. These debts need to be reduced before spending will start to pick up and a new upswing in the business cycle can start. The stock market will generally turn up nine to twelve months ahead of that recovery in the business cycle.

However, it is unproductive to speculate on timing. What is productive for investors is to assess the conditions around us and to tailor our strategy to the conditions we see.

Even more important, is the idea that we need to know what to look out for when the conditions change. In short, if we don't recognise our destination, we will not know when we have reached it and will therefore not take the action we need to take.

Forget the Coppock indicator in this. The first action signal will be when we see that the third phase of the bear market is forming shape. At that time, we then need to find upward trending stocks and begin to build positions for the coming bull market.

The third phase of the bear market is called *Distress Selling*. It is not difficult to pick when it has started. All we need to know is: what are its key indications? In other words: what should we be looking to see unfolding around us? I will discuss each of the key indications we should be looking for below.

Key Indications: Bear Market Phase 3 *Distress Selling*

Significant Undervaluation

This is a tricky one in more ways than one.

Firstly, let's look at the past. In 2007 I began warning that we were in the terminal phase of the bull market. Every indication of that phase was in place except possibly that there was significant overvaluation. In looking at dividend yields and price/earnings ratios, we

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could see that they were not at that time at the extreme levels they had reached in the last three bull markets. These indications were a little outside the long term average. That was about all that could be said about them.

What happened when I presented my view was that many listeners totally dismissed all the evidence except this item. They wanted to argue with me that I was wrong and there was no danger. I felt this was an argument that could only be judged in hindsight and privately saw it as clutching at straws.

Interestingly, as I spoke around the country in 2008, many people came up to me and said one of two things:

1. They wished they had listened to me.
2. They thanked me for warning them and were glad that that they had acted on it.

I am not saying this to prove how clever I am. The important point is that phase analysis is a matter of lining up as many indications as possible and making an overall judgement. One area of doubt should cause us to think more deeply about the situation. However, it should never be used to rationalise away the evidence that we do not want to see or hear.

Secondly, the present situation is also difficult. This is because we are at the start of a reporting season which reaches a climax on 28 February 2009. The market has priced in large drops in earnings for the half year just ended. Our statistics are mostly for earnings in the first half of calendar 2008, so are well out of date.

Currently, the ASX All Ordinaries price earnings ratio chart looks like this:

As you can see, the price/earnings ratio is now lower than it was in any bear market since the 1970s. This low ratio has come about because of the dramatic drops in price right across the market. However, the earnings figures in the calculation are for July 2007 to June 2008. We have to keep in mind that the index could jump around a bit once the earnings decreases start to flow through. To understand this, consider this scenario:

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Price $1.00
EPS 10c
P/E ratio 10 times

Now assume that the price falls dramatically:

Price 30c
EPS 10c
P/E ratio 3 times

That has been basically what has happened in the last year.

Now assume that the earnings per share fall significantly:

Price 30c
EPS 4c
P/E ratio 7.5 times

So, what could happen is that the earnings per share fall, but the price/earnings ratio rises. This is a little perverse, but what I am trying to show is that the present very low levels for the ratio are a function of the trailing earnings data. It is even possible for earnings to fall and prices to fall further as well, if the full extent of the earnings decreases have not been factored into the price. Of, course this is a negative view and other scenarios are possible. However, it is there to make us think through the possibilities. I feel myself that there is some benefit to playing around with the scenarios so that we have a full understanding of the possible outcomes. I am going to leave readers to do that for themselves.

In conclusion, fundamental valuations look very low. This would suggest that we are already in the final phase of the bear market. However, I am not so sure. If earnings keep falling for the next two or three half-year periods, we may not yet have seen the bottom of the market in time and perhaps in price. The jury is still out on this indication of the third phase of the bear market.

Unemployment Peaks

This is an easy one. A few months ago unemployment stopped falling. It has now begun to rise. The last statistics showed a rise and the next set of statistics, which are due any day now, are expected to show a further rise, perhaps to 4.5%. This is a low level of unemployment in Australia. It is expected to get worse before the coming recession is over. My judgement is that we have further to go and that rising unemployment will trigger lower household expenditure and consequently lower earnings by companies.

I hope unemployment will not be too bad this time. It is already far worse in the US, for example. We may be able to continue being the lucky country. Nevertheless, it would be unusual for present levels of unemployment to be the peak levels. The peak levels will come many more months down the track, I fear.

So, in my judgement, this indication of the third phase of the bear market is not yet in place.

Many Bankruptcies and Failures

I continue to receive emails from readers asking me how to get data on this indication of the situation. A few newsletters ago, I gave a URL to some statistics – past newsletters are

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on www.bwts.com.au. However, the primary source is to read *The Australian Financial Review*, something I have done every day since I was at university in the 1960s.

On 5 January 2009 on page 5 of the AFR, was an article with the heading *Real Carnage about to Start*. That article was about insolvencies. It began "Insolvencies and company administrations have jumped by about a third in the past year, but insolvency experts predict the real carnage will begin for a broad range of businesses early this year."

There was more in this article – both statistics and commentary – and in occasional articles like it. What it is telling me is that the process has started. However, I judge that it has much further to go in 2009 and maybe beyond. One reason I say this is that the big firms start to go first, but the real damage is done in small businesses and personal bankruptcies. This is the sad side of bear markets.

My view is that this spectre has reared its ugly head. However, the full extent is yet to come. So, in my judgement, this indication of the third phase of the bear market is not yet in place.

Bad News is Discounted

This is an easy one to judge. In the first two phases of a bear market, prices fall for individual stocks and across the board as each wave of bad news hits the fan. That will continue into the early part of the third phase of the bear market. What we need to be looking for is that the price of stocks does not fall, or fall very much, in the face of bad news. This indicates that the bad news was expected and has been factored into the price.

A good litmus test was some recent bad news. Take Leighton Holdings, a market darling. The market had anticipated bad news from it, yes, but when it came there were further falls. However, those falls did not go below the lows in the lead-up period. So, there is some possible evidence of this indication. Nevertheless, it is not yet conclusive. Sunland Group also announced bad news and the price did fall to a new low for the bear market.

There has also been bad news from the US, but our market has held its bear market lows.

My conclusion is that there are some signs of a staunching of the bleeding. This is a possible positive for this indication. The real test will be what comes out of the current reporting season, both for companies and for the broader market. On this one the jury is still out. We need to examine the evidence carefully as we go forward.

The Market is Rarely in the News

Mmmm... I still see a lot about the market in the news. Things have quietened down a bit, which is a move in the right direction. However, at the bottom there is rarely much coverage at all.

The litmus test will be when there is not enough market news of importance to make the newspaper or television news headlines. This will happen when the big failures are over. It will also come when the US-fathered credit crisis is no longer dangerous. At the moment any sign of danger is flashed in the news everywhere.

My judgement is that we have further to go on this one. I would actually like someone to write a leading story somewhere which advances the idea that things are just going to get worse and there is no sign of a way out. When those stories start, we are near the bottom.

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Low Public Interest and Participation

This indication is not unrelated to the previous indication. The media panders to public interest.

We need to get to the point where most people are no longer watching the market. Prices will have settled or even rallied a bit. They feel the real danger is passed and that they just have to be patient, which means wait years for their super to be made whole again. Many will still be totally in cash and not looking to change that. This is when the punters are not interested to talk about the markets when I tell them what I do. It is also when I will be spending a lot of time on research and be starting to build some positions. It is a lonely time, but is a key time to be ready to move back into the market.

My judgement is that we are not there yet. See also the next indication.

Stock Price Charts Show Accumulation

Those readers who follow my methods will be aware of my ***value*** model. This postulates that most stocks are cyclical in the way their prices unfold. A long downward trend is followed by a basically sideways pattern developing on the charts. This is when the smart money knows that prices are really cheap and begin to patiently accumulate positions in key stocks from disillusioned punters who are quitting the scene.

I do not see this on many charts yet, although there are a few where it may be starting. However, that is basically clutching at straws at this point, seeing what we want to see in the charts. An example is Commonwealth Bank. Its chart is below:

As readers will see, through most of 2008 it looked as though it may have been forming an accumulation pattern. Then CBA bungled a capital raising and announced bad news. Now I am having trouble seeing an accumulation pattern.

This is just one example. I suggest readers regularly look at the charts of the top 20 to 50 stocks in order to get a feel on this one as we go forward.

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In conclusion, I do not see this important indication in place yet. The best we can say is that it just might be starting, but that is pure speculation.

Overall Conclusion

Pulling it all together, the pessimists will say we are not in the third phase yet. The optimists will judge that we are. So long as the optimists buy upward trending stocks which make profits and pay dividends, they will be fine, providing they know what a stop-loss is for.

My own view, on balance, is that there are not enough turkeys lined up yet, but I am not taking my eye off what is unfolding. It will probably take quite a while for the massive deleveraging to work its way through the system. However, it is not impossible for the situation to change quite quickly. It is not a time to fall asleep at the switch.

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