

# Colin Nicholson: Newsletter 87

2 April 2009

## Hear me speak in Auckland NZ

Saturday 9 May 2009 9.00am  
STANZ

### **How to Buy a Young Bull**

Colin will discuss how he phased out of the 2003-2007 bull market as a prelude to a discussion about how he will go about phasing into the next bull market. This will focus on Dow Theory Phase Analysis, the Coppock indicator and basic trend analysis.

### **How Good Investors Think Differently to Beginners**

In his books *The Aggressive Investor* and *Building Wealth in the Stock Market*, Colin identifies some ways in which good investors think, which sets them apart from beginners. He will discuss some of these traits, which if developed can improve investment decision-making and therefore investing results.

**For further information:** [http://www.stanz.co.nz/auckland\\_meeting.php](http://www.stanz.co.nz/auckland_meeting.php)

I will have copies of my books (including a limited number of the new book *Building Wealth in the Stock Market*) for sale, so bring some cash with you.

## Further speaking engagements

I have now posted the dates and the available details for my 2009 speaking engagements on the *Hear Colin Speak* page on [www.bwts.com.au](http://www.bwts.com.au).

## He Who Hesitates is Last

The title of this article is a quotation from Mae West. It alludes to one of the more common investment mind traps, known as the inertia bias. This is a general tendency, which we all exhibit to some extent. The inertia bias comes into play when we procrastinate rather than make difficult decisions. For some people it can be even worse, when it becomes a propensity to delay acting even when the decision is a simple and unimportant one.

Almost everyone will be guilty of procrastination in some situations. For many this will be only a minor problem, something it would be nice to correct. For others it is a major problem. When it prevents us from making or acting on important financial decisions it can have far reaching consequences on the whole of our life.

Judith has worked all her life as an accounts manager in a big company. She is accustomed to dealing with large amounts of money. Her own finances are miniscule by comparison. Judith has a reputation for running her department in a highly efficient manner. She deals with problems brought by her staff expeditiously and prides herself in meeting deadlines.

Yet, in her own affairs she could not be more different. As she heads inexorably towards retirement, she has failed to make decisions about investing her savings to provide a standard of living which she hopes to have in her post-work life. She has been a diligent saver. She knows deep down that she should be investing in growth assets. Nevertheless,

Judith has held most of her savings in bank and term deposits, which have been whittled away by inflation and have not maintained their purchasing power.

Every time Judith resolves to make the necessary decisions to better focus her investments, she hesitates. She finds these decisions, which unlike her work decisions are not determined easily for her by company policies, to be very difficult. There is no certainty in investing in shares or property. Every investment that she looks at seems to have some unknowns. Also, it is difficult to decide which of the alternatives is best. They all have their pluses and minuses. She is afraid to make a decision in case she makes a mistake. So, she defers making a decision at all and resolves to seek more information, hoping that the decision will become clear sometime in the future.

There are many reasons why we might procrastinate. In the investment field, one of the most common is the fear of making mistakes. This is closely allied to the nature of investment decisions, which must be made without access to complete information and where the implications for the future performance of an investment are ambiguous. This produces anxiety which is resolved by doing nothing in case it is the wrong thing.

There are two broad groups of people who are particularly prone to the inertia bias. The first general group are those who lack a secure feeling of self-worth. They have probably spent a lifetime of taking great care not to expose their low self-esteem. The most dangerous time for them is when they have to make a decision about something. In doing so, they feel very strongly that their self-worth is on the line. Most often, the result is that they try very hard, both consciously and unconsciously, not to make decisions about almost anything. Perceptive readers will see the real problem here. This group of people are attaching their self-worth to the outcome of their decisions. This opens the door for the inertia bias. They are frozen into inactivity.

A moment's thought should suggest the great fallacy here. Our self-worth should be a separate concept to the outcome of decisions we make. Everyone, no matter how high or low their self-worth, will make decisions that work out well roughly as often as they make decisions which turn out to have been ill-advised.

Those with poor self-image have a problem in separating their ego from their actions. A bad action is interpreted that they are a bad person, rather than that a good person has taken a decision that happened to turn out badly.

The second group of people for whom the fear of making mistakes is particularly evident is generally labelled the perfectionists of this world. The extreme perfectionists are often quite unable to make decisions of any kind. They have set such high standards for themselves that failure seems to be almost the worst thing that could happen for them. When faced with any decision, a perfectionist is never satisfied with second-best. They see that as failure. Only the best outcome is acceptable, which makes them afraid to commit to anything. This group, even more so than the low self-worth group, will lean on the crutch of needing more information before they feel able to make a decision. The end result is that they never get around to deciding either way on important issues unless someone literally holds a gun to their heads.

The perfectionists are somehow unable to assimilate the obvious observation that perfection is always ultimately unattainable. They are seemingly unable to give themselves permission to be human.

The saddest cases of all can be the perfectionists with low self-worth. They will find investment decision-making a particularly difficult process.

The reason that investment decisions attract procrastination is inherent in what investing is all about. In investing, it is necessary to embrace risk in order to make a profit.

This should be self-evident. If everyone knows something, it will be impossible to profit from that knowledge. It follows that all investment decisions involve some level of uncertainty.

When the time comes for us to invest some of our savings, there will be many investment alternatives available to us. It will be very difficult to rank them in order with any certainty or confidence. There are always things we don't know, more information we think that might make the decision easier. Yet the perverse twist here is that, if it was possible to have enough information so that the decision was an easy one, it would in most cases not be possible to make a gain from the investment. We are now back to where we started. If there is no uncertainty, there is little chance to profit. Investing gains are made by intelligently assessing and assuming risk. Certainty of outcome is not possible except for investment choices where the return is close to certain, but very small.

### **New High – New Low Charts**

Dr Alexander Elder recently made me aware of how Australian New High – New Low charts can be accessed on one of his websites:

*As you may know, I consider New High – New Low Index the best leading indicator of the stock market. The daily NH-NL update is one of the key features of SpikeTrade.com that I run together with my friend and partner Kerry Lovvorn. We have a brilliant Brazilian fellow in our group who has built a system for creating NH-NL for any country. He began with Brazil, then UK and Germany, and a few weeks ago added Australia to the list.*

*The updates for Australia are published weekly, usually on Saturdays. All one needs to see them (and comment on them if one likes) is to come to [www.spiketrade.com](http://www.spiketrade.com), register as a Guest (free), and proceed to the blog.*

*I hope you like those charts and perhaps your readers will like them too.*

This information is published as a service to readers. Dr Elder does not pay me to include this notice.

The easy way out of uncertainty is to avoid making a decision, often by deciding to seek more information, delaying a decision until there is more evidence. Since this will not happen, nothing is done and all the opportunities are missed. This is the inertia bias in action.

The problem of uncertainty is far more acute when the decision is whether to sell an investment. Sometimes it is unclear whether the investment is going badly and should be closed out. There will always be a sneaking temptation that if we just hold on, it may come right. This is a recipe for the inertia bias to swing into action and we defer making a decision. In the industry, this is called a “hope trade”, because the only thing going for us is the hope that we will somehow be saved from making a loss. This situation frequently ends badly.

At other times, it will be perfectly clear that the investment has deteriorated and that we should get out of it to protect our remaining capital. This is especially difficult if the decision to sell would involve crystallising a loss. Now the perfectionists and those with poor self-

image are put to the sword psychologically. Their only way out is to procrastinate. This situation almost always ends badly. The initial loss, which was not accepted, is invariably much smaller than the eventual loss when the investment fails completely, or the investor reaches the point of capitulation and salvages what little is left of their capital.

One of the main ways to deal with procrastination is to carefully consider the causes, which were outlined earlier. The aim is to identify the ways in which we are not taking a balanced view of the world. Just becoming more aware of the root causes of our procrastination will help us to bring our thinking closer to reality.

Some other practical techniques can also be very effective if we work at them conscientiously.

Thomas, like Judith who we met earlier, had real problems making decisions. He was one who lacks self-esteem and therefore seeks to get peer reassurance before acting. This means that every investment decision Thomas made was discussed at length with all of his friends. The end result was that every decision Thomas made about his investments was a very public one that had been broadcast around his group of friends.

The end result of this was inevitable. When Thomas made a decision which turned out well, his friends gave him little credit and tried to take credit for guiding him towards a good outcome. On the other hand, when Thomas made an investment which turned out badly, all his friends seemed to know about it and to remind him of his failure. Over time, Thomas deferred more and more decisions and became very unhappy about it.

Now, Thomas might have taken the inertia bias to heart and continued to make very few investing decisions. However, luckily for him, he was seized with the insight that he must make investment decisions or his future welfare would slip away from him. He identified that the problem was his craving for peer reassurance. Yet that was the very thing which was creating the problem. Thomas resolved to attack the cause of his inertia bias.

His solution was to avoid the fear of making mistakes by keeping his investing decisions to himself. Thomas resolved not to talk to others about his investments before, during, or after the process. This was very difficult at first, but over time it worked. It reduced the psychological pressures on his ego and enabled Thomas to find it easier to simply follow his investment plan.

Interestingly, another possible technique is the exact opposite. It is still necessary to cease canvassing decisions among our peer group seeking reassurance, for the same reasons Thomas did. This was all Thomas needed to do because, having made a decision, he had a strong resolve to carry it out. However, many of us manage to keep the decision process to ourselves, yet still can't pull the trigger on the decision.

A useful strategy in this situation is that instead of keeping mum on our decisions, for both buying and selling decisions, we should announce to others what our plan is. If the price of XYZ rises to \$2.35, we will buy. If the price of ABC falls to \$1.20, we will sell. The power in this is that now we have invested our ego in following our investment plan. The only mistake we can make is the one we want to avoid, not taking the action that we usually put off making. If we do not make it, our friends will remind us, of that we can be certain. However, we can avoid having our nose rubbed in our inertia by acting on our plan. Then we head off our friends by announcing that we followed our plan. This can be the more difficult of the two

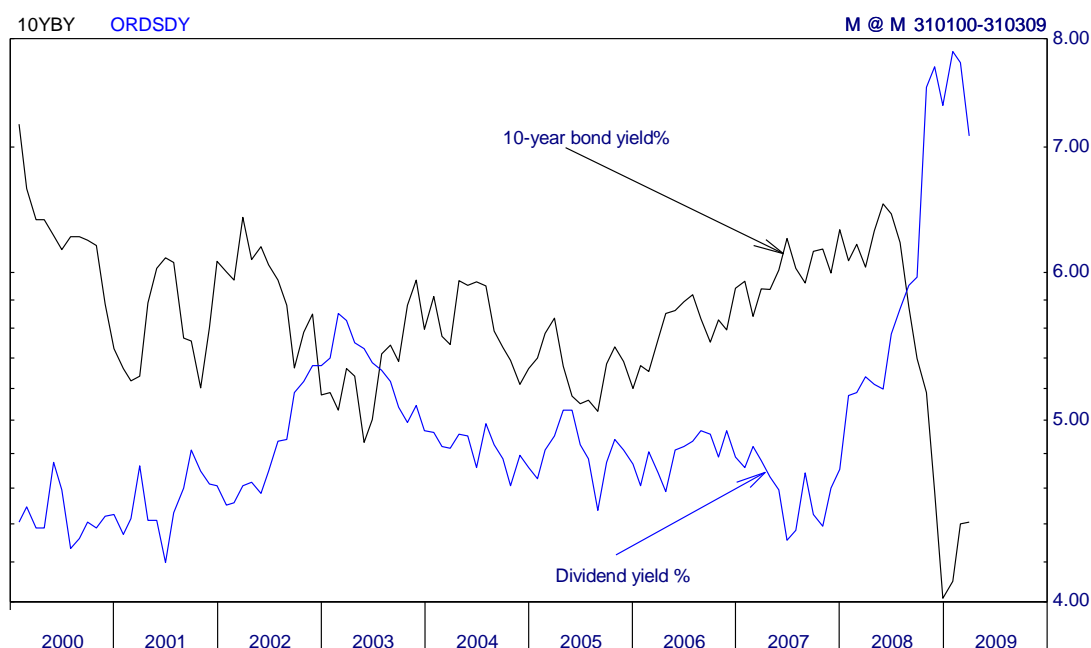
strategies, but once we consciously congratulate ourselves on following our plan every time we act on our decisions, it can become a self-reinforcing process.

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

If you found this article on investment decision-making of value, please consider buying a copy of my book *The Psychology of Investing*, which has more chapters like it and much more as well. To order it, go to [www.bwts.com.au](http://www.bwts.com.au) and click on Colin's Books at the left of the home page.

## Danger in the Bond Market

Be warned. There is an unusual situation in the bond market. On the one hand, the 2008 rout on stock markets has driven up the yield on stocks. Because of the level of fear in stock markets, there has been a flight to bonds, especially government bonds. This demand for bonds has driven up the bond price, such that the yields are now very low. The Australian picture on stock versus bond yields looks like this:



The blue line is the dividend yield on Australian stocks. The black line is the yield on Australian 10-year bonds.

As you can see, the normal situation is that the bond yield is higher than the dividend yield, reflecting the inflation risk in bonds. The relationship will sometimes invert when we have a bear market, as fear drives investors away from stocks toward bonds. This can be seen in 2003, the last bear market in stocks. The lines crossed, but it was not extreme as it is now.

Of course, these dividend yields on stocks are inflated, because they are based on current prices, but trailing dividends. The dividends relate to calendar 2008 in general terms. The recent cutting of dividends by some companies has already pulled the dividend yield down a bit.

The low bond yield works very well for governments, because they are selling bonds to raise money to pump into their economy to try to ameliorate the effects of the developing recession. In my last newsletter I mentioned the fear held by Warren Buffett and others that the printing of so much money will lead to inflation. In that case, the present bond yield will in effect give a negative real return. Something will have to give and that is most likely to be the

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bond price, which could fall sharply to adjust the real yield into positive territory. This prospect should be of great concern to long term buy-and-hold-to-maturity bond investors. Their return will be negative in real terms. Moreover, their capital will be returned in dollars that are worth a lot less in purchasing power than the dollars they loaned to the government.

It would also impact in a nasty way on retirees who are forced to release capital by selling their bonds before maturity. In that case, they will suffer a double-whammy of getting a lower price for their bonds in dollars that have also been ravaged by inflation.

The lesson: The bond market is an accident waiting to happen. There will be tears. Remember that I warned you. In inflationary times it is better to be a borrower than a lender. The asset classes of choice are physical gold, stocks and real property.

In today's *The Australian Financial Review*, there was an interesting article on this subject. It was written by Jonathan Compton, Managing Director of UK-based equities fund manager Bedlam Asset Management. His article is a splash of cold water across the face of anyone who thinks that bonds are indeed a totally risk-free asset. Some quotations from his article:

"... it is unusual for a country to have a track record longer than three generations for repaying bonds."

"Since 1823, no year has passed without a government defaulting."

"In the mid 1990s, the number of defaulting countries reached 60" (excluding states and cities)

"There is also a definition problem... Not paying interest in full or replacing bonds on their due date with new bonds rather than the cash promised are not considered defaults."

"... despite such a narrow definition, by the end of 2003, more than 20 nations out of the 192 members of the United Nations were in some form of default."

"...six Group of Nine countries have gone bust at least twice in the last 100 years."

His conclusion is that there will be only a few problems in 2009, but 2010 could see the chickens come home to roost.

This article is worth reading in full. It seems to be well researched and to be warning us that government debt may not be as safe as the textbooks tell us. Of course, many readers will think that it cannot happen in their country. Even if we are convinced this is the case, the basic rule for managing risk is diversification. If we must hold bonds, they should be spread across a number of countries. Personally, I will not be buying any bonds.

### **Are you changing your email address?**

If you change your email address, please do not forget to alter it on the list of subscribers to the newsletter. You do this by going to [www.bwts.com.au](http://www.bwts.com.au), then click on *Newsletters* and use the link provided. If this does not work for you, please email me your full name, your old email address and your new email address.

My policy is to delete email addresses from the list once I have received three bounce messages. I am unable to advise you of this action.

## Next Newsletter

This newsletter is a bit shorter than normal, for which I apologise. The next newsletter will be published around mid May, when I will have stocks of my new book *Building Wealth in the Stock Market* available for sale off the website.

## Worth Reading

This short article by Jeremy Grantham is worth reading. He talks from personal experience in 1974 and looks also at 1933.

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