

# Colin Nicholson: Newsletter 85

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## Improve your decision-making skills

There is an important difference between the analysis of markets or stocks and the task of implementing the resulting ideas as an investor. Most beginners think that analysis is all there is to investing. They think that the analysis process will throw up the best stocks to buy. Further, that the choice of what to buy and when to buy it is all that is required. What is more, beginners tend to think that the analysis is the difficult task and everything after that is easy.

The problem here is that this is incorrect thinking. Analysis throws up prospects. Investors then have to decide which of them to act upon and what is the best time to act. Moreover, it does not end there. The investments must be managed. Buying stocks is often the easy part of the whole investing process. The tough part is managing the investments through to the final sale at either a profit or a loss. Every time new information becomes available, decisions have to be made.

New information in the form of prices comes along every day the market is open. In addition, there will be lots of news about the stocks, the industry the stocks are in, the overall market and the economy. Even international news can affect local investments.

For this reason, the essential nature of investing should be viewed as serial decision making. Every time a new piece of information comes to the attention of an investor, a decision must be made, even if it is to do nothing.

Much of the time, these decisions will be easy to make. The new information may not greatly change anything. However, sometimes the new information quite dramatically changes the situation. Then, difficult choices may have to be made.

### The systematic approach

When tough decisions are called for, commonsense suggests that investors should ideally try to adopt a systematic and rational approach. However, this is something that most investors do not do very well, if at all.

The steps to making rational decisions are well described in the textbooks and consist typically of a series of steps:

1. *Make a clear statement of why a decision is needed in terms of what we want to achieve.* It should be noted that this is a two-part step. First, there should be careful consideration of the need to make any decision at all. Many poor decisions may have been totally unnecessary or aimed at the wrong problem. Second, it tends always to be the case that a lack of clarity about objectives leads to the making of poorly focused decisions which miss the main issues.
2. *List all the factors that we think are important in making the decision.* Most people naturally jump straight from the realisation that there is a problem to deciding what should be done. This is a very human response, which should be resisted. Having decided on the need for a decision and having set up clear objectives, an absolutely essential second step is to set out everything which should be considered. The great value in this step is that it helps avoid a common mistake. This is when a seemingly

sound decision is made without consideration of a vital aspect of the problem or situation.

3. *Assign a percentage importance weighting to each factor.* Clearly some factors are more important than others. In order to make a sound decision, it is useful to arrange the factors in order of importance. It is also desirable to attach a value to each factor which reflects, as closely as can be estimated, the weight to be attached to each factor.
4. *Search out and list all the options open to us.* A common technique used at this stage is brainstorming. This involves deliberately avoiding the formation of early conclusions. Instead, the idea is to range as widely as possible, recording any and all options which are suggested. Avoid arguing for or against them. At this stage, simply assemble a list of ideas.
5. *For each option, evaluate it in terms of each factor and assign a rating depending on how well it meets our objectives.* This initially involves research of what is involved in each option. Once the research is done comes the stage where the ideas are independently assessed. This process will have regard to the factors listed in step 2, using the weightings which were developed in step 3.
6. *Total the score for each option and go with the one with the highest score.* The total score will reflect the relevance of each option in terms of solving the problem. Clearly the one with the highest score will be the one which best meets the objective.

In investing, this systematic method is excellent for deciding which stock or stocks should be bought when investment funds are insufficient to buy all of the opportunities which are presenting themselves at that time.

The other common issue which all investors face at some time is deciding whether to continue to hold a losing investment or switch into another stock or into cash. The systematic method is ideal for dealing with this very emotionally charged problem. Most investors seem to decide that it is just too difficult and cannot face taking a loss. One of the good ways to get the mind around this is to use the systematic method to place a score on each of the alternatives. This is quite often a way to break through the barrier of taking a loss, something which is rarely a problem for successful investors.

### **Now the real world**

Having described the ideal process, it must be stressed that few people will ever attain this for investing decisions. Nevertheless, it is important to have a picture of the most desirable approach and to work towards implementing it as far as possible in the search for rational decision making.

What most investors, even highly professional ones, do most of the time falls far short of this ideal. This is not simply because they are lazy, in fact far from it. The issue is that there are only so many hours in a day and in order to make all of the decisions needed in investing, problems need to be prioritised. Some decisions can be dealt with quite quickly and simply,

leaving the really important decisions to be dealt with using something approaching the ideal of the systematic method described earlier.

Some investing decisions do not require an optimal solution. This can be because there is insufficient information to make the necessary fine distinctions in the rating process. In these cases, there may be several options, all of which may generally meet our objectives and in an inherently uncertain stock market, any of them will do. Nevertheless, this can be overdone. It is always useful to ask whether this idea is being pushed a little too far in the interests of speed, when quality of the decision is more important.

With simple and repetitive types of decisions, most skilled investors will employ heuristics or rules of thumb, which shortcut the process. It then depends on how skilled the investors are and how well their heuristics accord with reality. The use of heuristics in the hands of experienced and successful investors will often be very effective.

However, there is an important downside here. No matter how experienced we are, there will be times when the shortcuts let us down. This happens when we fall into one or more common mind traps well known in psychology or decision theory and being explored in the relatively new field of behavioural finance. The idea behind behavioural finance is to leave behind the simplifying assumptions of economics and study what people actually do in real world situations.

Every one of us suffers to some extent from a range of thinking biases that get in the way of making rational decisions. Nobody should feel guilty about this. Most people go through their entire lives without ever being conscious that they may be making these kinds of decision-making errors. The reasons that so many people do not realise the errors in thinking is because what they do seems so natural. The result is that successful investors often think quite differently about a range of issues in investing to the way beginners think.

By becoming aware of these biases and understanding them, it is possible to reduce the distortions they introduce and move our decisions closer to the systematic and rational model outlined earlier. There is no better antidote to these biases than studying them. My book *The Psychology of Investing* explores many of the common errors and biases and does so in simple non-technical language. The ideas in the book can add to our decision-making skills not just in investing, but in all aspects of our lives. To buy a signed copy of the book, go to my web site [www.bwts.com.au](http://www.bwts.com.au) using the following URL: <http://www.bwts.com.au/text.cfm?42>

A shorter version of this article was originally published in *AFR Smart Investor* December 2005

### **Do you want to sell *The Aggressive Investor*?**

I have a reader who is desperate to buy a second-hand copy of my book *The Aggressive Investor*. If you have a copy you would like to sell, please email me at [colin@bwts.com.au](mailto:colin@bwts.com.au) and I will put the reader in touch with you.

Please remember that I have updated *The Aggressive Investor*, which will be available in May under the new title *Building Wealth in the Stock Market*. So, this is an immediate need to be fulfilled quickly. I recommend that other potential readers please be patient until May. I do not have the time to run a second hand book sale.

## Questions on *The Aggressive Investor*

### Question

On page 79 of *The Aggressive Investor* you say you watch for shares making new highs when you are entering the market. Does this mean 52 week highs?

### Answer

Yes, my primary search methods are to search for new 52-week highs or for low P/E ratios. I did not explain this in chapter 8, because the subject there was managing market risk. Selecting shares to buy is dealt with in more detail in Chapter 11. There I explain the three entries for a stock breaking out of an accumulation/consolidation zone and also the three entries for a stock which is already trending. This is what making new highs means – the stock is breaking out upwards or is trending up. In both cases, it must by definition be making new highs, either for the accumulation/consolidation zone or for the trend.

### Question

Do you always wait for a share to make a 52 week high or do you allow some latitude on this? For instance if a share satisfied all the requirements but was only accumulating/consolidating for only 6 months and then broke out - would that be a contender?

### Answer

I did not specify a time because it is not all that important. The markets unfold in endless variations. Good investors do not follow rigid rules in this element of the plan; they think each situation through on its merits. There is a rough guide that the wider the sideways pattern, the bigger the expected rise, but there are always exceptions. If I had to choose between two stocks and one had a six months-wide pattern and another had a two year-wide pattern, I would usually choose the latter if that were the only difference. However, there may be big differences in fundamental elements and that could outweigh the simple guide of length of the sideways pattern.

### Question

On page 121 of *The Aggressive Investor* you say you tend to avoid shares that trend down and then up (presumably in less than a few months). Why are these difficult to buy into? If a share is trending up for say 2 to 3 months might it not present a reasonable buying opportunity irrespective of what has happened before?

### Answer

Stocks which change direction abruptly get picked up quite late on the technical analysis filter that is true. However, they will be picked up in time. The key issue is on the top of page 122: ***However, as previously explained, those shares are neither value nor growth model shares, so I am not generally looking for them.*** That is the key issue – they are not my investment plan, which is to exploit the two models. Unless we know what we are trying to do, we have no hope of ending up achieving it except by sheer luck. I am not saying that they might not be good investments. I am saying that they are not what I am trying to do. It is more effective for me to play my game than to try to develop a whole range of plans to play other methods. However, you might like to build your plan around these situations. There are ways of doing it, I am sure. You will need to think them through and test them before investing real money.

## Can you help? – Win a free book

I made the following appeal in the last newsletter and nobody responded. I now have two readers looking for this data. Surely, someone has the data and is prepared to share it?

**Two of my readers are 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](mailto:colin@bwts.com.au) and I will pass them on to the readers. Many thanks.**

The first reader to email me these files will be sent a free copy of my book *The Psychology of Investing*. I will decide who was first from the time stamp on the email. My decision is final.

## Debt-to-equity ratio

I recently received a question on the debt-to-equity ratio which I used in an article. I am now using this ratio as an explicit filter in my investment plan (all will be explained in my book *Building Wealth in the Stock Market*, which will be released in May). Therefore, I thought an edited version of this question and answer may be of general interest. It exposed some interesting and important issues.

### Question

In the Xinc newsletter on your members' only website, you use total debt in your debt-to-equity ratio. Why is that?

### Answer

The ratio I used in the Xinc newsletter article is the easiest ratio to understand. It is calculated as follows: financial debt ÷ shareholders funds.

The article in question was written for a newsletter which goes to people who are primarily property investors and I need to keep stock market material simple. Nevertheless it is my preferred ratio, as explained below.

When a company has a significant cash holding, we might use the net debt to equity ratio, which is (financial debt – cash) ÷ shareholders funds.

Another variation is total liabilities ÷ (net worth – intangible assets).

There is also the ratio which you mentioned in your expanded question: secured debt ÷ shareholders funds.

In a similar vein is the gearing ratio, which is another variation and commonly used in *The Australian Financial Review*: financial debt ÷ (financial debt + shareholders funds).

It is worthwhile to be able to deal with both the debt-to-equity ratio and the gearing ratio. In my method, my maximum debt-to-equity ratio is calculated like this: Debt (60) ÷ Equity (100) = 60%.

The equivalent gearing ratio is calculated like this: Debt (60) ÷ [Debt (60) + Equity (100)] = 37.5%.

So if you are reading an article using the debt-to-equity ratio, look for it being less than 60%. However, if the writer of the article is using the gearing ratio, look for it being less than 37.5%.

An alternative gearing ratio is total liabilities ÷ total net worth, which is similar to my simple definition of the debt-to-equity ratio.

Which ratio you use may be determined by exactly what you are trying to use the ratio for. Also, like technical analysis, security analysis has a range of tools which do essentially the same thing, but will be preferred in varying degrees by different analysts or their firms.

As to which ratio is most used, I don't know. However, the key point is not that question. It is that if you are using someone else's ratio, it is wise to know their definition and to ask them if it is not stated. If you are selecting a ratio for your own work it is also important to know what it means in terms of the purpose for which you are using it.

My own choice of this form of the debt-to-equity ratio is driven by my purpose, which is as a crude first filter and a simple one that most people will understand.

I look for debt-to-equity being less than 60%. If over that, I need an extremely good reason to be taking that higher risk and would be looking at ratios that the firm survived with through previous cycles and the nature of its business – the cyclicity or discretionary elements.

However, if it is less than 60%, that is not an automatic tick. I still need to analyse the stock fully. The initial filter has several ratios and other elements, all of which are designed to cull out the stocks which best fit my investment plan. In total they comprise a crude filter, which has served me well over time. The crude filter is just a starting point heading for a short-list of stocks, which need to then survive a more intensive analysis of every aspect of their business. The debt-to-equity ratio is a measure of relative financial risk. There are other risks which must be assessed.

## Investing for your children

### Question

I am very slowly working on building up a portfolio of shares for my children. They are five and three years old. My time frame for any share purchase is for when they turn eighteen or twenty one. So far they have a small number of NAB shares on a dividend reinvestment plan. Perhaps you could suggest a trading strategy.

### Answer

I will start with your last sentence first. I do not believe that it is appropriate to be trading in shares for your children. However, maybe you do not mean trading (speculating), you mean investing, because you said earlier that you were building up a portfolio. If you do mean trading, I would recommend that you seek some legal and particularly tax advice from a licensed adviser on this. There may be serious tax issues involved in running a trading business in your children's names.

Instead, I would personally lean very strongly towards building up a portfolio of blue chip shares for them. Whether you do this on a passive investing basis or a market timing basis is up to you. However, you should make up your mind on this issue right from the start and have a written plan. This could be important if you run into tax issues on the portfolio, because I understand that there are limits on how much a child can earn before being taxed at a very high marginal rate.

If you decide that you want to take an active, market timing approach, I suggest that you start by reading my book *Building Wealth in the Stock Market*, which will go on sale in May 2009. You should not copy that plan exactly for the reasons outlined in the book. Instead, you should use it as model of what should be in an investing plan and adapt it to the situation relevant to your children.

If you decide that you want to take a passive approach, I suggest that you look to use some variation on the dollar-cost-averaging method. In other words, you set up an account into which money is automatically credited from your pay and invest that dollar amount in an index fund or a portfolio of stocks every quarter or half year. Dividend reinvestment on any shares you buy is also possibly appropriate, because it is basically the same idea.

However, there are critics of dollar-cost-averaging. You can study the views pro and con on the internet – put “dollar cost averaging” into Google. Then make up your own mind.

The disadvantage of dividend reinvestment plans is that they involve a lot more paperwork and calculations for when you come to sell those shares. Nevertheless, this might be a good thing to teach your children, so maybe do it for at least one of the shares you buy.

No matter which method you use, your approach should, in my opinion, focus on growth investments like shares until within a few years of the termination date, which you have nominated. However, personally, my approach would be to do this to teach your children about investing. You should involve them in every decision from the youngest age possible. Of course, they may not be interested, but you should try.

I would not personally be aiming at a termination date at 18 or 21 years. I would simply be making that a date when they take over total responsibility for the investments. Well before that I would be inclined to be emphasising that investments are for life and you are giving them something to start with and continue until they need the capital in retirement.

I hope these few ideas are helpful. Nevertheless, none of this is advice. I suggest that you seek advice on this whole issue from a licensed financial planner who has a good knowledge of the taxation implications. You need to set it up the right way to maximise the benefit to the children and avoid harsh taxation rules.

## **Are you too old for active investing?**

I recently received a question which raised some important issues:

### **Question**

I enjoyed your book *The Aggressive Investor*, but I believe that it is more suited to a younger person. What I am looking for is advice as to the direction I should take when the market recovers somewhat. This would be to take me on a more conservative path in advancing years.

### **Answer**

My reader who asked this question did not tell me his age. However, from the general tone of it I assume he must be at least in his eighties. I say this because he is clearly concerned about a key issue with respect to investing in stocks.

This is that one of the risks in investing in stocks is that the stock market is cyclical. If investors adopt a passive investing style, there is the risk that stock prices may be in the lower areas of the cycle when they most need to use their capital. This is why I am assuming

that my reader is at least in his eighties. He is correctly envisaging that most of his heavy medical expenses will be in his remaining years. Also, he will be approaching or already in the final phases of his lifetime investing plan, where he needs to live more off remaining capital than simply the income stream it produces. The key risk here is that a passive investing style is possibly unsuitable, because stock prices may be in the bottom of the cycle at that time.

However, my reader is suggesting that an active investing style is also unsuitable. To the contrary, the whole idea behind the active investing style outlined in my book *The Aggressive Investor* and its shortly to be released (May 2009) update under the title *Building Wealth in the Stock Market*, is that my method seeks to be invested heavily in bull markets and to be in cash in bear markets. It is especially suited to retirees in their last phase of life. Indeed, I am using this approach for managing my mother's capital and she will turn 89 this year. When the next bull market is close, I will be moving her capital strongly back into stocks. When that next bull market ages, I will be phasing her capital back out again.

For these reasons, I believe that my reader is possibly on the wrong track in looking to avoid active market timing and head towards what he thinks to be a more conservative approach. In fact, I would go so far as to suggest that a passive approach can be seen as a more risky method for someone heading towards what they feel to be the last few years of their life.

Indeed, this raises another issue. Assume that my reader is 80 years old. His life expectancy on the government web site at [http://www.facsia.gov.au/guides\\_acts/ssg/ssguide-4/ssguide-4.9/ssguide-4.9.5/ssguide-4.9.5.46.html](http://www.facsia.gov.au/guides_acts/ssg/ssguide-4/ssguide-4.9/ssguide-4.9.5/ssguide-4.9.5.46.html) suggests that he should plan for another 8.24 years (9.98 years for females). Likewise, if my reader is 85 years old, his life expectancy is for 6.11 years (7.28 years for females). The fascinating thing about life expectancy is that the older you are the longer your total life expectancy. I suggest all readers study this table and ponder the implications for their financial planning. My mother is 89 this year. Her life expectancy on this table is another 5.66 years. Think about it.

The big danger in trying to avoid the risk in growth investments is that the biggest risk is trying to take no risk with capital. If we run into a period of moderate to high inflation, the purchasing power of our capital will evaporate very quickly in fixed interest investments.

There are as many heuristics that purport to deal with this as there are financial advisers. One is that you subtract your age from 100 and that is the percentage of your capital that should be in growth investments. So, if you are 90 years old, 10% of your investments should be in growth assets. I am not advocating this heuristic, but have quoted it as an example. It is actually still quite conservative in my opinion.

There is another possible issue here. My reader may well be in his eighties. However, he may have plenty of capital from diligent saving and smart investing through his working years. In that case, he will be looking to pass a great deal of the capital on to children and/or other relatives. These beneficiaries are likely to be younger. In this case, to maximise capital growth and therefore the overall size of bequests, it makes sense to have a fair amount in growth assets. These assets may be bequeathed in specie to beneficiaries, deferring any capital gains tax indefinitely beyond the grave. In this situation, it is worth giving thought to the life expectancy of the beneficiaries in shaping the portfolio structure. There are many things to ponder and balance in everyone's situation. There are no general rules, because every situation is different to some extent.

At this point I must stress that I am not a licensed adviser and nothing I have said above is intended to be advice or a recommendation for my reader who asked the question, or anyone else. I have tried to present some ideas for consideration in the context of opposing views that readers will encounter.

It is most important that readers appreciate three things:

1. Before they do anything, they should consult a licensed financial planner, who can develop ideas with full knowledge of readers' total situation. I am an educator who is trying to provoke thought about issues, not an adviser.
2. The responsibility for the appropriateness of financial plans does not rest totally on the financial planner or adviser. If it is your plan, you must be totally involved in the process. The quality of the plan will to a large extent depend on the quality of the brief. In other words, on how well you have set out what your situation is and what you want to achieve. You need to have thought through what the issues are and resolve them into questions. Bad plans generally result from poor briefs and abdication of involvement by the person being advised.
3. Market timing is not easy. It requires knowledge and experience. It takes a decade or more of hard work and deep consideration to become good at it. Not everyone has the required level of commitment, even if they have the years available to them.

Therefore, readers should take my thoughts away and ponder the issues I have raised as they work towards developing a financial plan with the assistance of a qualified and licensed financial planner. I hope that I have helped readers by posing the issues such that they know some of the questions to ask of themselves and of their advisers.

I am not legally able to recommend financial advisers or financial planners to specific readers, so please don't ask me to do that.

## Insolvency statistics

Readers looking for a source of insolvency statistics may find that [www.restructuringworks.com.au](http://www.restructuringworks.com.au) is a useful website.

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