# Trading Australian Shares

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## Introduction

There are many ways for traders to make money in the markets by exploiting changes in the prices of stocks. These include:

### Pure Fundamentals

This essentially comes down to stock picking.  Fundamental analysts will use their methodology to attempt to identify stocks in two groups.  Firstly, they will look to find undervalued stocks.  This under valuation will focus primarily on earnings, but will also encompass asset backing and dividend yield.  Other factors will be of importance at particular times, such as debt to equity levels.  Secondly, they will look to find growth companies.  Here the emphasis is primarily on earnings.

### Quants

This approach rests on statistical evidence that by far the largest element of investment return is derived from portfolio allocation and only a small element can be ascribed to stock picking. This rests essentially on the efficient market hypothesis and asserts that trying to add value through stock selection is relatively futile, because market prices are random.  This approach is sometimes known as a "top down" approach.  Some proponents will also advocate a mixed system where the basic approach is portfolio allocation, but part of the funds will be used to try to add value through specific stock selection.

### Pure Technicals

This approach is based on the observation that markets are not efficient and therefore not random.  Thus trends exist in the markets and can be traded profitably in both the short and longer terms.  While it is a stock picking approach, it is distinguished from the pure fundamental approach in that timing is now the primary issue, rather than value or growth.  The most extreme view rests on the key assumption of technical analysis that all information is reflected in price and that is all that is necessary to trade the markets.

### Hybrids

This is a mix of the above approaches as is implied by the name. The most common form is to use fundamentals to pick stocks, top down or otherwise, but to use technical analysis to time the trades.  This approach has the advantage of using both fundamental and technical input.  However, this is not as easy as it sounds, because it introduces conflicts between price and fundamentals, that the trader has to resolve.

### Inside Information

This is the best method of all, but is unfortunately not legally available to many of us.  However, its inclusion in the list is to make a point.  That is, that there is always an element of insider trading in the markets, legal or otherwise, because some people have faster access to developments or better insights into available information. When used in the market, this results in a change in the supply - demand balance and price will reflect this activity. This can be observed by the technical analyst, and acted upon. The opportunity to join in insider trading in this way has led me to describe technical analysis from time to time as "legal insider trading".

### Hindsight

This would be the best method, were it possible. I have not yet encountered a broker who will take orders in hindsight! Be aware though that many technical analysts are very good at this kind of analysis. They will talk at great length and with great authority about past market action. However, those who seek to profit in markets must make their assessments and decisions on the right hand side of the chart. They should always ask the hindsight analysts where the action points are, based on the latest information.

Every trader must develop their own approach, which must suit their own personality. Particular attention must be paid to the time frame they intend to trade. Many losses in the markets occur through entering medium term trades and then exiting on short term signals, whether the strategy is technically or fundamentally based.

The most important point is that they think through their approach before they take their money anywhere near the markets. I will try to show a way in which a trading plan can be constructed. The strong implication is that if traders cannot write their plan down, they are not yet ready to trade the markets.

## Elements of the Trading Process

To be a successful trader, all three of the key aspects of the trading process must be mastered:

### Analysis

As outlined above there is a variety of approaches available. The key is to be comfortable with the methodology chosen.

### Money Management

This covers the area of how many trades to make and, even more importantly, how large each trade should be. Under-trading will restrict profit potential, but over-trading is fatal. The first concern is to remain in the game - preservation of capital. Even when risk management is sound, traders can lose through faulty trade strategy. Their objective must be to avoid large losses and to expose their capital to the opportunity to make large gains. This is often encapsulated in the saying "keep losses small and let profits run". The sad fact is that most losing traders do exactly the opposite - take profits as soon as they appear and procrastinate on closing out losing positions. This leads into the third element.

### Psychology

This includes the key concepts of managing emotions and making decisions. Trading is a very emotional experience and this is one of the reasons why practising on paper is only effective up to a point. Once real money is involved, the key psychological elements of fear, greed and ego all come into play to sabotage the best of plans. It is not difficult to come up with a good plan for trading the markets. However, it is inordinately difficult to follow the plan. Most losses are not the result of a poor plan, but of failure to follow it.

In the above four sections, I have outlined the key elements of the trading process in reverse order of difficulty. Most traders spend an inordinate amount of time on analysis. Yet analysis is the easiest part of the trading process. It is the other three areas that are critical. Most good traders use only simple analysis techniques and have a sound foundation in good risk and money management. The thing that makes their results stand out is their ability to carry out their plan in the psychological cauldron of the market.

The reason most traders concentrate so much on analysis is based on the false premise that if the "right" stock is bought at the "right" time money will be made on the trade. While stock selection and timing entry are important, when the trade is closed is far more important. Anecdotal evidence of past markets is littered with stories of traders who bought stocks that went up very nicely in price. However, well after the party was over, they were still holding those stocks, often at a loss compared to their original buying price. No trader is complete until the art of taking losses is achieved.

Technical analysis must be seen as just the factual basis for trading decisions. This explains why we come across good analysts, who are poor traders. Trading is much more than analysis. We also come across good traders who are poor analysts. This reinforces that it not the analysis that is critical in the process. While good money management and psychology cannot turn bad analysis into spectacular profits, the best analysis will lead to losses with bad money management and psychology.

There is an extensive literature on good traders. The more one reads, the more obvious it becomes that only simple analysis techniques are needed. Indeed, the work of Dr Van K Tharp suggests that a good trader could enter trades on a random basis and still make money with good money management.

The real challenge is the psychology - making decisions. This is the same for any business. While people with special training are frequently well paid, the best paid people in business are the ones who make the decisions. This is no different in trading - the traders who are best rewarded by the market are the most effective decision makers.

## The Need for a Plan

If it is true that decision making ability is the key to trading, it is also true that there must be a framework within which those decisions are taken. This framework is called a plan. The plan must set out what the trader is trying to achieve and what methods they intend to employ. If these things have not been thought out, decisions will be made in a vacuum and will not always take the trader towards their objective.

I spent the first fifteen years of my working life in a large multi-national company. In such a large organisation, it is very important that each operating unit is working towards a common goal and using strategies that do not conflict with the efforts of other units of the organisation. Thus, not only does the organisation as a whole have detailed plans, so that everyone knows where it is trying to go, but each individual unit must have its own plan. Thus a great deal of time was devoted to planning. If this was done thoroughly, when it came to make decisions, not only could they be safely delegated, but they became easier to make.

Thus I learned the value of having a plan. Many others have learned the same lessons in smaller businesses - statistics indicate that absence of a business plan is one of the most important reasons for failure of small businesses. Since trading is a business, it should be natural to develop a plan for carrying it out.

Developing a plan is not easy. In fact, it is easily as difficult as actually carrying it out. It requires a great deal of self-examination and an intellectual effort to formulate something that is a coherent whole with logical consistency between the various elements. It is also something that is being continually questioned and refined as the trader learns more about trading and themselves.

The way I learned to draw up a business plan utilises three main headings: Objective, Strategy and Tactics. Most of the rest of this discussion will explore how to put a plan together under each heading.

## Objective

In its simplest form, this is no more than what it is you want to achieve.

It seems simple at first glance, in that most people quickly offer that their objective is to make as much money as possible in the shortest time. However, this is not good enough, in that one of the requirements must be that your objective is measurable. If you cannot measure your objective, you cannot measure your progress towards it.

It follows that your objective must also be realistic. If it is not realistic, the whole of the plan is flawed and the strategies and tactics you select to carry it out cannot succeed. Most people imagine that successful traders achieve much greater growth in capital than they do. Sure, there are traders that make large gains in one or two periods. However, their results over any reasonable period will be much less and even involve losses in some periods.

One of the most difficult things to come to grips with honestly is the trader's reason for trading. When this is first raised this with new traders, they all respond that they are trading to make money. However, this may not be the real reason most people trade. Many are trading for entertainment, or the thrill of the trading experience. There is nothing wrong with this, except when it is not recognised and is allowed to be taken to such an extreme that it impacts unfavourably on other financial objectives in the trader's life.

## Strategy

The first thing to recognise is that there are two ways to trade the markets - trend following or counter-trend trading. It is possible to do both, but they require different skills and attitudes. Most people are more comfortable with one than the other. As in all aspects of this discussion, it is important to go with what the trader feels is most comfortable.

The second thing to recognise is that the trader can trade either the long side or the short side of the market - the bull trends or the bear trends. It is quite possible to do both, but again there is generally a comfort zone around one or the other that must be respected. Each requires a different outlook and orientation - maybe even a basically optimistic versus pessimistic attitude to life.

The key words for any trading strategy are *patience* and *discipline*. Patience to wait for the good trades and to be prepared to be out of the market for long periods. Discipline to trade according to the plan.

## Tactics

This is where we get down to the nuts and bolts of trading. Here we roll money management and psychology into a set of rules that must be followed without exception. Following them without exception is, of course, the most difficult thing. No one that I have met or read about achieves perfection here, because good trading is psychologically such an unnatural activity. The key here is to be aware of the process of random reinforcement. The structure of markets is such that they reward both good and bad behaviour at times.

When traders profit from not following their rules, they are setting themselves up to make more mistakes. Somehow they must develop an internal reward system that makes them feel good when they follow their plan, even when they make a loss, and makes them feel bad when they do not follow their plan, especially when they make a profit. In a word they must be disciplined to follow a plan. If their trading is following their plan and not making money, then they should stop trading and develop another plan. Second guessing their plan during trading is one of the surest routes to losses.

One of the parts of the analysis puzzle that typically takes traders a long time to come to grips with is the first tactic: *knowing the time frame that the trader is trying to trade*. One of the first things to have in mind about markets is that trends exist in many time frames at the same time - rather like the tides, waves and ripples seen in the ocean. However, identifying the right time frame is not an easy thing and requires a great deal of effort and imagination in analysing charts. The best time to catch a tide in the market is just after it turns, but this is when it is most difficult to pick. Also, sometimes the trader will encounter such large waves, that they mistake them for the tide and exit too soon. However, this is less of a problem than mistaking a strong backwash or a weak wave for a change in the tide.

The key to time frames is two-fold:

Firstly, be aware of the problem. No one ever solves the puzzle for more than a short time, but if they do not know the question, they are not even aware that an answer needs to be found.

Secondly, trade the market rather than try to predict it. Trying to forecast or predict market moves is one of the most dangerous mind games traders can try to play in the markets. For one thing, predictions tend to stop them thinking. Traders must be open-minded at all times and receptive to all evidence. Remember that humans are really good at one thing - selecting only evidence that supports what they want to believe. It is called rationalising. The other aspect is ego. Once traders make a prediction, especially if it is a public one, they begin to defend their prediction, because they have attached their ego to it. So, once the trader begins to even dabble with the prediction game, they are setting themselves on the slippery slope to losses. It is for this reason that a second tactic is to *never discuss trades while they are open*. Like all the other rules, if the trader breaks this one from time to time, most times they come to regret it.

The third tactic is to *trade only from the individual stock charts, rather than the market indices*. This is not to say that the trader does not analyse the indices and watch overseas markets, commodity prices and interest rates. However, this is all background. They should take decisions only on the evidence of the stock chart. The rationale here is again related to the psychology of rationalisation. It is all too easy to take a position that goes bad and to justify to holding it because the general market looks good. Good stocks can do well in bad markets, but a bad stock will rarely be saved by a strong market and, more importantly, there will always be better stocks for the trader to have their money in. Holding a marginal stock in a good market is just trying to protect the trader's ego - remember the concept of opportunity cost. Time trades on technical evidence. Be consistent in only changing the position on technical evidence. Market lore: never fall in love with a stock.

The fourth tactic is to use a *trade size minimum of 5% of equity and maximum of 10% of equity*. This is a trade-off of risk and reward. Use the concept of diversification from portfolio theory to reduce specific risk. Thus the more non-correlated positions held, the lower the specific risk. However, the reduction in specific risk becomes less and less as the trader diversifies and the optimal point is somewhere around eight non-correlated positions, after which the reduction in specific risk is not substantial. However, we have to bear in mind that all stocks are at least partially correlated, so a little more diversification is needed than this optimum. By setting my number of positions between 10 and 20, is to be on the conservative side of the optimum. This is the risk side of the trade-off.

The reward side also is important. This invokes a concept that I learned from an excellent little book called *The Zurich Axioms - Investment Secrets of the Swiss Bankers* by Max Gunther (everyone should read this book). "The First Major Axiom" is "On Risk: Worry is not a sickness, but a sign of health. If you are not worried, you are not risking enough." This is further broken down: "Minor Axiom 1. Always play for meaningful stakes" and "Minor Axiom 2. Resist the allure of diversification". What this means is that the size of the position must be such that success will make a noticeable difference to results. If the trader over-diversifies, they do not reduce their specific risk much more, but guarantee that they will have mediocre results. So, diversify only enough to make specific risk tolerable and then go for a meaningful gain when right.

This is very important. If the trader holds too many stocks, their result will resemble the market overall, but not much better. If this is all they want, do not waste time trading, other than with play money for entertainment – put the rest in an index fund.

However, like everything else it is a trade-off. This little trade-off is part of an even larger trade-off. The larger trade-off is that the trader's primary concern must be preservation of capital. If they lose all their capital, they are out of the game. They do not have to lose all of their capital to have a problem though. If they lose 20% of their capital, they have to make a 25% return on the remaining 75% to just get back to where they started. It gets worse: If they lose 50% of their capital they have to make 100% to make it up. If they lose 90%, they have to make 900% to get back what they lost. Therefore, once they get anywhere near a 40% erosion of capital, there is not much realistic chance of recovery in the short term. Moreover, if traders start taking the risks necessary to recover, there is a strong likelihood to near certainty that they will go completely broke. This is all part of the complex area of risk of ruin, the theory of runs and so on. What it leads into is the fifth tactic, which is to *only take trades where the technical stop loss is less than 2% of equity*.

By restricting loss on any one trade to 2%, it gives the trader a chance of staying in the game. In futures, currency and options markets, the percent risk to equity on any one trade should probably be less than 2%.

This idea of risk to total equity is absolutely vital to trading performance. The way to use it is to only take a trade where the risk is under this threshold. If the resulting position size is less than 5% of equity do not take the trade, or look for an entry with a lower technical risk.

The sixth tactic is to *take losses immediately at the technical stop loss point*. Traders should always know where they are wrong technically when they take a trade. If they are wrong, they have already decided where they should cut their loss. If there is a secret to taking losses, this is it - make the decision on taking a loss before becoming emotionally involved in the trade. Then just execute this decision if things go wrong. The stop loss point is always a technical failure point. If the risk to such a point is too great, do not take the trade.

This leads into my seventh tactic, which is to *set protect profit stops at logical technical fail points*. The thinking is the same here. With both stop loss and protect profit stops, there is always a temptation to put your stop above a technical stop point because that is the greatest loss or erosion of profit that you can tolerate. Just remember that the market does not care what the trader can or cannot afford. It is driven by what others can afford and their pockets are usually deeper than the trader's. If in such a situation, either reduce the size of the position or do not take the trade at all. There are plenty more fish in the market sea.

Coupled with the above is a critical eighth tactic: *never lower a stop - stop loss or protect profit*. The first loss is always the smallest loss. If wrong, get out and try again. Lowering a stop is breaking a rule and sets traders up for some seductive random reinforcement therapy from the market. This therapist charges very high fees, called losses.

The last tactic is *to sell immediately a stop is hit - at the market*. Do not trade illiquid markets. If a stop is hit, exit at the market - always. Trying to finesse the last cent is called greed and again sets the trader up for some random reinforcement. If the trend is over, get out now. If wrong, get out even sooner.

## Final Thoughts

I would like to leave three final messages:

Firstly, selling right is more important than buying right. No profit has been made till it has been taken. However, profits will not mount up unless they are allowed to run - another of the trade-offs that make market decisions so difficult. So, how does the trader resolve it? The best way is to rely only on technical trend analysis. Stay with the trend, but get out when it is clearly over. This will rarely be the top price - only liars sell at the exact top. There is a big difference between letting profits run in an uptrend for further gains and letting them run after the trend is over, hoping to get back to the top, where the trader wished they had sold. Any asset has only one value - what it can be sold for – that is what someone else will buy it for. That it has sold for a higher price before has nothing to do with its present value. The only decision is whether the trend is up or down. If up, it may be possible to sell at a higher price. If down, the likelihood is that only a lower price is waiting. Most people put all their effort into buying. Successful traders put most of their effort into the selling decision.

Secondly, many people ask how is a beginner to learn? While there is really no substitute for experience, the learning process can be speeded up.

If a trader wanted to learn how to run a business, should they ask a successful business man or a bankrupt? In markets, psychology of trading, technical analysis, money management and trading strategy - there are a lot of books out there to study. Many of these are written by people who are successful traders or who are good coaches of traders. Many beginners tell me that a book is too expensive at $100, or a course is too expensive at $1000. Yet when I enquire about their trading experiences I find that their annual losses may be many thousands of dollars and their average loss some hundreds of dollars. These are the tuition fees they are paying already to learn by unguided experience. Yet they tell me that guidance from experts is too expensive at a fraction of that cost.

Go to courses that seem worthwhile. Sometimes it will be a waste of time and money, and sometimes it will be a pleasant surprise. It is rarely possible to tell in advance. Buy even more books. A book is worth its price just to get one good idea from it.

But more than that: teach. Teaching is a remarkable experience. I have had the experience of setting out to lecture a subject that I had just obtained a very high mark in. I thought I knew the material pretty well. What I found is that I did not understand it even half well enough to teach it. Teaching is a discipline for really understanding your subject matter. I sometimes think that I have got so much out of a teaching experience that I should offer to pay the students - that is not an offer!

Thirdly, trading is an intensely personal experience. I have told you above what I understand to be something of the shape of the road and where some of the pitfalls are. However, each trader is different and must find their own pathway to successful trading. They can learn from others, but copying them will not work. Traders all bring to the market a mixture of attitudes to all manner of issues, different personalities and different tolerances for risk. They are different ages and have different assets and liabilities. It sometimes frightens me when people say that they just want to know what a successful trader does so they can do it too. It is not that easy. What is comfortable for one trader will not fit them in every respect. Moreover, just like teaching, it is the process of understanding themselves in developing their plan that is important, not the plan itself.