

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

ACKNOWLEDGEMENTS

I dislike singling people out because, over a long time, a great many people have made contributions that were valuable in many ways to the creation of this book. However, four people were very special in helping me write and edit this book.

Michael Attwood read every word of the book. He made a great number of very important suggestions throughout. They led to great improvements. No less important is that Michael spotted a great number of typos and other errors.

My wife **Rosalyn Nicholson** was my first line proof reader. She corrected my grammar in many places and also found many typos and other errors. She also had to live with me while I was almost totally focused on writing the book.

Bernard Chapman is the brains behind the Insight Trader charting software which I use. In writing this book for an audience beyond the shores of Australia, there were some things that needed changing. Bernard went out of his way to help with those things, for which I am very grateful.

Janene Murdoch, who owns The Educated Investor bookshop at 500 Collins Street Melbourne, has been a wonderful support over many years. When I needed a friend with which to discuss a problem, she has been a tower of strength.

11 charts were produced using Insight Trader charting software. See www.insighttrading.com.au or phone Bernard Chapman on +612 751 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 513 9768 9611. Some of it was augmented by or sourced from ASX publications and website, *The Australian Financial Review* and www.fhoo.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.