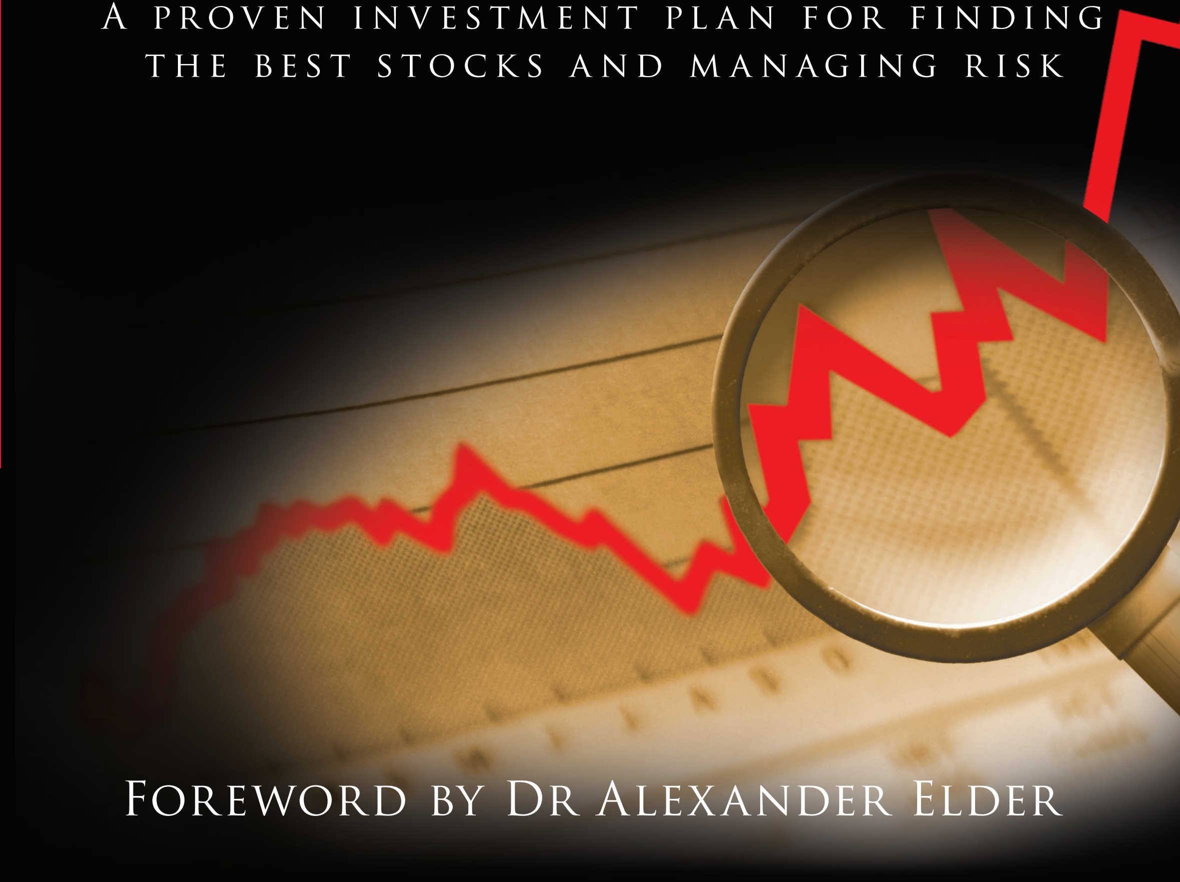
Colin Nicholson

Building Wealth in the Stock Market

A proven investment plan for finding the best stocks and managing risk



Foreword by Dr Alexander Elder

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For Rosalyn

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All charts were produced using Insight Trader charting software. See <www.insighttrading.com.au> or phone Bernard Chapman on +612 4751 2932.

The data used to draw the charts was mainly supplied by Insight Trading Pty Ltd and Vestdata. See <www.vestdata.com.au> or phone +613 9768 9611. Some of it was augmented by or sourced from ASX publications and website, *The Australian Financial Review* and <www.yahoo.com>.

Fundamental information used in the assessment of stocks was sourced from *Shares* magazine, *AFR Smart Investor* magazine, *The Australian Financial Review,* the Aspect Huntley research section of the CMC Markets Stockbroking website <www.cmcmarketsstockbroking.com.au>, various company annual reports and websites.

Some of the material in this book has previously been published in the same or similar form in:

- My books *Hot Stocks 2007* and *Hot Stocks 2008*.
- My book *The Aggressive Investor*, which was published in 2005.
- My videotapes/DVDs *How to Design a Trading Plan* and *Building Wealth through Shares* and in the seminar notes that accompanied them.
- Research Reports No. 1 and No. 2, which I self-published before making the videotapes/DVDs.
- Articles in the Australian publications *AFR Smart Investor*, *Shares* magazine, *Shares Charting Guides*, *Your Trading Edge* magazine, the *ATAA Journal*, the *ATAA Newsletter* and the Stockwatch page on the Ozemail website.
- My website <www.bwts.com.au> and my free newsletters.
- The subject notes for FIN231 Technical Analysis, which is part of the Kaplan Master of Applied Finance (originally the Securities Institute of Australia's subject E114 Technical Analysis, which was part of the Graduate Diploma in Applied Finance and Investment).

About the author

Colin Nicholson BEc, FSIA, investor and author

Colin has a bachelor's degree in Economics from Sydney University and the Graduate Diploma in Applied Finance and Investment from the Financial Services Institute of Australasia (FINSIA).

For many years, he taught both fundamental and technical analysis for FINSIA (now Kaplan) and was judged Outstanding Presenter for 1997 by student feedback. In 1995 he was made a Senior Fellow of FINSIA.

The Australian Technical Analysts Association made him an honorary life member in 2001.

Since the late 1960s, Colin has invested in stocks on the Australian market. This was a part-time occupation until April 1987; since then, he has earned his income from investing, writing and teaching.

Over the last decade, Colin has written weekly columns in *The Australian Financial Review* and *BRW* magazine. He has also written regularly about technical analysis and investment psychology for *AFR Smart Investor* magazine, *Shares* magazine, the *Shares Charting Guide*, his own email newsletter, his website <www.bwts.com.au> and the *ATAA Journal.*

Most of Colin's time is now devoted to investing and writing for his free newsletter and his website. He also accepts a limited number of public speaking engagements.

Important notice

This book has been written for the sole purpose of teaching investment techniques. It neither purports, nor intends, to offer advice to any reader to invest in any specific financial product, or to use any investment method.

Readers should not act on the basis of any matter in this book without considering their own particular circumstances, taking professional advice where appropriate.

The decision to invest is for the reader alone. The author expressly disclaims all and any liability to any person, in respect of anything, and of the consequences of anything, done, or omitted to be done, in reliance, whether whole or partial, upon any part of this book.

Colin Nicholson is not a licensed adviser. His writing and speaking opportunities are totally focused on educating investors. Colin does not give either specific or general advice as defined in legislation.

All investing entails risk of poor returns and/or loss of capital.

Past performance should not be regarded as evidence that any particular method will be profitable in the future.

Foreword

A lifetime of knowledge

The recent bear market has been a tremendous destroyer of wealth. The mass media, which acted as a cheerleader during the rising market, has now turned to arm-wringing and rending its garments in fear. It is time to put emotion aside and listen to intellect. This is the atmosphere in which Colin Nicholson's book sounds its key themes: trading is a serious business; here are its essential rules and techniques; this is how you should search for value in the stock market.

One of the key differences between professionals and amateurs in the stock market is the extent of their memories. Amateurs remember only recent events — this is why there is a lot of happy optimism near the top and fear and paralysis near the bottom. Professionals, on the other hand, know that bear markets create terrific buying opportunities. Great investors like Warren Buffet become essentially inactive during mature bull markets but eagerly scoop up bargains in bear markets.

Colin Nicholson brings a professional perspective to the enterprise of building wealth in the stock market. Winners think differently, the risks to be controlled, selecting stocks to buy, managing investments — these are the key chapters in his book. Colin is amazingly open about his own performance. He shows you everything, from his personal returns to his research screens and tools to the size of his trading account.

The encyclopedic sweep of this book is quite amazing. Colin begins with a discussion of trading psychology, spelling out in six brief chapters the requirements to succeed as an investor. Several chapters are dedicated to managing risk. You may have a brilliant trading system, but without proper risk management any system is guaranteed to fail. I enjoyed Colin's discussion of how one's taste for risk diminishes as the size of one's account increases. He also describes his favorite analytic tools: Dow phase analysis, the Coppock indicator and trend analysis.

Some two decades ago, I described the concept of 3 Ms: Mind, Method and Money (psychology, market analysis and risk management) as the foundation of trading success. Colin came to some of my early classes and eventually helped with some of my traders' camps. I am glad to see that in his book he did what every serious trader must do. He listened, tested key ideas, and then modified them to suit his own temperament and style to come up with a strong working system of his own.

About half of Colin's new book is dedicated to trading examples and case studies, showing you how he implements his rules and techniques. His stock charts span many years, but a shorter-term trader can look for similar patterns on his or her daily charts.

It is shocking how many books come out without quoting any sources. An honest author remembers his debts to others, and I always enjoy listing the works I learnt from in my own books. Colin's list of recommended reading is a terrific resource both for a junior trader looking to learn key concepts, as well as for an experienced trader who wants to round out his or her market education.

Colin has written a serious and helpful book, kind in its attitude, broad in its scope, and practical in its advice. If you have an uncle in the trading business who is willing to put aside his work and show you the ropes, you might be able to skip this book. For the rest of us, who learn and struggle to make our way in the stock market, Colin Nicholson's new book is an invaluable resource.

Dr Alexander Elder
New York
January 2009

Introduction

Aim of the book

Building Wealth in the Stock Market has been written for private investors who have saved or inherited a significant sum of money which they wish to invest and manage themselves.

I begin by setting out the ways winners think about investing, which is different to the ways beginners think. That discussion is followed by a complete explanation of my investment plan. It explains what risks I am trying to manage in my investment activities and how I go about managing them. It is centred on the simple big idea that I use, which should achieve a better return than passive investing.

Building Wealth in the Stock Market is suitable for both beginners and for more experienced investors. It is written as simply as possible using a minimum of jargon terms, making it easy for beginners to understand.

My complete investment plan and all of my methods are set out in this book. I do not have more secrets to divulge, nor will readers need to do an advanced course.

While the greater part of the book is taken up with explaining the plan, there are examples and case studies which show how I apply the plan in specific investment situations. The case studies are all actual investments that I have made. While I reflect on them in hindsight, I have tried to reconstruct them as I saw the situations at the time. I have explained why I made decisions in the course of managing the investments.

The case studies are a unique part of the book, where the ideas are brought to life by describing my thinking as I actually made real investments. Their particular advantage is that they record my thinking as the chart unfolded for each investment. They focus on how an investment is managed, which is probably the most difficult aspect of the investing process.

Why I wrote *Building Wealth in the Stock Market*

People from all walks of life are attracted to the idea of building their wealth in the stock market. While some succeed, the sad fact is that most of them fall well short of attaining their objective. This is often because they have several important weaknesses:

- insufficient capital
- lack of knowledge and experience
- lack of a viable investment plan
- lack of sound decision-making skills
- poor or non-existent records
- a failure to learn from experience.

The end result is that, through ignorance, they take on too much risk. This makes it highly likely that their sweet dreams may become nightmares.

However, their efforts do not have to end badly.

In this book, I will explain what is needed to succeed. I will show my investment plan, which I have developed over 40 years of investing in the Australian stock market. It is based on sound principles of risk management that bias the game in favour of the investor.

I will explain the various types of risk and outline strategies for managing them. Most importantly, my investment plan does not stop at explaining how to find good stocks. It recognises that managing investments through to the point at which they are sold is far more important. I outline clear tactics in the form of action rules and guidelines. These are the basis for a disciplined approach to investment decision-making.

For many years, I have advocated the importance of the idea that investors need to develop their own investment plans. They need to do this because everyone comes to investing with different attitudes, beliefs and tolerance for risk. Unless the investment plan we adopt is consistent with our personality, the inevitable conflict will lead us to unconsciously sabotage the plan. This is not to be underestimated. Indeed, the longer I work in this area, the more I respect this idea. For a long time I was therefore reluctant to teach my specific investment plan. It is appropriate for me, but not necessarily for others.

Investors started to come to me and say that they accepted the idea of needing an investment plan. They also said that they accepted that they had to do this for themselves. However, they had a problem. When they took a blank sheet of paper onto which to write their plan, they had no idea how to start. Nor did they know what should be included before they could consider it to be complete.

I could have chosen to teach a purely theoretical approach to the development of an investment plan. However, it seemed a better idea to use my own investment plan as a model. My investment plan is built around the core problem of managing the various kinds of risks. It shows how I have gone about managing them. However, my investment plan should not simply be copied. It must be adapted, as necessary, by each reader, because all of us are different in some important respects. Readers will have to manage the same risks, but will need to vary the methods for doing so to fit their own temperament.

In late 1999, I began teaching my investment plan in weekend seminars around Australia and in New Zealand. During 2000 and 2001, I also had the opportunity, through association with Dr Alexander Elder, to teach at trading camps in Fiji, Vanuatu and the Dominican Republic. I also taught a one-day intensive version in New York in June 2000, which was videotaped and sold in the US, Australia and New Zealand. In late 2001, I also teamed up with the late Neil Costa, Tony Plummer and Garnett Znidaric to run an Australian traders and investors' camp at Terrigal in New South Wales. This full version of the seminar was also videotaped and later converted to DVD. The DVD is no longer available, having been replaced by my books.

My objective in teaching the seminars was to refine the way to present the material I had. I am greatly indebted to Dr Elder for the opportunities he gave me and also for the feedback freely given by dozens of seminar students. By the end of 2003, I felt ready to write my first book *The Aggressive Investor*, which was published in 2005.

Since then, I have invested through a very strong bull market and into a nasty bear market. My plan has held up well through this cycle. Only a few minor aspects of my investment plan have been modified. However, I have worked to improve the explanation and presentation of my methods throughout the book.

The most significant adjustment to my investment plan is that I now analyse the market almost exclusively from weekly and monthly bar charts. The advantage in this is that it helps to avoid reacting to short-term patterns which are not relevant in my time frame. I would like to thank all the readers who sent questions which helped me refine my methods in this respect.

The other important change has been to add the debt-to-equity ratio as an explicit guideline in my plan. The bull market from 2003 to 2007 has reminded us all of the devastating effects of high levels of debt. Most investors had forgotten this lesson from the 1980s, but it has been drummed into them again this time around.

Therefore, very little has changed in my investment plan since I wrote *The Aggressive Investor*. Nevertheless, time has meant that the examples and case studies are no longer current. While this is not important because the plan I am explaining is based on timeless principles, most people relate better to recent examples.

My book is the product of many years of study, research and experience in developing and applying the plan, with examples and case studies that are drawn from recent market history. It is also the product of several years of honing the presentation of the material, so that it is accessible to beginners through to old hands.

I have learned many things from Dr Elder since I first encountered his material in the mid 1980s. His students will see much of his teaching adapted and applied in my approaches to money management in particular. However, one thing he often talks about echoes loudly in my own experience: that an investment plan is never really complete and final. There are always better ways to do things and markets may change over time.

My approach to this is to try to keep an open mind at all times. I study, test and evaluate each new idea. Then I incorporate those ideas which add value to my methods. I discard those which do not add value to what I do or the way I do it. This is really an analogy to the golden rule of investing: let the winners run and cut the losers quickly.

This book represents my present thinking, but it does not mean that I have found the ultimate secret of investing. Nor does it mean that readers cannot improve on it. They can, and I encourage them to do so.

Sir Isaac Newton said in a letter to Robert Hooke in 1675 that 'if I have seen further it is by standing upon the shoulders of giants'. In developing my investment plan, I have been fortunate to stand on the shoulders of the giants who wrote the great books on investment. It is my hope that readers can start their journey from my vantage point. I hope readers find the journey as rewarding as I have, financially, intellectually and creatively.

DIFFERENT MARKETS, DIFFERENT TRADITIONS

One issue which has to be addressed in writing about investing in stock markets is that there are many subtle differences around the world. These have a cultural and historical basis.

It is important to bear in mind that I am setting out to teach an investment plan which is based on universal principles that have been tested and applied to a wide range of national stock markets. The examples I use are only a means to teach those timeless and internationally applied principles.

All of my experience has been in investing in the Australian stock market. In world terms, it is a small corner of the stock market universe and it has its own traditional terminology and regulations. However, this should not be a problem for the thinking reader for these reasons:

- I learned almost everything I know from the great investors and writers in the US stock market. In the US stock market, a company is referred to as a stock. Australians most commonly refer to a company as a share. However, the term stock is well understood from contact with US books and wide contact with US media. In *The Aggressive Investor*, I called them shares. In this book I call them stocks, because that is the term used in the large markets of the world and it is equally well understood in Australia.
- Nevertheless, that is the easy fix to the question of making the book understood by an international audience. Ideally, I would then include examples and case studies from other world markets. However, this is a problem, because I have always confined myself to talking about and teaching things with which I have had personal experience. I feel that sticking to that policy maintains the integrity of the book as my own investment plan, rather than a theoretical discussion.

Some other areas of potential difficulty are discussed below.

STOCK PRICES

Australian stocks are priced in dollars and cents. That will be far more comfortable for international readers than it was not so many years ago when US stocks were traded in points, eighths and so on. Nevertheless, there is an adjustment that overseas readers will need to make. Australian stock prices are traditionally much lower than US stock prices. There is an easy way to deal with this. Readers who are more familiar with US stock prices could simply mentally multiply an Australian stock price by 10.

So, if I show a chart of a stock for which the price has ranged from $1.00 to $10.00, a reader who is more familiar with US stock prices could mentally translate that price range into $10.00 to $100.00.

DATES

Different countries have different conventions about the way dates are written. In Australia, as in the United Kingdom, dates are written in the form day/month/year. In the US, dates are written in the form month/day/year. This can make for confusion. I have used the Australian convention, but the dates will be spelled out to minimise this confusion. For example, the tenth day of May 2009 will be written as 10 May 2009. However, in the top right-hand corner of the charts in the Insight Trader charting software that I use, which is created for the Australian market, the start and finish dates of the chart are in the format DDMMYY. If readers find this a problem, that part of the chart may be disregarded. The time scale on the horizontal axis will be clear, because the month names will be in text; for example, November will be shown as N or as Nov.

SEASONS

In the southern hemisphere, the seasons are the opposite of the northern hemisphere. I will avoid any confusion in this area by referring only to months by name, not to seasons.

LANGUAGE

This is a tough one. English is spoken throughout the world, but there are many variations in spelling and word meanings. While I will try to avoid the obvious problems, I will be using Australian spellings and meanings of English words. Where I am aware of differences in meaning, I will attempt to put the US equivalent in brackets.

Currency

The US has a rich vernacular for the names of coins. Some of these will conflict with the UK names and the old pre-decimal Australian names. The US market refers to a dollar as a point. To avoid all confusion in this area, I will refer only to dollars and cents, which will be unambiguous in most jurisdictions.

Weights and measures

Australia, like most of the world, uses the metric system. This is not well understood in the US, which has its own derivation of the old British imperial weights and measures. To the maximum extent possible, I will avoid these terms in the book.

Jargon

All markets have a multitude of industry jargon terms. It can at times be difficult to avoid using jargon, because it is a form of shorthand which is ingrained in our common usage. I will try to minimise my use of jargon. Where I cannot avoid using it, I will endeavour to explain terms when I first use them.

Taxation

Taxation systems vary enormously from country to country. These systems also have a rich vocabulary which has grown up over time. As far as possible I will only be talking about pre-tax returns, thus avoiding the issue. However, where it is unavoidable that I refer to the Australian taxation system, I will endeavour to explain the terms used when I first use them.

CHAPTER 1

SETTING THE SCENE

There are many financial markets around the world, on which are traded stocks, bonds, currencies, financial and commodity futures and much more. Although the principles of analysis and investment are generally held to be universal, there are important differences, most especially in types and levels of risk. Since my experience is in the stock market, that will be the only focus of this book.

SPECULATION VERSUS INVESTMENT

There is a great deal of confusion about terms describing activity in the stock market. This confusion seems to be a large problem when people describe what they do as 'trading'. When that term is used, we will not know what they mean until we ask further questions. What kind of securities does the self-styled trader deal in? Does the trader's market activity involve the risking of capital to harvest many small gains? Or does it involve buying stocks in sound businesses in the expectation of low-risk accumulation of capital while reaping a dividend stream? At these extremes things are fairly clear, but in between there is a large murky area where the two activities are intertwined in many people's minds to a greater or lesser extent.

These issues were discussed by Benjamin Graham in his book *The Intelligent Investor*. I have found that the ambiguity of the term 'trading' can be clarified by falling back on the terms he used: 'speculation' and 'investment'. However, this is not a perfect answer. Perhaps there will never be an absolute solution to the issue. It is therefore important that I define exactly what I mean by these terms, so that my use of them in this book is clear.

If I say that I made a successful 'speculation' in a stock, my audience is likely to think that I bought a stock and later sold it for more than I originally paid for it. Or that I sold it short and later bought it back for less than I paid for it. People who buy and sell stocks in this way are essentially risking their capital with the aim of increasing it. Any dividends they receive are almost incidental and rarely mentioned. This activity is most usefully described as speculation.

If I say that I made a successful 'investment' in a stock, my audience is more likely to think that I bought a stock that paid me a good dividend stream and increased in value over the time I held it. In other words, I bought part-ownership of a business that was successful over time. People who purchase stocks in this way will be primarily concerned with preservation of capital, while earning an income stream and hopefully seeing their capital grow. This activity is most usefully described as ***investment***. Investment, as I use the term, will not involve short selling.

I have chosen to use the terms speculation and investment rather than trading and investing, to try to clarify things. However, if readers prefer the term trading, that is fine, just substitute it for speculation when I use that term.

The long-term average return from Australian stocks has been about 12 per cent per year. Over the long term, 4 per cent of this return was from dividends and 8 per cent was from capital growth.

These numbers will vary for other markets depending on the methodology used, the time period chosen and the nature of the market. For the US stock market, the total return over the last century has been about 9.6 per cent per year, of which 4.5 per cent was from dividends and 5.1 per cent was from capital growth.

When people hold stocks for more than a few days, weeks or months, their focus is likely to be on the total return from both capital growth and dividends. These people are best described as 'investors'.

This book is about investment. While many aspects of it may be usefully applied in speculation, there are important differences between these two activities in the stock market.

ACTIVE VERSUS PASSIVE INVESTING

When I first set down my investment plan, I wanted to emphasise that my investing method was the very opposite to a passive investment approach. I described this as aggressive investing, because, in general industry usage, that was the opposite of passive investing. In fact, Benjamin Graham used it in that sense in *The Intelligent Investor*, so it had an excellent pedigree. However, rather too many people exist outside the industry as private investors and so were picking up another general use in everyday life which meant that I had an aggressive temperament as a person. Instead, I had used the term as meaning that I used an investment style that was the opposite of passive. I am therefore going to refer to my investment plan as being an 'active' approach.

In my ***active*** investing method, I am seeking to be fully invested in stocks through most of a bull market and to be fully invested in cash through most of a bear market. This is called '***market timing***', and is not easy to do. I will explain in a later chapter what is involved and how long it will take most people to become proficient at this.

Active investing is usually castigated by professional fund managers. Their argument is that, if investors are out of the market on the 10 best days of a bull market, their long-term return is seriously damaged. However, these fund managers are talking their book: they want investors to leave their money in the fund long term.

What they say is true as far as it goes. However, a moment's thought will suggest that if we are out of the market on the 10 worst days of a bear market, our long-term return will be significantly better.

What I am attempting to do as an active investor is to be in the market when it is rising and out when it is falling. As we will see later, that can work very well.

This does not mean that ***passive*** investing, which is called '***time in the market***' in industry jargon, is an inferior approach. For one thing, it is much easier to do than active investing. While it still demands investment knowledge and skills, it is a generally safer approach. This is because, if it is properly carried out, passive investing is strongly focused on preservation of capital in the selection of stocks for a portfolio. The long-term upward bias in stock markets also works in favour of passive investors, because stocks in good businesses will tend to rise again after a cyclical fall.

Active investing is also strongly focused on preservation of capital. However, the timing aspect means that in order to pursue greater capital growth and strong dividends, many more decisions must be made. This means that there is also more opportunity to make bad decisions.

Of course, ***taxation*** is an overwhelming consideration for many private investors. This may bias many of them towards the passive approach to investment. Then again, focus on taxation also leads passive investors to make poor decisions sometimes, such that minimising tax means capital is lost. It always tends to cut both ways.

My approach to the taxation issue is simple. Start with the proposition that investing is a business. We are in it to make a return on our capital. If we did that by owning a whole company, we would know we have to pay tax on our profits. Is this any different if we are only part-owners by buying shares in the company?

So, my suggestion is to set up our affairs in the lowest tax environment that is legally and economically available to us. Then set out to maximise our investment return. No matter what rate of tax we end up paying, a tax bill of a million dollars is always better than a tax bill of half a million dollars because it means we made more profit.

ANALYSIS VERSUS INVESTING

Professional funds management companies employ people to analyse stocks or the market. They employ other people to make the investments and to manage the portfolio. Successful private investors will generally be carrying out both functions, so they will require two different types of skills:

- ➢ The formation of an opinion about the market or about a stock. We call this 'analysis'.
- ➢ The execution of buying and selling strategies, including money management. We call this 'investing'.

The skills of analysis and investing are different and many find it difficult to be good at both activities. One reason for this is that the two processes have quite different objectives:

- ➢ Analysis is trying to get each view about the market or a stock correct. With their reputation at stake on each recommendation, analysts will be trying to get every recommendation right. This book will use some analysis techniques, but only as a means to an end, which is investing.
- ➢ Investing is trying to make a net return from available capital. The return from each individual stock is not of critical importance. Rather, the investor's focus is on the net return on the capital over a period.

I regard myself as an investor first of all and an analyst as a distant second, even though I have spent a great deal of time learning a lot about analysis. The whole focus of this book is on investing.

Analysis tends to attract people who lean towards being perfectionists, who like to unravel mysteries or solve puzzles and who have great patience in collecting, analysing and synthesising information. Good analysts learn a great number of techniques. They know how to apply them to different situations, trying always to fit the tool to the task. They tend not to form views on the market lightly and tend to hold to them strongly once formed. They dislike being wrong. They gravitate to complex and intricate analysis processes.

Investors take analysis as a starting point for making their investment decisions. They have a strong focus on results and work hard on their decision-making skills. Good investors tend to have a few models with a high probability of success. If a situation does not fit one of the models, investors can simply pass it up. Compare this to analysts, who may be required to analyse any situation. Investors like putting strategies and tactics into effect and playing the game by adjusting tactics as necessary to win. They accept that each foray into the market will not necessarily be successful. Instead, they are concerned about their net results at the end of the investment period. They are comfortable changing their opinion quickly and as often as the market proves them wrong. They tend to use simple but robust decision processes.

It is not surprising that some people make good analysts and poor investors. Others make good investors, but poor analysts. This is why a large institution will look for different people to perform analyst and portfolio manager roles. The skills of the different personality types are put to work in the roles for which they are most suited.

However, the private investor does not generally have this luxury and must carry out both roles. It is therefore important for private investors to understand which personality type they tend towards. They should then try to make the necessary conscious adjustments in habitual behaviours and to adopt methods that help overcome natural biases.

It is especially important that the private investor realise that analysis is only one part of the investment process and not necessarily the most vital part. Private investors who have a penchant for the analysis role, and who seek to also take on the investing role, will face a problem. They are going to have to discipline themselves to simplify the analysis and work consciously on the portfolio management problems. Their focus here should be primarily on strict money management and the psychology of the investing decision-making process. Having a sound investment plan is an essential way to achieve this.

Fundamental versus technical analysis

Analysis of stocks is often divided into two broad disciplines, known as fundamental analysis and technical analysis. Both have the same objective, which is to form an opinion about a market or a stock. They simply approach the problem from a different perspective.

Fundamental analysis approaches the problem by attempting to estimate the ***intrinsic value*** of a company. If we then divide the intrinsic value of the company by the number of stock units that the company has issued, we have the intrinsic value of each stock. Conventional wisdom indicates that the price of a stock that is selling for less than its intrinsic value should rise, whereas the price of a stock that is selling for more than its intrinsic value should fall.

Intrinsic value is estimated with reference to the factors that should affect the future earnings of a company: sales, margins, capital structure, management, competition, industry outlook, government policy and economic outlook, to name a few. The fundamental analyst thus studies the factors that affect prices, or changes in prices, of stocks.

A problem with fundamental analysis is that it assumes that information is disseminated perfectly and that it is acted on rationally, rather than emotionally. Practical observation of markets suggests that these assumptions do not necessarily hold in the real world, particularly in the short term. However, it is generally accepted that prices will move as indicated by intrinsic value over the longer term.

Many private investors are put off by fundamental analysis. Why is this? Is it because it does not work? It cannot be that, because it is the mainstream method used by most professional analysts. It has been used by most of the stock market investors who have superior long-term results since Benjamin Graham invented security analysis as a discipline in the 1930s. So, we know it does work. There is very persuasive evidence that prices reflect earnings in the medium to long term.

Perhaps it is because it is difficult to do. This is more likely. Fundamental analysis requires a basic understanding of the dynamics of a business and how those dynamics are reflected in the accounting statements. There is nothing intellectually difficult about it. However, most people see a financial statement and their eyes begin to glaze over.

Need fundamental analysis be difficult? No, it does not need to be. Certainly, what the expert analyst does is very skilled. Professional analysts are trained to look into and understand the fine detail in the accounting statements. This is because they must have an opinion on any large company their firm covers, even when there may not be any clear conclusions to be reached from the data. However, for our purpose we do not need to make fine distinctions. We only want to know where the best investments are. We want a large margin of error. We want to paint with a very broad brush.

So, it does not matter very much whether the price we pay for a stock is 10 times or 11 times its earnings. There is little practical difference between those two calculations. The difference is a fine distinction that is best left to the experts. However, it does make a difference whether the price we pay for a stock is 10 times or 20 times its earnings. There is a big difference between paying 10 times earnings and 20 times earnings. We need to be able to see such big differences and know what they mean.

Likewise, it does not matter very much whether the dividend yield calculation arrives at 5 per cent or 5.1 per cent. However, it does matter whether the yield is 5 per cent or 10 per cent.

So, for our purpose we do not have to be all that precise about the data. We can use the crude data which is available in the newspaper or, increasingly, on the internet to identify opportunities.

Technical analysis approaches the problem by examining the market for a stock, as apart from the intrinsic value of the underlying company. The data from the market are primarily the price and the number of stock units traded, known as the 'volume'. Technical analysis is not concerned with the intrinsic value of the company, but with how the forces of ***supply and demand*** affect the price of its stock.

While they interact with each other, conceptually there are two separate markets. One is the market for an entire company. The other is the market for the stock of a company. The market for the entire company is most relevant in mergers and takeovers. The market for a company's stock is what investors are concerned with day in and day out. While the value of the entire company will impact upon the price of the company's stock, there can be significant differences, especially since control of companies is not an active market, compared to speculating on the price of the stock.

Fundamental analysis tends to the view that the price of a stock is directly related to the intrinsic value of the company underlying it. This is undoubtedly true in the long run. Technical analysis, on the other hand, recognises that there are short-term influences which shape supply and demand for its stock on the stock market. The price of the stock can therefore deviate significantly from the intrinsic value of the underlying company. The technical analyst therefore studies the effect of changes in the level of supply and demand for the stock itself, rather than the intrinsic value of the underlying company.

Technical analysis also recognises that information does not flow immediately to all market participants. Some people will know more than others about a situation. Alternatively, some people will make better estimates of future value than others. These people with better information or better insights will act on their view by buying or selling a stock on the market. Their activity can be seen on a price chart. In this way, technical analysts can often see changes in the balance between supply and demand, before the information that is driving it becomes generally known.

Technical analysis also recognises that people often act emotionally, rather than logically. It examines prices to detect changes in the balance of supply and demand. It also looks at how market participants react to price changes in the market. Some academics are now beginning to examine technical analysis as a way of looking at markets using a behavioural rather than simply statistical approach.

So, can using technical analysis be a way to avoid ever looking at fundamentals? Could we simply buy what is moving and forget value? Yes, we could. It might work most of the time. However, when it does not work is when it can do us the most harm. If the whole market is overvalued, it is a very dangerous place to be.

From all my experience, I have come to strongly believe that the best safeguard, especially in an overvalued market, is to be in stocks that have the least potential downside. They will be the stocks that are the best relative value. There is only one way to find them. That is with fundamental analysis.

Everybody who takes an interest in investing will encounter the antagonism there is between fundamental and technical analysts. Most people on both sides of this divide seem to take the view that they follow the only true faith and that those who use the other form of analysis are, at best, misguided. I am one of the heretics who believe that both forms of analysis have something to offer the investor.

To be successful, we need two things:

- ***Relative value:*** we need insights into whether a stock is undervalued or overvalued in the market. This we get from fundamental analysis.

- ***Timing:*** we also need insights into when the price of a stock is moving in the right direction and to know when it changes direction. This we get from technical analysis.

It seems obvious to me that we need both. If we lock ourselves into only one of them, we are giving up the insights that the other can provide.

This is not to say that we might not be primarily a fundamental analyst, or primarily a technical analyst. Whichever method we use as our primary type of analysis, we can always add value to our work from the other form of analysis.

Since timing is very important and my management of the investment is more important than stock selection, I am primarily a technical analyst. I use charts to find upward-trending stocks and to detect when the upward trend has failed.

However, this is not enough. The choice of company is also important to ensure that I am buying investment-grade stocks. I use fundamental ratios to find and select undervalued companies.

In conclusion, there is no inherent conflict between fundamental and technical analysis. We do not have to choose one over the other, as is advocated by many analysts of both persuasions. The two forms of analysis complement each other by adding value to the other. My approach is to employ the strengths of both.

Chapter 2

Winners think differently

The longer I spend investing and studying the stock market, the more convinced I become that an important reason why some people succeed and others fail revolves around the quality of their decision-making skills.

It is not how much they know, though knowledge is important.

It is not how hard they work, though nothing worthwhile is achieved without hard work.

It is not the depth of their experience, though one cannot become a seasoned operator without it.

The real difference is *the way winners think*. They have better decision-making skills than the average investor. This is what I believe makes them so effective.

In this chapter I will introduce the important ways of thinking, which I believe to be what separates the best investors from those who are yet to succeed.

Forget how much was paid

One mental hurdle that most investors never get over is a total focus on what they paid for an investment. The cost of their stockholding overwhelmingly dominates their thoughts. This means that they can never make any real progress towards being better investors. It blinds their thinking completely and they become trapped in the past. It blocks them from making a rational assessment of the present so they can move forward.

Anchoring everything in what was paid, rather than its current worth, is one of the best examples of the difference between the ways in which our untrained minds think naturally compared to the way the best investors think. Adopting current worth as a starting point is such an important idea that it has application beyond investing into many areas of our lives. Most successful people think this way about almost all of their problems.

The basic idea is this. We cannot change what has happened. We can only take decisions in the present and with regard to the future. This is a truly liberating breakthrough in the way we deal with problems.

Beginners buy a stock. Its price goes down. They agonise over what went wrong. One group blames others for what happened to them and revel in being victims. Others blame themselves and do great damage to their self-esteem and therefore their confidence to move forward. At the core of this natural reaction to a losing investment is that we all feel a loss more keenly than we enjoy an equivalent profit. We simply cannot get past agonising over the loss. We feel that we are trapped in the situation and there is no way out.

Winners tackle this situation completely differently. The only thing that we can change in making any decision is the future. What has already been spent cannot be changed. That money is gone. No matter how much the stock cost us to buy, it is irrelevant to what we do now.

In evaluating a losing investment, the only focus of good investors is how much the investment is now worth and what action will be likely to yield the best return from here onwards. The choice is always between three alternatives:

- Stick with the losing investment.
- Switch into another stock, which we judge will do better going forward.
- Sell the losing investment and enjoy interest from the cash we realise, while we reassess the opportunities ahead of us.

I have worked on this aspect of my decision-making for over 40 years and it is no longer a problem for me. I keep my stock portfolio valued every day at the closing price. While I have the cost in my records, it is extremely rare for it to be any part of my assessment of each stockholding. All I look at is the chart, to see if the uptrend is still intact. When the trend fails, I now know instinctively to sell without hesitation. This is the point all readers should work towards. Only when it is reached will they join the best investors.

DON'T PLAY WITH THE 'MARKET'S MONEY'

We have just seen how beginners tend to focus on how much they invested initially, rather than on the current worth of their investment. The end result is often larger ultimate losses, nursed by the self-deluding idea that a loss is not real unless it is realised by a sale.

A closely associated delusion is the idea that we can play with what some people refer to as the 'market's money'.

This situation arises when an investor, let's call him David, has a successful investment. Suppose David invests $10 000 in a stock which has a price of $30. The price then rises to $60. David's parcel of stock is now worth $20 000. This $20 000 comprises the initial investment of $10 000 plus a profit of $10 000. If David then sells the stock, he will have $20 000 to put in the bank.

Suppose that, instead of selling the whole parcel of stock, David sells half of the parcel. He will now have $10 000 to put in the bank and a parcel of stock that is worth $10 000. This is where the delusion comes in. Like most beginners, David would say that his initial capital has been recovered, which is true, and that what he is playing with, for free, is the market's money.

If David now has his initial capital back in the bank, and is playing with the market's money, what happened to his profit? Isn't the profit David's money? It cannot be both David's money and the market's money.

David is regarding his investment capital as his money, but the paper profits as the market's money. So, he will unconsciously take more risks with his profits than he would with his own investment capital.

Winners know that a profit is never real until it is in the bank. To regard it as the market's money is extremely dangerous. It is usually the first step to giving too much of it back.

The aim of investing is to make a profit. Profits are not easy to make. Winners treat profits exactly the same way as all their other investment money, whether the profits are realised or unrealised.

Make it strictly business

One problem beginners have is that they are investing more than money. They are investing their self-worth as well as their financial wealth in their investment decisions.

Winners look at investing rationally and dispassionately. For them it is a business, and a serious business at that. It is not a game, it is for keeps. Their investment decisions may sometimes have an element of judgement or intuition, but they never invest their ego in their decisions.

One professional speculator, who I know, always talks of his trades cooperating or not cooperating. Winners see their investments just as they see their other business decisions. Some opportunities lead to success and others simply don't work.

On the other hand, beginners tend to talk in terms of mistakes, implying that they did something wrong. When I talk to them about it they point to an investment that did not work out and apologise for their stupidity. They equate the outcome of their decision with their ability. Yet, over time, all of the great investors made investments that turned out badly.

The way out of this particular psychological trap for beginners is to change their mindset. They have to learn not to invest their ego along with their money. An essential aspect to this is that they have to change the way they think about the nature of investing. This is what we will look at next.

Focus on the bottom line

Table 2.1 shows two investment records. All the figures are dollar amounts. Investor A has all gains and no losses. Investor B has a mix of losses and gains. They both have the same end result. When you started reading this book, which one did you hope that you might become?

Table 2.1: investment records

Investment	Investor A	Investor B
ABC	+ 1 500	+ 200
DEF	+ 2 700	− 300
GHI	+ 1 100	+ 5 700
JKL	+ 1 400	+ 300
MNO	+ 1 800	− 200
PQR	+ 1 400	+ 100

Investment	Investor A	Investor B
STU	+ 1 500	+ 9 800
VWX	+ 1 000	– 700
YZA	+ 1 300	– 200
BCD	+ 1 100	+ 100
Net total	+ 14 800	+ 14 800

Inexperienced investors generally choose Investor A as their model. They do not yet understand the reality of investing. It is simply not possible to consistently win on every investment.

My whole experience is that all the net profit for a period comes from a small number of investments I make. All the other investments are, or should be, small losses and small gains that cancel each other out.

Those who are looking to be like Investor A are behaving like an analyst. Analysts try to be right each time they analyse a situation. These investors are seeking to be right with every investment. Now, it is correct to try to be as good an investor as we can and to make as good a return as we can. However, we have to do that in a realistic way.

The reality is that investing is about assuming risk and about what happens in the future. If it was possible to be right every time, there would be no risk and therefore no profit opportunity. The true nature of investing is that there will be investments that succeed and there will also be about the same number that do not succeed. The name of the game is to win more when an investment works for us and to win overall, but not to expect to win on every investment.

Investor B is a realistic investor. The realistic investor relentlessly cuts nonperforming investments and allows the few good performers to build into big profits.

Most beginners do the exact opposite to the realistic investor. They take profits early and ride losses until they cannot tolerate them any longer. Until taking losses ceases to be a problem for a beginner, that investor will not be able to become one of the winners.

The reason why beginners do the exact opposite to what the winners do is discussed in the next section.

RESIST DOING WHAT SEEMS NATURAL

There are many situations in investing where the best results are derived from acting in the opposite way to what is intuitive, based on our natural reaction to threats or our learned reactions in other spheres of our lives.

A simple example is the successful entrepreneur who comes to stock investing. Success in business has taught the entrepreneur that profits result from careful planning, taking risks and persevering in the face of adversity. In business, this works because success comes from hard work and persistence, often in controlling situations by force of personality or determination. However, these people often fail in the markets.

It is important to do the hard work in analysis and planning, which they do. However, where they come unstuck as investors is in persisting with a losing position. This is generally futile, because it is impossible for any one person to control the markets, no matter how determined and persistent the investor might be. The markets are just too big. No matter how much effort is applied to the situation, the markets are beyond control by these means. In business, not persisting with an idea that does not work initially is seen as weakness. However, in the stock market, quickly cutting losses on a risk that is not working out is one of the most important requirements for successful investing.

When faced with a loss, most people will grasp at any reason to hang onto their investment in the hope that it comes good. However, when presented with a profit, those same people will grab it quickly. What actually works in investing is the opposite. We should cut losses quickly and let profits build.

This method is based on some simple logic. Over a large number of investments, most of them will result in small profits or small losses. These tend to cancel each other out. However, there will be a small number of large losses and a similar small number of large profits. In other words, profits and losses will be distributed in a so-called normal distribution in the shape of a bell curve.

If we adopt the policy of never letting losses become too large, we can cut off the tail of large losses on the bell curve. Provided that we also let profits build when our investments work for us, we will still have the tail of large profits, plus all the small losses and small profits, which will tend to cancel each other out.

The result is that over the long term about 80 per cent of our investment profits will come from about 20 per cent of the investments. This is a principle discovered centuries ago by Pareto and was found to have very wide application in human affairs, especially business.

So, a critical principle of investing is to cut losses while they are small and to let profits build. However, this is not a natural thing to do and requires discipline to achieve. Understanding the way losses destroy our chance of succeeding is critical to developing this discipline. This will be discussed next.

WE CAN'T WIN IF WE LOSE TOO MUCH

Winners know that before everything else, they must stay in the game. Capital is invested in the market to secure a stream of dividends and to grow capital. Loss of capital will prevent the investor from making profits at all. Preservation of capital is the overriding objective of any effective investment strategy. Table 2.2 demonstrates why preservation of capital is of paramount importance.

Table 2.2: required gains to recover losses

% loss of capital	% gain on remaining capital needed to recover
10	11
20	25
30	43
40	67
50	100
60	150
70	233
80	400
90	900

This table demonstrates the percentage gain needed to just recover from a percentage loss. Clearly, the more of our capital that is lost, the more remote the chance that we will even recover to our starting point, let alone make profits on the initial capital.

As we have already discussed, investors must realise that they are going to make losses on some investments. This will not even be on a few investments. It will be on many of them. Therefore, the first thing to learn is the discipline to control losses. Most people think the answer is to develop better analysis, so that fewer bad decisions are made. However, this is futile because there is no analysis system that will yield the necessary reliability in all market conditions. The only way to control losses is to take them while they are small.

This sounds ridiculous at first, but it is soundly based on investing experience. As we saw earlier, most investments result in a small gain or a small loss. There are, however, a small number of investments that result in large profits. On the other hand, there will also be a small number of large losses. These are what can destroy our capital. The objective of money management is simply to eliminate the large losses and try to let the large profits build. The only way to avoid large losses is to take them when they are small. To adapt an old proverb: look after the losses and the profits will look after themselves.

If it is that simple, why can't everyone do it? The answer comes back to the psychology of investing: fear, greed, regret avoidance and ego. We are afraid to take a loss, even a small one, because it affects our ego. Instead we try to deny the loss and find reasons to hope that the investment will turn around, enabling us to get out square.

Likewise, we are afraid to let a profit run, because of fear that it will evaporate. In investing, the saying that we cannot go broke taking a profit is wrong. We can and we probably will. Our whole endeavour is to balance out all the small losses and the small gains, eliminate the large losses and let the large profits accumulate. If we take all our profits when they are small, the best result we can expect will be mediocre returns. It is more likely that we will let one or two large losses creep in, and these will seriously wound our account.

Avoid magical thinking

The exact opposite of the winning ways of thinking is the temptation to adopt magical thinking in search of the Holy Grail of investing.

The Holy Grail was the cup used by Jesus Christ at the last supper. It was endowed with amazing powers and became the object of the quest by the knights of Arthurian and other legends. Today, people who look for magical solutions to difficult problems are said to be seeking the Holy Grail.

There are some schools of thought, especially in technical analysis, that are based on the idea that the markets conform to hidden laws. Once uncovered, they will allow us to invest perfectly. This is a seductive, but utterly false, illusion.

The investment Holy Grail is usually the work of a guru who is said to have discovered the secret to making money in the stock market. Most often, the guru will undertake to show investment beginners how to predict the market by revealing some laws or internal order that markets conform to. Often, the guru's method is quite complicated, with many rules for unusual situations. Students are exhorted to work hard and master the complex ideas and rules, with the promise that they will then be able to invest perfectly. These gurus are the purveyors of magical thinking. If anyone says that they can consistently predict the markets, grab your money and run for your life.

I have observed markets for four decades and am yet to see any evidence of a hidden order. Nor have I seen anyone consistently make money from such beliefs. Carefully chosen examples of the hidden order are selected in hindsight. Similar situations that did not work out are conveniently disregarded or explained away.

Perhaps the biggest fraud committed on the inexperienced investor by these gurus begins with the guru explaining in great detail why something happened in the past. This is not a difficult thing for charlatans to do. The evidence is there for the persuasive rogues to carefully select. So, the gurus convince the beginners that they can explain the past. This sets up the students, because they wrongly assume that the gurus are experts and have some special knowledge with which they can predict the future. However, not even the honest and genuine experts can predict the future consistently in any field of endeavour. This is especially so when the underlying economic system involved is complex. (See William A Sherden's book *The Fortune Sellers* for more on this subject.)

The real problem with all the ideas of a hidden order or secret rhythm to the markets is that they fool us into seeing only the evidence that supports our theory. At the same time, we unconsciously disregard the evidence that is contrary to our theory. This is a dangerous mindset for investors to put themselves into. Instead, the best investors try to keep their minds open to all possibilities. They try to accept all the evidence and weigh it up with no preconceived ideas.

STOP LOOKING FOR A GURU

The central idea behind the search for the Holy Grail of investing is that out there somewhere is a method that always gives perfect results. That every time we buy a stock, it makes us a profit.

I see beginners looking for the Holy Grail all the time. They read a book and apply its ideas. If they are lucky, the ideas work for a while. Then they have a losing investment or two. They then abandon the method as faulty. They read another book and apply its methods. Again, some investments lose, so they abandon the new method because it is not perfect either.

It does not matter whether the book is about fundamental analysis or technical analysis. The result is always the same. All these methods eventually throw up losing investments, because the expectation that there is a perfect method is totally unrealistic. As we discussed earlier, all methods involve some losing investments. The reality is the best we can expect is that there is a greater probability that a method will work than fail in any single instance.

Winners seem to make investments that succeed only around half the time. The critical skill is in the way they manage both losing and winning investments. If successful investments give a much larger total return than is lost in the losing ones, they will be able to do very well in the stock market.

Try to focus on the correct question

A closely associated idea is that there are no right or wrong answers in investing. Quite often, people come to me with an investment idea and ask whether it is right or wrong.

One of the perfectly natural ways in which we are all tempted to judge whether an investment idea is right or wrong is to look at how it worked out in hindsight. However, hindsight does not prove whether one idea was right and another idea was wrong. All hindsight is telling us is that an idea worked out better in the circumstances that prevailed in the market when it was used. The next time we make a decision using the same idea, it may well work out differently.

The problem here is that asking whether an investment idea is right or wrong is asking the wrong question. It is often asked by perfectionists, who are consciously or unconsciously still looking for the Holy Grail.

Investing is an art. It is not cast in strong black and white tones with nothing in between. The art of investing is almost totally in shades of grey. There are many ways to make money in the markets. Some work better for a given investor than they will for others and vice versa.

The best investors will have left this incorrect question of what is right or wrong behind them years ago. They know that in order to improve their results they must work to improve their investing method. They make a decision to invest based on what they see to be an opportunity. They then focus on managing the investment. If the investment begins to succeed, the good investors build the position and let it run. If it starts to fail, the best investors sell out as quickly as possible.

The same kinds of issues arise with the choice of analysis tools. A great variety of methods and indicators are available to technical analysts. Many of these tools achieve the same analysis objectives. Indeed, we often find that two indicators, or a trendline and a moving average, give substantially the same signals. One may work better in one situation, while the other works better in another situation. Which tool is best is usually a matter of personal opinion or personal preference. It will tend to be the one that we feel most comfortable using.

Similarly, a study of the history of investing turns up many above average investors. When we study how these winners made their money, we find a great range of methods. In some cases the various methods they used successfully may appear to conflict with each other. The only intelligent conclusion is that there are many ways to be a successful investor. There is no single best, or right, method. So, it is not productive to search for the right method, but to find one that works and is comfortable for us to use.

DON'T BE SEDUCED BY TOPS AND BOTTOMS

One of the key ways in which the thinking of winners differs from inexperienced investors is in their attitude to seeking perfection. Winners have long ago abandoned the idea of perfection in any area of investing. Instead, they take aim at reality. Just as they know that there is no way that every investment will be successful, they know that there is no way to consistently make the perfect investment.

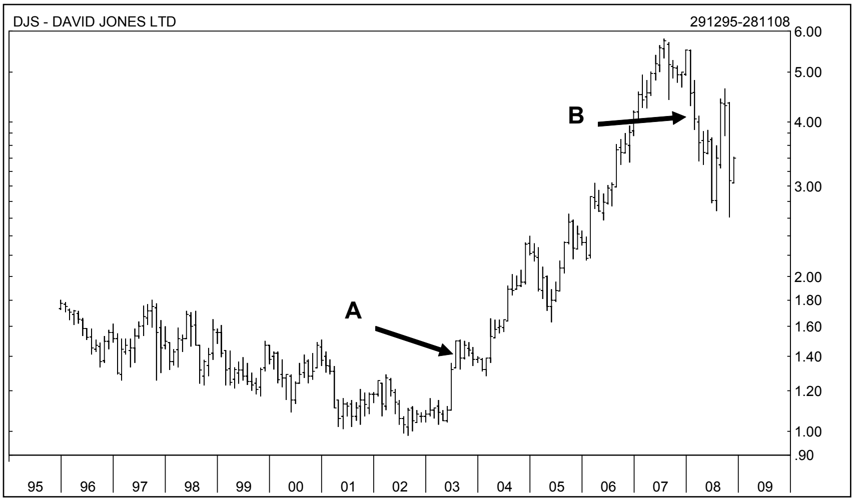
Most beginners have looked at a price chart and thought that what they want to learn to do is to buy here at the bottom, right at the start of the trend, and to sell there at the top, right at the end of the trend.

Perhaps the most consistent thing to come out of presentations by successful investors is that they have *absolutely no expectation* of buying at the bottom and selling at the top. They expect only to catch a substantial part of the trend. This comes out of the ideas discussed above. First, it is not possible to consistently predict the future. Second, it is dangerous to try, because it tends to unconsciously blind us to evidence that does not support our prediction.

Instead, what successful investors try to do is to concentrate on faultless execution of a sound process, rather than follow the futile quest for perfection. What they have found is that once a trend is underway it is more likely to continue than to fail. This leads to a disarmingly simple strategy. They try to buy into a trend once it has clearly started and to sell out of it once it has clearly failed.

This approach is illustrated in figure 2.1 (overleaf), showing an up-trend on a monthly bar chart of an Australian retailer called David Jones (DJS) in the first decade of this century.

Figure 2.1: monthly bar chart of David Jones



Leave aside at this stage the reason why the levels A and B on the chart were selected. With no knowledge of technical analysis, we can see that the low price of the 2003 to 2007 uptrend was at the bottom of the chart and the high price of the uptrend was at the top of the chart. We can also see that somewhere around A we could have worked out that the uptrend was happening. We can also see that somewhere around B we could have identified that the uptrend had failed. This is what successful investors aim to do. They try to buy near A and sell near B, taking a large part out of the trend.

Avoid making predictions

Forecasting or predicting stock prices or markets implies two things:

- That we can identify in which direction a stock or a market will move over a period of time.
- That we can calculate, or otherwise determine, the level that prices will reach at the end of the period.

It is amazing how most people believe without question that it is possible to predict the future in many areas of our lives, even though the record of most forecasters is abysmal. William A Sherden explored this in his book *The Fortune Sellers*, which I recommend should be read by anyone who is working with forecasts. The general conclusion is that it is impossible to consistently and accurately predict the future, other than in the very short term in rather simple systems.

There is another dimension to this whole question of forecasting. It is a very dangerous pastime from a psychological point of view. Suppose that we convince ourselves of a prediction of the price of a stock at a future time. As we monitor the unfolding situation, we will unconsciously tend to place greater weight on the evidence that supports our prediction than on the evidence to the contrary. We may even tend to unconsciously disregard, or not even notice, the contrary evidence.

This process is known as rationalisation and is one of the main ways we protect our ego. It is very dangerous in investing. This is especially so when the predictions have been made known to others. All of us will have a strong desire to protect our ego. We do this by arguing strongly for our prediction based on any evidence that suggests that our predictions may still come to pass. We will, without consciously realising it, tend to continue to hold a stock, waiting for the price to rise to the predicted level. This is despite the chart indicating, to an impartial observer, that the price has stopped rising and is now falling.

Forecasting is also a pastime that will come back to haunt us. I have had the experience of telling a friend simply that I thought a stock would go up. It went down soon afterwards. However, that friend never missed an opportunity to remind me that my prediction was wrong, even though I had long since sold the stock. We can do without this psychological baggage. This is the reason why good investors will rarely discuss their current positions. They know that once they do, they have cranked up the exposure of their ego. It will become increasingly difficult for them to maintain a balanced and flexible frame of mind.

It is also a fallacy that the ability to make correct predictions is necessary for success. This idea is very challenging to many people and is one of the ideas in investing that is counter intuitive. It is therefore unsurprising that when I explain how to manage the present situation in investment markets, I am then asked to predict what is going to happen. Again, these investors are asking the wrong question. I will have already answered the correct question in my presentation.

Like most good investors, I have therefore adopted an investment method in which prediction has no role to play. When asked for a prediction, I say I have no idea and do not think it is productive to try to forecast the future. I then reiterate that the correct question to have asked is how to manage investments in the present market environment.

I have found that the best investors I have heard or read about tend to disclaim having a view about where the market or individual stocks are going in the future. Instead of analysing the present condition of the market and making a prediction, winners address the strategy question. They devise a strategy for profiting from the opportunities thrown up by the present conditions. Sometimes that will be a proactive strategy. At other times, it will be a defensive strategy based on the level of risk that they perceive to be posed by the market.

Simple is better than complex

For some reason, most people seem to believe that complex ideas are better in some way than simple ideas. However, my study of the methods of the best investors indicates that they are based around simple concepts of how markets work. These concepts identify high-probability opportunities.

What the great investors know is that it is the simple big ideas that make a difference. Many of the complex and difficult situations that professional analysts are employed to form on opinion about are far from being clear-cut cases. The best investors simply avoid unclear situations. Instead, they seek companies where the opportunity is clear. That way, they have a larger margin of safety.

A common trait of the best investors is that they exploit a very strong concept that they can explain in simple terms. So if we come across someone selling us an idea that is complicated and difficult to understand, we should treat it with great suspicion.

Act on what is happening, not what should happen

Technical analysis often gives indications for which there is no fundamental explanation publicly available. This is a really tough one for beginners.

We see a stock for which the price is starting to rise. We access the last set of accounts. There is red ink everywhere. We reason that the company is a basket case. It is best to look elsewhere. Wrong. The accounts are the past. They record history. The market works on future expectations. If the price is rising, someone is buying the stock. Why are they doing that? Because they think the *next* accounts will be written in black ink.

So, what do winners do? They do their research as best they can and, if there is a good case, they go with the market. There will nearly always be uncertainty. If there is not uncertainty, if everyone knows what is going to happen, it will be too late to profit from the situation. So, the winners buy with those who know that the picture has changed, or is likely to change. These are the insiders. (Remember that not all speculating by insiders is illegal. For example, suppliers or customers of a company, who will be aware of how the company's business is performing even though the company has not yet announced its results, may legally use this information to buy or sell shares.)

Beginners abhor uncertainty. Unlike winners, they have not learned to make decisions in a context of incomplete and ambiguous information. They hang back waiting for more information. By the time it arrives, and everybody knows it, of course it will be too late.

Become a serial decision-maker

One of the most consistent beliefs held by beginners is that investing is about analysis, about finding the right stock. Their entire focus is on finding stocks to buy. They seem to believe that if they find the right stocks at the right time, they cannot fail.

Nothing could be further from reality. As they learn the craft of investing, most successful investors discover that analysis is only a starting point. Finding the high-probability situations is not difficult. What is difficult is managing the investment, staying the course with the successful investments and taking the losses when the analysis indicates the investment is failing.

Indeed, this focus on stock selection, to the exclusion of the more important tasks of managing investments, is one reason why I started teaching my methods. Late in 1993, most of the people I came in contact with in the Australian Technical Analysts Association were talking eagerly about the paper profits they had in the strong bull market of that year. This market turned bearish in early 1994 and by the middle of that year, when I was 100 per cent in cash, I was horrified by how many of these people were now complaining of paper losses on the same positions that had been in profit earlier. Clearly, these people had not learned that the buying decision does not guarantee we will make profits. It is what we do afterwards that counts most.

This has led me to describe the process of investing as 'serial decision-making'. This is the nature of the investing process for winners. Each day, new information comes along. Each investment position must be assessed and a decision made whether to sell some or all of the position, to buy more or to hold. Many people do not appreciate that deciding to do nothing is still a decision, just as much as a decision to do something.

Many beginners come to investing without a background in decision-making, from their business career or their upbringing. The ability to make timely and effective decisions is a skill that winners have and beginners tend to lack. It is a skill that can be learned.

The first step is to have an investment plan. The plan will provide the framework within which decisions can be made. The plan will be the reference point. Without an investment plan, a beginner will flounder around, uncertain what to do or even what it is they are trying to achieve. This book is about showing what should be in an investment plan and providing a model for readers to adapt in framing their own personal plan.

The aim is to develop a plan that is comfortable for every reader. It will be a plan in which they have developed absolute faith. This confidence will come through the process of testing it and then through their experience in applying it with real money in the market. They will then find it easy to follow and to make effective decisions. They will know when they have joined the winners. This will be because, when something happens with one of their investments, or an opportunity appears in the market, they will know instinctively what they should do. They will then be able to act without hesitation.

Never stop thinking

However, this does not mean that successful investors reach this point and stop thinking. The bull and bear market cycles unfold in ever-changing ways. There are always better ways to do things. Winners are always evaluating what they do, looking for better methods and techniques.

In short, winners tend to be original thinkers. They accept nothing on face value. They are the archetypal sceptics, who question everything. One of their common techniques is to be contrarian, which means forcing themselves to examine the other side of any situation, opinion or conclusion. This is very valuable in investing, because of the way people are picked up and carried along on popular fads that can lead to speculative bubbles, which always end in tears.

Contrarian thinking is also important in protecting against hubris. Successful investors are always on guard when something seems too obvious to everybody. They know it may well be right, but on the other hand it could easily be wrong. A good example is when the general view is that a stock should be bought and we feel absolutely sure about it.

Winners know that in order to buy a stock, someone must want to sell it. That seller may have a quite different view of the outlook for the stock. Good investors will make an effort to uncover the alternative view and then make a decision whether to proceed.

This confuses beginners no end. They see successful investors as calm and confident as they go about following their investment plan. What they rarely see is the way successful investors are never absolutely certain of anything. It is this constant questioning, and their ability to see all sides of a situation, that is their ultimate protection against mass hysteria and overconfidence.

Successful investors tend to be uncomfortable companions because they are sceptical about everything. They want to question, to see the evidence, to examine the other side of the argument. They often see things differently to the general view. They frequently hold views that are original or different and which challenge the accepted norms.

To become a successful investor does not mean that we will find a place where all our doubts are resolved and we are at peace. However, our constant questioning will mean that we understand our investment plan in depth. We will have internalised it so that it becomes instinctive, as described at the end of the previous section. When something happens to put our plan under pressure, we will be able to think through whether something genuinely different is happening. This will be rare, but may mean that we change the plan. More likely, we will keep thinking about the issue until we have collected all the available evidence, done the tests and weighed all the arguments and concluded that our plan is still valid.

Realise that it will take time to learn

It is amazing that so many people think that they can jump into investing without any real training or experience. I suppose they hear their friends boasting about the profits they made in the stock market and think it is just a matter of buying something and waiting for it to go up. However, stocks do not only go up. The psychology of crowds will often take beginners into stocks that are set to go down.

Professional investing is an occupation that is practised by some of the more highly educated, most intelligent and hard-working people in our society. Yet they do not always beat the market. Informed market commentators and my own experience suggest that most new investors lose money and drift away from the markets before they learn the skills needed to succeed.

So why is it that so many people want to believe that they can read a book or two or go to a seminar and then go out and be successful? Perhaps it is the perennial idea that the grass is greener on the other side of the fence. Or maybe it is just ignorance. Yet these same people would not attempt to keep the accounts of a large company after reading their first book on accounting. Nor would they try surgery after watching a TV program.

All professions demand many years of learning, followed by more years of operating experience, before they can be practised successfully. Investing is no different. Count on a minimum of five years, and more realistically, up to 10 years to learn the craft. The trick is to try not to lose too much capital while learning.

This book and others written by successful investors can help readers start on the right track and avoid some of the pitfalls. They will also save readers some time. However, no matter how quickly readers absorb the theory, they will still need the practical experience to develop the proficiency and confidence necessary to be a truly disciplined investor.

Beginners are bombarded in the media by sellers of seminars and courses, who make absurd claims about how quickly it is possible to make unrealistically large profits speculating or investing in the stock market. They are telling people what they want to believe, rather than the facts. It takes time. Winners have spent their time doing their training and apprenticeship. Many start out, but few complete the course to become winners. *There is no easy way.* It takes motivation and aptitude, onto which knowledge and skill are added with hard work and dedication, to learn one of the most fascinating and rewarding of arts, yet one of the most elusive.

CHAPTER 3

WHAT IS REQUIRED TO SUCCEED AS AN INVESTOR?

It takes time and effort to become a successful investor. It will not happen overnight. We have to want to make the necessary effort and to go about making it happen. It will always be to some extent a work-in-progress, because becoming a good investor is a lifetime learning program.

KNOWLEDGE

Investing is just like any other profession: we must first learn the basic knowledge. We can do this by doing courses, such as those offered by Kaplan (formerly FINSIA), the premier education body for the investment industry in Australia—see <www.kaplanprofessional.edu.au>. We can also do it by learning from books, seminars, videotapes, DVDs and the internet.

The knowledge that we need will include:

➢ ***Information on how stock markets work.*** This includes: the types of stocks and other securities available to investors; what the market's terminology means; how the exchange trading platform operates; how the settlement and registration system works; how our broker's internet trading platform operates; and the laws under which the stock market operates and which regulate the industry. There is a lot more to know in this area than beginners ever imagine and it is far more important than they think.

- ***Fundamental analysis.*** This will lead into a basic knowledge of accounting. It will also give insights into the dynamics of businesses.
- ***Technical analysis.*** This is also a far bigger field of knowledge than most people suppose. Moreover, there are some unscientific and doubtful areas in it. These usually depend on what I call magical thinking, as discussed in the previous chapter. However, in rejecting them we must resist the temptation to also dismiss the ideas and insights that are firmly based in the behaviour of investors. If we cannot work out a reason why some idea would work, based upon the way most people think, then we should treat the idea with suspicion.
- ***The history of stock markets.*** Beginners make mistakes that have been made many times by others who have gone before them. The only chance to avoid reliving history is to know and understand what has happened in the past.
- ***Decision-making.*** This includes the psychology of markets, personal psychology and the new field of behavioural finance. One of the most important areas of psychology for investors is how we go about making decisions. This is far more critical to success than most beginners think when they start out to learn investing. Humans are not very good at making decisions in complex situations. A study of psychology opens our minds to the myriad ways we can fool ourselves and not see reality. It makes us far more humble and less sure of most things, where otherwise we would be dangerously overconfident.
- ***The methods that have worked for the great investors.*** I have learned more about what actually works from the writings by or about these people than from all the theory textbooks. From these sources, I have picked up the way they think and the aspects of analysis they actually use from the huge body of available methods. As we study their methods, we come to appreciate what are key issues and what are just minor issues around the fringes. It is the simple big ideas these great investors exploit that make the real difference in the end.

It will take most people many years to acquire this knowledge. However, there is no realistic short cut in investing, any more than there is in any other profession.

And once up to speed, there is the need to stay there by continuing to keep up to date as things change. There are a number of ways to do this:

- ***Books*** are the best source of ideas and techniques. No matter how much we might think that we know already, if we want to learn to be successful investors we should try to read a new book about the markets every month. That is not as difficult as it sounds. If we read 10 pages, or a chapter, each evening before we go to sleep, it is possible to read a book in a month on average quite easily. All it takes is the will to do it and the discipline to carry it out. Focus on the great books which have been reprinted over and over again through the years and on the few new books that genuinely break new ground. There is a suggested list of further reading at the back of this book.
- I have read ***The Australian Financial Review*** most days since I was at university in the early 1960s. This is the best way to keep up to date with changes and to develop a wide knowledge of the financial world. In overseas markets there are equivalent newspapers and magazines, such as The Wall Street Journal and the Financial Times. At first it will be difficult to understand many things. We need to make a list of them and try to find a source that will teach us. The internet is one possible source, though sometimes of doubtful authority.
- ***Financial magazines*** are also an excellent source of knowledge. Focus on the in-depth articles in magazines and newspapers. Everyone knows the ones I mean; the ones nobody has time to read, except the best investors, of course.

AN INVESTMENT PLAN

In the previous chapter, I mentioned that successful investors treat their investing as though they were running a business. In reality, investing and managing our capital is a small business undertaking. It is therefore instructive to consider the reasons why most small businesses fail. One conclusion that emerges consistently from all the research is that the lack of a business plan, or of a sound business plan, is a major reason for failure. It is common sense really. If we don't have a clear idea of what we are trying to do, and how we are going to try to do it, we will have little chance of meeting our objectives.

There is another reason why an investment plan is so important. The most difficult part of investing is making decisions. A good investment plan will be a reference point for all decisions that are needed in managing our investment capital. What typical beginners do is to buy something on a tip or recommendation. They have no clear plan of what they are trying to do with the investment or how it fits with the rest of their portfolio. So, when the investment comes under pressure, they have to start working out from scratch what they should do. Without a clear objective, a defined strategy and clear tactical guidelines, they have little chance of getting it right. The psychology of the market and their own psychology toss them about from emotional high to emotional low. They will usually make the wrong decision. Alternatively, they may find it all too difficult and do nothing, which can also be the wrong choice.

If we have a clear and complete investment plan, there is a far higher likelihood of making an effective decision. There is also a far higher chance that we will follow a consistent approach. Once an investment is made we are all, to a greater or lesser degree, on an emotional roller-coaster. A sound investment plan provides an objective reference point that was set before we became emotionally involved in an investment.

This book is about creating an investment plan. In it, I am going to set out my investment plan. It is not there for readers to copy blindly. We are all unique individuals. My plan will have to be adjusted to suit each reader and his or her situation and objectives. However, what I will try to do in explaining my investment plan is to explain what I think should be in every plan. I will also show what risks I think have to be managed, followed by how and why I have chosen to manage them as I do. This means that my investment plan can be used as a model for readers to adapt to suit their specific requirements. Some things readers may choose to do in the same way, but others they should choose to do differently.

Experience

It is possible to avoid some mistakes by reading about the investment experience gained by others. However, in general, experience is something everyone has to gain for themselves and it takes time. It will probably take a minimum of a few years and maybe more years than most beginners envisage when they start out.

In every profession, a practitioner needs to have formal education and then some years of apprenticeship on the job before they reach peak effectiveness. It is the same with investing. There is simply no substitute for having been there and done it. Mistakes have to be made and lessons learned.

DISCIPLINE

My very favourite quotation about investing comes from Warren Buffett, in the Preface he wrote to Benjamin Graham's classic investment book *The Intelligent Investor*:

> *What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.*

What Warren Buffett has called an intellectual framework is basically what I mean by emphasising the need to have an investment plan. What he has called the ability to keep emotions from corroding that framework is what I mean by discipline.

Discipline comes from the sum of these actions:

- ***Developing an investment plan that is consistent with our personality, attitudes, beliefs and objectives.*** It is therefore highly unlikely that we can just adopt someone else's plan, because no two of us are exactly alike.
- ***Developing faith in our investment plan*** by thinking it through in depth for ourselves and understanding how each part interacts with the rest of it. We must not just like a plan. We must understand it in depth.
- ***Testing our investment plan on paper and then in the market with real money.*** This is what I called experience in the previous section. The most important outcome of experience is that it results in confidence in the investing plan. No matter how completely we accept the validity of the logic of an investment plan, the real test is when it comes under pressure in the market. What most people do then is to question the investment plan and depart from it, or even throw it out completely. Later they find that if they had stuck with it, they would have been fine. This is experience in action. After doing this many times, it is possible to develop the confidence that the plan really works if we stick with it.

- ***Developing an understanding of our own psychology.*** This will flow back into the previous points. Many people come to investing, and more likely to speculating, as a way to make easy money to solve problems in their lives and their personalities. One thing is certain: if we are using the market to hide from a problem in our life that we have not yet learned to deal with, the market will search it out and expose it brutally. Learning to be a good investor is, in many ways, a journey of self-discovery and will often lead to benefits in other areas of our life.

Patience

A lesson that everyone should have learned at school is the power of compound interest. The lesson from compounding returns is that most of the final capital sum was earned in the later periods and the longer the period over which returns are allowed to compound the better. So, having the time to reach our investment objectives is of far more importance than almost any other aspect of investing. The only alternative is to take so much risk that success becomes doubtful, except by sheer luck.

We live in an age of instant gratification. We want everything now. Investment does not work like that. If we want to invest and receive huge percentage rewards immediately, we should go to the casino or buy lottery tickets. That is the only way it can be done. However, the chances of success there are extremely small. It is possible, especially through options or futures, to find such potentially high rewards in financial markets, but the risks are so high that the chances of success are comparable to the casino and the lottery.

I have often come across people who discover the need for investment as they near retirement. Through their life they have earned and spent one or more million dollars over maybe 45 years and now they realise they do not have enough to retire on. So, they come to the stock market to make the money quickly through speculation, when they should have been saving and investing over their working life. When I work out roughly what rate of return they would need to earn on their small capital to make up for lost time, I can see that it is often wildly unrealistic. They made the critical decisions not to save and invest a long time ago. There is a limit to what can be realistically achieved now.

No matter when an investment plan is started, it will require a realistic idea of what is possible and likely. Time and patience are needed to learn the craft of investing without losing too much capital while learning. Time and patience are then needed to allow a sound and realistic investment plan to work.

Winning thinking

Investing is a game that is played in the mind. Physical strength is useless, though it does require some staying power to put in the work required. Character is important, though many people who succeed in sport or business fail in investment. Investment requires constant decision-making in the context of uncertain or incomplete information. This is one of the most difficult things in which to become proficient. Yet the rewards are enormous, not only in investing, but in the rest of our lives. This is why I chose to deal with the way winners think right at the start of this book, in the previous chapter. Everything that follows is essentially useless in the hands of someone who does not have winning concepts of how investment success is achieved.

Chapter 4

Roadmap of my investment plan

Even though much of it is quite straightforward, some parts of my investment plan require detailed explanation. There is the potential to lose track of the overall structure of the plan and where the present discussion fits in the whole. This chapter is therefore brief, but important, in providing a general roadmap of the plan. Please refer back to it if, in the middle of a long chapter, you lose your sense of where we are going.

My objective

In chapter 5, I set out what I am trying to achieve. After explaining why I have chosen the stock market, I set out the return on my capital that I am aiming for.

My basic investment philosophy

In chapter 6, I enunciate the simple big idea that will be exploited to achieve that return on my capital.

Risks and strategies

In chapters 7 through 10, I discuss the kinds of risk that have to be managed and the strategies I have developed to manage them.

Managing investments

In chapter 11, I discuss how I find and choose good investments. In chapter 12, I discuss everything I do in making and managing my investments.

Summary of the plan

In chapter 13, I have set out a summary of my whole investment plan, which will be a valuable reference.

Case studies

In chapter 14, I will go through investments that I have made in the 2003 to 2007 bull market, showing charts, explaining calculations, outlining my thinking and drawing a few lessons.

CHAPTER 5

ASSET CLASS AND PERFORMANCE TARGET

Framing an investment plan involves making some key policy decisions. We need to decide which investment markets to participate in. We then need to set a performance target.

CHOICE OF ASSET CLASS

The average annual returns for the 20 years ended June 2007 for different types of financial investments were as shown in table 5.1.

Table 5.1: average annual returns for the 20 years to June 2007

	Annual return
Australian stocks	11.0%
Listed property	12.1%
Australian bonds	9.6%
Cash	7.7%

Note: Assumes that income is reinvested.
Source: Vanguard Investments *Realistic Sharemarket Expectations.*

Over shorter periods, these rates of return drift around somewhat. Vanguard also shows the 50-year return on Australian stocks as 12.8 per cent. Other long-term studies show similar returns from Australian stocks.

My investment expertise is in the Australian stock market. As its return is more than satisfactory, my investment plan is focused on being in either Australian stocks or cash. I will explain this in more detail when I discuss my market exposure strategy in chapter 8. In brief, I will be invested in stocks except when the stock market risk is high, when I will move out of stocks and into cash.

Speculation or investment

Once I have elected to invest in stocks, there is a choice between speculating and investing. I have chosen to be an active investor for these principal reasons:

- Investing presents me with a better lifestyle and its requirements suit my temperament better than speculating.
- I have made better returns from investing than from speculating, and certainly with less time and effort expended.
- My investment capital is now in the retirement phase of the Australian superannuation system. The greater part of my investment income is tax free and only a small part attracts a very low rate of tax.
- Running a business from within a superannuation fund is not permitted. Speculation would clearly be a business activity, which means I would have to move my capital out of the superannuation system, where it would attract a much higher level of taxation. This would require a far greater rate of return before tax to achieve the same after-tax result.

Other asset classes

As for other asset types, I have made a policy decision not to invest in them for the reasons given below.

Bonds

Bonds would be an attractive alternative to cash, except that I do not have any expertise in that difficult market. I have never had a liking for, or been attracted to, the bond market in the way that I am to the stock market.

International stocks

I do not invest on overseas stock markets for several reasons. These basically revolve around the additional risks involved in investing in overseas stock markets, which should only be undertaken if those risks are offset somehow by equivalent advantages. Some of these additional risks are:

- Higher knowledge and experience risk, because I would be investing in markets I do not know well and where I have no experience.
- Higher information risk, although the internet has reduced this somewhat in major markets.
- Currency risk, and since I do not anticipate significant future expenses in foreign currencies, there is no need to create a natural hedge by keeping some of my assets in other currencies.
- Administration and tax are more complicated and probably involve greater costs.

Finally, while there may be short-term differences in opportunities, the long-run returns from most major world stock markets seem to be similar to Australia. The grass is rarely greener on the other side of the fence when reality intrudes into the illusions.

Real estate

After Australian stocks and cash, the rest of my assets are in real estate in the form of a private residence. I have avoided any other property investments because my expertise is in the stock market and I believe that I can achieve higher returns in that market.

My investment performance target

My investment performance target is ***to exceed an average annual return of 12.5 per cent***. This is a pre-tax return, as were all the other returns shown earlier for other asset classes.

The logic to seeking this return is that, unless I can beat the long-term passive investment return, I may as well invest in an index fund and save a great deal of time and effort.

This does not mean that I will make 12.5 per cent or more every year. That is not possible in some years. In other years I will exceed it significantly. However, I will be aiming to make my capital grow every year, no matter how small that increase is. This is because I will be mostly in cash when stock prices are generally falling and therefore earning interest on my investment funds.

My investment return will therefore be the sum of:

- capital growth (or losses), net of transaction costs
- dividends (cash dividend and franking credits)
- interest on cash held on deposit.

> 'Franking credit' is a term that will be unfamiliar to readers outside Australia. Companies are taxed on their profits. Then part or all of those profits are distributed to shareholders as dividends. Those dividends are taxed in the hands of the shareholders. This means company profits that have been distributed as dividends are taxed twice.
>
> To overcome this double taxation, the Australian taxation system mandates that shareholders receive a dividend and also a statement of what tax the company has already paid on that dividend. This is called a 'franking credit'.
>
> The shareholder then includes both the dividend and the franking credit in his or her income tax return. The amount of tax is determined and then it is reduced by the franking credit. The end result is that company profits are only taxed once at the shareholder's tax rate.

Dividends tend to average around 4 per cent per annum in the Australian stock market. Therefore, capital gains will average around 8 per cent per annum (12 per cent total return less 4 per cent dividends).

Interest will vary, depending upon rates at the time.

My costs of data, software, communications and equipment are all offset against my writing income, for convenience. Should I retire completely from writing, they would have to be deducted from investment income. These costs are no longer significant for me when measured against my investment returns, but they were in the past when my total capital was smaller.

This is *my* investment performance target. Readers may choose to set either a higher or lower performance target. However, whatever performance target is decided upon, it should pass three tests. It should be specific, measurable and realistic.

Specific

My performance target is to exceed a specific average annual return.

There are other ways in which a performance target could be framed and still pass this test. For example, most professionals aim to exceed a benchmark, which is a variable rather than an absolute. Commonly, they are aiming to beat a market or sector index.

Measurable

It is absolutely vital that the investment performance target is stated in such a way that an independent person could take my records and verify whether or not my performance target has been achieved and by what margin.

Realistic

Most people will have no trouble with the first two tests. It is easy to see whether a performance target is specific and also whether it is measurable. However, whether it is realistic is not so easy.

Study after study has shown that it is difficult for professional fund managers, investing a large pool of funds, to beat the average return for the market as a whole, as measured by the percentage change in the market index. Some of these studies are unfair and are propaganda for the index fund industry. However, there is enough evidence that is valid to support the general statement.

When measured over periods that include both rising and falling markets, the best professional fund managers will average in the range of 15 to 20 per cent per year. There are not many who can do this. A few exceptional ones will do better, but this is probably because they are exceptional people. Other reasons why managers can show exceptional returns include:

- they were taking higher risks in various ways
- they were only managing a small fund
- the period over which their return was earned coincided with a bull market and is therefore not representative of all market conditions.

It is tempting to think that we also have the potential to be exceptional. However, it would be unwise to make that assumption until we have the results to demonstrate it. Arguably the best investor of the last half century has been Warren Buffett. The Berkshire Hathaway 2007 Annual Report shows that in the 43 years to 2007, his compound annual return was 21.1 per cent. The report compares this return to a compound return of 10.3 per cent for the S&P 500 index including dividends. This suggests that if readers are trying to beat 20 per cent per annum over the long haul, they are assuming that they are one of the most exceptional investors of recent times.

These facts are also very salutary when we encounter claims for an investment method which purports to generate very high returns. It is wise to regard any claim of more than 20 per cent per annum average annual investment return with the greatest scepticism.

My investment track record

For many years I did not keep detailed records of my investment results. There were also quite a few complications along the way. For many years it was tax effective for me to be a speculator. Those results are not relevant to my current investment plan. As I swung over to a total focus on investing, my methods were still being moulded by experience. There were many things that I changed, or at least modified, as I went along. I was also not as disciplined as I am now in keeping to my investment plan.

By the late 1990s, I felt that my methods were reasonably settled and that I was well disciplined in sticking to my plan. I felt that the end of the technology and internet bubble in early 2000 was a good starting point, because I was clearly not cherry-picking a period leading into a bull market. In fact, by choosing to start rigorously recording my results at the top of a bull market, I was being reasonably conservative.

My investment results up to the time this book was finalised for publication were as shown in table 5.2.

Table 5.2: investment results: percentage return

Financial year	My return	Average target return	Difference
2000/01	+9.69%	+12.5%	−2.81%
2001/02	+2.11%	+12.5%	−10.39%
2002/03	+20.61%	+12.5%	+8.11%
2003/04	+17.48%	+12.5%	+4.98%

Financial year	My return	Average target return	Difference
2004/05	+26.88%	+12.5%	+14.38%
2005/06	+33.62%	+12.5%	+21.12%
2006/07	+45.25%	+12.5%	+32.75%
2007/08	−5.11%	+12.5%	−17.61%
2008/09 (5 months)	+2.64%	+5.21%	−2.57%

Notes: I measure my results for Australian financial years, which run from 1 July to 30 June.
These results are all before tax.

The first thing to notice here is that my returns do not meet the average target return in some years. This cannot be a realistic expectation. When markets are weak, my returns will tend to be below the target. On the other hand, when markets are strong, my returns should tend to exceed the target.

What is far more important is how this all pans out over a number of years, and particularly over complete market cycles. An easy way to see this is to notionally invest $100 000 at the beginning of the 2000/01 year and follow how my return compared to the average target return on a cumulative basis. Table 5.3 shows this comparison.

Table 5.3: investment results: return on $100 000

Financial year	My return	Average target return	Difference
2000/01	$109 690	$112 500	−$2 810
2001/02	$112 004	$126 563	−$14 558
2002/03	$135 089	$142 383	−$7 294
2003/04	$158 702	$160 181	−$1 479
2004/05	$201 361	$180 203	$21 158
2005/06	$269 059	$202 729	$66 330
2006/07	$390 808	$228 070	$162 738
2007/08	$370 838	$256 578	$114 259
2008/09 (5 months)	$380 628	$269 946	$110 682

Notes: The average target return is calculated on 12.5 per cent per annum.
The capital growth included is before tax.

This table covers a bear market, followed by a bull market and part of another bear market. Thus, over a complete cycle, my results might be seen as being ahead of my plan. However, it is early days and the real test will be how well the plan copes with the bear market that is well under way as I write this chapter.

While my objective is stated in terms of a specific percentage, another comparison is also of some relevance. As stated earlier, it is one thing for me to set an average target return and try to beat it. However, the real game plan is to manage my own capital better than might be done using a low-fee index fund or a professional manager.

Comparison to an index fund is easy; at the very best an index fund will match the index. Comparison to professional managers is more difficult. However, research over the years strongly suggests that most professional managers do not on average perform much better than the index. This is especially so if we use an accumulation index, which is calculated including the notional reinvestment of dividends.

Table 5.4 shows how my returns are stacking up so far against the ASX Accumulation Index.

Table 5.4: returns compared to Accumulation Index

Financial year	My return	Accumulation Index	Difference
2000/01	+9.69%	+8.85%	+0.30%
2001/02	+2.11%	−4.50%	+6.26%
2002/03	+20.61%	−1.08%	+20.78%
2003/04	+17.48%	+22.37%	−6.24%
2004/05	+26.88%	+24.75%	+2.13%
2005/06	+33.62%	+24.20%	+9.42%
2006/07	+45.25%	+30.28%	+14.97%
2007/08	−5.11%	−12.12%	+7.01%
2008/09 (5 months)	+2.64%	−29.63%	+32.27%

Notes: I have compared my results to the Australian Securities Exchange (ASX) All Ordinaries Accumulation Index. This is the most appropriate comparison, because it assumes reinvestment of dividends. I measure my results for the Australian financial year, which runs from 1 July to 30 June. These results are all before tax.

Another way to present this comparison table is to assume that $100 000 was notionally invested on 1 July 2000. The results from my active investing compared to the notional passive return represented by the ASX All Ordinaries Accumulation Index were as shown in table 5.5.

Table 5.5: active investing compared to notional passive return

Financial year	My capital	Accumulation Index	Difference
2000/01	$109 690	$108 845	$845
2001/02	$112 004	$103 946	$8 059
2002/03	$135 089	$102 818	$32 270
2003/04	$158 702	$125 819	$32 883
2004/05	$201 361	$156 955	$44 406
2005/06	$269 059	$194 932	$74 126
2006/07	$390 808	$253 961	$136 847
2007/08	$370 838	$223 181	$147 657
2008/09 (5 months)	$380 628	$157 052	$223 576

Notes: The Accumulation Index column has been calculated using the changes in the ASX All Ordinaries Accumulation Index from the previous table. The capital growth included is before tax.

So far, my active investment plan is showing a comfortable margin over the market return and thus what might have been obtained from an index fund or a good professional manager. This assumes that we accept that the market is a rough proxy for those alternative investment approaches.

The ASX Accumulation Index column is also a useful rough proxy for the return we might have expected from a passively managed diversified share portfolio. The difference column is a reasonable approximation for the additional return that I have been able to make from my active investment plan.

Important caveat

It should be emphasised that past returns are not necessarily indicative of future returns. I may have been on a hot streak and we had just come though a very strong bull market. There is a strong tendency for returns to revert to the mean over time.

Therefore, readers should see this analysis as simply suggesting that my plan works and that it is ahead of my objective return and of the market *so far*. Investing is a long race. Leading the first lap proves very little, but is a pleasing sign.

Calculation of my returns

The following section is a discussion of the technical issue of how I have gone about calculating my returns. It is a dull and dry subject. If you are not interested in this topic, you will miss very little by skipping it now and returning to it later. However, I have included it because whenever I have mentioned it in the past I have received many questions. Hopefully, I will now address those questions for readers who are interested.

The discussion that follows is entirely a pre-tax calculation, except for the inclusion of franking credits, because it is part of the pre-tax return in the Australian taxation system. Overseas investors may simply disregard it.

At the start of the year and at the end of every day through the year, I value my stocks at the last or closing prices for that day. I also deduct the known transaction costs assuming that I realised the holdings at those prices. I do not make any allowance for slippage. (Slippage is a jargon term in most markets for the difference between the last or quoted price in the market and the actual price achieved when the transaction is executed.)

The difference between the value of my portfolio plus cash reserve at the end of the year and the start of the year will be my return, expressed as a percentage of the portfolio value plus cash reserve at the start of the year. I will qualify this slightly below. However, it will suffice for the moment.

The difference between the starting and end value of the portfolio will be the net total, plus or minus, of these items:

- ➢ Net return from investments closed out during the year at a value greater than the original cost.*
- ➢ ***Less*** net return from all investments closed out during the year at a value less than the original cost.*
- ➢ ***Plus*** all dividends received and any associated franking credits.**
- ➢ ***Plus*** all interest earned on the cash reserve.

* All purchases and sales are net of transaction costs and the original cost is reduced for any capital returns by the company.

** A franking credit is the notional tax already paid by the company on the profit from which the dividend has been paid. This is not relevant for investors who are not Australian residents.

This is a really easy calculation if there are no additions to or subtractions from capital during the course of the year, other than from investment activity. In most years, there will be some additions as more capital becomes available for investment. There will also often be some capital withdrawn for various large expenditures other than investing. It can make things very complicated. There are several ways to work out the return, but as a practical person, I have opted for a fairly simple procedure.

In working out the return, I take the net total of the four items listed above. I then calculate the return not on the starting capital, but on the time weighted average capital (TWAC). The calculation of TWAC is very simple. I work out how much capital I had to invest for how many days and weight it by the fraction of the year for which it was available. A simple example to illustrate the method is shown below. For simplicity, I will use the calendar year 2008 in the example.

Facts

I start with $1 000 000.

On 8 March, I withdraw $50 000.

On 17 September, I add $160 000.

Table 5.6: TWAC calculation

Period	Days	Capital available	Calculation	Time weighted capital
1 Jan.–7 Mar.	66	1 000 000	1 000 000 × 66 ÷ 365	180 822
8 Mar.–16 Sep.	193	950 000	950 000 × 193 ÷ 365	502 329
17 Sep.–31 Dec.	106	1 110 000	1 110 000 × 106 ÷ 365	322 356
TWAC	365			1 005 507

Return calculation

So, if the net total of the four income items listed above was $185 500, my return for the year would be calculated as follows:

Return	÷	TWAC	×	100	=	Return%
185 500	÷	1 005 507	×	100	=	18.45%

This is the before-tax return and is roughly comparable to the ASX Accumulation Index, which assumes reinvestment of dividends.

Chapter 6

My simple big idea

Many of the books written by and about investors talk about them exploiting an edge of some kind. This is a colloquial expression which means to have an advantage of some kind. In investing, it is often used in the sense of a central idea or a method that the investor has discovered or developed. The main characteristic of such an idea or method, which makes it into an edge, is that it captures opportunities that produce consistent results. Since it will not be perfect, in the sense that it always makes profits, the more useful description should be that it produces a greater total of profits than it produces losses.

The more I read about the outstanding investors, the clearer it is that most of them have succeeded by doing relatively simple things consistently well. It is rare to find that what they do is difficult to understand or is highly complex and intricate. They have made a policy decision as to the edge they intend to exploit and they exploit it single-mindedly.

It is the analysts who gravitate towards the complex methods. Uncharitable observers have suggested that they seem to be trying to blind us with science. A more charitable explanation is that it is in the nature of the analyst's job to be seeking to understand, explain and extrapolate from situations that are often far from clear.

Contrast this with Warren Buffett, who famously advised us never to invest in anything we could not understand. He followed his own advice during the technology and internet boom in the second half of the 1990s. He said he did not understand these companies, so he did not invest in them.

Investors, unlike many analysts, have the freedom to pick and choose. If an investment situation is difficult to understand, or does not fit within the requirements of their edge, they simply pass it up.

I have lost track of the number of times someone has sat through one of my seminars, in which I outline my investment plan, and then come up to me afterwards and commented on the simplicity of what I had taught them. This comment is often leading to a question: do I run an advanced seminar in which I tell them what I *really* do?

What is implied here is: they are finding it difficult to accept that what I do seems to be so simple. They seem to feel that the best ideas and methods should involve some secret which is highly complicated and difficult to understand, hence the demand for advanced seminars. They are always surprised, and some are quite disbelieving, when I tell them that my seminar explained everything I do.

My own personal breakthrough in this area was to realise that the Pareto principle applies to almost anything. The Pareto principle is also known as the 80/20 rule. It simply states that a small number of inputs lead to most of the results. So, about 20 per cent of customers will account for about 80 per cent of sales, to take one simple and well-known business example.

Where I found expression of the Pareto principle in investing is that about 20 per cent of what successful investors do leads to about 80 per cent of their profits. Specifically, there will be one or a very small number of ideas that really make a difference and all the rest are not of any great importance. This one idea is what was described earlier as an edge. I prefer to call it my simple big idea. Everything I do is in pursuit of this idea.

My simple big idea is not some dramatic new discovery. Nor are its two elements all that original. It is easy to find them in the myriad books which have been written about investment and speculation over the last century. The only claim that I am making is to have combined two very powerful ideas into my simple big idea.

My simple big idea, around which everything I do revolves, has these two components:

1. Any stock that I buy must be of investment grade and be cheap in fundamental analysis terms.
2. Its price chart must show an upward breakout from an accumulation or consolidation pattern, or be already trending upward.

In later chapters, I will go through the application of this idea in detail, showing exactly how it is implemented.

The first component of my simple big idea comes from the ideas of Benjamin Graham and his acolytes, who as a group have been very successful over a long period of time.

The second component comes from the ideas of Stan Weinstein and many others before and after him. The idea of price trend is basic to technical analysis–based investing.

It is important not to underestimate the power that flows from the combination of these two elements into my simple big idea. The first element involves buying good businesses at cheap prices. The trending requirement is the vital overlay to that idea, which helps to winnow out the best prospects. This is because there are always smart investors in the market, who have better knowledge or superior insights in their analysis. The price is the first place we will see them acting on their knowledge or judgement, usually well before announcements are made. Therefore, if the price/earnings ratio is low, but the price is not heading upwards, something has changed since the fundamental value data was reported. It is best not to buy the stock until the trend changes to upwards. It is also best to sell any existing investment where the upward movement has failed.

This trend element flows from the observation that stock markets and individual stock prices tend to move in trends and that those trends often persist for periods of from one to many years. We will define a trend later, but for the moment a trend is simply a tendency for prices to move upward or downward for a significant period of time.

Remember that the long-term total return from investing in stocks is about 12 per cent, made up roughly by 8 per cent in capital growth and 4 per cent in dividends. Capital growth is therefore an important element in securing a superior return. There is only one way for investors to grow their capital: by buying stocks that go up in price. Since trends tend to persist once they start, it makes sense that there is a better chance of making our capital grow if we buy stocks that are trending up, rather than stocks that are trending down.

There it is. I am looking to buy cheap stocks that are going up and avoid or sell ones that are going down. This one simple idea took me more than a few years to really wake up to. It is now absolutely central to everything I do in selecting stocks and managing investments. I no longer waste any time or energy on any stock whose price is heading toward the bottom right corner of the chart, no matter how good the story is, or how cheap it seems to be. If its price is not rising, the chart is telling me that I am wrong or that someone knows more about the business and its prospects than I do.

CHAPTER 7

THE RISKS TO BE MANAGED

Consider for a moment that there was an investment and the outcome was absolutely certain. This often happens with a takeover, once it has been declared unconditional. In such a situation, everyone will know the certain outcome of buying the stock and can calculate the value of the stock. That is the only price they will sell for. There is no chance to make a gain by buying the stock, because there is no risk. It follows that the only way to make money by investing in a stock is to assume and manage risk.

Profits are the reward for managing risks successfully and losses are the penalty for unsuccessfully managing risks.

Risk is not a simple idea. There is no universally agreed way to measure it. Academics and many market practitioners have taken the easy way out by defining risk narrowly as volatility. In other words, they take the highest and lowest price over a period and define risk as the width of that range of prices. So, if a stock fluctuates only 20 per cent in a year, it is said to be less risky than one that fluctuates 50 per cent in a year. More sophisticated approaches measure volatility relative to the overall market benchmark or index. However, the general idea is the same.

This is the easy way out, adopted because it is easily measured. However, there are those who maintain that this definition of risk is too narrow. Indeed, it is not the definition that typical private investors have in mind when they use the term risk. When typical private investors think about risk, they are apprehensive about two possibilities:

- They are afraid that the price will go down. They do not see a rise in prices as a risk, but as a reward. So, it is only downward volatility that the typical investor sees as risk, not the full range from high to low in a period.
- They are afraid that the company will fail and the entire investment will be lost. This is simply an extreme example of the first fear, but it is different in an important way. The typical investor knows that an investment in a failed company is a total and permanent loss. However, a falling stock price is less worrying, they think, because it may recover if they wait long enough.

In reality it is more complicated than that. Risk can be divided into many types, depending on what drives the possibility of loss. These types of risk can be divided into four groups:

- market risk
- specific risk
- financial risk
- liquidity risk.

I will define each type of risk in turn below.

Market risk

This is the risk associated with the overall market, quite apart from the fortunes of any one company. The prices of all stocks will be affected by general market sentiment. An old saying on Wall Street is to the effect that all ships rise and fall with the tide. Thus, in a strong market, the stocks of sound companies will tend to rise in price more than they would in a weak market. Likewise, in a weak market, stocks of weak businesses will tend to fall further than they will in a strong market. Market risk cannot be fully managed by diversification, because all stocks are affected to some extent. Rather, it is managed by varying the proportion of capital that is invested in stocks or held in a cash reserve.

Chapter 8 is a major chapter of this book. It is about managing market risk. This element of strategy in my investing plan is one of its most important aspects. It is also a subject area on which many other investment methods are largely silent.

SPECIFIC RISK

This is the risk associated with individual stocks. No matter how good the economy or business conditions are, misfortunes of all kinds can affect an individual company. In the worst case it may go bankrupt. In less spectacular terms, its earnings may fall, or it may even make losses, while the general run of companies are prospering.

Specific risk is managed in three primary ways:

- By selecting investments with a good probability of appreciating in value over time. Aspects of this relate to the conceptual models used to identify opportunities, the time frame over which we invest and the type of stock we invest in.
- By spreading our capital over a number of stocks, or as it is known in investment jargon, through 'diversification'.
- By limiting the proportion of our capital that is risked in any one stock or, as it is known in investment jargon, through 'position sizing'.

Specific risk will be discussed in chapter 9.

FINANCIAL RISK

This is the risk associated with borrowing money to invest. This can be the obvious sort of leverage, by giving a financial institution security over another asset, such as real estate, or over the stocks purchased with the loan (often called a 'margin loan').

It can also manifest itself in another variation of financial risk which operates through the leverage available on derivative securities such as futures, options, warrants, contracts for difference (CFDs) and instalment receipts, which involve buying on margin or undertaking to pay more at a later date.

In all these situations, small changes in the value of an investment can result in large gains or equally large losses. In many cases it is possible to lose more than the initial investment.

The other important aspect of financial risk is the level of debt held in those companies that are being considered for investment. This is usually measured using a ratio called 'debt to equity'. It is simply the total debt in the business as a percentage of the total stockholders' equity in the business. We have recently seen large losses by stockholders in a number of major companies and property groups. This followed directly from the debt binge through to 2007. It has hammered home to me the lesson that had moved from the front of my mind since the same thing happened in the 1980s. It should not be forgotten again, lest we be taught an expensive lesson by the market next time. I have now made it an explicit part of my investment plan to check the level of debt in a company before deciding whether to build a position in it.

Financial risk destroys businesses and investors when conditions turn down and they are unable to meet debt servicing charges or debt repayment schedules. There may also be difficulty in refinancing maturing debt, because lenders are unwilling to lend again or lend only at increased interest rates. In the worst case, businesses may fail and are passed into the hands of liquidators. Investors may find that they are unable to meet margin calls and either lose heavily or fall into bankruptcy.

Financial risk will be further discussed in chapter 10, where I will show how I deal with this important issue.

Liquidity risk

This is the risk associated with the ability to quickly move into or out of an investment. Stocks are generally liquid investments, because there is a stock market on which prices are quoted continuously by buyers and sellers.

Nevertheless, some stocks are easier to buy and sell, especially in significant parcels, than others. We may decide to sell, but find that there are not enough buyers available with which to deal in the volume of a stock that we wish to sell.

The liquidity of a company is not an absolute. One measure of liquidity is the number of shares and the value of a company's stock traded each day. The problem is that investors come in all sizes, from a small private investor to a giant fund. What is liquid for one investor may not be for another. I have found personally that, as my capital has grown over the years, there are many more companies where I am too big for the market in their stock. In other words, liquidity is in the eye of the beholder.

Nor is liquidity only a function of the size of the company, usually measured in the industry by its market capitalisation. Market capitalisation is a jargon term meaning the value of the total number of shares issued by the company multiplied by its current share price. However, some big companies and many smaller ones may have a situation in which a small number of stockholders own a large proportion of the issued stock and it rarely trades in any appreciable volume. Here liquidity relates to the ownership structure of the company.

Liquidity risk will be discussed in chapter 10, where I will show how I deal with these issues.

CHAPTER 8

MANAGING MARKET RISK

Investment is about assuming risk in pursuit of a reward. Unless there is an element of risk in an investment there is unlikely to be the possibility of a significant reward. If the result of an investment is certain from the outset, then it will be quickly priced at a level where there is no profit left.

In general terms, it is accepted that the greater the risk, the greater the reward. However, by itself, this is not a useful idea, because it does not suggest to us what we should do about it. Instead, we should focus on the goal of investing. This is to balance the risks taken against the potential reward, so that the ratio of reward to risk is as great as it can reasonably be without endangering our objective.

There are also several kinds of risk, as we have seen in the previous chapter. There must be an overall balancing of these different risks. There are many choices. Deciding that a greater risk might be tolerated in one area of the investment plan has to be weighed against the level of other risks being taken elsewhere in the investment plan. Each person must find a balance that is appropriate for them at any given time.

In the next three chapters, I will show where I have set the balance for myself as a model. This is not for readers to copy slavishly, but should be adapted to each reader's own unique situation, experience, beliefs, attitudes and personality.

Deciding on asset classes

The total of funds we have to invest may be placed in various types of securities. The various types of securities are called 'asset classes' in financial jargon. The most common asset classes for investments are stocks, property, bonds (which include fixed-interest securities) and cash. Each of these asset classes has periods of relatively high returns and periods when they will perform less well than the other asset classes. This is a higher level of specific risk, as it applies to whole asset classes. It is dealt with through diversification across the asset classes.

The starting point for most investment plans is the decision to set the proportion of capital that is allocated to the main asset classes. It is usual to set these asset allocations as percentages of the total of funds available for investment, but to do so in bands. Thus, an investment plan might allow stocks to be at any time between 40 per cent and 60 per cent of total funds. The other asset classes will have their own percentage bands.

The idea of the bands is that from time to time the proportion of funds allocated to each asset class may be changed, depending on the perceived risk or outlook for that class of asset. So, when the outlook for one asset class is good, relative to the others, and the risk is low, a higher proportion of investment funds will be invested in it and less in other asset classes.

Since I am concerned about building wealth through stocks, I am only dealing here with the allocation to the stock market. The idea is that when the risk is low, I will try to maximise the proportion of my capital that is invested in stocks and hold only a minimal cash reserve. Conversely, when the risk increases, I will try to reduce the proportion of my capital that is invested in stocks and hold a much larger cash reserve.

So, when I say that I am 20 per cent invested, I mean that 20 per cent of my capital is invested in stocks and 80 per cent is in cash. If I say that I am fully invested, I mean that 100 per cent of my capital will be invested in stocks.

When the proportion of my capital that is invested in stocks is reduced, the funds released are placed in my cash reserve. Likewise when I increase the proportion of my capital that is invested in stocks, the additional funds will be drawn from my cash reserve.

There are two basic approaches to varying the proportion of my capital that is invested in stocks: passive investing and active investing.

PASSIVE INVESTING

This is where the capital is always effectively 100 per cent invested in a broadly diversified portfolio of quality stocks. The stocks are held long term and rarely sold. The investor lives off the growing dividend stream. Dividend income attracts low taxation, because of the Australian dividend imputation rules where company tax already paid on the dividend is used to reduce the investor's tax liability. The capital growth accumulates largely tax free and is either realised in retirement or inherited by the children.

Passive investing is driven by the time-in-the-market philosophy. This approach makes no attempt to reduce market risk. It is based on statistical research which shows that a large proportion of the gains in a bull market are made on relatively few of the days that it runs for. It follows that, if we are out of the market on these days, it is extremely difficult to even match the market, let alone to beat it. Of course, this argument ignores the converse. This is that if we are out of the market on the worst days, this strategy will also improve returns. Investors who find it difficult to believe that it is possible to time the market will generally be passive investors. If they are disciplined and patient, they will generally do very well with this method.

There is a variation on the passive investing approach. This is where a professional investment fund manager follows a stock-picking philosophy. The idea is that the manager will use his or her skill to gain a greater return than the purely passive approach. The rationale is that the additional return, called 'alpha' in industry jargon, will more than compensate for the fees charged by the professional manager.

The professional fund manager will buy stocks for the fund that are judged to be likely to give a greater return than a broadly diversified passive portfolio. The stocks selected will be changed from time to time in search of a superior return. Sometimes the professional manager will be permitted to hold a small proportion, usually less than 10 per cent, of the fund in cash. However, even where cash is not held, there may be some degree of market risk reduction. This is because there is some evidence that outstanding companies rise more than the market index on the up side and fall less than the market index on the down side. Whether this happens in reality depends upon the stock-picking skill of the professional fund manager.

Many private investors may also use this approach, even though they don't do so consciously. This is because their investment capital is relatively small and they buy and sell based on what they read in newsletters and the media generally.

ACTIVE INVESTING

This is where the proportion of the capital that is invested in stocks varies according to perceived risk and opportunity. This is the pure market timing philosophy and is the antithesis of passive investing.

Active investing is based on the idea that we can buy somewhere near the start of a bull market. We hold through the greater part of the bull market. Then we sell out somewhere near the top. This way we should catch the best days of the bull market and avoid the worst days of the bear market.

Active investing is also based on the idea that good companies tend to outperform the market index quite dramatically. It is not unusual for the price of a company to double or more in a year or to rise by five to 10 times in a few years. The market index will rarely come anywhere near this. There is therefore a fair margin for error in being out of the market on some of its good days. Our chosen stocks may more than make it up over the full market cycle.

WHICH APPROACH IS BETTER?

It is difficult to determine whether passive investing or active investing works best. Each school supports its view by producing convincing statistical evidence, based on carefully chosen assumptions. This is often what statisticians call torturing the figures until they confess.

Which is best will probably never be proven conclusively. The matter tends to come down to a belief in one method, which is probably based on the attitudes and personality of the investor concerned. It is also obvious that some people can succeed with either one of these methods, just as many may fail with the same methods. It may depend more on the quality of the investors' skills, and whether their attitudes are in tune with the method used, rather than the merits of the method by itself.

I am most comfortable with, and have built up my skills in, an active timing strategy. My overall approach to active timing is that I increase or decrease the proportion of my capital that is invested in stocks depending upon perceived risk in the market:

- ➢ When the risk is low, the proportion of my capital that is invested in stocks will be higher.
- ➢ When the risk is high, the proportion of my capital that is invested in stocks will be lower.

➢ When the market is trending down (in a bear market), I will have switched to having my capital 100 per cent in cash.

My strategy for determining the proportion of my capital that should be invested in stocks is driven by three analytical tools:

1 Dow Theory phase analysis.

2 The Coppock indicator.

3 Trend analysis of the market index.

In the remainder of this chapter, I will discuss each of these tools in turn and then bring them together in an overall strategy to manage market risk.

THE FIRST TOOL: DOW THEORY PHASE ANALYSIS

Dow Theory is the name given to the ideas that derive from Charles H Dow. He was one of the founders of *The Wall Street Journal*, which he edited up to his death in 1902. What we know now as Dow Theory is the cumulative work of Charles Dow, William Hamilton (who followed Dow as editor of *The Wall Street Journal*) and Robert Rhea, who researched and codified the ideas of Dow and Hamilton.

The single most important analytical tool that drives my strategy as to the appropriate proportion of my capital that should be invested in stocks at any time is Dow Theory phase analysis. This is a deceptively simple and powerful way of looking at the way market cycles unfold. I will discuss the three bull market phases first and then the three bear market phases.

INTRODUCTION TO BULL MARKETS

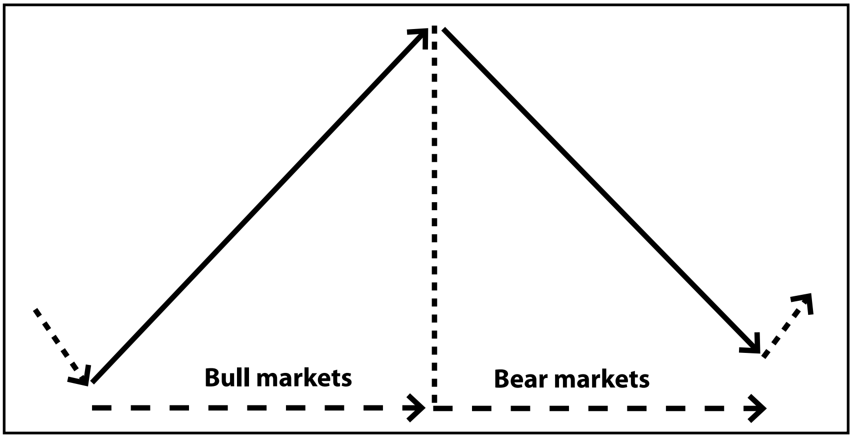
At first sight, it seems sensible to start with trend analysis of the market indexes to determine the condition of the market as bull and bear markets unfold. While this seems to be self-evident, I have found that it is not always true in practice. Technical analysts often believe that everything they need to know is on the charts. Nevertheless, it seems sensible to me to use other tools as well, because they can give us valuable insights that cannot be found on the charts.

One of the more neglected parts of Dow Theory is the idea that both bull and bear markets each tend to unfold in three recognisable phases.

This roadmap of bull and bear markets provides an exceptionally powerful tool for identifying the level of risk associated with the market from time to time. I use this assessment of risk as the primary method to drive my strategy for what proportion of my capital should be invested in stocks at any time.

Dow observed that markets swing up and down in bull and bear markets. Each swing will last from less than a year to several years. Bull markets are broad upward movements in prices. Bear markets are broad downward movements in prices. In conceptual terms, the big picture of these primary movements can be represented diagrammatically, as shown in figure 8.1.

Figure 8.1: primary bull and bear markets



I need to stress that this is only a conceptual diagram. It is not a chart of the market. In particular, there is no intention to imply that bear markets move the same distance in price, or take the same time to unfold, as bull markets.

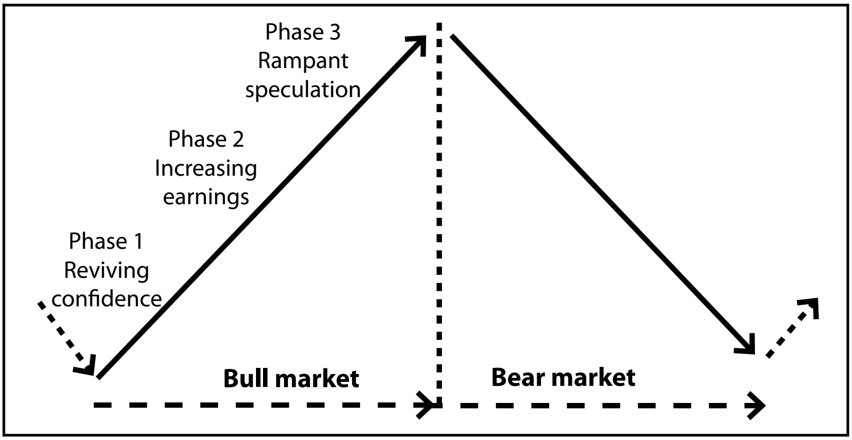
> As an aside, the only thing that is worth commenting on in that regard is that the length and strength of bear markets will, in general terms, tend to be proportional to the length and strength of the preceding bull market. Deep, long bear markets can be expected after long and strong bull markets, and vice versa. This is not a rule. It is a general tendency and no more than that. Do not be tempted to make too much of it or use the idea to make predictions. In markets, anything can happen. It is best to react to what is unfolding at any time, rather than to lock ourselves into a preconceived pattern.

Dow Theory has identified that primary bull markets tend to consist of three phases:

- reviving confidence
- increasing earnings
- rampant speculation.

The three phases of bull markets are represented conceptually in figure 8.2.

Figure 8.2: bull market phases



The phases of bull and bear markets can be identified by intelligent observation of what is happening around us in the market. To some extent this is a subjective process. We need to be careful that we do not ignore evidence contrary to our preconceived ideas. This is a very common trap in thinking. It is called 'confirmation bias'. This is where we see in neutral information only what we want to see, in order to confirm our view. There is also a strong tendency to ignore or downplay evidence that is contrary to our preformed view.

In the following sections, I will describe each phase in detail, setting out some of the important evidence to look for. By carefully working through this checklist, we can guard against our tendency to only see evidence that confirms our existing view.

Even with the inherent risk of deluding ourselves with a subjective process, most people will tend to put the market no more than one phase away from what the consensus of objective observers would agree was the situation. This lack of precision is not a problem. Our observations are being used only to drive broad strategy, not specific buy and sell decisions.

Bull market phase 1: reviving confidence

Bull market phase 1: reviving confidence

Key indications:

- ➛ All news is bad.
- ➛ Based on anticipation.
- ➛ Public absent from the market.
- ➛ Market may ignore bad news.
- ➛ Thought to be a bear market rally.
- ➛ Disbelief turns to fear of missing out.
- ➛ Fundamental undervaluation.

Watching and waiting for the end of a bear market can be a lonely pastime, requiring great patience. Most of the news will be reporting recession conditions in the real economy. One very important difficulty is that stock markets do not make prices based on what is happening now. Stock prices are based on what savvy investors believe will be unfolding six to 12 months ahead. This anticipation factor means that while everything is gloomy, the market is anticipating what is ahead. For this reason, economists regard the stock market as a leading indicator for the real economy. It turns down before a recession begins and turns up before it is over.

It is common at this time for most people to have completely lost interest in the stock market. The general public will be completely disillusioned about stocks. They have abandoned the market to the professionals, except when they are perhaps forced to liquidate a holding to raise cash. The irony in this is that just when the best opportunities are emerging, the general public are not watching.

One important clue that the conditions for this phase are in place can be that the market may tend to ignore bad news. This can be about the economy as a whole, but particularly about individual stocks. It is as though the market has already factored the bad news into the price, and is expecting it. This can mean that the market trades essentially sideways for many months, and perhaps for up to a year or more. The market may be listless on bad news, but will not make new significant lows. In other words, a kind of equilibrium zone develops.

However, another alternative scenario is that there is one last downward move. This is the final capitulation of those who have hung on through the bear market. This last move down sees the remaining weak and disillusioned holders exit, removing the overhang of supply and preparing the way for the next bull market to begin. Then the reviving confidence phase starts with a swift rise. There will have been no obvious equilibrium period. As most weak holders will have bailed out in the last fall, some clear-sighted longer term holders will have come in and snapped up their cheap offerings.

Later in this chapter I will discuss the three basic ways in which the bear market ends and the bull market begins on the chart of the market index. This may sometimes help in confirming that the reviving confidence phase is starting, distinguishing it from what may look like just a rally in the bear market.

Because most people do not appreciate that the stock market is a leading indicator, the first rally in a bull market is likely to be misinterpreted as being another bear market rally. So, this phase will begin with disbelief that the worst is over. However, this rally will tend to run further and faster than they anticipate. Thus, the initial disbelief gradually turns into a fear of missing out. This is especially the case among professional fund managers. They scramble to buy the hot stocks, lest their performance suffers compared to that of their competitors.

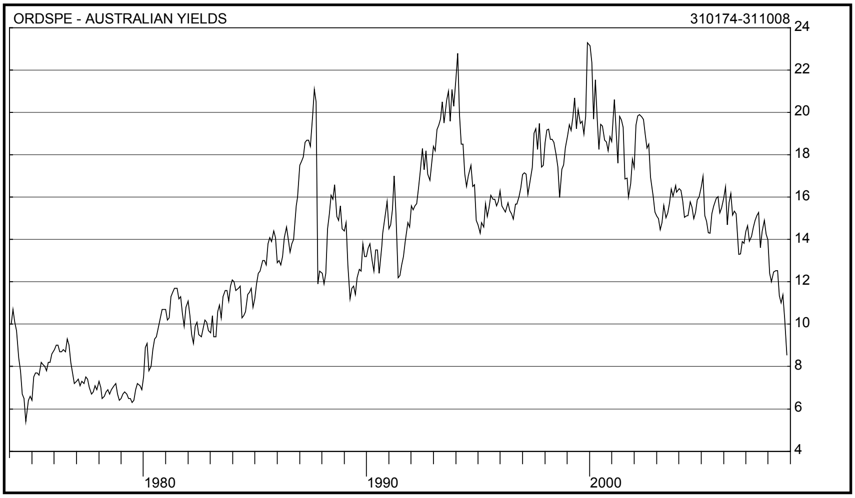
The factor that can be measured, though not precisely, is that the market will be undervalued in fundamental terms. There are many ways to assess this. The easiest is to monitor the overall average price/earnings (P/E) ratio for the stock market. This should be relatively low. Also helpful is to monitor the overall average dividend yield. This should be relatively high. Specific levels for these indicators are difficult to set. However, since we are looking for an extreme, it should not be too difficult to identify on a long-term chart of monthly P/E ratios or dividend yields.

> Readers who would like to continue to track and chart this data may download my historical data file from the *Resources* page on my website: <www.bwts.com.au>. It is updated soon after the end of every month.

The charts shown below are an amalgam of the data published regularly in the tables section of *Shares* magazine (prior to 1 July 2001) and in the weekend and Monday editions of *The Australian Financial Review*.

Figure 8.3 shows the Australian Securities Exchange average price/earnings ratio for the All Ordinaries index stocks.

Figure 8.3: ASX All Ordinaries index average price/earnings ratio

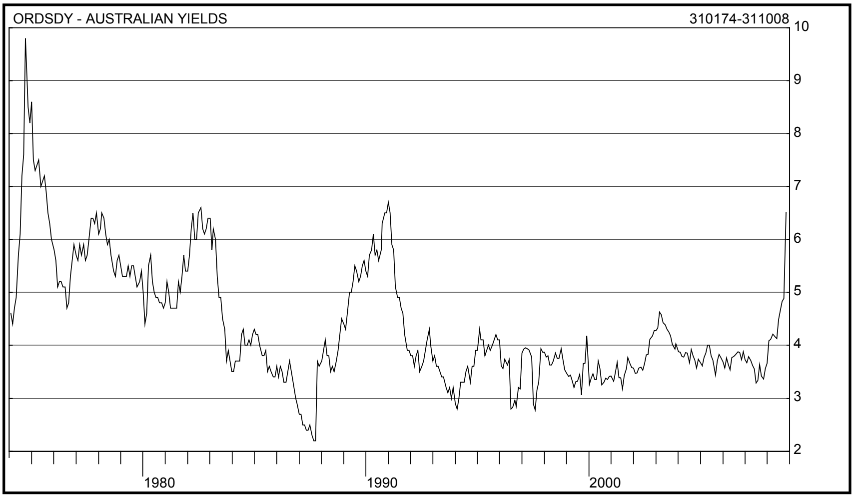


If we are looking for the start of a new bull market, we would expect to see price/earnings ratios down around the levels experienced in previous market bottoms.

I have previously seen the 1970s as an exception, because inflation was very high. However, there is another view that may be taken. This is that it was a very traumatic time. I remember that there was a great deal of fear in the market. What I think may be important is that at the end of the chart we are again living through a very severe bear market with banks and large companies failing around the world in a credit crisis. Real fear was palpable through 2008. What happened in the stock market in 2008 brought back vividly my memory of 1974 when the market fell relentlessly month after month. Price/earnings ratios fell to very low levels. This is happening again, which echoes the severity of the current bear market. It may take some years before the market again forgets what can happen and we again see the elevated P/E ratios of the late 1980s and the 1990s.

Figure 8.4 shows the Australian Securities Exchange average dividend yield for the All Ordinaries index stocks.

Figure 8.4: ASX All Ordinaries index average dividend yield (%)



The standout feature was the very high yields enjoyed at the nadir of the bear market plunge in the early 1970s. We are again heading towards the upper reaches of that chart, driven by the extreme fear in stock markets around the world. It will be interesting to see just how far the yields will rise this time. It may be another rare opportunity to buy into sound companies at bargain basement prices. Nevertheless, before we get too excited, we need to see how things pan out this time. There may be a lot of pain to bear first and it may take a few years rather than months before the tide finally turns.

Interpreting these price/earnings ratio and dividend yield charts is complicated by changes in the methodology over time, the advent of dividend imputation, and, most importantly, the level of inflation.

Notwithstanding all these difficulties and complications, extreme levels are not that difficult to identify. They will often alert us to avoid being fully committed at the top of bull markets. We should therefore be able to avoid being caught holding stocks through bear markets. In addition, these charts can give us good clues as to roughly where we are in the bull and bear market cycles.

BULL MARKET PHASE 2: IMPROVING EARNINGS

Bull market phase 2: increasing earnings

Key indications:

- ➣ Earnings increases emerge.
- ➣ Good news announced.
- ➣ Employment picks up.
- ➣ Longest and safest phase.
- ➣ New companies floated.
- ➣ Significant corrections end higher.
- ➣ Fundamental values normal.
- ➣ Sector rotation.

As the name of this phase suggests, it will be marked by the announcement of higher earnings by many companies. Smart investors will not pay attention only to actual profit announcements. They should also be attuned to profit forecasts by chief executives and remarks by company chairmen, which are strong indicators for their increasing confidence in the period ahead.

Generally good news about the economy will dominate both the financial and broad media. The economy will be seen by most commentators as being well on the road to recovery and continued growth. The level of optimism and confidence generally will be rising. In particular, employment will start to rise as new jobs are created and new businesses are started.

This tends to be the longest of the three phases. It can also be the most orderly, with lower volatility of prices than in either of the other two phases. This makes it the safest and easiest phase in which to be invested in the stock market.

Rationalisation of troubled companies and industries will be behind us and there will start to be the floatation (initial public offerings) of existing private businesses and some new enterprises on the stock market.

Fundamental valuation of the overall market will have returned to more normal and sustainable levels. Again, the long-term price/earnings ratio and dividend yield charts will be useful measures.

Some stocks will be strongly leading the rise. However, most stocks will participate in the uptrend to some extent. The exception will be a few basket cases from the excesses of the previous boom that have limped through the bear market, but are still too weak to participate in the improved conditions.

This phase is not one of uninterrupted rises in prices, however. There will be significant reactions to the upward trend. Sceptics may mistake them for the beginning of a new bear market. In reality, they represent further buying opportunities. The key thing to watch is that significant corrections finish higher than the previous correction, such that the upward trend remains intact.

Another interesting phenomenon will appear in this phase. This is called 'sector rotation'. There is no objective measure for this, but as its name suggests, different sectors in the market tend to take their turn in leading the advance, while the previous leading sectors tend to take a breather. Thus, banks might run upward for a while, then chemical manufacturers, then insurance companies, then retailers and so on.

Bull market phase 3: rampant speculation

Bull market phase 3: rampant speculation

Key indications:

- Significant fundamental overvaluation.
- Interest rates relatively high.
- Increased price volatility.
- Many new floats and capital raisings.
- Public enter the market; also day traders.
- Media coverage and interest increases.
- Market regulation relaxed.
- New paradigm theories advanced.
- Market driven by few stocks.

This phase is in many ways more important than phase 2. In phase 2 the idea is to stay fully invested. However, in phase 3 it is time to begin executing the market exposure strategy. This is the time when risk has increased substantially and we should be taking money out of stocks. I will discuss later how I do that. For the moment, the task is to recognise that we have entered this phase.

The first sign will be that fundamental valuations are much higher than normal. In the 2003 to 2007 bull market, we were lacking a good guide here. If we go back to the long-term price/earnings chart, we can see that the previous three bull markets ended with the price/earnings ratio over 20 times. In 2007, as we approached the top, the price/earnings ratio looked more normal than overvalued. This is when it pays to look at all the evidence, rather than to see one indication as evidence that all the other indications are wrong. Nevertheless, the price/earnings ratio was elevated to some extent, even if not compared to the three previous bull markets. It should be noted that the price/earnings ratio in 2007 was still higher than at the 1980–81 top. Clearly, this is a relative rather than an absolute measure.

To distil these comments into a more general statement, fundamental measures, such as price/earnings ratios and dividend yields, will indicate relative overvaluation. This applies to the market as a whole, but particularly to stocks in the hot sectors. The market is not only discounting current values and reasonable expectations. It is also making wild extrapolations into the future. Everyone is bullish.

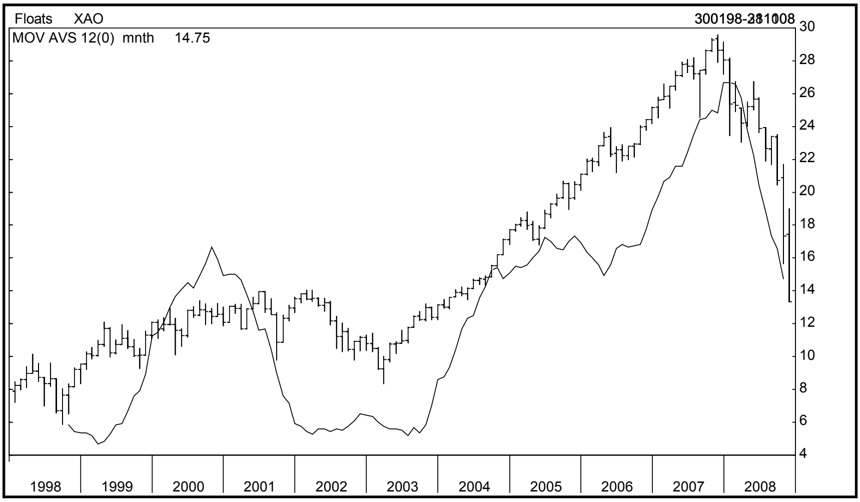
By this stage in the business cycle, reserve banks will have increased interest rates. This is done to try to cool the speculative heat in markets and to prevent the outbreak of inflation. Interest rate increases will have a direct effect on the cost of debt to businesses and hence reduce their profits. Likewise, higher interest rates will depress spending by consumers because more of their income is needed for mortgage payments. This in turn will tend to depress demand and hence business profits.

This is also a time when price volatility increases; this means the extent of the daily and weekly price movements for the overall market, but more particularly for individual stocks. We are in a time of speculative excess, and rumours of all kinds result in extraordinary bursts of speculation in the hot stocks of the day. This volatility builds on itself as day traders come in to exploit the volatility and in doing so exacerbate it.

This will also be a time of many new floats of existing or new businesses. What is happening here is that the market is now in the wild final stages of the bull market. It is pricing assets at way more than their intrinsic value in normal times. In that situation, many owners of private businesses see an opportunity to sell part-ownership of the company to the public at inflated prices, often while retaining a large enough stockholding to retain effective control. It is also a time when promoters of speculative business ideas will sell them to the speculators.

I maintain a data file which records the number of new floats in each month. This data is easy to obtain from the Australian Securities Exchange website. However, it is an unusual series, in that it is remarkably seasonal. There are strong peaks just before the halfway point in the Australian financial year (November–December) and to a lesser extent the end of the Australian financial year (May–June). To deal with this seasonality, I plot a 12-month simple moving average of the number of new floats. I overlay this series on a monthly bar chart of the ASX All Ordinaries index, as shown in figure 8.5.

Figure 8.5: 12-month moving average of new floats



Readers who would like to continue to track and chart this data may download my historical data file from the *Resources* page on my website: <www.bwts.com.au>. It is updated soon after the end of every month.

The chart of new floats is not a timing indicator. Its purpose is to show visually the amount of speculative heat in the market. Many of the newly floated companies will be quite speculative and concentrated in the latest hot sectors of the market. Companies in the speculative end of the market will change their name and switch their business into whatever is the hot sector this time around. Governments may privatise state enterprises and big companies float off unwanted businesses, all at the inflated prices being paid for assets in the stock market.

Notice that the new floats line topped out ahead of the index in 2000. This was because the speculative part of the market was technology stocks and that bubble came to an end in early 2000. The market went on to retest the high, driven by large stocks in the manufacturing and service sectors, particularly banks and other financial stocks. In 2007, the new floats line topped out with the market index, driven in part by the peaking of the financial and property company sectors, which are relatively large in the Australian stock market.

This is when the public comes into the market. Brokers rediscover private investors. Newspapers, magazines, TV news programs and internet sites start to take an interest in the stock market. Lots of people want to quit their day job and become day traders. Computerised trading systems are actively marketed to the uninitiated. Rank beginners and latecomers will all seem to be making money, on paper at least, in the stock market. Everyone around us will be only too willing to take any opportunity to talk about stocks.

It is worthwhile to keep an eye on the media. When stories appear on the front page of newspapers or the covers of magazines proclaiming the stock market will keep rising forever, it is often one of the last bells to ring at the top. Be afraid at this time and act urgently to get out of the way of the coming bear market. It may seem to take a while coming, but coming it is.

Around this time, market regulations will be relaxed. There is a cycle to market regulations. After each bull market ends in tears, governments and the market regulators tighten up laws, rules and regulations to avoid the same abuses happening again. It is called closing the stable door after the horse has bolted. Then, when the next bull market gets quite hot, there is pressure to relax the laws, rules and regulations. An example from the last few cycles is the banning of short selling in the 1970s, only to be reintroduced in the 1980s and again banned for a time in 2008. Another example is the banning of cash box floats (companies that raise large amounts of money with no definite investments in hand, often in other securities rather than real businesses) in the 1980s, only to be reintroduced in 2004–05.

New paradigm theories begin to be advanced. Phrases like 'sustainable growth at high levels' and 'it is different this time' begin to be heard. Absurd statements are made. One might be that the latest technology will make all traditional industries redundant. Another common one is that governments have abolished the business cycle. They will claim that, although they are taking steps to restrain growth, there is no risk of a recession, because they can engineer a soft landing. This has happened once or twice in living memory, but rarely after significant excesses have insinuated themselves into the markets, so that even the old hands sometimes do not see what is coming.

A very sure sign, if another is needed, is that the few stocks that led the bull market may continue to advance. However, the general body of stocks outside the speculative sectors will not make further significant upward progress. They may churn sideways, or even start to fall on the charts. The market will continue to rise on the back of a small group of companies as the speculative binge works its way to its final denouement.

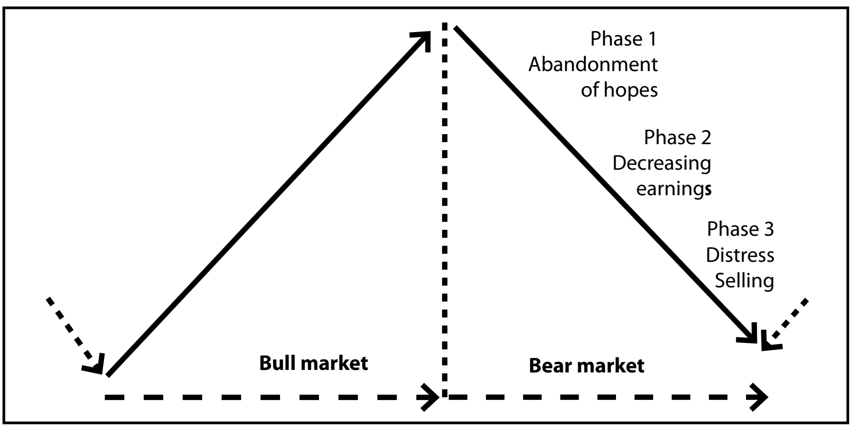
Introduction to bear markets

Once a bull market is finished, a bear market will follow. There may be a period of transition between a bull market ending and a bear market starting. However, once it begins, Dow Theory has identified that a primary bear market tends to consist of three phases:

- abandonment of hopes
- decreasing earnings
- distress selling.

The three phases of bear markets are represented conceptually in figure 8.6.

Figure 8.6: bear market phases



BEAR MARKET PHASE 1: ABANDONMENT OF HOPES

Bear market phase 1: abandonment of hopes

Key indications:

- Fundamental valuations will still be high.
- Interest rates peak.
- The economy is still strong.
- Public see a buying opportunity.
- Volume falls; buying is done.
- Market may ignore good news.
- There may be some shock news.
- The public may also panic, triggering a crash.
- Floats fail and are then abandoned.

In a bull market, investors have driven prices ever upward in the expectation of growth in earnings.

At the end of a bull market and the start of a bear market, fundamentals usually suggest that the market is overvalued. Price/earnings ratios are relatively high. Dividend yields are relatively low. Sometimes the high price/earnings multiples that investors and speculators are paying for companies will be reflected in headline news items. Examples are the 80 and 90 times earnings paid at the end of the great 1980s bubble market in Japan and up to 300 times earnings paid for some technology and internet companies in the US bubble market of the 1990s. These are sure signs that we are near the top of the bull market and the first move down is just around the corner. It will come as a surprise to most investors and speculators, because they have been slowly conditioned to think that the high prices are normal as the bull market has risen ever higher for several years.

Interest rates will also be in the news at this time. Rates will have been ratcheted up as the bull market unfolded in an effort to control inflationary forces building up in the economy. Interest rates usually reach a peak in the first phase of the bear market. Sometimes one of the interest rate increases will seem to have precipitated an initial sharp drop, which ends the bull market and starts the bear market. This first drop can be quite traumatic. All those left in the market at this time will discover that they have stayed for one upward move too many.

It is often ironic at this time that the real economy seems strong. It may even be booming. Usually, many commentators and advisers will point to the economy. They will argue that everything is fine and it is just another little bump along the road. Instead, we must try to focus on the cyclicality of the stock market. The other thing to remember is that the stock market always turns down ahead of the economy. It sets prices in anticipation of what is to come. Many months and maybe a year or so later we are likely to be in a recession.

At the very end, we may see a mad dash upward in a last speculative fling. However, the end may also come almost quietly as volume seems to dry up, except for a few speculative darlings that have their run, one after another. Volume will have dried up because all the buying has been done and investors are waiting for their expectations to be met with higher profit announcements.

Then, at some point they wait to see evidence of the great expectations on which high prices are based. All the buying has been done and results are awaited. The buyer prepared to pay the highest price for a company has paid it and this has happened generally across the market. Around the top and especially after what turns out to have been the first move down, the market may seem to ignore good news. Expectations have been raised so high that ordinary good news seems to be just that, ordinary. There can also be a great general feeling of disbelief.

Sometimes the end takes the form of a substantial transition period. A very wide and deep trading range will form on the chart, over many months and perhaps up to a year or more. Eventually, the market may slide lower for lack of buying rather than active selling. Almost everyone treats it as a normal correction in the bull market. They might even look at it as a buying opportunity.

This is not the only way the bull market can end. Sometimes, there will be a wild rush of speculation, driving the market steeply upward, until it collapses just as suddenly in a crash. Prices tumble quickly across the board. Alternatively, there may be just a series of waves of selling, interrupted by sharp but nervous rallies. Generally, people realise that the expectations that drove speculation to such a frenzy have been dashed.

There will often be some event, or series of events, that suggests doubt about the wild expectations on which the last phase of the bull market was built. It may be a series of earnings downgrades as companies warn analysts that their expectations are too high. There may be a spectacular failure of one or more large companies which have taken the excesses of the bull market too far and paid the ultimate penalty. There may be an announcement or other event that shocks the market. A good example here is the attack on the World Trade Center in New York in 2001. The downward move was already well under way in 2001, but this disaster crystallised the situation and there was another big fall in prices.

Some high-profile floats will fail by listing well below the prices paid by subscribers to the float. Other floats in the pipeline will be abandoned.

Bear market phase 2: decreasing earnings

Bear market phase 2: decreasing earnings

Key indications:

- Earnings decreases announced.
- Market ignores good news.
- Former market leaders may fail.
- A recession begins.
- Sharp rallies leading to further falls.
- Few new floats.
- The public lose interest.

Phase 2 tends to be the longest and most orderly of the three bear market phases. It can require great patience to sit through months, or perhaps years, of successive declines, punctuated by rallies. However, in the worst bear markets, it can also be a time of great distress as the market falls relentlessly month after month.

Fundamentals will have returned to reasonable values. In cyclical companies, they may even be at undervalued levels. However, no one is in the mood to buy these stocks, expecting prices to go lower.

Companies will generally try to maintain dividends, so the dividend yield could even begin to look very attractive. Some commentators and advisers will be telling the public that stocks are cheap with good yields.

However, this may only mean that prices are cheaper than they were. Nobody knows how much cheaper they may become. There may also be a real danger that profits keep falling and dividends are reduced or even cut completely.

The other thing to remember about price/earnings ratios is that they are based on past earnings. So, they may look attractive on that basis, but not if earnings fall further in the process of bringing the price/earnings ratio back to a normal level. Some will suggest using estimated earnings to calculate the ratio. I generally ignore such estimates, because they tend to be simple extrapolations or rosy hopes in a situation where things change for the worse.

The market will now tend to fall on bad news, either general developments or specific company announcements. On the other hand, good news will tend to have little effect on the stock concerned or on the market; because everyone is now so gloomy, they are in no mood to buy.

The bad news at this time may be economic developments generally as the economy slides into a recession. There will be discussion in the media about the definition of a recession. This is much like passengers on a stricken ship arguing about the precise point at which they can definitely say the ship is sinking.

News can also involve former market leaders struggling to survive. Some of the previous market leaders will crash and burn. They will go into liquidation, or be taken over at greatly reduced prices. Stockholders will suffer enormous losses. Previous speculative darlings will have fallen 80 or 90 per cent from their peak prices. They will still be held by the general public and professionals alike, but primarily by the general public, in the vain hope that one day they will recover. Bankruptcies begin to rise throughout the economy.

Nevertheless, in a bear market there are often very strong rallies. Brave souls can trade them. The innocent mistake them for the start of a new bull market. These are known in the business as 'sucker rallies'. This is because many investors and speculators have not yet fully realised that the bull market had conditioned them to buy into rallies. In the bear market, this behaviour just pulls in more suckers. The market then begins the process of teaching them the reality of a bear market. Each such rally is followed by a decline to new lows. In the second phase of a bear market, these declines are driven by an expectation of, and then the actual announcement of, lower earnings.

There are very few floats. However, those that make it to the market will often be sound businesses and are worth watching. This is because it is very difficult to find buyers for new floats at this time and only very sound, established businesses with a good track record will be taken public. Some new listings come through a so-called backdoor listing in the shell of failed companies, when the shell is sold by the liquidators.

The general public lose interest in the stock market completely. Except, that is, for following the sensational reports of the spectacular failures that are uncovered from the boom times: 2008 examples include ABC Learning Centres, Centro, Babcock & Brown and Allco.

Bear market phase 3: distress selling

Bear market phase 3: distress selling

Key indications:

- Significant undervaluation.
- Unemployment peaks.
- Many bankruptcies and failures.
- Bad news is discounted.
- Market rarely in the news.
- Low public interest and participation.
- Stock price charts show accumulation.

This is the end game of the bear market. Profits will have fallen and begun to stabilise for the companies that will survive. This means that pricing becomes more rational. Price/earnings ratios will be relatively low, because the market is undervalued on a long-term basis. Similarly, dividend yields will be relatively high.

Professional investors begin patiently buying stocks that are sold by disillusioned or financially strapped investors. However, they almost never push prices up, unless there is a panic sell-off, when they might start buying aggressively at bargain prices. Instead they simply absorb stocks offered by the general public, those who speculated at or near the top of the market and are now desperate to sell.

This desperation is driven by the increasing fear that prices will never recover. They get out while they have something left. This selling is also driven by the need to meet mortgage or personal debt repayments, often associated with loss of a job.

A strong sign of the final phase of the bear market will be high unemployment levels, perhaps peaking at this time or at the latest in the first phase of the next bull market. This will be placing strong pressure on governments. This is typically a time when the ruling party is voted out, if an election falls in this phase.

There will be widespread financial stress. There are increasing reports of companies failing or being in severe difficulties. Vulture funds are formed to buy distressed companies or assets. There are many bankruptcies and failures among both listed and unlisted companies and especially among the ranks of small business. Small business always suffers the most in the recession that accompanies a bear market.

We will know that we are near the end when the market begins to accept bad news as though it is already built into the price. The company concerned may see its share price fall, but more likely the bad news is already well anticipated. Sometimes, what seems like bad news will lead to a rise in the price of the company. This is because the market had feared it would be worse and investors are actually relieved.

At this time, the market will not be prominent in the news. Even bad news seems mild compared to what has gone before and what is happening in the real economy. Specialist magazines and newsletters catering to the former market frenzy shrink and then either close or merge. Newspapers shrink their market coverage. Television only features the markets when one of the savage declines carries to new lows, or a former market leader calls in the receivers.

Brokers reduce staffing and concentrate almost entirely on institutional and professional clients. Private clients are simply not interested at the very time they should be. Research, of any kind, will dry up for them. There will be failures and mergers of broking firms. People day trading for their living are never heard of again. Promoters selling computerised trading systems go broke or just close their doors and disappear.

There is often much debate among those who use phase analysis. This will centre on whether we are in the second or the third phase of the bear market. In chapter 11, I will introduce my value model for how charts of value stocks unfold. In the final phase of the bear market, we should see increasing numbers of stocks forming accumulation patterns on their price charts. This pattern takes the form of a broad sideways formation. It forms as patient professional investors and savvy private investors buy undervalued stocks from the disillusioned public. If there are now quite a lot of these charts, it will give some comfort to our view that we are already in the last phase down in the market.

Conclusion: market phase analysis

Dow Theory phase analysis is very important. It adds qualitative evidence, which is usually very easy to see around us, to any conclusions from trend analysis. It is not that difficult to know which phase we are in. It is more difficult by far to detect, at the time, the top or bottom of bull or bear markets on the charts.

The value of phase analysis is that we can expand the proportion of capital that is invested in stocks when we are in the first and second phases of a bull market. We can then cut it back once it is clear we are in the third phase of the bull market. Once we detect the first phase of the inevitable bear market, we can even withdraw entirely from the market.

Then, as the third stage of the bear market emerges, we can dust off our charts and begin cautious buying. We should not be caught asleep at the switch when the first stage of the next bull market begins. Brokers or the media will never announce it. We have to see it for ourselves. It will not be difficult to see once we know what to look for. We should be building positions as it unfolds.

Once we discern from Dow Theory phase analysis what phase we think we are in, we can look for evidence using the charts of the market indexes. If we think that we are in a trending phase, we will look for evidence of a trend on the charts.

Likewise, if we think that we are near a turning point, we will again look for evidence on the charts. Any correction in the trend will be given more importance now. Contrast this with earlier in the bear market, when we will be more disciplined to stay out of rallies, no matter how strong and inviting.

The second tool: the Coppock indicator

The Coppock indicator was invented by Edwin Coppock, a US investment adviser. He designed the indicator to do only one thing. This was to indicate when it was time to buy long-term holdings near the bottom of a bear market. Before we look at the calculation and interpretation of the indicator, we should understand what Coppock was trying to do.

Most investors come into the stock market in the closing stages of a bull market. They then suffer losses in the following bear market. Many take their losses at some point and swear off the stock market for life. A few learn the lesson and work at getting back into the market early in the next bull market, when risks are much lower.

Coppock pointed out that even a superficial look at long-term charts of stock markets will show that from time to time there are deep valleys, when it would have been perfect to buy. Beginners never do this, but some professionals calmly wait for these times and take advantage of them. Coppock made this point very strongly when he pointed out that most people buy on good news and sell on bad news.

Our aim should be to buy early in bull markets with the professionals, not in the high-risk terminal phase of the bull market when rampant speculation sucks the punters into buying on greed and hope. Coppock designed his indicator for just this purpose.

Coppock described the calculation of the indicator and its use at some length in his paper *Realistic Stock Market Speculation*, which seems to have been last revised about 1967 and has long been out of print. The indicator was designed for the Dow Jones Industrial Average and is calculated monthly. It has been found to be useful for almost any stock market index.

Although some books suggest the indicator is calculated from average monthly values of an index, it is clear from Coppock's paper that the closing index value for the month is used. The steps in its calculation are:

- Calculate the percentage change between the index value at the end of the current month and its value 14 months earlier.
- Calculate the percentage change between the index value at the end of the current month and its value 11 months earlier.
- Total the two percentages.
- Calculate a 10-month weighted moving average of the total of the two percentages.

> Readers are invited to download an Excel spreadsheet from the *Resources* page of my website, <www.bwts.com.au>, which shows each step of the calculation, including the weighted moving average, and has over 100 years of history data for several market indexes.

This is the indicator, which is plotted on a chart.

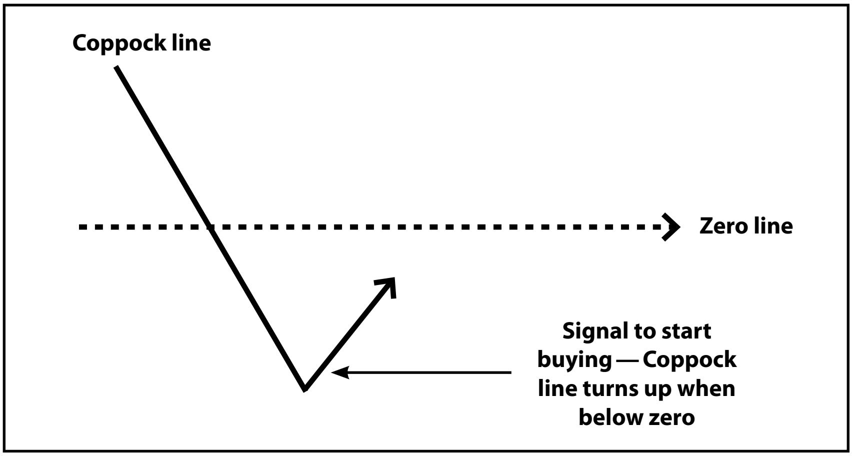
The Coppock indicator is a little cumbersome to calculate, but it is possible to do it by hand, especially since there is only one set of calculations to make each month. It is built into many computer charting packages and can also be easily calculated on a spreadsheet.

The Coppock indicator is usually plotted as a line chart below a monthly bar chart of the market index. Technically, the Coppock indicator is only a very specific form of the general indicator type known as a long-term momentum oscillator. In other words, it measures changes in the speed of price change in the stock market.

Being an oscillator, the Coppock indicator will swing between positive and negative values. The signal for long-term investors to begin buying is when the indicator turns up when it has fallen below the zero line. In other words, the signal is when it becomes less negative than it has been. Figure 8.7 shows the signal.

Experience has shown that the Coppock indicator can give a signal a few months earlier than the exact bottom of the bear market. It can also give a signal a few months later than the exact bottom.

Figure 8.7: the Coppock indicator signal



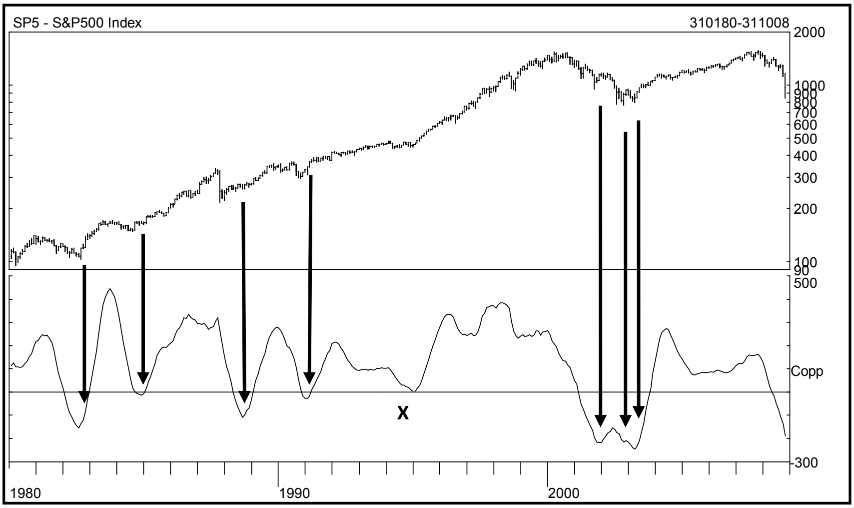
It was never intended to be a precise timing indicator to pick the bottom of the market cycle. Instead, it was only designed to indicate a period of low risk when long-term investors might start buying. Therefore, it is one more tool that we can use to help us identify the level of risk as input for our strategy for deciding what proportion of our capital should be invested in stocks.

Coppock's strategy for signals on his indicator was to start buying strong stocks for long-term appreciation, not for short-term speculation. Strong stocks are stocks that are trending up. They will have moved out of a downtrend or of a sideways price pattern by rising above a significant peak on their charts. If we cannot find any of these stock charts, then the signal may be premature and we should wait until they appear.

Following Coppock's advice to buy stocks that are trending upwards should not be disastrous. These stocks could well be the leaders of the next bull market. However, if any of their upward trends fail by dropping below a significant trough on their charts that will signal us to execute our sell stop.

While the Coppock indicator has a very good record, it is not infallible. Coppock was quite clear that all methods may at times fail in some markets. Thus, he believed that different methods must be used in parallel as a means of reducing risk. Indeed, the Coppock indicator posed some challenges in the bear market that began the third millennium, as it seemed to be giving premature signals in several major stock markets, particularly the US market, for which it was designed.

Figure 8.8: monthly US S&P 500 index with Coppock indicator in sub-chart



The monthly bar chart in figure 8.8 of the US S&P 500 index, with the Coppock indicator in the sub-chart, covers the period 1980 to 2008 and shows seven signals marked with arrows:

- ➢ The 1982 signal was well timed, suggesting buying at the start of the great bull market from the lows of the recession of 1980–82.
- ➢ The early 1985 signal, while it looks late compared to the exact bottom, anticipated the tremendous rise into the 1987 peak.

- ➢ The 1988 signal came in good time after the sharp correction in 1987. It should have positioned Coppock indicator followers for the great bull run of the 1990s on the US stock market.
- ➢ There was another confirming signal in the 1991 recession. There were no more signals from the Coppock indicator until 2001, because it remained in positive territory right through the 1990s.
- ➢ 2002 brought two signals. The first one was early in the year and, as it turned out, a little premature. The second signal late in 2002 was during the formation of the sideways pattern at the end of the bear market, so was appropriately timed.
- ➢ 2003 produced a signal that, in hindsight, was almost perfectly timed and that led to a sustained rise in the market and took the Coppock well up into positive territory.

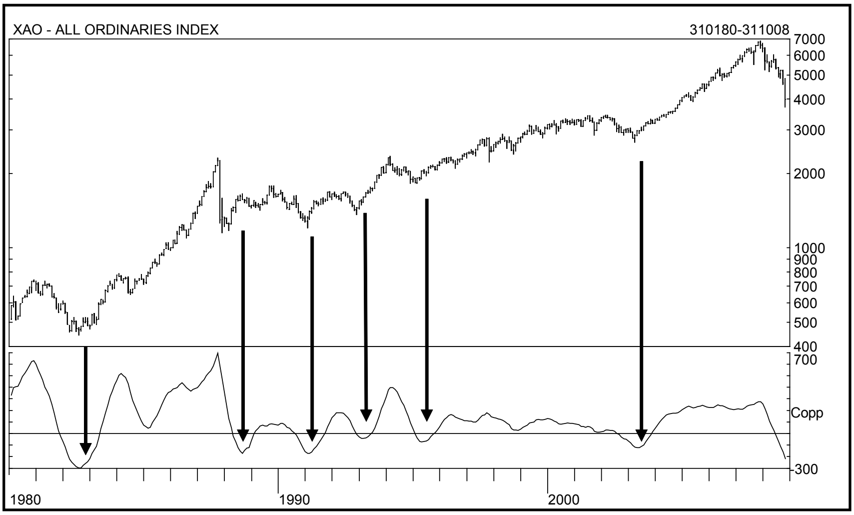
At the end of the chart, in late 2008, we see that the Coppock indicator has again fallen deeply into negative territory, where a signal is likely. How soon that signal comes remains to be seen.

There is also a very interesting situation in early 1995, marked X on the chart. There had been a strong downward trend in the index through most of 1994. This was arguably a bear market. This time, however, the Coppock indicator sunk to 2, which looks on the chart as though it was at zero. This is where the discretionary investor has an advantage over the mechanical systems investor. It seems to me that it is quite in order to have seen this as being so close to what is technically a signal that it might have been used as a signal. It turned out that 1995 was a very good buying opportunity, because it preceded a very strong upward section of the bull market.

However, being able to see which signals were premature and which were well timed in hindsight is of little use. What is important is the action we take from signals when they occur. My view is that investors should have acted on them by looking to buy uptrending stocks. If there were uptrending stocks, then the signal really was early. However, if it were possible to find some strong stocks, an investor ought to have begun building positions in those stocks. If some had weakened and hit sell stop levels, they would have been sold. Of course, I did not take any of them, because I do not invest in US stocks, but a US investor would have done little harm by gradually moving into the market in strong stocks on each of these signals.

The record of the Coppock indicator in the Australian market over the same period is equally impressive, as shown on the monthly bar chart of the ASX All Ordinaries index from 1980 to 2008 in figure 8.9.

Figure 8.9: monthly ASX All Ordinaries index with Coppock indicator in sub-chart



In the Australian market, the Coppock indicator gave six signals in the 28-year period, marked on the chart with arrows:

- The 1982 signal was a bit early, but nicely positioned us for the rise out of the recession of 1980–82.
- The 1988 signal followed the 1987 crash and was late, being near the top of the subsequent rally. As it turned out, this rally and the next one can be seen in hindsight to have been part of a wide sideways pattern as the market digested the excesses of the boom leading up to the 1987 crash. It took longer for the Australian market to recover than in the US.
- 1991 saw a good signal, just after the bottom of a sharp decline.
- The 1993 signal was similar, but turned out to be even more rewarding. The market was able to rise above the peaks of the broad sideways pattern formed between 1988 and 1992.
- The 1995 signal was given a little after the bottom, but still in plenty of time to catch most of the great rise into the end of the century. This was followed by a long period without a signal. This is not unusual for such a strong and consistent bull market.
- The 2003 signal was a little after the exact bottom, but in plenty of time to catch most of the rise, which had carried the index to the late 2007 peak.

At the end of the chart, in late 2008, we see that the Coppock indicator has again fallen deeply into negative territory, where a signal is likely. How soon that signal comes remains to be seen.

Appropriate use of the Coppock indicator

When some people see this evidence, they fall in love with the Coppock indicator. They then try to use it for everything. A common question I find myself fielding is whether it will work for sector indexes and for individual stocks.

Also, some beginners ask whether the Coppock indicator can be used for selling signals as well.

My answer is that I have never done any research on those usages. Nor has anyone ever shown me his or her research on them. The Coppock indicator is not magic. It is simply a specifically optimised long-term momentum oscillator, which was created for one purpose. Also, timing the buying of individual stocks is quite a different problem to assessing general market risk.

The technical analyst toolbox contains many other methods, which may be even better than the Coppock indicator in these situations. Nevertheless, if readers wish to use it on stocks or sector indexes, I would caution them to do the necessary research before using real money on it.

When using technical analysis, it is important to always understand how the various indicators work. Most of the time, they can be used fairly mechanically. However, at critical times they may pose challenges that require us to understand how a situation may be different to normal. As we saw in the charts of the US and Australian markets for 1980 to 2008, the Coppock indicator generally gives good, clear signals when bear markets unfold steeply without large prolonged rallies. The long-term charts (not shown) reveal that there have been occasions when a bear market has taken rather longer than normal and descended rather more slowly and unevenly. When this happens, there is a risk that the Coppock indicator may give several premature signals before the final bottom is reached.

The third tool: trend analysis of the market index

The logic of the definition of trend is my third tool in deciding when to vary my level of market exposure. It is also the critical idea around which my approach to managing investments in individual stocks revolves, as we will see in chapter 12.

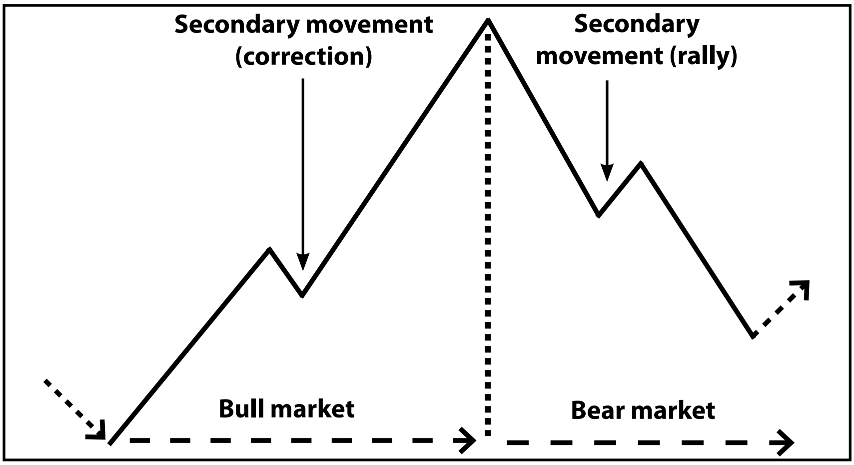
Dow Theory holds that markets swing up and down in primary bull and bear markets. Each swing can last from less than a year to several years. Bull markets are broad upward movements in prices and bear markets are broad downward movements.

These broad bull and bear markets are not all one-way affairs. Secondary movements will interrupt these primary trends:

- In a bull market, secondary movements take the form of corrections, or downward movements, which are counter to the primary upward trend.
- In a bear market, secondary movements take the form of rallies, or upward movements, which are counter to the primary downward trend.

These secondary movements can be represented conceptually by adapting the diagram we used earlier for phase analysis, as shown in figure 8.10.

Figure 8.10: secondary movements in bull and bear markets

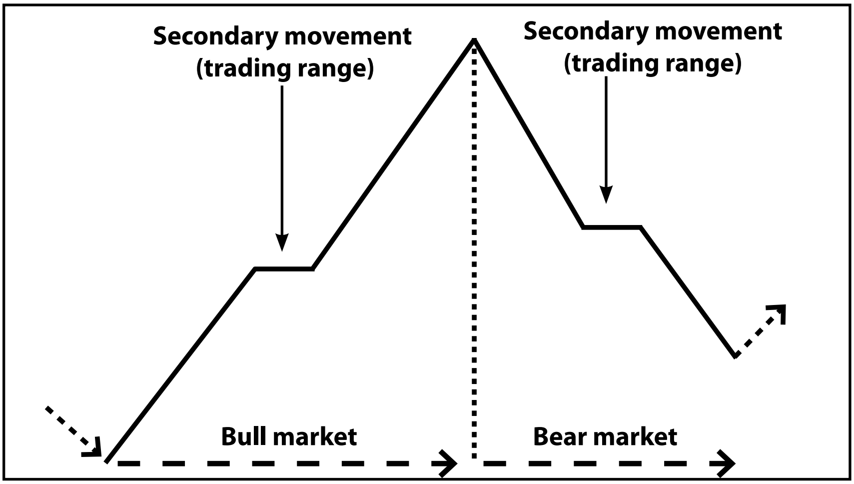


It should be noted that this is a purely conceptual diagram. For simplicity, I have chosen to show only one correction in the primary bull market. Likewise, I have chosen to show only one rally in the primary bear market. There are usually many more secondary movements in typical bull and bear markets. Both the number and size of secondary movements will vary from one bull or bear market to the next. Size refers both to the price range of, and to the time it takes to form, a secondary movement. Also, the size of secondary movements will vary from previous secondary movements in the same bull or bear market.

Corrections and rallies in the form of trading ranges

Dow Theory includes one exception at this point. The secondary movements in a bull market are shown as counter-trend corrections. Likewise, the secondary movements in a bear market are shown as counter-trend rallies. However, it was noticed that secondary movements may take the form of a sideways movement. This was given the general name at the time of a line. It is now generally described as a trading range. Figure 8.11 shows this important variation in the form that secondary movements can take.

Figure 8.11: secondary movements as trading ranges in bull and bear markets



These trading ranges sometimes slope slightly in the direction of the primary trend, rather than being absolutely sideways movements.

The same phenomenon can also be found reasonably often on the charts of individual stocks. Accordingly, it is important not to get locked too closely into the conceptual diagrams that are being used to explain the theory. Markets unfold in endless variations. It is better to think of trends as strong movements in one direction, with pauses from time to time. These pauses can retrace some of the ground covered by the last trending move, be a sideways movement, or only a marked slowing in the primary movement.

WHEN BULL AND BEAR MARKETS BEGIN

One of the most important things to notice on the last two diagrams is that identifying the endings of the primary bull and bear markets is difficult from the chart alone. The start of a new bull or bear market will initially look very similar to the start of one of the many secondary movements in the primary trend.

There is no way to resolve the difficulty of distinguishing the start of a secondary movement from the start of a new bull or bear market. However, this is where Dow Theory phase analysis is so useful. It helps us to suspect when a correction is more or less likely to be the end of a bull or bear market. It does not give us certainty, but it suggests whether the risk is relatively high or low. If we know the relative risk, then we can adopt an appropriate strategy to deal with that market condition.

By far the most significant contribution of Dow Theory to technical analysis is the definition of bull and bear markets. Dow's insight into how to define them was simplicity itself:

- ➢ A bull market is in place when the market rises higher than its previous peak.
- ➢ A bear market is in place when the market falls lower than its previous trough.

The simplicity of this definition is beautiful. We can work from it logically and define some precise models that give us clear signals when bull and bear markets begin and end.

Before we discuss them, we need to recognise that what Dow Theory calls bull and bear markets are actually uptrends and downtrends respectively.

This aspect of Dow Theory was only concerned with the overall stock market, so it is customary to talk about bull and bear markets when discussing the direction of stock markets as a whole.

However, the idea that markets move in trends is of general application. The rest of the time, it is customary to talk in terms of uptrends and downtrends.

Since this discussion is about assessing the trend of the stock market as a whole, I will adopt the convention of referring to bull and bear markets. When I discuss individual stocks, later in the book, I will refer to uptrends and downtrends.

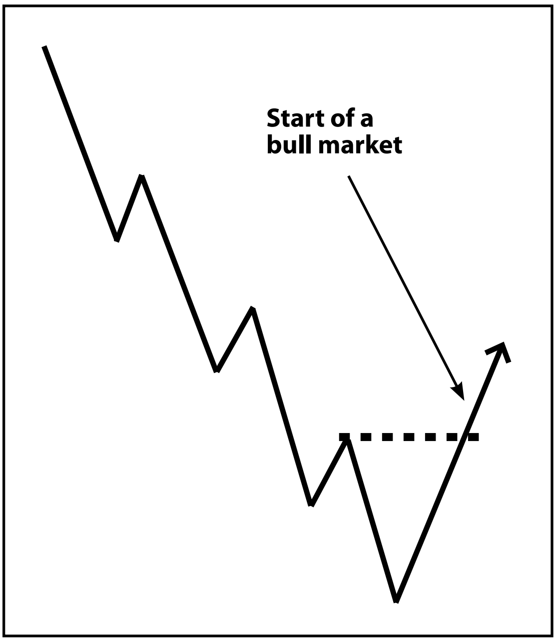
It is possible to work logically from Dow's definition of bull and bear markets and define precisely when they start and when they end. It is actually a little more complicated than we might think at first. Markets can unfold in many different ways. This is very confusing to most people. However, there are only three general ways in which bull and bear markets begin and end. Once these are understood, we can deal with almost anything the market throws at us.

Bull markets

Dow's definition was that a bull market is in place when the market rises higher than its previous peak. This means that there are only three general ways in which a bull market can start.

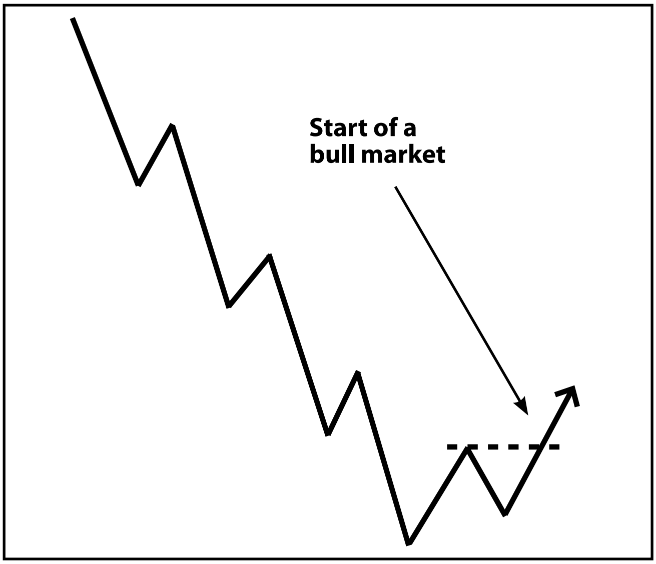
1 The market is falling. It then rallies above the peak formed on the previous rally, as shown in figure 8.12.

Figure 8.12: rally above the previous peak



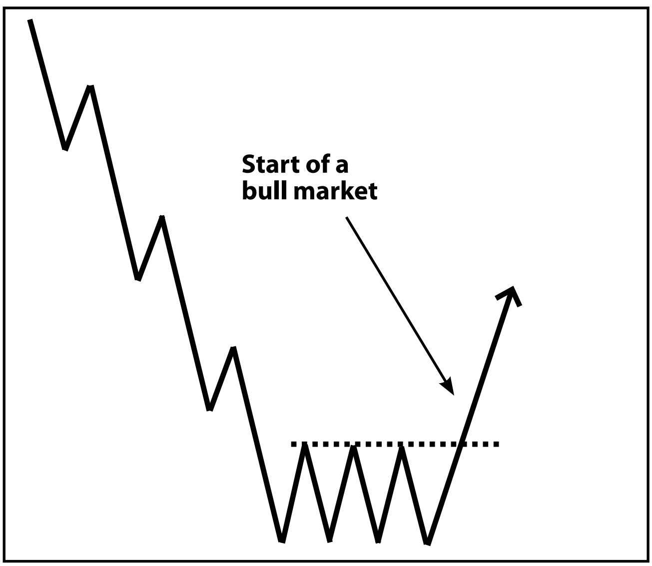
2 The market is falling. It then rallies, but does not rise above the peak of the previous rally. After forming a trough which is higher than the previous trough, it then rallies again and rises above the peak formed on the rally from the lowest trough, as shown in figure 8.13.

Figure 8.13: rally above the previous peak after forming a higher trough



3 The market is falling. It then rallies and declines several times, forming a trading range. It may have given several consecutive conflicting signals, which were quite quickly negated. Eventually, the market rallies above the highest peak in the trading range, as shown in figure 8.14.

Figure 8.14: rally above the highest peak in a trading range



Bear markets

Dow's definition was that a bear market is in place when the market falls lower than its previous trough. This means that there are only three general ways in which a bear market can start.

1 The market is rising. It then declines below the trough formed on the previous decline, as shown in figure 8.15.

Figure 8.15: correction below the previous trough

2 The market is rising. It then declines, but does not fall below the trough of the previous decline. After forming a peak which is lower than the previous peak, it then falls again to below the trough formed on the decline from the highest peak, as shown in figure 8.16.

3 The market is rising. It then declines and rallies several times, forming a trading range. It may have given several consecutive conflicting signals, which were quite quickly negated. Eventually, the market declines below the lowest trough in the trading range, as shown in figure 8.17.

Figure 8.16: correction below the previous trough after forming a lower peak

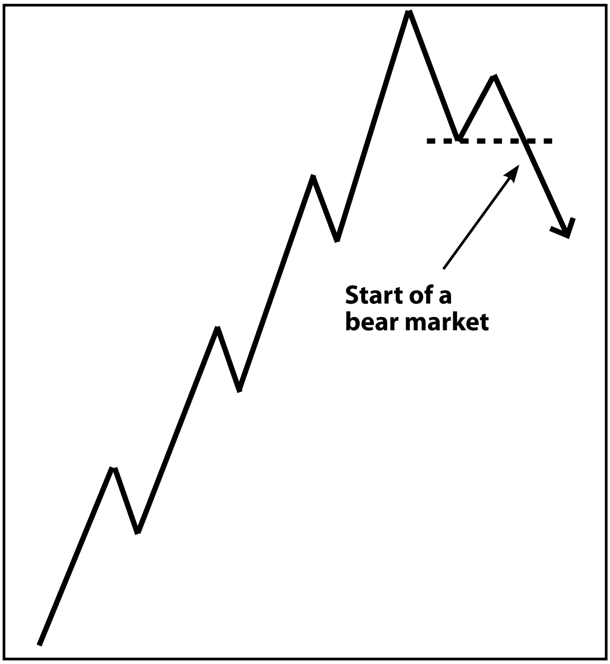
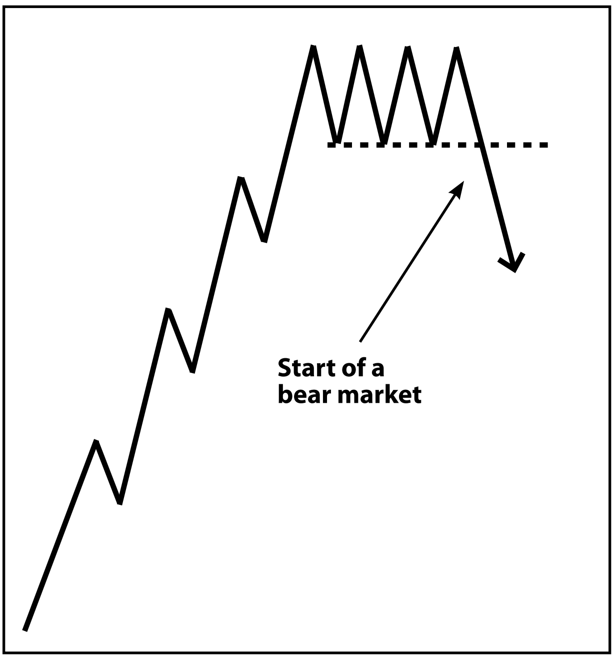


Figure 8.17: correction below the lowest peak in a trading range



The definition and discussion of the three general ways in which bull and bear markets begin is based on Dow's editorials. There is one important problem that needs to be addressed. This is that a change in trend will sometimes be signalled, but that signal will be later negated by an opposite signal and the initial trend will reassert itself.

This greatly concerns some people. They think that somehow the signal has failed and that the whole idea does not work. However, there are few methods that do not present such challenges from time to time. We should not lose sight of our most important objective in investing, which is the preservation of capital. If one of the trend-ending signals occurs, we should stand aside. If the opposite trend develops, then we will be very glad that we stood aside. If the trend reasserts itself, we can easily get back into the market. The transaction cost paid on the additional sales and purchases is usually far smaller than the potential losses if the early signal turns out to be a real one and we ignored it.

Strategy for managing market risk

All investing involves managing risk. However, there are many kinds of risk. One of the most important risks to be managed is market risk. This is the risk associated with the movements in the overall stock market.

Strangely, discussion of strategies of managing market risk is generally absent from most textbooks about speculating and investing in shares. The concentration is on selecting stocks. It is assumed that we will always be looking to buy. Selling is generally given less attention than buying, but that is another issue. Very few writers consider whether we should be fully in cash or how we would make such a decision.

My experience has led me to believe that the management of market risk is critical to investment success. In 1987, we saw a crash on world stock markets. It started on Wall Street and spread instantly around the world. In the lead up to that event, the Australian stock market had been through a wild speculative boom. It was not difficult to have seen the rampant speculation of the third and terminal stage of a bull market all around us. We knew the bull market was on its final rush upward. The only thing we did not know was when the end would come. Nor did we know whether the game would stop abruptly or gradually.

As 1987 displayed more and more signs of rampant speculation, I had put my strategy for the proportion of my capital that should be invested in stocks into place. The third phase of a bull market is one when risk is very high. Sure, good profits were to be made. However, sooner or later, it had to end badly. My strategy calls for reducing the proportion of my capital that is invested in stocks as the risk becomes higher. I learned this from the story of Bernard Baruch, one of the great US speculators. His explanation for his success as a speculator was: 'I made my money by selling too soon'.

By October 1987, I had only about 25 per cent of my capital in the market. This saved me when the market fell about 25 per cent overnight. That year was my greatest loss in any year at 14 per cent, but it would have been a lot worse had I not reduced the proportion of my capital that was invested in stocks as the inevitable end approached.

As I write this book in late 2008, we are living through another bear market, the like of which we have not seen for a long time. It reminds me of 1974, but others have compared it to the US market in 1929–32. My experience with the current bear market has reinforced my conviction of the importance of my market risk management strategy.

By late 2006, I judged that we were entering the third phase of the bull market which began in 2003. I began to reduce my exposure to the market to 70 per cent stocks and 30 per cent cash. In late July 2007, the market came off a significant peak and I sold down my market exposure to about 50 per cent stocks and 50 per cent cash.

Although I put a little money back into the market in the subsequent rally to new highs, I was still about 55 per cent invested when the market topped out in November 2007. I then acted urgently to reduce my exposure to the market. In particular, I ruthlessly sold at market any stock which hit or in some cases threatened to hit its sell stop. By early 2008 I was essentially out of the market, and remained 100 per cent in cash through most of 2008.

I will discuss this market ending in more detail in the case study at the end of this chapter. For now, I have given a quick outline focused on the way my market exposure strategy has protected me from giving back too much of the bull market gains when the music stops.

The two greatest sins

There are two big sins that investors commit in the stock market and which my strategy is designed to avoid.

The story usually begins in a time when a bull market is well advanced. These new investors have not even noticed that there is a stock market until they read headlines about a boom or hear boasting from acquaintances telling how much they have made speculating in stocks.

New investors know nothing of economic history and how the boom and bust cycle has repeated throughout the last few centuries. Moreover, they believe the theories that it is different this time or that a new era is beginning.

Beginners rush in, with all their money, right near the top of the market. They buy speculative stocks, often because they feel they have to make up for lost time. More likely it is simply because that is where the action is and they have never heard that some stocks are more risky than others. Besides, stocks always go up in the long term, don't they? The result is inevitable and they get badly burned. They suffer big losses, because they had no plan. When the end came, they froze, having no strategy to protect their capital.

So, what were the two big sins in this story?

The first sin was that beginners entered the bull market much too late. If they had entered the market in 2002–03, when I did, then the losses in 2007–08 would not have been as catastrophic. This is because there had been several very good years beforehand. Even if they had been a bit slow getting out when the end was clearly happening in December 2007 and January 2008, they should have been able to switch into cash with much more than they started with in 2002–03. Over that period, I had been able to double my capital on a before-tax basis. However, most people only had investments they made near the top of the market.

The second sin was that beginners failed to get out when the bull market ended. They hoped that the bull market would come back and make them whole. They did not appreciate that stock markets are cyclical. Bull markets are followed by bear markets. So, they held on and their losses grew ever larger. Eventually, many of them will reach the point where they can no longer stand the pain. They will sell out at horrendous losses. Sometimes the market will make the decision for them when the company fails and disappears forever. Others will hold on grimly. This may work out satisfactorily in the long term. However, that will only apply where they have invested in sound businesses. The unfortunate truth will often be that they are holding erstwhile speculative stocks, some of which will vanish without trace, while others will suffer a slow, lingering death. Often, these failed speculative company shells are recapitalised after a huge consolidation of existing capital, which effectively wipes out the value of the original stock holdings.

Inexperienced investors come in near the top and get out near the bottom. Experienced professional and private investors will be doing the exact opposite. They get in near the bottom when stocks are undervalued. They get out near the top when stocks are overvalued. Professional investors and savvy private investors will frequently be on the other side of the transactions made by inexperienced investors.

Of course, it is not easy to do what the experienced investors do. At the best time to buy, near the bottom, everything looks very grim. It is tempting to put off investing because of fear. At the best time to sell, near the top, everything looks very rosy. Then, it is tempting to stay fully invested because of greed and overconfidence. The reason why so many get it wrong is simple. They do not realise that the market is cyclical and that it acts on expectations. It is looking six, nine or 12 months ahead. Smart investors do not invest on the basis of last year's earnings, or even this year's earnings just announced, but on their expectations of the next and the following year's earnings.

So, when things are really bad, when most of the bad news is out, smart investors will look forward and see that prices can only go up. Likewise, when silly prices are being paid for assets, those smart investors will reason that all the upside and more is already in the price and the market can only go down.

The timing of this process is not precise. It can be difficult to get it exactly right to the week or the month. Bull markets often run longer than rational people expect. Bear markets often end right when things look worst. People tend to extrapolate current conditions into the future, when they should be expecting that a change is due.

The objective for my strategy for the proportion of my capital that should be invested in stocks is to get me in near the bottom of a bear market and get me out near the top of a bull market. My strategy needs to give me a wakeup call when things are at their worst and sound alarm bells when things are too good to be true.

Another way of saying this is that I want to:

- ➢ Start putting my money into stocks when the risk is low and be completely invested as early in a bull market as possible.
- ➢ Start taking my money out of stocks as the risk becomes high and be completely out of stocks as early in the bear market as possible.

It is not difficult to set down what must be done. It is doing it that is difficult. Therefore, my strategy is designed to force me to confront the key decisions at an early stage.

The following strategy makes reference to a certain percentage exposure of my capital. My capital refers to a percentage of the total sum that I have allocated for investment in the stock market. My capital may be invested in stocks, or be sitting in cash. It is separate to the money that I may have allocated for investment in other asset classes like property, bonds and fixed interest or as a general cash reserve for day-to-day living expenses.

The percentages given are indicative *guidelines* only. I vary them depending upon my assessment of the circumstances in the market at the time.

STRATEGY FOR GETTING INTO THE MARKET

1 As soon as the third stage of a bear market (distress selling) is detected, I watch for stocks making new highs. If there is real fear in the market, so much the better, because any stock trending up in a savage bear market may be a screaming buy. I begin to buy them cautiously, investing up to 20 per cent of my capital into stocks.

2 When the Coppock indicator gives a signal, I increase the proportion of my capital that is invested in stocks to around 40 per cent. The Coppock signal is sometimes early. I try to have faith, so long as my stocks are making new highs. I may have to back out of some of them if they hit my sell stop level.

3 As soon as there is a clear upward breakout from a broad trading range on the index, or the index starts trending up by moving above the last significant peak in the index, I begin increasing the proportion of my capital that is invested in stocks to around 70 per cent.

4 After the first significant correction in the upward trend on the index is completed and the index moves above its previous peak, I will have 100 per cent of my capital invested in stocks.

STRATEGY FOR GETTING OUT OF THE MARKET

1 At the first suggestion of having begun the third phase of a bull market (rampant speculation), I reduce the proportion of my capital that is invested in stocks to around 70 per cent.

2 As the third stage of a bull market becomes more developed, I gradually reduce the proportion of my capital that is invested in stocks to around 30 per cent, acting urgently if the market comes off a very strong peak.

3 If the market index breaks down out of a trading range, or starts to trend down by moving below its last trough, I sell any stocks that do likewise immediately. I do not replace them. The bear market has begun. This will gradually take me out of the market altogether.

Inexperienced investors usually make a big mistake when they come to the point where they decide to reduce the proportion of their capital that is invested in stocks. They decide to take profits by selling their best performing stocks first. However, these are the best companies. What they should do is sell the stocks in their portfolio that are performing worst. These are the ones that have not made the grade and may never make it. So, I first sell any stock on which I have not yet made a profit, even if I have just bought it. The last stocks to begin running in a bull market are the weakest.

Only once all the stocks on which I have not yet made a profit are cleared out do I start reducing holdings that are showing profits and still trending up. I sell my entire holding in the stocks that have made the smallest percentage profit so far. I sort my portfolio of stocks in descending order by percentage gain on cost. I sell the stocks upward from the smallest gain toward the largest gain until I have reduced my exposure to the market to the level required by my strategy. Remember that the best stocks in each bull market tend to keep going the longest and go much further than we ever imagine. If they had begun to trend down, I would already have sold them. If they start to trend down next week, I will sell them then.

This approach is the exact opposite of what most people will feel they should do naturally. It takes a lot of conscious discipline. That is why, when the hard decisions have to be made, I adopt an almost mechanical procedure.

Another aspect of this that will worry some people is that it is calling for the sale of stocks which are still trending up. Isn't this breaking the rule of letting my profits run? Yes it is, however my strategy for the proportion of my capital that should be invested in stocks overrides this rule in recognition of the most important principle in investing, which is the preservation of capital. The risk is now too high to have all my money on the table.

Above all, remember that we are investing in individual stocks, not the index. Regardless of our view of the market as a whole, we should get out of any stock which begins to trend down. It can always be bought back if it turns around. Once we have sold a stock that has begun to trend down, we are no longer emotionally attached to it and cease to rationalise holding on to it. Moreover, this often opens our eyes and capital to better opportunities. A major cause of losses in investing is the holding of a bad investment, justified to ourselves by reference to the market as a whole, or good profits on the whole stock portfolio. This is a simple case of rationalising a bad position based on evidence that is not relevant. The only thing pertinent to investing in a particular stock is its own chart.

Most of us have extreme difficulty staying out of the heady days towards the end of a bull market. Everyone we talk to seems to be making money on stocks that we know in our heart of hearts to be sheer speculations. We should remember that the inevitable result will be large losses.

There are three case studies in chapter 14 that demonstrate the practical implementation of my market exposure strategy.

Chapter 9

Managing specific risk

In the previous chapter I outlined my strategy for dealing with the risk associated with the gyrations of the general market. The rises and falls of the general market affect all stocks to a greater or lesser degree. However, the movement in the price of individual stocks is often quite different to the general market, in extent and sometimes also in direction. This is reflecting the market's expectations for each individual company.

In the long term, the price of an individual stock is largely driven by the trend of its earnings. In the short term, the price of a stock will tend to swing up and down more widely than the trend in its earnings, as investors react emotionally to news and rumours and form expectations of its next earnings report. These swings will tend to be around the underlying longer term trend of the price of the stock.

At any one time, there will be companies that are performing far better than the general run of companies in the economy. There will be others that are in varying degrees of trouble. Therefore, it is quite possible for a stock's price to fall sharply even in a strong bull market if its business runs into serious trouble. In other words, there is risk in the business, quite separate from the risk that derives from the overall swings in the market. This is called specific risk and is the risk associated with an individual company.

Diversification

The standard way to deal with specific risk is to diversify the portfolio of stocks. Instead of having our capital riding on the fortunes of one company, we spread it over many companies, in different lines of business. The idea is that if any one company goes belly up, or if a whole industry falls on hard times, it will not be catastrophic for our capital. The more we spread our risk by diversification, the less exposed we are to the fortunes of any one company or industry.

However, there is a problem with this. If we spread our capital over a large number of companies, we will have minimised our specific risk, but we will also have doomed our capital to mediocre results. If our capital is large, we may have effectively constructed our own index fund (a managed fund which seeks to generate a return equal to a market index). Our results will tend to mirror the rise and fall of the market.

My objective requires that I try to do better than the index. One way this will be achieved is through the market risk strategy, which aims to keep me out of the market when it is going down. This is not generally enough to meet the overall objective. I am also looking for my portfolio of stocks to do better than the index when I am invested in the market. This means that I have to focus my portfolio on excellent stocks that do better than the overall market. In other words, if I select my stocks well, each one has the potential to make a meaningful contribution to my results.

To understand this, assume that I have a widely diversified portfolio of 100 stocks and that I have 1 per cent of my funds in each stock. If I get one of them right and it doubles in price, it will generate 1 per cent of the annual result. My aim is to exceed 12.5 per cent annual return. Since 4 per cent of that return will be from dividends, I need to have nine of these stocks that double in price (nine stocks times 1 per cent plus 4 per cent dividends gives 13 per cent total return) .

Now assume that I have a tightly focused portfolio with 20 stocks in it, each one being 5 per cent of my funds. To exceed 12.5 per cent annual return, of which 4 per cent is dividends, I only need two of them to double in price (two stocks times 5 per cent plus 4 per cent gives 14 per cent total return).

In the widely diversified portfolio of stocks, I have to find nine outstanding stocks each year. However, in the sharply focused portfolio of stocks, I only have to find two.

So, in devising a strategy to deal with specific risk, we have to balance two competing requirements:

- ➢ There should be sufficient diversification of our portfolio of stocks so that specific risk is manageable.
- ➢ There should be concentration of our portfolio of stocks into a small enough number of stocks that, if we get them right, they will make a meaningful contribution to results.

Portfolio management theory has shown that as we increase the number of stocks, we reduce the level of specific risk. However, it is not a simple relationship. If we start with one stock in our portfolio, specific risk is high. Just adding one additional stock reduces it considerably. The same happens as we add a third stock, but soon the benefits start to level off. As we add a few more stocks to the portfolio, the reduction in specific risk levels off even more. After a point, as we add more stocks to the portfolio, the risk is only reduced marginally.

The optimum number of stocks in a portfolio is somewhere between eight and 12, depending on which textbook we read. However, there is a very important caveat on this conclusion. This introduces the problem of correlation. Portfolio management theory specifies that eight to 12 stocks are sufficient only when they are not correlated. In other words, their prices tend not to move together. However, we have already seen that all stocks are to some extent correlated, because they are all subject to the ebb and flow of the overall market. This suggests that we need more diversification than this ideal minimum.

My diversification ***guidelines*** are:

- ➢ I invest ***at least 2 per cent*** of my capital in any one stock. This means that it is a meaningful stake.
- ➢ I invest ***no more than 6 per cent*** of my capital in any one stock. This means that if I were fully invested and went to the maximum on every stock in my portfolio, I would be holding 17 stocks.
- ➢ I try to ***avoid having more than two companies in the same industry*** at any one time.

The first thing to note is that these are guidelines. I am not obliged to stick to them rigidly in all market conditions. If I think that the situation warrants it, say because the risk is low, I may be at the most active end of these guidelines, with 17 stocks. However, if I think the risk is somewhat higher, I may not go so heavily into so few companies and may spread my capital across a greater number of stocks. Somewhere between 20 and 30 might be typical in this situation. Theoretically, I could have

50 stocks, with 2 per cent of my funds in each, but this is far too many. More typically, my portfolio will contain a number of stocks in the low 20s.

There is another reason why these must only be guidelines. I do not often put 6 per cent of my capital straight into a stock in one lot. I will start with 2 per cent and build the stake toward 6 per cent as the trend I am trying to exploit unfolds. This means I could have quite a few positions that are incomplete at any point. For one reason or another, some will never be built to 6 per cent of my capital.

Also, there will be some stockholdings in my portfolio that I had built up to 6 per cent of my capital, but which later matured to the point where I have taken some profits. In some circumstances, I may be left with less than 6 per cent of my capital in the stocks after taking profits.

Another complication can be if my capital increases significantly, say with the addition of savings. This may mean that theoretically more should be put into some existing positions. However, I may judge that the trend is well advanced and I do not wish to invest more at that time. An extreme example of this was in July 2003, when I brought in more capital, approximately doubling what was available for investment. I had some existing holdings that I did not want to increase. So in the following year, my portfolio had somewhat more stocks in it than normal. In time, these situations worked themselves out.

Finally, it is important to understand that the 2 per cent and 6 per cent guidelines only apply when I make the initial investment and when I complete building it respectively. The total capital may change subsequently in either direction, which may alter the percentages. Also, the performance of each stockholding will either increase or decrease and this will vary the percentages.

Position size

The problem of managing specific risk is a little more complicated than simply deciding how many stocks should make up the portfolio and how they are spread over the different industries.

Most people initially think that the amount of money we have invested in a stock is the amount which is at risk in that investment. Indeed it would be if the company we had invested in suddenly went into liquidation. However, while that does happen from time to time, it is highly unlikely that we would lose the entire amount allocated to buying a stock. We should get some warning that things are going wrong and be able to sell out and recover a large part of our investment.

Also, we have already dealt with the unlikely event of a company failing without warning in the previous section dealing with diversification.

The better way to measure how much is at risk in a single investment is quite different. It is the subject of the second leg of my approach to managing specific risk. When we invest in any stock, we select a price at which we decide to buy it. We should have decided to buy the stock in the expectation of making a profit by selling it later at a higher price. So, we should have some model in our mind for what should happen if the investment works out as we hope. The corollary is that we should also have in mind what price move would signal that our investment was going wrong. This is where we should cut our losses and run. Assuming that we stick with that plan and cut our losses at that point, we have now defined the amount we have risked on any single investment. What we have risked is the difference between where we buy and where we plan to cut our losses. So, if we buy 1000 shares for $10 each, we have allocated $10 000 to the investment in that stock. If the price at which we would be wrong about the investment is $7.50, then we have risked $2.50 on each share or $2500 in total of the $10 000 invested in that stock.

In considering how much to risk on any one stock, we must be careful to look at things so that we keep our overall aim in mind, while being careful that we are making valid comparisons. The key to both these requirements is to express risk in terms of our total capital. That way we maintain focus on the risk to our total capital, remembering that our objective is to make a return on the total capital over the year. It is not to try to make a return on every individual investment, because we know some of them will work out very well, while others will result in losses.

I always express risk as a percentage of my total capital. I have already done this in the previous section when I talked in terms of a percentage invested in each stock and how easy it was to see the effect on total return if the prices of the stocks doubled.

I need to be precise about what I mean by my capital. I am only referring to the capital that I have invested, or intend to invest, in stocks. It excludes any capital allocated to other asset classes, like property or bonds. At any one time, my capital will be either invested in stocks or held as a cash reserve. The cash reserve is that part of my capital that is awaiting investment opportunities. I may also hold some of my capital in cash if my market risk strategy does not permit it to be invested in stocks at the time. So, ***when I refer to my total capital, I mean the total market value today of all my stockholdings plus any cash reserve.*** The value of my capital changes every day on which the market operates.

I revalue my portfolio of stocks every night. I use that value to calculate the size of the position that I may buy in any stock the next day. This means that if I am doing well, the value of each successive stockholding I buy will tend to be larger. If I am doing poorly, the value of each successive stockholding will tend to be smaller.

I could express the amount that I am prepared to risk in dollar terms. That is simple enough, but I like the way risk can be easily related to my objective by expressing everything as a percentage of the same base figure, my capital.

My firm ***rule*** is ***never to risk more than 0.5 per cent of my capital on any one stock***.

It can be seen immediately that this is a better way to think about losses and profits than dollar amounts. If I think in terms of a percentage of my capital it keeps me from fretting about the size of some holdings. When we invest, we are typically dealing with what for us can be very large amounts of money. Thinking of a risk as $20 000 will terrify some people, for whom that is more than they ever handle day to day. However, if they think of it as only half of 1 per cent of their total capital, it is easier to keep the risk in perspective. We would need 200 such risks to fail before we were wiped out.

One thing must be emphasised here. This is that 0.5 per cent is a ***maximum*** that I am prepared to risk. Typically, I will risk less than 0.5 per cent on any one stock. I am always amazed at how many people take the 0.5 per cent maximum as a minimum in the same way that they treat the speed limit as the minimum speed they drive on the roads. They creep above it a bit, and then a bit more. The whole idea of this rule is that it is to manage risk, not to take on more risk.

The other thing to emphasise here is that I described this as a ***rule***, not a ***guideline***, as I did with diversification. A rule means it is inviolate. I should feel uneasy and guilty if I am tempted to break it or stretch it a bit. The amount risked on any one stock is far more important to results than diversification, which is a rather more elastic idea.

The 0.5 per cent maximum refers to the price at which I buy in relation to the price at which I am going to cut my losses. To keep it simple, I ignore transaction costs. I also ignore slippage, which is when we put an order in to buy or sell at a price, but the trade gets done at a less favourable price. So, if I have my price to cut losses in a stock set at less than $1.45 and the market falls below that price, I may only succeed in selling at $1.42. The 3¢ difference is slippage.

The result of not taking transaction costs and slippage into the calculation of the 0.5 per cent maximum risk is that the calculation is easier. However, realistically it means that the actual loss is sometimes greater than 0.5 per cent. This is one reason why my risk percentage of 0.5 per cent is lower than similar approaches found in other books where transaction costs and slippage are supposed to be taken into account in the percentage. However, as I noted above, most people creep above the maximum. What is more, they get lazy and leave transaction costs and slippage out. The end result is that they risk a lot more than they set down in their plan.

By now, readers may be wondering why I titled this section ***Position size***, when I have not even mentioned it so far. The reason why I talk about specific risk in terms of the size of the position to buy in each stock is because that is how the risk control is exercised in practice.

Suppose that I decide to buy a stock and risk 0.5 per cent of my capital. Assume that the stock is currently selling at $12.00. Suppose also that, if the stock price fell to $10.00, my investment plan indicates that I would be wrong about the investment. What I have to do is to work out how large a position to buy in the stock.

Now suppose that my capital is $400 000; 0.5 per cent of that is $2000. So my plan allows me to risk no more than $2000 on any one stockholding. I would work out the maximum size of the position that my plan allows me to buy like this:

Buying price	$12.00
Price to cut losses	$10.00
Risk ($12 – $10)	$2.00

The size of the position I can buy is the $2000 that I am allowed to risk divided by the $2 I will be risking, which is a position of 1000 shares in this stock.

Notice that, if I bought 1000 shares in the stock at $12, my total investment would cost $12 000. This is 3 per cent of my capital, so it is well within the 6 per cent upper guideline for diversification. I made the example work out that way, but it will vary enormously in practice. Readers may therefore decide to buy a smaller position than 1000 shares, if they intend to build their investment in stages. I will return to this issue and how I balance diversification against how large a position to buy later in the book.

IMPORTANT CAVEAT ON POSITION SIZE

The percentage of capital that should be risked on any one position should be as low as possible. However, it is very important to understand that my choice of the percentage of capital to risk is not independent of the size of my total investment capital at the time at which I am writing.

When I started using this money management method, I used to risk 2 per cent of my capital. Then, my capital for investment in stocks was much smaller ($50 000 to $200 000). As my capital increased (over $400 000) through saving and investment returns, I reduced the percentage risked to 1 per cent. By the start of the last bull market in 2003, my plan was to risk a maximum of 1 per cent, but in practice I had tended to risk 0.5 per cent or less.

During the 2003–07 bull market, I was able to double my capital (now circa $1.8 million). This being the case, I find that I can now operate on a 0.5 per cent maximum risk per stock.

What this means is that this aspect of my investment plan will not suit every reader any more than will many other parts of the plan. We all have different amounts of capital to invest in stocks and we are comfortable with different levels of all the various types of risk which are involved. Readers with less capital than I have will find that they need to risk a higher percentage of their capital on any one stock in order to have a position of meaningful size. This also means that the transaction costs, which they have to pay on purchases and sales, are more manageable.

CHAPTER 10

MANAGING FINANCIAL AND LIQUIDITY RISKS

In the previous chapters I have discussed my strategy for dealing with the two main types of risk: market risk and specific risk. However, in devising an investment strategy, there is a need to also deal with other types of risk. The two principal risks still to be considered are financial risk and liquidity risk. Financial risk is the most straight-forward and will be dealt with first. After that, I will go through how I deal with liquidity risk. I will round out the discussion of my investment strategy by looking at several other aspects. All of them involve some element of specific or liquidity risk. They are often not given sufficient explicit attention by beginners.

FINANCIAL RISK: GEARING AND LEVERAGE

Financial risk results from borrowing money. The more money that is borrowed, the greater the financial risk that is involved. To understand this, consider a simple example.

A highly geared company may be financed like this:

Stockholders' funds	$10 million
Debt	$50 million
Total capital	$60 million

If the company makes $15 million profit (after interest payment on the debt), then the return on stockholders' funds is 150 per cent. If the whole $60 million capital had been contributed by stockholders, then the return would have only been 25 per cent.

This is the bright side of gearing. The dark side is that it also works in reverse. Suppose that instead of making a profit of $15 million, the company ran into trouble and made a loss of $15 million. In that case, the stockholders will have lost all their capital. The company could become insolvent and the directors or the lenders would call in receivers, unless stockholders were prepared to subscribe more capital.

However, if the whole $60 million capital had been subscribed by stockholders, the loss would only have been 25 per cent of their funds and it is still quite possible that the business could trade out of its difficulties.

This is how financial risk works: the higher the gearing, the less room for error and the higher the chance of the business failing.

One of the problems with investing in stocks is that, leaving trusts aside, we are investing in a company. Most industrial companies will have financed their business to some extent with borrowings. This means that even before we consider borrowing money to buy stocks, there will already be financial risk in the stocks we are looking to buy. The company may have over-borrowed and go out of business if things go against it. This is an aspect of specific risk. It can be managed using diversification and the size of our position in the investment. This was described in the previous chapter.

However, financial risk can be even more dangerous at another level. This is when money is borrowed to invest in stocks. In this case, we should be especially alert for companies that have high levels of debt. If we consider borrowing money to buy stocks in such a company, we would be adding more financial risk to an already high level of financial risk.

Although I have strategies for managing risk, there are some areas of my investment plan where I accept significant levels of risk in order to try to beat the average market return:

- My stock portfolio is not heavily diversified.
- The small number of stocks I hold when fully invested and the consequent size of these investments relative to my total capital is also reasonably risky.
- I deal in more volatile and risky stocks outside the range usually called 'blue chips'.

- I invest in a time frame and with sell stop levels that involve giving investments room to move.

Balancing this risk profile, I have adopted a conservative approach to financial risk:

- **I have a *rule*** that I do not borrow money to invest in stocks.
- **I have a *guideline*** that I avoid investing in companies with a debt-to-equity ratio over 60 per cent.

The debt-to-equity ratio for a company is calculated very easily from a company's balance sheet:

$$\text{Debt-to-equity ratio} = \text{Interest-bearing debt} \div \text{Shareholders' equity} \times 100$$

This simple formula gives the percentage that debt is of equity. While it is easy for a beginner to calculate, it is generally not necessary, because the ratio is readily available on the internet. Many stockbroker websites will give clients access to the Aspect Huntley research data, which includes this ratio. It can also be seen for most companies on the *Financial Review Smart Investor* website, <www.afrsmartinvestor.com.au>, on the Shares Tables page. It is also possible to subscribe to the Aspect Huntley Equity Review research website at <www.aspecthuntley.com.au>.

It should be noted that the 60 per cent limit is a ***guideline***, rather than an absolute rule. Companies in very cyclical businesses like building material suppliers are more risky than non-cyclical companies like grocery retailers and breweries. The point about this guideline is that it is a starting point. If the debt-to-equity ratio of a company is over 60 per cent, I would be looking very closely at the company and its industry. I would want to find a very strong case to accept a higher ratio than 60 per cent. On the other hand, some companies with debt-to-equity ratios well below 60 per cent may be in industries which are very volatile and I might want to see a far lower ratio.

Beyond the rule of not borrowing to invest and the guideline of 60 per cent debt to equity, it should be noted that I do not invest in stocks using securities that involve gearing or leverage in any form.

Gearing is simply the proportion of debt relative to our own equity in the investment, as explained above.

Leverage is slightly different. It refers to situations where we can invest a small amount, but control a large parcel of securities of some kind. These are usually what are called 'derivatives'.

Derivatives are simply securities whose value is determined by the value of some other asset. Typical examples are:

- futures
- options
- warrants.

The risk as well as the reward is magnified. In many cases, it is possible to lose more than the initial investment. I have a ***rule*** that I do not invest in derivative securities.

There is also some element of leverage involved in some other stock derivatives, which I will also avoid, particularly:

- company-issued options
- partly paid or contributing stock (also called 'instalment receipts' in Australia).

It should be noted that I am not opposed to borrowing to invest in stocks in any situation. It just does not fit with the active risk levels in other parts of my investment plan. However, borrowing may be appropriate for a long-term passive investor. The level of borrowing should still be kept to very conservative levels.

However, at the other extreme, investors who borrow a lot of money relative to their capital by mortgaging their home to buy derivatives of a stock with high debt and a history of volatile profits and losses is a financial risk accident waiting to happen.

There are a few other aspects of financial risk that are worth discussing. The first is whether to write options against the investment portfolio as a way of boosting the return. I do not do this. One important reason is that it complicates the selling decisions on my portfolio, which are difficult enough already. Another is that writing options involves a limited return with an unlimited risk of loss. However, the key is that my portfolio is actively managed. I can see the case for writing options against part of a long-term passive portfolio, but that is not my game.

Pyramiding is another interesting investment idea. We pyramid an investment when we use paper profits to borrow more money to buy more of the security at higher prices. This increases financial risk. It is therefore something I would not do. However, that said, there can be an element of pyramiding in the way I build a profitable investment in chapter 12 and theoretically in the way the size of my investments increase as my capital grows. This element of pyramiding is a minor and incidental aspect of my investment plan.

LIQUIDITY RISK: SIZE OF COMPANY

Liquidity risk is one of those risks of which many inexperienced investors are only vaguely aware. It will usually first manifest itself to them in one of two situations. The first is when they have heard a hot tip on a small company and find that there are very few sellers. They will have to bid much more than the last sale price in order to buy the position size that they want. Of course, in this situation, they could decide not to buy the stock and look elsewhere.

However, the second situation is much more inconvenient and potentially costly. This is when they have invested in a small company and the investment goes bad for one reason or another. They go to sell it and find that there are simply no buyers, or the best bid, probably for much smaller positions than they want to sell, is a long way below the last sale price.

They may not have noticed that the stock was illiquid, or thinly traded, when they bought it. At that time there may have been a great deal of interest in the stock. Or there may have been lots of disillusioned sellers who had losses on their holdings and were just waiting for buyers to take the stock off their hands on any rally.

However, when something goes wrong with a stock, the supply of buyers will dry up as potential investors wait for the situation to become clearer. Fear is a far stronger impulse than greed or hope. Therefore, in this situation there are bound to be a lot more fearful sellers than hopeful buyers.

The end result is that the unfortunate investors either refuse to sell at these prices, or they reluctantly accept the prices being bid. If they hold on hoping for a change, my experience suggests that prices will often continue to fall and the bid they knocked back will end up looking quite good in hindsight. If they accept the price being bid, they will be selling significantly below the level called for in their investment plan. This element of the plan was designed to keep losses small or to protect an unrealised profit. However, the reality is that there is no guarantee that it is possible to sell at the target price. This is one reason why I operate on a 0.5 per cent maximum risk to my capital in any one stock. The actual loss can turn out to be somewhat larger.

Liquidity refers to the number and size of buyers and sellers that have orders in the market at any one time. On the Australian Securities Exchange trading platform, it can be seen on the market depth screen:

- One side of the market depth screen shows the bids by buyers. It details the number of shares in a stock which they are bidding to buy at each price level.

- The other side of the screen shows the offers by sellers. It details the number of shares in a stock which they are offering to sell at each price level.

Big stocks will generally have issued a large volume of shares to a wide range of large and small investors. These stocks tend to have deep markets and are highly liquid. There will usually be only a small difference, or spread, between the highest price bid and the lowest price offered. Small investors can readily buy or sell shares in these companies at any time without significantly affecting the price.

Small stocks will not have issued a very large volume of shares. In addition, it is not unusual for many of the issued shares to be held by the original founders and key stockholders, who rarely sell any of their holdings. Therefore, small stocks will not have deep markets and are generally illiquid. There may be quite a wide difference, or spread, between the highest bid and the lowest offer. Sometimes there may be no buyers or sellers at all. Even small investors may find that it takes some time to get in or get out. They may find that they are the only buyer or seller and cannot achieve a price very near to the price of the last sale.

Clearly, this means that if we invest in smaller, less liquid stocks, we will be assuming greater risk.

What most inexperienced investors do when they become aware of liquidity risk is to swear off the stocks in smaller companies and stick to blue chips. However, I think this is a mistake. An important insight about investing is that the essential problem is to balance risk and return. It is rarely possible to do something that both reduces risk and increases return. Rather, as we tweak any aspect of our investment plan to reduce risk, we invariably also reduce the potential return.

There have been various studies that attempt to show that there is no significant advantage in investing in smaller companies. However, these studies have to be read very carefully, because what is a small company is in the eye of the beholder. Also, there are small companies that have good businesses and small companies that are mineral explorers or technology start-ups. The former have a lot greater probability of succeeding and staying in business than the latter. So, if the latter are included in the database of the study, it may be making the results look worse than if we only consider companies that have an ongoing profitable business.

The idea behind investing in a smaller company is partly based on its size. It can win a significant new order from a client of a large competitor without retaliation. This is because what is a big order for a small company is probably a relatively small chunk of business for a large competitor.

The large competitor is unlikely to start cutting prices to try to hold it, because of the flow-through effect across its entire customer base. For the small company, the extra sale may be a significant percentage of its sales and make a large contribution to its earnings.

Smaller companies are also far more agile in lots of ways than large blue-chip companies. Small companies tend to be more fast-moving and entrepreneurial than large companies which tend to be slow-moving and bureaucratic. Of course, there are always exceptions, but this is a general tendency.

Moreover, large companies will find it difficult to increase in size much more than the rate of growth in the general economy. They are unlikely to be able to increase in size by 50 per cent or more for several years in a row. However, smaller companies can grow very rapidly for several years in a row. All of this means that if we are looking for companies whose stock price might double, triple or even more in a few years, we should be fishing among the smaller companies.

However, smaller companies fail far more often than large ones. The leverage from their smaller size works both ways, just like financial risk. Smaller companies have small reserves and, unlike large companies that carry a great deal of financial fat, can often fail quite quickly. In other words, their potential for increasing their stock price significantly is matched by the potential to suffer large percentage falls in price quite suddenly in difficult economic conditions.

As always in managing risk, we are back to the problem of finding a balance, where risk is manageable, but potential return is not too restricted. My strategy in this area of my investment plan is relative to the level of risk that I am assuming in other areas. So, some investors might want to be less active than I am in this area of my investment plan, but more active than I am in another area, such as the use of leverage.

My strategy on size of company has two dimensions:

- capitalisation
- frequency of trading and volume.

CAPITALISATION

This is the total value of the company at present prices if we were to buy all of the shares it has issued. It is simply the current price multiplied by the number of shares issued by the company.

It is generally accepted that the largest 300 stocks on the Australian Securities Exchange are what is called 'investment grade'. This means they are large enough for professional investors to include in managed fund portfolios. The implication is that they could buy a reasonable holding without forcing up the price significantly, or ending up holding a large proportion of the stock issued by the company. At the end of November 2008, the smallest of the 300 largest companies on the Australian Securities Exchange had a capitalisation of about $220 million.

If I am buying a stock which may have had some problems, but is recovering, its price may have declined by 50 per cent or more. So, if I am looking for at least a doubling in price, to get back into the 300 largest stocks, it could now have a capitalisation of $100 million or less. Also, an aggressive little growth company that will make the top 300 list in a year or so will be around this size too. So, I am prepared to go down the list to companies with a capitalisation of $80 to $100 million, with a few even smaller at any one time.

Market capitalisation is readily available on the internet at the sites mentioned earlier in this chapter for the debt-to-equity ratio.

Frequency of trading and volume

My *guidelines* for assessing how easy it is for me to buy and sell a stock are that:

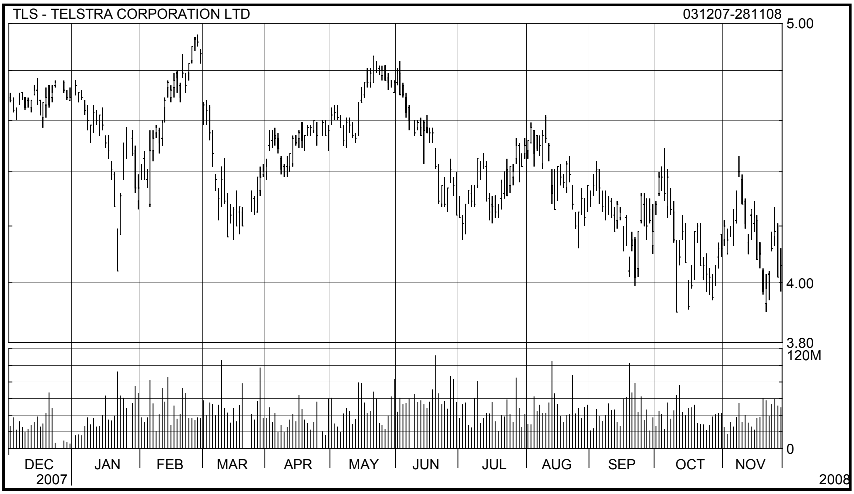
- ***It should trade on most days.***
- It should trade in ***sufficient volume for me to get in and out in one lot***, especially getting out. One lot means that I can place an order today such that I will be able to buy the position I want by bidding a price that is not too far from the last sale.
- It should not take me beyond ***holding only a few less-liquid stocks at any one time.***

There are several ways to do this statistically, but my preference is to do it visually by looking at a daily bar chart for the last year with volume, because it is more flexible. It is simple to do with charting software, but could also be done using an internet charting service that allows the user to display a bar chart and volume histogram. Below are some examples.

Heavily traded blue chip

The stock in figure 10.1 clearly has plenty of liquidity.

Figure 10.1: heavily traded blue chip

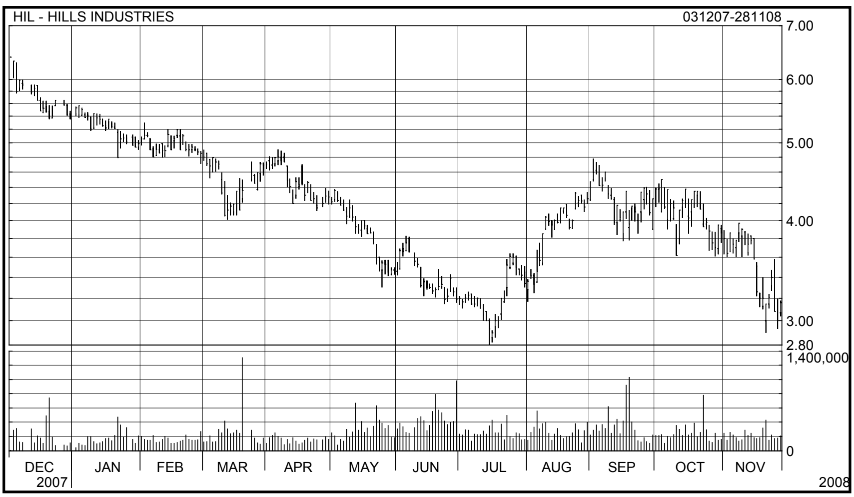


There is a price bar for every day except public holidays, with a reasonable range between the high and the low. Likewise, there is a significant volume bar for each of these days, except between Christmas and New Year, which is a holiday period in Australia.

Consistently traded second rank stock

The stock in figure 10.2 is less liquid, but safe enough in good market conditions.

Figure 10.2: consistently traded second rank stock

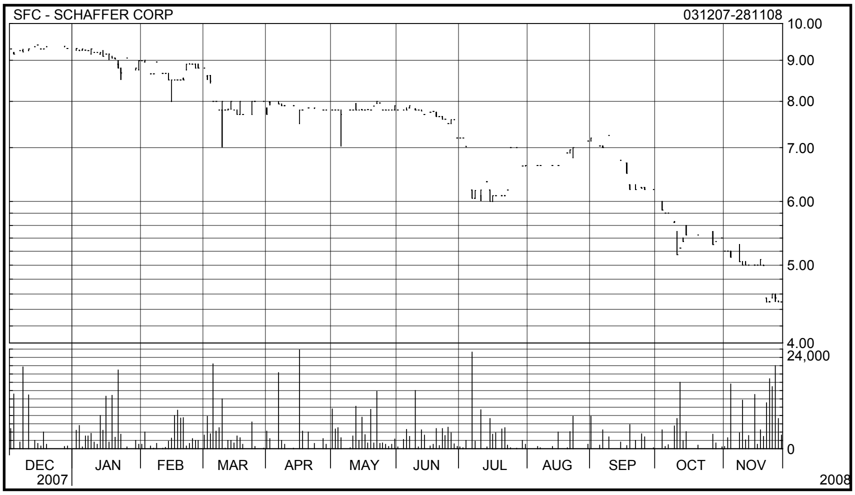


There is a price bar for most days. Sometimes on these charts a few price bars may have no range between the high and low, indicating that all trading took place at one price (see figure 10.3 for an extreme example). Likewise, there is a volume bar of reasonable size for most days.

THINLY TRADED SECOND OR THIRD RANK STOCK

The stock in figure 10.3 is not really investment grade and should be treated with great caution.

Figure 10.3: thinly traded second or third rank stock



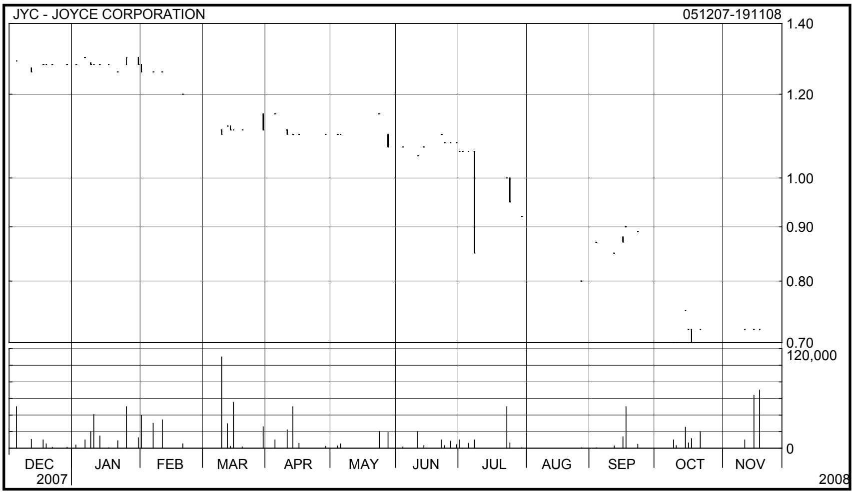
There are many days with no price bars, or only one-price bars. Likewise, on many days where it traded, the volume bar was small.

This is the kind of stock that I would only hold one or two of at any time, and only if the chart showed very significant potential. It may take several days or up to a week or more to find a seller at a price near the last sale.

RARELY TRADED SMALL STOCK

The stock in figure 10.4 is not investment grade or sufficiently liquid.

Figure 10.4: rarely traded small stock



There are only trades a few times a month and usually only a few hundred shares at a time. This sort of stock will often superficially look to be good value on fundamentals, but this may be only because the market is giving it a margin for the obvious liquidity risk.

In addition to the types of risk discussed in this and the two previous chapters, there are three other elements of strategy that impact on the overall level of risk in my investment plan. These are discussed in the next three sections.

TYPE OF COMPANY

An important decision in developing my investment plan was to decide which stocks I plan to invest in. All stocks are not the same in terms of size, industry, cyclicality and risk.

There is really only one liquid stock market in Australia, the Australian Securities Exchange. This is what I invest on. I have already made a policy decision not to invest on overseas stock markets in framing my objective. Having decided to focus on the Australian stock market, I am careful to distinguish between investment-grade stocks and purely speculative stocks. While I will invest in blue-chip industrial and mining stocks if they meet my criteria for stock selection, my ***guideline*** is to focus on second rank industrial stocks and a few producing miners that make profits and pay dividends.

Smaller companies are less efficient markets. This is a jargon term for saying that information about them is more closely held and that most brokers and institutions do not research them. This leaves some scope to beat the professionals. Also, smaller companies can grow much faster in percentage terms than can larger companies. Both of these ideas mean that better profits may be obtained from investing in smaller companies, most of the time. However, for some periods better returns are obtained from larger companies. Also, it does not mean that the smaller the company the better. Very small companies carry other risks that mean they are best avoided.

My best results have come from investing in fully paid ordinary stock of companies as follows:

➢ I mostly invest in Australian industrial and service businesses that make profits and pay dividends. These are the types of businesses which I best understand.

➢ To a far lesser extent, I will also invest a small part of my capital in Australian producing miners from time to time. These also must make profits and pay dividends.

The size of the company is not a critical issue, providing there is sufficient liquidity for me to easily buy and sell, as discussed earlier in this chapter.

Of far greater importance to my investment plan was the decision that I will only invest in investment-grade stocks. I define investment-grade stocks as being businesses that have a good record of making profits and paying dividends. It is extremely rare for me to depart from this and would require a very special situation. I regard any company that does not make a profit and pay a dividend as being speculative and therefore outside my definition of investment grade.

The decisions described in the previous discussion mean that there are certain stocks that are automatically excluded from my investment plan:

➢ Mining or oil explorers.

➢ Companies trying to discover or develop new technology, commonly called 'technology start-ups'.

➢ Listed investment companies (because I am doing myself what they do).

➢ Trusts. They are taxed differently in Australia and as a result lack the growth from retained earnings which is available in company structures.

- ➢ Preference and hybrid securities.
- ➢ Stapled securities (a stock which trades bound to one or more trust units).
- ➢ Overseas companies. They carry additional information, currency and sovereign risks.
- ➢ New floats (initial public offerings), unless it is a very well established business. It is very rare for me to invest in a stock for which I do not have a chart of its price history and a track record of profits and dividends.

In other words, I want to invest in companies that have real businesses, which have been able to demonstrate that they can make good profits and where I have a chart to monitor the activity of insiders. Insiders are investors with more and better knowledge of the company or superior skills in evaluating the available information. I will sometimes invest in a company that seems to have got into temporary difficulties. However, I always want the price action on the chart to tell me that insiders are backing its recovery with their money by bidding the price up.

LONG, SHORT OR BOTH

The most common way to make money from investing in stocks is to buy them, collecting dividends while we hold them and hopefully making a capital gain by eventually selling them for more than we originally paid for them.

However, it is also possible to borrow stocks and sell them now, with the intention of making a capital gain by buying them back later for a lower price than we originally sold them. This is called 'short selling'. The idea of short selling is not well understood by most beginners to investing on the stock market.

My investing is confined to buying stocks and holding them for dividends and capital growth. I avoid short selling, even in falling markets. There are several reasons why I only buy stocks and never sell short.

The first reason is that stock markets have a strong long-term upward bias. There is dispute about the explanation for this. Some point to inflation. Others point to growth in earnings or reinvestment of retained earnings. However, there is no disputing the tendency. This means that investing in stocks by buying, rather than short selling, is investing in the direction of the long-term trend. A quick look at any long-term chart of Australian, US or UK stock market indexes will show that the chart basically runs from the lower left corner towards the upper right corner.

The second reason is quite a personal one. I have found over a long time that I am a naturally optimistic person. This makes it difficult for me to bet on failure. I am much more comfortable backing success. This may sound like a very ephemeral thing, but the longer I live and work in markets the more I respect the need to trade in harmony with my belief system.

The third reason is that I have found it difficult to re-orient my thinking to selling short. It seems to me that to be successful, we need to develop an investment style that we can hone to the point where it almost becomes instinctive. We achieve mastery at the point where, when something happens, we know what to do immediately and without question. To achieve this level we need to specialise.

The fourth reason is that there is greater complication and expense in short selling. Complicated things are implicitly dangerous in the markets, because unusual situations do happen and can bring us undone.

An extension of this greater complication and expense is that while we are short of a stock, we are responsible to reimburse the lender of the stock for any dividends that are paid and any other issues of stocks or entitlements to other issues. Since the total return from an investment is the capital growth plus the dividend stream, this is another strong negative to short selling, placing it outside my investment plan by definition.

The final reason is one that I used to not worry over much about, but for which I now have a greater respect. That is the prospect that short selling can involve unlimited risk. There is an excellent discussion of this in Jack Schwager's book *Stock Market Wizards* in the part in the back of the book where he draws lessons from the interviews. The danger he highlights comes from takeovers. Takeovers are quite likely to occur in the stocks that are sold down strongly by the market because they become very cheap. Combine a takeover with a trading halt and we have a very nasty experience. It can be argued, as I used to, that takeovers are a fairly rare risk. That is true. However, it is these sorts of rare events that can play havoc with an investment account. The Nobel laureates at the US Long Term Capital found this out to their cost when Russia devalued the Rouble and defaulted on debt, destroying their Nobel Prize winners' valuation models.

I will conclude this discussion of short selling with a little warning. The first thing that must be understood when reading my investment plan is that it is for me and not necessarily for every reader. Readers may feel that their attitudes, risk tolerance, experience and skill levels are different to mine. If so, readers do not have to follow what I do, but they should plot their own course knowing the risks.

However, before readers embark on short selling, they should consider that bear markets have a habit of turning on a tack. Rallies are usually driven by short covering, which can have enormous emotional power, called fear, because short selling can involve the risk of unlimited loss. This is especially the case, because the most afraid will be the public who started short selling late in the down move, when it was obvious, and therefore go underwater on short sales immediately the rally starts. The speed with which these rallies emerge and move make short selling a game at which only the very best, most disciplined and experienced investors succeed.

What I have tried to do here is to provide a view of the other side of the short selling story. In a bear market, it will seem that everyone wants to go short. They are the same people who, not long before, wanted to buy the hottest speculative stocks of the bull market with every cent they had. Think before following these lemmings over their latest cliff.

Time frame

Trends in the stock market exist in many time frames. There are trends that only last a few minutes. There are other trends that run for a few hours, a few days or even a few weeks. All of these are generally referred to as 'short-term trends' and are exploited by speculators, rather than investors.

There are also bigger trends that run for many weeks, months and even for several years. There are even a few trends that persist for decades. These bigger trends that run for months to years are generally referred to as 'longer term trends' and are exploited by investors, rather than speculators.

Speculators focus on the quick capital gains, hoping to compound small gains many times over a year. If they can make a series of correct decisions, the potential is indeed spectacular.

Investors focus on total return from both dividends, which they reinvest, and large capital growth that matures from holding stocks in excellent companies over a year to several years. It is not unusual for a few of their investments to double or triple over a year or more and the best companies can increase tenfold or more over longer periods. Again, the potential is spectacular.

I am an investor, not a speculator. ***I invest in stocks with the intention of holding them for many months to several years.*** The exact time will depend on the length of time that the stocks stay in their uptrend.

There are several reasons for this. The first reason is that my experience shows that the big gains are made by holding through the big uptrends. Capturing all of a big uptrend is usually better than trading in and out of it many times, even if the gains are compounded. Much of the gain will be missed and some of the trades may even be losses that set back the compounding aim. Remember too that if I put 6 per cent of my capital into each stock I buy, I only need two of them to double in a year on top of the dividend stream to exceed my objective. All the rest of my investments can consist of small gains and small losses, which cancel out.

The second reason is a lifestyle decision. When I was employed full time, it was very difficult to watch markets closely enough to speculate in the short term. Now that I have the opportunity to speculate in the short term, if I wanted to, it would mean giving up a lot of time to monitor the market. It seems to me that I can do very well investing in a longer time frame. I can do all my research and analysis in a few hours each day and do not have to watch the market during the day, leaving me free to do other things.

The third reason why I prefer to invest rather than speculate is that speculating is very difficult. It requires making a large number of decisions and getting a lot of them right. The theory that says we can take a small amount of capital and compound many small gains to turn it into a million dollars or more is far more difficult than it sounds. It falls down on each losing trade, which interrupts the compounding. The theory also gives far too little attention to the lead weights in the saddlebag of every speculator. These lead weights are transaction costs, slippage and overhead costs. The more we trade, and the shorter the period over which we trade, the heavier these lead weights will be.

Short-term speculating is also inherently far more difficult than investing. The shorter the time frame over which we speculate, the more random the market movements tend to be. However, the price of stocks will tend to follow the trend of earnings of companies over a longer time frame. These bigger trends are easier to spot, require far fewer decisions and tend to persist for long periods. In contrast, the short-term speculator has to contend with emotional reactions to news and rumours of all kinds, which can be inconsistent and irrational.

So, why are most beginners attracted to speculating rather than investing? For many it is simply ignorance of what is involved, its difficulty and the handicaps that have to be overcome. For others it is the thrill of the game. These are the gamblers. Good luck to them, but I am playing a different game called building wealth. For me it is a business, not an entertainment.

CHAPTER 11

SELECTING STOCKS TO BUY

My approach to selecting stocks to buy employs both technical analysis and fundamental analysis:

- The way I use technical analysis is a direct expression of the big idea that drives my whole investment approach. I want to select stocks that have indicated a high probability of beginning a new uptrend, or which are already in a good uptrend.
- The way I use fundamental analysis is based on the method taught by Benjamin Graham and followed by his many acolytes, the most famous of whom is Warren Buffett. This is to try to invest in sound profit-making companies at prices that afford a margin of safety.

My technical analysis filter is based on the two models I intend to exploit. Models are simply conceptual ideas of how markets unfold. The two models are called the value model and the growth model. After I have explained them, I will show how I filter all the stocks on the market to find ones that are at the appropriate buying point on the models. Having found them, I then apply some basic fundamental analysis tests.

I will then show how I approach it from another direction using a basic filter for fundamental value as a first step. Having found a list of stocks that satisfy the filter rules, I then discard any of those stocks that are not at the appropriate buying point on the technical models.

To survive my analysis and become candidates for investment, stocks must meet both the technical analysis and fundamental analysis requirements of my investment plan.

There is an important reason for having both a technical analysis and a fundamental analysis filter. Sometimes I may too quickly discard a stock that is thrown up by either of the filters. When the other filter is run, I may better appreciate the opportunity in the same stock. I have therefore found that running both filters helps to find interesting stocks that may otherwise have been overlooked.

Readers might wonder why I do not combine both filters. It is not difficult to do that. The reason I keep them separate is based on experience. The more tests in the filter, the fewer stocks will pass them all. This is especially a problem with the fundamental analysis test rules which are not meant to be precise.

To explain this, suppose I filtered for stocks which have a price/earnings ratio less than 10 and are also making a new yearly high. That filter would exclude a stock with a price/earnings ratio of 11 even though it was just breaking out upward from a multi-year accumulation pattern on the chart. I would usually want to look at such a stock. By having two separate filters, I would pick that stock up on the technical analysis filter. The separate filters give me more stocks to look at. This takes time, but in the end finds more good stocks.

Introduction to value and growth models

There are two mainstream investment approaches, or styles in the jargon of the industry. The two broad investment philosophies, within which we can classify almost all successful investors, are generally called the value method and the growth method. There are endless arguments in the investment community over which is the best method. However, I try to avoid what is surely a futile argument and one that will never be resolved absolutely. The truth is probably that both are successful over time for those who are expert in their use. One method might give better results for a time, but the balance inevitably swings to the other method for another period.

The value method

The value method derives from the ideas of Benjamin Graham. His most accessible book is *The Intelligent Investor*. The reasoning on which this method rests is that, since we cannot hope to predict the future consistently, our best course is to seek out companies that have shown consistently sound results over a significant period and which can be purchased cheaply in the market.

This idea that they should only be purchased when they are relatively cheap rests on Graham's key investment idea, the margin of safety. What this means essentially is that, even if we are wrong about the company by a large factor, or it runs into trouble for a while, the odds are strongly in our favour.

THE GROWTH METHOD

The growth method is probably best exemplified in the ideas of Philip Fisher in his book *Common Stocks and Uncommon Profits*. The reasoning on which it rests is that there are some truly outstanding companies. These outstanding companies will do far better than the market will do on average. In order to achieve outstanding results, we should seek out these companies and concentrate our investments on them.

Fisher's method was based on extensive research to find and monitor these outstanding companies. He identified industries where he would be likely to find these companies, often related broadly to what we now call technology. He then searched out the very best companies in those industries.

It should be stressed that Graham and his followers are not against buying outstanding companies. However, where the value crowd differ is that they will only buy such companies on the rare occasions when they may be purchased relatively cheaply in the market.

THE COMMON ELEMENTS IN BOTH METHODS

The interesting thing is just how much there is in common between the two methods. Indeed, they are best seen as the two extremes of a continuum. There is considerable middle ground, where both approaches might lead their adherents to buy the same companies at around the same time. After all, both might readily agree that the ideal is to buy outstanding companies cheaply.

Where they diverge is that the value adherents will not pay too much even for an outstanding company. They always aim to buy low and sell high. The growth adherents, on the other hand, are ready to buy outstanding companies at anything short of ridiculous prices. They aim to buy high and sell higher.

What I have found is that both methods require attention to basic fundamental analysis. We must know what it is we are buying. Many successful investors rely only on fundamental analysis. While fundamental analysis is strong on which stocks to buy, it is weak on timing and suffers from reliance on information. So, fundamental analysis is enhanced by employing technical analysis as well.

Technical analysis tells us little about what we are buying, but it does tell us a lot about timing and can alert us when the market is acting on something that is not yet generally known, or is taking a view about available information that differs from our own.

I find that my investment plan is stronger when I utilise the strengths of both fundamental analysis and technical analysis.

Charting the two models

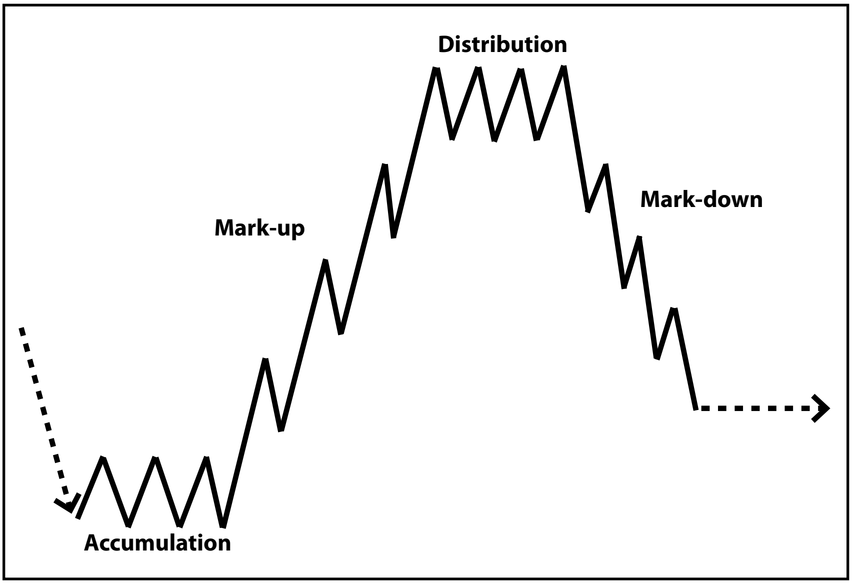
The two basic investment methods, the value method and the growth method, can be applied using technical analysis. This is because the charts of value stocks tend to form in a certain way, which is quite different to the way the charts unfold for growth stocks. This enables us to describe two chart models, one for value stocks and another for growth stocks.

The value model

One of the most valuable concepts from technical analysis is the way that the prices of many stocks follow a distinct cycle. The cycle flows from undervaluation when a stock is out of favour with the market, through to overvaluation, when speculation, and patently unreal expectations, drive it to an extreme overvaluation. Figure 11.1 summarises the cycle conceptually.

Despite the efforts of an army of cycle enthusiasts looking for regular cycles, this cycle is only a broad description of the development of prices. Both the length of the cycle and its amplitude seem to be different for every stock. They also vary on each occasion that a stock moves through the cycle. This is despite the basic shape being highly influenced by cycles in the overall market index. It is also important to appreciate that the cycle will fail to develop properly at times and there will be failed signals. Companies run into unexpected problems and windfall opportunities. It is only a model of what tends to happen most of the time.

Figure 11.1: the value model



ACCUMULATION

The cycle starts with the stock well out of favour with the market. It has suffered a significant decline in price. Stockholders who were speculating in the stock at higher prices are locked in and are hanging on in the hope that one day they will get their money back. Although it may seem offensive to private investors, they comprise most of this group and are collectively known as 'the public'.

Experienced private investors and large active fund managers will tend to take a different view. This group are collectively called 'the professionals'. They identify that the out-of-favour stock is now undervalued and they buy patiently. They then hold until the market recognises its mistake. Their buying is mainly from the public, as members of that group are forced to liquidate their positions because they need cash, or because they have abandoned hope of recovery. Thus, in this phase, the professionals accumulate undervalued stocks from the public at bargain prices. The term 'undervalued' is a loose one that means different things to different people. Later in this chapter I will discuss what I look for in my fundamental analysis filter of the database.

MARK-UP

At some point, the price begins to rise and typically breaks upward out of a broad sideways range that may have taken up to several years to form. This initial upward move is due to most of the public having sold out, or to professionals becoming more eager. Other professionals scrambling aboard fuel the rise, because they fear missing out on the uptrend that has started. The public are typically ignorant that markets move in cycles and that anything has changed. Those who are still holding stocks often sell into this first rally or on the first decline after the initial rally. The mark-up phase continues to gather strength and is boosted as increased earnings and new developments are announced. Brokers begin to recommend the stock and profiles on the company appear in the print media. Wild estimates begin to be made of future earnings to justify the ever increasing prices. This sustains the final leg of the mark-up phase, which represents the public flooding into the market in a speculative surge.

DISTRIBUTION

The public continue to buy in the belief that prices will continue to rise. This view is supported by news announcements and bullish promotion in the media, or from brokers. It is reinforced as new earnings peaks are established. The professionals now sell to the public stocks that are now wildly overvalued. The price often swings widely. Eventually most of the public have bought and the professionals have disposed of their overvalued stocks. Thus, in this phase, the professionals distribute overvalued stocks to the public at inflated prices.

The term 'overvalued' is a loose one that means different things to different people. It is not unduly important to be precise, because I sell based on technical analysis, not fundamentals. However, in rough terms a value model stock is overvalued when its price/earnings ratio is well above the average price/earnings ratio for the market as a whole. A growth model stock is overvalued when its price/earnings ratio is well above its average percentage growth rate of earnings.

MARK-DOWN

Demand dries up as the public wait for the promised earnings growth. Any selling takes prices lower and suddenly the price falls below the lows of the distribution zone. Most of the public now have paper losses and they abandon hopes of profits. Instead, they hold in the hope of getting out even. However, before many of them have a chance to do that, earnings decreases are announced and the price falls further. Finally, the public begins to sell indiscriminately, because they need the funds, or can no longer stand the pain, and get out at any price. Professionals now begin to see the undervaluation and the accumulation process begins again.

EXPLOITING THE CYCLE

Now that we know the cycle, how can we take advantage of it? How can we invest with the professionals, rather than with the public? We should seek to buy stocks at the end of the accumulation phase or in the first part of the mark-up phase. We should look to be out of the market no later than the first part of the mark-down phase.

The best single time to buy is when a stock first breaks out of the accumulation phase. It has shown sufficient strength to overcome resistance from all the disillusioned sellers. That resistance should now provide support from those who wished they had bought earlier and come in on any fall back into the accumulation zone. This is also where we can add to our initial position.

Patience in waiting for the right opportunities, and discipline in staying out of overvalued stocks, will bring the best rewards. The real benefit of using the value model lies in its dual objective:

1. Identification of stocks that are selling below their fair value, because their price is likely to rise as the market comes to appreciate this situation. This is also a defensive method, because these stocks should have less downside risk than stocks that are already overvalued.

2. The avoidance of already overvalued stocks. We want to avoid these stocks, because they are more likely to go down than go up. If it achieves no more than to keep us out of the grossly overvalued popular speculative stocks, the value approach will have served its purpose. Since the primary objective of investing is preservation of capital, this goes to the heart of what we are about as investors.

It can be tempting to purchase in the accumulation phase. Although it can be rewarding, I avoid it for two reasons. Firstly, because what looks like an accumulation phase may turn out to be only a consolidation in a downtrend. Waiting for the breakout puts the odds more in our favour.

Secondly, because of what economists call 'opportunity cost'. This simply means that while our money is tied up in an accumulation phase that could go on for years, the real cost is what we might have earned in an alternative investment that was in a mark-up phase.

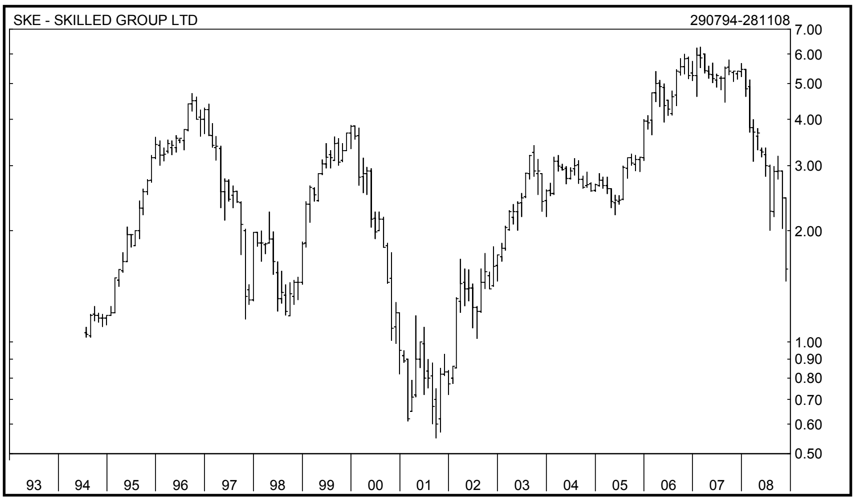
CAUTION

These breaks above accumulation zones can be very rewarding investments. They are often found on the charts of undervalued stocks. However, they are not without risk of failure. What we are looking for here are the big moves. One or two out of 10 will provide big profits and more than make up for the ones that fail. It must be emphasised that this strategy is highly dependent on an ability to quickly close out the investments that fail and stay with the ones that trend strongly.

Below are three examples of value model charts.

Figure 11.2 shows a monthly bar chart of Skilled Engineering and it should be easy to recognise the cyclical pattern.

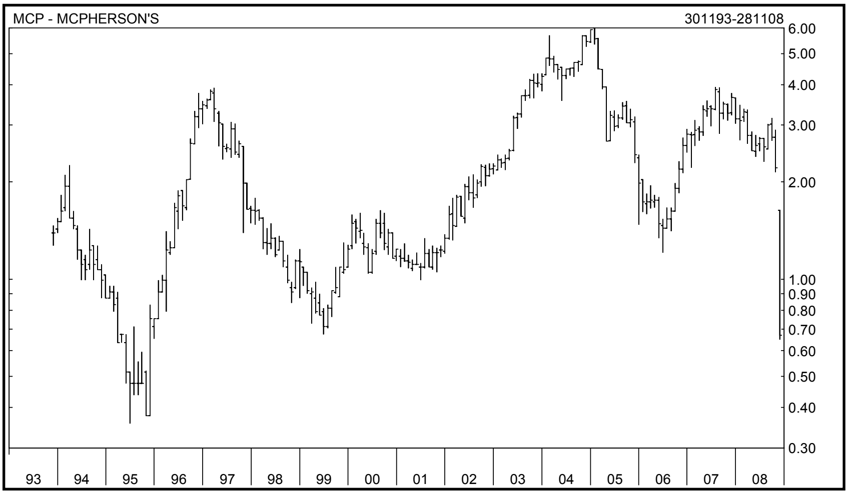
Figure 11.2: Skilled Engineering



Notice that the accumulation and distribution phases were fairly short and rather more volatile at times than the conceptual diagram. It is also interesting how it appeared that a distribution pattern was forming in 2003–04. However, that sideways pattern saw a further upward trend to the eventual distribution pattern in 2006–07.

Figure 11.3 is a monthly bar chart of McPherson's.

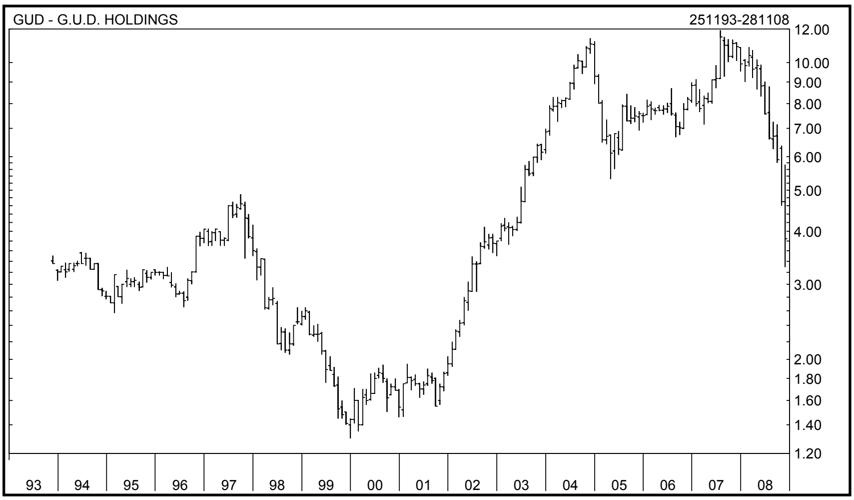
Figure 11.3: McPherson's



This one is a little more difficult to identify against the conceptual diagram because of the failed start in 1999–2000. Nevertheless the essential pattern is there. Notice, too, that some mark-up phases lasted for longer and carried further than others.

Figure 11.4 is a monthly bar chart of GUD Holdings.

Figure 11.4: GUD Holdings



The overall cyclical pattern is very clear. However, prior to 1997 we would have had great difficulty identifying this stock as having a value model chart. Mark-down, accumulation, mark-up and distribution phases are quite clear after 1997.

It takes a little practice to spot these cyclical patterns at first. This is mainly because there are endless variations in the way the cycles unfold. In particular, if there are several cycles on a long-term chart, there can be significant differences in amplitude (height) and period (length) from cycle to cycle. Also, the accumulation and distribution phases can be either quite extended through to almost non-existent as the trend swings from one direction to the other quite sharply.

THE GROWTH MODEL

The price cycle for stocks which was outlined in the value model is very useful in identifying companies that are in a cyclical business, an unpopular business, or have fallen on hard times and have become undervalued. However, there is another important group of stocks. These are the ones that seem to keep growing for prolonged periods and do not suffer large mark-down phases. Instead, they keep rising, but with sideways trading ranges in the trend that mark periods when the market gets ahead of itself on overly optimistic expectations and treads water while earnings catch up with the price. Sometimes, these companies may even become undervalued towards the end of these sideways phases and will also qualify as value situations.

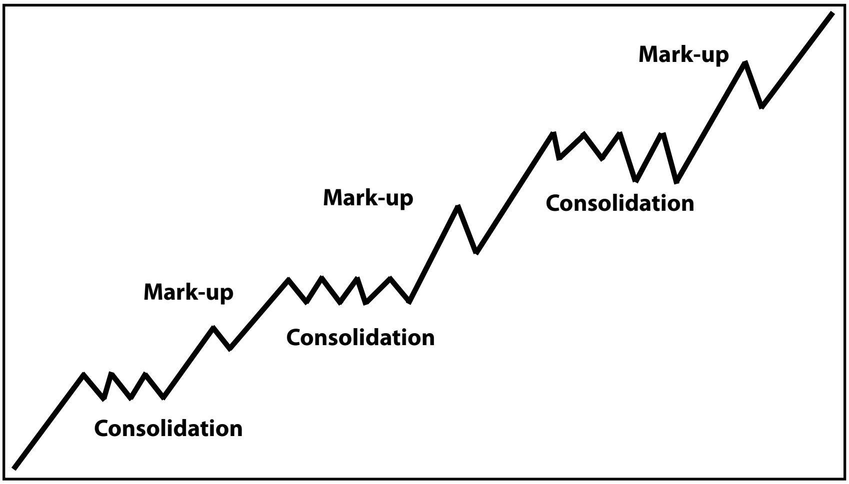
Of course, no stock will continue to go up forever. Sooner or later, earnings will disappoint, or rampant speculation will develop in the stocks, and distribution and mark-down periods will follow. However, great rewards can be gained, sometimes for a decade or more, in such growth stocks.

Figure 11.5 summarises conceptually how the ideal growth stock chart will look.

The consolidation areas may form a variety of shapes, such as rectangles or triangles. The mark-up phases may also vary in speed. Particularly in the early and late stages of the trend, they may be quite volatile and steep. At other times they will be more leisurely and orderly affairs.

The greatest return will be secured by holding throughout the trend. However, active investors may find the opportunity cost of staying with the stock during the sideways consolidation phases to be unacceptable. This is especially so because these consolidations can sometimes last a year or more. These investors may quit the stock once it is clearly no longer trending. Then they would buy it back when a new upward breakout occurs.

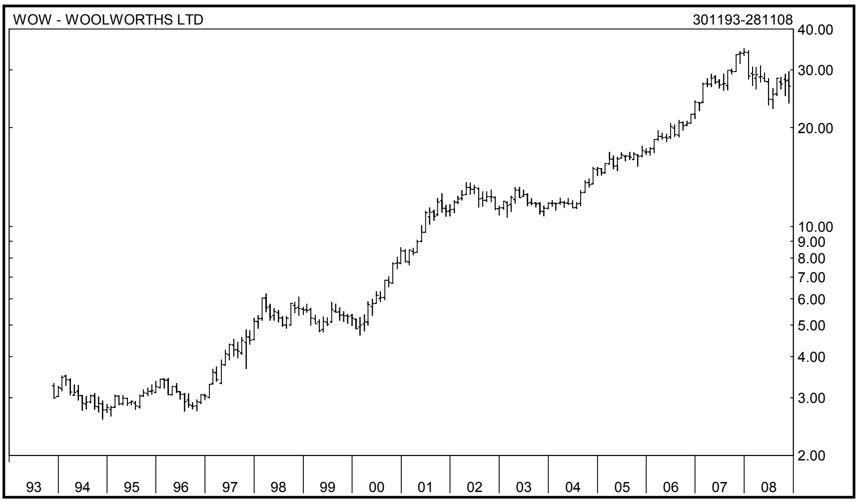
Figure 11.5: the growth model



Below are three examples of growth model stocks.

Figure 11.6 is a monthly chart of Woolworths.

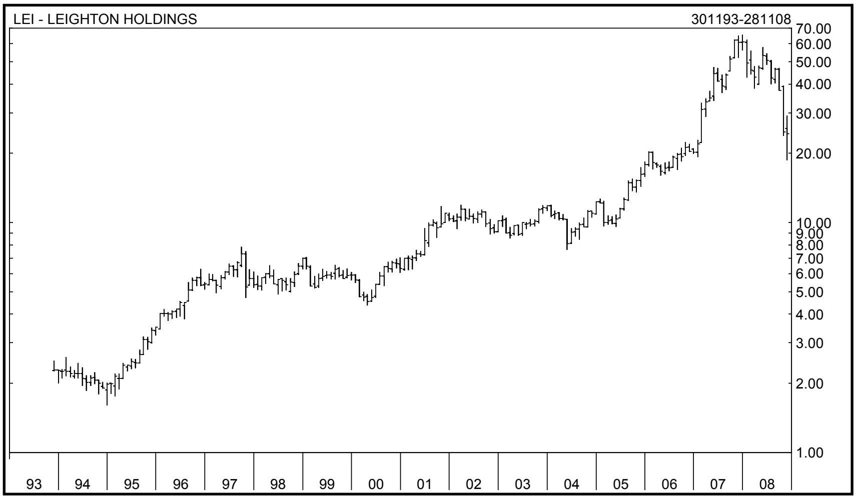
Figure 11.6: Woolworths



This is a more or less perfect example of the growth model. At the end of the chart, it appears to be forming another consolidation pattern.

Figure 11.7 (overleaf) is a monthly chart of Leighton Holdings.

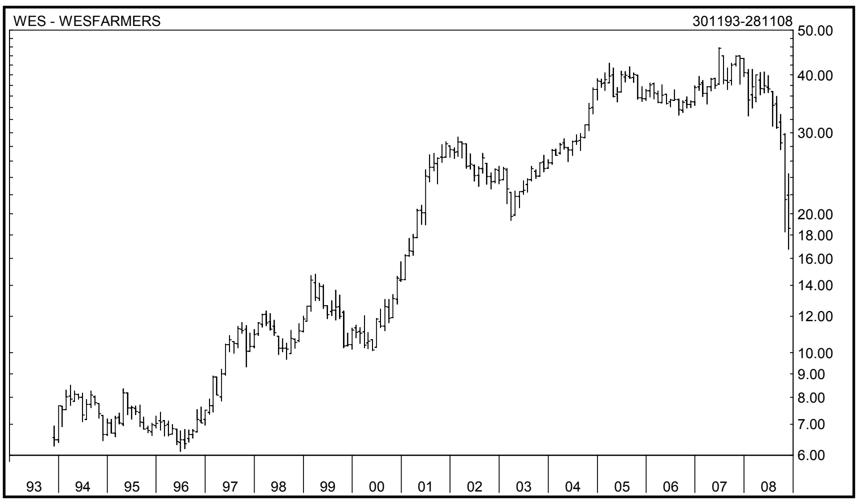
Figure 11.7: Leighton Holdings



From the early 1990s through to 2008, this was another great example of the growth model. However, in 2008 the pattern has changed abruptly with a fall from over $60 to under $20, which cannot be seen as a consolidation pattern. It is likely that this will now become a value model stock.

Figure 11.8 is a monthly bar chart of Wesfarmers.

Figure 11.8: Wesfarmers



This one has also clearly finished its growth phase and should be assumed to now have become a value model chart.

In assessing which model a chart fits into, it comes down to experience in deciding what is a mark-down phase in a value model stock and what is just a consolidation phase in a growth model stock. Investment analysis is an art, rather than a precise science.

It can be particularly difficult at times to decide whether we are looking at a consolidation phase. The key is to remember that a consolidation phase is essentially a sideways pattern. While it will retrace a part of the previous mark-up phase, it should not look like a downtrend. There should be a significant sideways element in a consolidation pattern. If we are unsure about whether we are looking at a sideways consolidation pattern, it might be best to assume the possibility that it was a growth model stock, but has switched to being a value model stock.

CHARTS WHICH ARE NEITHER VALUE NOR GROWTH MODEL

While most charts will tend to fit the value model and a lesser number to fit the growth model, some charts will not fit either model. These often seem to just wander aimlessly across the screen. I simply ignore them. We are looking for the ones that fit the models. If they do not fit either model, they are best left to investors with an investment plan quite different to mine.

THE TECHNICAL ANALYSIS FILTER

With the value model, we are looking for stocks that are breaking out upwards from an accumulation area, or have already done so, and are trending upward in a mark-up phase. With the growth model, we are looking for stocks that are breaking out upwards from a consolidation area, or have already done so, and are trending upward in a mark-up phase. This means that if we can find stocks that are breaking out upward from a trading range, or that are trending up strongly, we will find both value and growth model stocks.

There are several ways we could go about this. We could inspect the charts of all listed stocks looking visually for the patterns. This would be very effective, but it is also time consuming and means we would look at many hundreds of charts that are of no interest at all. It is better to use the power of the computer to filter for the likely candidates. We could use several different indicators that locate trending markets. However, indicators are not quite as good at finding breakouts.

I have found that a very basic filter is the most effective. I simply run a filter using Insight Trader charting software on all stocks looking for those that have made a new yearly high this week. If readers do not have computer software to do this, the list of new yearly highs for yesterday is printed in *The Australian Financial Review* in its Rolling Year Records table.

One year is an arbitrary choice. It seems to work quite well for breakouts, because it means we will find breakouts from quite lengthy trading ranges. It also picks up stocks that continue to trend. It should be noted that this filter will be very late in picking up stocks that trend down and then abruptly start to trend up. Since they have no accumulation phase on their charts, these stocks are not value model stocks at this time, so I am not generally looking for them.

I run this filter once a week. Remember that I am an investor, so running the filter once a week is fine. If desired, it can be run more or less often.

Insight Trader charting software creates a list of stocks that are found by the filter. I can then create charts of these stocks with a few keystrokes and review them one after the other. I set the chart template up to show the last 5500 calendar days (just over 15 years) and display it as a monthly bar chart with semi-log scale (see appendix B for further explanation). I like to put a 12-month simple moving average on the chart. I must stress that I do not use this moving average to identify buy and sell signals. I simply use it to better reveal the direction of the trend.

I use a long-term monthly chart at this point. This is because I wish to see which model the chart fits. Later I will use a weekly chart for closer analysis.

My template chart for this purpose would therefore look like the one shown in figure 11.9.

There is one other use for the moving average. I find that ***the best growth and value stocks will rise in a trend that stays fairly consistently above the 52-week moving average***. Those stocks that have trouble staying above the 52-week moving average may still be trending up, but their rate of ascent may be slower. This is sometimes useful when having to decide which stocks to buy when available funds do not allow me to take all available opportunities.

Figure 11.9: long-term monthly chart

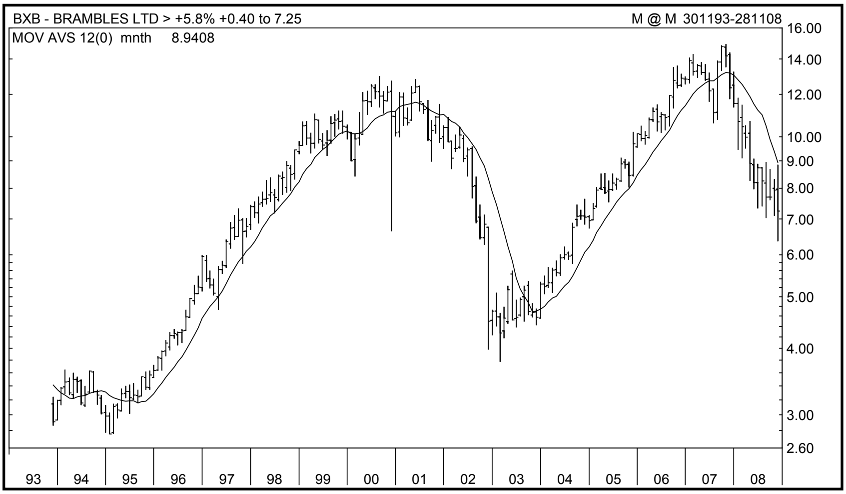
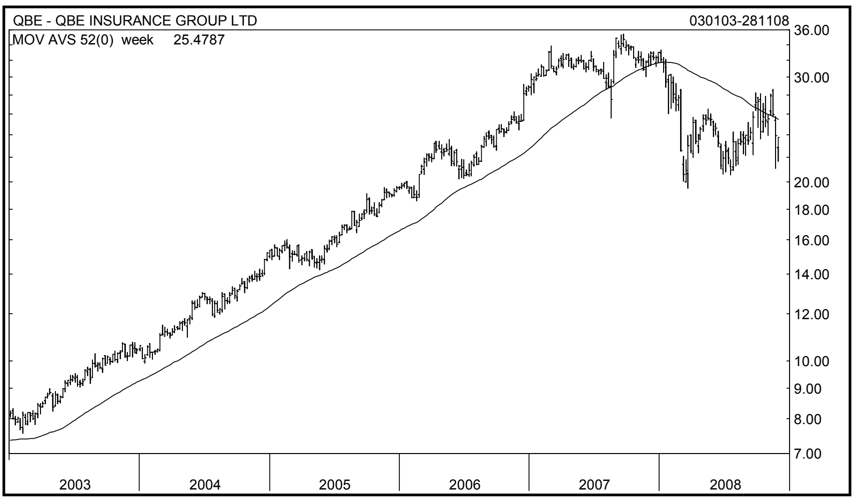


Figure 11.10 shows a good example in QBE Insurance Group (QBE) with a 52-week moving average. Between 2003 and 2007, the weekly bar chart remained above the 52-week moving average. This is exactly what I am looking for. At the end of the chart, the price has crossed clearly below the moving average and the trend appears to have ended.

Figure 11.10: price above the 52-week moving average



However, some of the charts that come out of the 52-week high filter list will have charts that are not as good as the one for QBE. One of the other chart types is the stock that is in an uptrend, but the price does not consistently rise above the 52-week moving average. Figure 11.11 shows an example in Ridley Corporation (RIC). After it began to trend upwards in 2000, I took a position. However, the price chopped down through the 52-week moving average several times in 2001 and it shook me out on a sell stop. These charts are more difficult to invest in and tend to produce lower capital growth. The Ridley trend improved on this score in 2002, but deteriorated again in 2003, as it formed a distribution pattern. I have found that the best stocks tend to stay clear of a strongly rising 52-week moving average.

Figure 11.11: price violating the 52-week moving average

Some of these stocks may be worth carrying forward into the next stage of analysis. However, I will regard them less highly than the stocks with the textbook perfect charts. What the failure to stay above the moving average is telling us is that the uptrend is slower and less consistent. The ride is therefore bound to be less exhilarating and quite bumpy. Sometimes, a high dividend yield will be part compensation for a lower rate of capital growth.

So, I go through the 52-week new high filter looking for value and growth model stocks that are in a strong uptrend above the 12-month moving average, or which are breaking out upward from broad trading ranges.

Having found an interesting chart, I apply a fundamental filter. For a stock to stay in the list, my ***guidelines*** are:

- The company ***must make a profit***.
- If it is a ***value model chart***, the ***price/earnings ratio must be significantly lower than the average price/earnings ratio*** for the market.
- If it is a ***growth model chart***, the ***price/earnings ratio must not be significantly higher than the average price/earnings ratio*** for the market.
- If it is a ***value model chart***, the ***dividend yield must be significantly higher than the average dividend yield*** **for the market**.
- If it is a ***growth model chart***, the dividend yield is less important. The ideal is for its ***dividend yield*** to be ***not significantly below the average dividend yield*** for the market.

Finding all of this fundamental information is easy in Insight Trader charting software because it shows the current dividend yield and price/earnings ratio. If there is no price/earnings ratio, or the price/earnings ratio is shown as a negative value, then the stock either has no profit history or makes losses respectively.

The market average price/earnings ratio is published every week on Saturday and Monday in *The Australian Financial Review*.

There are numerous other sources of the current price/earnings ratio and dividend yield in newspapers, *Financial Review Smart Investor* magazine and the Aspect Huntley Equity Review website (a subscription service). Some online brokers provide client access to Aspect Huntley data.

I will comment on what the word 'significant' means after I have explained the fundamental analysis filter later in this chapter.

EXAMPLE OF THE TECHNICAL ANALYSIS FILTER

Probably the best way to learn any technical analysis method is to look at lots and lots of examples. The problem with this for authors of books is that charts take up a large number of pages. It is therefore practical to only show a limited number of examples. What I recommend for readers is that they try to look at lots of charts. If readers have access to Insight Trader charting software or some other common charting software, this is not very difficult to do. Failing that, the filtering needs to be done manually from *The Australian Financial Review*, followed by charting the stocks using one of the free internet charting services such as Yahoo Finance or Bigcharts.com.

On 30 November 2008, I ran a filter of all securities listed on the Australian Securities Exchange. It was possible for this list to include five types of security that I do not require for my investment plan, but which are difficult to easily exclude before the list is generated:

- ***Trusts.*** These will be property trusts, investment trusts or utility trusts. Trusts are financial instruments that are created to distribute income streams to investors. The Australian tax rules preclude them from retaining earnings, the key source of growth in a company structure. In general terms, trusts will rarely have the same potential for capital growth as a company.
- ***Investment companies.*** These are companies that have been formed to invest in other securities. In very general terms, they are doing what I am trying to do, so are simply managed funds in the form of listed companies.
- ***Foreign companies.*** There are several problems with investing in foreign companies listed on the Australian Securities Exchange. There is significant information risk compared to local companies. The accounting rules in their home jurisdiction may add additional risk. There is an element of currency risk, for which I have no natural hedge. There are problems with accounting for them for tax purposes and receipt of income in foreign currency. Holdings may not be registered on CHESS (CHESS is the Australian Securities Exchange's electronic register of stockholdings). Many of these are quite technical issues. Suffice to say that they are outside the focus of my investment plan.
- ***Resources explorers, technology developers and start-ups.*** These are speculative enterprises that do not make profits or pay dividends. I have already excluded them in my strategy as not being investment-grade stocks with an adequate margin of safety.
- ***Producing miners.*** In simple terms, in an industrial company there is an implicit assumption that the earnings can be maintained into the future. The whole focus of fundamental analysis is to calculate the maintainable earnings of an industrial company. Because it makes things or supplies services to meet an ongoing need, it is assumed that the profit is maintainable almost indefinitely. This makes a heuristic (rule of thumb) like price/earnings ratio or dividend yield a valid way to get a measure of relative value and hence the margin of safety.

> However, producing miners are quite different. In general terms, they are exploiting a wasting asset. Also, demand for most resources tends to be very cyclical. Moreover, their output is often sold in volatile foreign currencies. This means that there is not a level of earnings that we can confidently expect to extend into the future almost infinitely like an industrial company. It is more appropriate with a resources company to forecast, not the maintainable earnings, but the future cash flow, earnings or dividend streams. To arrive at a present value, we would then discount that cash flow, earnings or dividend stream. This is quite a different proposition.
>
> Put it this way: if we buy an industrial company for 10 times earnings, we can expect to get our money back in earnings in 10 years. However, if a resources company is mining a deposit which will be exhausted in three years, paying 10 times earnings for it might be speculative to say the least. Of course, it may find more deposits, but … There are many more ifs and buts that make the task far more difficult and speculative.
>
> Similar problems exist to a lesser extent when using ratios to assess value in companies in very cyclical industries, like banks, stockbrokers, agriculture or building and construction. These companies usually trade at lower than normal price/earnings ratios and higher dividend yields to compensate for the higher risk that derives from the uncertain long-term maintainability of earnings and other risk factors.

Some of these companies will come to light in the filter runs from time to time. I simply discard them as being outside my investment plan in the same way that I would discard a chart that did not match one of my two models.

THE FILTER RULE

The criterion for the filter was that the security had made a yearly high in the last week. In Insight Trader charting software, the System Module filter rule is:

```
H(W):=:MAX(52,W)
```

In plain language, this says that we want a list of stocks for which the high price this week was the maximum price reached in the last year (52 weeks). These stocks are often referred to as making a 52-week new high.

There are two other conditions necessary to meet my investment plan criteria, which may be easily and usefully built into the filter. The stocks on the list must also make a profit and pay a dividend. The stocks that do not meet both of these conditions can be filtered out in Insight Trader charting software with these two additional filter rules:

AND PER(D):>:0

AND DIVYD(D):>:0

In plain language, the first condition says that the stock must also have a price/earnings ratio greater than zero, which it must do if it makes a profit. The second condition says that the stock must also have a dividend yield greater than zero, which it must have if it pays a dividend.

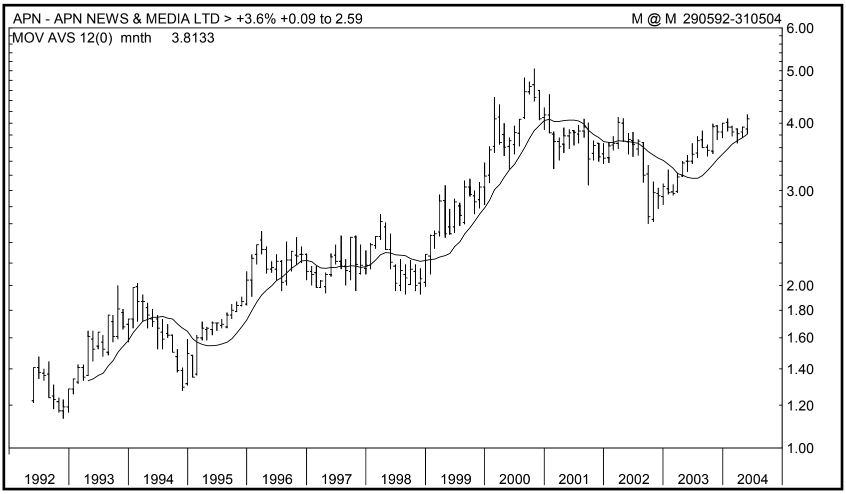
> The charts used in the book have been created with Insight Trader charting software. There is an explanation of their format in 'Appendix A: Insight Trader chart format'. Also see 'Appendix B: Semi-log or linear charts?'

Some examples

The filter run on 30 November 2008 failed to find any securities which satisfied the conditions of the filter. This is a little unusual. It is because we are at this time in the second phase of a steep bear market. This has to some extent affected every stock on the market, so there are none making a new yearly high in the last week. In a bull market, we may have got 50 or more companies to look at.

Therefore, not finding any stocks at this time is not a problem. Instead it is both very useful information and to be entirely expected. The only problem is that I do not have some current examples to show. To get around that, I need to go back to another time when I did find some stocks and also recorded my analysis of what I found. Since space is limited in a book, I have chosen 10 of the 67 stocks found at that time, 23 June 2004, which should illustrate the filter method. I will now discuss each chart in turn, showing how I analysed them and what action I took, or thought that I might take, at that time.

Figure 11.12: APN News & Media (APN)



ANALYSIS

APN News & Media was listed in 1992. Through to 2000, it seemed to be either a growth model chart or a value model chart which was in an extended mark-up phase. The decline from the 2000 peak near $5 to the 2003 trough near $2.60 was close to a 50 per cent fall and rather too much for a consolidation phase in a growth model chart. However, it is quite possible that all of the price action between 2001 and 2004 was a large consolidation pattern below about $4 (the peaks in 2001, 2002 and 2004). This would be an easy conclusion without the sharp dip in 2002. That period might then look much like the 1996–98 consolidation. So, if we give it the benefit of the doubt that the dip in 2002 was exaggerated by a strong bear market, the last month is looking like a breakout from a multi-year consolidation.

PROFITS

Profits grew every year since 1994 except for a slight dip in 2001.

P/E RATIO

19.95. This is moderately higher than the market average of 15.19.

DIVIDEND YIELD

4.45 per cent. This is reasonably above the market average of 3.84 per cent.

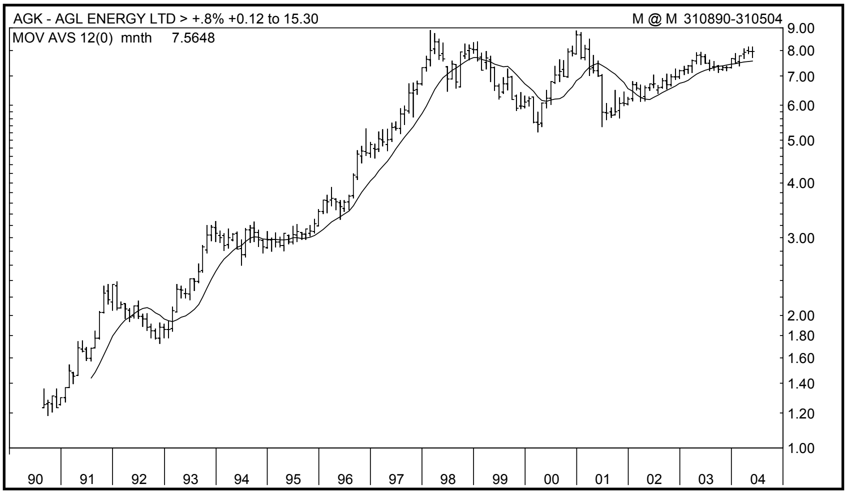
ASSESSMENT

Although the accumulation pattern is not ideal, this stock meets most of my criteria. It is also trending nicely above the 12-month moving average.

CONCLUSION

APN News & Media was added to my portfolio in June 2004 when it broke above the 2001, 2002 and 2004 peaks.

Figure 11.13: AGL Energy (AGK)



ANALYSIS

This is clearly a growth model chart. We could be looking at a large consolidation phase. Then again, it could be a large top reversal pattern.

PROFITS

AGL Energy makes consistent profits.

P/E RATIO

17.54. This is moderately above the market average of 15.19.

DIVIDEND YIELD

4.82 per cent. This is above the market average of 3.84 per cent.

ASSESSMENT

AGL Energy is a power utility. It is a big, safe company. In the past, it has shown enough growth to trade consistently above the 12-month moving average in good trends.

To be sure that we are looking at a consolidation phase, we need a breakout above the 1998 and 2001 peaks. Ideally, my investment plan would call for me to await such a breakout. However, the pattern is so large that it also seems there is opportunity to invest in the trend within the pattern, which would provide a good platform to enjoy the next mark-up phase.

CONCLUSION

I took a small position, which I built as AGL made new highs for the trend. I would sell quickly if the three-year-old uptrend falters. I had already sold out of it once at a profit when it triggered one of my selling rules in 2003, but I re-established the position when the trend re-asserted itself.

Figure 11.14: Blackmores (BKL)

ANALYSIS

The fall in 1993–95 is too much to be a growth model chart at that time and it would have been seen as a value model chart. However, since the 1995 trough, Blackmores resembles a growth model chart.

The rate of growth in 1996–98 was quite fast as it trended up nicely above the 12-month moving average. However, since then it has traded in a couple of extensive consolidation phases. It is now trending again nicely above the moving average.

PROFITS

Blackmores' profits have been reasonably consistent and growing well over the last 10 years.

P/E RATIO

14.3. This is just below the market average of 15.19.

DIVIDEND YIELD

3.82 per cent. This is right on the market average of 3.84 per cent.

ASSESSMENT

This is clearly an interesting share. It is trending well, and above the moving average. The fundamentals are quite attractive for a growth model chart.

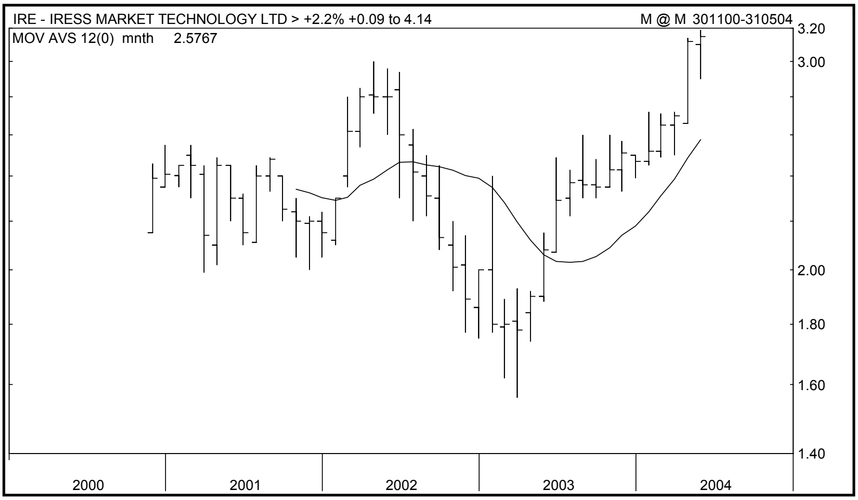
CONCLUSION

This share had been on my short list for some time. I had not bought it only because my funds had been otherwise employed in value model charts with good trends and high dividend yields. It was more attractive at the start of the present trend, but at that time I did not like the slow rate at which it had been rising in recent years.

POSTSCRIPT

Blackmores was also included in my book *Hot Stocks 2007*, which was written in November 2006 and showed my analysis of it over two years later in the bull market.

Figure 11.15: Iress Market Technology (IRE)



ANALYSIS

This is another chart with insufficient history to say whether it is a value or growth model chart. If you held a gun to my head, I would say value model, because the 2002–03 dip is more than I am comfortable with. However, see the APN News and Media chart.

PROFITS

Good growth, except for a dip in 2002.

P/E RATIO

20.3. This is well above the market average of 15.19.

DIVIDEND YIELD

4.03 per cent. This is above the market average of 3.84 per cent.

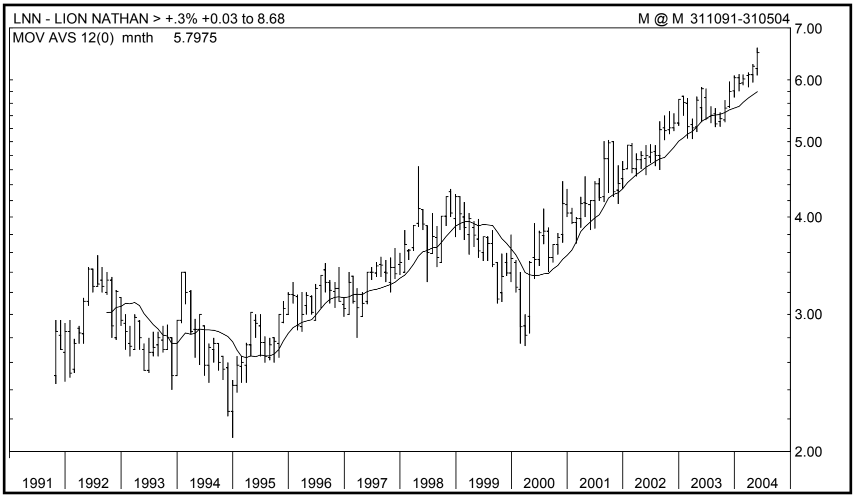
ASSESSMENT

The fundamentals are suggesting that this may be a growth model chart. The high P/E ratio is suggesting that the smart money expects growth. The dividend yield indicates that it represents good value for a growth model share.

Conclusion

This is definitely the kind of share I am looking for. The only reason it is not in my portfolio is that I am fully invested in shares that represent better value on the criteria in my investment plan.

Figure 11.16: Lion Nathan (LNN)



Analysis

This appears to be a growth model chart, though the extent of the two dips in 1994 and 1999 are unsettling.

Profits

Profits have been erratic, but have grown in the last three years.

P/E ratio

23.5. This is well above the market average of 15.19.

Dividend yield

4.13 per cent. This is above the market average of 3.84 per cent.

ASSESSMENT

The profit history suggests that this might better be classed as a value model share, in which case its P/E ratio is too high for my plan. However, if it is a growth model share that has some problems in the past, it is reasonable value, but not outstanding.

Also important for me is that it is a New Zealand company, though most of its operations are in Australia. This would probably not stop me investing if it looked to be an outstanding situation.

CONCLUSION

The chart looks good and it is close enough to my investment plan, but being a foreign company tips me against investing in it when there are better home-grown opportunities.

Figure 11.17: Perpetual (PPT)

ANALYSIS

This looks as though it is a growth model chart. There is scope to argue that the growth has finished with the 2002–03 dip and it is now a value model chart. However, on balance I see it as a growth model chart on the available evidence.

PROFITS

Impressive growth story, though with a flat result last year.

P/E RATIO

23.4. This is above the market average of 15.19.

DIVIDEND YIELD

2.92 per cent. This is well below the market average of 3.84 per cent.

ASSESSMENT

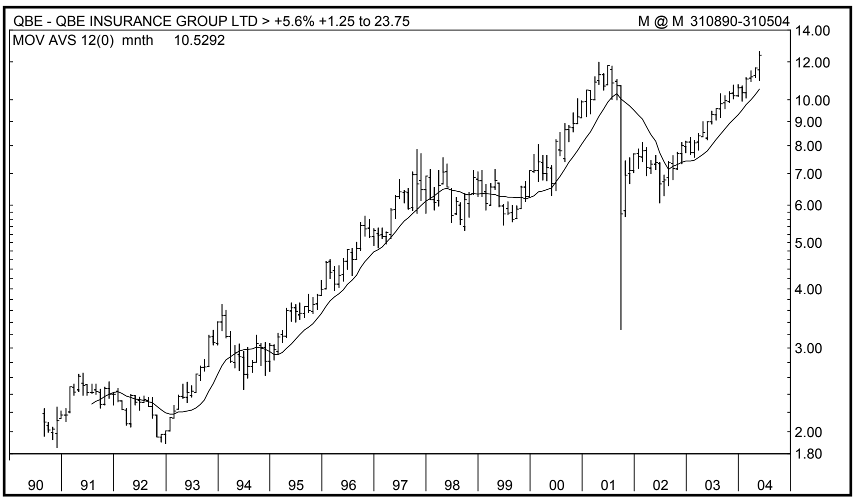
The fundamental ratios are fine for a growth model stock, which this has been except for last year. If the growth can be continued they are quite acceptable. It is not possible to buy great companies much cheaper than this.

However, the question is whether it can keep growing. The chart is not conclusive, as we may be looking at a double top reversal pattern. I would not be interested in this chart until it clearly breaks above the 2002 peak.

CONCLUSION

This is an interesting chart. If it breaks above the 2002 peak it will keep coming up on the filter and I can consider it again then.

Figure 11.18: QBE Insurance Group (QBE)



ANALYSIS

This is clearly a growth model chart, but with a massive interruption caused by losses from the 2001 terrorist attack on New York and Washington.

PROFITS

Profits have shown slightly patchy growth until the small loss in 2001. Since then, two record profits.

P/E RATIO

15.0. This is right on the market average of 15.19.

DIVIDEND YIELD

3.23 per cent. This is below the market average of 3.84 per cent.

ASSESSMENT

This is an outstanding chart, which was difficult to analyse because of the huge overreaction to the 2001 disaster, which led to only a small loss for QBE. The new all-time high confirms its growth pattern.

For a growth company, the fundamentals are very cheap, but maybe there is some doubt whether its recent growth can be continued.

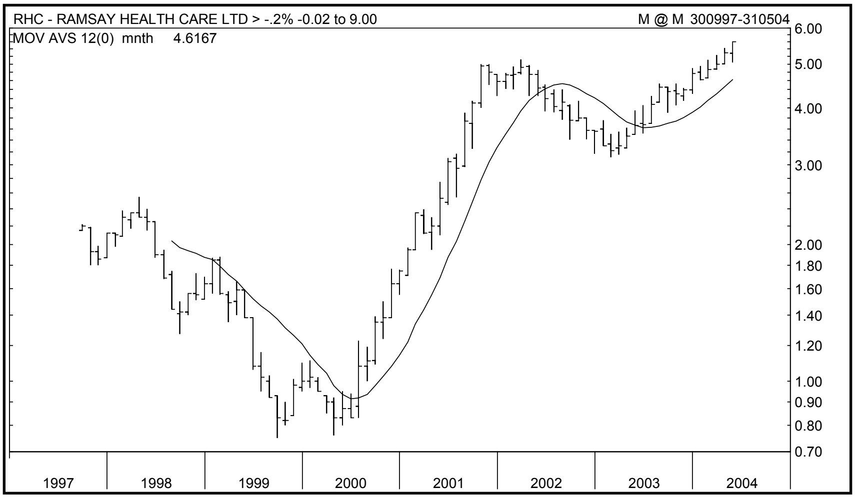
CONCLUSION

This is just the sort of growth model chart and fundamentals I am looking for. It has been on my short list for a while and is my choice of insurance shares. The only reason I have not bought it is because I have seen better potential shares that are already in my portfolio.

POSTSCRIPT

QBE Insurance Group was also included in my book *Hot Stocks 2007*, which was written in November 2006 and showed my analysis of it over two years later in the bull market.

Figure 11.19: Ramsay Health Care (RHC)



Analysis

Until 2003, I would have seen this as indisputably a value model chart. However, while that is still my best judgement, it is possible to argue that it is now a growth model chart in a new mark-up phase.

Profits

Significant setback in 1999 and 2000, but since then it has resumed good growth in the last three years.

P/E ratio

18.3. This is a bit higher than the market average of 15.19.

Dividend yield

3.1 per cent. This is a little below the market average of 3.84 per cent.

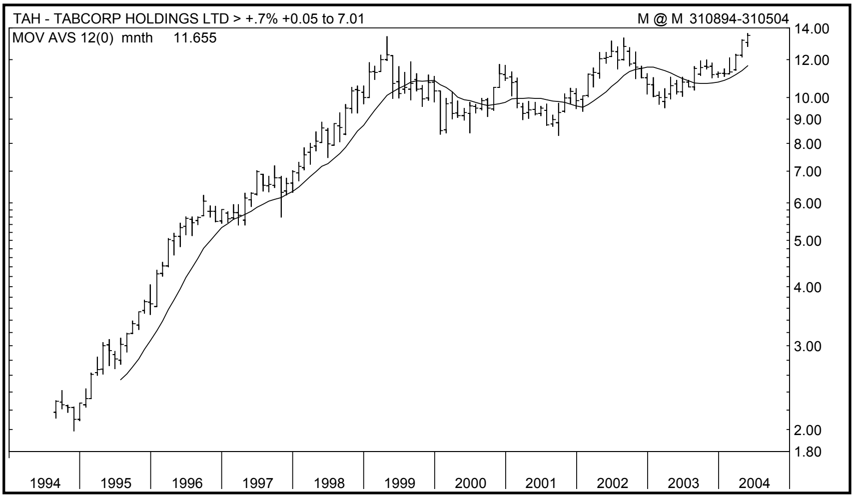
Assessment

The chart is trending up strongly above the last major peak. The fundamental ratios do not look too demanding for a growth model chart.

CONCLUSION

This is what I am looking for in my investment plan. It has been on my short list for a while. Again, the only reason I have not bought it is that I see better potential in my existing portfolio.

Figure 11.20: Tabcorp Holdings (TAH)



ANALYSIS

This is clearly a growth model chart. It seems to have completed a major consolidation area and be in a new mark-up phase.

PROFITS

It has shown consistent growth, before having flattened out for a few years.

P/E RATIO

19.1. This is moderately above the market average of 15.19.

DIVIDEND YIELD

4.9 per cent. This is well above the market average of 3.84 per cent.

ASSESSMENT

Tabcorp is starting a new mark-up phase, with attractive fundamentals for a growth business.

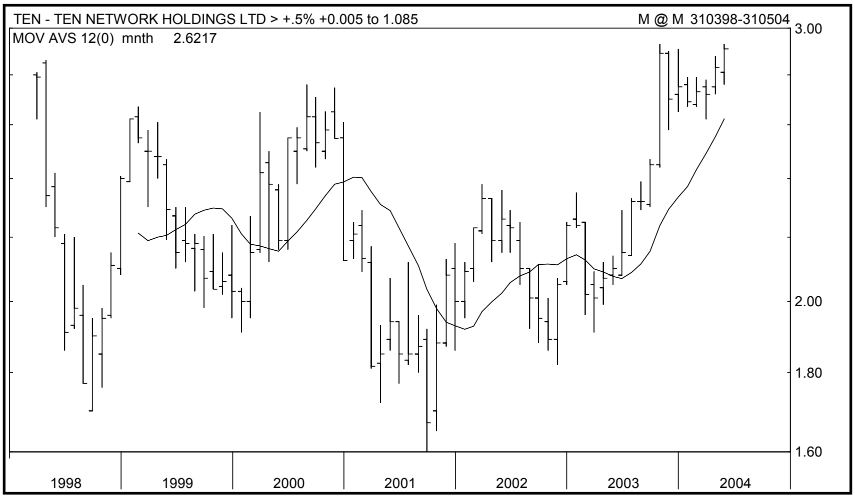
CONCLUSION

I have been building a position in this share, because it seemed to be rising out of its consolidation area.

POSTSCRIPT

Tabcorp was also included in my book *Hot Stocks 2007*, which was written in November 2006 and showed my analysis of it over two years later in the bull market.

Figure 11.21: Ten Network Holdings (TEN)



ANALYSIS

I am seeing 1998 through 2003 as a large accumulation area in a value model chart that has now started a strong mark-up phase.

PROFITS

Patchy, but seems to be coming off a media cycle low.

P/E RATIO

11.7. This is well below the market average of 15.19.

DIVIDEND YIELD

4.82 per cent. This is well above the market average of 3.84 per cent.

ASSESSMENT

If readers accept my view of the chart, it is an outstanding opportunity. The fundamentals also show that this is a cheap share.

CONCLUSION

This is the sort of share I am looking for. I have built a significant position in this share, which I have found irresistible on charting and fundamental grounds.

THE FUNDAMENTAL ANALYSIS FILTER

I will usually start looking for interesting stocks with the technical analysis filter. However, sometimes it is more effective to start with a fundamental filter. This will be when the market conditions at the time indicate that a higher priority be placed on the margin of safety than the trend.

The objective in starting with a fundamental analysis filter instead of a technical analysis filter is to first find stocks that are available at prices that may afford a margin of safety. Their charts will then be scrutinised to identify any that fit the value model and are either just breaking out of an accumulation phase or are already in a mark-up phase. Occasionally we will also find some good growth model charts that afford a margin of safety.

Starting with the fundamental analysis filter is particularly relevant in the late stages of a bull market when the risk is high and many stocks are in uptrends. It will enable us to quickly focus on the ones that may provide a margin of safety in a dangerous market.

There are many ways we could filter for potentially undervalued stocks. My first choice is to use the price/earnings ratio. In the time frame of my investment plan, the big trends are driven by earnings. The price/earnings ratio is a good way to look at how reasonable the price is in relation to the earnings of the company.

The remaining issue is what price/earnings ratio to use for the filter of the database of stocks. In practical terms, any arbitrary number below the current market average price/earnings ratio will be workable. It will give a list of stocks with a relatively low price/earnings ratio. However, I like to be a little more logical about it.

I do this for two reasons. Firstly, the market average price/earnings ratio might be unreasonably high if there has been a long-running bull market. What is cheaper than the market average may not be cheap in absolute terms. Secondly, price/earnings ratios are not unrelated to the rate of inflation. This is because bond yields are at least partly a compensation for inflation risk and move up and down with the inflation rate. Since stocks compete with bonds for investment funds, stock yields are related roughly with bond yields. Price/earnings ratios are the inverse of earnings yields, hence the relationship of price/earnings ratios and bond yields or inflation rates.

Bonds are so-called risk-free investments, because coupon payments and capital repayments are guaranteed by governments, who have the power to levy taxes. Stocks are more risky than bonds, because neither the dividends nor the price of the stock are guaranteed in any way and depend entirely on the success of the underlying business.

In order to be quite conservative, I assume that stocks should have a 50 per cent risk premium over bonds. I therefore take the current bond rate, add 50 per cent for risk and calculate the equivalent price/earnings ratio.

The 10-year bond rate for 28 November 2008 was 4.58 per cent. To calculate the equivalent price/earnings ratio:

Step 1: Add 50%

$$4.58 \times 1.5 = 6.87$$

Step 2: Divide 100 by the answer in step 1

$$100 \div 6.87 = 14.6$$

I have found over many years that this method will work well most of the time. However, another thing which I have learned the hard way is that we should never stop thinking. This idea also means we should never blindly rely on general rules. About everything, we should be sceptics, continually asking whether the situation is normal or unusual. We have already seen in the technical analysis filter that we are in unusual times. A severe bear market meant we could not find a single stock trending upward or breaking upward out of a sideways pattern.

The result of the above calculation rang alarm bells in my mind for two reasons:

1 The market average price/earnings ratio at the end of November 2008 was 8.63. It is very unusual for my calculation to throw up a higher price/earnings ratio than the market average. Clearly, this is because of the extent of fear in the market that has driven prices so low. It is also because the ratio uses last year's earnings and the market is pricing its estimate of the current year's earnings.

2 The increase in the Australian Consumer Price Index, which is a fair measure of inflation, was running at 5 per cent in the year to September 2008. With a 10-year bond rate of 4.58 per cent, we have a situation where the flight to safety in bonds during the credit crisis has priced bonds at a negative real return. This is also a very unusual situation, even given the expectation that both the rate of inflation and the general level of interest rates are expected to fall in the coming year.

In such an unusual situation, it is therefore inappropriate to use my calculation until things return to somewhere near normal.

In deciding how to proceed in this situation, my thinking begins with the objective behind the fundamental analysis filter. I am looking for stocks with low price/earnings ratios. Among them, I hope to find some stocks that may be starting to build a sideways pattern on the chart. These patterns will be accumulation patterns on value model stock charts and consolidation patterns on growth model stock charts. It seems appropriate therefore to simply discount the market average price/earnings ratio by 10 per cent and see what that brings up in the filter. The market average price/earnings ratio at the end of November 2008 was 8.63; 8.63 × 0.90 is 7.77. I rounded this to 7.8 and used that in the filter below.

However, before we do the filter run, an important thing to remember about a filter for stocks with a low price/earnings ratio is that a low ratio can mean one of two things:

1 It can mean that the market is undervaluing the stock. The price has been driven down, perhaps because the company is out of fashion or because there have been temporary problems to be remedied.

2 It can also mean that the market does not expect the company to repeat its last earnings. Earnings are expected to fall and perhaps the company is even expected to make losses. The primary way that we will eliminate these companies is from the chart. They

are unlikely to be breaking upward out of accumulation or consolidation phases on the charts or to be in mark-up phases.

A partial way to filter some of this second group out is through the other condition in the filter. This condition is that the company pays a dividend. This is a part of my investment plan and was used also in the technical analysis filter. Failure to pay dividends can be an indication of distress or that the company's business is not yet sufficiently mature to start rewarding stockholders.

The next issue is when to run this filter. I run it regularly as an alternative to the technical analysis filter when market conditions indicate it to be the preferred method. This is because the price/earnings ratio varies with the price of the stock, which fluctuates all the time.

However, there are two other important times to use the fundamental analysis filter. The price/earnings ratio also varies with the earnings figure and this will change twice a year in Australia. Most Australian companies report on a financial year to 30 June. They therefore announce their full-year results in the two-month period July–August and their half-year results in the two-month period January–February. Many results are announced towards the end of these 'reporting seasons'. It also takes a week or so for all the data to flow through into the database. It is therefore very useful to run this filter in mid March and in mid September to pick up significant changes in earnings.

The filter rules

In Insight Trader charting software, the System Module filter rules are:

```
PER(D):<=:7.8
```

In plain language, this means that the filter will give us a list of stocks with a price/earnings ratio equal to or less than 7.8. The actual number will vary. The choice of a price/earnings ratio of 7.8 was explained above.

```
AND PER(D):>:0
AND DIVYD(D):>:0
```

In plain language, the first condition says that the stock must also have a price/earnings ratio greater than zero, which it must do if it makes a profit. The second condition says that the stock must also have a dividend yield greater than zero, which it must have if it pays a dividend.

Before going any further, though, there is one important aspect to my philosophical approach that is worth articulating. This filter will throw up a number of stocks that are of no interest. However, keep in mind that we are always looking for the few outstanding opportunities. It is rather like mining. There will be many tons of useless rubble, but scattered through it there might be a few gems.

WHAT IS SIGNIFICANT?

In this respect, the question that often arises is: what do I mean by significant when I say a ratio should be significantly above or below the market average? There are two reasons why I do not define it precisely:

1. I do not define significant exactly because everything is relative. I am looking at a situation where I am judging on several criteria. The ratios are also relative to the market averages, which may be relatively high or low. It is the overall balance that is important.
2. I do not define significant mathematically, because that would dramatically reduce the list of stocks that come out of the filters. While I do not want to have to go through the entire 2100-odd stocks listed on the Australian Securities Exchange, I have found from experience that when I set tight rules for each parameter in the filters, the result was that I missed too many really interesting stocks that were just outside the range.

The problem is in part that computers are relentlessly logical, but my requirements are not. Suppose that I say I want a company with a price/earnings ratio less than 8 times and a dividend yield above 6 per cent. It would be simple to design and run that filter. But the computer would reject a company with a dividend yield of 5.99 per cent and a price/earnings ratio of 6, because it failed the dividend yield test by 0.01 per cent. I might be really interested in this company.

It might also be that all the companies that meet the filter have unattractive charts against the two models. In that case, I might want to find attractive charts that were just a little outside the filter rules. There is no reason why a reader could not do multiple filter runs in that situation, easing the tests slightly until the right charts came up. However, I wonder if that would be quicker. In the end it comes down to personal preference. I prefer to be exposed from the filters to a somewhat wider range of possibilities, from which I need to choose.

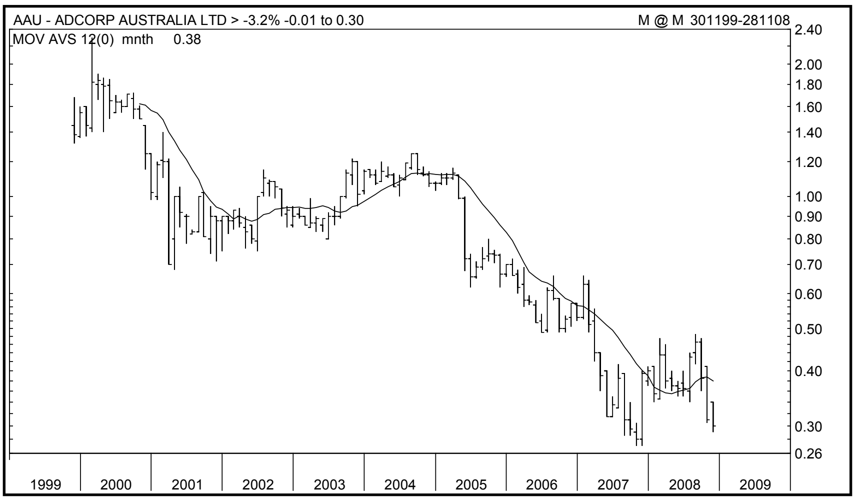
Please keep in mind that my investment plan is for me. There are lots of ways to manage most risks and the risk tolerance will be different for each investor. I encourage readers to adapt my investment plan to suit the way they like to analyse things. If readers like fuzzy rules with a high level of choice and judgement, use my approach. If readers like to have nice precise rules for everything, then there is no reason I know of why they should not go down that path. If readers don't know what suits their personality and attitudes, they should experiment with both and see which one they are most comfortable with.

Having clarified this important issue, it is now time to use the filter rules. I ran a filter of all companies on 30 November 2008. The filter returned 220 securities that satisfied the test. This is a relatively large number.

I then went through the 220 charts. Something very significant came out of it. There was only one stock that even remotely looked as though it had finished falling and may be forming an accumulation pattern. Almost all the charts were still in a savage downward trend. This is consistent with my phase analysis that we were still in the second phase of a bear market. Clearly, the bear market has further to go in time, if not also in price, before we start to see signs of accumulation.

The one stock I found was Adcorp Australia, shown in figure 11.22.

Figure 11.22: Adcorp Australia (AAU)



ANALYSIS

We are looking at a multi-year mark-down phase. It must therefore be a value model chart. The other possibility is that it is neither a value nor a growth model chart. My inclination is to give it the benefit of the doubt and assume it is a value model chart.

The chart does seem to be forming what could turn out to be an accumulation pattern. Through most of 2007 and all of 2008 to date, it has traced out a sideways pattern.

The nasty thing about this stock is that it has been trending down right through a very strong bull market from 2003 to 2007. This is a clear worry. The question it raises is whether it has a sound business.

PROFITS

Adcorp has a history of making some profits most years since it listed, although there was one large loss, roughly double the average annual profits. It also pays dividends, or it would not have been on the filter results.

P/E RATIO

4.64. This is well below the market average of 8.63.

DIVIDEND YIELD

16.67 per cent. This is way above the market average of 6.51 per cent. This is another worry, because it is suggesting that the market does not believe it will continue paying the same dividends it has paid in the last year. However, this yield is also not really that unusual in these times for smaller companies.

DEBT-TO-EQUITY RATIO

The company has zero debt.

LIQUIDITY

Adcorp has a current market capitalisation of only $21 million. There is not enough volume for me to transact safely.

ASSESSMENT

Because of the chart, I have to say this stock may be forming an accumulation pattern. However, that assessment will be instantly negated if the present downward move fails to hold at the 2007 lows.

CONCLUSION

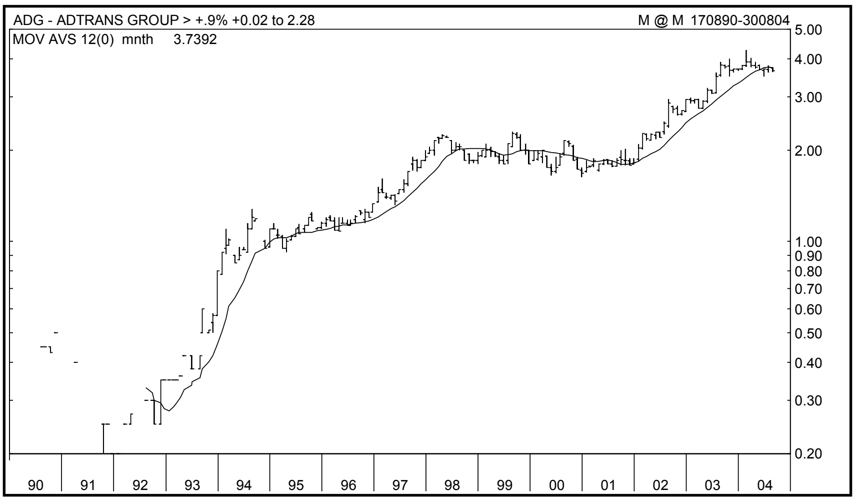
This stock lacks the liquidity I would need. However, I included it for its discussion value. Ignoring liquidity for a moment, I am in two minds about this stock. Its business did not thrive in a boom and it seems to be trying to change away from its old business model to a new one. This is not a good sign. Maybe the company will get it right, but maybe not. The chart will tell the tale in time.

Nevertheless, this was an interesting situation to analyse.

We are now in the same position as we were with the technical analysis filter. I have explained the fundamental analysis filter and run it on the market at the time I am writing this chapter. However, it effectively turned up nothing. This is not surprising, as I have already explained. What I need to be able to do, though, is to show what to look for when the time comes. Since I cannot go forward, I need to go back to the previous bull market to show examples of what will come around again in the last phase of the present bear market and the first phase of the next bull market.

As with the technical analysis filter, I have selected 10 stocks from a filter run on 15 September 2004, which produced 146 securities that satisfied the filter rules.

Figure 11.23: Adtrans Group (ADG)



ANALYSIS

This is clearly a growth model chart, having a series of mark-up phases interrupted by substantial consolidation phases. I have successfully bought into the last two mark-up phases (1996–97 and 2002–03).

PROFITS

Have grown fairly consistently, with a couple of slips, but recovered the following year.

P/E RATIO

12.2. This is just below the market average of 15.2.

DIVIDEND YIELD

5.57 per cent. This is attractive, compared to the market average of 3.74 per cent.

ASSESSMENT

This is a growth model chart that appears to be in a consolidation phase.

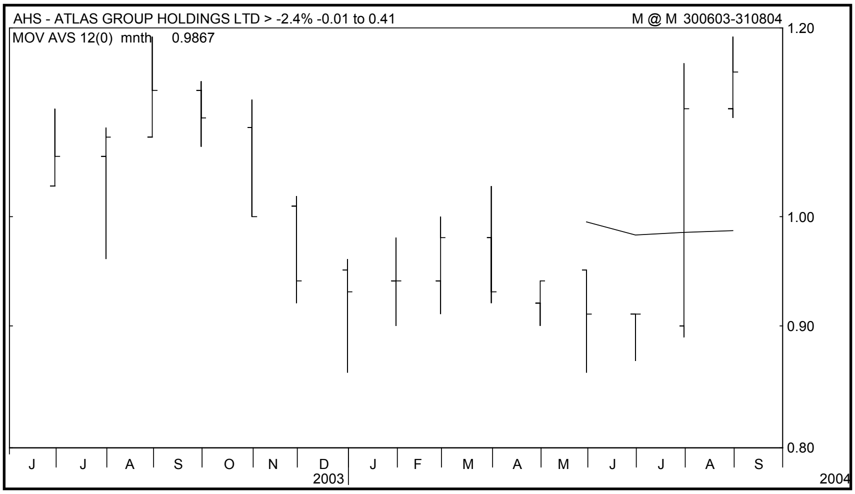
CONCLUSION

I sold out of this stock when it hit my sell stop. It would become interesting again if it broke upwards above the highs of the present consolidation phase. It will come up on the technical analysis filter at that time.

POSTSCRIPT

Adtrans Group was also included in my book *Hot Stocks 2007*, which was written in November 2006 and showed my analysis of it two years further into the bull market.

Figure 11.24: Atlas Group Holdings (AHS)



Analysis

There is insufficient historical data to form a view on this chart. It could be assessed that this is an accumulation phase.

Profits

Only two years available. However, this is not a new company and it is not a small business.

P/E ratio

9.3. This is attractive, compared to the market average of 15.2.

Dividend yield

6.9 per cent. This is attractive, compared to the market average of 3.74 per cent.

Assessment

This is a steel distribution business that was listed for many years, taken over and now has been floated again. If it were to begin to clearly trend upward above $1.20, we could assume that it has completed an accumulation phase and is in a mark-up phase.

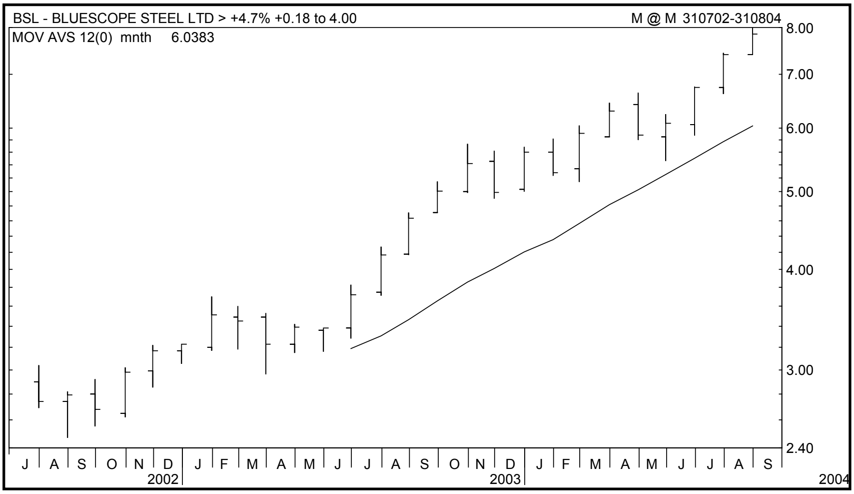
CONCLUSION

Well worth considering if and when it begins to trend.

POSTSCRIPT

Subsequent to writing this, I purchased this stock, when it broke above $1.20.

Figure 11.25: Bluescope Steel (BSL)



ANALYSIS

This is clearly a mark-up phase. We cannot say from the chart whether it is a value model or growth model chart. However, by reference to its industry, which is cyclical, it should be assumed to be a value model chart without evidence to the contrary.

PROFITS

Since listing, Bluescope Steel has recorded two years of large profits and good year-on-year growth.

P/E RATIO

10.7. This is below the market average of 15.2.

Dividend yield

3.61 per cent. This is just below the market average of 3.74 per cent.

Assessment

This is a very solid business. It passes all of my investment plan tests except for a high dividend yield, but that would be exceptional in such a strongly growing big industrial company.

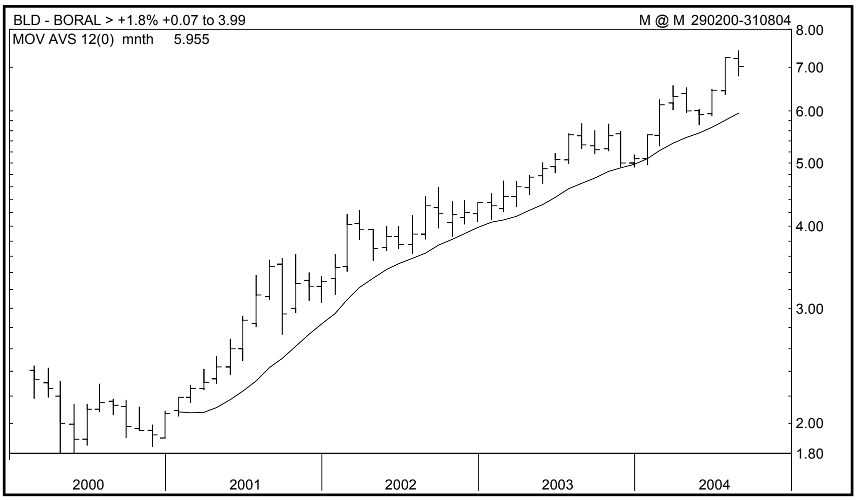
Conclusion

This is a strong candidate for my portfolio. It is not currently in it, because I have found some excellent smaller companies.

Postscript

Bluescope Steel was also included in my book *Hot Stocks 2008*, which was written in October 2007 and showed my analysis of it two years further into the bull market.

Figure 11.26: Boral (BLD)



ANALYSIS

We have evidence of what may be part of an accumulation phase on a value model chart or a consolidation phase on a growth model chart at the beginning of the chart, followed by a strong mark-up phase. It is impossible from the chart to identify which model it belongs to at this stage. However, since the company is in a cyclical industry, we might have a working assumption that it is a value model chart.

PROFITS

Since 1999 there is a strong pattern of increasing profits.

P/E RATIO

10.8. This is below the market average of 15.2.

DIVIDEND YIELD

4.35 per cent. This is moderately above the market average of 3.74 per cent.

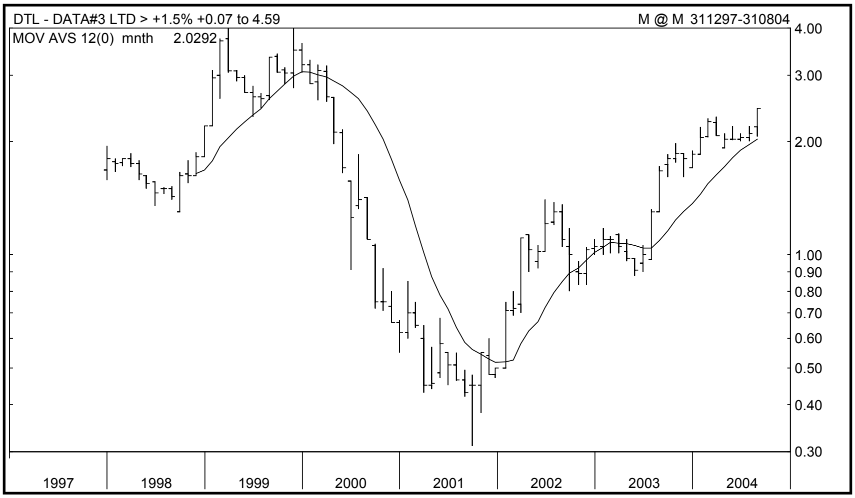
ASSESSMENT

The low price/earnings ratio and higher dividend yield may reflect the cyclical risk in Boral's industry, rather than undervaluation. Nevertheless, this is an extremely strong chart and fits my investment plan.

CONCLUSION

I did own this stock in 2001 and made a good gain, but sold when it hit a sell stop level. I did not repurchase it when the trend reasserted itself because of concerns about the industry being near a peak. So far that fear has not been borne out.

Figure 11.27: Data#3 (DTL)



ANALYSIS

This is clearly a value model chart, which is in an increasingly stronger mark-up phase.

PROFITS

Rather variable, including a couple of years of losses.

P/E RATIO

10.2. This is attractive compared to a market average of 15.2.

DIVIDEND YIELD

6.65 per cent. This is attractive compared to a market average of 3.74.

ASSESSMENT

Everything is in place here awaiting a confirmation of the break above the latest trading range. There are two negatives: the somewhat uneven profit record and the proximity of the all-time high, which is likely to be a resistance level.

CONCLUSION

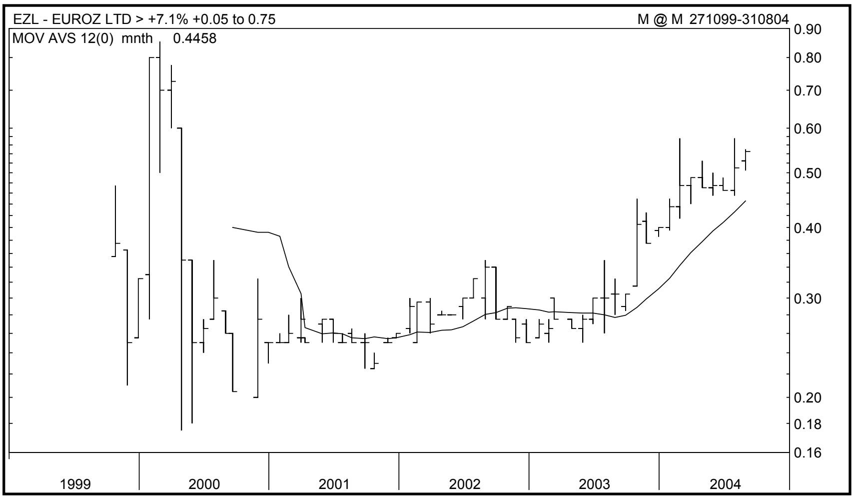
A clear move to new highs for the trend would increase interest in this share.

POSTSCRIPT

Subsequent to writing this analysis, I began building a position in this share. It had begun moving up. The overhead resistance would be a severe test. One consideration for me was that I wanted to have some exposure to the IT sector and my only other position had been closed out on a sell stop.

Data#3 was also included in my book *Hot Stocks 2007*, which was written in November 2006 and showed my analysis of it two years further into the bull market.

Figure 11.28: Euroz (EZL)



ANALYSIS

The chart picture in 1999–2000 is unhelpful. However, since then, there is the suggestion of a value model chart which has completed an accumulation phase and started trending up.

Profits

Profits have been highly variable.

P/E ratio

7.1. This is attractively below the market average of 15.2.

Dividend yield

14.89 per cent. This is extremely high and unrealistic if the market thought the last profit and dividend were repeatable.

Assessment

I have no idea what is going on here. The company is a stockbroker. The ratios suggest market expectation that there has been a one-off windfall profit and/or high dividend, which is not likely to be repeated. Broking is a very cyclical business and profits are not maintainable unless conditions are favourable. This renders the price/earnings ratio and dividend yield poor guides, much like resources shares.

Conclusion

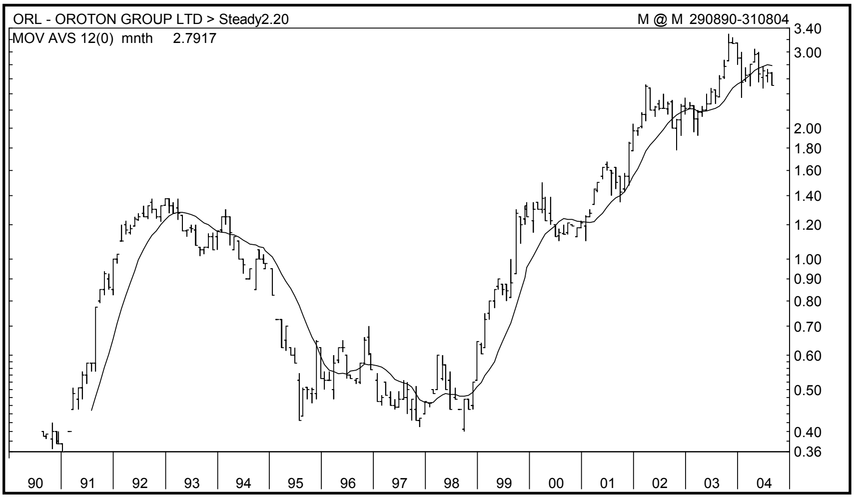
This one is too difficult for me without a lot of research work, and then it may be inconclusive. If there is a good situation here, it will make more new highs and come up on the technical analysis filters, when it can be reassessed.

Postscript

I included this stock because it provides a good lesson. I did not keep watching it closely and passed it over too quickly on subsequent scans. I missed out on a very good mark-up phase. One can argue that it was a situation that was simply too difficult. Maybe so, but we should try to learn from later assessment of poor judgements.

Euroz was also included in my book *Hot Stocks 2008*, which was written in October 2007 and showed my analysis of it three years further into the bull market.

Figure 11.29: Oroton Group (ORL)



ANALYSIS

This is clearly a value model chart. It has enjoyed a very strong mark-up phase. The momentum of the uptrend has slowed appreciably. It is possibly forming a distribution phase.

PROFITS

Six years of good growth after three years of losses, but the last year was steady.

P/E RATIO

10.6. This is moderately attractive against a market average of 15.2.

DIVIDEND YIELD

4.42 per cent. This is moderately attractive against a market average of 3.74 per cent.

ASSESSMENT

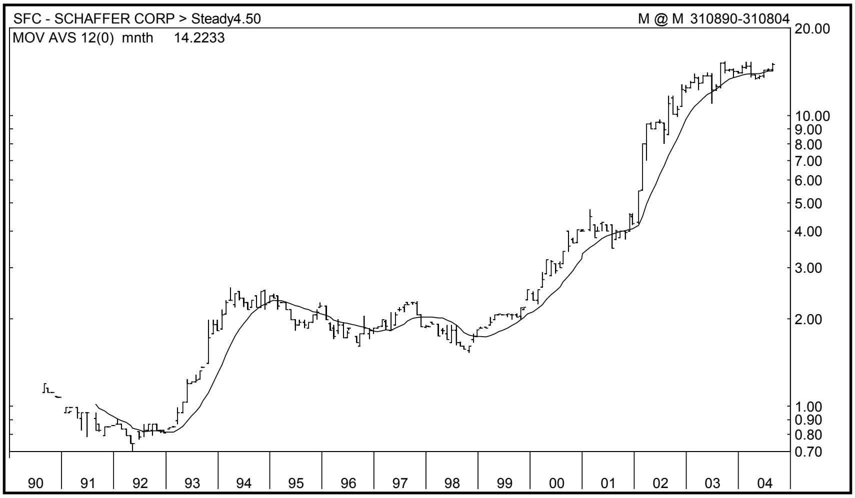
If Oroton was to break downward from the present sideways pattern, it would probably be completing a distribution phase and I would lose all interest.

However, it was currently on my watch list because I owned it earlier. It will only be considered for purchase if it can move strongly up out of the present sideways trading range.

CONCLUSION

Maintain a watch on it. This is in line with my policy of monitoring shares I have sold out of when they hit sell stop levels, in case the trend resumes. See 'Guideline for re-entry' in chapter 12.

Figure 11.30: Schaffer Corporation (SFC)



ANALYSIS

This one looks to be a growth model chart. It seems currently to be forming a consolidation phase. However, I am a little concerned about the length of the 1994 to 1999 consolidation. That is a very long time to sit through a consolidation.

PROFITS

They have been surprisingly variable considering the chart, with a loss in 1999. Profit before abnormal items is more consistent.

P/E RATIO

11.7. This is not compelling against the market average of 15.2 for a value model chart. It would be acceptable for a growth model chart.

DIVIDEND YIELD

7.11 per cent. This is outstanding against the market average of 3.74 per cent.

ASSESSMENT

It could be that the high dividend yield has held this share's price up when it might otherwise have been a value model chart.

If it is a growth model chart it will break upward from the present consolidation. However, if it is a value model chart, the present sideways pattern could be a distribution phase.

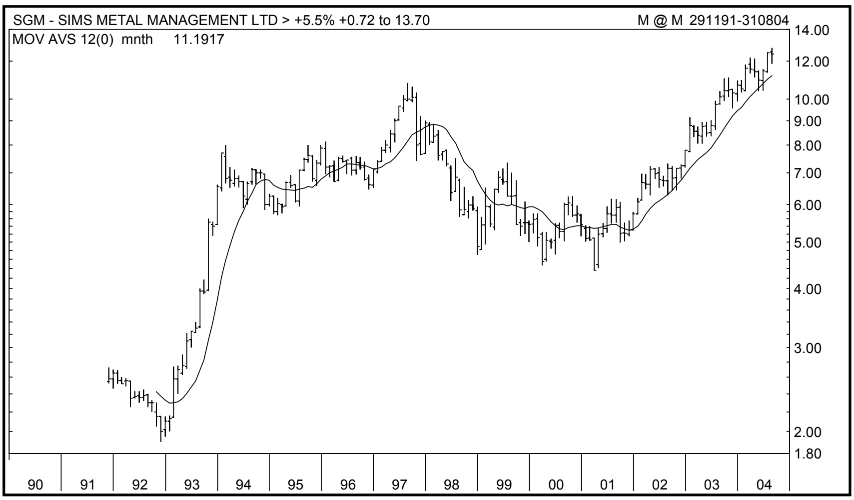
CONCLUSION

Reassess if it breaks out upward, in which event it will come up on the technical analysis filter.

POSTSCRIPT

Schaffer Corporation was also included in my book *Hot Stocks 2008*, which was written in October 2008 and showed my analysis of it three years further into the bull market.

Figure 11.31: Sims Metal Management (SGM)



ANALYSIS

This is not all that easy to pick at first glance, but I am seeing it as a value model chart.

PROFITS

Profits declined for five years to a loss, before rising for five years.

P/E RATIO

10.2. This is moderately attractive against a market average of 15.2.

DIVIDEND YIELD

5.3 per cent. This is attractive against a market average of 3.74 per cent.

ASSESSMENT

The attractive ratios suggest some discount for cyclical risk. However, the chart has looked good since the breakout upward in 2002, when the ratios were quite attractive.

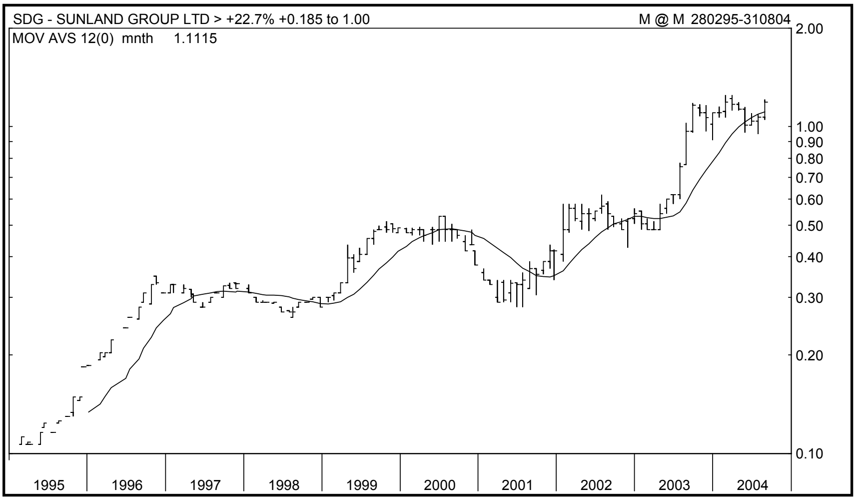
CONCLUSION

This stock has been in my portfolio for some time and has now more than doubled in price.

POSTSCRIPT

Sims Metal Management was also included in my book *Hot Stocks 2007*, which was written in November 2006 and showed my analysis of it two years further into the bull market.

Figure 11.32: Sunland Group (SDG)



ANALYSIS

This one also has some aspects of a growth model chart. However, I am inclined to treat it as a value model chart, or perhaps neither. My main concerns are the depth of the fall to the 2001 trough and the general lack of momentum across the whole chart. This one also used to be very thinly traded, but is a bit better now.

PROFITS

Except for a dip in 2001, it shows a strongly growing profit picture, especially in the last two years.

P/E RATIO

4.3. This is extraordinary value against the market average of 15.2.

DIVIDEND YIELD

4.55 per cent. This is of moderate attraction against a market average of 3.74 per cent.

ASSESSMENT

My feeling about the low price/earnings ratio is that the market is not expecting the company to repeat the last profit. It is a property developer, so there is also some risk, along with the likelihood that profits could be lumpy.

CONCLUSION

This one is potentially interesting. However, I am inclined to consider it too risky in the late stages of the property boom.

POSTSCRIPT

This is another stock which I might well have paid a bit more attention to. A very strong upward trend unfolded over the following few years.

Sunland Group was also included in my book *Hot Stocks 2008*, which was written in October 2007 and showed my analysis of it three years further into the bull market.

COMPARING THE TWO FILTER RUNS

It was interesting that the 15 September 2004 fundamental analysis filter found only seven stocks that were on the 23 June 2004 technical analysis filter. It is also worth noting that it found interesting stocks that had not been picked up on the technical analysis filter. This highlights the value of running both filters.

It is also notable that many of the interesting stocks picked up on the fundamental analysis filter will not reach a potential buying point until they break out of an accumulation or consolidation phase. They may therefore come up on a regular technical analysis filter sometime in the future.

This suggests that the technical analysis filter is the prime method. However, it seems to be well worthwhile running the fundamental analysis filter from time to time, and especially at the end of profit reporting seasons. The big advantage of the fundamental analysis filter is that it can pick up potential breakout situations that can be closely monitored.

MAKING THE FINAL DECISION

Once the filters have been run and assessed, I end up with what might be called a hot list of stocks. These are charts that fit the value or growth models. They also have an adequate margin of safety. Some of them will be immediate potential investments. Others will be interesting, but the chart needs to improve before I consider buying them. For example:

- Some may have yet to break out of an accumulation or consolidation phase. They will generally be set aside until the breakout is flagged on a regular technical analysis filter for new yearly highs.
- Others may be in a strong mark-up phase, but stretched on the upside in a rally. I need to wait for a better entry point. These require close monitoring. Every day, after the market closes, I review all of the stocks in my existing portfolio. I then review each of the charts where I am waiting for a better entry point. I do this in Insight Trader by setting up a Replay Chart Category called Portfolio and Hot List. The stocks in the portfolio come first and the hot list charts are set up behind them.

If a stock on the hot list comes into a desirable position to buy it, there are several issues to be decided which are discussed below.

WHETHER I HAVE A CASH RESERVE AVAILABLE TO BUY IT

If not, I generally do not buy it. I will leave it on the hot list though, because another opportunity may arise when cash is available, or one of the stocks in the portfolio may hit a sell stop, freeing up some capital for reinvestment.

WHETHER I WOULD SELL AN EXISTING STOCKHOLDING IN ORDER TO BUY A NEW STOCK

I will not normally make a switch. This is especially the case where the new stock had previously thrown me out on a sell stop. It may fail to behave well in the future as well.

However, I am much more likely to make a switch by selling an existing investment that is not working out. It might be one that has not fallen to its sell stop level, but is threatening to do so. I might also sell an investment that is trending upward all right, but not strongly above the 12-month moving average.

In making a decision to switch, I try very hard to compare the existing and proposed investments objectively. In particular, I will try to disregard what the existing investment has done to date. In other words, I try to compare them on the assumption that I currently do not hold either of them. I consider which I would buy, if faced with a choice between two new investments today.

I will also tend to make any switches in stages. I would reduce the existing investment, if it was more than the minimum size, rather than selling it all. I would then make the two investments compete. The new investment should prove its case. It must perform better than the original investment, before I switch the rest of it.

The transaction costs involved in the switches are not a key consideration for me, but may be for readers with much smaller investment capital.

WHAT I WOULD DO IF I FIND SEVERAL ATTRACTIVE INVESTMENTS AT ONCE

The first guideline is the strategy of not buying more than two stocks in the same industry. This may discount one or more stocks. I do not entirely discount selling an existing stock in an industry and replacing it with one of the new prospects in the same industry. However, the existing holding would have to be performing poorly and the new prospect outstanding for me to do this, as discussed above.

Beyond that, I also have a preference for second rank stocks over big blue chips, because of their greater capacity to grow at a faster rate. This is at the heart of my active approach to investing.

Finally, I will make a list of the stocks that are competing for the available cash reserve. I will tabulate the price/earnings ratios and dividend yields. I will also write down what I see to be the opportunities and risks in each prospect. Then I weigh them up. This bit is judgement and I am not sure it can be easily taught. It is only learned from experience. If market risk is high, I will lean toward the margin of safety. At any time, low price/earnings ratios and high dividend yields are preferred.

A GENERAL PHILOSOPHY

I do not agonise over these issues too much. Remember that we cannot predict the future with any certainty. A textbook perfect chart may fail miserably and a marginal one may succeed brilliantly. A huge effort may be made at this point only for it all to come to naught. So, I use my judgement and buy a starting position. Then I let the market decide. If an uptrend develops, I stay with that stock and build the position if cash is available. If an uptrend does not unfold, or if it fails, I get out and try another one.

It was unfortunate that in this chapter there were so few current examples to show. This means that I had to go back to a previous time. When the bear market has advanced well into the final phase (distress selling), I will post a lot more example charts from filters which are run at that time on my website <www.bwts.com.au>. For legal and other reasons, these will have to be on my Members Only website, for which there is a joining fee and annual charge. I will advertise the posting of these charts in my free email newsletter (see below).

It was also not possible to show all of the charts from the 2004 filter runs, due to space limitations. However, all of the 2004 filter runs have been posted to the *Resources* page on the free section of my website.

If readers are interested, they may also join the list for my free email newsletter. Just go to the Newsletters page of the free section of my website and fill out the form to join the list.

CHAPTER 12

MANAGING INVESTMENTS

A surprising number of beginners tend to think that once they have found good stocks to buy, all they have to do is buy them and wait for the profits to flow. Experienced investors know better. They know that finding interesting stocks to buy is only the first step. It is what they do after finding the good stocks to buy that largely determines their results. In many cases it determines whether they make a profit or a loss on the investment. It certainly determines how big a profit or loss they make. Indeed, I have seen many instances where two investors have bought the same stock on the same day, yet one goes on to make a profit, while the other goes on to make a loss, or at least a significantly smaller profit. Likewise, when the investment does not work out, one investor will make a small loss, while the other one makes a large loss.

Managing investments is far more involved than most beginners imagine. Many decisions have to be made, including:

- when to buy
- what position size to buy
- when and how to build a position
- when to cut losses
- when to take partial profits
- when to sell.

In this chapter we will look in detail at how I do these things in theory. These are my investment management rules and guidelines. In chapter 14, I look in even greater detail at how these rules and guidelines are applied in case studies of actual investments that I made in the 2003–07 bull market.

Before we start, there is one very important aspect to highlight. This is that everything I do hangs together logically. Everything is based on exploiting the simple big idea of riding an uptrend. The rules and guidelines follow logically from the definition of a trend explained in chapter 8, when we looked at analysing the trend of the market index.

There is also a need to explain why some of the sections below refer to rules and others to guidelines. This is not accidental:

- A ***rule*** is an absolute. I try never to break a rule.
- A ***guideline*** is somewhat less firm. It is what I am aiming to do, but I allow myself some flexibility to adjust to situations as I see them.

Now, clearly these guidelines are a danger area. I think they work for me because I have had a lot of experience. I am also a generally unemotional investor. Investing is a business for me. So, my discipline, while not perfect, is sound. However, I recognise that other people may find that they have to turn these guidelines into rules until such time as they are confident to trust their judgement.

The aim is to get to the point where we have so internalised the rules that we know instinctively what to do in any situation. Until that happens, whenever we find that we do not know what we should do in a situation, we need to be able to fall back on firm written rules in our investment plan.

GUIDELINES FOR BUYING

On value model charts, I am looking to buy when a stock breaks upward from an accumulation phase or during a subsequent mark-up phase. On growth model charts, I am looking to buy when a stock breaks upward from a consolidation phase or during a subsequent mark-up phase.

In both cases, I am essentially looking to do the same things: buy when a stock breaks upward from a prolonged sideways period of trading, or buy when a stock begins to consistently trend upward from such a breakout. Added to this last point is that I prefer stocks that trend above the 52-week moving average, which indicates strong momentum to the trend.

My buying ***guidelines*** can therefore be treated in two parts:

- ➢ Buying an upward breakout from a sideways trading zone.
- ➢ Buying into an existing uptrend.

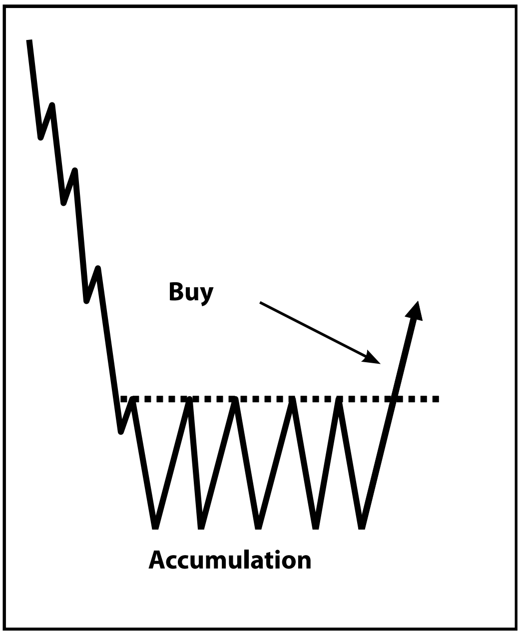
These are somewhat different, so I will discuss them separately.

BUYING A BREAKOUT

First, we will look at the value model.

In figure 12.1, we start with a mark-down phase. This levels out into an accumulation zone. The shape of this phase is shown as being very regular in the diagram. However, in practice these sideways patterns take an endless variety of forms. They can be narrow, in the sense that they form in only a few months. However, the best ones seem to take a year or more to form. The sideways pattern should be clearly visible on the weekly bar chart.

Figure 12.1: buying a breakout: value model

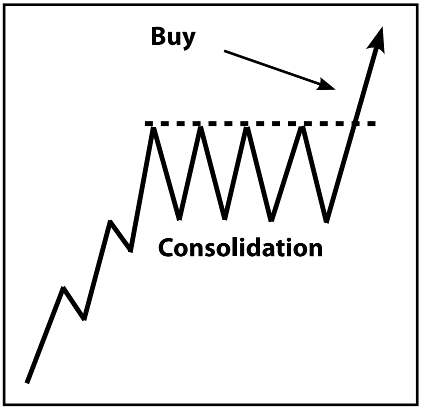


Then the price breaks upward above the highest high in the accumulation pattern. This is where I like to buy. The presumption is that it is a value model chart and therefore a good proportion of these breakouts will lead to a mark-up phase.

Next, we look at the growth model.

In figure 12.2, we start with a mark-up phase. This levels out into a consolidation zone. The shape of this phase is very regular in the diagram, but it may be somewhat more irregular in practice. However, the key is that it is a sideways pattern of trading, rather than a correction, which retraces a fair bit of the last mark-up phase. It can be narrow, in the sense that it forms in only a few months. However, the best ones seem to take a year or more to form. The sideways pattern should be clearly evident on a weekly chart. Even when the pattern has taken only a few months to form, the breakout should still be purchased, because it is probably a very strong stock that does not need long to consolidate previous gains.

Figure 12.2: buying a breakout: growth model



There are a number of important issues that arise with breakouts:

➢ ***How much does the price have to move above the high of the accumulation or consolidation zone to be considered a breakout?*** I am not too fussy here. However, if in doubt, I like to see the price move at least 2 per cent above the high of the accumulation or consolidation pattern and will wait for it to meet this test.

➢ ***Is volume important?*** It is a good sign if the volume increases on the breakout, indicating that the buyers are keen. However, my experience with the Australian stock market is that many good breakouts occur without an increase in volume. I no longer worry about the volume.

- ***What if it breaks out during a day, but closes back below the breakout level?*** I am inclined to wait until the breakout is confirmed by another move above the breakout point. The best breakouts on the strongest stocks never give these problems. If in doubt, I demand that the stock prove its case before I buy.
- ***What if it races away from the breakout level?*** This means that demand for the stock is very strong. I buy some. Supposing that I have to make a choice between buying two stocks—one stock that races away from the breakout, or another stock that hovers near the breakout point—I will always buy the one that is rising strongly. If it is racing upward it is stronger than the one that hovers.
- ***Is it better to wait for the first correction?*** From experience, I have learned that some of the best ones go a long way on the first move and never come back to the breakout level. So, I buy some on the breakout, even if I have to chase the price upward, just in case it is one of the really strong ones. However, as we will see later, I build my position, so this is often just a first step. If it races up and up, it is better to buy a few than be left standing at the altar with nothing.
- ***What about failed breakouts?*** At this point, I am often asked about false breakouts. I usually confess that I have never seen one. A breakout either takes place or it doesn't. There is either a price bar above the highs of the sideways pattern, or there is not. What people actually mean is not that the breakout was false in the sense that it did not actually occur. What they mean is that the breakout in question did happen, but that it was one which was not subsequently sustained. In other words, there was no follow through and the breakout failed. So, why not call it by a name that accurately describes what we are saying: a failed breakout? I will address the issue of how I deal with failed breakouts when I come to sell stops, later in this chapter.

BUYING INTO AN UPTREND

While buying a breakout from a sideways pattern can be difficult for some people, at least some of the time, all beginners have problems buying into an existing trend. Buying a stock that is already moving upwards strongly is difficult for two reasons:

- The perfectionist in us is screaming that we missed the ideal time to buy when the trend first started.

- ➢ We are fearful that we will buy at the very top of the move and look stupid.

It is true that many beginners do succeed in buying near, or at, the top of a move. They wait and wait, but the price keeps rising. Eventually, they can stand it no longer and plunge in at the top price. The top price is always where the most fearful buyer has bought.

Many beginners also tend to let the stocks that are already in strong uptrends go and look for ones that are just starting to trend upwards. This is a mistake, because these can be the weak ones which are only moving up out of sympathy with a strong market.

The key is to buy into the first stocks that begin to trend upward, in the market overall, or in an industry, and buy into them sooner rather than later.

Experience has taught us that established trends tend to persist. While these established trends will have begun with a breakout, some breakouts will fail to produce a subsequent upward trend. There is no getting away from this. It is an inescapable part of the landscape of investing.

The two models help to bias things in our favour. We know that mark-up phases originate with an upward breakout from a sideways pattern. We also know that early in the bull market cycle is when a greater proportion of breakouts tend to see good follow through into a mark-up phase. Breakouts in the late stages of a bull market are the ones which tend to have a greater proportion of failures. Nevertheless, breakouts from the best looking patterns and at the best time will sometimes fail.

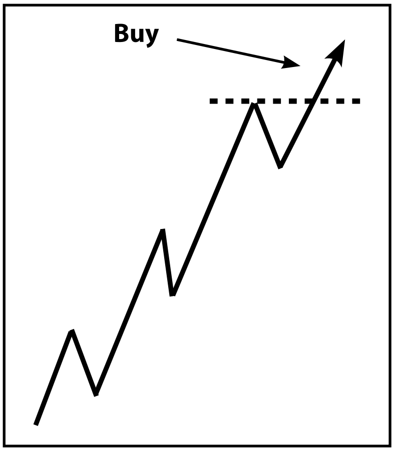
That is why I build a position in a stock. I buy some. If the uptrend is confirmed, I buy more. When the uptrend is confirmed again, I finish buying. This is an important tactic to manage risk, which I will return to later in this chapter when I deal with my guidelines for building positions.

If we recall that an uptrend is a sequence of higher peaks and higher troughs, it follows that there are two points at which an uptrend will be confirmed as it unfolds:

- ➢ If it moves above the last peak. This means that it must now form a higher peak.
- ➢ If it falls from a peak and then begins rising from a trough that is higher than the previous trough. This means that it is likely to form a higher trough.

First, we look at buying above the last peak, shown in figure 12.3.

Figure 12.3: buying into an uptrend: buy above the last peak



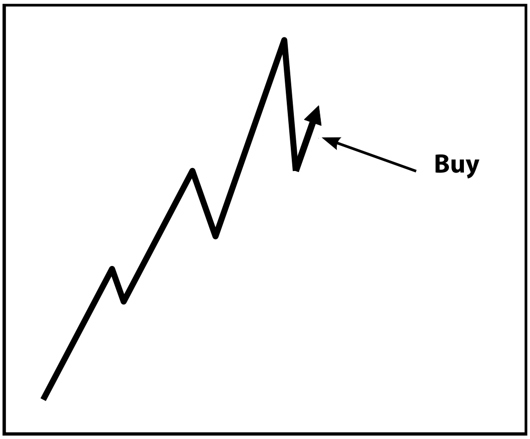
Buying a stock when it moves to a new high above the last peak in a trend tends to be the more certain. This is because buyers were previously overpowered by sellers at the old peak. Buyers have now come back in strength after some profit taking. They have bid the price up through any remaining selling pressure and are back in control. The trend is clearly confirmed and is persisting.

As with breakouts, the stronger the move above the previous peak the more keen the buyers are. Once any resistance is overcome around the old peak, the price can start to move higher very strongly. These are the best ones. The situations in which to be more cautious are when the move to a new high above the old peak seems to be weak and indecisive. Either the buyers lack strength, or the sellers are still very strong.

Next, we look at buying above a potential trough, shown in figure 12.4 (overleaf).

Buying a move above a potential higher trough in the trend tends to be less certain than the first situation. This is because what looks like a rise from a trough may fail and turn out to be only a small rally in a bigger downward move. In the worst situations, such a further decline will violate the previous trough and will trigger a sell stop, resulting in a loss.

Figure 12.4: buying into an uptrend: buy above a potential higher trough



The reality is that this will happen sometimes. It is the reason why I have a sell stop below the last trough in the trend to deal with investments that fail. Some failures are an integral part of investing. There is nothing wrong in them, providing the sell stop is executed immediately. Where the whole situation goes awry is where there is no selling discipline and a small loss becomes a large one.

I will discuss buying potential troughs in more detail in the next section.

Guidelines for position building

If I am buying into a breakout from an accumulation or consolidation phase, there is always the risk that a trend may not unfold. When I am buying into a breakout, I will build my position in three steps, ideally each step being 2 per cent of my capital. Each step will be at a point where there is additional evidence that a trend is unfolding, based on the logic of the definition of a trend.

Building a position from a breakout

My ***guidelines*** for building a position after a breakout are:

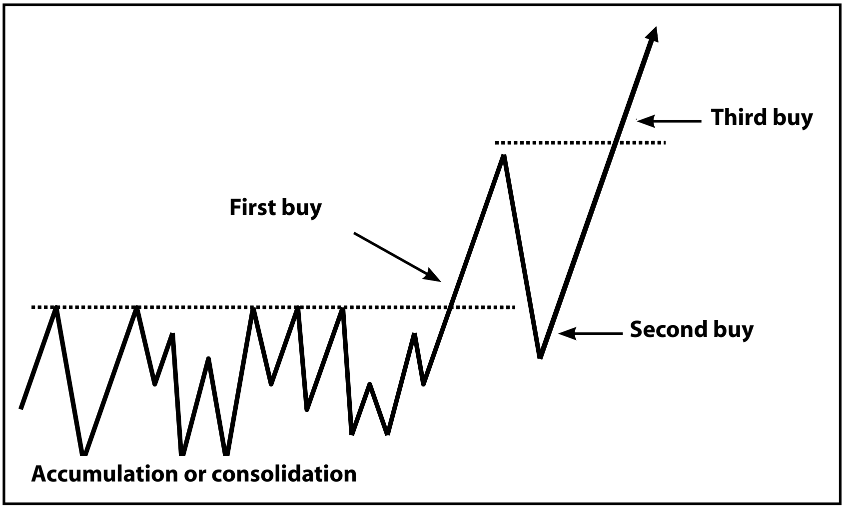
- Invest 2 per cent of my capital on a breakout from an accumulation or consolidation pattern.
- Increase the investment to 4 per cent of my capital when it appears that the first trough after the breakout may have been formed.

- Increase the investment to 6 per cent of my capital when the price has completed a confirmed trough after the breakout by rising above the peak formed after the breakout.

All of these steps are always subordinate to my 0.5 per cent of capital maximum risk rule.

Figure 12.5 shows these first three position building points.

Figure 12.5: position building after a breakout



BUILDING A POSITION IN AN ESTABLISHED TREND

Although my guidelines allow me to invest up to 6 per cent of my capital into a stock if it is already in an established mark-up phase, there will be many occasions when I prefer to build my position in three or more stages. One reason may be that my strategy for managing specific risk does not allow me to buy a position that large. Another reason may be that I would like to see progressive confirmation of the trend in the new stock before I switch more of my capital from another stock in my portfolio, which may not be performing as well as it might.

My ***guidelines*** for building a position in an established trend are:

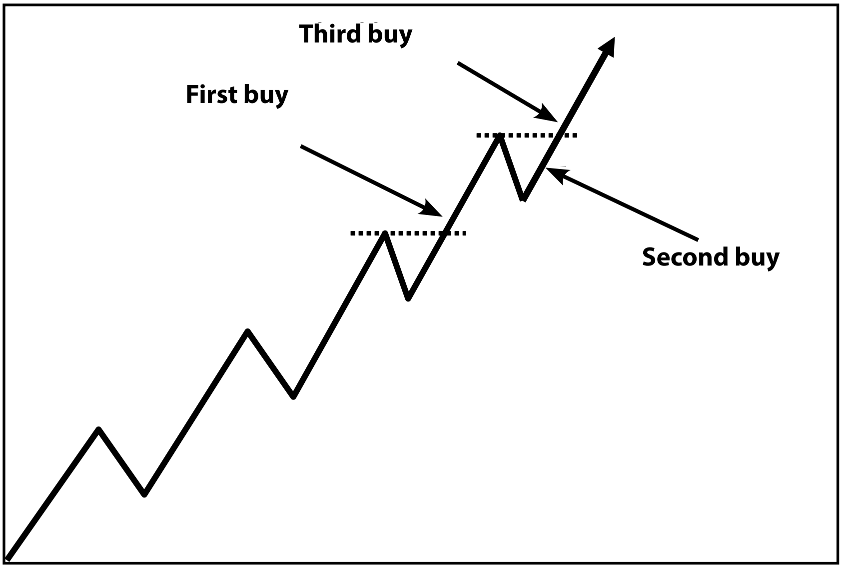
- Invest 2 per cent of my capital on a move above a peak in the trend.
- Increase the investment to 4 per cent of my capital when it appears that the first trough after the breakout may have been formed.

- Increase the investment to 6 per cent of my capital when the price has moved above the next peak in the trend.

All of these steps are always subordinate to my maximum risk rule.

Figure 12.6 shows how I tend to stage purchases in an existing trend.

Figure 12.6: position building in an established trend



Note about buying potential troughs

The most difficult of the position building guidelines is buying just above what appears to be a potential trough. It is difficult because we can never be sure that what appears to be a trough really is one until it has been validated by a rise above the last peak. It may be simply a bounce part way through a decline.

Unfortunately, there is no way to know for sure. However, there is a useful clue based on an extension of the chart analyst's concept of support.

The market remembers previous troughs, which become potential places for price to find support later. Once a trough has been established, both buyers and sellers suffer feelings of regret:

- ***Sellers*** will regret selling and be tempted to buy in again if the price comes back to near that level.

- ➢ ***Buyers*** will wish they had bought more and will welcome a second chance if the price returns to that level.
- ➢ ***Potential buyers*** will regret missing the opportunity last time and be anxious to buy if they get a second chance.

So, previous troughs become important support levels.

It is also true that the market remembers previous peaks. Once a peak has been passed on the upside, both buyers and sellers suffer feelings of regret:

- ➢ ***Sellers*** will regret getting out and will look to buy back in if the price returns to near that level.
- ➢ ***Buyers*** will wish they had bought more and will welcome a second chance if the price returns to that level.
- ➢ ***Potential buyers*** will regret missing the opportunity last time and be anxious to buy if they get a second chance.

So, previous peaks also become important support levels.

This concept of support provides me with a behaviourally based logic for buying what look like potential troughs:

- ➢ If the bounce that I think is a trough occurs at or near the peaks which were at the breakout level from an accumulation or consolidation pattern, I will buy with some confidence, knowing it is likely to be a support level.
- ➢ If the decline from the peak after the breakout sinks into the range of the accumulation or consolidation pattern, I will look for a trough to be likely to form at any very clear support level within the pattern.
- ➢ If the bounce that I think is a trough occurs at or near the last significant peak or a strong minor peak in the trend, I will buy with some confidence, knowing that it is likely to be a support level.

Other than that, I will buy if all the evidence seems to point to the decline having tested a level by bouncing off it a few times and the price then appears to have started moving up.

So, buying the potential troughs is not just luck. I am looking for evidence that a trough may have been formed. Nevertheless, I find that quite often I buy what I think to be a rise out of a higher trough, only to find that the price drifts down and forms a trough at a lower price than

I bought at. I am not unduly concerned when this happens. My sell stop rules will protect my investment when the trend fails. Investing is not a science, it is an art.

Rules for placing sell stops

Having determined a price at which to buy when building a position in a stock, the next step is to decide the price at which the investment would fail. This is something that inexperienced investors simply do not seem to think about. I have lost count of the number of times beginners have asked me what they should do about an investment. I always ask them for the price at which they set their initial sell stop. They rarely have an answer.

Determining the price at which my investment will have failed before I place the initial or subsequent buy order is critical to my whole plan. I call this my sell stop. My sell stop is a price level which I will have determined, written down and marked on my chart of the stock. This is the price level at which I will sell to cut my losses. I do not place such a stop order with my broker. However, I always know where the sell stop level is and I sell as soon as I am aware that it has been violated. That might be during the day on which it was violated, or early on the next day.

There are two very important reasons for determining the sell stop level before the investment is undertaken:

- I need it to calculate how large a position I will buy. This refers to one of my strategies for managing specific risk. I will discuss it in detail a little later in this chapter.
- The last time I am not emotionally involved in the investment is just before I buy it. Therefore, it is my last chance to make a calm and rational decision.

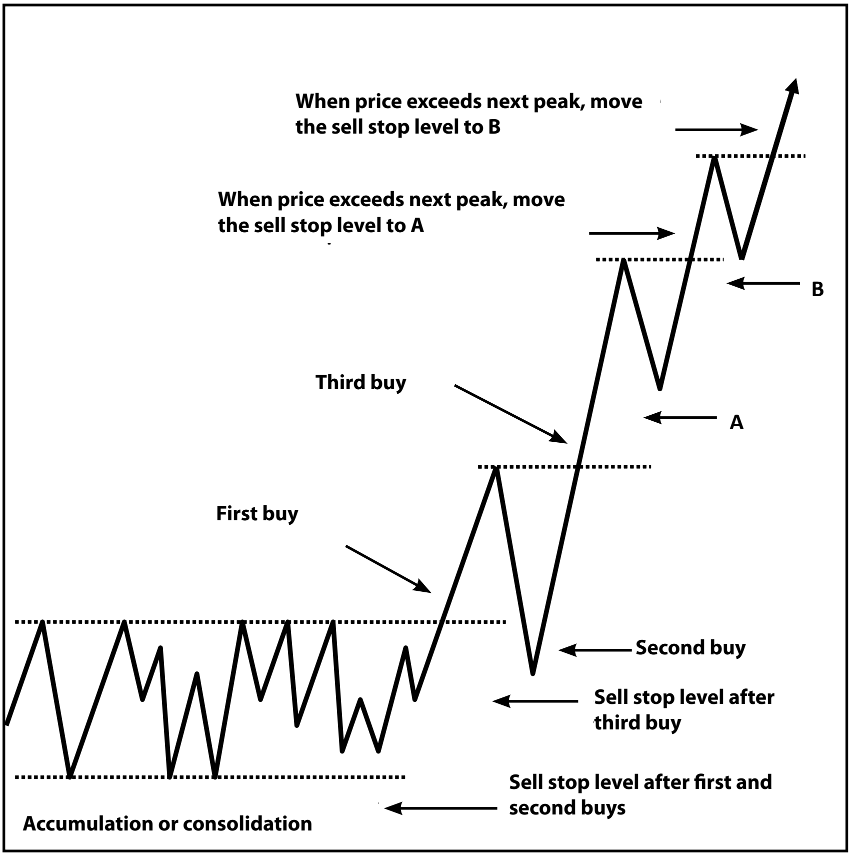
On the second reason, it is true that I regard myself as a fairly unemotional investor. However, that is a relative description. We are all emotional beings to some extent and I am no exception, simply on the low end of the spectrum through experience. It is also true that, having found a stock and decided to buy it, I will already be to some extent emotionally involved with it. However, that will be much less than the emotional involvement once I have actually placed the order and bought it.

If the initial sell stop level is not triggered and the price moves upward as I anticipate, I will use the logic of my investment plan to raise the sell stop level. At some point, the stop level will no longer be where I would be taking a loss, but where I would be protecting part of my profit.

PLACING SELL STOP LEVELS WHEN BUYING AFTER A BREAKOUT

The process for setting sell stop levels is continuous. Figure 12.7 shows the progressive process by which I set and move the sell stop levels to protect my capital where I am beginning the investment from a breakout.

Figure 12.7: sell stop levels when buying after a breakout



This looks a little complicated, but it is really very simple.

THE FIRST PURCHASE

For the first purchase on the breakout from an accumulation or consolidation pattern, the sell stop level is situated under the low of the accumulation or consolidation pattern. The logic behind this sell stop level is based on my two models:

- ***Accumulation pattern.*** In the value model, if the accumulation phase is complete, the breakout should lead to a mark-up phase. The breakout may be followed by a correction back to the breakout point, or even lower into the range of the accumulation pattern. However, if a correction were to fall below the accumulation pattern, then I am not looking at a completed accumulation pattern. The bottom of an accumulation pattern is also the lowest level at which sellers were prepared to sell and where buyers were prepared to take on the risk of ownership. If the price falls lower than this, then the sellers and the buyers both think something has changed for the worse about the outlook for the company.
- ***Consolidation pattern.*** In the growth model, if the consolidation phase is complete, the breakout should lead to a new mark-up phase. Like the accumulation pattern situation, if a correction were to fall below the consolidation pattern, then I am not looking at a completed consolidation pattern. If the price falls lower than this, then the sellers and the buyers both think something has changed for the worse about the outlook for the company.

THE SECOND PURCHASE

For the second purchase, the sell stop level remains where it was set for the purchase of the first part of the position I am building. The trough has not yet been confirmed, such that a trend is definitely unfolding.

THE THIRD PURCHASE

For the third purchase, we now have a confirmed higher trough in the unfolding trend and the sell stop level for the whole position is moved up to just below the last significant confirmed trough. The logic behind placing the sell stop level just below the last significant confirmed trough in the trend is based on the definition of a trend. For an uptrend to be intact, it must have a sequence of higher troughs as it unfolds. If it violates a trough, then the trend has potentially failed. This means a mark-up phase may have ended and I want to get out of the investment.

THE TRAILING SELL STOP

Then, each time the price makes a new high for the trend by rising above the last peak, the sell stop level for the whole position is trailed up to just below the last significant confirmed trough. This continues for as long as the trend continues. This is based on the same logic of the definition of a trend as for the third purchase.

PLACING SELL STOP LEVELS WHEN BUYING INTO AN ESTABLISHED TREND

When I begin an investment by buying into an established trend, I skip the first two sell stops described above, which are not relevant in this case. From there, the process of moving a trailing sell stop upwards as the trend unfolds is essentially the same as that described for moving sell stops after a breakout from an accumulation or consolidation zone.

This time the sell stop levels are based only on the definition of a trend: if the uptrend is intact, it must have a sequence of higher troughs as it unfolds. If it violates a trough, then the trend has potentially failed. This means that the mark-up phase may have ended and I want to get out of the investment. Figure 12.8 (overleaf) shows the progressive movements of the sell stop levels as a trend unfolds.

WHEN IS A TROUGH SIGNIFICANT?

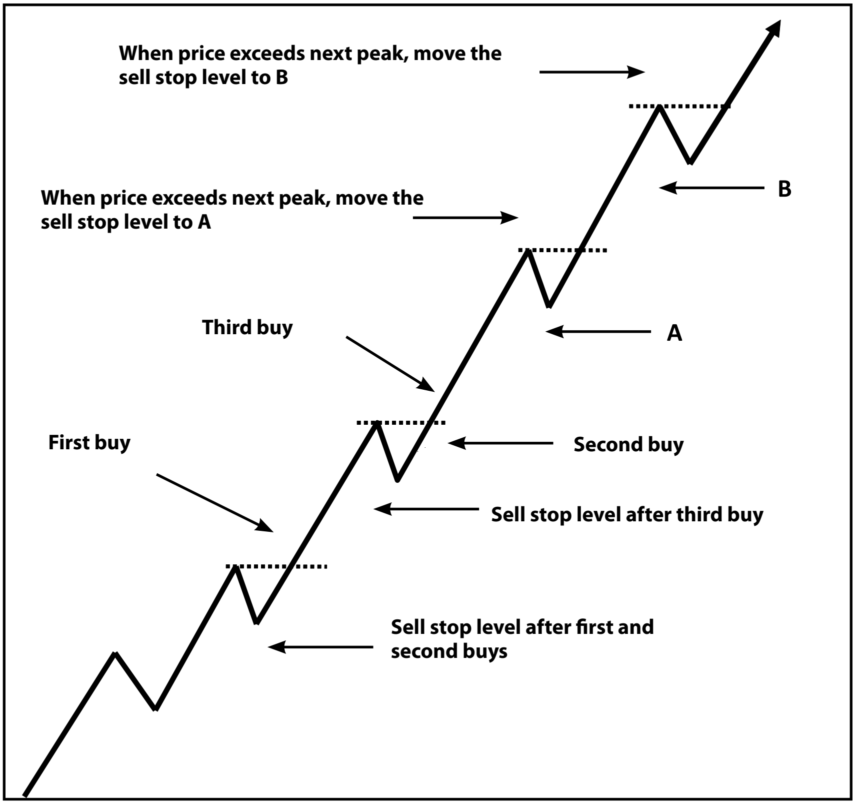
The problem with situating sell stop levels under troughs is that it begs the question of what is a significant trough. A trough is not a validated trough until the price has moved above the last peak. This is a basic idea about a trend. If the price falls away from a peak and then starts to bounce, we cannot be sure that it is a real trough. It could be just a bounce in a downward movement to a trough.

There is no escaping that this is largely a matter of judgement that can only be developed from experience. However, there are two useful guidelines:

- The important thing is to assess the width and depth of the trough and peak in relation to what is normal for the trend so far. The peak and trough should look as large on the chart in terms of width and height as the peaks and troughs that preceded it in the trend.

➢ If a potential trough does not look significant on a weekly bar chart, it is probably just a short-term fluctuation in the trend.

Figure 12.8: sell stop levels when buying into an established trend



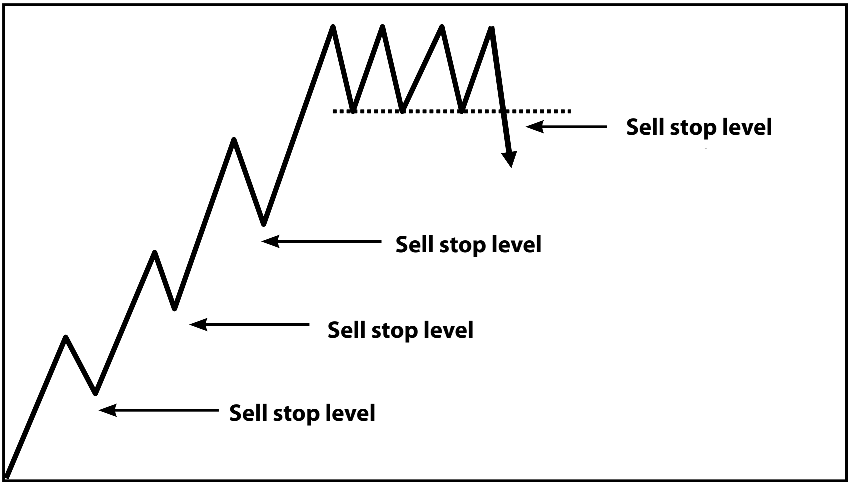
The only way to really absorb these ideas is to look at a great many charts, preferably as they unfold in real time so that we do not know the outcome. This simulates the real decisions we will have to make in managing our investments.

The sell stop level rules described so far have been driven first by the logic of the value and growth model charts and then by the logic of the definition of a trend. However, flowing from the definition of a trend are three logical situations where we can say the trend has ended. The rules described above only cover one of the three possible trend endings. The other two trend endings can occur before the sell stop level has been violated. I therefore have two additional selling ***rules*** that ***have precedence over the sell stop levels***.

FIRST ADDITIONAL SELL STOP RULE

An additional rule is needed for placing sell stops when a large sideways pattern develops in a trend. This means that the price has clearly moved sideways out of the slope of the trend. Several peaks and troughs will form that are not at significantly different levels to the previous ones and this develops into a trading range. It could be a distribution phase that ends a trend in a value model stock. It could also be a consolidation phase before the trend resumes in a growth model chart. In either case, I do not want to hold the stock if it breaks below these patterns. So, as the trading range develops, I move my sell stop level up to just below the lows of the troughs in the sideways pattern. Figure 12.9 shows this situation.

Figure 12.9: first additional sell stop rule



The difficulty with this selling rule is deciding when a trading range is big enough to warrant moving the sell stop level to just below it. To some extent this is a matter of judgement, which is developed from experience, but there are three guidelines:

- The sideways pattern should be large enough that it is clearly not a pattern formed by normal fluctuations in the trend. Sometimes a line drawn through the troughs of the trend can be useful. The trading range should have taken the price well to the right of this line. However, not all trends lend themselves to this approach.

- Similarly, if the sideways pattern has taken the price action to the right so that is also to the right of the 52-week moving average it will usually be significant for this rule for placing sell stops.
- Finally, the trading range should be clearly visible on the weekly bar chart. If it does not stand out on the weekly bar chart, it may not be significant.

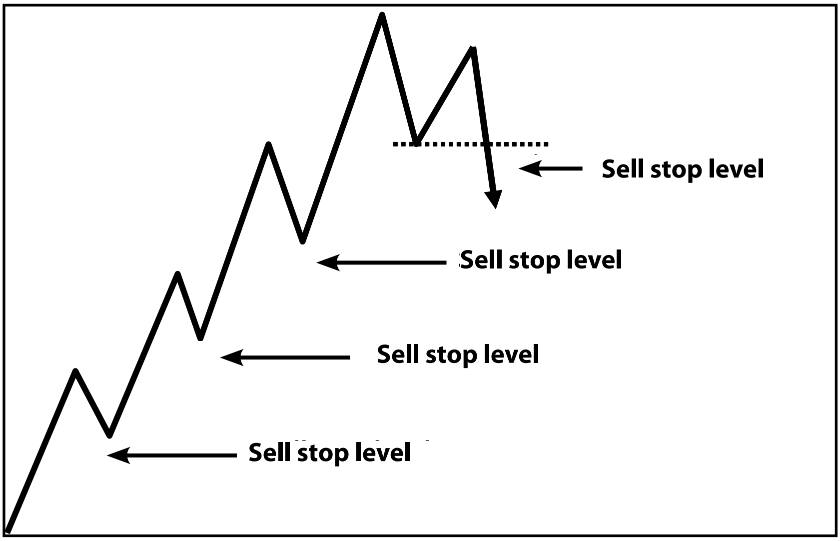
This rule for placing sell stops is very important. I am often asked what I do if a stock stops rising. Do I stay with it, or switch into another stock that is moving? This selling rule is a partial answer to that question. If a sideways pattern develops, I move the sell stop level up to just under the lowest bar in the sideways pattern. Eventually, one of two things will happen. Either it will break out downwards and trigger the sell stop, or it will break out upwards and a new mark-up phase is likely to unfold. In most cases, I will continue to hold while the trading range unfolds, even if it takes months or more than a year. Patience to allow our investment plan to work is one of the things needed to be a successful investor.

However, there must be some limit, otherwise we pay a high opportunity cost. So, if the market is presenting lots of opportunities and is strongly trending up, I may be more likely to switch half or all of an investment in a big sideways pattern into another stock. Any eventual upward breakout would be picked up on my technical analysis filter for new yearly highs. It then becomes a candidate for rebuilding the position. However, if there are few other opportunities and the market is going sideways as well, I would tend to hold on.

SECOND ADDITIONAL SELL STOP RULE

There is one other additional rule needed for placing sell stops. This deals with the situation when the price rises from a normal higher trough in an uptrend, but the move fails before exceeding the last peak. If the price then falls below the last trough, we have the third trend failure situation. I sell as soon as the price has fallen below the last trough. Figure 12.10 shows this situation.

Figure 12.10: second additional sell stop rule



This is the most difficult of all the three selling signals to assess. The problem is that this situation can appear to unfold, but the trough and peak involved are not significant enough. They may be only a part of a larger downward movement to a normal trough. It is easy to act prematurely in this situation. Whether I act in these difficult situations comes back to my judgement. There is no substitute for experience in forming good judgement skills.

DETERMINING THE EXACT SELL STOP LEVEL

The sell stop rules require me to position my sell stop levels below either the low of a trough in a trend or below the lowest point in an accumulation or consolidation pattern. The question then is: how far below?

I do not want to put the sell stop level right at the low of the trough or sideways pattern. These were price levels where buyers previously came into the market in sufficient strength to overcome all selling orders, and then some. If it was perceived to be a price that was good value before, I can expect buyers to act there again, supporting prices. It is only if buyers do not come in again at that level that it is significant for me, because it suggests that something has changed in the way buyers perceive value. Experience shows that these levels, where buyers tend to support prices, tend to persist. In other words, buyers and sellers remember them as previous low points.

Nor do I want to position the sell stop level too close to the low of a trough or sideways pattern. Support levels are not always that precise. Some buyers will anticipate them and start buying before the support level is reached. They do not bother me here. However, some buyers may be indecisive in the face of falling prices. Sellers may also be especially fearful. The downward move may overshoot a bit. I want to try to avoid selling out of my investment for the sake of a few cents of sloppiness around the support level.

The other danger is that very short term speculators may sell prices down to just below support to trigger sell stops. These speculators will then become buyers as they clean out the sell stops, providing them with an excellent buying price.

My general ***guideline*** is that my sell stop level should be anything up to 2 per cent below the low. In a stock that is very heavily traded, and on which the spread between the highest buyer and the lowest seller tends to be only ever one or two cents, I will place the sell stop level much closer to the low than for a thinly traded stock.

PROTECTING PROFITS

I am often asked what I do when a stock rises more or less continuously over many weeks or even months, without a significant trough forming on the weekly chart, under which to place a sell stop.

The answer is that it all depends. The easiest situation in some respects is when the stock has doubled or is close to doubling from my initial purchase price. In this case, my guideline for taking profits will look after it. I will discuss this guideline a little later in this chapter.

Beyond that, I do not have a guideline in my plan. There are so many different possibilities that it comes back to a question of using my judgement. I do not find that this situation lends itself to fixed rules or guidelines.

What I ***do not*** do is very clear in my mind, however:

➢ I do not resort to the daily chart to find short-term troughs. This sounds like a logical solution. However, from hard experience, I have found that it is not productive for an investor to become a speculator. The daily chart is not my time frame. Over the years I have tended to regret many decisions which were taken outside my time frame.

➢ I do not change my method of placing sell stops. Again, that is switching my investment plan in mid stream. In the past I have found this to be a recipe for making really poor decisions. An integral part of my investment plan is that I let profits run with sufficient room for me to catch the big moves over many years. A necessary corollary is that I will sometimes give back a significant chunk of paper profits at the end of a trend. This is an aspect of developing an investment plan that I have come to realise from thinking it through and using it over four decades. Each of us has to have a full realisation of what our investment plan involves. It is why readers should use my plan only as a model. Those who blindly copy it will generally fail many times before they succeed. There is no short cut on the journey to developing a good plan and becoming a good investor.

- Taxation plays absolutely no part in my investment plan. When I was a beginner, I struggled with this. Over time, I came to the realisation that it was absolutely irrelevant. Readers will notice that there is nothing in my investment plan that is driven by taxation considerations. My thinking is that each of us should set up our investments in the lowest tax environment we can legally find. Then we invest to maximise total return. That is, dividends plus capital growth. In the end it is better to pay $2 million in tax next year than to give back lots of paper capital growth in order to reduce the tax bill to $1 million. Think about it. Every legally operating business in our economy has to pay tax on profits. Investing is no different, except that there are some great tax breaks available for some sections of the population. These differ from country to country.

GUIDELINES AND RULE FOR CALCULATING POSITION SIZE

Sometimes I may buy an initial position in a stock that is 6 per cent of my capital. That is unusual. More often, I will build my position in a stock in three stages. No matter what the size of my position, or how many steps I took to build it, my sell stop is the same for the whole position in that stock. Also, all amounts in the position size calculations are for the full position in that stock. In my investment plan, I cannot conceptually hold more than one position in a stock. All my purchases of that stock are part of one position.

My guidelines and rule for calculating my position size flow directly from the strategy decisions that deal with managing specific risk outlined in chapter 9. My calculation of position size hinges on three elements:

- I invest a minimum of 2 per cent of my capital in any one stock (***guideline***).
- I invest a maximum of 6 per cent of my capital in any one stock (***guideline***).
- I never risk more than 0.5 per cent of my capital on any one stock (***rule***).

The best way to understand how these guidelines and the rule operate in practice is by working through examples.

> For simplicity, in the examples that follow, ***assume that my capital is always $300 000.***

Determining my initial position size

In determining the size of my initial position, I need to balance my maximum risk in any one stock of 0.5 per cent of capital against my guideline of the initial position being a minimum of 2 per cent of capital.

I start by determining the price at which sellers are offering enough volume in the stock that I want to buy. I then determine my sell stop level as explained in the previous section. The difference between the price at which I can buy and the price at which I would cut my losses is the amount that I am risking per stock. If I then divide 0.5 per cent of my capital by the risk per stock, it gives me the maximum position size that I may buy without exceeding 0.5 per cent of my capital. In the example below, my maximum position size is 3000 shares.

Step one	
My purchase price	$4.25
My sell stop level	$3.75
My risk (4.25 – 3.75)	$0.50
0.5% of my capital	$300 000 × 0.005 = $1500
Maximum position size	1500 ÷ 0.50 = 3000 shares

Next, I need to calculate my position size if I invest 2 per cent of my capital. I start by determining what amount is 2 per cent of my capital. I then divide that by the purchase price. In the example below, which follows on from step one, my minimum position is 1412 shares.

Step two	
2% of my capital	$300 000 × 0.02 = $6000
My minimum position size is	6000 ÷ 4.25 = 1412 shares

STEP THREE

Finally, I need to compare the maximum position size to the minimum position size and decide whether to buy and how large a position to buy. In the example above, which follows from steps one and two, my minimum position of 1412 shares is less than my maximum position of 3000 shares, so I would buy a position of 1412 shares. I may adjust this slightly up or down to make a round number when I place the order.

Most of the time, this is the sort of outcome I have when making the calculations for establishing an initial position in a stock. However, sometimes the position size calculations will reveal that my minimum position is greater than my maximum position. Such a situation might be similar to the example below where I have assumed some different prices for the purchase and the sell stop.

Step one	
My purchase price	$9.55
My sell stop level	$5.40
My risk	$4.15
0.5% of my capital	$300 000 × 0.005 = $1500
Maximum position size	1500 ÷ 4.15 = 361 shares
Step two	
2% of my capital	$300 000 × 0.02 = $6000
My minimum position size is	6000 ÷ 9.55 = 628 shares

In this example, my maximum position size when I limit my risk to 0.5 per cent of my capital will not allow me to make a sufficiently large investment. In this situation, I will not proceed with the investment at that time.

I will continue to monitor the trend on the stock concerned and look for an opportunity to buy where the risk is less. Otherwise, I will look for another stock where I am allowed to buy a sufficiently large position.

There are two things that I ***will not do*** in this situation:

- Buy anyway, rationalising that the risk is only a little more. My view is that the rule is describing my absolute maximum risk. I might sometimes depart slightly from the minimum investment guideline, but I will never break the maximum risk rule.
- Arbitrarily set a higher sell stop. This is changing the logic of my investment plan, which is based on the definition of a trend and was explained in the previous section of this chapter. Setting an arbitrary sell stop at a higher level is a recipe to be taken out of the investment by a normal decline in the trend. In other words, it may sound like we are reducing risk, but it actually increases the likelihood of a losing investment.

Building my position

When the time comes to continue building an existing position, I need to balance two things against one another:

- My maximum risk in any one stock of 0.5 per cent of capital.
- My guideline of the increased position being a maximum of 6 per cent of capital.

When building my position, there are also two additional things to do:

- Recalculate the risk based on the sell stop level as it now stands.
- Subtract the existing position from the new total position determined.

There is more than one way in which I could go about determining the size of the new total position. The way I have settled on over a long period is based on an important principle. The risk must be recalculated so that it does not exceed 0.5 per cent, taking into account the current market price and the current sell stop level. My sell stop may have been raised from the level it was when the original position was acquired.

The key thing to appreciate here is that the cost at which I purchased the initial position is no longer what it is worth. The real value of the existing holding should now be calculated on the current market price. This may be higher or lower than the initial purchase cost.

Step one	
My purchase price	\$4.95
My latest sell stop level	\$4.50
My risk	\$0.45
0.5% of my capital	$\$300\,000 \times 0.005 = \$1500$
Maximum position size	$1500 \div 0.45 = 3333$ shares

This tells me that the maximum that I can increase my position to now is 3333 shares.

Assuming that I now wish to move to a position which is 4 per cent of my capital, the next step will look like this:

Step two	
4% of my capital	$\$300\,000 \times 0.04 = \$12\,000$
My minimum position size is	$12\,000 \div 4.95 = 2424$ shares

This does not pose any problems. My maximum risk allows me to move to a maximum position of 3333 shares. Moving to a position which is 4 per cent of my capital means I would build the position to 2424 shares. So that is what I would do.

Step three will now be slightly different to when we calculated the initial position size. We now need to take the initial purchase into account.

Step three	
My new minimum position	2424
Less my existing position	1412
My additional purchase	1012 shares

Notice that because the price of the stock has risen since the initial purchase, the second purchase is a smaller number of shares in the stock.

The example above shows the most common outcome for this calculation. However, sometimes the size of the position that I could buy when increasing my investment to 4 per cent of my capital will be greater than the maximum position that I am allowed to buy without risking more than 0.5 per cent of my capital. In this case, I will do one of two things:

- In most cases it will be sensible to buy up to the position size that I am allowed to hold without risking more than 0.5 per cent of my capital.
- However, sometimes the number of shares that I can add to the existing position in this way is so small that it is not worth doing. In that case, I will continue to monitor the unfolding trend for another opportunity to add to the position, where the risk is lower.

When an initial investment continues to succeed by riding an upward trend, there will be an opportunity to complete building the initial position towards my maximum guideline of investing 6 per cent of capital in the stock.

The calculations for adding to the position again will be the same as those for the first addition to the initial position.

There is one matter that is worth mentioning here. On the second addition to the initial position, I am more likely to run into a problem. This is where the minimum position guideline of 6 per cent of capital is calling for me to build to a larger position than I am allowed to by my rule of never risking more than 0.5 per cent of my capital.

This can be somewhat frustrating, but is an excellent discipline. This is where I will be tested in my resolve to never break a rule in my investment plan. So long as I hold to that, my choice is one of the following:

- Let the opportunity go and move on to other stocks in which I can buy positions that are within the rules and guidelines of my investment plan.
- Continue to monitor the stock, looking for an alternative opportunity to build the position within the risk limits of my investment plan.

The longer my experience in following my plan, the easier it becomes to stick to the rules and guidelines. These situations are quite normal and will occur over and over in the stock market.

My position size calculator

In order to make the explanation of the calculations of the size of my positions as clear as possible, I have shown all the reasoning and calculations in detail. However, over time, I have devised a spreadsheet for making the calculations. It is based on the logic explained above in this chapter. It may be downloaded from the Resources page of my website <www.bwts.com.au>.

THE RISK CHANGES OVER TIME

Alert readers will have noticed that I do not carry out a dynamic rebalancing of my stockholdings as my capital changes and as my investments flourish or are weeded out. Neither do I make adjustments for the size of the risk in a position once it is purchased and the price of the stock changes. Nor do I have a maximum risk limit for my total stock holdings, because this is basically managed by my market exposure strategy.

I am by nature something of a perfectionist. However, in order to succeed at investing, I have trained myself to be more of a realist. I do not attempt any dynamic rebalancing of my stock holdings as such. I feel that it is hardly practical, because of its complexity. Also, it would increase transaction costs significantly.

However, my position sizing rule and guidelines achieve a partial rebalancing at two points. Firstly, when I add to a position, as explained above, I am effectively rebalancing the size of the position in that stock. Secondly, my guideline for taking profits, which is discussed a little later, effectively rebalances the portfolio periodically if an investment has been very successful.

NOTE ON CALCULATING THE TOTAL VALUE OF MY CAPITAL

To keep the explanation in this section of the book as simple as possible, I assumed that my capital has a constant total value of $300 000. In practice my total capital will change periodically as additional savings are added or money is withdrawn for large purchases, and also as dividends or interest on the cash reserve comes in. More importantly, the total value of the stock portfolio will fluctuate daily depending on the market prices of the stocks held.

I revalue the stock portfolio every day to reflect the closing price of all holdings, any sales or purchases and any dividends and interest received. I do this in a spreadsheet that I have designed to meet my requirements. The spreadsheet has cells that constantly recalculate 0.5 per cent, 2 per cent, 4 per cent and 6 per cent of my total capital. So, every position size calculation is done on my current total capital.

There is nothing magical about my spreadsheet, which is quite simple. I have no plan to make this available to readers for legal and other reasons.

However, readers without the skills to design their own spreadsheet will find several portfolio management software programs on the market.

Guideline for taking profits

At first sight, this section seems unnecessary. By the time an investment is showing a substantial unrealised profit, I will have a sell stop level established which is where I will sell if the trend fails. Moreover, I have the two additional selling rules, which cover the situations where the trend fails before the sell stop level is reached. Since one of the most important principles of investing is to let profits run, taking profits before the trend has run its full course seems to be both unnecessary and inappropriate. However, there are two strong reasons for acting earlier to take some profits out of the market.

Diversification

One of the ways I manage specific risk is to limit the percentage of my capital that is invested in any one stock. This means that if one investment fails suddenly and disastrously, it will not destroy my capital. My strategy for managing specific risk involves limiting the maximum proportion of my capital that is invested into any one stock to 6 per cent. This is fine, but if a holding doubles in price, while everything else remains static, it will represent, not 6 per cent of my capital, but approximately 12 per cent. The more a stock increases in price, the more my diversification strategy is eroded.

Of course, a portfolio is dynamic. While it is possible, it is also unlikely that one stock will double in price while everything else remains unchanged. More likely, my total capital will have increased as well. This means that if a stock doubles in price it is likely then to be somewhere between approximately 6 per cent and 12 per cent of my capital. If the rest of my portfolio has doubled as well, there is no problem. However, it is far more likely that the stock in question will have grown much faster than the rest of my stocks. There may then be a strong need to partially rebalance my position size for this stock by reducing the proportion of my capital that is invested in it.

Psychology

Having discussed the logical problem, we also need to consider the emotional dimension. As a stock increases strongly in price, it starts to swing my total capital around as it rises and falls in the trend. There is a very strong temptation to resolve the stress this causes by taking the profit while it is there, lest the price falls. Regret is a powerful emotion and nobody is immune from the fear that is involved in monitoring a profit that the market could snatch away from us at any time. Most investors sooner or later reach the point where they cannot stand the pain any longer and they sell out the entire holding.

Selling the entire holding is often justified with the rule we can't go broke taking a profit. Maybe so, but it has broken the cardinal rule of letting profits run. This is essential if we are to make a lot more on the good investments in order to more than outweigh the inevitable losing ones. Selling the entire holding when a stock has increased in price leaves us feeling good, but it cuts us off from the potential the stock might have to triple, quadruple or even turn out to be one of the great stocks that increase by 10 times or more. I feel very strongly that I need to have a way to participate in those stocks to capture at least part of the great results.

Beginners always tell me this is not a problem at all. They will just let all the profits run. I always smile to myself when they say this. Sure, a few in every thousand will do this, but most people just do not know what psychological pressures they will come under when they have a big profit at risk, until they have been there a few times. The vast majority will sell out too early and live to regret it. Even very experienced and quite unemotional investors will find it difficult to sit on an escalating profit, especially where small changes in its price make a big difference to the value of that stockholding and to the value of their total capital.

My approach to the diversification problem and the psychological problem is to take some profit out of the market, but leave a substantial part of the profit there to keep building. I have a simple ***guideline: each time a stockholding has grown to be 12 per cent of my total capital, I reduce my holding in that stock back to 6 per cent of my total capital.***

This is a guideline, not a rule. I am a little flexible about it. The action point is when a stockholding has approached 12 per cent of my total capital. This is particularly important when the weekly price bars have started to rise almost vertically on the chart. A correction is inevitable and will take back a lot of my paper profit. This is when this guideline works well. Instead of doing what most people do and sell everything at the first sign of danger, I realise some of the profit, but keep a still substantial position against the possibility that it is one of the great investments.

Initially, this guideline was phrased a little differently in my investment plan. I expressed it in terms of the trigger point being a doubling in price. I found this to be rather impractical. I tend to build my stock positions in at least three steps. Sometimes these entry prices can differ quite substantially. It becomes difficult to choose which price has doubled. The simpler approach is to have a column on my stock portfolio spreadsheet showing what percentage of total capital each stockholding is at the latest market price.

The flexibility in this guideline can be dangerous for beginners. There are as many different ways to time the action as there are investors. Each of us may use different tools. There is no single right way that can be chosen for all situations without thinking. I recommend that beginners make this a rule rather than a guideline, until they become much more experienced.

One of the reasons this is a difficult area to gain experience in is that it does not happen very often. It is likely to put most of us under great pressure, watching it anxiously. However, some people react differently. They become complacent and take their eye off the stock. Most people worry more about losses than about profits. This is why I suggest beginners make my guideline a rule.

Guideline for re-entry

The frustrating thing about any method of timing investment decisions is that they are not perfect. This applies equally to methods that are based on fundamental analysis or technical analysis. No matter what method we use, we will sometimes be taken out of the trend because one of the sell stop levels has been violated, only to subsequently see the price rally back above the high of the trend and continue upward. This is unfortunate. It used to bother me a lot. I kept looking for a better method, though I never found one. Then I came to accept that investing is not a science, it is an art. Markets do not unfold in textbook perfect patterns. The definitions of an uptrend and of the two models are logically sound, but there are always exceptions. The question then became not to search endlessly for a perfect method (the Holy Grail), but to manage the imperfection. The solution is actually a very simple ***guideline: if the trend reasserts itself by making a new high for the trend, then consider building a new position in it.***

The problem is that buying back into a trend at a higher price is quite difficult psychologically. I freely admit that dealing with this issue was one of the last important investment skills that I have developed. It has turned out to be very rewarding.

The big trap is to sell out of a stock when it violates a sell stop and then forget about it. I now keep any stock that I have sold on my hot list of stocks that I review every day until such time that I am sure that the uptrend I was exploiting has failed irrevocably. This means that there is crystal clear evidence that it has moved into a mark-down phase of some kind.

However, it is still not simple or easy to do. There is one more key issue in this situation. The stock in question must be treated as though it is now a completely new opportunity. It must be evaluated from scratch with the same rigour as any other stock being considered for buying at any time. Providing this is done, everything from that point should be exactly according to the investment plan we are following. This includes the difficult issue when there is no available cash reserve and a switch from another stock must be considered.

MY CHART TEMPLATES

The format of the chart templates that I use is something I have changed in recent times. My standard Insight Trader chart arrangement for a stock is now as discussed below.

A MONTHLY BAR CHART

This template is constructed from a data file compressed to monthly. It shows in monthly bars a running time window of 5500 calendar days. This is about 15 years. It is a semi-log chart. The chart has a 12-month simple moving average on it. My template chart is shown in figure 12.11.

Figure 12.11: monthly template chart

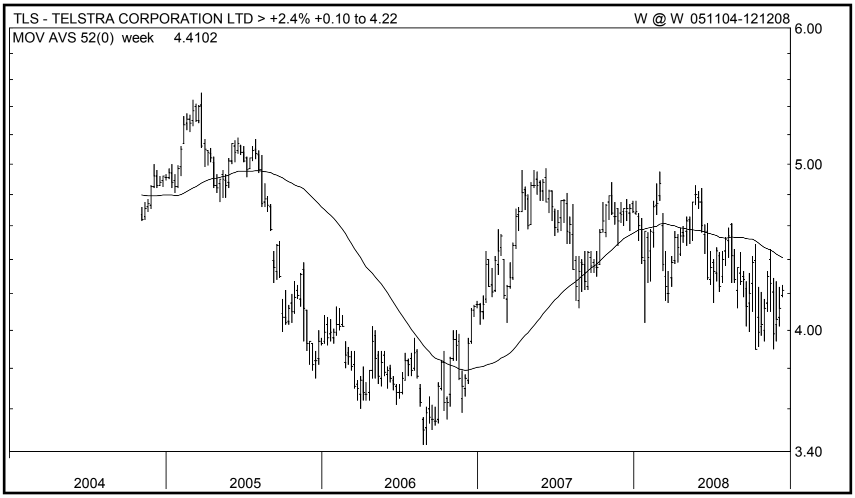
This chart and others in the book are, of necessity, reproduced in black and white. On the screen, I use a white background, with black bars. The moving average line is in red. There are good reasons for this colour scheme that relate to my presenting the charts through a projector when speaking publically. For most people, the colour choices will be different, depending on their personal tastes and specific methods.

My template chart is Telstra. As the chart shows, it has not been listed for 5500 calendar days yet, so does not fill the screen horizontally. This is another thing I have changed in recent years. I display every stock with the same running time window of 5500 calendar days on the chart, even when the stock has not been listed that long. This is to make the charts of different stocks a little more comparable.

A WEEKLY BAR CHART

This template is constructed from a data file compressed to weekly. It shows in weekly bars a running time window of the last 1500 calendar days. This is a little over four years. It is a semi-log chart. The chart has a 52-week simple moving average on it. My template chart is shown in figure 12.12.

Figure 12.12: weekly template chart



The onscreen colour scheme is the same as for the monthly bar chart.

FORMAT OF THE CHART ARRANGEMENT

I used to have four chart windows in my template chart arrangement. This worked well in having all the chart windows on the one screen. However, the current two chart windows do not work well for me when tiled on the screen vertically or horizontally. So, what I do is to have the weekly bar chart full screen and the monthly bar chart behind it, also full screen. To switch views in Insight Trader is a simple toggle of the sideways arrow keys on my laptop keyboard. Whether the monthly or weekly chart is the first view is not an issue, when it is so easy to choose what I want, depending on the purpose.

WHAT, NO DAILY CHART?

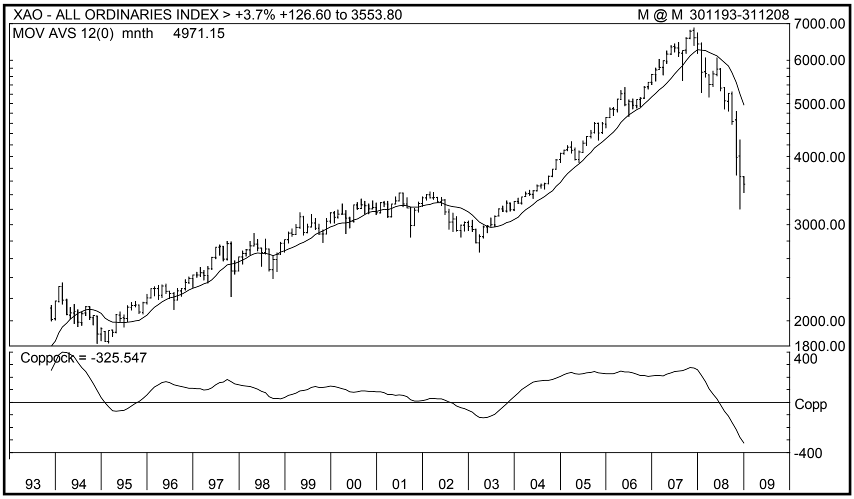
No. This is very important for me and it took me a long time to come to this point. The daily chart is not my time frame. It is too short. I found that when I used it, there was a temptation to react to short-term patterns, which should have been under my radar. So, I stopped looking at the daily charts. It was not easy. It took a resolution not to look at a daily charts for a couple of months as I learned how to read the market from the weekly charts and monthly charts alone. After a couple of months, I no longer felt I wanted to look at daily charts, except when trying to finesse a buying or selling decision. I am more likely to do that on my broker's website for convenience.

Nevertheless, I need a daily chart occasionally. In an average week, I may look at a daily chart once or twice. That is all. However, it is no problem in Insight Trader. If I need to see one, I press Shift + D on the keyboard, then D and use the F6 function key to zoom in to what I am looking for. Once I learned this, it became automatic.

MARKET INDEX CHART TEMPLATE

This is the same as for stocks, with one exception. The weekly chart template is exactly the same as for stocks. The monthly bar chart template has a Coppock Indicator below the bar chart, as shown in figure 12.13 (overleaf).

Figure 12.13: market index monthly chart template



The instructions for creating my template chart arrangement are on my website <www.bwts.com.au> on the *Resources* page.

Chapter 13

Executive summary of my investment plan

Policy

Asset classes *Chapter 5*	Stocks or cash.
Target rate of return *Chapter 5*	12.5 per cent p.a.
Simple big idea *Chapter 6*	Buy stocks heavily only in bull markets. Only buy uptrending stocks. Build position if the uptrend is confirmed. Sell quickly if the uptrend fails.

Strategy: Managing market risk

Getting into the market *Chapter 8*	As soon as the third stage of a bear market (distress selling) is detected, watch for stocks making new highs. Begin to buy them cautiously, increasing the proportion of capital invested in stocks to around 20 per cent.

Getting into the market *(cont'd)*	When the Coppock indicator gives a signal, increase the proportion of capital that is invested in stocks to around 40 per cent. As soon as there is a clear upward breakout from a broad trading range on the index, or the index starts trending up by moving above its last significant peak, begin increasing the proportion of capital invested in stocks to around 70 per cent. After the first significant correction in the uptrend on the index is completed and the index moves above its previous peak, move to having 100 per cent of capital invested in stocks.
Getting out of the market *Chapter 8*	Once the third phase of a bull market (rampant speculation) has begun, reduce the proportion of capital invested in stocks to around 70 per cent. As the third stage of a bull market becomes more developed, gradually reduce the proportion of capital invested in stocks to around 30 per cent, acting urgently if the market comes off a very strong peak. If the market index breaks down out of a trading range, or starts to trend down by moving below its last trough, sell any stocks that do likewise immediately. Do not replace them.

STRATEGY: MANAGING SPECIFIC RISK

Diversification *Chapter 9*	Invest at least 2 per cent of capital in any stock. Invest no more than 6 per cent of capital in any stock. Hold only two stocks in the same industry.
Position size *Chapter 9*	Maximum risk per stock of 0.5 per cent of capital.

STRATEGY: MANAGING FINANCIAL, LIQUIDITY AND OTHER RISKS

Gearing and leverage *Chapter 10*	Do not borrow money to invest in stocks. Avoid stocks with a debt-to-equity ratio over 60 per cent. Do not invest in derivatives.
Liquidity *Chapter 10*	A stock must trade on most days. Look for sufficient volume to transact in one day. Hold only a few less liquid stocks at once.
Type of stock *Chapter 10*	Focus primarily on second-rank industrial stocks and producing miners. Only buy stocks making profits and paying dividends.
Long, short or both? *Chapter 10*	Long only.
Time frame *Chapter 10*	Aim to hold for months to years for dividends and capital growth.

TACTICS: STOCK SELECTION

Value model *Chapter 11*	Buy value model stocks breaking out of accumulation phases or in established mark-up phases.
Growth model *Chapter 11*	Buy growth model stocks breaking out of consolidation phases or in established mark-up phases.
Margin of safety: value model *Chapter 11*	Price/earnings ratio is significantly lower than the average price/earnings ratio for the market. Dividend yield is significantly higher than the average for the market.
Margin of safety: growth model *Chapter 11*	Price/earnings ratio is not significantly higher than the average price/earnings ratio for the market.

	Dividend yield is not significantly below the average for the market.

TACTICS: MANAGING INVESTMENTS

Initial purchase *Chapter 12*	Breakouts: invest a minimum of 2 per cent of capital. Existing uptrends: invest a minimum of 2 per cent of capital on seeing a new high for the trend.
Position building *Chapter 12*	Invest another 2 per cent once the next trough appears to be formed. Complete building the position to 6 per cent of capital once the peak after the breakout or the first buy is exceeded.
Selling rules *Chapter 12*	Buying into a breakout: situate the sell stop up to 2 per cent below the accumulation or consolidation pattern. Buying into an existing trend: situate the sell stop up to 2 per cent below the last trough that has been validated by a subsequent move above the peak that preceded it. As the uptrend unfolds: situate the sell stop up to 2 per cent below the last trough as soon as it has been validated by a subsequent move above the peak that preceded it.
Additional selling rules *Chapter 12*	Situate the sell stop level up to 2 per cent below a substantial trading range that develops in the trend. Sell if the price forms a lower peak and then moves up to 2 per cent below the preceding trough.
Profit-taking guideline *Chapter 12*	Each time a stock grows to 12 per cent of capital, consider reducing the holding to 6 per cent of capital.

Re-entry guideline *Chapter 12*	If a sold stock makes a new high for the trend, consider it for reinvestment using the usual rules and guidelines.

Chapter 14

Case studies

It is easier to teach the theory behind my investment plan using conceptual diagrams, rather than actual charts. This avoids the ambiguity that can come from unusual formations on the actual charts. However, once the theory is set out, it has to be translated to actual charts. The real charts that we have to work with never look as simple as the theory diagrams. Also markets unfold in endless variations. It can be difficult to identify the peaks and troughs on the charts, especially in the right time frame. In the final analysis, much of the art of investment is learned through experience. The learning process can be accelerated by having someone guide students through the charts for a while before they have to make the decisions for themselves. This makes this chapter one of the most important parts of the book. In it, readers will be able to metaphorically sit at my side while I explain how I made the various decisions that go into making and managing my own investments.

I will begin with some case studies dealing with my market exposure strategy decisions:

- First, I will look at the decision process in getting into the bull market. These remarks were written after the event.
- Then I will deal with the end of the bull market. For this, I will use material which I wrote and published at the time I made the decisions.

➢ Finally, I will go through how I see the situation at the end of 2008 and looking forward for the factors that will influence my decisions about getting into the next bull market whenever it begins.

From there, I will look at investments in individual stocks. I will work through examples of the investments that I actually made in the 2003–07 bull market. I will discuss the things which, in hindsight, I feel that I did well and also the things which, looking back, I might have done better. This second group includes some experiences that I continue to learn from.

Sources used

In reconstructing the investments shown in the case studies, I have had recourse to my records and my memory. All of the prices, dates and calculations of position size have been retrieved from my records.

The only data shown which I did not always record were the fundamental ratios and the pattern of profits for each company prior to purchase. I have reconstructed what the ratios were at the time to the best of my ability. The observations on the pattern of prior earnings have been made with reference to Aspect Huntley data, which was on my broker's website at the time, or to company annual reports and presentations to stockholders.

Some readers may be puzzled by what seem to be errors in my calculations. These will generally be rounding issues. I frequently round off the numbers in the calculations. Don't worry about this. Maintain a focus on the process, rather than the numbers. Precision in the calculations gives me no protection against risk.

In chapter 8, I discussed the tools I use in managing market risk and alluded to a general investment strategy for varying the proportion of my capital that is invested in stocks according to the perceived level of market risk.

Having a sound model for analysing the market is vital. Without it, we have no roadmap with which to read the signs as they loom up before us. Having a general investment strategy is also vital. It sets out where we are heading and how we will try to get there. Without it, we have no basis for making decisions and little hope of staying on our chosen course.

However, as always the devil is in the detail. More specifically, the difficulty is in the application of the theory and general strategy. So, what is needed next is an example of how the theory and general strategy is applied.

One way to do this is to look backward. The advantage of this is that, in hindsight, we can know most of the facts and also how the decisions would have panned out. However, any competent historian can analyse the past and suggest what we should have done in the light of subsequent events.

While studying history can be instructive, it is not realistic as an example of what the investor faces in practice. History is written from the left-hand side of the chart, when what happened afterwards is known. However, investing in real life is carried out at the right-hand edge of the chart. Investment decisions have to be made in the present and with no certain knowledge of how they will turn out.

In writing this chapter, I have tried to recreate what I was thinking at the time. This will be done from my records, which are reliable. However, they will also have been written from my memory. Once we know what happened afterwards, a common bias comes from unconsciously thinking that, at the time, we knew more than we did. This is known as hindsight bias.

In the case studies on market exposure strategy, the first case study is from my records and memory. I originally wrote it in 2005. Nevertheless, hindsight remains a risk. The second case study was written and published at the right-hand edge of the chart in 2006 and 2007. The third case study was written on the right-hand edge of the chart in December 2008, as I finalised the book for publication.

The specific stock investment case studies were all written in December 2008 from my records and my memory. I will show the charts as they were at the time and have done my best to explain my decisions based on the evidence available at the time. However, all these investments are long finished and hindsight bias remains a risk.

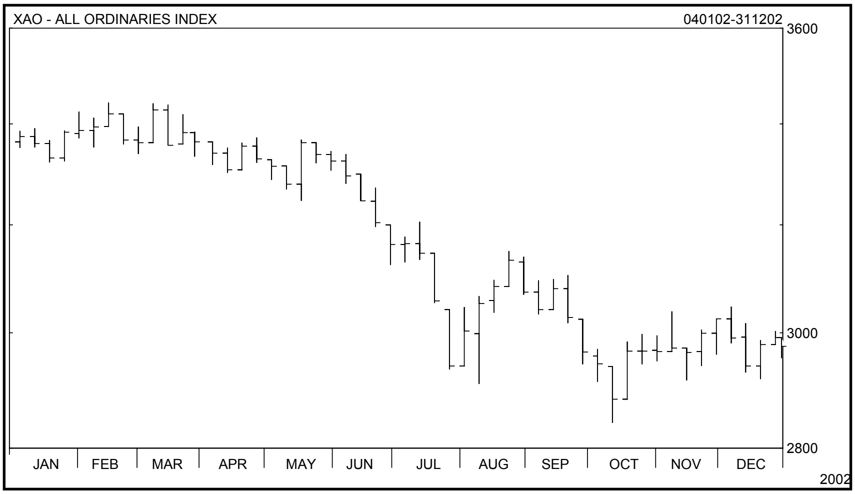
> When I begin to make investments from the third phase of the current bear market onward, I will publish some case studies in real time. For legal and other reasons this will be on the Members Only section of my website <www.bwts.com.au>, which involves a joining fee and annual charge.

Case studies of managing market risk

Case study 1: entry to the 2003–07 bull market

We begin at the end of 2002. The ASX All Ordinaries index chart in figure 14.1 shows that at that time we were in the grip of a bear market. That year the market had fallen by 601.3 points, or 17.5 per cent, from the week ending 15 February 2002 peak of 3443.9 points, to the week ending 11 October 2002 trough of 2842.6 points. From there the market had rallied a little, rising to around 3000 points, and seemed to be in a sideways pattern.

Figure 14.1: weekly ASX All Ordinaries index — sideways pattern



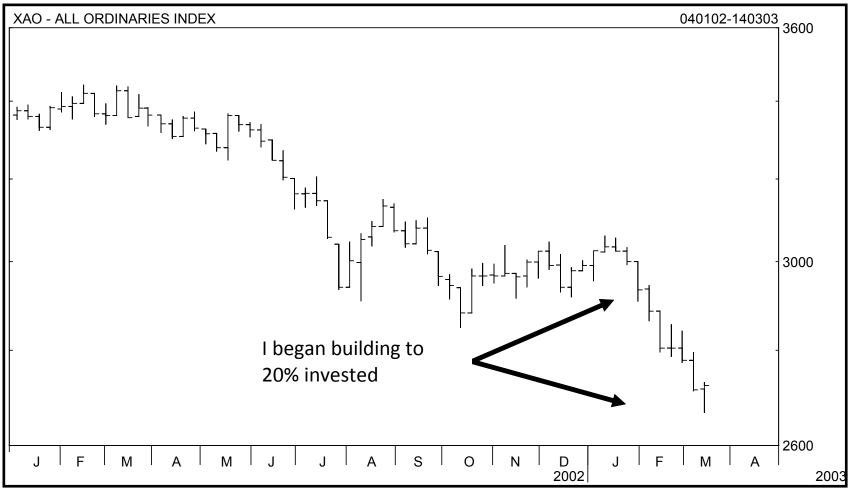
My analysis at the time was that we were well advanced in a moderate bear market. I assessed that it was probably towards the end of the declining earnings phase of the bear market. I did not record my detailed analysis of the factors which helped me reach that decision. It would be difficult now to accurately reproduce my detailed thinking, because of hindsight bias, so I will leave it at that.

Around this time there was a great deal of uncertainty because of tensions over the crisis in Iraq and the threat of a US invasion. This is bad for stock markets, which abhor uncertainty. As 2003 opened, my analysis suggested we were possibly in the distress selling phase of the bear market. Again, I did not record my detailed thinking at that time.

As I had judged that we were in the third phase of the bear market, I looked for stocks to buy. I found there were some stocks which were beginning to trend upwards. I began to build some positions in some of the uptrending stocks towards the 20 per cent invested level dictated by my investment plan.

As it turned out, this took a bit of nerve, because the crisis in Iraq deepened and the market moved sharply lower, as shown in figure 14.2.

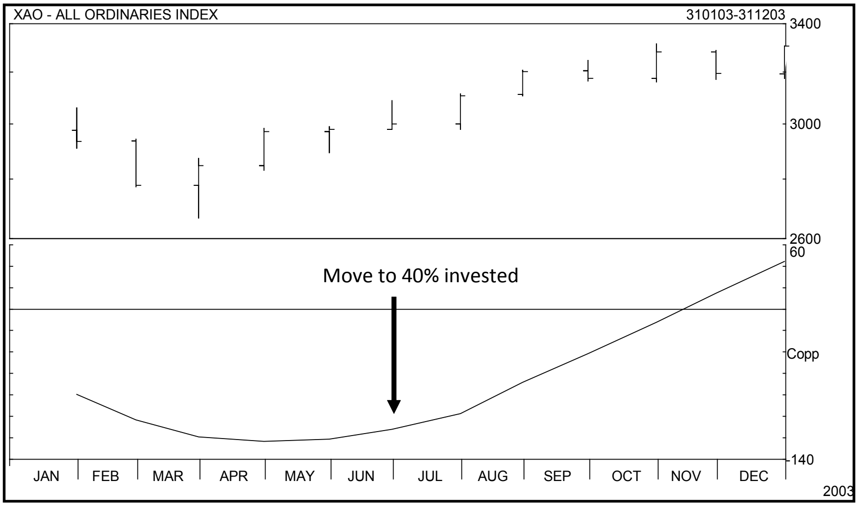
Figure 14.2: weekly ASX All Ordinaries index — building to 20 per cent



By the week ending 14 March 2003, the fall from the February 2002 peak had extended to 777.6 points, or 22.6 per cent, to a trough of 2666.3 points. This turned out to be the low point. The initial invasion of Iraq went well for the US and its coalition of the willing. The market bounced strongly off that low. My uptrending stocks had held above their sell stops.

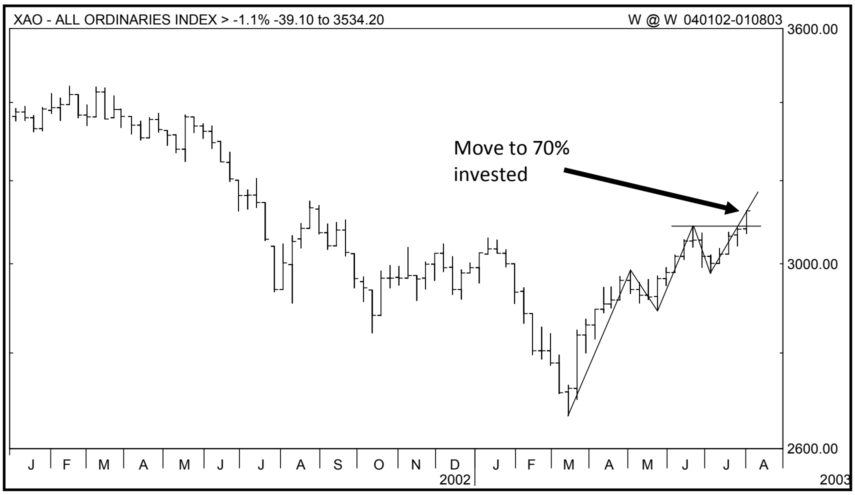
At this stage, the Coppock indicator was still falling. It levelled out in April 2003 and I began to put more money into the market on the basis of that and the strong rally during April 2003. At the end of May 2003, the Coppock indicator turned up, but it was a marginal signal. The Coppock indicator had declined steadily to minus 122. The May reading was minus 120. I waited for a confirmation, which came at the end of June, when the Coppock recorded a reading of minus 111. This was a clear signal to begin moving to 40 per cent invested, as shown in figure 14.3 (overleaf).

Figure 14.3: monthly ASX All Ordinaries index with Coppock in sub-chart



By August 2003, the market had formed a series of rising peaks and troughs. It was therefore trending up. I began building towards 70 per cent invested. At this point, the chart looked as shown in figure 14.4.

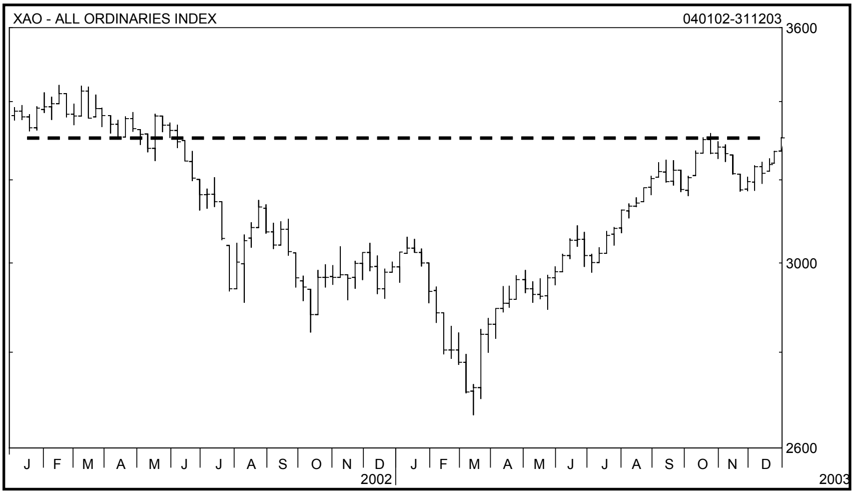
Figure 14.4: weekly ASX All Ordinaries index — move to 70 per cent invested



These peaks and troughs had been rather mild so far. Moreover, the market had run into strong selling as it reached the bottom of the range of the 2001–02 top pattern. I wanted to see it clear the old top pattern. In particular I wanted to see a recovery from a significant correction in the uptrend, before I moved to 100 per cent invested in stocks.

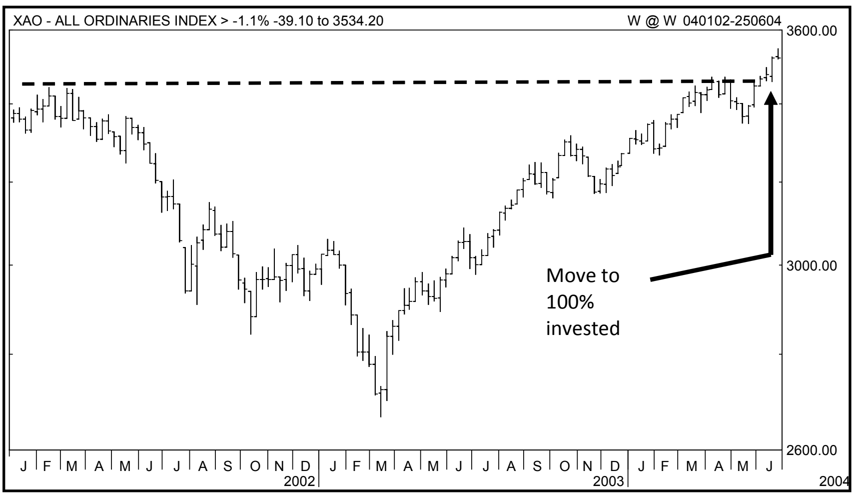
At December 2003, the market was about to make a second attempt to get through the range of the 2001–02 top pattern. Figure 14.5 shows the situation.

Figure 14.5: weekly ASX All Ordinaries index — progress slowed



We did not get a really significant correction, because the uptrend was so strong. However, it struggled a bit to get above the 2001–02 peak. Nevertheless, by the end of June 2004 it was above the old peak and I moved to 100 per cent invested. Figure 14.6 shows the situation at that point.

Figure 14.6: weekly ASX All Ordinaries index — move to 100 per cent invested



I am often asked to nominate the perfect entry point for a bull market. I do not believe this can be done. What I do believe is possible is that we can move progressively into the market around the bottom of the market. This is how I did it, from early 2003 to mid 2004. That is around 18 months.

In hindsight, some will say I was too cautious. The problem with this is that we cannot invest in hindsight. We have to invest at the right-hand edge of the chart. Hindsight is a good way to mess with our minds and berate ourselves for being too cautious. I have long moved past any thought that hindsight is at all relevant to assessing decisions. What we should do in evaluating an entry campaign like this is to look at the chart as it was at the time and see if there is something on the actual chart which we might have missed or could have interpreted better.

One thing is worth discussing here. This is that my percentage market exposure levels are not rules cast in stone. Rather they are tests that are there to check that I am not leaving it too late to get into a bull market.

While I have on my spreadsheet the percentage that I am invested on any one day, it does not rule my decisions in an absolute or mechanical way. If I had 50 per cent of my funds in the market, I would still think that was in line with the 40 per cent guideline.

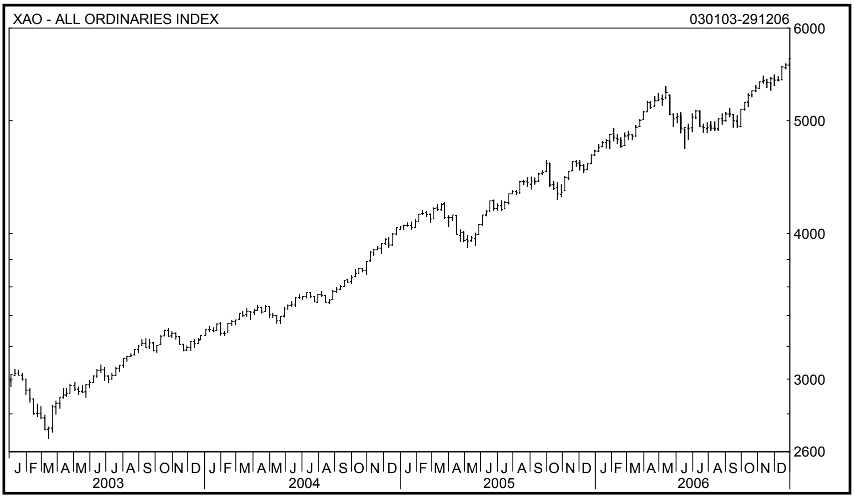
Also, my records show that I did not sit still and then move suddenly with many purchases the moment one of these key levels was reached. Rather, there was a gradual movement towards the next level as the market signal became more likely and then was passed.

Yes, I would have probably had a bigger return in the financial year 2003/04 if I had got into the market earlier or faster. It would have been at the expense of accepting a higher risk, though. In hindsight, it was the way to go, but there was no way to know what was ahead of us. If the market had not unfolded the way it did, if it had just been a strong bear market rally, my results may have looked very good indeed. I also believe that I was more involved in the bull market and earlier than most beginners. That is my plan working as it should.

Case study 2: the decision to begin reducing exposure to the market

By the end of 2006, I had completed my book *Hot Stocks 2007*. In it I had set out my reasoning for moving in early 2007 to only 70 per cent invested in stocks. The market chart is shown in figure 14.7.

Figure 14.7: weekly ASX All Ordinaries index — long-term uptrend



The most important thing to notice here was that there was no evidence of a trend ending on the chart. My decision flowed from my Dow Theory phase analysis. Below is how I published my thinking in late 2006 in my book *Hot Stocks 2007.* I have tidied up and slightly extended some of the explanation. However, I have not changed the substance of the original points. Nor have I added any new points. One minor error was corrected.

BULL MARKET PHASE 3: RAMPANT SPECULATION

IS THE GENERAL PUBLIC IN THE MARKET?

In the first phase of a bull market (reviving confidence), it is mainly the professional investors who make the running. The general public come in during the second phase of the bull market (improving earnings). They are tentative at first and tend to wait too long to get involved. There is an unfortunate human tendency to then act on regret at having missed the good times so far and jump, margin loans and all, into the final phase of the bull market (rampant speculation).

My assessment is that the general public is heavily in the market as we approach the end of 2006. More and more people around me are discussing stocks. Indeed when they find out that I teach investment, they come looking for advice. I have noticed this pick up markedly in the last year. Also, more are clearly interested in speculating than investing. They find investing to be boring.

HAVE STOCKBROKERS REDISCOVERED PRIVATE INVESTORS?

It seems to me that they have indeed. This is typical of rampant speculation. Professionals do plough capital into speculative new floats. However, it is a relatively small part of their stock portfolio. Stockbrokers also need lots of private speculators to subscribe for shares in these floats. This means the general public. Quite often these speculators will have a stock portfolio which is almost entirely made up of speculative companies. What is happening is that overpriced assets are being distributed to the inexperienced, who do not understand the risks.

HAS THE MEDIA DISCOVERED THE BULL MARKET?

It seems to me that coverage of markets in almost all media has picked up and is more often in headlines.

IS THERE MORE DAY TRADING?

In the last year, there does seem to be an increase in the number of people who are actually giving up their day job. This is in order to try to make a living from speculation in the market. I have been coming across many more beginners for whom speculating in stocks has become a part of their life in the last year.

ARE TRADING SYSTEMS BEING PROMOTED?

My word they are. In some cases there have been regular expensive full-page advertisements in the national press. These are for courses, methods, trading software and so on. In the past, this has been a very reliable indicator of the move into rampant speculation. The inexperienced want to hear they can buy a way to turn lead into gold on the stock market. There are always plenty of promoters who are prepared to tell them what they want to believe.

ARE THERE LOTS OF NEW FLOATS?

Yes, as discussed earlier for the second phase. This is also a strong sign of rampant speculation, especially when the quality of the floats moves from sound businesses to speculations, as has been happening. There is also a high element of risk, which the uninitiated do not understand, in hugely leveraged trusts and financial companies. They have been engineered to get high returns out of assets that were bought at inflated prices, in order to flog shares or trust units off to the punters. The obscene fees for managing the trusts have attracted a lot of media attention. It seems this is being ignored by greedy speculators and investors.

Are speculative companies changing their names?

This is an interesting marker of rampant speculation. The promoters of speculative companies tend to move to the latest fad sectors. Mining explorers became tech stocks in the 1990s. Many have switched back to mining exploration in the 2000s or started new exploration companies. There is no shortage of casino chips for the speculators.

Are governments selling off their enterprises?

Yes they are. Telstra is the big one. The third tranche is being sold at lower prices than the government said they would entertain a few years ago. To increase the level of subscription to the float, the instalment receipt system is again being used to ramp up short-term dividend yield. Clearly the government knows that the end of the bull market is nigh.

The Snowy River Hydro float was withdrawn under political pressure. The sale of Medibank was postponed to keep it away from the Telstra circus. However, the state of Queensland is belatedly selling off its power companies.

Are fundamental ratios at high levels?

No, not really. This is strangely at odds with many of the other markers of rampant speculation. My thought is that gearing and leverage are the big risks this time, rather than extreme overvaluation of stocks in general.

Is everyone bullish?

It seems to me that there is a lot of bullishness among the uninitiated who are experiencing their first bull market. They seem to have forgotten that stock markets are cyclical. Or have they never been taught this basic fact of investment and speculation? The professionals seem to be more cautious. This is because they tend to know about cycles. This suggests to me that the professionals were selling, which normally marks the end of the value model mark-up phase of the cycle.

Are new paradigm theories being advanced?

Oh, yes indeed. One of the big new paradigms this time is the stronger for longer theory that the Chinese economy will keep growing at amazing rates for the next 50 to 100 years. This is rubbish. What is happening there is not unlike the development of the US. It was a great story for over 100 years, but along the way there were some of the worst depressions and bear markets on record. Australia's history is little different with many terrible depressions. China will be no different. Human nature is basically a constant. We humans do not learn from history, so we are doomed to repeat it.

Another important paradigm is the talk of a soft landing in the property boom and for the US and Australian economies as a whole. How many times have I heard this before and how few times has it not ended in a nasty recession?

As an aside, one thing that is different these days is that the Reserve Bank increases interest rates gradually, often only a part of 1 per cent at a time. This is like the apocryphal tale of how to boil a frog. By slowly creeping up interest rates, we hardly notice it happening. Each little move does not seem as bad as the media pundits sensationalise it to be. However, it all adds up over time and eventually the pain is unbearable. This is a much delayed signal compared to the abrupt credit squeezes of the old days a few decades ago. It is more acceptable politically than a credit squeeze, but it takes longer to be effective and is therefore far harsher in the ultimate effect.

Another old paradigm that has come back to prominence is the peak oil hypothesis. This is a theory that the world is running out of oil. Each time the oil price cycle swings up, this one reappears.

Another new paradigm concerns the end of the world scenarios based on global warming.

Maybe readers remember when the internet was going to change the world. Old industrial companies would fade away. Imagine believing that rubbish. Lots of people who lost large chunks of capital in the 1990s tech boom did believe it. Before that it was canals, railways, electricity, the telephone, the motor car, radio, air travel, computers and television. Why would the internet be different?

Are market regulations being relaxed?

There is strong pressure around the world to get around or remove the strong legislative and regulatory protections put in place after the last boom. There is pressure to relax regulations on companies.

Another is to remove the accounting rule that requires assets on company balance sheets to be marked to market. Marked to market is an industry jargon term for valuing assets at the real current market value, rather than historical costs or director valuations. Fictitious costs were used in Japan in the aftermath of the boom to 1990. It was part of the reason why Japan suffered 13 years of bear market. Japanese banks only looked solvent because failed loans were still carried on the balance sheet as though they were real assets. However, it is not possible to borrow money from an insolvent bank.

These issues are a sure sign of rampant speculation.

Is there speculative activity going on?

Private capital firms are increasingly driving to take over and privatise cash cow companies. This has certainly reached a peak recently with a failed attack on Coles Myer (postscript: Coles Myer was later taken over by Wesfarmers).

Takeover activity seems to have grown to a heightened level. Some of the raiders seem to be motivated more by fear of being taken over themselves, than for the takeover to make real economic sense. There is a huge excess of money sloshing around looking for deals. This is a sure sign of rampant speculation. The smart businesses have nothing to do with takeovers when markets are expensive.

Then there is the flavour of the month new market trading tool contracts for difference (CFDs). Just think about how much money is being poured into advertising them. I find every second person I talk to either uses CFDs or is seeking to know about them. Many years ago I read Edwin Lefevre's classic market novel *Reminiscences of a Stock Operator*. If readers don't know what a bucket shop is, I suggest getting this book and reading it. They are back in a new guise, called CFDs.

Are stock markets more volatile?

The answer to this is mixed. There is some evidence of it. It is also evidenced in very spiky movements in prices on the slightest rumour or suspicion of takeovers or changes in metal prices. However, it is not yet at the wild extremes of 1999–2000.

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Where are we now and what to do?

I have worked my way through a long discussion. This is necessary to build up a composite picture of many elements and forces at work. They rarely all point in the same direction, so it is the overall balance that is important.

On balance it seems to me that we have left the second phase of the bull market (improving earnings) and are into the early stages of the third phase of the bull market (rampant speculation).

On that judgement I am reducing my market exposure to closer to 70 per cent of my capital. This compares to the second phase, when it was mostly 100 per cent, except in the few big corrections.

If the market comes off a strong peak, I will act urgently to lower my market exposure closer to 30 per cent, especially if sell stops on individual shares are violated. This is not a time to equivocate.

The important point to reiterate here is that I took the decision to reduce exposure to the market solely on the basis of phase analysis. There was no evidence on the chart of the trend failing. Those who have not wanted to believe my analysis point to the chart and one or two odd things to try to contradict my thesis. I see this as clutching at straws.

A time for action

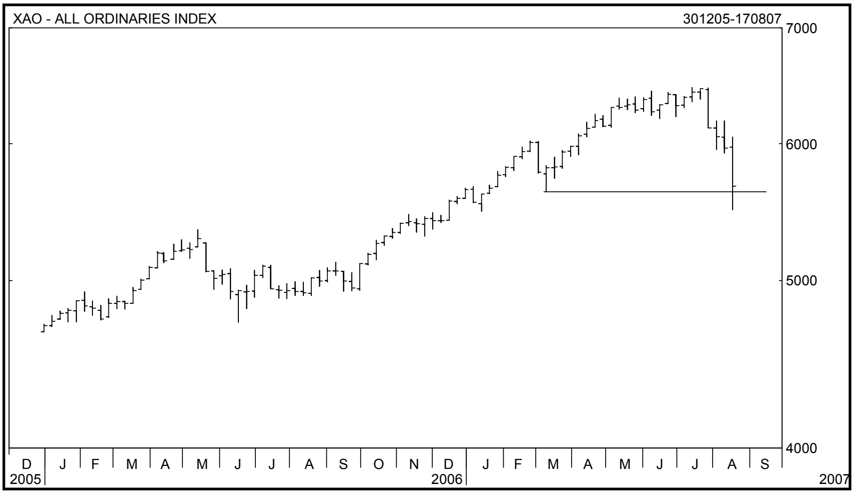
The market continued merrily higher through 2006. I had opened myself up to being criticised for warning and acting too early. This does not worry me. I would far rather people laughed that I was too early, than that I left it too late.

In July–August 2007, the uptrend was interrupted by a sharp and deep correction off a strong peak after a sustained rise. Rampant speculation was rife. Quite significant was that the correction had fallen below the previous trough in the trend. The chart as it looked in mid-August 2007 is shown in figure 14.8.

I also sold some stocks which were still trending up and some more of my stocks quickly violated their sell stops in this correction, so I sold them urgently at market. In total, this reduced my exposure to 20 per cent stocks and 80 per cent cash.

However, this was not to be the end. The market quickly powered higher and made a new peak. I re-established some of my closed positions in uptrending stocks, but did not move my exposure much beyond 30 per cent of my capital in stocks and 70 per cent in cash.

Figure 14.8: weekly ASX All Ordinaries index — correction fallen below previous trough



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Almost a year later, in early October 2007, I wrote down my thinking and my suggested strategy for the next year in my book *Hot Stocks 2008*, which was published later in October 2007.

Therefore, what follows was my published analysis at that time. I have edited out material which basically repeats what is in this book, or is not relevant to this case study. Again, I have done some editing to improve the explanation. The substance of the points has not been changed. No new arguments have been added.

Bull/bear market phase analysis

As I complete *Hot Stocks 2008*, we are over halfway through the fifth year of the bull market, which began in the Australian stock market in March 2003. There are no set rules for how long a bull market should run. Experience has taught me that strong bull markets tend to run for longer and go much higher than I expect. Nevertheless, it is foolish to disregard the signs that the risk level may be higher than it was.

As I thought a year ago when I wrote *Hot Stocks 2007*, I doubt there is anyone who thinks we are currently in any of the three phases of a bear market. As I spoke to groups around the country in the first half of 2007, the overall consensus I discerned was that we were still in a bull market.

When I was writing *Hot Stocks 2007* a year ago, I concluded that we were in the third phase of the bull market (rampant speculation), albeit probably the early stages of that phase. Nevertheless, on my market exposure strategy, it was time to act. By New Year 2007, I had reduced my exposure to stocks from 100 per cent of my investment capital to 70 per cent of my investment capital. Later in 2007, I reduced my exposure further, in line with my investment plan, which I will explain later in this chapter.

It should not therefore be surprising that I am now firmly of the opinion that we are in the final rampant speculation phase of the bull market. I make no apology for not having any idea of how long we have to go before it ends. It could be weeks, months or even one or more years. My approach to investing is now concerned with managing the situation by implementing an appropriate strategy.

In simple terms, what I have been saying as I spoke to groups around the country in 2007 is that it has been possible to at least double our capital in the last five years. The objective now should be to avoid the sin many beginners commit, which is to give too much of it back when the bull market ends.

Of course, many beginners will have joined the bull market only recently. This is normal behaviour for new investors. They will naturally want to try to make up for lost time. The only way to try to do this is to take greater risks. They will try to run with the herd right to the last minute and get off when they hope to be able to see the top of the bull/bear market precipice. Like all beginners, they will be hugely overconfident of their ability to do this. In my experience of almost 40 years through many bull/bear market cycles, I have found that it is very difficult to know, at the time, which peak in the market is the last one. It is usually only possible to know this after the event.

In my view, the best course is to treat the rampant speculation phase of a bull market as a time of heightened risk. The sensible strategy is to take a very defensive approach and preserve capital which can be employed to fully exploit the next bull market. If we have missed most of this bull market, we cannot make up that time now any more than we can make up for any of the previous bull markets which we may also have missed.

There are a number of indications which generally give a clue as to whether we may be in the rampant speculation phase. I will take them in turn below.

Increased price volatility

There are several aspects to this. The first and most obvious one is that the market moves more than it used to in a day. Not only that, but it is often up significantly one day and down almost as much the next day. This is a tricky thing to get a good idea of, because in a strong bull market, the index value will rise quite substantially over several years. So, what used to be a big move now seems to happen more commonly. It is not unusual for the media to tell us that new records are being established—the biggest one-day rise or fall. The problem with this is that they are measuring it in index points, so it is inevitable in a rising market that the numbers become larger. In effect, it is nonsense. The only correct measure is the percentage rise. So, be careful not to be misled.

That said, in the last year especially, the market has been jumping around from day to day more than it was previously. The percentage moves have often been larger. This is one indication that the market is becoming wilder. The depth of the corrections in the last two years has also increased.

In addition, we need to look at how far individual stocks are moving from day to day. Again, this needs to be done in percentage terms. My clear impression is that there are increased daily percentage movements in many stocks. This feeds back into a later indication that we may be in the rampant speculation phase—that there are more day traders about. Day traders need a lot of intraday price movement in percentage terms to make money speculating within a day.

Significant fundamental overvaluation

A bull market typically begins with many stocks relatively undervalued. By the second phase, prices will have risen and many stocks will be fairly valued. In the final phase, we would expect to see many stocks become relatively overvalued.

The problem with this is that valuation is a slippery concept. For a start, fair valuation will depend in part on the bond yield. The bond yield relates directly to the rate of inflation. So, if inflation and bond yields are relatively low, we would expect the earnings yield on shares to also be relatively low, since shares are an alternative investment to bonds.

As of 7 September 2007, the 10-year bond yield was 5.945 per cent. The Australian Securities Exchange calculated the price/earnings ratio for the All Ordinaries index at 13.83 times. The earnings yield is the inverse of the price/earnings ratio: 100 ÷ 13.83 = 7.23 per cent. Although some will make a direct comparison and say that shares are better value on this measure, such a conclusion may be a little simplistic. It can be argued that the bond yield is a risk-free rate. Since shares are inherently more risky, there should be a premium in the earnings yield on shares to compensate for the risk.

Another problem is that bond yields have been very low, driven by the yen carry trade (see <www.investopedia.com/terms/c/currencycarry trade.asp>) and the market's apparent disregard for risk generally in very bullish markets until quite recently.

Summing this up, my feeling is that shares are probably near fair value, rather than significantly overvalued. This is supported by the rather crude measure of historical price/earnings ratios for the All Ordinaries index.

The market tops in 1987, 1993–94 and 1999–02 were all accompanied by price/earnings ratios of over 20 times. However, we need to be careful with this. It is highly dubious to draw conclusions from only three observations, especially when they could be closely related within a single overall economic cycle. If we go back a little further, the 1980 top formed with an average price/earnings ratio of less than 12 times and led into a sharp bear market. So now we have three tops near or above 20 times and one near 12 times. This is a very small sample from which to draw any valid conclusions. All I feel we can say here is that the present market is well advanced in a bull market. Its price/earnings ratio is not very near the readings for the last three major tops. However, it is already above the reading for the 1980 top. Depending on what we want to believe, this can be interpreted as suggesting we are a long way from the end, or then again it can be interpreted as suggesting we are already at dangerous levels. I don't think we will know the answer to this riddle until after the event.

Another idea worth considering in reaching a conclusion on this indicator of the rampant speculation phase is that on 11 September 2007, I ran two scans of the whole market. I found 380 stocks with price/earnings ratios above the average of 13.83 times. I only found 260 stocks with price/earnings ratios less than the market average of 13.83 times (and greater than zero, because the Australian Securities Exchange excludes loss-making companies). This is difficult to interpret, because the average is heavily weighted to a few large companies. It simply suggests there are more companies which are above the average (on the expensive side) than below the average (on the cheap side).

I am essentially a value investor. I have been finding it more and more difficult to find relatively undervalued companies in the last year. This suggests to me that the general level of the average price/earnings ratio has increased and the average dividend yield has dropped. This does not say we are at the top, but may be suggesting that we are getting closer.

In more general terms, until July 2007, the stock market in Australia had been running in a sweet spot and investors seemed to have forgotten about risk. The sub-prime loans disaster has changed that picture somewhat and an element of fear has emerged in the form of some fund bankruptcies and a nasty shakeout in the stock market. This may have been one of the first signs that valuations are near a peak for this bull market, which will be with a lower average price/earnings ratio than at the last three major tops.

To sum up this discussion on valuations, a more defensive investment posture would be wise, in case we are closer to the end of the bull market than might be suggested by the comparison of the raw numbers. It is also the case that although this indicator is ambiguous, the other indicators are almost universally pointing clearly to us being in the rampant speculation phase.

FULL EMPLOYMENT, RISING INTEREST RATES AND INFLATION

The Australian economy is running at the highest level of employment, or lowest level of unemployment, for a long time. There are shortages of labour in many industries. Importing guest workers on short-term visas is only helping at the margin. This has led to upward pressure on wage rates.

The inflationary pressures have been rising gradually, as anyone doing the grocery shopping will know. The Reserve Bank has been trying to control these pressures by gradually raising interest rates. This increases business funding costs and depresses profits. It also increases home mortgage costs, which reduces money available for spending, which reduces business sales and profits.

This is clearly a typical picture for the rampant speculation phase of a bull market. Keep in mind, though, that it is not a precise timing indicator and the situation can continue for some time. Indeed, in dangerous booms, inflation can get right away from us before it is possible politically to take the necessary measures.

THE PUBLIC ENTER THE MARKET

One of the saddest things about bull markets is that small private investors, especially people who have no prior investing knowledge or skills, come into the market in the final stages. Everywhere around us there is heightened interest in shares. Lots of people want to start speculating on the stock market. Of course, their paper profits will turn into real losses when the end comes. That is why I decided to try to teach what I have learned about investing over 40 years.

This indication is clearly signalling that we are in the rampant speculation phase of the bull market.

Day trading

In the rampant speculation phase, many new investors give up their day jobs to become day traders. A day trader is someone who buys and sells on the same day. He or she does not carry positions overnight. Day trading is only really profitable when there is significant daily price volatility, also known as rampant speculation. It simply confirms that we are in the final phase.

Many takeovers

For the last year or more it has been difficult to pick up *The Australian Financial Review* without finding reports about takeovers. This always happens when the stock market has pushed stock prices to high valuations, such that companies can use their stock to acquire other businesses. This time, the whole process has been turbo-charged by the availability of cheap credit, mainly the yen carry trade. This was, until recently, heavily exploited by private equity firms and hedge funds.

This indicator is clearly suggesting that we are well into the rampant speculation phase of the bull market.

New floats

Another indicator of high valuations is when lots of business owners start to float their companies on the stock market. They do this because they know the market is paying more for their assets than they are worth. Even worse, lots of totally speculative enterprises are floated to give the punters lots of casino chips with which to speculate.

The number of new floats this time is running much higher than in the technology bubble of the 1990s, which reached a peak in early 2000. New floats are a good signal of heat in the market and this chart (shown in chapter 8) is shouting rampant speculation at us.

TRADING SYSTEMS PROMOTED

At the same time, there has been a plethora of advertising and promotion of courses and seminars to teach stock speculation. If we have been to a trading and investing expo in the last year, many of them will have been prominent exhibitors. It has been difficult not to notice the persistent full-page advertising. Clearly the climate is one of rampant speculation, and all these promoters are trying to profit from it in their way.

LEVERAGE AND RISK

One of the features of this bull market has been the promotion of CFDs. Enormous sums have been spent on advertising and promotion of this instrument. What is worse, the promotion has been aimed at new entrants to the market. I have heard some horror stories of inexperienced speculators losing all their savings speculating in CFDs when they were caught in the August 2007 market downturn. Nobody should use this dangerous speculating instrument unless they know what they are doing. It is my firm opinion that CFDs should not be used unless an investor can show a profitable investing or speculating track record of at least two years without using any leverage.

This discussion of CFDs is just one example of the way the marvellous bull market we have had for the last four and a half years has led beginners to think that investing and speculating in stocks is a low-risk game. Unfortunately, this disregard of risk is typical of the rampant speculation phase of the bull market.

OTHER INDICATIONS

Some of the other indications, which have not been difficult to see around us, have been:

- Increased media coverage of stock markets, especially on front pages and at the top of news bulletins.
- Pressure to relax market regulation. This has been less evident this time perhaps, but it is there. The private equity attacks on several big companies prompted calls to relax governance on public companies.
- New paradigm theories. This time it has been talk of soft landings in the economy and the housing booms. As well there is wishful thinking that the Chinese boom will go on forever without a

problem and that the resources boom will therefore run for longer and prices will stay higher than ever before. We saw this in Japan in the 1980s and it led to an economic disaster.

➢ Fewer and fewer stocks are leading the market up, instead of the earlier broadly based advances.

Conclusion — bull market phase analysis

My feeling from all this discussion is that the evidence is overwhelming that we are now well into the rampant speculation phase of the bull market. A year ago I said this, though possibly not as strongly. I foreshadowed that people would laugh. Some have. Mostly they have clutched at one or two straws in order to cling to their hopes that the bull market will go on much longer. A part of this process is also to minimise the relevance of the other evidence. This is a natural way to try to protect our preconceived ideas when they are under threat.

As I said earlier, the bull market may go on for a while yet. Nobody will know for how long it will continue until after it has ended. However, that does not change my judgement that the bull market is now closer to the end than to the beginning. For me, speculation about timing is a fruitless exercise. The relevant issue now is the strategy to adopt in this situation.

The other way to try to divine where we are in the bull and bear market cycle is by analysis of what buyers and sellers are doing through charts of key market indexes. This adds a layer of chart analysis to phase analysis. When it confirms the conclusions from phase analysis, it affords additional comfort. When it is at odds with phase analysis, it is a cause for caution and careful reexamination of the facts on an ongoing basis.

For the Australian market, I prefer to use the All Ordinaries index, because it is the broadest measure. However, the S&P/ASX 200 and S&P/ASX 300 indexes will tend to give essentially the same picture if readers prefer to use them.

From March 2003, we have had one of the best bull markets seen in our market for quite some time. For most of this period, our market has been one of the best places to be invested, other than some of the emerging markets in developing countries like China, where the risks of failure are also extreme.

Figure 14.9 is a weekly bar chart of the All Ordinaries index from the start of 2003. This covers the period to date of the bull market. On the chart, I have drawn a trendline and above it a trend channel line through the early peaks of the bull market. This is a very unusual chart. It is quite rare to find such an almost textbook perfect example of a trend channel.

Figure 14.9: weekly ASX All Ordinaries index — trend channel

What has been valuable about this chart is how it has told us two things.

Firstly, it shows the sheer consistency of the trend. This is suggesting that so far we have not had an extreme buying binge that would have led to a crash ending. It could still happen, but there is little sign so far of a set-up for something like the 1987 disaster. That said, as observed earlier, the trend has tended to become more volatile as it has unfolded. The August 2007 shakeout has been the worst one so far, albeit the ensuing rally has quickly restored much of the damage.

Secondly, it became obvious from at least 2006 onward that when the index had climbed to near or above the channel line, a correction was due. Some corrections were worse than others; 2007 saw a short, but mild, dress rehearsal early in the year. Then the index climbed back above the channel line and hugged it for a few months. This situation looked as though a correction was waiting to happen. I steadily reduced my exposure to the market in this period. The only questions were when the correction would come and what would be the catalyst to set it off. It came in late July, triggered by the sub-prime loans fiasco in the US market that reverberated in debt and equity markets around the world.

The August shakeout was savage. The index fell through the trendline, but only on a couple of days. The lowest closing prices were very close to the expected support level at the March 2007 lows. It is not unusual in a sell off for intraday prices to overshoot support levels, which are not precise. The key issue here was that, although the price spiked significantly through the trendline on the low day, it closed above the trendline and there was no follow through on the downside. This suggests that the trendline is essentially intact. The price has since rallied very quickly to the top of the trend channel. At the time of writing, it surged up through the heavy resistance from the several months of sideways action prior to the shakeout.

As I see it, the only conclusion at this point is that the bull market uptrend is still in place. The shakeout in many ways has been healthy. There are now two possibilities to worry about:

1. That the present rally fails and falls through the August lows, which would also be through the bottom of the trend channel. In this case we would technically have a bull market ending in place—a fall through the last trough of the trend.
2. That at some future time, the market becomes very wild. The speculative excesses driving such a market would take it up steeply well above the trend channel. This would be exciting, but very dangerous, because it would be a set-up for a possible severe market move to the downside. Maybe it would not be as bad as 1987, which was an unprecedented crash, but it may be more of a crash ending than a simple trend reversal. The steepness of the present rally is causing me some concern that the market is much hotter than it has been earlier in the bull market. It may turn out to be the final buying binge before the end of the bull market.

Of course, markets unfold in endless variations and neither of these things may happen in the immediate future. I am not saying that I thought they would. What I am saying is that they were the possibilities which we would need to worry about. I have tried to set out what to look out for. If we know the key action levels, then we can execute our strategy in a timely way and not be too surprised, such that we act too late.

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I have edited out comment on other world stock markets. However, one had direct relevance to Australia: since 2005 the Chinese (Shanghai) stock market has soared upward sixfold. This is a bubble market. It is only a matter of time before the bubble bursts. There is no reason to imagine that this time will be any different.

The demise of such a bubble market could have quite unpredictable implications for the rest of the world, especially Australia, because China has become one of our largest trading partners. The implications of the collapse of a stock market can be profound for capital formation and be very detrimental for the real economy.

STRATEGY FOR 2008

The discussion above suggested that:

1 We are still in a bull market. It is intact at the time of writing and there is no obvious set-up for a market crash scenario. Challenges on the upside were noted, as were failure points on the downside.

2 We are clearly in the final rampant speculation phase of the bull market. The evidence examined and discussed is pointing almost universally in that direction.

Having established that point of view, the strategy which I believe to be appropriate for the situation in the market must focus on the management of risk. Our clear objective must be the preservation of capital. We are now in a situation where the market risk is high. We need to position our capital such that we retain as much as possible of the growth in capital that we have enjoyed in the bull market so far. That means moving to a more defensive posture.

A key part of my investment plan is to maintain a fully invested posture until I form the view that we have moved into the rampant speculation phase of the bull market. That was the point reached late in 2006 and was fully discussed in my book *Hot Stocks 2007*.

My strategy called for me to take 30 per cent of my capital out of the market at that point. I had effected that reduction by New Year 2007. This was not very easy to do. I had to sell some stocks which had not yet given a sell signal and were still technically trending up. In line with my plan, I sold the ones which I thought were the weakest ones.

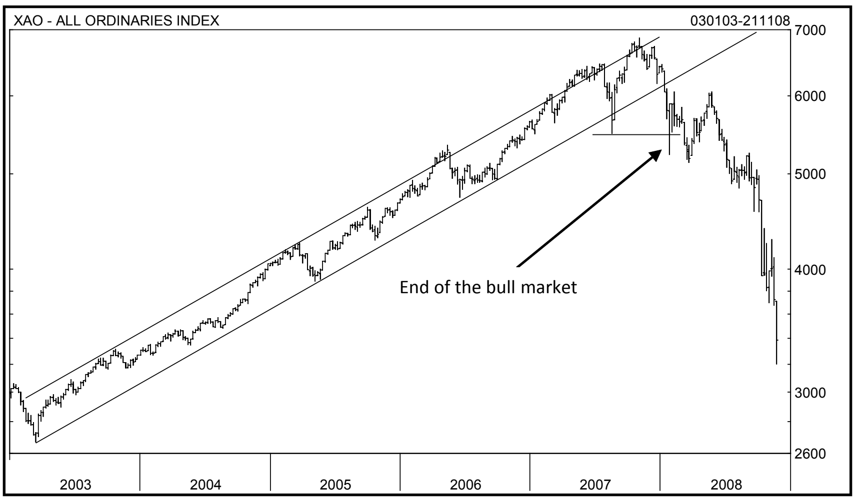
As described above, 2007 saw the ASX All Ordinaries index chart move up to, and just above, the trend channel line. It then continued to rise, generally hugging the channel line. This went on for 15 weeks. I saw this as a correction waiting to happen. Every time the market had got to that position before in the bull market there had been a correction. I began to reduce my exposure to the market by selling any stock which gave a sell signal as usual, but also by continuing to sell the stocks in my portfolio that I thought to be the weakest. By the time the correction came in August, I was just under 50 per cent invested. Some more stocks gave sell signals in the correction and by the time the correction was at its bottom, 80 per cent of my capital was in cash.

I have rebuilt my exposure to about 30 per cent of capital as I write this section in mid October 2007. Because we are in a rampant speculation phase, I am unlikely to take it much higher. As I see the market now, 40 to 50 per cent invested would be as far as I would go. If the market again looks to be near a strong peak, and near or above the trend channel line, I will pull back to 30 per cent invested.

The problem now is that we are in the dangerous part of the bull market. The paramount aim towards the end of a bull market is preservation of capital. The biggest sin is to give back too much of our profits.

Those comments in *Hot Stocks 2008* and the chart shown above were finalised on 12 October 2007. As it turned out, that was just four weekly bars before the peak of the bull market was established. The market then weakened back into the trend channel through November and December, before plunging sharply in January. As shown in figure 14.10, the break below the August trough came in the week of 25 January 2008. From that week, the bull market was finished.

Figure 14.10: weekly ASX All Ordinaries index — end of bull market



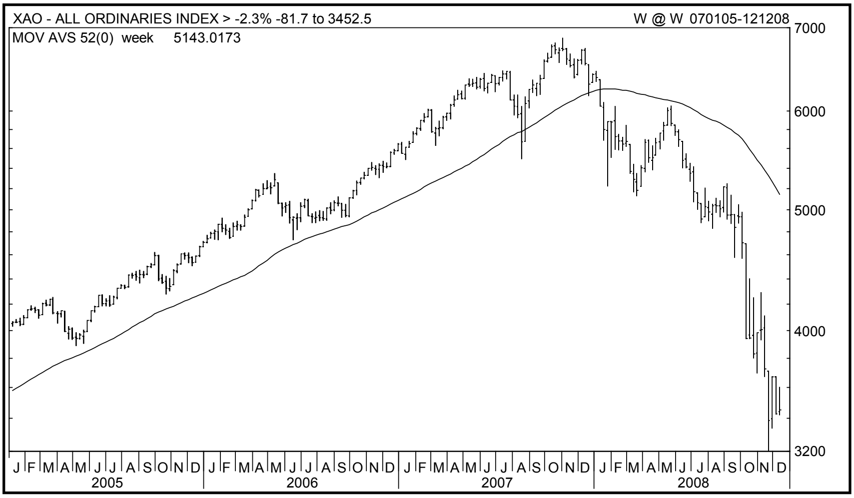
As the market began falling, I sold immediately any stock which hit its sell stop. Very soon, I had only one small holding left, which I held for a few months until it too capitulated to the bear market. Since then I have been 100 per cent in cash.

CASE STUDY 3: THE SITUATION AT 12 DECEMBER 2008

This bear market has turned out to be more severe than most. In my lifetime, I can only compare it to 1974. The parallels have been eerily familiar. In 1974, the market fell to a new low month after month, as has this one. There was no serious rally. This has happened again in 2008.

Figure 14.11 shows the chart for the Australian market on 12 December 2008.

Figure 14.11: All Ordinaries index — 53.4 per cent decline



The descent from the November 2007 peak of 6873.2 points to the November 2008 low of 3201.5 points was a 53.4 per cent decline. It may well not be all over yet. This ranks it as one of the most severe bear markets in our short history of stock markets in Australia.

Many commentators have compared it to Wall Street in 1929. It is interesting that they have made this comparison, but they are relying on legend rather than personal memory. Of course, many of these commentators are too young to remember 1974 from personal memory either.

All of this comparison to the past is really totally irrelevant. It makes good headlines and stories, but it is not useful for analysis. The bear markets of 1929 and 1974 are just two observations of market behaviour. There is no statistical validity in any theories of recurrent patterns based on such a small sample.

What is useful is to take a completely different approach. We need to assess where we are in the bull and bear market cycle. Then we need to adopt a strategy which is appropriate for the condition of the market.

I am dismayed by the number of people who have read my book *The Aggressive Investor* and are just looking at one thing now—the Coppock indicator. I am dismayed because this is a totally wrong approach. It comes from a misunderstanding of my investment plan, which was outlined in chapter 8 of this book and was essentially the same in the earlier book.

Sometimes, the Coppock indicator can give a signal before the bottom of the market is reached. This is usually a premature signal, caused by a very strong rally. That rally can be a good place to start buying, but it may be some years too early if we have not yet reached the bottom of the bear market. This kind of rally is generally known in the industry as a sucker rally. It draws in some more suckers, who lose money on the subsequent decline to the bottom of the bear market.

Coppock indicator signals usually come near and more often after the bottom of the bear market. The Coppock indicator is a long-term momentum oscillator. As such, it tends by its very nature to be a trailing indicator. I cannot emphasise enough that this is the ***second*** signal I would be looking for.

The ***first*** signal, which is invariably well ahead of the real Coppock indicator signal, can be evident many months before the bottom of the market. This is that we are in the third and final phase of the bear market, called distress selling. As of 12 December 2008, in my analysis, we are not yet in that phase. My analysis suggests that we are still in the second phase of the bear market (decreasing earnings). In that case, I should be sitting on my hands and staying out of the market.

The only other sensible approach is to be gradually buying undervalued stocks on a dollar cost averaging approach. This is for those who eschew market timing and are not following an active investment approach.

> **Dollar cost averaging** is a time-honoured method. It guarantees that investors do not put all their capital into the market at a bad time. In essence, investors divide their available capital into many equal parts. The same amount is invested regularly in the same stocks. This means that in expensive markets, fewer shares are purchased. In cheaper markets, larger parcels of shares are purchased. This gives an average cost, over the market cycle, which is neither near the top prices nor near the bottom prices.

Dow Theory phase analysis is not difficult, but it does involve knowing what to look for. This was all outlined in chapter 8. Then all it needs is to be observant as to what is happening around us. I find all I need from reading *The Australian Financial Review* each day. I have been reading it every day since I was in university in the early 1960s. It is still one of the first things I do every morning, except Sundays.

What phase are we in now?

This is why I think we are still in the second, or decreasing earnings, phase of the bear market. I will now take the markers of this phase one by one, as listed in chapter 8, and discuss each one.

Earnings decreases announced

This began around April–June of 2008 as we approached the end of the 2007/08 Australian financial year. Companies began giving so-called guidance to the market that profits would be lower than was being expected. Then, in the July–August 2008 profit reporting season we saw two things. Firstly, company after company reported lower profits, or at least decreases in the rate of growth in profits. There were exceptions, but not very many. Secondly, the overwhelming majority of company chief executives or chairmen declined to make profit forecasts for the coming year. This was a sure sign that they thought more bad news was coming. Bad news tends to travel slowly in stock markets. Prices tend to anticipate bad news.

Since then, there has been a rash of reports from retailers and the motor vehicle dealers that sales are badly down. Right across industry there are announcements of retrenchment of workers and delays in capital investment or expansion. Businesses are battening down the hatches for an economic recession ahead. More earnings decreases are now a virtual certainty when the half-yearly results come to light in January–February 2009.

The market ignores good news

It sure is. Good news comes out and the share prices of the companies involved do not move much, or only temporarily. Any company which attempts a capital raising is suspect and its share price is smashed. I will revisit this below when I look at the third phase markers.

Former market leaders may fail

How the mighty have fallen. ABC Learning Centres has failed. Many others are teetering on the edge of the abyss: Centro, MFS (now Octaviar), Allco, Babcock & Brown, ING Industrial Fund and more. Former market leaders have seen their share prices shredded because of concerns about debt, like Wesfarmers, Suncorp-Metway, Macquarie Group and Rio Tinto. Many funds, especially mortgage funds, have closed their redemption windows.

A recession begins

The definition of a recession is a live issue that will never be resolved to everyone's satisfaction. The US is clearly in recession. China is heading that way. Japan and much of Europe are in recession, or on the edge. Australia managed to record a tiny increase in GDP recently, which was seized on by the government to deny we are in recession. However, most business leaders believe we are headed that way and are acting accordingly.

Sharp rallies leading to further falls

No, not this time so far. It has been even worse. There were six months in a row of lower monthly lows with very little relief. This is as bad as it gets in a bear market. It is just like 1974 all over again. Until we see an end to these falls, we are still likely to be in the second phase of the bear market.

Few new floats

The number of new floats each month can be counted on the fingers of one hand. In addition, only the strongest companies have been able to raise new capital, and often at great cost to their stock price.

The public lose interest

The only comment about the stock market among our friends now is how bad the situation is. Those who have speculated unwisely want to blame short sellers, company managements, the regulators, advisers and anyone else who shows his or her head above the trapdoor to their bunker. Generally, it is difficult now to sustain a social conversation about the stock market beyond a few moans and groans.

CONCLUSION: SECOND PHASE OF THE BEAR MARKET

All these indications are therefore in place. My analysis above suggests that we are well and truly into the second phase of the bear market (decreasing earnings).

The question now is whether we are yet in the third phase of the bear market (distress selling). When we think we are in the third phase is the time to start looking for uptrending stocks to buy.

I will now look in turn at each of the markers for the third phase (distress selling) of the bear market.

SIGNIFICANT FUNDAMENTAL UNDERVALUATION

I have lost count of how many commentators and newsletter writers have been saying that prices are cheap. I disagree. What I would say is only that prices are ***cheaper*** than they were in the unreal days of the rampant speculation at the end of the bull market. We became conditioned to those prices and now prices are much lower. However, I am here to tell readers that things can get worse.

It is not the price of stocks we should look at. We should look at the price/earnings ratio and the dividend yield. Price/earnings ratios are ***lower*** than they were last year. In some cases they are much lower. This is because the market thinks earnings will fall going forward. So, if a company has earnings per share of 20¢ and its price is $2.00, its price/earnings ratio is 10. If earnings per share fall to 10¢, the price/earnings ratio will ***rise*** to 20. Except that this will not happen. What will happen is that the price will fall sharply to bring the price/earnings ratio into line.

The same applies to dividend yield. Suppose that this stock paid a dividend of 10¢ per share. Its dividend yield would be 5 per cent. If the profit halves, as described above, and the dividend were also halved to 5¢ per share, the yield would ***fall*** to 2.5 per cent. Except that this will not happen. What will happen is that the price will fall to produce a higher dividend yield.

I have spent a little time on this point. This is to emphasise that these ratios react to earnings and to dividends, but it will be the price that will change to bring them into line. In many cases, the market has already anticipated earnings and dividend decreases and reduced prices. For these situations, price/earnings ratios are in low single figures and dividend yields are already at astronomical percentages. This simply means that the price has moved ahead of the results to be announced in the next reporting season.

My thought is that we are well on the way to this marker falling into place, but as has happened in previous deep recessions, it could get much worse yet.

Unemployment peaks

As we came into 2008, Australian unemployment was lower than we had seen for a long time. Labour was short and wages were beginning to rise as business competed for the available workers. Many industries brought in overseas workers on special short-term visas. We had not seen guest workers in Australia on this scale for a very long time.

Now, retrenchments are being announced almost daily. The unemployment graph has begun to turn up. However, it is still very low historically. It would seem that we have a fair way to go before unemployment again begins to peak.

Many bankruptcies and failures

We have seen a few high-profile companies crash and burn. Some are still suffering a lingering death. Usually, the problem was high gearing.

However, in a bear market, the bellwether is small business and individuals. Personal debt agreements are starting to creep up, suggesting individuals are coming under pressure. The government has recently deferred tax payments for small business, expecting that they are also heading into cash flow problems. Bankruptcy follows when a business runs out of cash. However, this has not yet begun to happen in any numbers. It is likely to get worse before we can be sure we are in the third phase of the bear market.

Bad news is discounted

This marker says that we are near the bottom when the market does not react much to bad news, because it has already been anticipated and built into the price. We are definitely not yet at this stage. Right now any bad news sees the market weak and the prices of directly affected stocks are hammered down.

When we see bad news being calmly accepted by the market, we will be in the third phase. Right now, we are not there yet.

THE MARKET IS RARELY IN THE NEWS

World stock markets and the economic situation still seem to be in the news every day. Unexpected things are happening. People do not generally understand what is happening in the markets. Uncertainty breeds fear. Markets abhor uncertainty.

When things improve towards the end of the bear market, this fear and uncertainty will recede. We are nowhere near that situation yet.

LOW PUBLIC INTEREST AND PARTICIPATION

This is closely related to the previous marker of the third phase. When we get near the bottom, the public will have drifted away. In some cases they don't even want to look at the prices of their stocks any more. Some sell everything and swear off shares for life.

This is where my seminar indicator comes into play. When we are in the rampant speculation phase of the bull market, the room is full and latecomers have to stand. Recent seminars have seen some empty seats, but still a good audience. When we get to the distress selling phase, the room will be half full if we are lucky. You don't believe me? Come to some seminars over the next year and see for yourself.

I feel that public interest has not yet slipped to low levels. However, we are moving towards it.

STOCK PRICE CHARTS SHOW ACCUMULATION

In the value model discussion in chapter 11, I described how smart investors begin accumulation of good stocks at low prices at the bottom of the cycle. This causes sideways patterns to form on the charts of those stocks. Right now there are a few of them. When we get into the third phase of the bear market, there will be many more of them. We are still in the mark-down phase on the charts of most stocks.

CONCLUSION: THIRD PHASE OF THE BEAR MARKET

All of the markers of the third phase of the bear market are still to fall completely into place. This makes me believe that this bear market has further to run in time, if not in price.

This discussion of what is not yet in place for the third phase is something each reader should bookmark and review each month going forward. Don't worry yet about the Coppock indicator. Dow Theory phase analysis is not only my major analytical tool, but it will be most likely to give the first action signal for my investment plan. For all those looking exclusively at the Coppock indicator at this point, my advice is that they are looking at the wrong thing. Many readers want to know my secrets. I don't have any, because everything I do has been disclosed for some years now, as it is in this book. However, if there are still some readers who want a secret, I have just told them what it is for the present market situation. Phase analysis is the secret weapon that will give us an early start on the next bull market.

Case studies of specific stock investments

The remaining case studies are of specific investments which I made in the last part of the 2003–07 bull market. I have written them as a teaching tool. I attempt to demonstrate how I looked at the issues as the investment unfolded.

There is one aspect which I need to make clear. Over time, my investment capital has increased. During the 2003–07 bull market, this was largely due to income from capital growth, dividends and interest on the cash reserve. However, on two occasions I brought new funds into my investment capital. Also, there was the need to occasionally take some funds out of investment capital for large expenditures. The reason for mentioning this is simple. I have shown the actual calculations I made in determining my position size in the case studies. However, the case studies are difficult to present in strict chronological order and some of the decisions overlap each other. This means that the amount of capital used in the calculations may appear to jump around. Please disregard this and focus on the process and underlying logic of the case studies, rather than the actual amounts of capital.

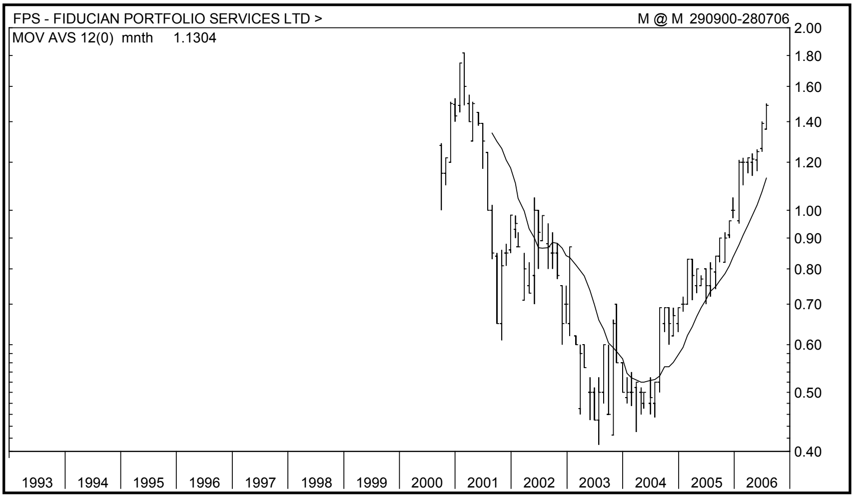
Case study 4: Fiducian Portfolio Services (FPS)

Company profile

Fiducian Portfolio Services is the holding company for the Fiducian Group. It was established in 1996 and listed on the Australian Securities Exchange in 2000. It provides services including financial planning, funds management and investment administration to individuals and organisations.

Fiducian first came to my attention in early August 2006 on a technical analysis filter run. Its chart is shown in figure 14.12.

Figure 14.12: Fiducian Portfolio Services



This was my first view of Fiducian, which is a monthly bar chart. The first thing to notice is that it was clearly a value model stock chart. From its listing in 2000, Fiducian traced out a mark-down phase through to 2003. Then an accumulation zone formed through to the second half of 2004. Since then Fiducian had been in a strong mark-up phase. The mark-up phase was remarkably consistent and tracking nicely above the 12-month moving average.

I have found that many beginners will, at that point, reject this chart on two grounds. First, that it has already gone up too far. Second, that there is resistance ahead of it in the range of the 2000–01 peak, which may have been a distribution pattern following its listing. I feel that this is unduly negative. We should not dismiss these concerns out of hand. Rather, we should keep them in the back of our mind as possible issues to be considered if the trend was to begin to falter near the range of the 2001 peak.

My view was that this stock was well worth further analysis.

PROFITS

After a scratchy start, its earnings per share had grown strongly in the last two financial years to 30 June 2005 and 2006. This is not surprising for a fund management company in a strong bull market.

Price/earnings ratio

Fiducian's price/earnings ratio was 15.1. The market average was 15.22. This was high for a value model stock.

Dividend yield

Fiducian's dividend yield was 4.7 per cent. This was acceptably higher than the market average of 3.82 per cent, although I might have wished it was another 1 per cent higher.

Debt-to-equity ratio

This ratio was not explicitly in my investment plan at that time. Fiducian had not had any long-term debt since listing. I suspect short-term debt was very small or nonexistent.

Conclusion: margin of safety

While not ideal, on balance I thought Fiducian was fairly safe. The strong uptrend on the chart was suggesting the smart money and insiders thought profits would keep growing strongly.

Liquidity

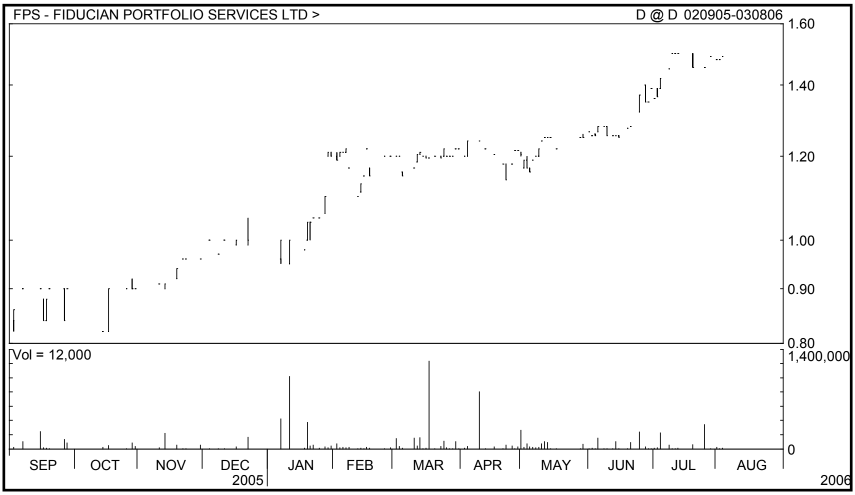
I did not record this at the time, but I think that the capitalisation of Fiducian was close to $50 million at the time. This was therefore only a small stock.

Moreover when I looked at the volume of trading, the daily chart in figure 14.13 was not encouraging. There were many days with no trades. There were also many days when Fiducian only traded at one price, suggesting there may have been only one transaction on the day.

I also looked at the daily volume numbers in the database, because it was difficult to read them on the chart. There were days with enough volume for me, but I would need to be a little patient getting in and out.

After careful thought, I decided that I would open a position in Fiducian as one of my very few thinly traded stocks. I also decided that I would not build the position beyond 2 per cent of my capital in recognition of the volume situation.

Figure 14.13: Fiducian volume



POSITION SIZE

These were my calculations on the morning of 7 August 2006:

Buy price	\$1.49
Sell stop	\$1.13
Risk	\$0.36

My capital at that time was approximately \$1 620 000 (I round it off to simplify the calculations).

Maximum position size (my plan was to risk a maximum of 1 per cent of my investment capital at that time): \$16 200 ÷ 0.36 = 45 000 shares.

If I invested 2 per cent of capital, I would buy \$32 400 ÷ 1.49 = 22 000 shares.

If I bought a position of 22 000 shares, my maximum risk was:
(22 000 × 0.36) ÷ 1 620 000 × 100 = 0.49%.

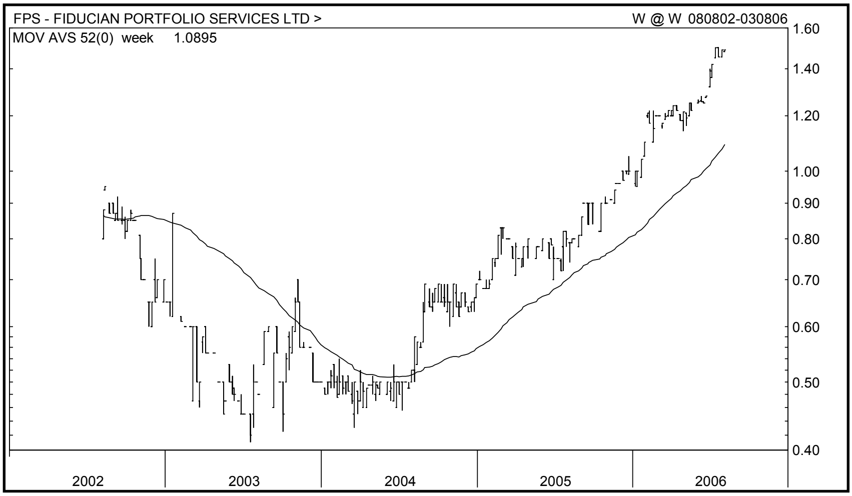
This was the maximum risk I used to try to stay under, so I was happy with it. It would have been just inside my latest maximum risk percentage of 0.5 per cent of capital.

ORDER EXECUTION

I was able to buy 22 000 Fiducian on that day, 7 August 2006, for \$1.49.

From then on, I would be managing the investment from the weekly bar chart, which is shown in figure 14.14.

Figure 14.14: Fiducian weekly bar chart



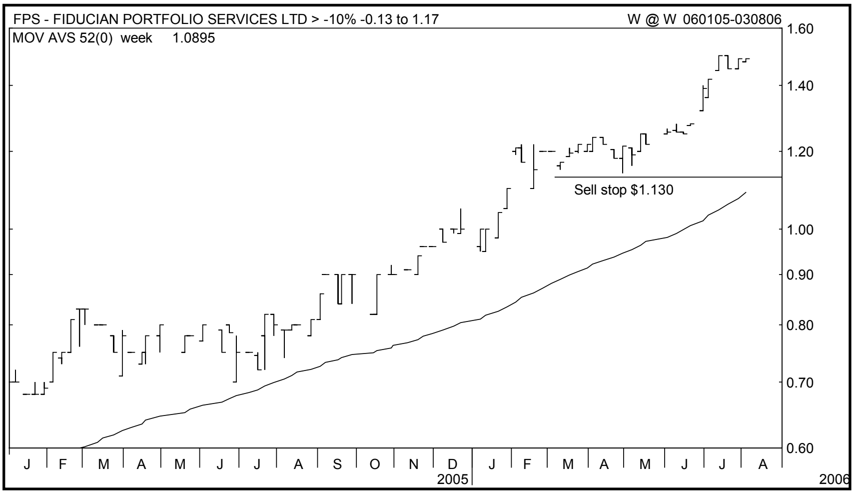
One thing worth mentioning is that this was an investment where I was buying into an established uptrend. The trend came out of an accumulation pattern on a value model chart. The ideal time to have begun building the position had been back in late 2004 or early 2005. However, I have no records for what the situation was then. Fiducian is a small stock. That issue alone may have been the decisive factor in passing over it at the time.

The other issue worth examining at this point was the placement of my sell stop level, as shown on the shorter term weekly bar chart in figure 14.15.

It was placed only $0.01 below the February to May 2006 sideways pattern. This is rather closer than I might normally place it after a breakout. However, the trend had by that time left this last trough quite a way behind. The sideways pattern should have acted as support on any normal correction. So, I saw the violation of the low of the pattern as important. It was also not the kind of stock where day traders would be looking to trigger sell stops.

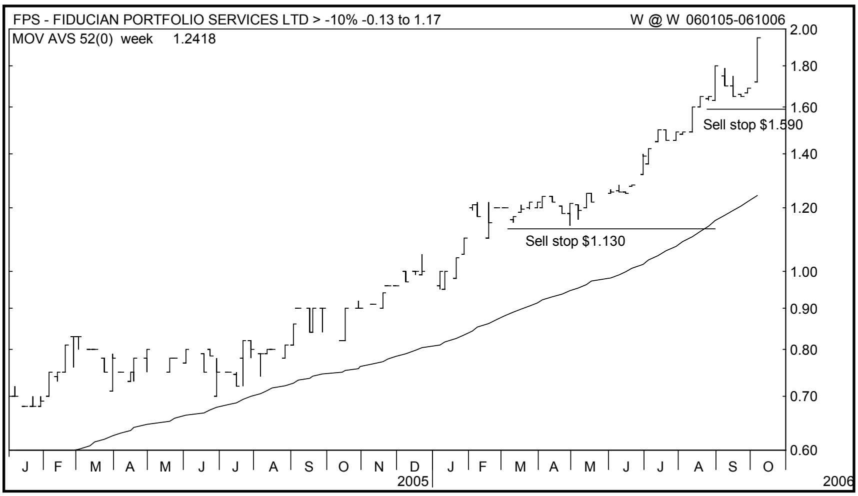
The week after I established my position, the market closed strongly upwards at $1.600.

Figure 14.15: sell stop placement



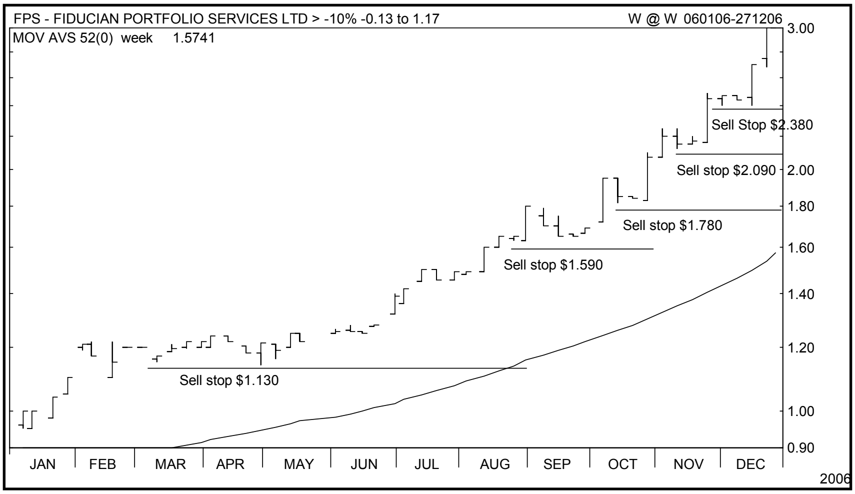
By early October 2006, a new trough had formed in the trend, followed by a strong move to a new high. I moved my sell stop up to $1.590. This was below the $1.650 low of the trough. This is shown in figure 14.16.

Figure 14.16: sell stop raised



As the trend unfolded beautifully, I kept moving my sell stop upwards under the successive troughs in the trend. The sell stops are shown in figure 14.17 (overleaf).

Figure 14.17: sell stop moved under successive troughs



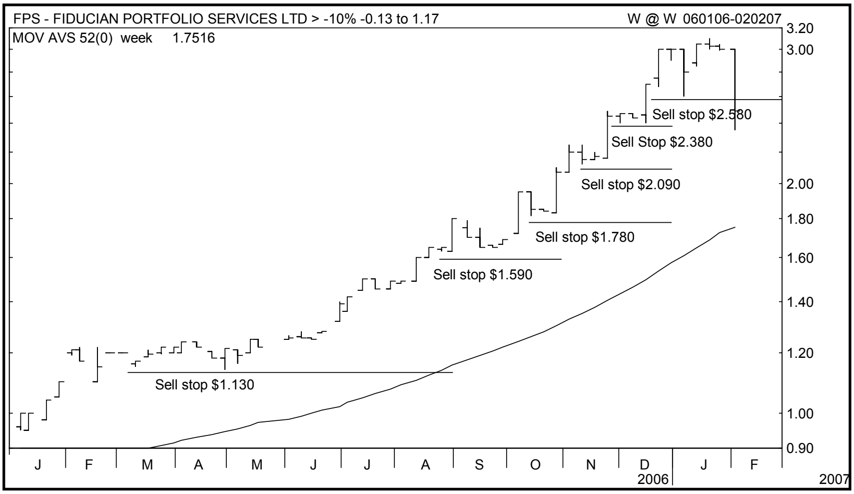
Some readers may be troubled by how small the successive troughs in the trend seem to be. There is good reason for this. Firstly, it is a weekly chart. Most of those troughs are around a month wide. Secondly, the trend was very strong as we were moving into the rampant speculation phase of the bull market in late 2006. As always, we have to tailor our interpretation of the situation we are managing to the current characteristics of the trend.

The above chart shows the situation just after Christmas 2006. By that time, I had written my book *Hot Stocks 2007*. In it I had outlined the reasons why I thought that we were in the rampant speculation phase of the bull market (see case study 2, earlier in this chapter). I had decided to reduce my exposure to the market. Although Fiducian was performing beautifully, I had in the back of my mind that it was a thinly traded stock. It was one of the stocks I decided to reduce my exposure to in taking 30 per cent of my capital out of the market. I decided to sell half of my position.

This is where the liquidity issue came back to haunt me. We were in the hiatus between Christmas and New Year, which is when most Australians are on holiday. It took me several days to patiently sell 11 000 shares in four tranches. Three lots were at $3.000 and the last 4132 shares were at $2.820 on 2 January 2007. This is a good illustration of why my investment plan is to hold only one or two thinly traded small stocks at any time. I had needed to act at a time of low volume. Also, in small thinly traded stocks, there can be substantial slippage in percentage terms. In this way, the additional volatility of thinly traded stocks works both ways. On the positive side, the upward movements can be stronger, but rather more of the paper profits can be yielded in slippage on the way out.

I now had half my position still riding in the market. During January 2007, I moved my sell stop up to $2.580. Then on 2 February 2007, the price cut down through my sell stop as shown in figure 14.18. The market had been very weak the day before, so I checked it on the day and acted as soon as I could to sell my position.

Figure 14.18: price falls through sell stop



I was able to sell my holding in three lots during the day at $2.650, $2.670 and $2.680. This is something that always attracts questions, often argumentative ones, from my audience when I show this in a presentation.

My stop was at $2.580. The price went well below that. However, by the time I picked it up and acted, the price was back above my stop. I see this as a great piece of luck, because unlike the previous sale of the first half of my position, I now had slippage again, but it was in my favour. This happens from time to time.

This is when the argumentative ones in the audience get excited. They want to know why I have sold above my sell stop. My answer is simple. The sell stop is a rule. I always act on it without hesitation.

The reason I do this is based on the logic of my investment plan. I am trying to ride an uptrend while it continues. An intact uptrend has a series of higher troughs. As soon as a trough is violated on the downside, the trend has failed. That is the logic of my sell stop. So I always act on the sell stop.

The argumentative types then want to propose that if the price has risen back above my stop, why don't I wait? Wait, I ask; what for? I get a range of answers. The key for me is that what they seem to want me to do is to change my investment plan on the basis of one situation. In many cases they are doing this in hindsight, knowing how it would have turned out. This is hindsight bias at its worst. We must act on the right-hand edge of the chart, not in hindsight.

The other proposal from the arguers is that I should change my investment plan to requiring the close to be below my sell stop. The same answer applies. This is altering the logic of my plan on the basis of one situation, or at least on the basis of an untested assertion.

Although it does not in any way change the above discussion, it is interesting to note that Fiducian went on to close the day below my sell stop.

Another interesting issue here is to reflect on the reason for having a sell stop. The sell stop is to protect me from catastrophic loss. When a stock nudges through a sell stop, I only know in hindsight what happened next. For all I know, the stock may be in big trouble and go belly up. Or it may suspend trading while bad news breaks and eventually opens some days or weeks later at much lower prices.

In the final analysis, sell stops are about preservation of capital. We might get away with hesitating for some days or weeks on hundreds of occasions. However, there is always the one that will bite us in the financial nether regions.

Years ago I bought a stock called Chamberlain with a sell stop at $0.990 under a wide sideways pattern. It drifted through the sell stop by a few cents and I watched it for about a week. Then one day I opened *The Australian Financial Review* in the morning (we did not have the internet then) to find the board of the company had called in some administrators. The stock opened that day at $0.230. I sold it at $0.210 that morning. I had learned an expensive lesson. The market always charges high tuition fees. I have since never forgotten what a sell stop is for and to act on it ruthlessly. Remember, we can always buy the stock again later.

For those who would like to know what happened to Fiducian after my investment campaign, figure 14.19 shows the chart to December 2008. It is almost a perfect value model chart example. A big distribution pattern formed and it is now tracing out a mark-down phase.

Figure 14.19: Fiducian to December 2008

INVESTMENT RESULT SUMMARY

Purchase cost	$32 816
Sale proceeds	$61 424
Capital growth	$28 608
Dividends	$924
Franking credits	$396
Total return	$29 928

My time weighted average capital (TWAC) for the financial year 2006/07 was $1 490 633

My return on my TWAC = 29 928 ÷ 1 490 633 × 100 = 2.01% of capital

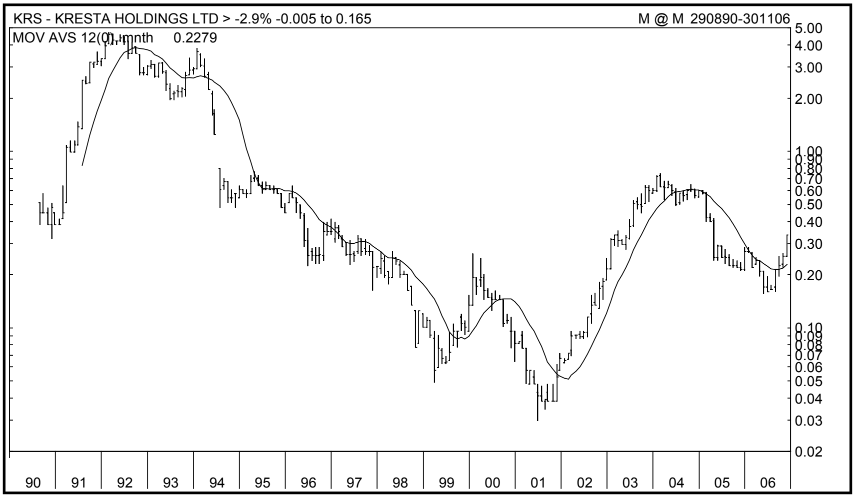
Some readers may be surprised that I look at my return this way. However, it comes back to my objective, which is return on capital for the year. What this says is that 2 per cent of my capital, which was employed for six months, contributed 2.01 per cent of my return for the year.

CASE STUDY 5: KRESTA HOLDINGS (KRS)

This is a stock in which I had already made a very successful investment in 2002–03. I had sold it when it triggered a sell stop, and then continued to monitor its progress for a while until it was clearly trending down.

At the end of November 2006, I looked at it again. The monthly chart in figure 14.20 shows the big picture.

Figure 14.20: Kresta Holdings



This is clearly a value model stock. It begins with a mark-up phase. That was followed by a wide distribution pattern. After that, the price went into a mark-down phase, which developed into a near death experience for the company. In 2001 it formed a brief accumulation pattern and began climbing in a mark-up phase. This was the period during which I had invested in it successfully. A distribution pattern took me out of that investment and a mark-down phase ensued. An irregular accumulation pattern formed in 2005–06. There then seemed to be an upward breakout. This was what caused me to take a fresh look at this stock.

COMPANY PROFILE

Kresta is a manufacturer, marketer, distributor and retailer. Its products include a range of window coverings and components. The retail operations consist of a branch and commission network. Its main brands are Kresta Blinds and Vista Coverings. It has a geographically extensive export business.

PROFIT HISTORY

Its profit history was patchy, with several substantial losses until there was a strong improvement in the financial years 2001/02 and 2002/03. Then profits had deteriorated again, but not into losses.

PRICE/EARNINGS RATIO

12.0. This compared to the market average of 13.83. I would have liked the ratio to be much lower, but continued my analysis.

DIVIDEND YIELD

5.97 per cent. This compared to the market average of 3.88 per cent. It was most attractive for a value model stock.

DEBT-TO-EQUITY RATIO

This was not an explicit part of my investment plan at this time and I did not record what the ratio was. It seems that it was around 35 per cent at June 2006. This was not excessive on my latest investment plan criteria of not more than 65 per cent.

CONCLUSION: MARGIN OF SAFETY

The ratios were a little equivocal. Maybe I should have passed it over. However, at the time we were in a strong bull market. I had also made a good return from this stock a couple of years before. I also knew this stock fairly well from my previous exposure to it. I decided to look further.

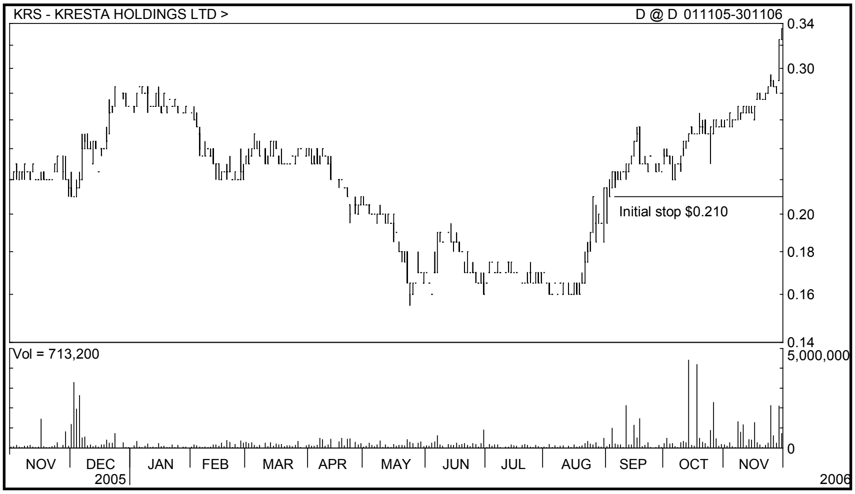
LIQUIDITY

I did not record the market capitalisation at the time, but I estimate now that it was about $35 to $40 million. Therefore, I was looking at a small stock.

The daily bar chart in figure 14.21 (overleaf) shows that Kresta traded most days. However, some days were traded at only one price and therefore may have been only one transaction.

The daily volume was quite variable, but overall, I felt that I would be able to get in and out with a little patience. It was clearly another small stock and I could not take on very many of these. I already had a small position in Fiducian (previous case study) in my stock portfolio at that time. As the Fiducian position was only 2 per cent of my capital, I decided to initially take a position in Kresta that was also 2 per cent of my capital. This was essentially within my overall plan. If the opportunity came later to increase my holding, I might need to first reassess the situation.

Figure 14.21: Kresta Holdings volume



POSITION SIZE

These were my calculations on the morning of 11 November 2006:

Buy price	$0.325	
Sell stop	$0.210	(see figure 14.21 for its positioning)
Risk	$0.115	

My capital at that time was approximately $1 870 000

Maximum position size (1 per cent of capital then) $18 700 ÷ 0.115 = 160 000 shares

If I invested 2 per cent of capital, I would buy $37 300 ÷ 0.325 = 115 000 shares

If I bought a position of 115 000 shares, my maximum risk was:
(115 000 × 0.115) ÷ 1 870 000 × 100 = 0.71%

I decided to go with this. However, since then I have reduced my maximum risk rule to 0.5 per cent of capital. Today, I would most likely not have gone ahead.

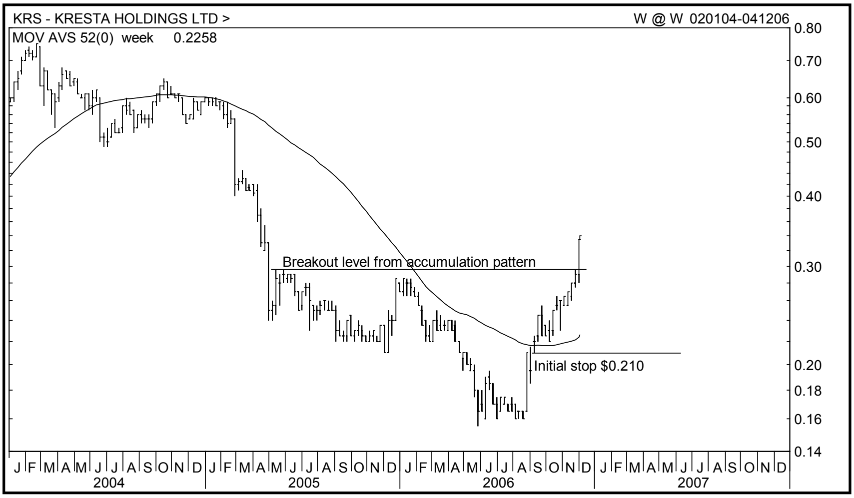
The only other alternative would have been to bend a guideline and take a position that was less than 2 per cent of my capital. If I had risked only 0.5 per cent of my capital at that time, I would have had a maximum position size of 80000 shares. I needed to be able to buy 115000 shares to take a position that was 2 per cent of my capital; 80000 shares would have been a position using only 1.4 per cent of my capital. This would have been a fair way beneath my guideline of 2 per cent. I would have needed to have a very good reason to stretch a guideline that far.

ORDER EXECUTION

On 1 December 2006, I found there was only scattered volume available. I bought two lots on that day. The first tranche was 88 000 Kresta at $0.325, but I had to bid $0.335 for another 22 000 shares. Since this brought my outlay to $36 000, I left it at that, a total of 110 000 Kresta. This buying campaign illustrates the greater slippage to be expected at times with small thinly traded stocks. It is also more likely to be significant with low-priced shares. Thirty odd cents per share is relatively low for Australian stocks.

From this point, I managed my investment from the weekly chart, which was as shown in figure 14.22 at the close of 1 December 2006. I have again marked my sell stop on the chart.

Figure 14.22: Kresta weekly chart



It is a very good idea to have sell stops marked on the saved charts of stocks in the portfolio. This is a wonderful discipline. The sell stop is the last level which, if the stock trades at or below it, I had already decided that the investment will have failed. This makes it much easier to avoid procrastinating. I have found that this simple procedure has helped me immensely in developing my skills. I now always act on my sell stops without hesitation. Every time I act ruthlessly on my violated sell stops, I can congratulate myself for executing a good investment. The outcome of the investment is not relevant here. There will always be some investments that will not work out as we hope. What matters is that we scrupulously follow our winning plan and cut potential losses as soon as a sell stop is triggered.

On figure 14.22, I have marked where I saw that Kresta had broken out upwards from its accumulation pattern. The theory diagrams show a nice rectangular accumulation pattern. However, real life can differ from the theory. Sometimes there will be the start of a rectangular pattern, as in this case. Then there will be a final drop as the weak holders are shaken out. Then the mark-up phase can get under way.

Another common pattern is where there is a plunge to the absolute low of the mark-down phase. This is followed by a strong rally. At that point a sideways accumulation pattern will form.

What I am suggesting here is that markets unfold in many variations on a theme. The key issue for an accumulation pattern is a rounding out of the mark-down trend into a sideways pattern of some description. Then a mark-up phase will begin. Sometimes there will be a clear upwards breakout, as with the above Kresta chart. These are the easier ones to manage. However, there are always some where there is no really clear breakout. With these, we are looking more at an entry into an established uptrend.

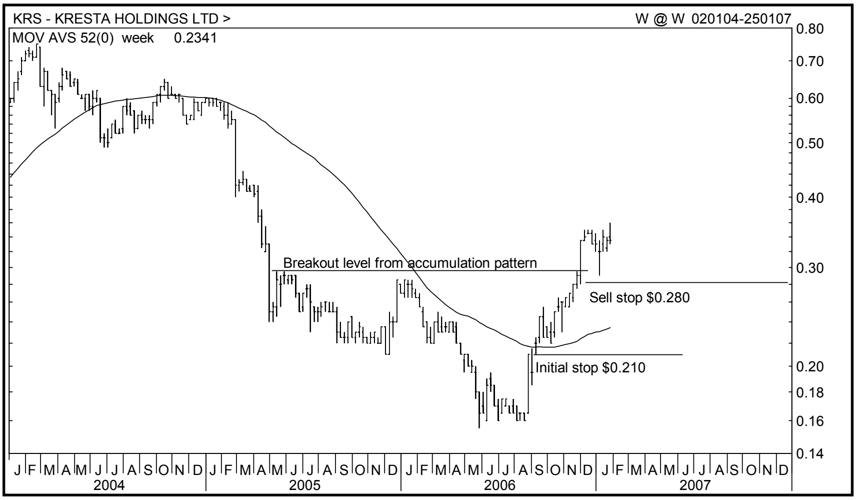
The important point to absorb, though, is that close similarity to the theory diagram is no guarantee of success. The patterns can take infinite forms.

INVESTMENT MANAGEMENT

After I bought it, Kresta moved higher. This was followed by a correction back to \$0.290. After the price then rose to a new high for the trend on 25 January 2007, I was able to move my sell stop up to \$0.280 as shown on figure 14.23.

This sell stop is one full cent below the low of the trough formed in January 2007. I could have made it \$0.005, but I wanted to be more than one tick below the trough (the tick size for stocks priced \$0.100 to \$2.000 on the Australian Securities Exchange is \$0.005). So, I went with \$0.280, even though that was 3.4 per cent below the trough. With low-priced stocks, the guidelines have to be a little flexible. I would never bend a rule, but a guideline allows me to do so if there is a good reason, as there was in this case.

Figure 14.23: sell stop placement



Since Kresta was now trending upwards strongly, I considered building my position. On 2 February 2007, as it happens, I had been stopped out of the other small thinly traded stock in my holding: Fiducian (see case study 4).

Although I did not know it at the time, I then did something which turned out to be an expensive lesson. My records show that I knew this was a small stock with limited liquidity. So, I made my position size calculation on risking only 0.5 per cent of my investment capital. The position size calculation is in my records like this:

Purchase price	\$0.375
Sell stop	\$0.315
Risk	\$0.060

Maximum position size: 0.5% of capital = \$9800

Maximum position = 9800 ÷ 0.06 = 163 000 shares

Desirable investment = 4% of capital

4% of capital = \$79 000

Therefore, I should move my position to 79 000 ÷ 0.375 = 210 000 shares

This was more than my maximum position size, albeit I had chosen to use 0.5 per cent of capital, which was half of the rule in my investment plan at that time. Therefore, my maximum position size of 0.5 per cent of capital was now a rule. I would not break a rule. However, my position building guidelines were flexible. I felt comfortable building to less than 4 per cent, which was a lower risk situation than exceeding my position building guideline. I then made the following calculation:

Position to buy on guideline	210 000 shares
Maximum position rule	163 000 shares
Already held	110 000 shares
Buy now	53 000 shares

On 2 February 2007, I bought 53 000 Kresta at $0.375.

Alert readers might have noticed the mistake I made. I broke a rule. I had used a sell stop in this calculation of $0.315. However, my sell stop had already been moved as far as my investment plan rules allowed —to $0.280.

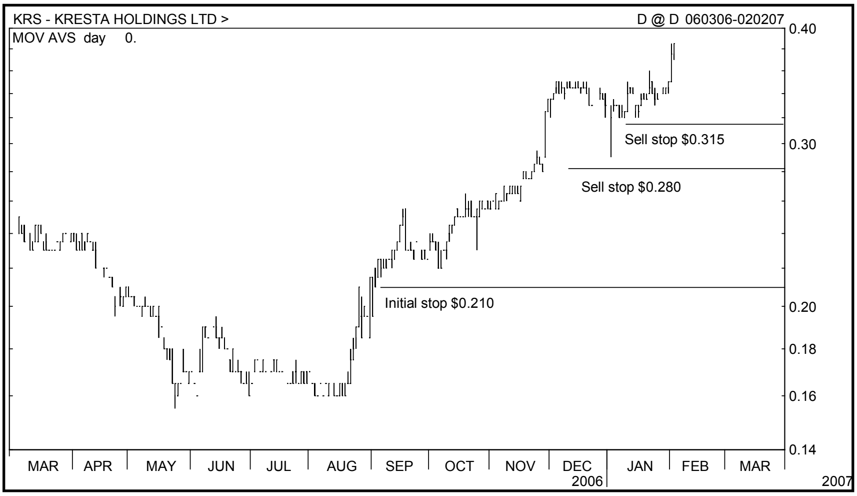
If I had not broken this rule, I would not have bought more of Kresta, unless I had moved above the minimum risk of 0.5 per cent of capital, which I had adopted for this investment.

My investment plan rules make it mandatory for me to position my sell stops under the last trough in the trend. I had done that correctly at $0.280. Therefore, how did I come to set the sell stop at $0.315 in building this position? I could tell you I just made a mistake. However, that was not so, in the sense that I knew I was doing it.

I was looking at the chart shown in figure 14.24. It was a daily line chart. I had chosen to ignore the daily bar which had spiked down to make the low of the trough. Instead, I had picked up a very short term support level on the daily chart.

At that time, I was still using daily charts. Even so, it was no excuse. I had broken a rule. There was nothing in my plan about using short-term support levels as the basis for sell stops. Such a rule would have defied the logic of my investment plan. I was riding a trend while it lasted. The trend was defined as higher troughs. Any sell stop above a trough would be setting an exit point while the trend was still intact.

Figure 14.24: sell stop movement



There is nothing to prevent me selling out of a stock before it has triggered its sell stop. This is only if my market exposure strategy calls for me to sell some positions, or I am anticipating a sell stop may be violated. However, that is a totally different situation to changing the logical basis on which a sell stop is set.

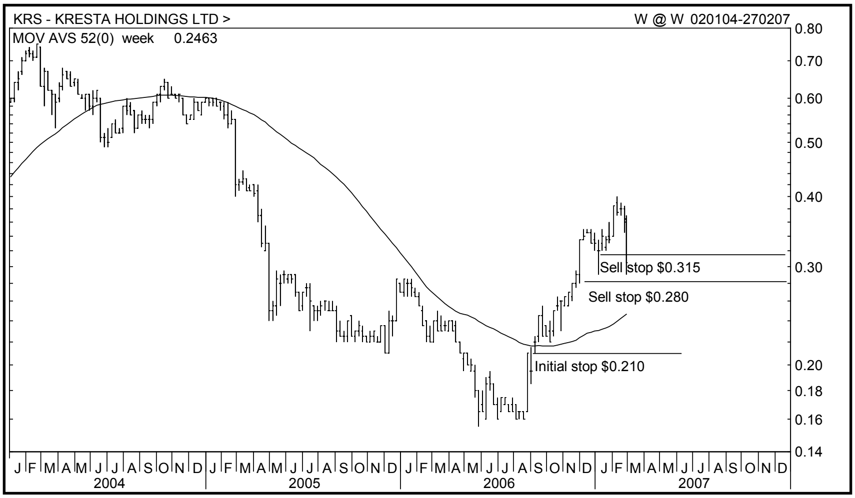
The lesson I have learned out of this, and a couple of other similar transgressions over the years, is twofold:

1 The daily bar chart is not my time frame. I have now changed my investment plan to work on weekly bar charts only for setting sell stops. I only use daily bar charts when finessing entries and exits on the day I act on signals or decisions.

2 Never break a rule, no matter how it can be rationalised. Bend a guideline with sound reasons, but never break a rule.

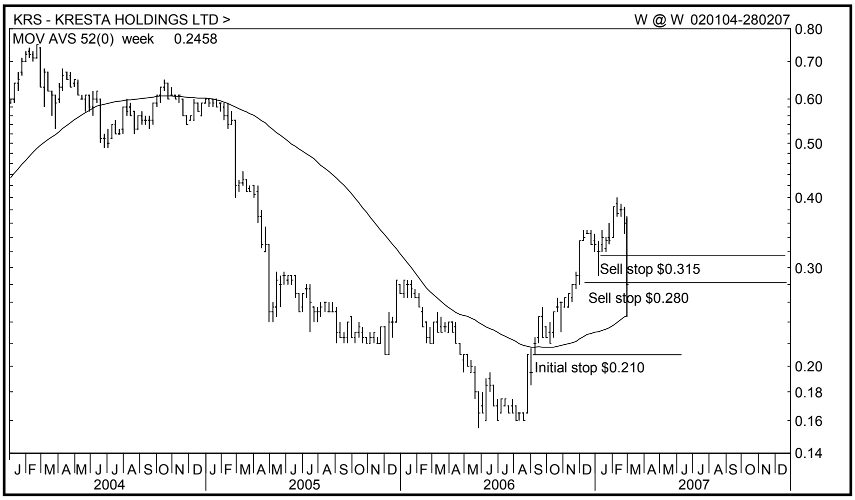
On 27 February 2007, Kresta fell abruptly through my sell stop of $0.315. The chart as it then looked is shown in figure 14.25 (overleaf).

Figure 14.25: price falls through sell stop



I did not act on that day. Maybe I was busy and did not see it until after the market closed on 27 February 2007. Figure 14.26 shows what happened the next day.

Figure 14.26: Kresta falls to $0.250



Kresta's half-year report had been released on 27 February 2007. This report was not well received and had triggered the fall. I sold my entire holding the next day, 28 February 2007, for $0.250. There was over a million Kresta traded that day, so there was plenty of volume. Clearly the reaction to the news the day before had triggered more sell stops than mine.

For those who would like to know what happened to Kresta after my investment campaign, figure 14.27 shows the weekly bar chart to December 2008.

Figure 14.27: Kresta to December 2008

After I sold my position, Kresta traded basically sideways for over a year. Then around mid 2008, there was a downward breakout from this sideways pattern. At the end of the chart, Kresta seems to be trying to stabilise above $0.160, which is around the area where it found support in 2006 and arrested the decline. Time will tell what pans out from here.

Investment result summary

Purchase cost	$55 915
Sale proceeds	$40 705
Capital decline	($15 210)
Dividends	$1100
Franking credits	$471
Total return	($13 639)

My time weighted average capital (TWAC) for the financial year 2006/07 was $1 490 633

My return on my TWAC = –13 639 ÷ 1 490 633 × 100 = (0.91%) of capital

In other words, a three-month campaign in Kresta, employing 2.9 per cent of my capital, had subtracted 0.91 per cent from my return for that year.

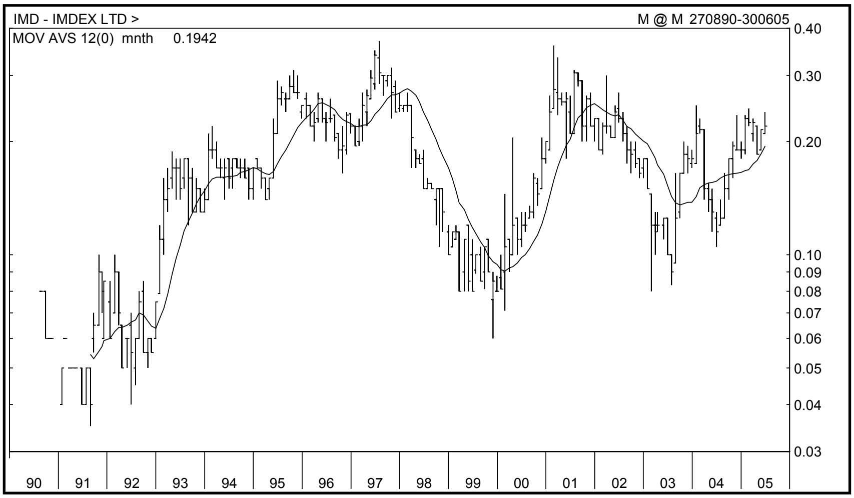
The negative lesson was that I broke a rule. However, I did learn something out of that mistake and subsequently tweaked my investment plan.

The positive lesson was that, when the crunch came, I acted ruthlessly on my sell stop to minimise further losses.

CASE STUDY 6: IMDEX (IMD)

Imdex is an interesting case study because of the way its chart changed character. On the odd occasions when I had brought up its monthly bar chart in the past, it looked as shown in figure 14.28.

Figure 14.28: Imdex



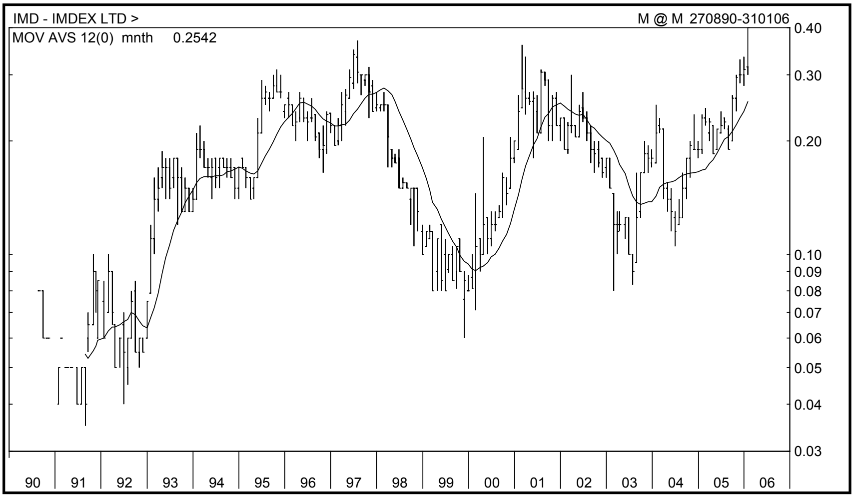
I have to admit that I had dismissed it rather quickly as being one of those charts which did not fit either the value model or the growth model. Now that I look back on it today, it is possible to say that it did have features of the value model. There is a basic cyclical pattern. However, the accumulation and distribution patterns were not well defined. The exception may have been 1999–2000. However, the upward and downward spikes around that time were most disconcerting.

I believe that I was correct in not spending much time on it. It would have been possible to grow capital on the mark-up phases 1992–97 and 2000–01. While this is true, it is really a case of hindsight bias. It looks easy now, but it would have been difficult to manage in real time.

Basically, this one was just too difficult. There are usually many more stock charts which are far easier to exploit. There is no need to sweat over the hard ones.

On 1 February 2006, Imdex appeared on one of my technical analysis filter runs and its chart had changed in an important way. The chart I was looking at is shown in figure 14.29.

Figure 14.29: Imdex February 2006



Imdex had been trending upward since 2003. However, what had changed is that the closing price for January 2006 was $0.400. This indicated a breakout above all past trading levels. I always see this as a positive. Old all-time highs are very significant and are difficult to get past. There is invariably some churning as sellers come in around the old high and buyers then battle to get past them. Imdex had hesitated in the low to mid $0.30 range before it had then spiked above the old highs made in 1997 and 2001. We can see that hesitation near the old highs in hindsight. However, this could be only because it has become significant once we consciously look for it.

The second reason I like this price action is that all past trading in a stock represents someone who bought the stock. Many of those buyers will have been locked in, reluctant to realise losses. When the price comes back to near their buying price, they will be tempted to sell in relief that they can get their money back. This activity is what causes the charting phenomenon of resistance. The key issue is that, once a stock rises above all past trading levels, there is no more overhead of resistance to worry about. They are what I call 'blue sky' stocks. They are in clear air above all the pollution of historical trading. Therefore, I decided to look a bit more closely at Imdex.

Company profile

Imdex supplies drilling products and services in Australia, South Africa and 20 other countries to the mining, oil and gas and horizontal drilling industries. Imdex had sold off some unwanted businesses and acquired others to build its core activities. In short, it was reinventing itself. Moreover, Imdex was a supplier to the booming resources industry. It was therefore in one of the hot sectors of the market at the time.

Price/earnings ratio

Its price/earnings ratio was 16. This compared to the market average price/earnings ratio of 16.48. This was not as low as I would have liked for a value model stock. However, its half-year result announcement was due in less than a month. The smart money was in the market backing a good increase. When Imdex announced their half-year result late in February, the price/earnings ratio at the 31 January 2006 price would have been 10.25. This was more than satisfactory for a value model stock.

Dividend yield

Imdex had not paid a dividend since 1997. This was one reason it had not come up on my fundamental analysis filter runs. That filter has a requirement that the company pays a dividend.

This set me back, because my investment plan calls for me to avoid stocks that do not pay a dividend. After looking closely at Imdex, it seemed to me that its recent results would have allowed it to consider resuming dividend payments. In fact, if the recent growth in earnings continued, dividends may well be resumed in the present year. I decided to back my research judgement and consider building a position.

In hindsight, I was correct. Imdex announced the resumption of dividends three weeks later. For the year to 30 June 2006, Imdex paid 2¢

in dividends. At the 31 January 2006 price, those dividends gave a yield of 5 per cent. The market average dividend yield at that time was 3.57 per cent. Dividends were then increased strongly in the following years.

Debt-to-equity ratio

This was not a specific guideline in my investment plan at that time, so I did not record it. However, as best I can judge it now, its debt-to-equity ratio was quite low, in the range of 5 to 15 per cent.

Conclusion: margin of safety

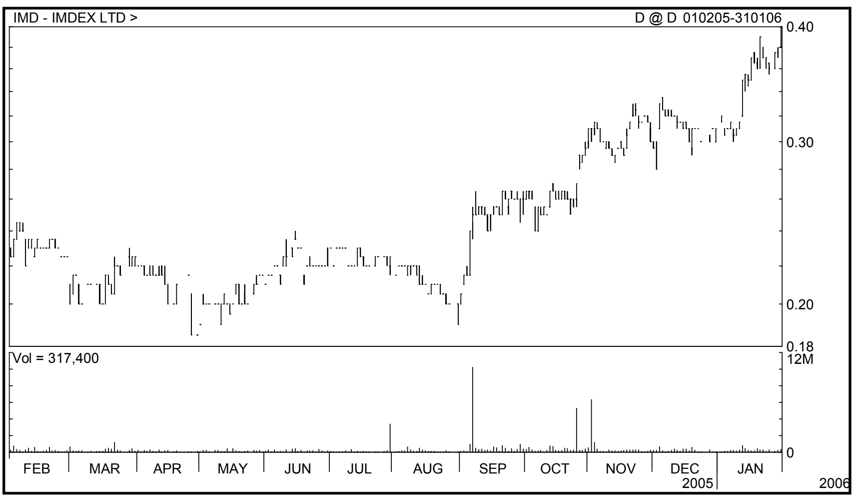
The ratios were a little equivocal. However, the chart looked good and the company had reinvented itself in a booming industry. I anticipated that the imminent results announcement would change this. Imdex would then come within my plan. If not, the trend would fail and I would back right off.

Liquidity

I did not record Imdex's market capitalisation at the time. My best estimate now is that Imdex had a market capitalisation of around $60 million.

The daily bar chart with volume in the sub-chart is shown in figure 14.30.

Figure 14.30: Imdex volume



At first sight, this was not that encouraging. It was what I would expect for a smaller company. It traded most days. There were quite a few days when it only traded at one price, which suggested maybe only one transaction.

However, when I went into the database and looked at the daily volume numbers, there seemed to be enough volume for me to transact my business with a modicum of patience.

Position size

When I look back at my records, these were my calculations:

Purchase price	$0.400
Sell stop	$0.350
Risk	$0.050

1 per cent of capital was then $13 100

Maximum position size: 13 100 ÷ 0.05 = 262 000 shares

2 per cent of capital was then $26 300

Desirable position: 26 300 ÷ 0.40 = 65 750 shares

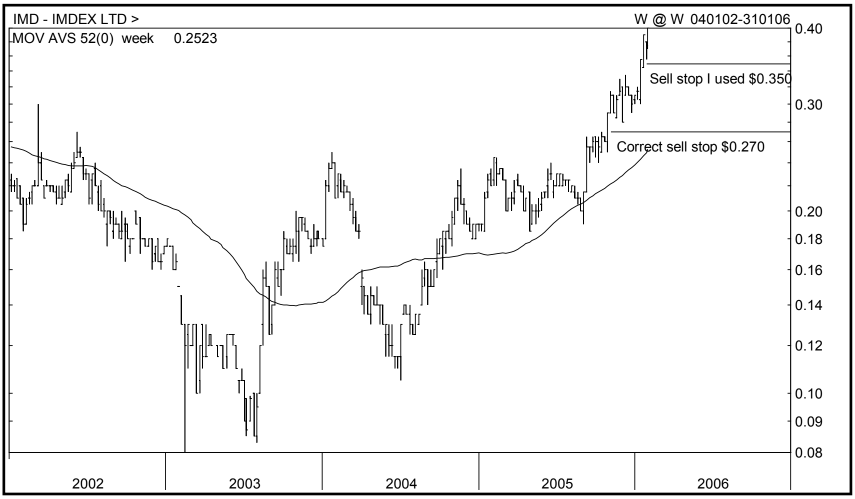
On the surface this all looked fine. I was allowed, on my 1 per cent maximum risk rule, to buy up to 262 000 shares.

To buy an initial position using 2 per cent of capital, I only needed to buy 65 750 shares. So everything looked fine, until we look at the weekly bar chart below.

In 2006, I was still using daily bar charts. I had clearly set my sell stop under a support level on the daily chart. In other words, the same deviation from my plan as was explained in the previous case study on Kresta. This was one of the investments which have helped to shape the change in my investment plan to now focus on my correct time frame. That means the weekly chart.

In figure 14.31, I show the sell stop which I used for the calculations at $0.350 and also the one I should have used at $0.270.

Figure 14.31: sell stops



What is interesting is this. Suppose instead that I had used my rules and guidelines properly. Not only that, but suppose that I had used the rules and guidelines that are now firmly in my investment plan. The calculations would have looked like this:

Purchase price	$0.400
Sell stop	$0.270
Risk	$0.130

0.5 per cent of capital was then $6550

Maximum position size 6550 ÷ 0.05 = 50 400 shares

2 per cent of capital was then $26 300

Desirable position 26 300 ÷ 0.40 = 65 750 shares

This suggests that, if I had placed my sell stop correctly and had only risked 0.5 per cent of capital, I would have been limited to buying 50 400 shares, instead of 65 750 shares.

My guess is that I would have bought 50 000 shares. This would observe the rule on maximum position size. Instead, I would have slightly bent the 2 per cent minimum investment guideline. The cost of 50 000 shares would have been $20 000 and that position would have been 1.53 per cent of capital.

The alternative would have been to monitor the trend and look for another entry point where I was completely within my rules and guidelines.

However, this is all academic. I have gone through it to draw out the lesson from evaluation of the investment. It reinforces the need to go back over all of our investments afterwards, checking how well we followed our plan. Above all, we should be looking for ways to improve what we do.

In addition, when we go back over our records, two things will tend to stand out from my experience of doing it myself. Firstly, it is surprising how often we sneak outside the rules and guidelines of our plan. We may or may not be conscious of doing this at the time. More likely, we will have let its memory slip away and in hindsight we don't even remember all these little transgressions.

Secondly, we will be struck by how powerful the review can be in improving our investing process. We should be able to see what we did that was outside our investment plan and we luckily got away with. This behaviour makes us lazy and sets us up to break the rules one time too many and end up paying the penalty. It has greatly improved the consistency of my decision-making over a long period.

This does not mean that we should laboriously analyse every investment we have made. It may be enough to regularly choose four to six investments from the last year. The choice should be random, except that half should be successful investments and half should be unsuccessful investments.

The only thing which I know that is more powerful in learning to be a good investor is to teach the methods we use. However, years of self-examination and realignment of decision-making must come before that is possible.

Managing the investment

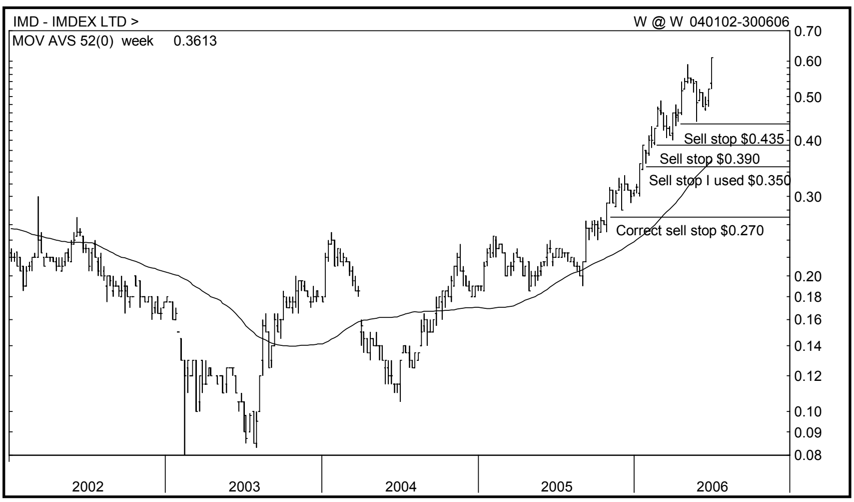
Returning to the case study, I was able to buy 65 000 Imdex that day, which was 1 February 2006. I was able to complete my entire order at \$0.400 per share. Figure 14.32 shows that Imdex moved up nicely from my entry point. By 21 April 2006, it had formed a clear higher trough on the chart and moved to a new high for the trend above the previous peak. I was able to move my sell stop up to \$0.390, two ticks below the trough low of \$0.400.

On my investment plan, I should have looked at increasing my position on the rise from the trough at \$0.400. I should also have built the position further on the rise in April above the last peak in the trend. However, I had experienced a bad accident late in March 2006 while bushwalking. I spent a couple of weeks in hospital and a long time recovering at home, unable to work at all. So, I missed these opportunities.

Figure 14.32: sell stop moved

Nevertheless, Imdex continued to unfold in a great upward trend. By June 2006, I was doing a little work. As figure 14.33 shows, Imdex had made a higher peak, then a higher trough at $0.440. By 30 June 2006, it had moved above the last peak in the trend. I decided to increase my position.

Figure 14.33: sell stop moved under higher trough



These are the calculations I made in my diary:

Purchase price	\$0.580
Sell stop	\$0.435
Risk	\$0.145

0.5 per cent of capital was then \$8500

The correct result here was 58 620, but I transcribed it incorrectly in my diary as the rounded answer 56 600

4 per cent of capital was then \$63 600

Desirable position size: 63 600 ÷ 0.58 =	110 000 shares
I already had	65 000 shares
I should now buy	45 000 shares

Alert readers will have noticed the problem here. If my maximum position size was 56 600 shares, I was not able to move to 110 000 shares.

I went ahead and bought 45 000 shares at \$0.580 on 30 June 2006.

Why I did this, I do not know now. I made no record of what I was thinking. The only thing I can think of is that, not being very well, I mistakenly compared the maximum position size with the 45 000 additional shares and thought it was within my plan. I will never know exactly how I made this mistake. It is not something I would normally do. Now that I am using the position size calculator, this mistake will be avoided. The logic within the position size calculator would have exposed my mistake in a very obvious way.

It should be noted that I had by then started to use 0.5 per cent of capital for my maximum position. However, I was not consistent according to my records. I made two calculations that way on 30 June 2006, but reverted to 1 per cent of capital for calculations a few weeks later.

It is a poor crutch to lean on now, but had I used 1 per cent of capital as my maximum risk, I would have been allowed by my plan to bring my total position up to 110 000 shares.

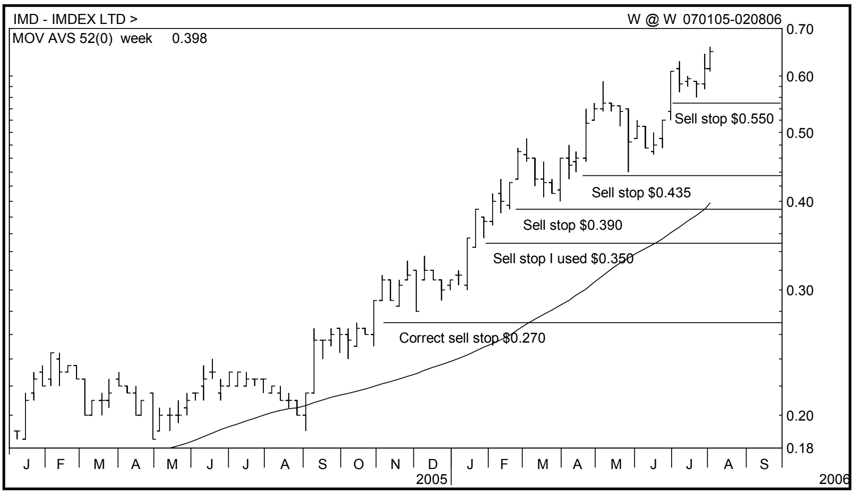
Another point I picked up on was that my sell stop in the 30 June 2006 calculation was only one tick below the low of the trough. This is fine in the sense that it was about 2 per cent below the trough. However, I had chosen to place the stop two ticks below the trough earlier.

Imdex continued to move up beautifully for me. It formed a new higher peak, then a new higher trough. By 1 August 2006, the price again moved above the highest peak in the trend. I decided to complete building my position.

Before I explain the mechanics, alert readers will have noticed something else in the previous pages. This is that my plan has guidelines to build positions on potential troughs as well as breakouts above the last peak. I had not chosen to do that. This seems like some missed opportunities. However, look closely at figure 14.34. The price bounced off the lows of what were to be the last few troughs very quickly. In short, there was not realistically enough time to act.

That is not all. The other factor is that my personality prefers to buy new highs rather than try to pick new troughs. I am working on this, but it is not easy to change instinctive behaviours.

Figure 14.34: price bounced off lows



My calculations reverted to the 1 per cent of capital maximum position size and were as follows on 1 August 2006:

Purchase price	$0.625
Sell stop	$0.550
Risk	$0.075

1 per cent of capital was then $16 000

Maximum position size: 16 000 ÷ 0.075 = 213 000 shares

6 per cent of capital was then $97 000

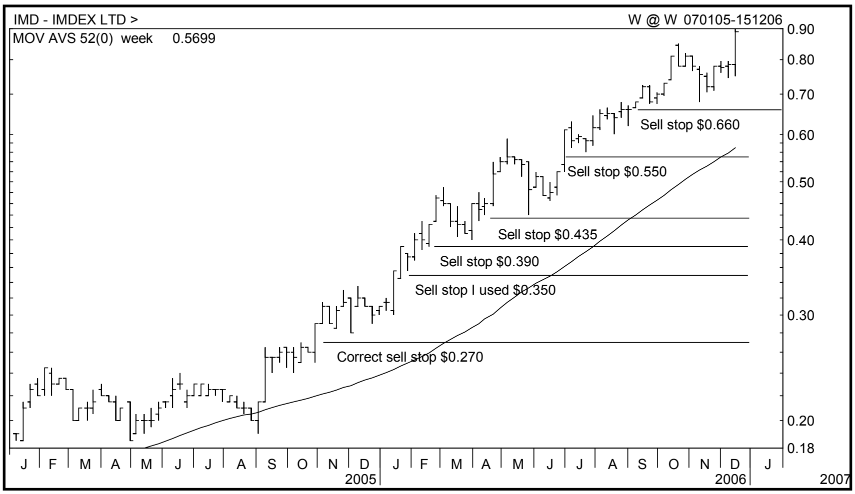
Desirable position size: 97 000 ÷ 0.625 =	154 000 shares
I already had	110 000 shares
I should now buy	44 000 shares

Other than the reversion to 1 per cent of capital (which was my formal plan at that time), I seem to have made the right calculations this time.

However, I then ran into a far from unusual situation. The price offered for Imdex was moving up steadily. I had calculated buying at $0.625, but by the time I tried to execute the transaction, the market spread in Imdex was $0.630–$0.640. I left my order size at 44 000 shares. However, I ended up securing only 5517 shares at $0.635 and had to bid $0.640 for the balance to complete my order. I ended up outlaying an extra $660 over my calculations, which was not material. Nevertheless, had the price run even further away from me, and I decided to chase it, I would have needed to revise the order size down from 44 000 shares.

From there, Imdex rose steadily in a very orderly upward trend. In October 2006, it formed a strong higher peak. There was then a correction to a new higher trough at $0.680 in November 2006. From there, Imdex rose strongly above the October 2006 peak in December 2006. At that point, I moved my sell stop higher. I situated it at $0.660, four ticks below the low of the October 2006 trough. Figure 14.35 shows the situation at that point.

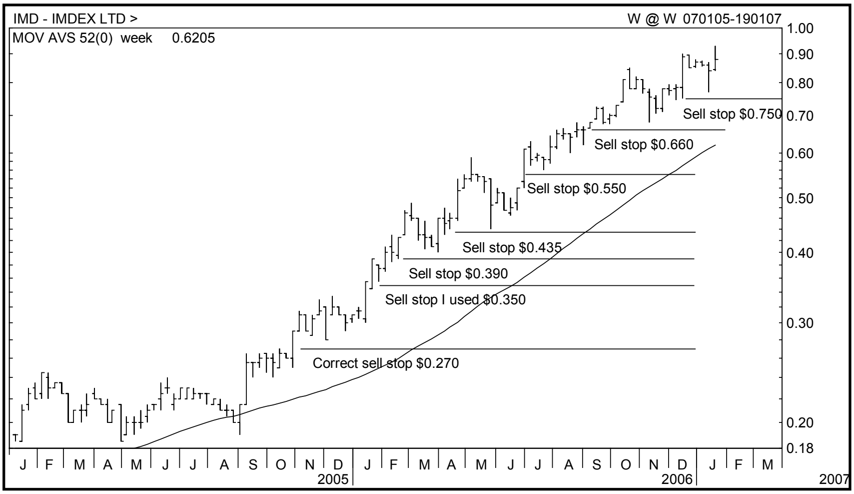
Figure 14.35: sell stop movement



The trend continued and on 19 January 2007 a new high for the trend enabled me to move my sell stop to $0.750, four ticks below the most recent trough earlier in January 2007. Figure 14.36 shows how the chart appeared at that point.

I am not sure now why I chose $0.750 for the sell stop. Two ticks would have been enough ($0.760), otherwise five ticks ($0.745) would have avoided the round number of $0.750.

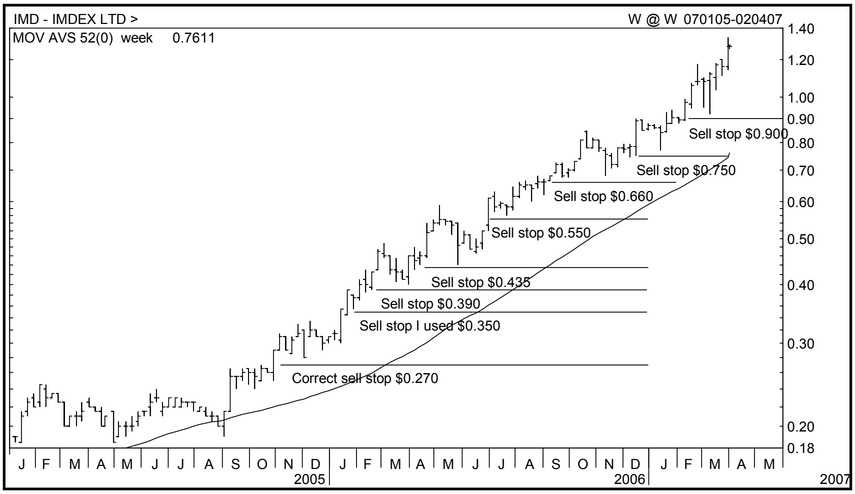
Figure 14.36: new trend high



After that, the trend continued to unfold strongly. However, in March 2007 it became a little more volatile than it had been so far. A new high for the trend formed at the end of March 2007. The previous trough had formed at $0.920, so I moved my sell stop up to four ticks below that at $0.900.

The chart now looked as shown in figure 14.37 (overleaf).

Figure 14.37: increased volatility



I was now conscious that the position was approaching the time when my guideline for taking profits suggested selling half my position.

In considering this action, I was still working on my old investment plan of selling when the position had doubled in price. This is a good example of the difficulty managing this guideline, so it is worth discussion.

My purchases had been:

- 65 000 Imdex at $0.400 total cost $26 030
- 45 000 Imdex at $0.580 total cost $26 130
- 44 000 Imdex at $0.640 total cost $28 162.

The issue is simply: what is double the purchase price? I had three purchase prices. They were a fair way apart. This may not have been as bad if I had not had my accident, which forced me to delay building the total position. However, this is always an issue to some extent.

One approach is to work out an average cost. I had bought 154 000 Imdex for a total cost of $80 322. This gave me an average cost of $0.520. At the end of March 2007, Imdex had closed at $1.290. On this approach it had doubled in price.

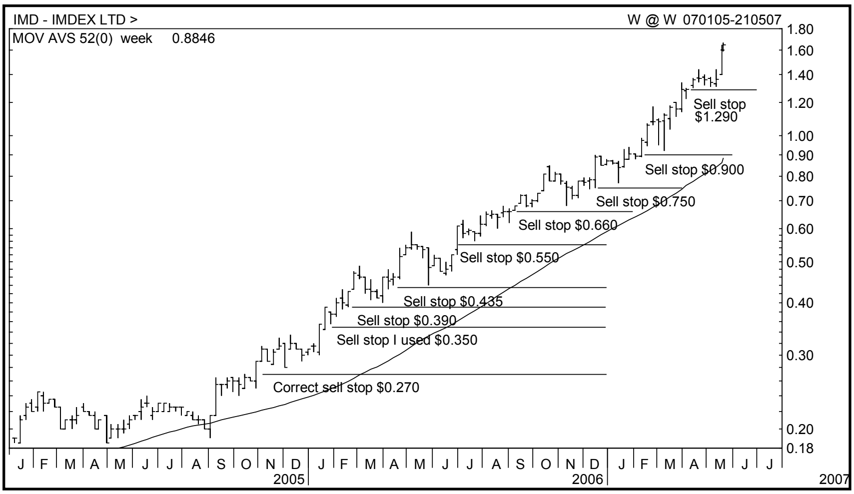
Therefore I should sell half the position on my guideline. Guidelines are flexible to some extent. This is where I took advantage of the wriggle room. It made sense to me to keep things simple by selling the first tranche of shares I had bought. I had bought them more than 12 months before, so they were taxed more lightly. However, if I also sold some of the second tranche that I had bought, they would be taxed more highly. The 65 000 share parcel which I sold was not quite half of my total position of 154 000 shares. It was only 42 per cent of it. I judged that this parcel was sufficient to sell at that point. Selling half is a guideline, not a rule.

I avoid this problem now by changing my investment plan slightly. I have my spreadsheet show what percentage of capital each position represents. Once a position grows to 12 per cent of the portfolio, my guideline is to bring it back to 6 per cent.

On 4 April 2007, I sold the 65 000 Imdex for \$1.245. I have noticed now that this happened by chance to yield \$80 836, which was just over the total cost of my full position before the sale. I doubt that this was a consideration in my mind at the time and is purely an interesting aside.

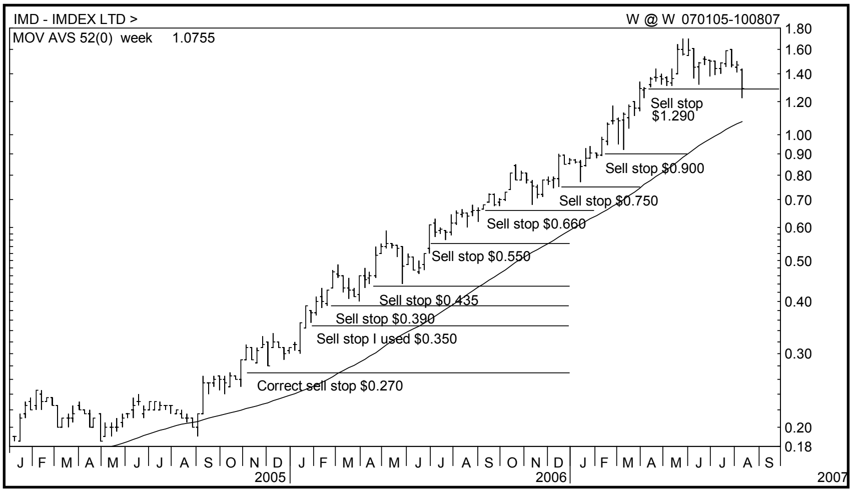
Figure 14.38 shows that by 18 May 2007, there was a need to raise the sell stop again. I raised it to \$1.290, four ticks below the recent trough low of \$1.310.

Figure 14.38: sell stop raised to \$1.290



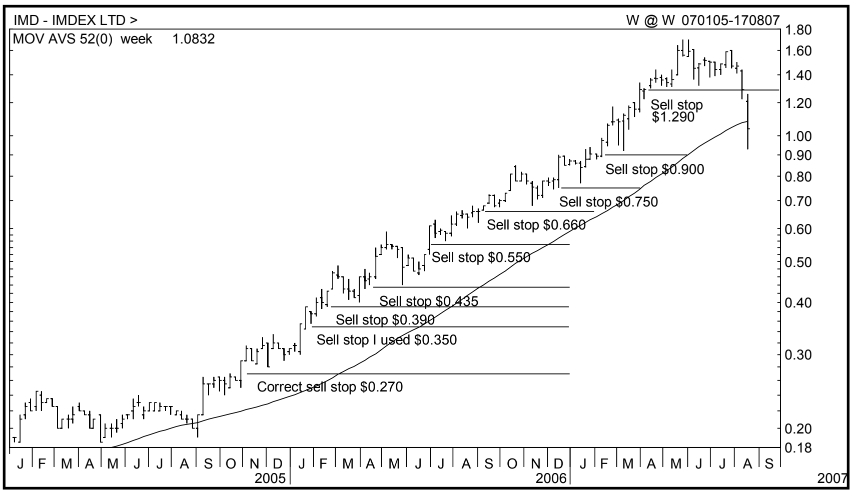
Imdex then rose a little further. It traced out a sideways pattern above my sell stop, which did not need lifting. I was now looking at the possibility of one of my alternative sell signals, which is a breakout below a sideways pattern. As it happened the sell stop was already in the right place for that sell signal. Then the sell signal came in the week to 10 August 2007, as shown in figure 14.39 (overleaf).

Figure 14.39: sell signal



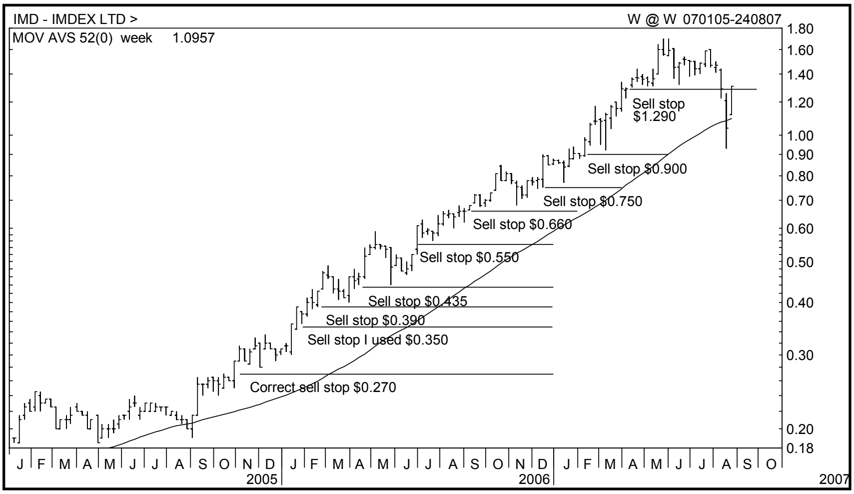
The following week, Imdex sold off very badly. At that time, I was in the UK visiting our daughter. It is not always easy to manage investments while travelling. For a time I was out of London and did not even have internet access. The next week after the sell signal was indeed nasty, as is shown in figure 14.40. Had I been at home I am certain that I would have sold urgently at the offer.

Figure 14.40: price fall



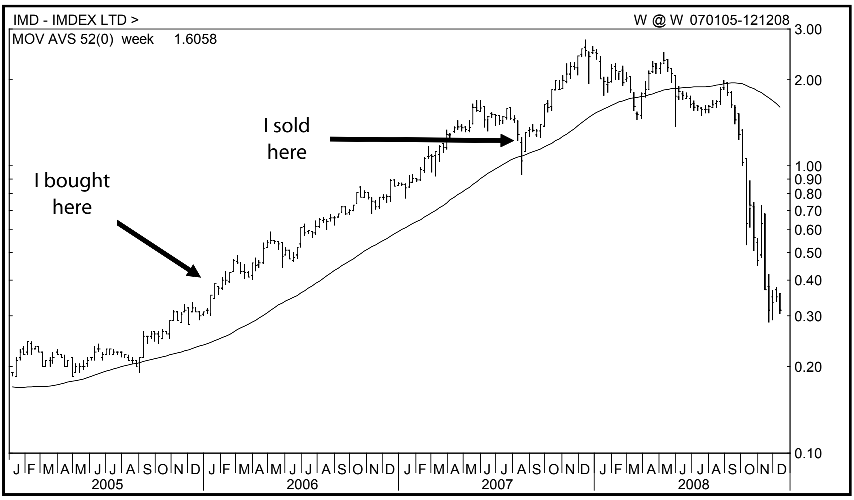
Luckily for me, by the time I had access to the internet two weeks later, there had been a rally and I was able to sell the entire holding at various prices between $1.800 and $1.950 on 20 August 2007. The chart to the week ending 24 August 2007 was as shown in figure 14.41.

Figure 14.41: price rally



For those who are interested in what happened after that, the chart to 17 December 2008 is shown in figure 14.42.

Figure 14.42: Imdex to December 2008



There are a number of interesting points to come out of this campaign in Imdex.

Firstly, there is the issue of how much of the unrealised capital growth had to be conceded at the end of the campaign. It was exacerbated by my being overseas and away from the internet. However, this situation is not uncommon with smaller stocks and is simply part of the territory. I accept it as being an inevitable part of my investment plan.

Secondly, we all need to take holidays. I generally like to keep in touch through the internet. Had I been in London, I would have had that daily access. I have been able to keep in touch this way for extended periods in the past when working or on holidays in London, Canada, the US, Russia, New Zealand, Vanuatu and Fiji. This was nearly impossible before the internet came along.

I have also had other trusted people watch my portfolio and execute my sell stops when I have been in Nepal for a month at a time on four occasions. It worked well, but it is not a task that anyone can take on easily.

Readers might like to set automatic sell stops with their broker when they are travelling. Of necessity, this does not work well with the limits mandated by Australian brokers.

Finally, I need to summarise how the campaign in Imdex finished up.

Investment result summary

Purchase cost	$80 322
Sale proceeds	$186 230
Capital growth	$105 908
Dividends	$3750
Franking credits	$1599
Total return	$111 257

Because my campaign in Imdex extended over three financial years, the calculated returns are quite complex. To keep it simple, I have made a very rough calculation as follows:

The total return was $111 257.

My time weighted average capital (TWAC) for the financial year 2006/07 was $1 490 633.

Using that as a proxy for the TWAC for the whole campaign, the total return added something like 7.5 per cent to my return on capital.

Imdex was one of the great investments, in that it doubled in price and then some. I was slow building it and slow getting out again due to personal circumstances. I am looking in my investment plan to find one of these investments each year or so of a bull market. If I am to beat the market, I need to have the one out of every 10 or so investments that emulates this one.

CASE STUDY 7: MINCOR RESOURCES (MCR)

INTRODUCTION: RESOURCES STOCKS

My investment plan basically keeps me away from resources stocks. Most of them will be excluded from my technical analysis filter, because my filter rules require a company to make a profit and pay a dividend. This means that a resources company will only come through the filter if it is a producing miner and has registered a new yearly high in the week of the filter run.

Resources companies operate in a very volatile environment. Some of the risk factors are:

- Commodity price booms and busts.
- Currency fluctuations.
- Hedging risks in metal prices and currency.
- Technology challenges in ore composition, designing, building and operating plant.
- High debt associated with development of resources.
- Huge risks in exploration.

In addition, resources companies are in many ways more difficult to analyse and value than industrial companies. Price/earnings ratios are not a valid measure, because a miner is exploiting a wasting asset and has no maintainable earnings stream. A skilled analyst has to model the operation over its life and estimate the ongoing pattern of cash flow. The cash flow stream then has to be discounted back to current value. Everything in this process requires estimates of prices, currencies, reserves and much more.

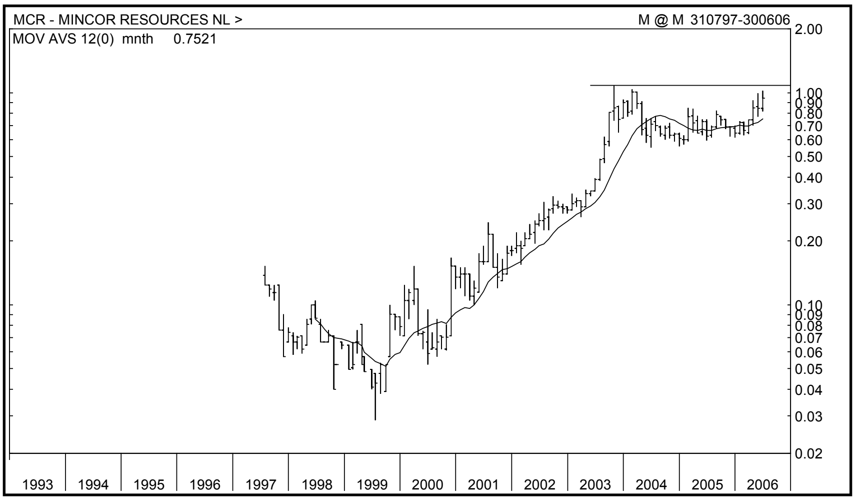
This means that, unless I am to become a skilled resources analyst, the margin of safety aspect of my investment plan will be less firmly based than for an industrial stock.

Even so, producing resources stocks can show enormous gains in bull markets. It would be silly to entirely disregard them. Therefore, in a boom period, I will look for a few of the better ones to diversify my stock portfolio. That is the benefit, but the risks are high. The key to controlling that risk is discipline. I have learned over 40 years that the main things to be aware of and to manage are:

- Never invest in explorers. Stick to established producers.
- Trust the chart entirely. Only invest in breakouts and uptrends.
- Be content to take the easy part of the trend to the bank. Never get carried away and overstay the opportunity.
- Resources stocks should be only a small part of my stock portfolio.

During April, May and June 2006, Mincor Resources had come up on my technical analysis filter as making new yearly highs. At the end of June 2006, its monthly bar chart showed the situation on the chart in figure 14.43.

Figure 14.43: Mincor Resources



The last three monthly bars were the ones that had been generating the filter signal. Readers may wonder why I had not already acted on these signals.

My concern was that old all-time high prices are known by every chartist as levels where we can expect strong selling pressure. With the all-time high not far above the breakout levels, I took the cautious stance of waiting for a break to blue sky above the 2003 high. This level is marked on the chart with a horizontal line.

The breakout into blue sky came on 5 July 2006. The weekly bar chart at the end of that week is shown in figure 14.44.

Figure 14.44: price breakout

COMPANY PROFILE

Mincor is a nickel miner and explorer. It has three major mines in the Kambalda region of Western Australia.

PRICE/EARNINGS RATIO

This is not relevant for a miner. I did not record it in my diary.

DIVIDEND YIELD

Dividend yield is also not relevant for miners. This is because they do not have a stable dividend policy. This makes dividend yield an unreliable measure for mining stocks. I did not record it in my diary.

LIQUIDITY

This was not an explicit part of my investment plan, so I did not record it. However, as far as I can judge it, Mincor's market capitalisation at the time was in the vicinity of $200 million. Clearly, it was a substantial company.

Figure 14.45 is a daily bar chart with volume in the sub-chart. It shows that Mincor was a liquid stock. It trades every day and over a range of prices. Except for the end-of-year holiday period and a dull period late May–early June 2006, there was more than adequate volume for my investments to be executed easily.

Figure 14.45: Mincor volume

POSITION SIZE

When I look back at my records, these were my calculations:

Purchase price	$1.145
Sell stop	$0.770
Risk	$0.375

1 per cent of capital was then $16 000

Maximum position size: 16 000 ÷ 0.375 = 43 000 shares

2 per cent of capital was then $32 000

Desirable position: 32 000 ÷ 1.145 = 28 000 shares

This now seems quite straightforward. My maximum position size in my investment plan at that time was 1 per cent of capital. Had it been the 0.5 per cent of capital, which it is now, the maximum position would have been only 21 000 shares. Had that been my plan at that time, I would have had to scale back my initial position size, or seek an entry point where the sell stop was closer to the buy price.

Nevertheless, there was an issue here of a different kind. Referring back to the chart before last, it is evident that I chose $0.770 as my sell stop. This was the exact low of the trough under which it was situated. The trough was chosen correctly. However, my sell stop should have been a tick or two below it. At that price range, a tick on the Australian Securities Exchange is $0.005, so my sell stop should have been $0.760 (two ticks) or $0.755 (three ticks). Five ticks ($0.745) may have been even better, avoiding the round number at $0.750. This is another example where reviewing an investment campaign reveals small transgressions of the investment plan. Uncovering them in later reviews is a good way to refine our investing skills. This point cannot be over emphasised.

On 7 July 2006, I was easily able to buy 28 000 Mincor for $1.145.

Mincor then moved higher. Soon it seemed to be putting a new higher trough in place. I had not been able to lift my initial sell stop. However, on 7 August 2006, it seemed that Mincor had moved off its next higher trough, so I made the calculations to build my position. They were as follows:

Purchase price	$1.160
Sell stop	$0.770
Risk	$0.390

1 per cent of capital was then $16 200

Maximum position size: 16 200 ÷ 0.39 = 41 500 shares

4 per cent of capital was then $64 900

Desirable position: 64 900 ÷ 1.16 = 55 900 shares

This position was larger than my maximum position rule allowed, so I had to scale back my new position size as follows:

Maximum position	41 500
Already held	28 000
Buy now	13 500

It is interesting that on my new maximum position size rule of 0.5 per cent of capital, I would not have been able to buy any Mincor at this point. The problem was how far the sell stop was currently from the available buying price. I would have had to wait for an entry opportunity that allowed a closer sell stop.

On 8 August 2006, I was easily able to buy 13 500 Mincor at $1.160.

After my second purchase, Mincor retested the low of the potential trough at $1.065, but then rose strongly above the previous highest peak of the upward trend. This is shown in figure 14.46. This enabled me to lift my sell stop to $1.050, just beneath the trough low of $1.065. This move to a new high for the trend also opened up the next opportunity to build my position. My calculations on 24 August 2006 were as follows:

Purchase price	$1.300
Sell stop	$1.050
Risk	$0.250

1 per cent of capital was then $16 500

Maximum position size: 16 500 ÷ 0.25 = 66 000 shares

6 per cent of capital was then $100 000

Desirable position: 100 000 ÷ 1.30 = 77 000 shares

Figure 14.46: sell stop movement

Clearly, I should have cut back my total desirable position to my maximum position size. However, I did not. This suggests that I was either careless, or had been carried away with the enormous gains in the bull market. This was a very dangerous position to have been lured into. Again, this emphasises a good lesson from reviewing past investments.

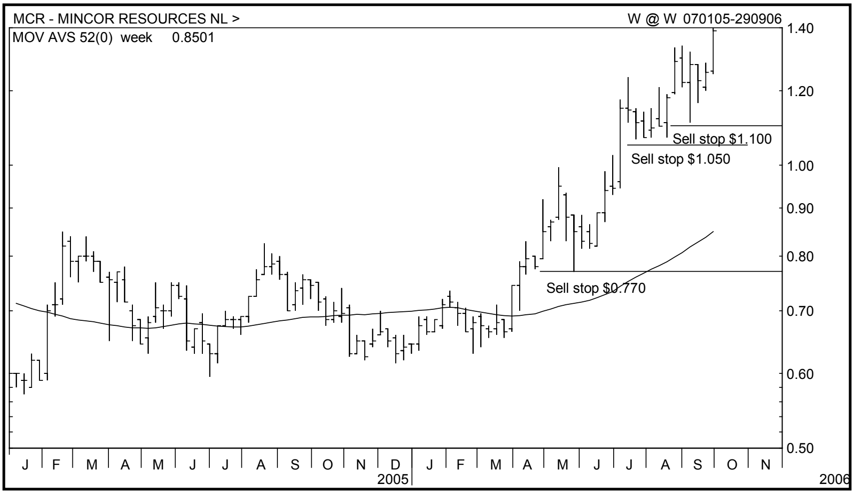
My actual calculation from that point was:

Desirable position size	77 000 shares
Already held	41 500 shares
Buy now	35 500 shares

On 24 August 2006, I was able to buy 35 500 Mincor at $1.280. This was $0.020 better than the estimated purchase price in my position size calculation.

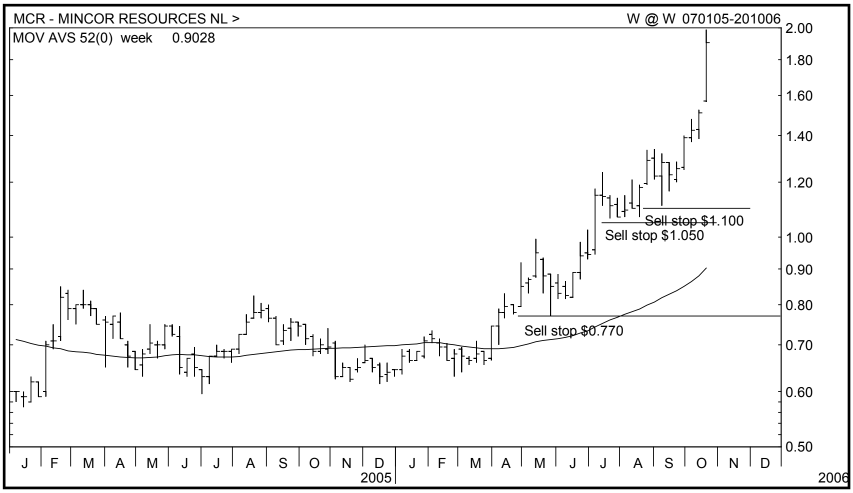
In the closing days of September 2006, a new high had been made for the trend. I was able to lift my sell stop slightly to $1.100, two ticks under the last higher trough at $1.110. The situation at that point is shown in figure 14.47.

Figure 14.47: sell stop movement



As October 2006 unfolded, Mincor's price began to rise almost vertically at a much faster rate than previously. By 20 October 2006, the chart was as shown in figure 14.48 (overleaf).

Figure 14.48: dramatic price rise

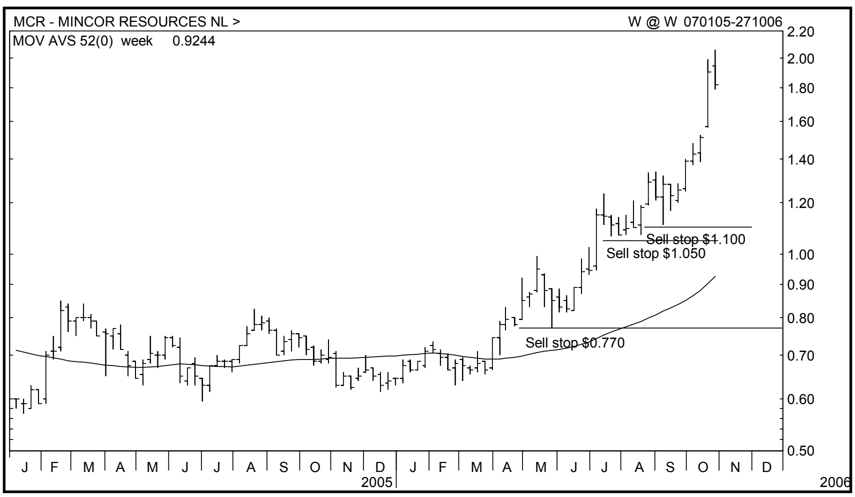


The price had gone very close to $2.000 and my sell stop was way back at $1.100. There were no higher troughs where I might situate my sell stop according to the logic of my investment plan. I decided that it was time to bank the capital growth, as soon as I saw a pause in the exploding price.

The following week, Mincor fell back from that peak and I sold my entire holding between $1.800 and $1.810.

The way the chart looked at the end of that week is shown in figure 14.49.

Figure 14.49: fall back in price

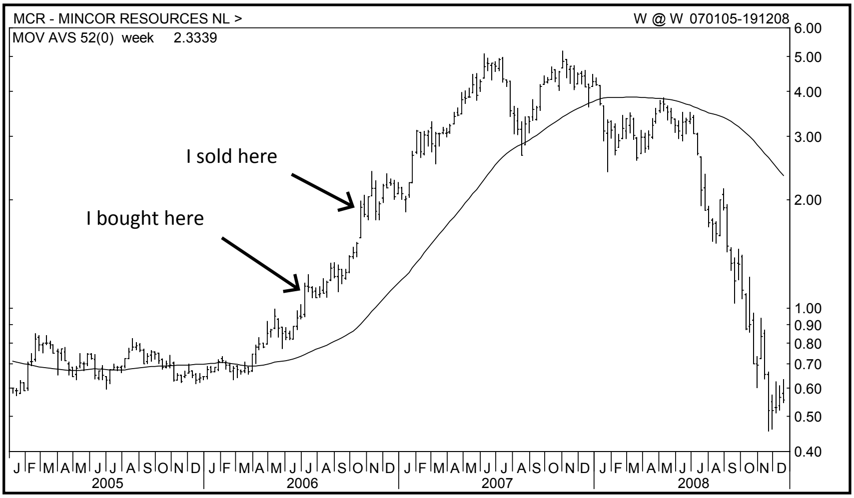


In retrospect, it may have been closer to my investment plan guidelines if I had only sold half of my position. It had not quite doubled in price from the original purchase. Nor had it become 12 per cent of my portfolio on my latest investment plan.

I could easily have bent the guideline in that situation. Guidelines are meant to be flexible. However, this is really hindsight bias. I now know that Mincor rose much higher. This is why hindsight is such a dangerous bias. I had to act on the right-hand edge of the chart. Violent upward moves often signal the end of trends. I acted on my experience and judgement. I would do the same thing again in the same situation.

For those who are curious as to what happened to Mincor after that, the chart to 18 December 2008 is shown in figure 14.50.

Figure 14.50: Mincor to December 2008



However, there is another interesting issue here. It is not that I might have only sold half my position. What I might have done is to have bought back into Mincor. After I sold, a sideways pattern unfolded. This established a new trough. I could have then looked at buying back into Mincor when it made a new high.

However, this is not as simple as it seems. There are two problems.

Firstly, the opportunity arose after I had formed the view that we were in the third phase of the bull market. At that time, I was in the process of selling some profitable positions which were still above their sell stops. This was to reduce my exposure to stocks. I doubt that I would have bought back into a resources stock, which had already risen a long way, in that situation.

Secondly, I cannot be sure that I am not falling for hindsight bias here. I know what happened. I might have bought back into an industrial stock if I had the margin of safety working for me. However, I would have been without that prop in a resources stock. I would have been buying into the late stages of a resources boom.

Therefore, on balance, it is an interesting issue to chew over. However, I doubt I would do anything different if I lived that time over. If we stay close to a ticking time bomb for too long, we are apt to get blown up. Preservation of capital is always the number one priority.

Investment result summary

Purchase cost	\$93 275
Sale proceeds	\$138 697
Capital growth	\$45 422
Dividends	\$2310
Franking credits	\$990
Total return	\$48 722

My time weighted capital for the financial year 2006/07 was \$1 490 633

Return from Mincor: 48 722 ÷ 1 490 633 = 3.3%

In other words, this short campaign in Mincor added 3.3 per cent to my return for the 2006/07 financial year.

Case studies conclusion

The investments I chose for the printed case studies were selected to include both successful and unsuccessful investments. I also included one resources stock investment, even though I do not generally make very many investments in that sector. My intention was to expose and explore as many practical issues as possible.

There were two objectives in presenting these case studies.

Firstly, I believe that case studies bring the theory to life in a realistic way. I could not avoid first taking readers through the theory of my investment plan. It is difficult to teach my plan only from examples. Readers of my earlier work have consistently requested more case studies, because it was only when they got to them that everything began to fall into place.

Secondly, I have picked up on many occasions that readers and students think that I am not human and that they should castigate themselves for failing to follow their plan. I carefully chose the stocks for the case studies of individual stock investments to bring out that I am human just like all my readers. What I wanted to bring out was how valuable this exercise of reviewing our past investments can be. The first step is to keep a diary. Then we need to go back over it later. When we do that in a rigorous and honest fashion, we will find just how many little ways in which we did not stick exactly to our investment plan.

Being aware of these transgressions is the first essential step to improvement. Elite performers in any field relentlessly critique their efforts and welcome informed constructive criticism. In fact, most of them will actively seek it out. This is tough. However, it is that toughness which makes them into elite performers.

I am working to improve what I do and how I carry it out. I hope my case studies will motivate readers to start keeping good records and periodically review what they have done. In some ways, this is the most valuable advice I can give on how readers may try to improve their game from here.

CHAPTER 15

CONCLUSION

While there are many sure-fire ways to lose money in the stock market, there are also many ways to make money. Rather than the precise method, it probably depends much more on the investor, what they know, how much experience they have had and, above all, how they think. This is the reason why the first part of this book, which deals with the way the best investors think about investing, is the most important part and came first.

After that, it is the control of losses and management of risk that seems to determine results, no matter what investment method is adopted.

While my method may appear to be ultra conservative compared to a gung-ho speculator, I regard it as being quite active, because I appreciate where the risks are. I am seeking to beat the market index, and to do so I am taking greater risks than the average professionally managed fund.

What makes my method ***active*** is:

- I am trying to ***time the market***, both with respect to the overall proportion of my capital that is invested in stocks and my investments in individual stocks.
- I invest in ***smaller, fast growing, but volatile companies*** which can sometimes be thinly traded. I do this to capture the greater scope for dramatic growth in stock price and higher dividend yields, but the opposite of this is greater downside risk.
- I ***concentrate my portfolio*** on a relatively small number of stocks. This is one way that I plan to beat the market index, but it is inherently more risky than a widely diversified portfolio.

To survive and succeed, my method requires strong discipline and risk control. It also means that I am risk averse in other aspects of my investment plan. Many observers have looked at aspects, other than the big three in the bullet points above, and say I am not active at all, but conservative. I think this is mistaken. I am active in the three areas where I think I can exploit my market models to beat the market. Since I am going after my objectives actively in these key areas, it should not be surprising that the rest of my investment plan is conservative.

My final word is an important reminder. My investment plan has been developed over a long time to suit my personality, attitudes, risk tolerance, financial objectives and experience. I am teaching it because most beginners and many experienced investors lack an investment plan and do not know what should be in one. I am therefore providing my investment plan as a model, but no more. Any investment plan should manage all the risks managed by my plan, whether in similar or different ways. If risk is increased in one area of the plan, it should be reduced elsewhere, or the greater overall risk accepted with open eyes.

If readers try simply to follow my investment plan blindly, I expect they will fail. They may be able to do it successfully in a bull market, because almost anyone can do that. However, when the going gets tough, such as when a bull market becomes a bear market, they will lose faith in the plan and throw it out. Then they have to start again on the real task, which is to take the time and make the effort to think out and test an investment plan that fits their personality, attitudes, beliefs and experience.

So, each reader has a journey to make, which they may have already started some time ago, or be just beginning. I hope this book is of assistance. If readers find they have questions that the book does not seem to answer, I invite them to email me at <colin@bwts.com.au>. I will try to answer questions, though my schedule may sometimes mean that weeks or even months could pass before I have time to reply. However, I do try to reply eventually. I prefer emails to phone calls for many reasons please. Also, remember that most questions have been asked before. Many of them will already be answered on my website <www.bwts.com.au> in the Ask Colin section or on the Newsletters page.

I hope readers have enjoyed the tour through my investment plan and that it is of assistance their investment journey.

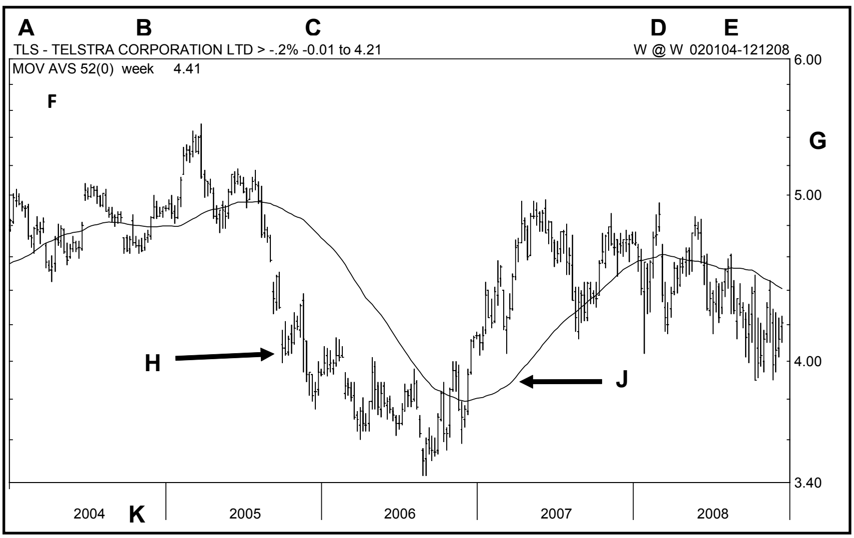
Colin Nicholson
Sydney
December 2008

APPENDIX A

INSIGHT TRADER CHART FORMAT

Each brand of charting software has its own way of presenting information. All of the charts in this book have been created using Insight Trader charting software. To assist readers who are unfamiliar with its way of displaying charts, the Insight Trader chart in figure A.1 has been marked up with an explanation of each element of a stock chart.

Figure A.1: Insight Trader chart



Key	Description
A	The ASX code for the stock or index.
B	The name of the stock or index.
C	Data for the last day: percentage change, dollar change, closing price.
D	Display @ Data Compression. D is daily, W is weekly, M is monthly. My charts will be M@M and W@W, but other combinations are possible.
E	Date range for the chart. Is in Australian format; that is, DDMMYY.
F	Any indicator on the chart and its value for the last bar on the chart. My charts will have a moving average on them. On a W@W chart the moving average will be calculated on the weekly closing prices. On a M@M chart, the moving average will be calculated on the monthly closing prices.
G	The price scale in Australian dollars (logarithmic). Index charts will be scaled in index points.
H	Price bars. Weekly in this example.
I	Not used.
J	Moving average line. In this case a 52-week simple moving average.
K	Time scale (linear).

APPENDIX B

SEMI-LOG OR LINEAR CHARTS?

I have used mainly semi-log charts in the book. A semi-log chart has a linear time scale and a logarithmic price scale. I have also used a few linear charts, but only for very specific things, where a semi-log chart is not very useful. A linear chart has both a linear time scale and a linear price scale.

The reason why the semi-log chart is the most common and the preferred scaling is that it does not distort the relativities when there is a large dynamic range. If there is a large dynamic range, then the portion of the chart at the lower areas of the price scale will be reduced to insignificance and the portion of the chart at the upper areas of the price scale are exaggerated out of all proportion.

To show the difference between the two types of chart, it is best to look at examples. The first example is for a market price index, as shown in the following two charts (figures B.1 and B.2).

Figure B.1: linear chart of the ASX All Ordinaries index

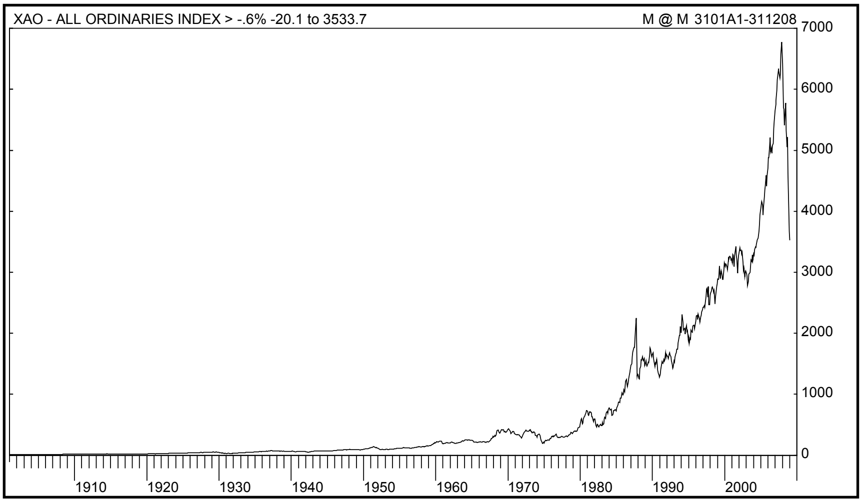
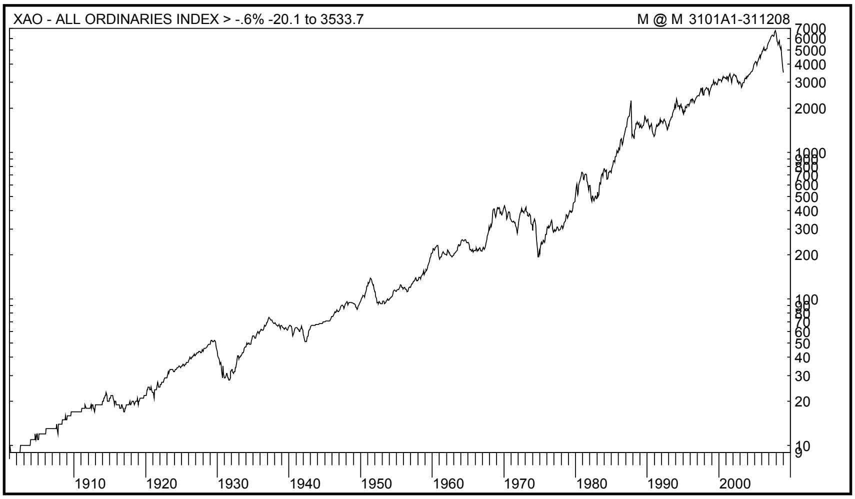


Figure B.2: semi-log chart of the ASX All Ordinaries index



The same situation pertains to a chart of a stock, as shown in the following two charts (figures B.3 and B.4).

Figure B.3: linear chart of BHP Billiton

Figure B.4: semi-log chart of BHP Billiton

It easy to see in these examples that, for the time frame of an investor, the semi-log chart is far superior in showing the detail of the historical price action. This is more so the larger the dynamic range on the price chart.

While this ability to be able to see the price action is important, it is even more important in keeping a sense of proportion to price movement.

The aim of investment is to maximise our percentage return on capital employed, not merely the dollar gain in price of a stock.

The linear scale shows a gain of 1¢ at a price of $1 to be equally important as a gain of 1¢ at a price of 10¢. However, the first is a 1 per cent gain, the second a 10 per cent gain. This is the way a semi-log chart displays those relative prices.

For choice, I always use a semi-log chart, unless there is a compelling reason to use a linear chart.

Further reading

Over the years, I have been strongly influenced in developing my investment plan by many books. The most important of them might form a useful program of additional reading to further explore the ideas that underlie my investment plan and in helping readers to adapt it for their own investing.

They have been listed alphabetically by author. No other order seemed appropriate, because the priorities of each reader will be different.

Most beginners will naturally think this is a very long list. However, remember that it will take at least 10 years to learn the art of investing. All that is needed is to aim at reading one of these books each month. Reading a dozen or so pages each night before going to sleep will reach that target easily.

This book should have convinced readers of the need to embark on a lifelong journey of learning. Neither my book, nor any other one book, is enough on its own. Students of investing must read widely and deeply to be able to think through all of the problems and to thoroughly understand and accept the answers.

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