

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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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.

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.

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