

# Active Investing

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## Course Notes

by Alan Hull

Revision 0208

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# Active Investing Course Notes

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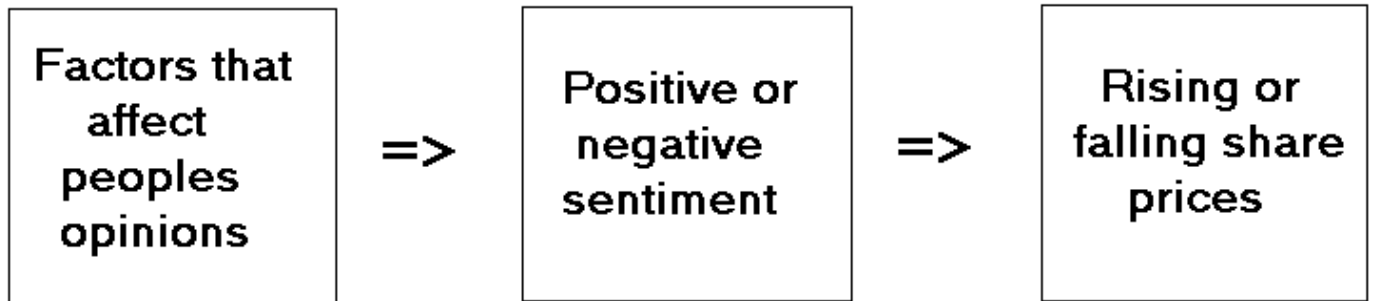
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# Dynamic Analysis

The simple dynamic that drives share prices either up or down is shown below in block diagram form. Note the use of the word 'Factors' as opposed to the word 'Facts' in the first square.



This diagram summarizes the whole process that moves share prices and is the foundation of dynamic analysis. Factors that affect opinion include fundamentals, market cycles, macro economics, global factors, etc. Investors who rely on fundamentals are coming at the market dynamic from the left hand side. Chartists, on the other hand, are coming at the market from the opposite direction by simple measuring the output of the whole dynamic process. As active investors we will approach the market dynamic from both ends by employing dynamic analysis. There are, in fact, Blue Chip shares with good fundamentals and rising share prices. By testing and measuring the market dynamic we can locate these shares. The following charts show the results we can achieve with this process.

Flight Ctr SUM-Weekly 06/08/2001 C=25.700 **-.200** O=25.900 H=25.900 L=25.500



Created with SuperCharts by Omega Research © 1997

Cochlear SUM-Weekly 06/08/2001 C=36.800 **-0.090** O=37.000 H=37.200 L=36.800

**Cochlear has risen from \$4 to a high of \$40 over 4 years.**



Created with SuperCharts by Omega Research © 1997

Lang Corp SUM-Weekly 06/08/2001 C=10.022 **-0.378** O=10.443 H=10.443 L=10.020

**Lang Corporation rose from \$1.50 to a high of \$12.50 over 3 years.**



Created with SuperCharts by Omega Research © 1997

These are the types of shares that we want to own because we only make money when the share price is rising. Whilst we want to constantly monitor the financial facts relating to our lifetime assets...in the stockmarket we buy and sell share prices and not fundamentals.

By testing and measuring Blue Chip shares with good fundamentals we won't own either of the following shares (at the time of writing).

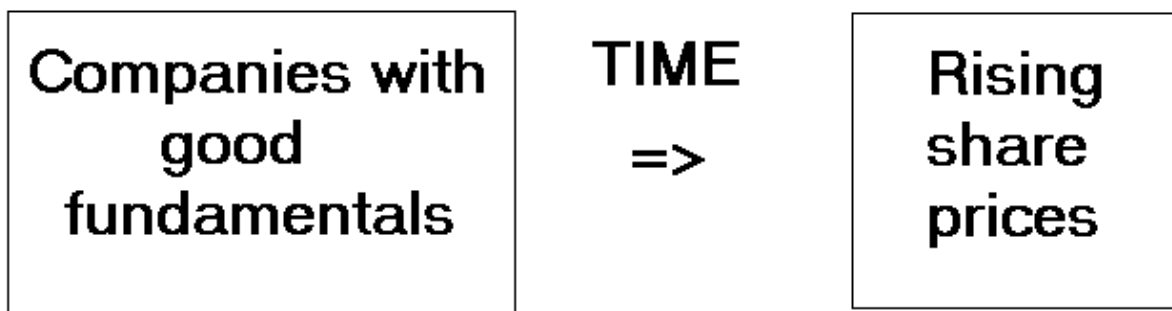
Telstra SUM-Weekly 06/08/2001 C=6.540 +.080 O=6.470 H=6.640 L=6.470



HIH Ins SUM-Weekly 06/08/2001 C=.175 .000 O=.175 H=.175 L=.175 V=0



Telstra is a Company that is considered to have good fundamentals and good future prospects. HIH was also considered to be a sound Blue Chip Company. However, when we test and measure the share price we find that it is falling and therefore market sentiment towards these shares, by inference, is negative. Let's take a look at how fundamentalists view the market dynamic. Conventional investment wisdom ignores sentiment and assumes that if the financials and future prospects of a company are good then positive market sentiment can be assumed. This is absolutely true...given time. Hence the age old reliance on having patience when it comes to investing.



By testing and measuring the market dynamic as Active Investors, we can eliminate the time factor. But if we ignore good fundamentals and just look for rising share prices then we had better be prepared for some nasty surprises...not to mention having to watch the market everyday.

Davnet SUM-Weekly 06/08/2001 C=.130 .000 O=.135 H=.140 L=.125

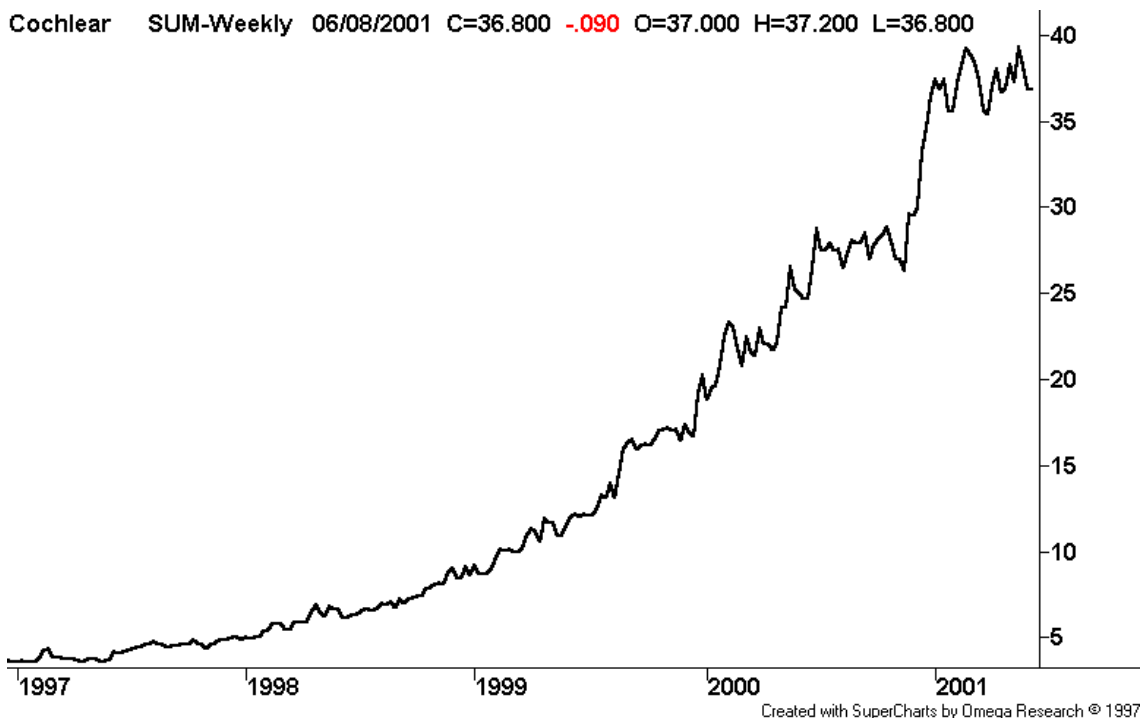
**Davnet enjoyed a brief period in the top 100 shares but it got there on the back of the Tech Bubble & not because of good fundamentals.**



Dynamic analysis combines fundamental analysis and technical analysis for good reason.



Our primary objective in the Stockmarket is to make more money with less effort. Buying and selling shares like Davnet is too much hard work because they require daily monitoring. On the other hand, waiting around for shares in Telstra to start rising is a grossly inefficient use of our time and money as well. Lets take another look at the chart of Cochlear.



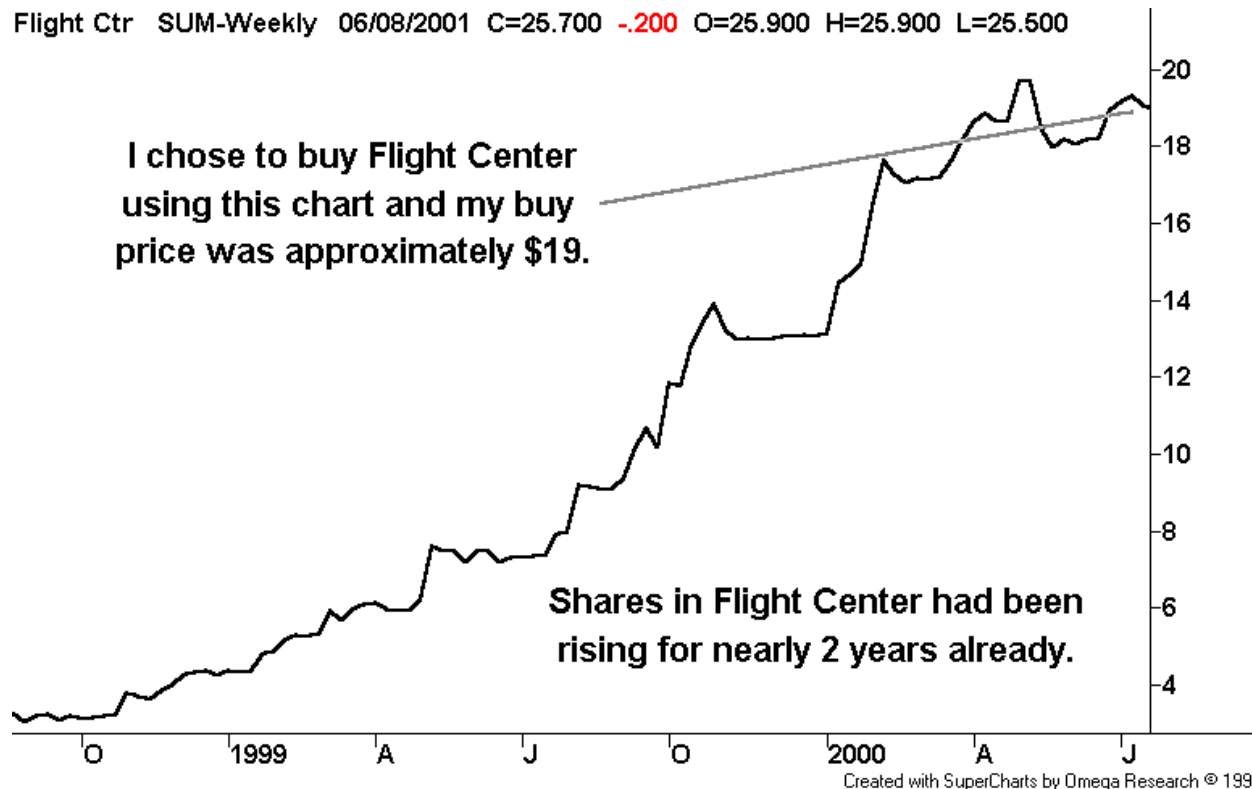
The price of Cochlear shares hasn't risen steadily over the course of 4 years because of takeover rumours, market bubbles, etc.. It has risen steadily over time because of its sound fundamentals and good future prospects. The above chart of Cochlear is a weekly one and only requires checking on a weekly basis. Owning Cochlear for the past several years would have meant spending about 10 seconds per week glancing at this chart. What we are doing as active investors is riding on the coat tails of fundamentalists. Cochlear is a perfect example of a share that is being driven upwards by its own fundamentals. Note how the correction of October 1997 and the Tech Wreck of April 2000 had virtually no affect on the share price. The trend in Cochlear has also remained immune to annual market cycles. By choosing to operate in a weekly timeframe we go along way towards filtering out alot of the unpredictable factors that affect the crowd's opinion. The following table categorizes and prioritizes the different factors that affect opinion by their timeframe, degree of significance and predictability. Although this list is by no means complete, it includes all of the major factors that we should take into consideration.

- |                          |             |               |
|--------------------------|-------------|---------------|
| • Fundamentals           | Long term   | Predictable   |
| • Global Factors         | Long term   | Predictable   |
| • Macro Economics        | Long term   | Predictable   |
| • Market Cycles          | Medium term | Predictable   |
| • News & Rumours         | Short term  | Unpredictable |
| • Gambling & Speculation | Short term  | Unpredictable |

Using dynamic analysis we can systematically test and measure each of these factors, in order of priority, to ensure that the balance of probability is working in our favor.

Active investing flies in the face of, 'Buy low...sell high'. This concept is probably the single greatest cause why most market participants don't own shares that are rising in price. 'Buy low' makes a lot of sense when it comes to buying tangible assets but, 'Buy low...sell high' when buying and selling shares for profit ignores the prevailing market sentiment and relies on prediction rather than probability. During a Live Trading night that I held on the 25<sup>th</sup> of July 2000 I chose Flight Center for my Blue Chip portfolio. My choice was met with wide disagreement from the audience of 50 people who thought the share price was too expensive.

Flight Ctr SUM-Weekly 06/08/2001 C=25.700 -200 O=25.900 H=25.900 L=25.500



But Flight Center had been enjoying double digit profit growth, good fundamentals and the share price was rising over time. The result was a share price that continued rising.

Flight Ctr SUM-Weekly 06/08/2001 C=25.700 -200 O=25.900 H=25.900 L=25.500



# Investment/Trading Objectives

All market participants need to have a clearly defined set of realistic goals. Successful market participants see themselves as being in business. As Active Investors we are running our own investment businesses and we don't want to end up, 'Out of Business' like 95% of other small businesses in Australia. We will be buried under a mountain of information if we try to shop around for products and services without a clear set of objectives in mind. Most people who want to take an active roll in the Stockmarket behave like children in a Lollie shop when they are searching around for the products and services they need to be investors. Our goals form the foundation of our business plan and they need to address the following areas.

## Risk

Trading and investing of any kind includes risk that needs to be managed. A long term strategy should have very tight risk management whereby it is virtually capital guaranteed. Serious market participants always have a long term view. Hence the saying, "There are old traders and bold traders but no old/bold traders". Investing or trading without risk management is better known as gambling. Success comes to those who control their losses.

## How much time does it take to be an Active Investor?

Less work for more pay gives us lifestyle freedom. At the start we often have little time to spare because of family and work commitments. A workable strategy will become a losing strategy if it becomes neglected due to other demands on our time. A realistic time commitment for the majority of individuals is about 1 hour per week. This time will increase as your income from active investing grows. Active Investing allows us to generate an income stream with very little effort or it can be a part-time starting platform for those who want to go on to more demanding Stockmarket activities such as full time trading.

## How much starting capital do I need?

The only limiting factors are the costs of entry to the stockmarket, ie. brokerage fees, Internet access, etc. To nullify the effect of these costs a good minimum amount of starting capital would be \$10,000. Capital can be raised in several ways including a home equity, margin lending, superannuation rollover or a combination of a personal loan and existing savings.

*Tip - If you are starting with less than \$25,000 capital, it is a good idea to start by using an online discount broker to minimize your brokerage fees.*

## What annual growth on my capital do I want?

As Active Investors using a low risk, low effort approach we want to aim for at least 20% per annum. By compounding this rate of return we can create wealth over time. If we have enough capital we can actually generate a comfortable income stream with 20% per annum.

# The Tool Box

Active investing is a strategy that uses both fundamental and technical analysis. Whilst we should have an understanding of both methods of analysis there are shortcuts available to us when it comes to locating companies with good fundamentals. By allowing others to do the fundamental analysis we can focus our attention on technical analysis and observing price activity. Our time is better spent this way because we buy & sell price and not fundamentals.

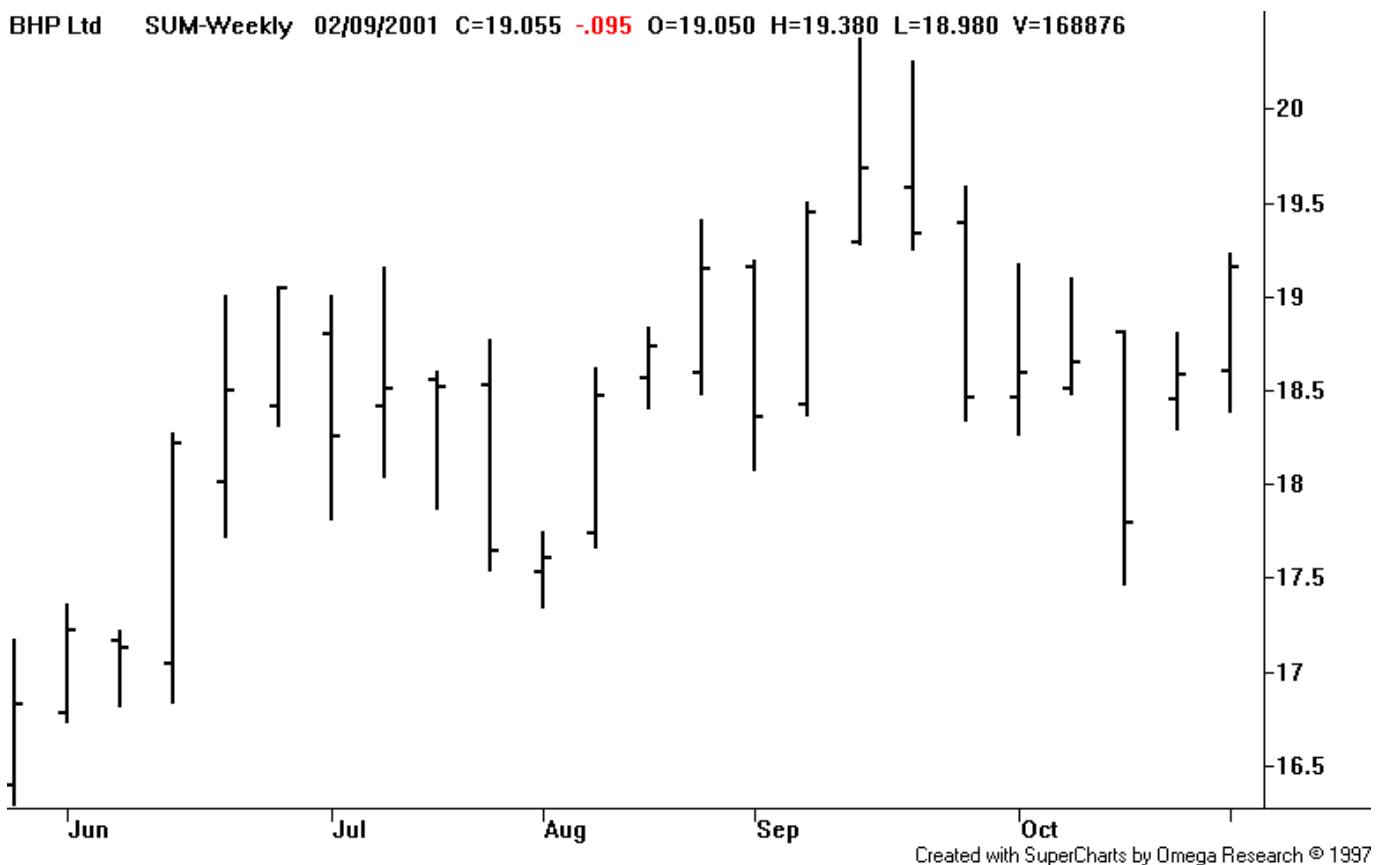
## Finding shares with good Fundamentals

To avoid doing tedious research of our own we can utilize the research of other analysts to build a sizeable database of companies with good fundamentals. Some possible sources are;

- The 'Top 100 Companies' listed in the business section of the Weekend Australian.
- All of the shares listed in 'Top Stocks' by Martin Roth. (Published by Wrightbooks)
- Stock Doctor Star Stocks with a market capitalization higher than 100 Million.

## A quick lesson on price charts

Technical analysis is the study of price charts as shown below.



In the above chart each week is represented by a bar that has a tick to the left of the bar and another tick to the right. The top of the bar and the bottom of the bar represent the price range of trading for the week (ie. the high and the low). The tick to the left of the bar is the opening price of the week and the tick to the right represents the closing price for the week.

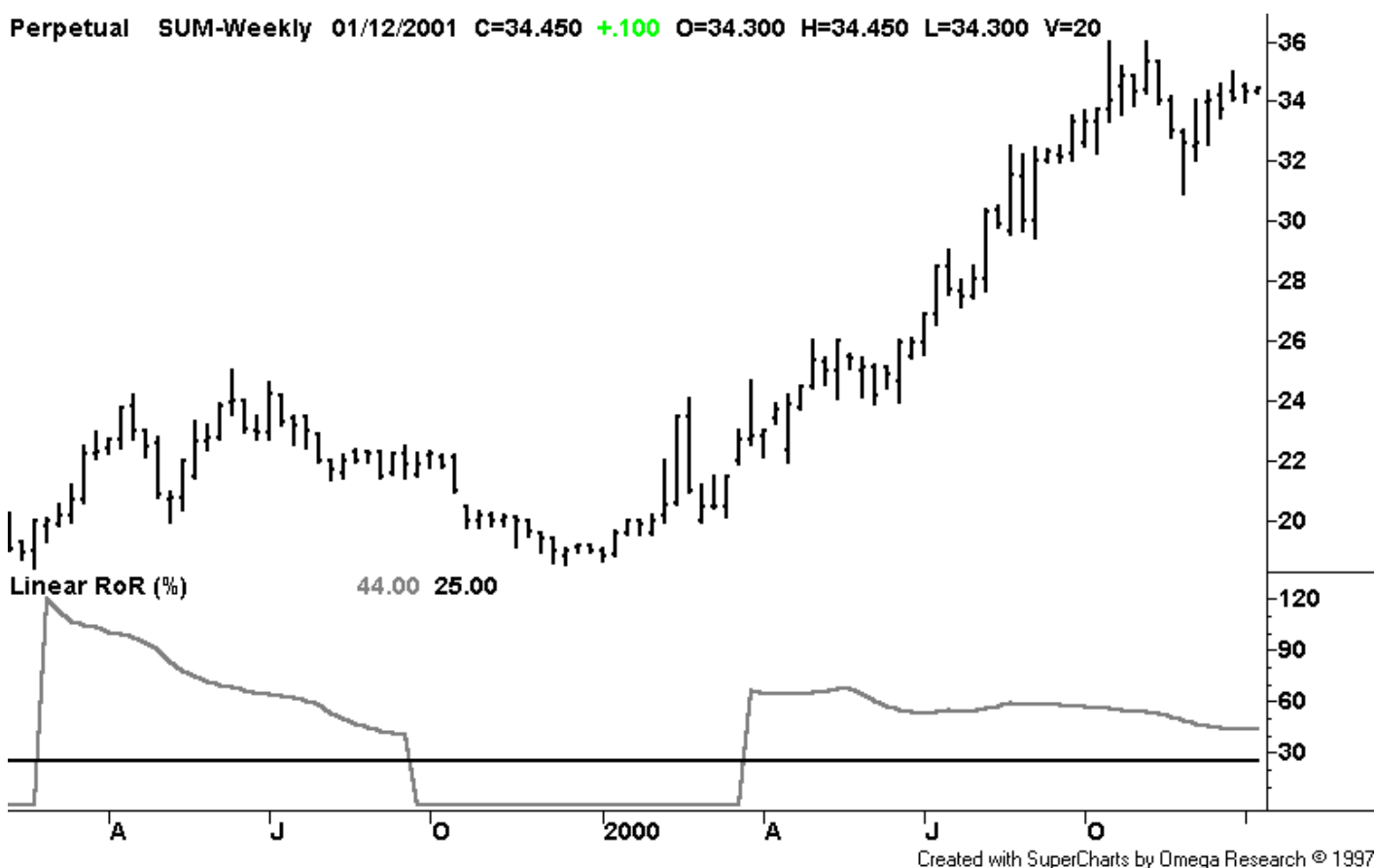
# The 'Rate of Return' Indicator

The 'Rate of Return' indicator is used to calculate the annual rate of return of a share given its current rate of climb or fall. It achieves this by calculating the annual return and dividing it by the current share price. The result is then multiplied by 100 to convert it to a percentage.

## Example

- Lets assume that a share is climbing at a rate of \$2 per year.
- The current price of the share is \$5.
- The annual 'Rate of Return' would be 0.4 (\$2 divided by \$5).
- Converting this to a percentage we get  $0.4 \times 100 = 40\%$ .

The 'Rate of Return' Indicator can be seen in the following chart. This indicator is called the 'Linear RoR' Indicator because it uses linear regression as opposed to moving averages.

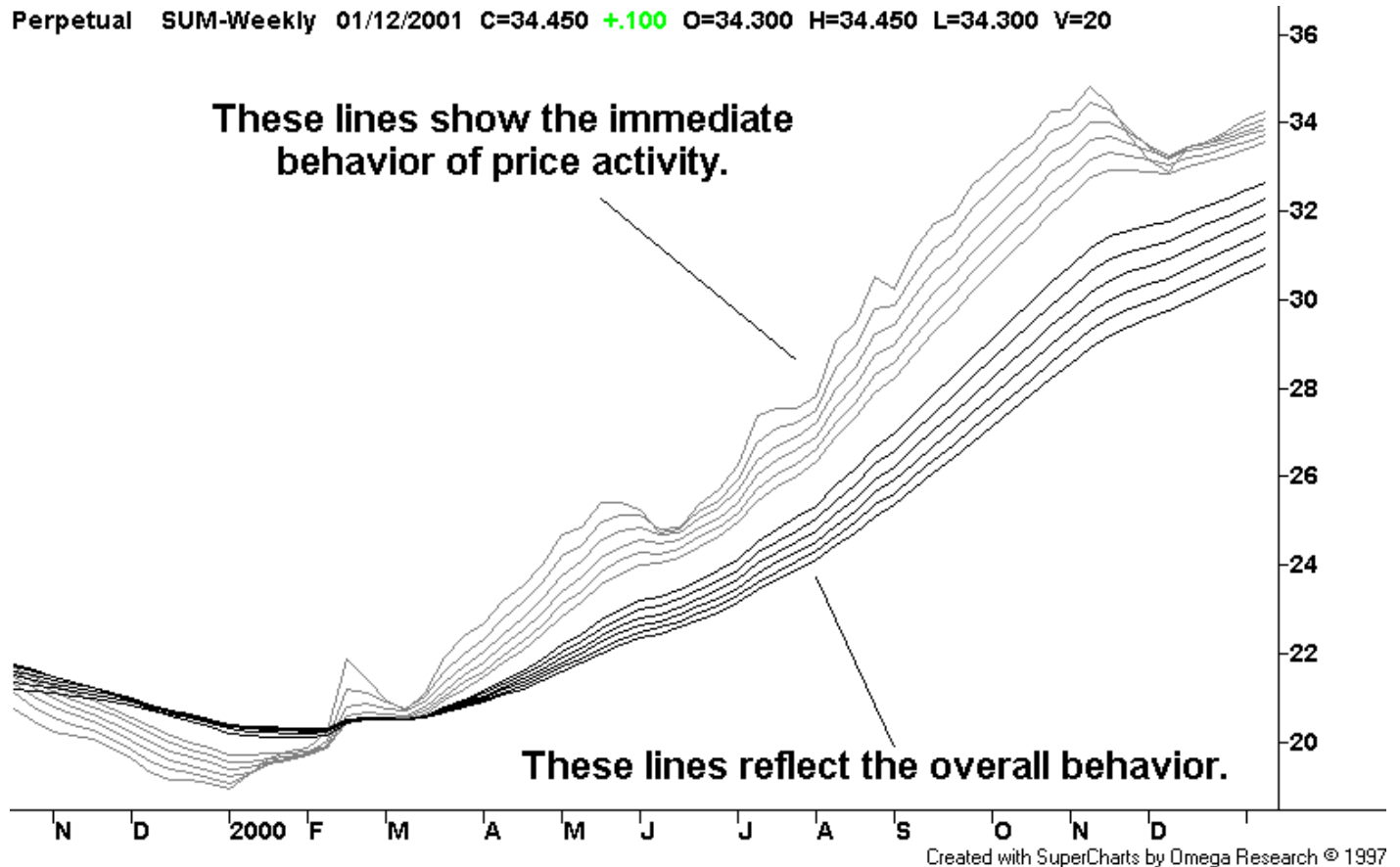


Perpetual is currently enjoying an annual rate of return of 44%. The horizontal bar placed at 25% is the cutoff level. Searches can be performed using the 'Rate of Return' Indicator to sift out shares that only have an annual rate of return higher than the 25% cutoff. The linear RoR indicator switches itself 'On' when it detects the presence of a valid trend. It automatically switches itself 'Off' if the rate of return falls below 25%, the money flow drops below \$10million/3 Months, the trend reverses or price activity moves sideways for an extended period of time. It is an 'Intelligent' non-lagging indicator that gives unambiguous signals.

*The Linear 'rate of return' indicator is used to generate the values given in the weekly ActVest newsletter. The 'Rate of decline' indicator uses the same mathematical concepts.*

# Multiple Moving Averages

Multiple moving averages, MMAs, are a sophisticated tool that can be used in a range of applications. MMAs are a series of lines that track and filter the weekly price movements. They consist of 2 sets of lines that allow Technical Analysts to observe and compare the immediate behavior of price activity with the long term behavior of the price activity. Exponential moving averages are used for this type of analysis. The price bars in the following chart have been switched off to improve readability of the MMA lines.



Short term group (Grey Lines) - 3, 5, 7, 9, 11 & 13

Long term group (Black Lines) - 21, 24, 27, 30, 33 & 36

Once we have found a share that has an acceptable 'Rate of return' we must make a qualitative judgement of the trend. We are looking for a strong and consistent trend that is not likely to reverse shortly after we enter the market. The following points are critical;

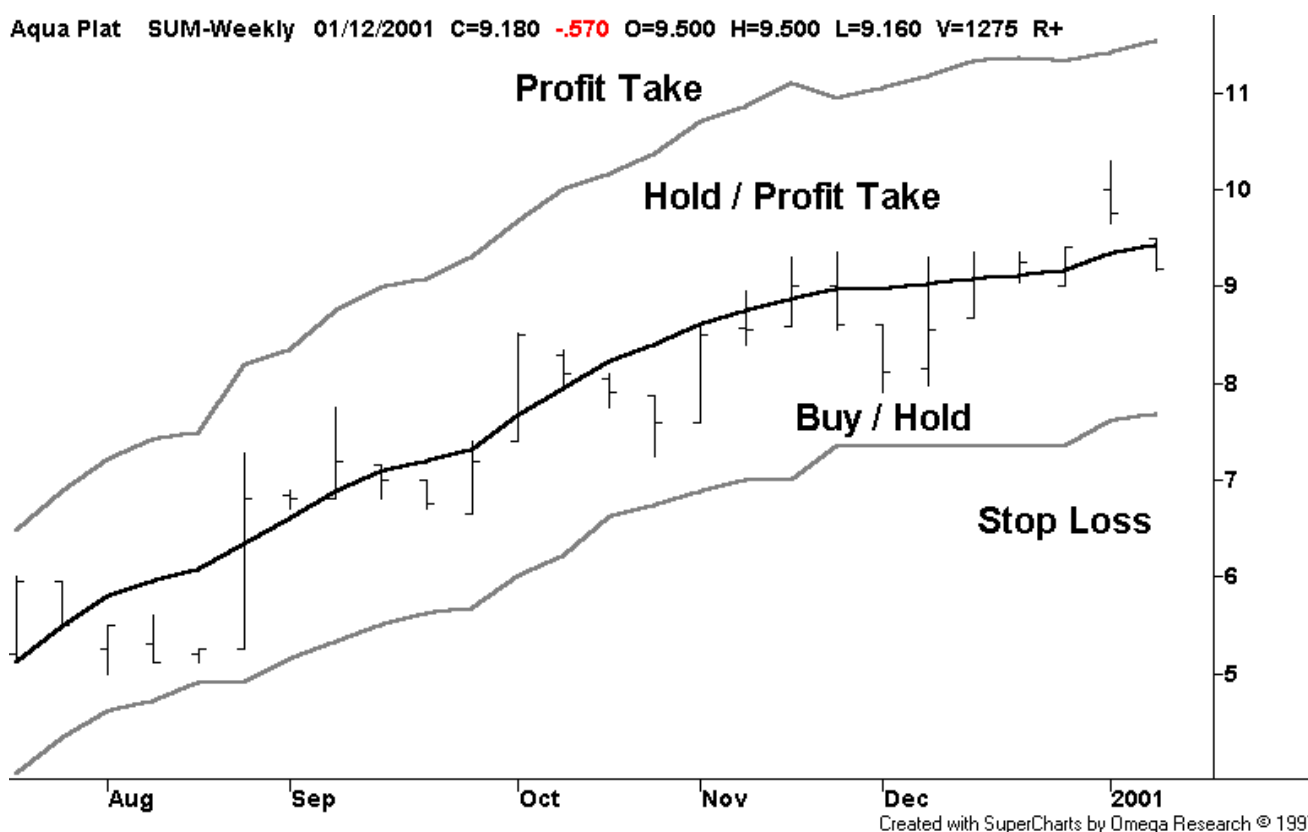
- The long term group must be spreading apart or running parallel with each other.
- The long term group must be pointing upwards.
- The straighter the long term group of lines are; the less volatile the trend is.
- The short term group can pullback (ie. compress together) but if they cross into the long term group then the trend is weakening and may be about to break.

This type of qualitative analysis is only used when entering the market and the idea is to avoid volatility. We want to 'Buy and Hold' and not get bounced in and out of the market. Judging the quality of trends is the most subjective function we will have to perform.

# The Range Indicator

The range indicator provides us with a series of price ranges that tell us when to buy, sell, hold or profit take. Although simple in construction, it tells us when the price activity is pulling back, rallying up or the trend is reversing. It is constructed around a 13 week line of linear regression known henceforth as the central cord. A function called 'Average true range' that measures price volatility over a 13 week period is then used to position upper and lower lines based on the central cord. These lines are referred to as the upper deviation line and lower deviation line. These two lines create an envelope that defines our tolerance towards price activity. The central cord, upper deviation and lower deviation lines create four distinct price zones that tell us when to buy, hold, take profit or sell.

The following chart illustrates how the range indicator is used to set buy, hold and sell zones.



When price trends either up or down it moves in a sawtooth pattern and not a straight line. In an upward trend this behavior is caused by the repetition of a rally/profit-take cycle. As long as the buying force behind the rallies is greater than the selling force behind the profit-taking the trend will continue. Upward trends end when the buying force is exhausted which is an inevitable occurrence. Market participants often forget that all trends must come to an end.

By using the range indicator to control our entry and exits we can avoid buying overpriced shares and sell when a trend reversal occurs. Although we are using weekly charts in Active Investing, the buy and sell signals can be applied in both daily and weekly timeframes.

If price rallies beyond the upper deviation line then there is a heightened probability that it will then fall past the lower deviation line. At this point investors and traders should sell and lock in profit.

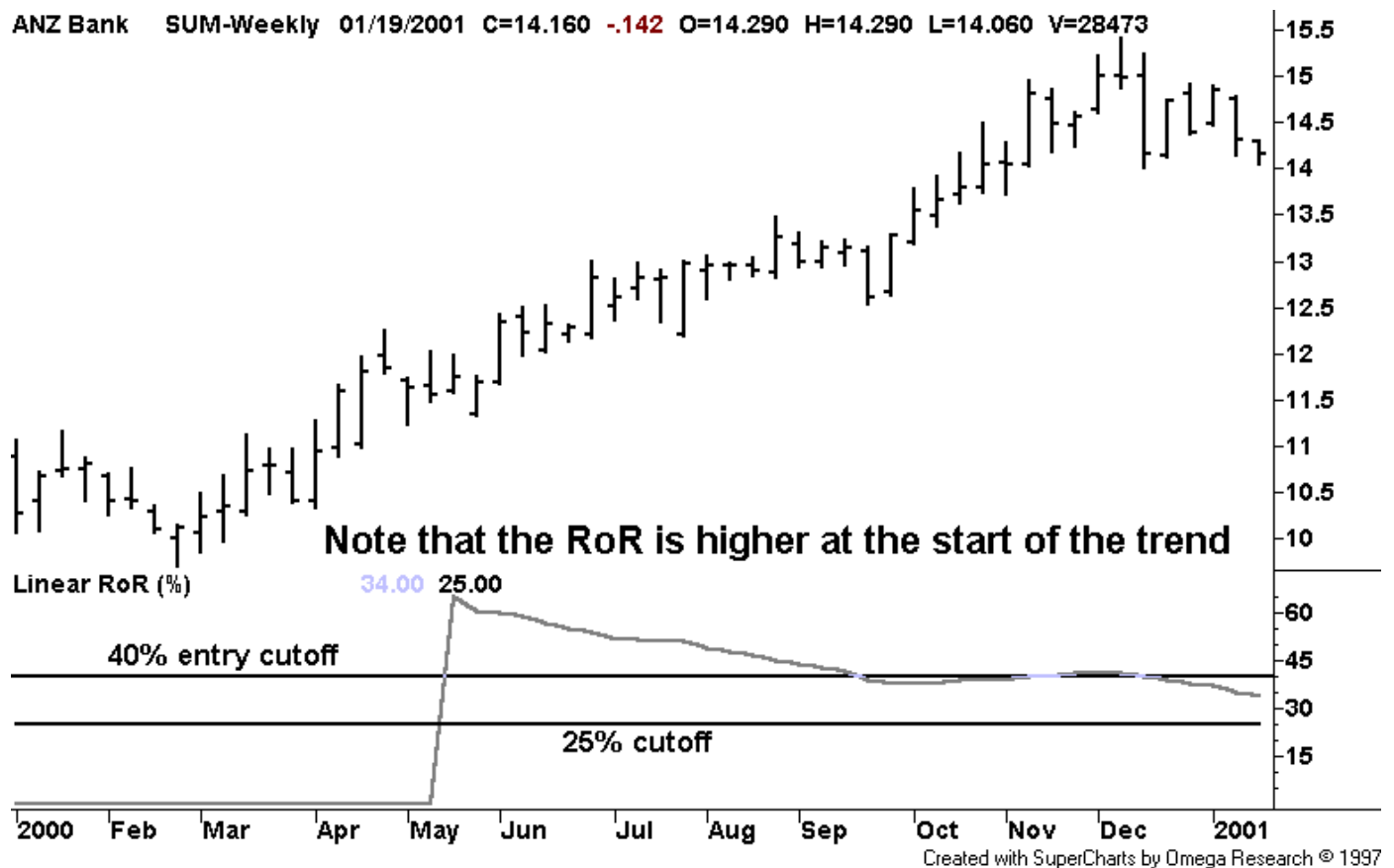
*Range indicator values, ie. upper, lower and central lines, are provided in the newsletter.*

# The Trading Strategy

We want to put a minimum amount of effort into locating and trading quality shares that are in stable, upward trends. Whilst the analysis is done on a weekly basis, the trading strategy can be implemented on a day to day basis. We can spend as little as 1 hour per week as Active Investors or we can monitor our positions everyday by checking the end-of-day prices.

## 'Rate of Return' Searches

We begin by searching our group of shares to locate the most profitable trading opportunities. We hold shares with a RoR of at least 25% but we only buy when the RoR is at least 40%.



The Linear RoR indicator switched 'ON' in mid May of 2000 exactly 13 weeks after ANZ began trending upwards. The best point to have entered the trend was soon after this time when it had a rate of return of at least 40%. As the trend has worn on, the rate of return has dropped due to the rising share price (The indicator uses the current price to calculate the RoR). Now is an acceptable time to hold this position but it is no longer an optimal time to be entering ANZ.

This 40%-plus entry criteria ensures that we are using our capital efficiently and it prevents us from entering worn out trends. But be aware that there are some shares that have trended for long periods of time that are still potential trading candidates. Don't judge the profitability of a trend by the current share price. Only when the rate of return falls below 25% or the share moves sideways for a long time do we want to move our capital to a better position.

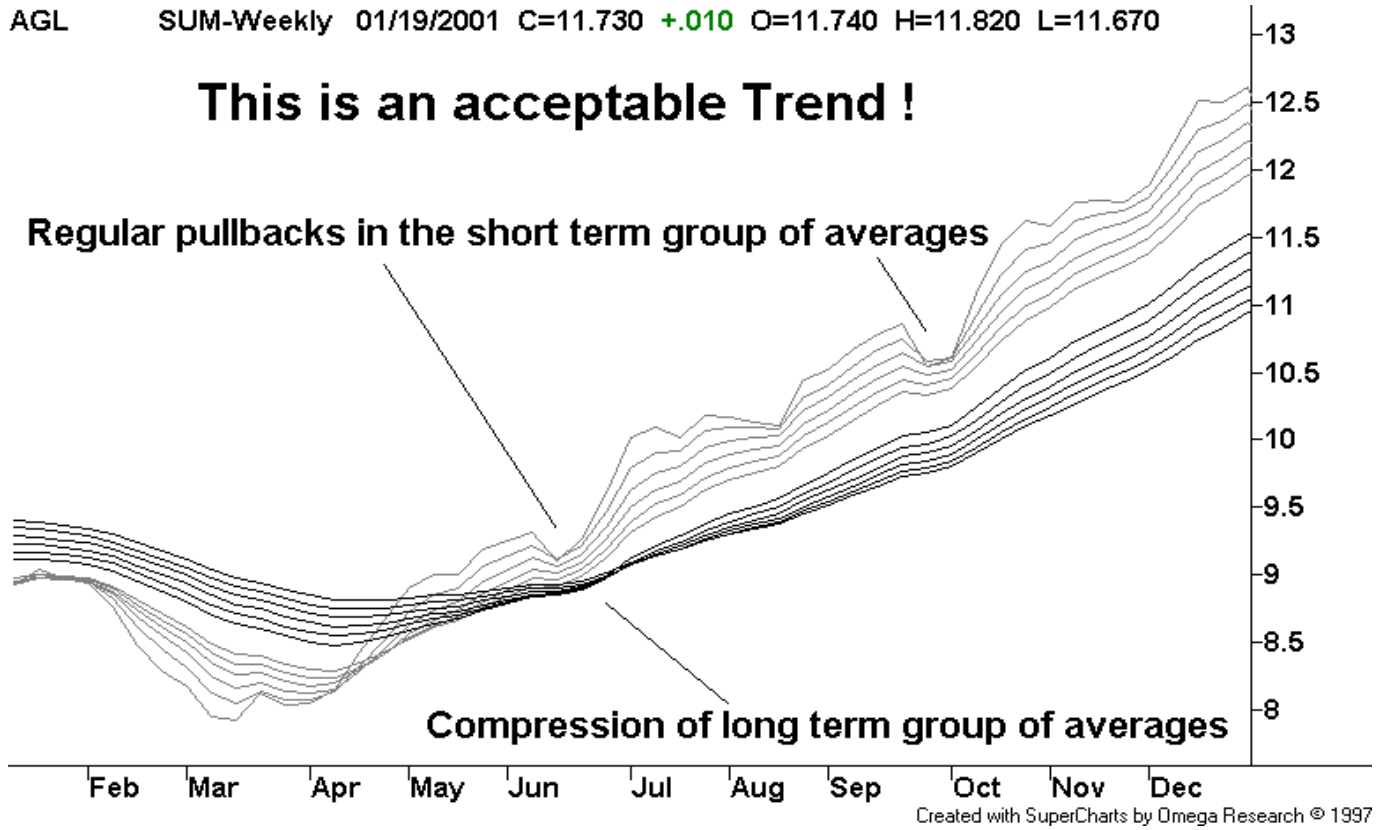


# Verifying & evaluating the Trend

The next step is to ensure that the share is in a stable upward trend. In the early stages of a trend the long term set of lines will initially compress and then expand as the trend gets under way. Only enter trends where the long term set of averages has begun moving out of compression. Note that the quality of the trend is critical to our success and profitability.

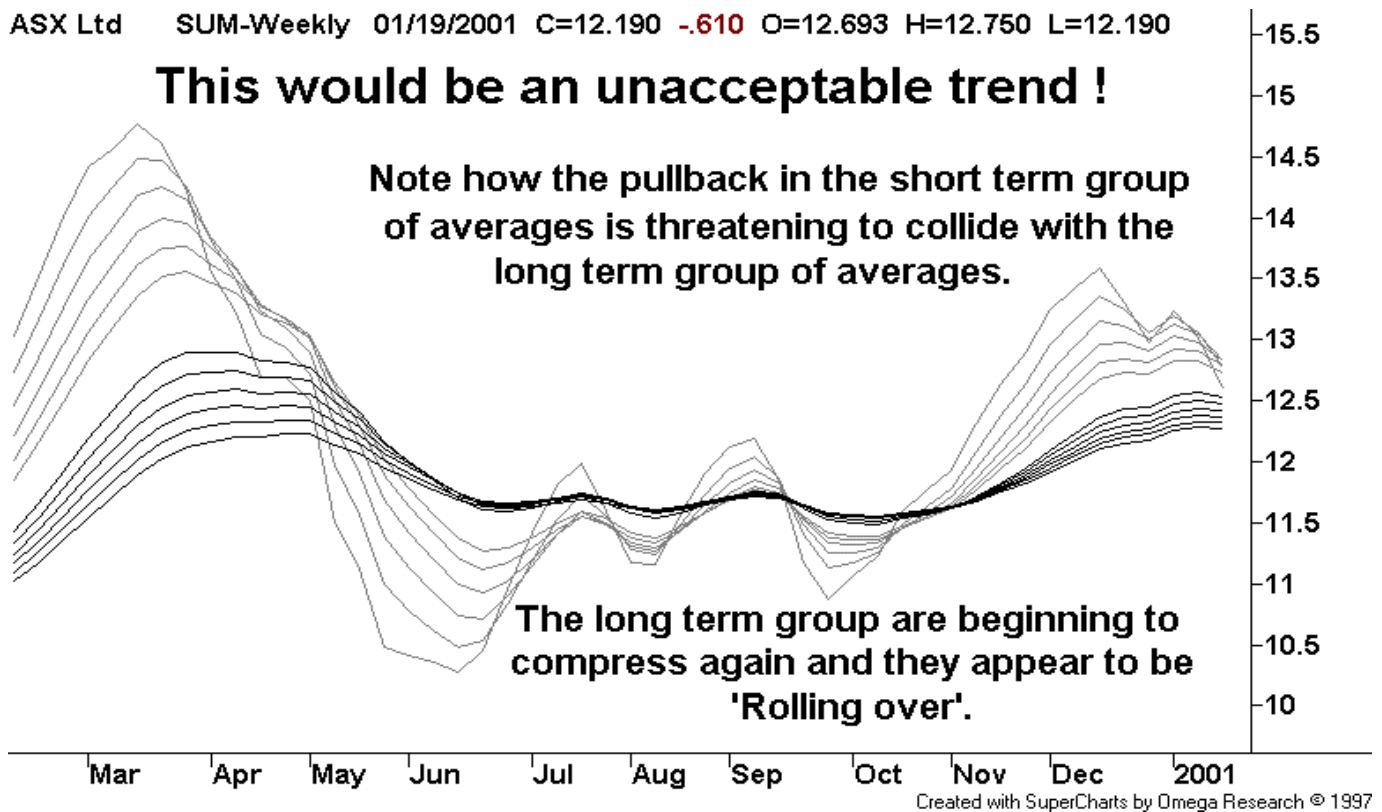
AGL SUM-Weekly 01/19/2001 C=11.730 +.010 O=11.740 H=11.820 L=11.670

## This is an acceptable Trend !



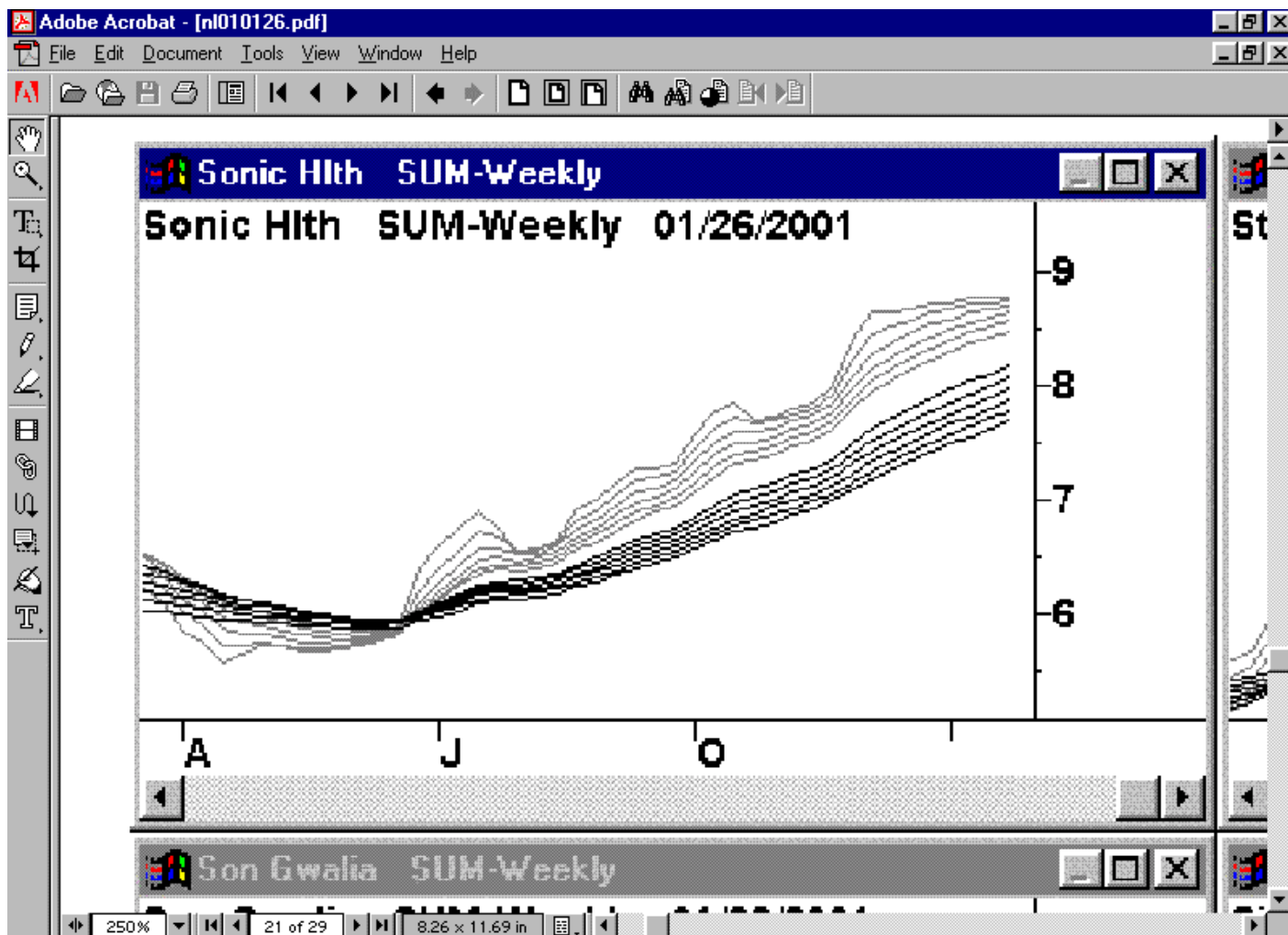
ASX Ltd SUM-Weekly 01/19/2001 C=12.190 -.610 O=12.693 H=12.750 L=12.190

## This would be an unacceptable trend !



# Using the ActVest Newsletter MMA Charts

The ActVest Newsletter is sent in PDF file format and is viewed using the Adobe Acrobat Reader which is freely available on the Internet. There are 8 MMA charts per A4 page... making them quite small. You can use the 'Zoom' function in the Adobe Acrobat Reader to enlarge the charts. Using the 'View' pulldown menu at the top of the screen; select 'Zoom to...' and type '250' into the box that appears in the middle of the screen. This magnification level will increase the size of an MMA chart to the point where it almost fills the entire screen as shown below. Having the newsletter means not having to buy expensive and complex charting software nor having to pay for an ongoing data feed from the ASX.



You can then use the slide bars situated on the right hand side and right hand bottom of the screen to navigate around the charts. To zoom out again simply go back to 'Zoom to...' and type '125' into the magnification box. This will return you to the full page width display.

Identifying a good trend using the MMA charts is a matter of opinion and there is no right and wrong answer. Your ability to interpret MMA charts will improve with practice and your hip pocket nerves will guide you better than any external guidance can. However I can share my opinion by looking at some examples and the above MMA chart of Sonic Healthcare looks acceptable at this stage of the trend. The pattern has been consistent over time.

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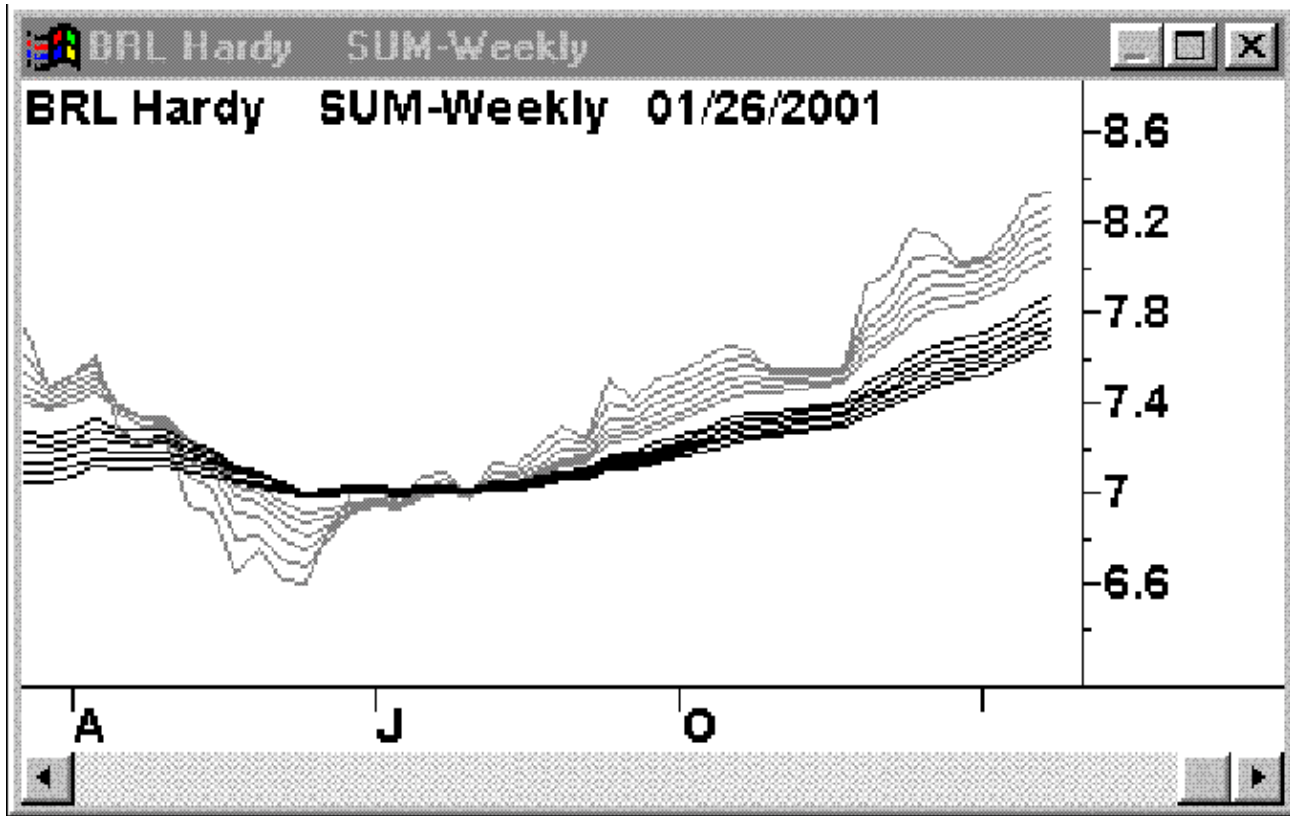
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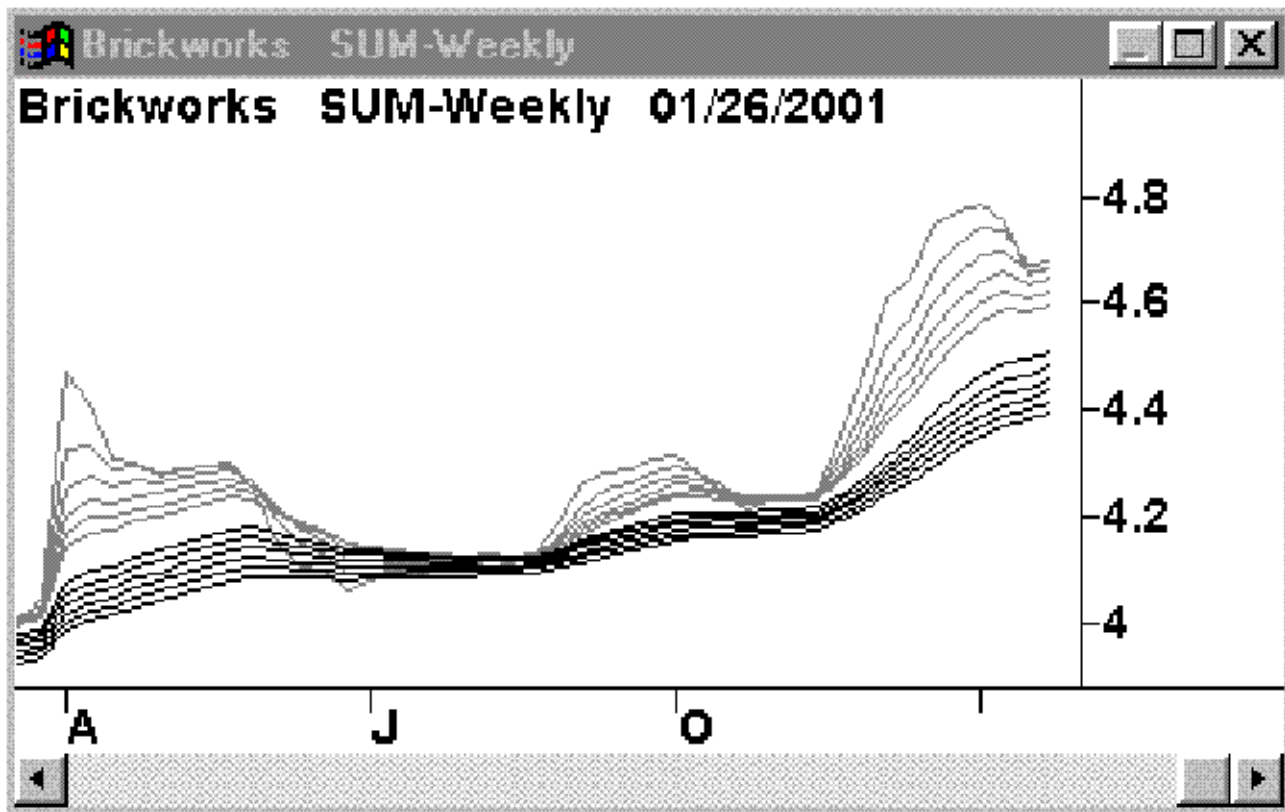
Skype: andreybbrv

ICQ: 70966433

I don't like irregular patterns in the short term group of averages as shown in the chart below.



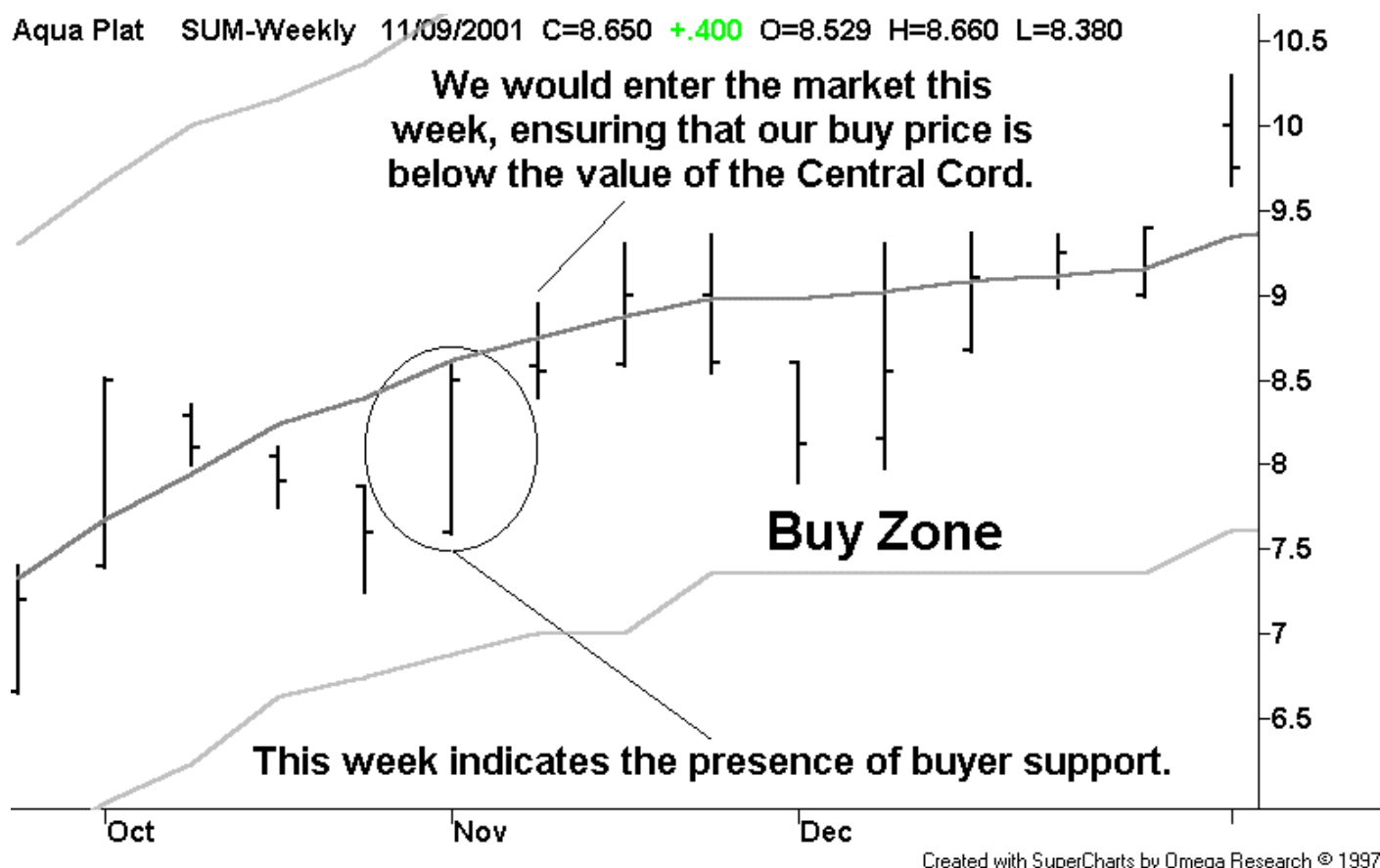
And I definitely don't like what I refer to as a 'Rolling in' situation as shown below.



Brickworks is not trending smoothly at all and the long term averages are turning sideways.

## Market entry

Once we have found a share with an acceptable trend and a RoR greater than 40% we must fine tune the entry. Although we want to jump on board a trend when the price is in a dip it is important not to enter the market whilst the price activity is 'Gunning the stop loss'. We need to wait for the market to reverse and show evidence of buyer support. The green light is flashing after we have witnessed a rising week with a closing price higher than the previous weeks close. When the green light is flashing we act on a daily basis and ensure that our buy price is in the buy zone, ie. lower than the central cord. It is possible for the 'Market' to get away. The following chart shows a point of entry into the uptrend in Aquarius Platinum.



The following is a summary of the entry criteria.

- A rate of return equal to or greater than 40%.
- Buyer support as evidenced by a rise in share price during the previous week.
- Price activity is in the 'Buy' zone.

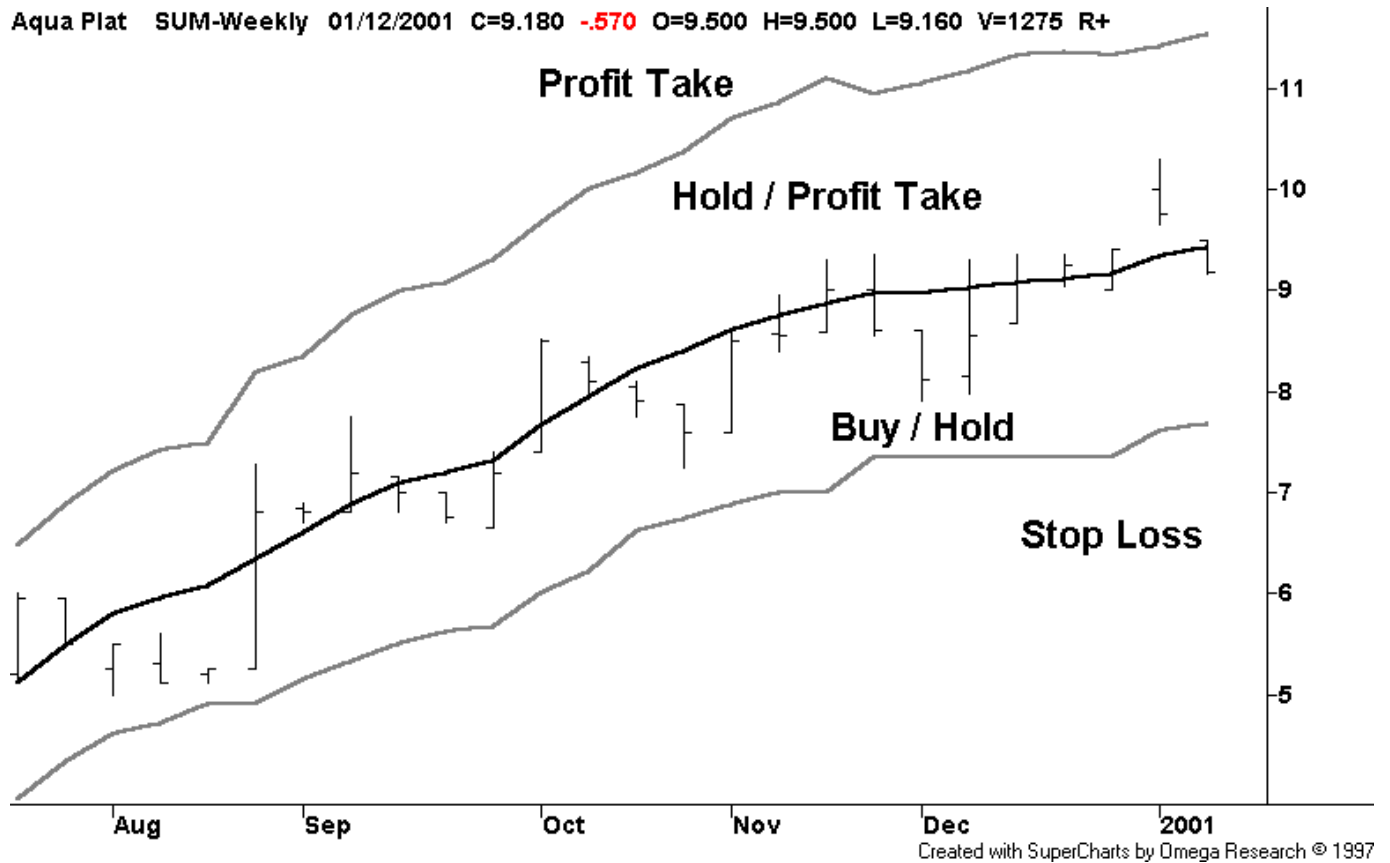
We will not be able to purchase an entire portfolio of shares immediately because many of the shares we want to buy won't be in the 'Buy Zone'. It is quite normal to spend several Months buying into the market, catching each share as it dips down.

*ActVest Subscribers can check for all of the above conditions using the weekly ActVest Newsletter. A Subscriber would observe the following information in the data tables.*

- *The 'Rate of Ret.(%)' column has a value equal to or greater than 40.*
- *The 'Closing Price(\$)' column has an up arrow (↑) next to the price. (e.g. 6.58↑)*
- *The closing price is between the Central Cord and the Lower Deviation values.*

# Holding and Profit Taking

Although holding or profit taking are often conceived by market newcomers to be the easiest aspects of trading they are in fact one of the few areas of trading that require the use of human discretion. The range indicator as shown in the following chart dictates, as much as possible, the boundaries for holding and profit taking.



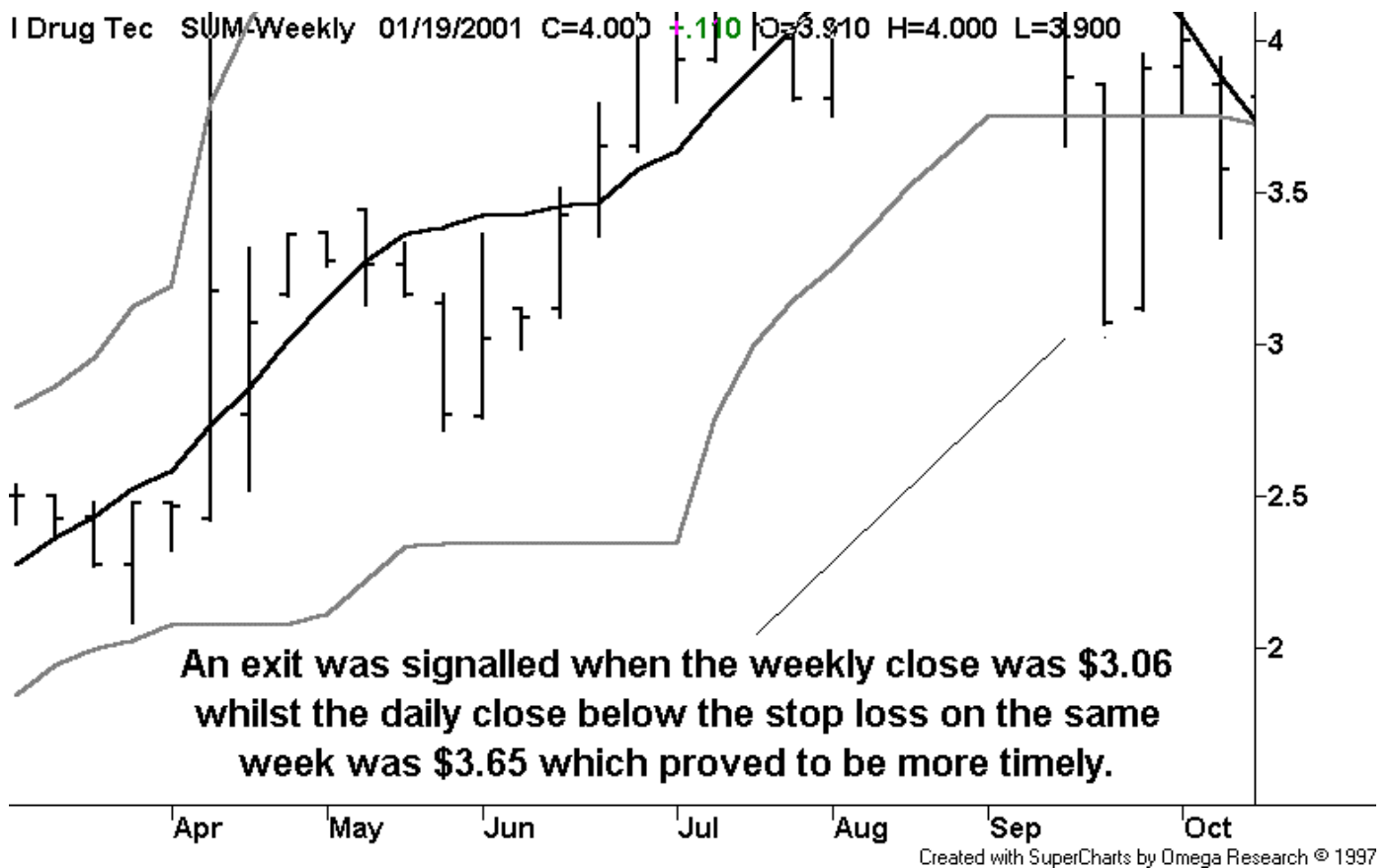
Active investing is a trend following strategy and, providing price activity remains between the upper and lower lines of deviation, there is no need to close a position. If, however, the price activity overheats and closes at the end of the week in the 'Profit Take' zone then selling is mandatory. A true cliché is 'You will never go broke by taking profit'.

The reason for selling when the price activity exceeds the upper deviation line is because the next stop, on the balance of probability, is the 'Stop Loss' zone. As mentioned earlier, price activity moves in a sawtooth pattern and a weekly close outside our trading range is a powerful indication that the volatility has reached a critical level. The fact that the trading range has initially been breached to the upside is fortuitous as we can make a timely and profitable exit. As with all aspects of trading our actions are driven by the balance of probability and if our upside exit proves to be premature then we can always re-enter the ongoing trend.

Discretion can be exercised when it comes to profit taking in the upper part of the trading range. Whilst some will always hold, others will want to take quick profits if they are significant enough. A bench mark for profit taking is, 'Am I up 10% per month or more'. If we are up 10% per month or more then we are looking at an annualized profit of 120%. Our objective as Active Investors is to achieve a return between 20% and 50% per annum. At 120% per annum we are well ahead of the curve and it is prudent to take profit at this point.

# Selling

This is the most critical aspect of any strategy and the decision to sell must be mechanical and carried out with total discipline. The stop loss can be monitored on either a daily or weekly basis. If the price closes at the end of the day below the lower deviation value then you can elect to sell. But if the price closes at the end of the week below the lower deviation, you must sell immediately. Daily monitoring of your portfolio and daily stop loss execution is not essential but it will prove more efficient when it comes to protecting your trading capital. Using daily stop loss execution as opposed to weekly stop loss execution in terms of profitability is insignificant. Daily stop loss execution, whilst being superior when it comes to protecting our trading capital, can cause us to occasionally exit the market prematurely. This offsets any gains that we may achieve in terms of profitability. One factor that can help us to decide between using daily or weekly stop losses is the state of the Broad Market. If the U.S. Stockmarkets are behaving nervously then it is a good idea to use daily stops and when global markets are trending upwards we can fall back to using just weekly stop losses.



Note how the price activity bounced back up after breaking the stop loss. This 'Bounce back' is common and often leads undisciplined traders into ignoring their stop losses. Always bear in mind that this stop loss is not set arbitrarily and is designed to indicate a trend reversal. If it does prove to be wrong then you can always wait for a re-entry signal to rejoin the market.

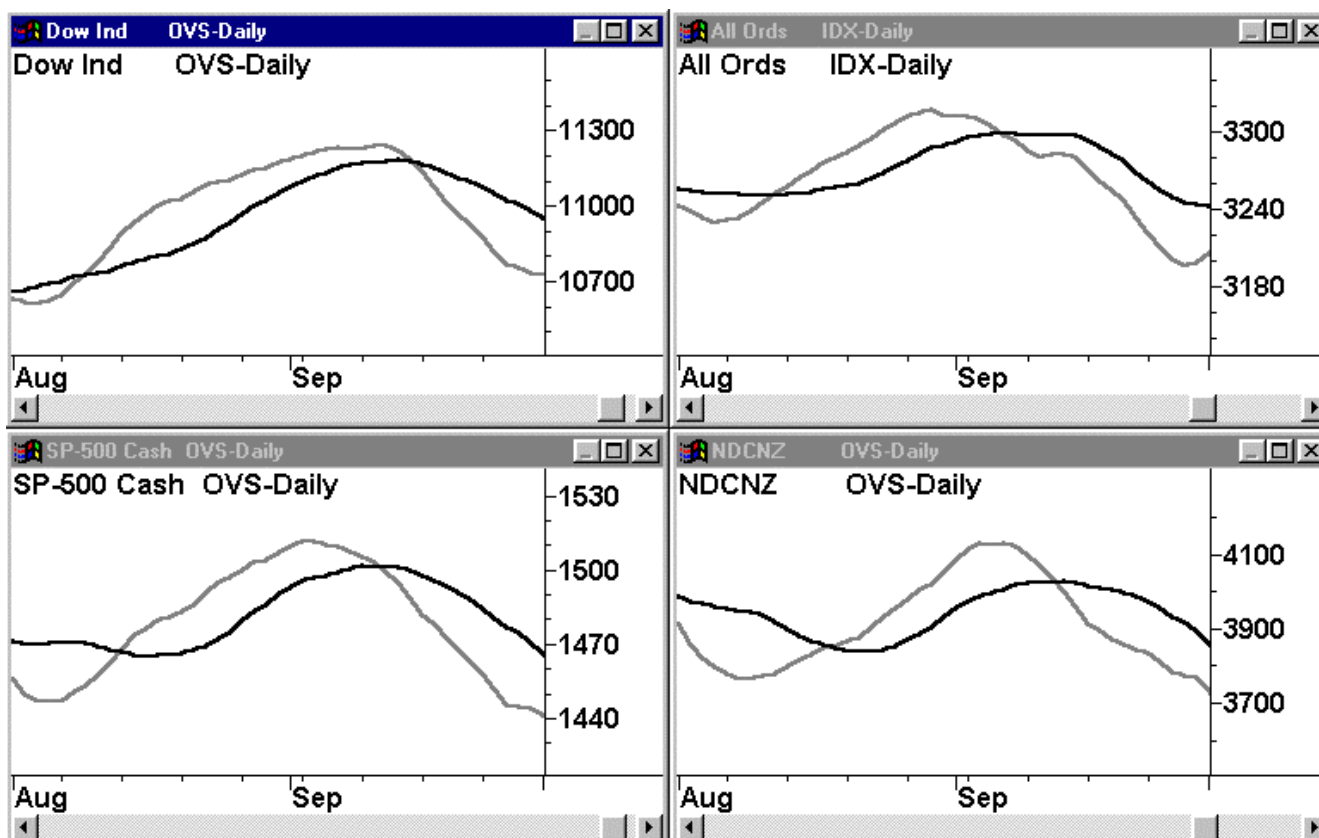
The Linear RoR indicator can also signal an exit by switching itself 'OFF'. It is telling you that you are no longer trading a valid trend because the RoR is below 25%, the market has been moving sideways for too long or the liquidity has dropped to an unacceptably low level.

**Important - If the Linear RoR indicator for a particular share switches 'OFF' then the share will be immediately removed from the ActVest Newsletter. This is an exit condition.**

# The Broad Market

Active Investing assumes that sound fundamentals are the reason for share prices to be rising. But there are periods in the market cycle when other influences will control market sentiment and push factors such as good fundamentals, sound management and profit growth into the background. Broad market sentiment is clearly one of them and can be taken into consideration. If the broad market is retreating, we can refrain from opening new positions.

The following diagram shows the three main US Indexes and the All Ordinaries Index. These daily charts contain a 9 day (Grey) and 21 day (Black) simple moving average. When the fast moving average (Grey 9 day SMA) is below the slow moving average (Black 21 day SMA) the index is in retreat and heading downwards and when the fast SMA is above the slow SMA then the index is trending upwards.



A broad market decline is signaled when *all* of the Indexes are retreating at the same time as they are in the above charts. If you are stopped out of the market when all of the Indexes are in retreat then you should not re-enter the market on the long side until the broad market retreat has ended. The reverse applies for opening new short positions. This method tells traders and investors when to leave their money in the bank and stand aside. Global Stockmarkets often retreat in unison during the Months of June and September. If we can see this pattern of retreat in the crossover charts then it pays to wait until the market has turned up again before opening new long positions. The first quarter of 2001 was a negative period for global markets and many analysts feared that it was going to be the start of a protracted bear market. Had it been the eve of a global Bear market, the crossover charts would have prevented us from opening new long positions and therefore, compounding our losses.

*The newsletter includes crossovers charts for the All Ords and the 3 major US Indexes.*



# Global & Economic Factors

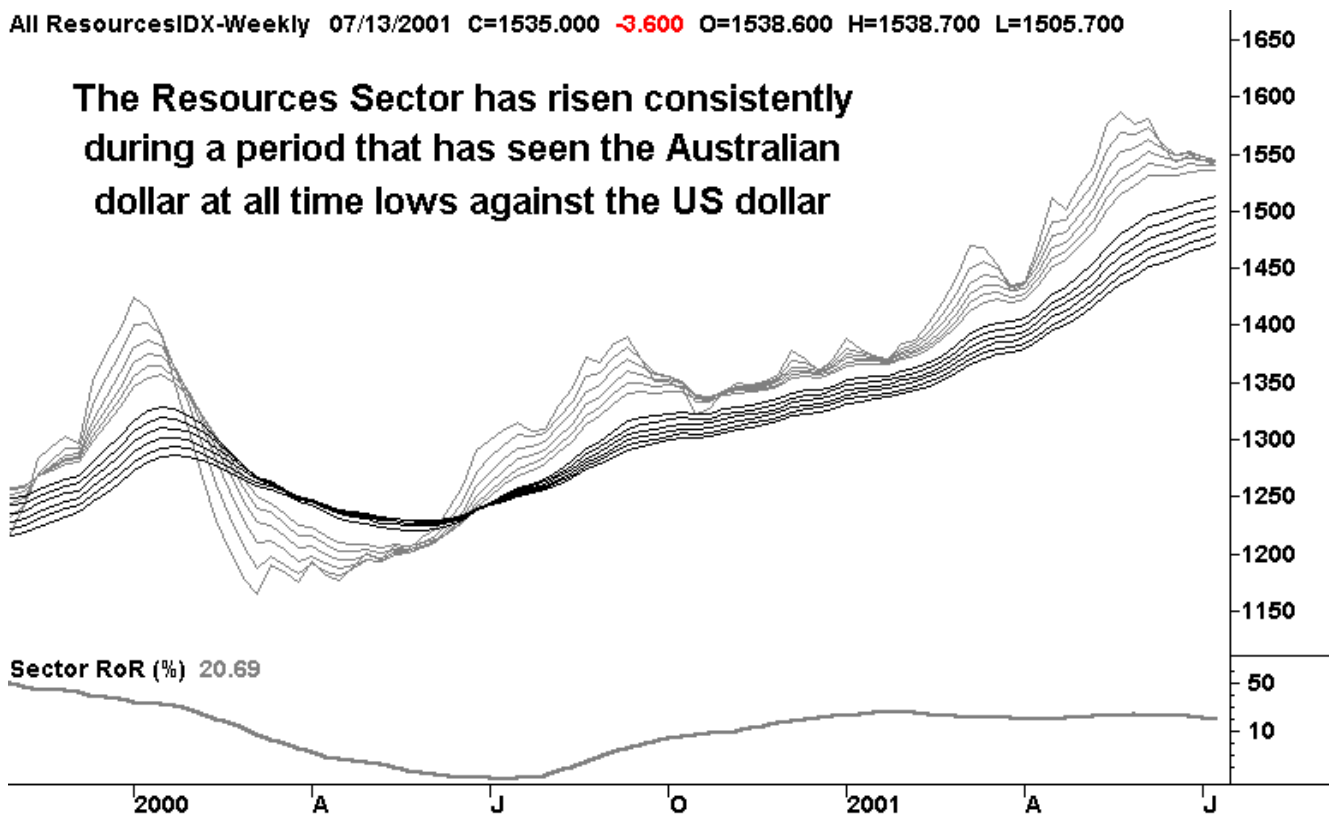
We can test and measure the affect that global and economic factors have on share price movements by analysing the performance of individual sectors. What's more we don't need to have an intimate understanding of these factors or how they affect specific industries. To illustrate how we are going to test and measure the effect of these factors, we will look at a specific example. Imagine that you are an Australian manufacturer exporting widgets to the U.S.

- Each widget costs you \$10 Australian to produce.
- \$1 US is the equivalent of \$1.50 Australian
- You sell your widgets for \$10 U.S. which equals \$15 Australian.
- The Australian dollar falls against the U.S. dollar and \$1 US now buys \$1.80 AUS.
- You continue to sell widgets for \$10 US which now equals \$18 AUS.
- Therefore your profit increases from \$5 AUS to \$8 AUS per widget

Of course, weakness in the Australian dollar will have the opposite affect on importers. But Australian resource companies, which produce and export commodities are in the same boat as we are as a widget exporter. Any Australian company, which is a net exporter will benefit from weakness in the exchange rate between our currency and the US dollar. It therefore follows that any weakness in our currency will be reflected in the performance of our resource sector. The following chart of the All Resources Index demonstrates how we can test and measure the entire sector's performance using a Sector 'Rate of Return' Indicator. We can simultaneously apply our multiple moving averages to assess the stability of the sector. The stability of trends in sectors is just as important as it is with individual shares. Sectors with high RoR's and unstable trends should be passed over for sectors with greater stability.

All ResourcesIDX-Weekly 07/13/2001 C=1535.000 -3.600 O=1538.600 H=1538.700 L=1505.700

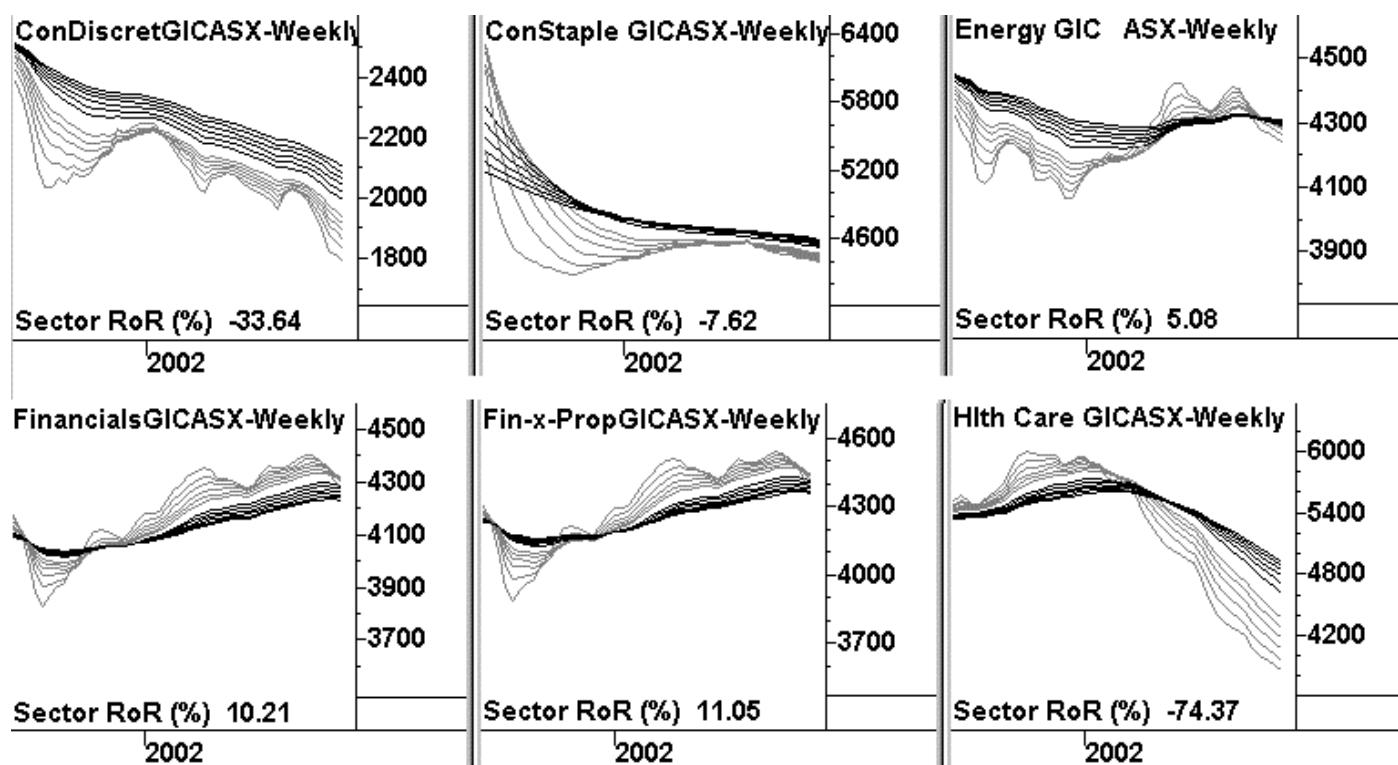
**The Resources Sector has risen consistently during a period that has seen the Australian dollar at all time lows against the US dollar**



Created with SuperCharts by Omega Research © 1997

The All Resources Index is currently rising at a rate of 20.69% per annum in a fairly stable manner. By testing and measuring the performance of individual sectors not only do we deduce the impact of macro economic factors on specific industries but we also gain an insight into the thinking and behavior of institutional investors. If you read articles in the print media or listen to fund managers being interviewed on television you will have noticed that they talk in terms of different sectors rather than specific companies. Their actions reflect this as they allocate funds on a sector by sector basis, spreading it around several leading companies from the same industry group. Australian Fund Managers have a strong tendency to follow their offshore cousins and therefore, by using sector analysis, we are tracking not only our local Fund Managers but global trends as well.

The following chart shows how we can assess several sectors at the same time by reducing them in size. There are a total of 12 individual economic sectors under the International GICS (Global Industry Classification Standard) system which the ASX adopted from July of 2002. Note that the sector 'rate of return' indicator doesn't switch 'OFF' as we want to monitor its value at all times.



It is not practical, or indeed possible, to set up rules for interpreting sector charts as it includes making qualitative judgements about MMA charts. My preferred approach is to use the sector charts to prevent indecision when I am analyzing individual shares. If I have two shares, both with acceptable MMA charts and similar rates of return, then the share from the best performing sector will be my choice. We can see from the above charts that the building materials sector is steaming along, ahead of the rest. By periodically checking these charts I carry around a short list of the best performing sectors in the back of my head. Almost on a subconscious level, this list will influence my share selection. But sector picking is secondary to our primary strategy of selecting individual shares using dynamic analysis.

***Sector analysis charts for all 12 GICS Sectors are included in the weekly ActVest Newsletter.***

# Risk Management

Traders are able to manage the risks involved in share trading because they use clearly defined entry and exit prices. Active Investing uses the same quantitative approach.

## Position Risk

The potential loss in owning each share is referred to as position risk. Traders normally use the 2% rule that states;

***'The total loss for any single trade must not exceed 2% of total capital'***

Your total capital is the current value of all shares held plus the total amount of cash on hand. By risking only 2% of our total capital on each trade it would take 194 consecutive losses to lose all of our money. Statistics from the United States indicate that 20% of Traders use risk management and this proportion coincides with the fact that only 20% of Traders survive.

### Example

- We are trading with \$20,000 total capital and using the 2% risk rule
- Assume that the closing price of a share is \$12 & the stop loss is set at \$10.  
(It is always assumed that the closing price is the probable entry price.)
- The potential loss per share is  $\$12 - \$10 = \$2$  and  $2\% \text{ of } \$20,000 = \$400$
- Divide \$400 by \$2 to get the number of shares we can buy = 200 shares
- Multiply 200 by the closing price of \$12 to get the position size = \$2,400
- Divide \$2,400 by \$20,000 and multiply by 100 to get the percentage of total capital that can be spent on this position = 12% (This is the maximum position size.)

## Sector Risk (Also referred to as Industry Risk)

We want to be able to capitalize on strong sectors without being exposed to speculative risk. To limit our exposure we will only allocate a maximum of 30% of our total capital per sector and a maximum amount of 6% position risk per sector.

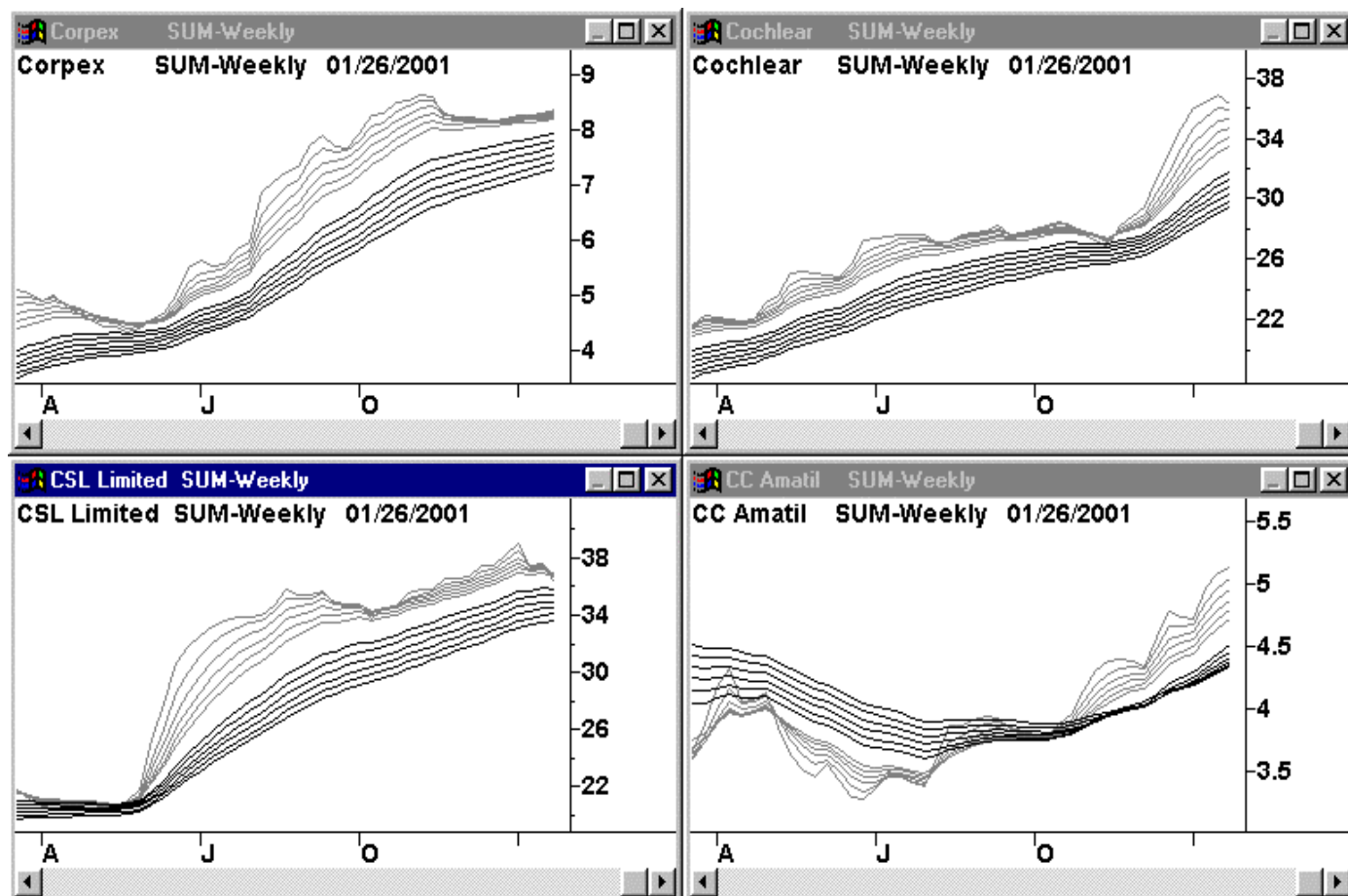
## Portfolio Risk

Portfolio risk is the sum total of our position risk. Our portfolio can have a minimum of 5 shares and a maximum of 15 shares. No single position can be greater than 20% of our total capital or less than \$2,000 in value. By using the 2% position risk rule we will probably own somewhere between 5 and 10 different positions. Note that the more positions we have; the higher the portfolio risk. This is why diversification is a dangerous and 'Goopy' form of risk management. It is in fact the result of risk management.

*The '2% Risk Rule for T.C.(%)' column in the ActVest Newsletter is calculated using the central cord and the lower deviation values. This column will display a maximum value of 20 because the largest allowable position size is 20%. By providing these portfolio weightings for Subscribers, the ActVest Newsletter makes light work of what is usually a complex task.*

# Using the ActVest Newsletter for the first time

Lets assume that you are now studying your very first ActVest Newsletter. The first step is to ensure that the Index Crossover charts aren't all crossed to the downside, signalling a 'stand aside' condition. It then pays to quickly peruse the Sector analysis charts to develop a mental picture of which industry groups are performing the best. The next step is to go to the MMA charts and make a short list of the shares that you believe have the least amount of volatility.



Cochlear's trend is well established but looking rather inconsistent in recent months whereas Coca Cola Amatil is a relatively new trend. The short term averages in both CSL and Corpex have a bad habit of flattening out for long periods of time. CCL would be my No.1 pick.

*Common mistake...Going to the data list first and choosing shares with high 'Rates of Return'*

*Common Question...Should I look for long term, established trends or for new trends?  
The usual Answer...My opinion is to have a majority of established trends over new trends.*

Your ability to read MMA charts will improve with time and practice. Avoid volatility and you will be more profitable, with less work, over the long term. Remember the more critical you are...the better. You should have made a list of between 10 and 20 shares. If your list has more than 20 shares then go back to the charts and be more critical, using sector analysis if necessary to eliminate more shares. At this point you should be armed with a list of shares that are in stable upward trends and you are now ready to turn your attention to the data list.

Weekly search results are presented in the following format.

<i>Share Code</i>	<i>Closing Price(\$)</i>	<i>Central Cord(\$)</i>	<i>Upper(\$) Deviation</i>	<i>Lower(\$) Deviation</i>	<i>Rate of Ret.(%)</i>	<i>2% Risk Rule for T.C. (%)</i>
ABC	11.87↑	12.17	13.94	11.38	68	20
IBM	19.40↑	20.12	22.69	17.75	33	17
NEC	15.11↓	14.63	16.73	12.68	46	15

We now have to check each of the shares in our short list of 10 to 20 stable, upward trending shares to see which ones have an entry signal. An entry signal is given when the following conditions have been met. Note that 'ABC' is the only share in the above list that meets all three of the following criteria.

- The 'Rate of Ret.(%)' column has a value equal to or greater than 40.
- The 'Closing Price(\$)' column has an up arrow (↑) next to the price.  
(Note - If no arrow appears next to the closing price then there has been no change in the price over the past week. E.g. This weeks closing price = last weeks closing price)
- The closing price is between the Central Cord and the Lower Deviation values.

Once an entry is signalled you can purchase the corresponding share with an amount of your capital less than or equal to, but never greater than, the percentage given in the '2% Risk Rule for T.C.(%)' column. The entry is only valid for the forthcoming week...during which time you can 'Buy' the share providing the purchase price is between the 'Lower Deviation' and the 'Central Cord'.

As it is highly probable that you will only be able to enter 1 or 2 positions each week, you will have to repeat the above process many times. In fact it can take up to 13 weeks or more to secure your entire portfolio as some shares won't pullback for several months or even longer.

The Newsletter also contains a complete listing of all the shares being searched with their corresponding sector. (Situating towards the end of the newsletter...this list is referred to as the 'Complete ActVest Share List'.) Using this list, you must also be watchful that you do not allocate more than 30% of your total capital to a single sector. Also ensure that you never own more than 15 individual positions or less than 5. (Sector & Portfolio Risk Risk...p25)

Once you have setup your portfolio you can write down the 'Lower Deviation' values for each of your shares on a weekly basis using the Newsletter. Each day you can check to see if any of your shares has closed at the end of the previous day below their respective lower deviation values...signalling an end-of-day stop loss. Alternatively you can simply check the Newsletter as you receive it to see if any of your shares has been 'Stopped out' on a weekly basis. Remember that the weekly stop loss is mandatory. If a share that you own is removed from the listing then the RoR indicator has switched 'OFF', also signalling an immediate exit.

# Stockmarket Crashes

Exposure to any stockmarket means exposure to crashes. Stockmarket crashes are an integral part of stockmarket behavior. Crashes and similar events, such as Iraq invading Kuwait, are referred to as catastrophic events and they represent catastrophic risk.. The only way that we can avoid exposure to this form of risk is to simply not be in the Stockmarket.

## The effect on Capital and Time

Examination of past crashes shows that an immediate loss of up to 50% of total capital can occur through ownership of Blue Chip shares. At an annual rate of return of 30% it would take approximately 4 years to recover the lost capital. This recovery time assumes that the market would resume its normal progression within 1 or 2 months of the crash. A more realistic recovery time would be 7 years. During some historical periods in the Stockmarket this recovery time was as long as several decades.

## Hedging

Active investors and traders have a distinct advantage over passive investors because their approach to the stockmarket is to profit from the movement in share prices in either direction. If you 'Buy low & sell high' you are going 'Long' and when you 'Sell high first & buy low later' you are going 'Short'.

**Note - Hedging or Short Selling is not an essential part of Active Investing!**

### Example

- Imagine that you rented a brand new TV from Acme Rentals.
- The rent is \$100 per annum.
- You sell the TV to Fred Nurk for \$600.
- 1 year later you buy the TV back for \$400 making a profit of \$200.
- You then return the TV to Acme Rentals and pay the \$100 rent.
- Your net profit after the rent of \$100 is repaid would be \$100.

In order to hedge against a crash you need to 'Short' at least 30% of your total capital. The ASX requires a 20% deposit for 'Shorting' giving short sellers a form of leverage. Always use a 50% deposit giving 100% leverage.

### Example

- A Stockmarket Crash has occurred causing all shares to fall 50% .
- You have \$70,000 long and \$30,000 short (Short positions=\$60,000)
- Your \$70,000 of long positions is now worth \$35,000.
- You have \$60,000 of short positions that you can cover for \$30,000.
- You lost \$35,000 long and made \$30,000 short. Total Loss=\$5,000 or 5%

# Short Selling Ordinary Shares

In order to short sell ordinary shares you will have to use a full service Broker. The bad news is that every Broker has different terms and conditions for 'Short Selling'. The parameters for our strategy are based on the following set of generic terms and conditions. When you are short selling it is important to check that the terms and conditions you are using coincide with the following list. Shaw Stockbroking is the preferred Stockbroker for Active Investing.

## **Jeffrey Shaw - Shaw Stockbroking - 03 9268 1107**

### **Generic terms & conditions for 'Short Selling'**

- Only certain securities are available for short selling. (Approximately 150)
- A separate 'Short selling' account must be opened.
- The stock must be borrowed prior to the order being placed.
- The ASX must be notified prior to the placement of short orders.
- Costs for borrowing stock will be deducted from the clients account.
- Borrowing fees apply separately for each order of the same stock.
- An upfront administration fee of \$55 inc. GST will apply from each lender.
- Lenders reserve the right to recall stock at any time.
- If a stock is shorted over the exdividend period the client will be liable for any dividends and franking credits owing to the lender.
- Brokerage fees, stamp duty and GST also apply to short selling.

An interest charge of 6.1% per annum inc. GST, calculated and charged on a daily basis, will apply to all borrowed stock. This interest rate will vary with changes in official interest rates.

#### Example

Assume we want to short \$10,000 worth of shares in Widgets LTD. We would pay the normal brokerage fee plus the \$55 administration fee upfront and be charged \$1.67 on a daily basis. This daily fee is calculated by multiplying \$10,000 by 0.061 and dividing it by 365.

### **Short Selling Rules**

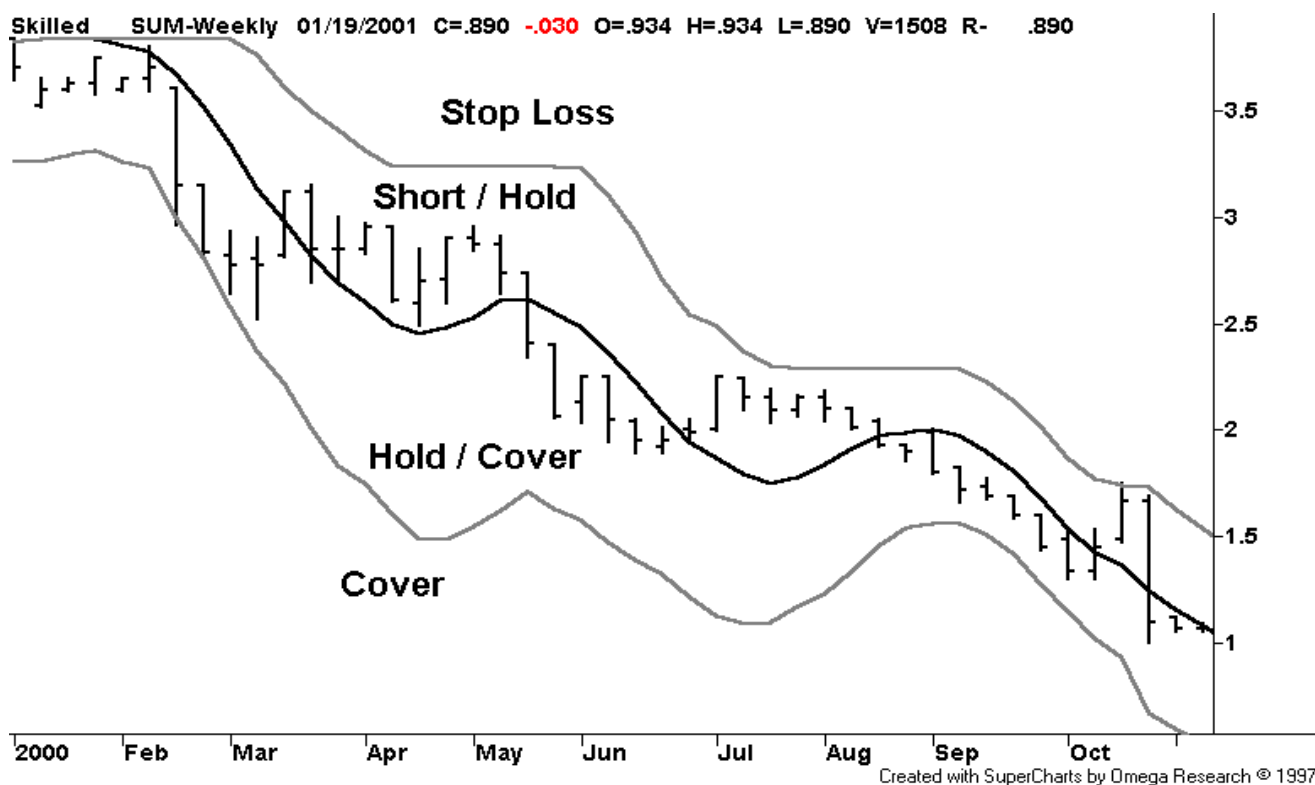
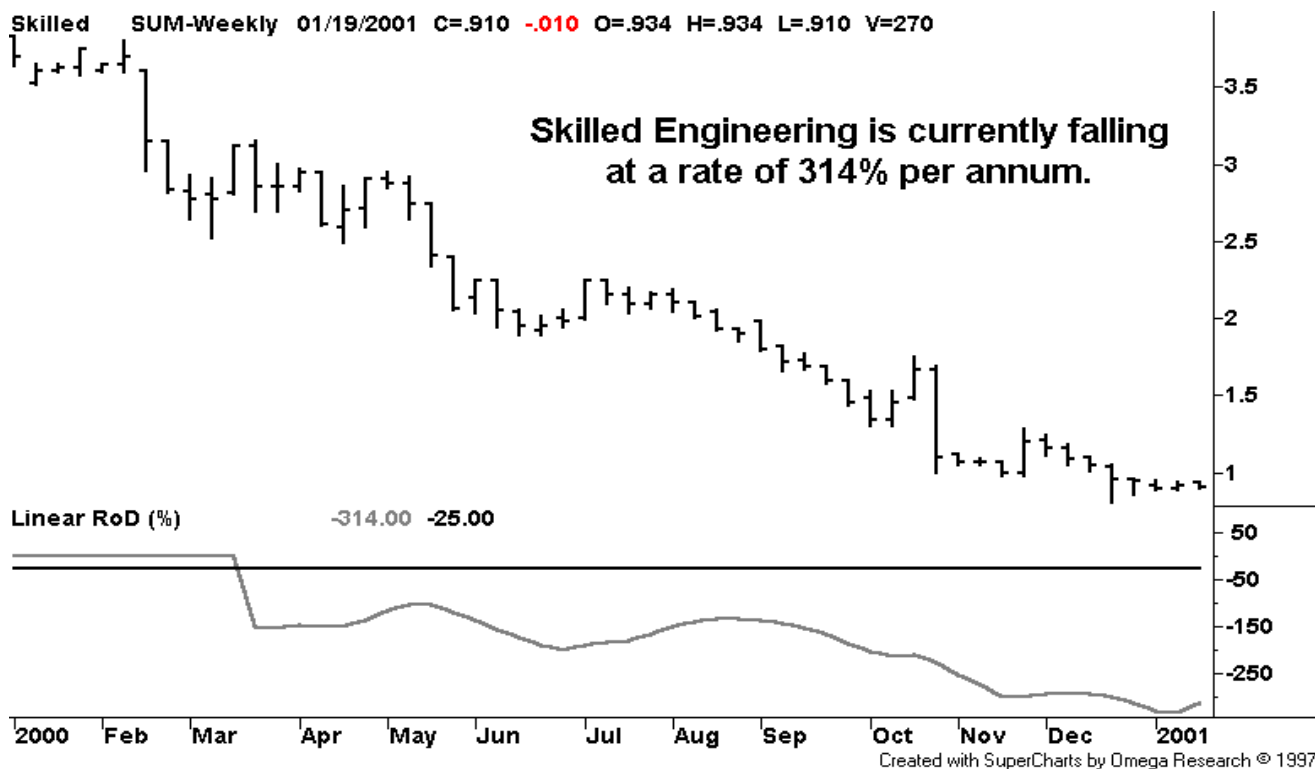
To absorb the above costs and hedge effectively the following rules apply.  
Note that a 20% fall is a 25% profit. (Short at \$10,000 - cover at \$8,000)

- Minimum position size of \$5,000.
- Minimum annual 'Rate of Decline' of 25%
- Always use a 50% deposit for 'Short Selling'. An example would be 'If your deposit is \$20,000 then only short \$40,000 worth of stock'.
- You must 'Short' at least 30% of your total capital to be hedged effectively.
- Never use the value of short positions when calculating your total capital. Use the current balance of your 'Shorting Account'. (See - 'General Considerations')

A total capital base of at least \$25,000 is recommended for short selling. This is because the minimum position size is \$5,000 as opposed to \$2,000 for trading long.

# Reversing the Trading Strategy

Short selling uses a completely upside down version of the conventional approach with the 'Rate of Return' indicator becoming the 'Rate of Decline' Indicator.



In Australia, 'shorting' is uncommon and many market participants are psychologically uncomfortable with it. If you fit into this category then short selling should be overlooked.

*The ActVest Newsletter includes data for falling equities based on the short selling list from Shaw Stockbroking. Note that the market entry procedure is reversed when shorting.*

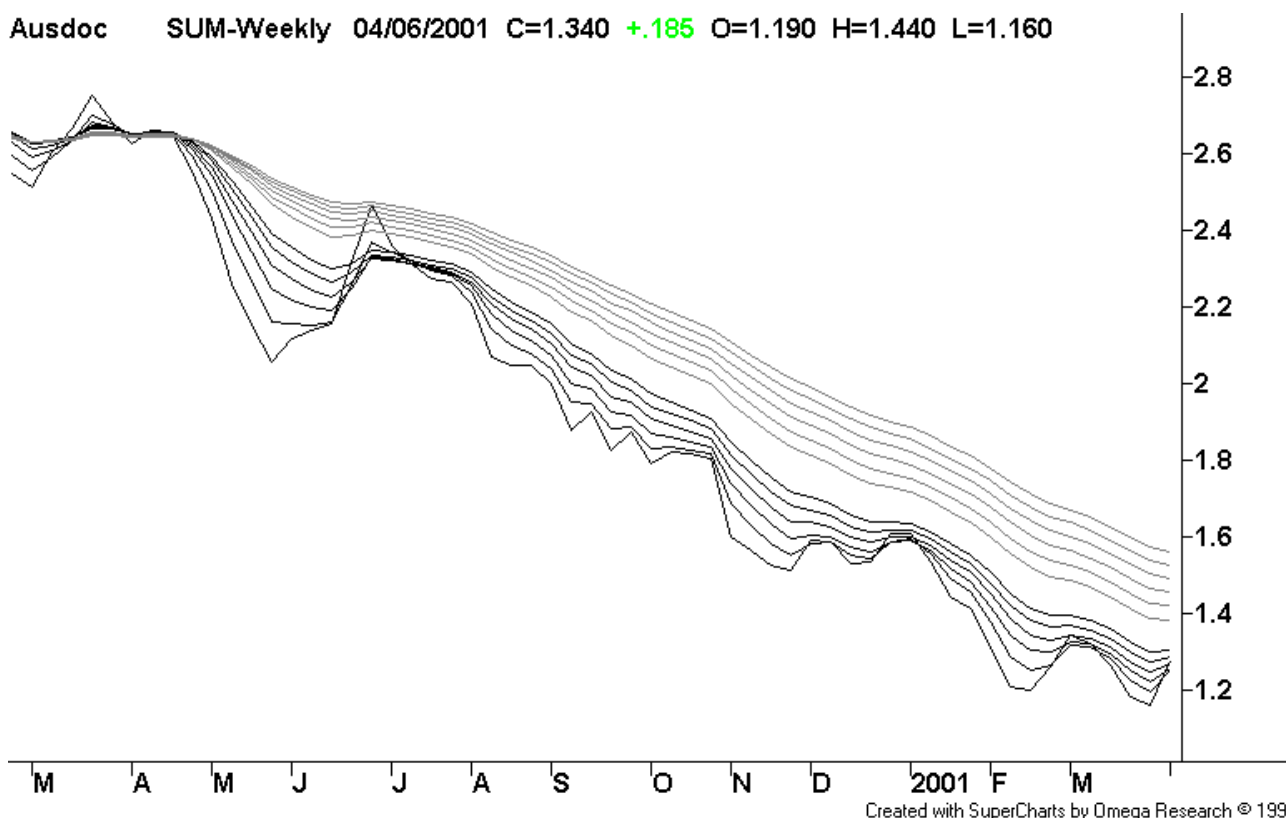


# Short Selling Tactics

The sentiment that drives equity markets up is not the exact reverse of the sentiment that pushes share prices down. Bulls run on greed whilst bears are driven by fear and these emotional forces are not mirror images of each other. Therefore, given this lack of symmetry, we need to use a slightly modified set of tactics for trading the sharemarket on the short side.

The most noticeable difference is that the bears act with greater impetus but in shorter bursts than the bulls. Historical examination of stockmarkets supports this observation as global markets will rise for much longer periods than they fall but they will fall with greater speed. However human beings, in the majority, are optimists and they will react swiftly when a glimmer of hope appears on the horizon. Therefore, when we short the market we will enjoy greater profits at the expense of increased risk. It is the increased risk that we must address by modifying our trading tactics. We must resist the attractiveness of shares with high 'Rates of Decline' because we know they carry a greater chance of a trend reversal and increased risk.

When searching through the MMA charts for shares that are falling by at least 25% per annum you will find that volatility is harder to avoid and that the regular pullbacks in the price activity are more pronounced. We must place added importance on avoiding volatility when selecting shares for short selling.



Ausdoc, pictured above, has been falling steadily over time. But even Ausdoc is capable of a sharp reversal if the right catalyst appears in print such as a take-over announcement, etc. Therefore we must be more vigilant in monitoring and executing our stop losses and daily stop loss execution is highly recommended. If a severe pullback has caused us to prematurely exit the market then we can always re-enter the trade when the downtrend resumes. Short selling is more intense, potentially more profitable but the downtrends are typically shorter.

# General Considerations

## Calculating your Total Capital

You must know at all times what your total capital is. Long positions are calculated by multiplying the number of shares by the current share price. Each short position is calculated in the following way and the total is added to the current 'Short Selling' account balance.

$(\text{Entry price} - \text{Current share price}) \times \text{Number of shares being shorted}$

It is possible to quickly calculate an approximate value of your total capital based on the weighting and current value of your long positions.

### Example

Total long positions = \$90,000 & Weighting = 60% or 0.6  
Therefore Total Capital =  $\$90,000 / 0.6 = \$150,000$

## Reweighting and Optimizing your Portfolio

Optimization is not necessary but reweighting your long and short positions should be done periodically. Reweighting is needed because one side of the market will inevitably outperform the other causing a shift in your Long/Short weighting. When reweighting it is essential to calculate the exact value of your portfolio. It is recommended that reweighting and optimization be done no more than twice a year. (June & December are quiet months)

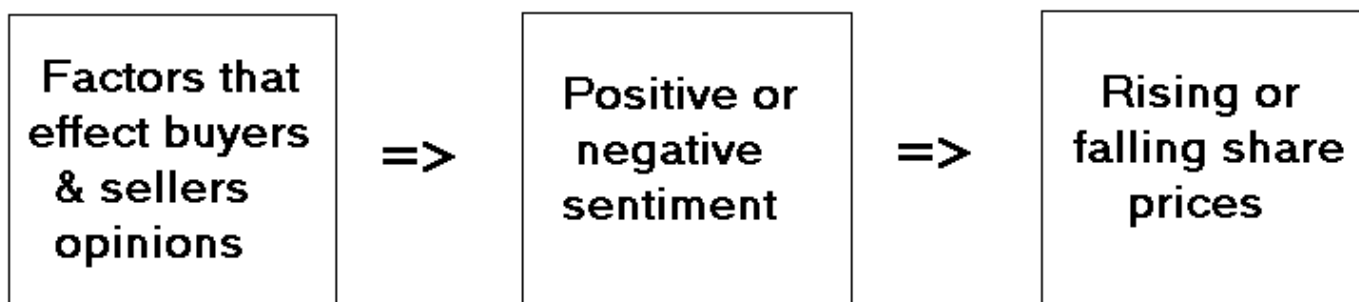
## Important Tips

The following tips are based on the past experience of other Active Investors. They are given with the intention of helping new Active Investors to avoid some common pitfalls.

- Don't double guess your trading system. No one likes incurring losses but the reality is that no trading system has a 100% success rate. Expect a win/lose ratio of 40 to 70% and you will be profitable from staying with the winners and selling the losers. The secret to success in the Stockmarket is the ability to cut your losses...not pick winners.
- Don't dabble with the strategy. Buying 'Just a couple of shares to give it a go' is like mowing just a bit of your lawn. There is no point if you don't fully commit because the logic behind the strategy is based on your 'Total Capital'. If you want to test the system then paper trade with it until you are satisfied with the results.
- It does makes sense to diversify across different investment mediums if you have a large amount of capital. Other investment mediums include property, bonds, term deposits, etc. Those seeking advice in this area should consult with a licenced Financial Advisor such as Nigel Smith at Segue Portfolio Partners on 03 9509 1599.

# Trading Strategy versus Trading System

Active investing is a trading strategy as opposed to a trading system. It is a set of guidelines built around the basic concept of analyzing the entire dynamic process that drives share prices either up or down. The market dynamic, pictured below, is universal and timeless.



We could try and build a trading system based on 'Dynamic Analysis'. By comparison, a trading system is a set of rules, as opposed to a set of guidelines, where there is no room for interpretation by the user. This is why a trading system can be made into a 'Black Box' computer program as computers can execute a set of rules. But a trading strategy cannot be subjected to the same process as it can't be reduced to a finite set of computer instructions.

The irony is that a systematic approach is fundamentally flawed because it assumes that market conditions are fixed and all market participants are identical in nature, ie. we all have the same risk profile, whereas a strategic approach allows for too much indecision. This irony leads the makers of trading systems to build in as much flexibility as possible and the creators of market strategies to be as rigid as possible. Ultimately we must trade the markets without indecision and it is up to each individual to evolve their chosen strategy into a set of unique trading rules. Each of us must trade with a system that is tailored to our individual requirements.

***As Active investing is a market strategy and not a trading system, it should be viewed as a set of guidelines and not as a set of rules.***

Part of our strategy is to only enter the market when a share has a rate of return equal to or greater than 40% and hold a share as long as the rate of return remains equal to or greater than 25%. But let's assume that the stockmarket doesn't offer enough opportunities for us to build an entire portfolio of shares. We must then be prepared to adjust these guidelines. We may have to lower our entry level 'Rate of Return' from 40% to 30% in order to find enough trading opportunities given the prevailing market conditions. We could also adjust this guideline to 35%. A famous U.S. Army General is reported to have drawn his sidearm and said to an indecisive subordinate, "Go left, go right...but if you stand still I'll shoot you". We must also be decisive when adjusting our guidelines. Once we, as individuals, have chosen a value between 30 and 40 as our new entry level RoR then we have taken a step towards reducing the Active Investing strategy into a personalized trading system. It is a good idea to write down your personal set of rules for Active Investing and not alter them for at least 6 Months. After this time you will have enough feedback to make accurate adjustments to your set of rules. But changing the rules as you go along is just another form of indecision.

# Asset Management

As well as Blue Chip share trading, Active Investing also includes the science of Asset Management where our primary interest is in acquiring income streams, not capital gains.



To understand Asset Management, it pays to know the answers to the following questions.

- Is there a difference between the value of shares and the Companies they represent?
- What is the difference between investing and trading?

The best place to start is by understanding the difference between shares and the underlying companies that they represent. The difference is the crowd. The crowd being the market participants, who collectively place a value on companies via their share price.

## Example

If there are 10 million shares issued for ABC company and the shares are trading at \$2 each then the market capitalization or the value that the market places on the company is;

$$10,000,000 \text{ shares} \times \$2 = 20 \text{ million dollars}$$

If the shares are sold down to \$1 each then the market has halved the value it places on ABC company.

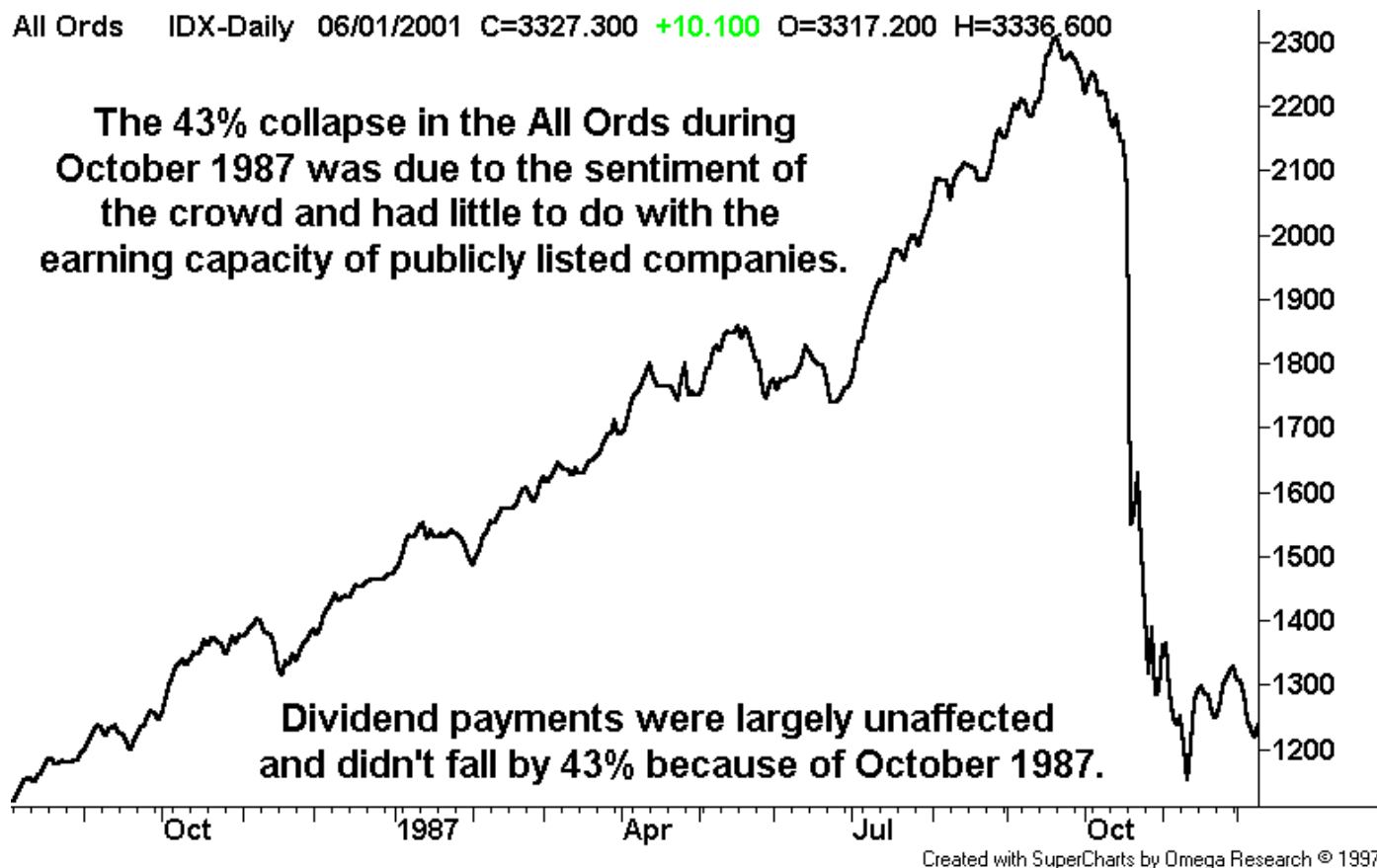
$$10,000,000 \text{ shares} \times \$1 = 10 \text{ million dollars}$$

The key point here is that the share price may alter without any change in the performance of the underlying company, its management or future prospects. In theory, the value which market participants place on a company and the actual value of the company in terms of its assets and earnings, should be one and the same...in theory.

But the crowd forms a slippery barrier between the value of the shares and what the company is actually worth. The crowd may value the shares using factors that have little or nothing to do with the company itself. Whilst this may seem to be an unwanted complication, it is the very reason for the marketplace's existence. If we could value shares using just solid facts then the stockmarket would probably cease to exist as the volume of trading would dry up.

Items with a fixed value can't be traded in a marketplace. (You wouldn't pay \$60 for a \$50 note, nor would you sell a \$50 note for \$40.) Shares are in fact an intangible representation of tangible companies. The two components are linked together via us, the crowd. But although we own public companies by possessing shares in them, it is important to differentiate between shares and the public companies they represent.

In the following chart of the All Ordinaries you can see how the crowd effectively devalued Australian Public Companies by 43% during the stockmarket crash of 87'. This devaluation had virtually nothing to do with any change in the performance of the Public Companies.



The next point requiring clarification is the difference between investing and trading. To understand the difference is extremely difficult when investing is defined as applying or using money to create profits and/or devote time and effort to an enterprise. One could include, by this definition, any undertaking that involves putting effort into realizing either profits or savings.

Apart from making the expression 'Passive investing' a contradiction in itself, this definition makes everyone present in the marketplace an investor of sorts. So we will differentiate between investors and traders by coming at the issue from the other end. Traders by definition are individuals who buy and sell products for profit.

Most of us think of traders as the people who run retail stores selling tangible goods. Stockmarket traders are doing exactly the same but they don't have retail stores. They are generally perceived to be working in a shorter timeframe than investors but this is a commonly held misconception as traders themselves are a type of investor. The time that a share is held for or the number of buy and sells orders executed by an individual in a given space of time has absolutely no bearing on whether they are a trader or an investor.

If we eliminate everyone in the stockmarket who is buying and selling shares for profit, ie. traders, then we are left with the people who use shares or companies as assets. Hence, we will define investors as individuals who own shares in publicly listed companies as assets. Now that we have defined shares, companies, traders and investors we can look at all the options that are available to us. The following four combinations are possible.

- 1 - We can invest in companies
- 2 - We can invest in shares
- 3 - We can trade companies
- 4 - We can trade shares

Asset management is defined as option 1...investing in companies. If we are investing in companies, then our perception is that we own part of the company as an asset. The purpose of our assets is to produce passive income and companies produce this income for us by paying an annual dividend, a share of the profits. We may also have the bonus of tax credits, in the event that the company has already paid some or all of the tax owing on the profits which are paid out to us as dividends. Commonwealth Bank of Australia is a good example of a public company as an income producing asset. If you had bought shares in CBA around the time of their initial listing, late 1991, you would have paid approximately \$6.50 per share and you would now be receiving an annual dividend payment of approx. \$1.30 per share. That's a very respectable 20% annual return on your original investment. Assets mature over time and CBA shares have matured very nicely thanks to the bull run of the last decade. Let's now examine the current share price by looking at a price chart.



During this 6 month period, the value of CBA shares has fallen by approximately 5%. But, since we own the company as an income producing asset, the current share price is of little relevance to us. We are only interested in the dividend as a percentage of the price we paid for the shares. The current share price is only important to us if we wish to sell our shares.

If we choose to sell our CBA shares then we will incur Capital Gains Tax. (and lose an income source) That's why it doesn't pay to sell assets. To realize any capital growth on the share price we can borrow against the equity. If you borrow against the equity then you won't have to pay capital gains tax and if you use the borrowings for further investment purposes then you will receive a tax deduction on the interest repayments. This is one of the tricks of the wealthy. When the banks lend money against the value of shares, it's called margin lending. The best way to understand margin lending is to look at some examples.

### Example 1

- Assume that you bought \$10,000 worth of CBA shares at \$6.50 each in 1991
- Today the share price is \$29.50 and your CBA shares are now worth \$45,385
- The bank will loan you up to 70% of the value of your CBA shares.

Tip - Only borrow against 66% of your holdings ( $0.66 \times 45,385 = \$30,000$ )  
By only borrowing against 66% of your holdings you will avoid a margin call in the event of the share price suffering a significant fall.

- You can borrow 70% (the margin for CBA shares) of \$30,000 which equals \$21,000
- You don't pay tax on the \$21,000 because it's money that you've borrowed
- You can use your dividends to pay off the loan because you still own the shares

You can use the \$21,000 for any purpose including buying more shares. If you use the \$21,000 to buy more shares, then you are leveraging your existing assets. Leveraging has been the central theme at every wealth creation seminar that I've ever attended whether it was based on property or stockmarket investment. Whilst the concept of leveraging and gearing is totally valid it is often used as a marketing tool, in conjunction with home equity, to promote dubious investments. Unfortunately, people can become so blinded by the opportunity of owning 100 acres of land that they take the agent's spiel at face value. Often it turns out to be a swamp and the only likely tenants are native water fowl. Always evaluate an investment on its merits and worry about how you're going to pay for it, if and when, you decide to acquire it. One of the best ways to put the equity in our CBA shares to work is to buy more CBA shares just after a stockmarket crash. The mathematics of margin lending is slightly different in this application.

### Example 2

- Assume that CBA shares have dropped to \$20 each in a crash
- Your CBA shares are now worth \$30,769 and you want to buy more CBA shares
- The bank will loan you up to 70% of your entire holdings in CBA shares
- Therefore you can borrow \$70,000 from the bank to take your holdings to \$100,000
- Only borrow 66% of \$70,000 (\$46,200) to avoid a margin call if the share price drops.
- You will receive the dividends for your entire holdings ( $\$30,769 + \$46,200 = \$76,969$ )
- The loan interest is tax deductible because you are using it for investment purposes.
- The annual dividends are driven by the performance of the company and a stockmarket crash will have no direct impact on their value. You are only concerned with what the CBA Bank is worth in terms of real assets and its income producing capabilities and not what an irrational stockmarket values it at during a period of mass panic.

We want to accumulate assets...not buy and sell them. The teachings of Warren Buffet become extremely relevant when it comes to investing in public companies. We won't go into great detail on how to value companies but here are several points worth summarizing.

- You want to own your assets forever...you never want to be forced to sell.
- You must very carefully assess the income producing capabilities of your assets
- You must purchase your assets at the lowest price possible
- Your assets must be able to withstand the passage of time.

These points cover property investment as well as investing in public companies. Bearing in mind that Warren Buffet has the financial wherewithal to control the public companies that he buys and we don't, we must be very careful when choosing companies that will last us a lifetime. You can see how this single criteria rules out high technology stocks given the volatility of their operating environment. This is why Warren Buffet has a strong preference for companies that produce essential products such as toilet paper manufacturers, etc.

## **Asset Class Shares**

We can refer to shares that represent companies which we deem to be 'Lifetime, income-producing Assets' as 'Asset Class Shares'. To seek out 'Asset Class Shares' we must first establish a set of specific benchmarks based on the expectations listed above. Whilst there is a degree of mystery surrounding the apparent genius of the likes of Warren Buffet and Ben Graham, they in their turn use or used a discrete set of pre-defined benchmarks to seek out asset class shares and not a crystal ball. Searching for lifetime, income producing assets is a boring and monotonous task, reliant on hard work...not an ability to foretell the future.

That said - let's now examine the guidelines for determining our benchmarks. As we are seeking 'Lifetime, income producing assets' we must consider the following 3 areas.

- Lifetime - Asset Class shares represent Company's that will exist for our lifetime.
- Income - Asset Class shares must have an acceptable dividend yield...or better.
- Assets - Asset Class shares should be of quality and bought at a reasonable price.

But before delving into each of these areas in detail, it is important to reiterate that the purpose of the Active Investing strategy, as it applies to either asset management or share trading, is to establish a minimal set of guidelines. Each of us has a different set of financial circumstances, financial goals and we are all of different ages. Therefore each of us must reduce the Active Investing guidelines to set of personalized benchmarks...or set of rules.

### **Lifetime**

Before we can make a judgement as to whether a company will last our lifetime, we must firstly quantify our own life expectancy and, secondly, determine the life expectancy of the Publicly Listed Company in question. Our lifetime...the obvious guideline here is to find out what the average life expectancy of an adult Australian is and then subtract your own age from it. You may choose to go a step further and be gender specific. Your life expectancy will also vary dramatically depending on whether or not you smoke cigarettes, etc, etc, etc. Hence, for the purpose of establishing a minimum guideline let's use the broadly accepted male retirement age of 65 minus your current age.



A Company's lifetime...there are several guidelines that we can combine in order to estimate a Company's life expectancy. The main problem is that we are required to make qualitative judgements about the stability of different commercial operating environments. Ie., we must make an assessment of the longevity and stability of different industry sectors.

Warren Buffet's choices in this regard are typified by some of the Companies that he has acquired in the past. He believes that men will always have to shave so he has bought shares in Gillette whereas he completely abstained from the 'Tech' doom on the simple basis that he perceived the operating environment to be subject to rapid change...a sensible assessment.

Another guideline we can employ is the size of a Company in terms of its market capitalization. The simple logic here is that the bigger a Company is, the less likely it is to disappear off the face of the Earth. Mind you, owners of HIH shares and Enron in the States might disagree with this logic. But whilst size doesn't necessarily ensure survival, it is a statistically valid approach with the vast majority of delistings occurring among smaller capitalization companies. For asset class shares we will apply a cutoff of 100 Million dollars as a minimum as this level fairly accurately defines the top 500 shares listed on the ASX.

Of course we still need to assess each company on its own merits as there are always individual circumstances that can't be incorporated into global benchmarks as we have done previously. A typical example of this would be ANZ or Westpac. These banks would become likely takeover targets by the larger banks in the event of the dismantling of the 4-Pillar banking policy by the Federal Government. Therefore the 4-Pillar banking policy could have a direct effect on the life expectancy of these companies. It would be a very similar scenario for Media companies in the event of changes to the restrictions of foreign ownership of media assets. So when it comes to assessing the life expectancy of a Company it will always depend on personal judgment.

## **Income**

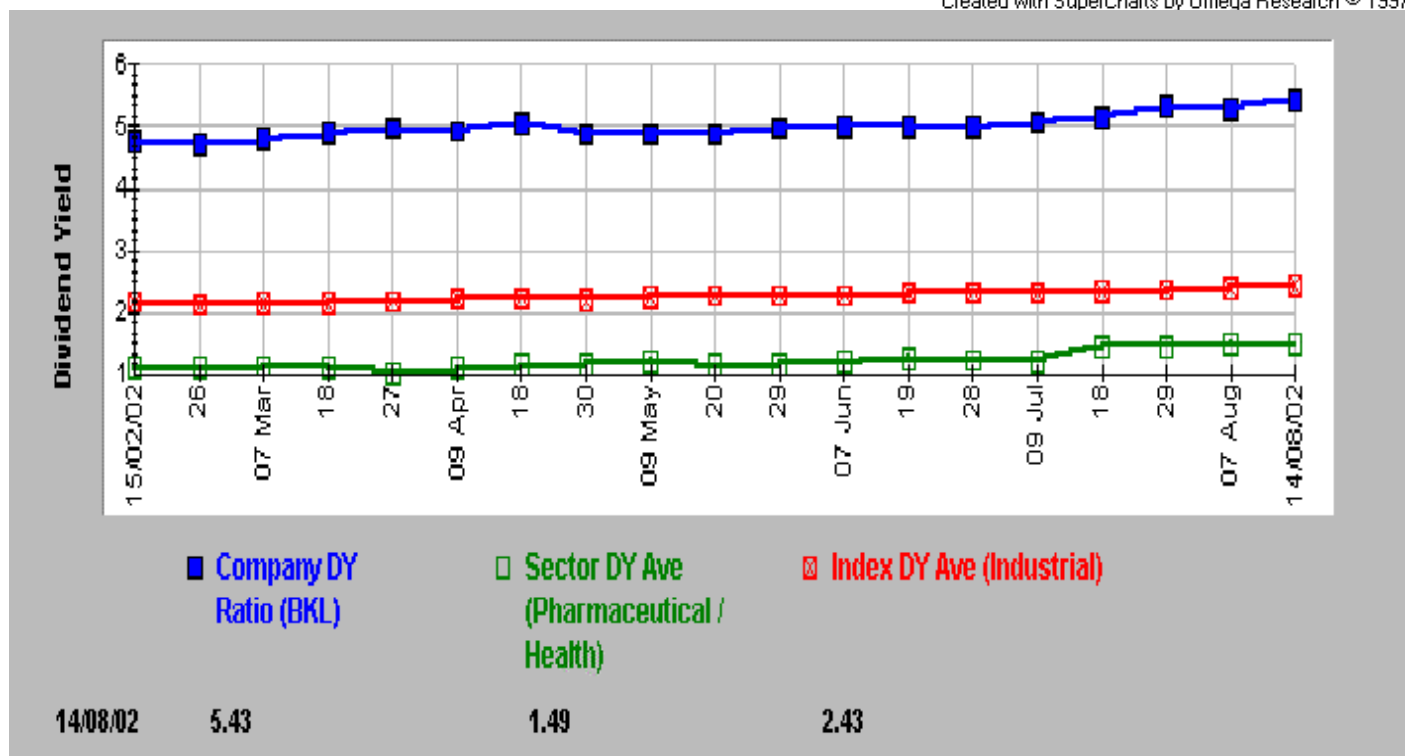
Before we look at establishing a minimum benchmark for income, it is important to understand the inverse relationship between a companies share price and its 'Dividend yield' which is the amount of income generated per share, per annum.

This is one of the more common tripwires where market participants confuse the science of share trading with the science of investing. In acquiring assets we are purchasing income streams whereas Traders buy and sell the price of the asset itself. It is normally wrong for a trader to buy a share with a falling price but, as asset managers, we want to buy an income stream for the lowest possible price. So as the annual dividend of a share remains constant at, let's say, \$1 and the share price drops from \$25 to \$20, the income stream or dividend yield increases from 4% to 5%, making the share more attractive as an income producing asset.

'Buy low - sell high' doesn't apply here because we have no intention of ever selling our assets. And, although we are bargain hunting as the stockmarket declines, we are in search of undervalued companies and the income streams they represent. We are not searching for undervalued shares with the expectation that the market will inevitably come to its senses and push prices back up. This is the logic used by bargain hunting Traders who use the word 'Should' a lot when talking about share price movements.

We can visually observe the inverse relationship between share price and dividend yield with the use of charts. Both of the following charts of Blackmores represent the same time period.

Blackmore SUM-Weekly 08/09/2002 C=6.270 +.020 O=6.250 H=6.270 L=6.160 V=96



The above dividend yield chart was generated using StockDoctor by Lincoln Indicators, a very handy fundamental analysis program, unique to Australia. ([www.stockdoctor.com.au](http://www.stockdoctor.com.au))

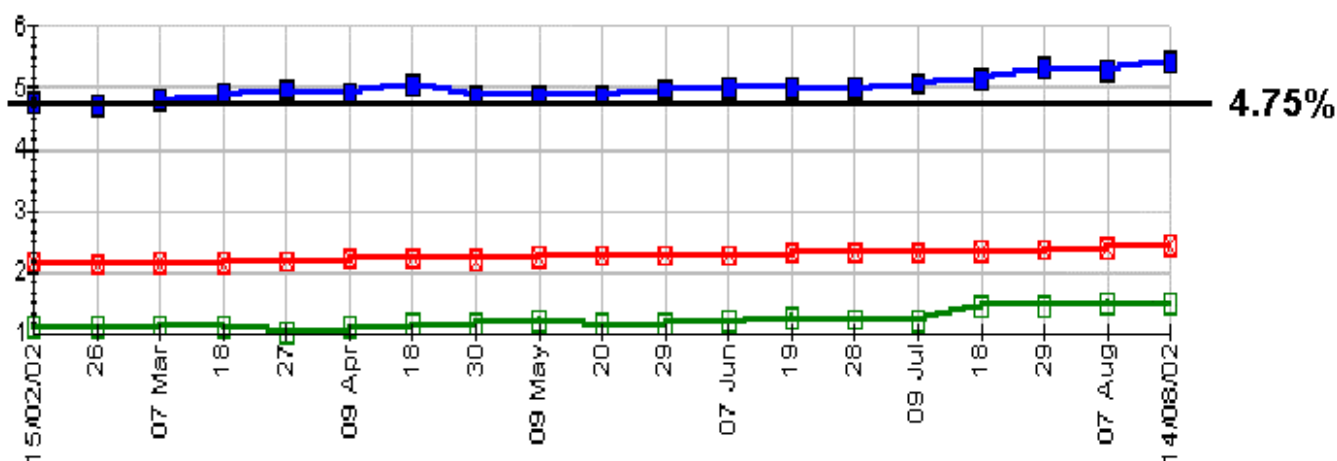
Blackmores share price, shown in the first chart as an unbroken blue line, is steadily falling over time whilst the dividend yield, shown in the second chart as an unbroken blue line with small blue squares, is steadily rising.

As the average dividend yield of the entire stockmarket has a very strong tendency to track official interest rates, our expectations in terms of income must remain flexible and in keeping with the Reserve Bank of Australia's official cash interest rate. As the average dividend yield is usually just below the official cash interest rate we will set our minimum benchmark at the RBA's official cash rate, 4.75% at the time of writing. (www.rba.gov.au) This will ensure that our income stream is always above the official cash rate and we're always ahead of the curve. What's more, this benchmark doesn't take into consideration any franking credits, ie. tax credits, that we may also be entitled to.

Be aware that whatever benchmark we choose to employ is only our starting point and should reflect our tolerance towards minimum income. As seen in the earlier example of CBA shares bought in late 1991 for \$6.50, our assets will gradually mature over time. The income streams from these assets will grow in magnitude and proportionality with respect to the prices we originally paid for them. For example, if you paid \$6.50 for CBA shares in 1991 then the annual dividend of approximately \$1.30 per share represents an annual income stream of 20% with respect to your original purchase price whilst it only equates to a dividend yield of 4% with respect to the share price of approx. \$32 at the time of writing.

So if we were to apply the benchmark of 4.75% to the dividend yield chart of Blackmores we can see that it exceeds our expectations in terms of minimum income requirements.

### Dividend yield chart for Blackmores



But, taking the example of Blackmores a step further, the dilemma we now face is 'Do we buy today or, given that the share price is falling (see previous page), do we wait for a possibly higher income yield in the future?'. The answer is...we buy if the current dividend yield is above our threshold and we continue to accumulate shares into the future if the share price continues to fall. Whereas traders will cry foul because we're averaging down our purchase price, a no-no when trading, we are in fact averaging up the dividend yield.

It is also interesting to note that when we are accumulating shares in a particular company, while the share price continues to fall, we could in fact be losing money. In other words if we add the dividend payments to our capital losses, the result is a negative one. But given our timeframe of a 'Lifetime', these losses are just the short term impact of an imperfect market entry. Fund managers will often use similar reasoning as an excuse for losses but it is only a valid excuse if their timeframe is the same as ours and they are accumulating income streams.

On a final note on income, it is always wise to ensure that the 'Dividend per share' or DPS is not of an abnormal nature and is in keeping with the normal dividend payment pattern of the company. In other words, check that the company has not paid out an extraordinarily large dividend because its income has been abnormally inflated due to a unique circumstance such as the selling of a major asset. An example of this is when Mayne Nickless sold its interest in Optus which led to a bonus payment to shareholders of an extra \$1 per share.

## Assets

This section covers two very important areas...the first being the issue of 'Quality' and the second being 'Value for money'. Of course by quality I am referring to the quality of the company that the shares represent where an assessment can be made using fundamental analysis. To this end I will, once again, enlist the help of StockDoctor by only considering Star Stocks (Companies deemed to be of low risk and good future prospects by StockDoctor) as possible asset class shares. Attempting to individually assess the financial wellbeing, or quality, of approximately 500 companies is totally unrealistic and unnecessary given the existence of programs like StockDoctor by Lincoln Indicators. ([www.stockdoctor.com.au](http://www.stockdoctor.com.au))

But, no matter how good the quality of any product is, I always like to pay as little as possible for it. In order to know that I'm getting a bargain, or at least value for money when buying shares, I must ensure that the P/E and P/A ratios are within acceptable benchmarks. But before we explore the question of acceptable benchmarks we should first clarify what these ratios are.

'P/E Ratio' is an abbreviation for 'Price/earnings ratio' and defines the relationship between a company's market capitalization and its annual net earnings after tax. A low P/E ratio indicates that the earnings of a company are proportionally high with respect to its share price whereas the opposite is true for a high P/E ratio. Whenever the share price of a company changes or a new financial report is issued by the company, the P/E ratio will change.

### Example

- A company has a total market capitalization of \$10 Million.
- Its annual net earnings after tax are \$1 Million.
- Therefore it has a P/E ratio of 10 (\$10 Million / \$1 Million)

'P/A Ratio' is an abbreviation for 'Price/asset ratio' and defines the relationship between a company's market capitalization and its net tangible assets.

### Example

- A company has a total market capitalization of \$10 Million.
- Its total net tangible assets (ie. property, plant and equipment, etc) are \$2.5 Million
- Therefore it has a P/A ratio of 4 (\$10 Million / \$2.5 Million)

A low P/A ratio indicates that the asset backing of a company is proportionally high with respect to its share price whereas the opposite is true for a high P/A ratio.

It is possible to find companies with P/A ratios of less than one , which means that a \$1 share represents more than \$1 of value in net tangible assets. This situation occurs when the future prospects of a company are poor and the marketplace is more focused on earnings rather than asset backing.

To ensure that this situation doesn't occur we need to look for companies with both a low P/A ratio, indicating substantial asset backing, and a low P/E ratio, indicating good earnings. Our minimum benchmarks will be a price/earnings ratio of 15 or less and a price/asset ratio of 5 or less. These minimum levels for earnings and asset backing will reasonably ensure that we are getting value for money when we go shopping for asset class shares.

### **Short Listing**

The following is a summary of the minimum benchmarks that we have developed for our asset class shares. (This list excludes any discretionary guidelines such as life expectancy)

- Market capitalization of at least 100 Million dollars
- Dividend yield greater than the official RBA cash interest rate (Currently 4.75%)
- Fundamentally sound - companies must currently be StockDoctor Star Stocks
- The P/E ratio must be less than 15 and the P/A ratio must be less than 5

Using these minimum benchmarks we can, with the help of StockDoctor, create a short list of potential asset class shares. The following is a sample listing from mid 2002.

### **Asset Class Shares**

<i>Company Name</i>	<i>Code</i>	<i>P/A Ratio</i>	<i>P/E Ratio</i>	<i>Dividend yield%</i>
AlintaGas	ALN	2.52	12.78	5.28
AV Jennings Homes	AVJ	1.24	6.90	10.11
Blackmores Laboratories	BKL	4.92	13.39	5.43
Bristle	BRS	2.28	10.57	5.73
Casinos Austria Int.	CAI	2.79	6.67	6.00
Centennial Coal Company	CEY	1.39	9.58	5.09
Crane Group	CRG	1.51	12.33	5.99
Joe White Maltings	WJM	1.45	8.00	5.58
Simsmetal	SMS	2.60	14.14	5.18
Stockland Trust Group	SGP	1.36	14.38	6.70

The above list includes only 10 possibilities from a time when global markets are severely depressed in 2002, a period when this list should be relatively long. The possibilities are few because our benchmarks are tough and we haven't even begun to examine this list with respect to 'Life Expectancy'. The reality is that you should only expect to uncover 1 or 2 ideal opportunities over a period of several years. But when you do, it pays to have the confidence to act swiftly...lest you suffer the regret of not buying CBA shares for \$6.50 all over again.

**An 'Asset Class Shares' list, as pictured above, appears every week in the ActVest Newsletter. This list is generated using Stockdoctor's StockFilter function and the above parameters.**

# Supercharts Indicator Formulas

All of the following indicators are for use on weekly charts only.

## 'Rate of Return' Indicator

Only plots 3 & 4 are visible with plots 1 & 2 being used for calculations only.

### Plot1

```
iff( round(
((6.854*LinearRegValue(close,13,0))+4.236*LinearRegValue(LinearRegValue(close,13,0),11,0))+2.618*
LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0))+1.618*LinearRegValue(LinearR
egValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0),5,0)) +
(1*LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7
,0),5,0),3,0)) )/16.326,2) >plot1[1] ,iff(round(
((6.854*LinearRegValue(close,13,0))+4.236*LinearRegValue(LinearRegValue(close,13,0),11,0))+2.618*
LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0))+1.618*LinearRegValue(LinearR
egValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0),5,0)) +
(1*LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7
,0),5,0),3,0)) )/16.326,2)-(2.5*AvgTrueRange(13))>plot1[1],round(
((6.854*LinearRegValue(close,13,0))+4.236*LinearRegValue(LinearRegValue(close,13,0),11,0))+2.618*
LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0))+1.618*LinearRegValue(LinearR
egValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0),5,0)) +
(1*LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7
,0),5,0),3,0)) )/16.326,2)-(2.5*AvgTrueRange(13)),plot1[1]),LinearRegValue(close,13,0))
```

### Plot2

```
iff( Summation(weightedclose*volume,13)>100000 and
(LinearRegValue(weightedclose,13,0)+LinearRegValue(LinearRegValue(weightedclose,8,0),13,0)+LinearR
egValue(LinearRegValue(LinearRegValue(weightedclose,5,0),8,0),13,0)+LinearRegValue(LinearRegValue
(LinearRegValue(LinearRegValue(weightedclose,3,0),5,0),8,0),13,0)+LinearRegValue(LinearRegValue(Lin
earRegValue(LinearRegValue(LinearRegValue(weightedclose,2,0),3,0),5,0),8,0),13,0))/5 >
(LinearRegValue(weightedclose[1],13,0)+LinearRegValue(LinearRegValue(weightedclose[1],8,0),13,0)+Li
nearRegValue(LinearRegValue(LinearRegValue(weightedclose[1],5,0),8,0),13,0)+LinearRegValue(LinearR
egValue(LinearRegValue(LinearRegValue(weightedclose[1],3,0),5,0),8,0),13,0)+LinearRegValue(LinearR
egValue(LinearRegValue(LinearRegValue(weightedclose[1],2,0),3,0),5,0),8,0),13,0))/5 and
LowestBar(weightedclose,Tperiod)=Tperiod-1 and plot2[1]=0 and
average(weightedclose,13)>average(weightedclose,21),Tperiod-1,iff(plot2[1]>Tperiod-2 and
average(weightedclose,13)>average(weightedclose,21) and plot3[1]>24 and plot1 >= plot1[1] and
Summation(weightedclose*volume,13)>100000,plot2[1]+1,iff(average(weightedclose,21)>=average(weight
edclose,13) or Summation(weightedclose*volume,13)<100000 or plot1[1]>plot1 or plot3[1]
<25,0,plot2[1]))
```

### Plot3

```
round(iff(plot2>0,iff( plot2<52,(5200/(plot2+1))*((LinearRegValue(weightedclose,13,0)-
weightedclose[plot2])/LinearRegValue(weightedclose,13,0)),100*((LinearRegValue(weightedclose,13,0)-
LinearRegValue(weightedclose[51],13,0) )/LinearRegValue(weightedclose,13,0))),0,0)
```

### Plot4

25

## 'Rate of Decline' Indicator

Only plots 3 & 4 are visible with plots 1 & 2 being used for calculations only.

### Plot1

```
iff( round(
((6.854*LinearRegValue(close,13,0))+4.236*LinearRegValue(LinearRegValue(close,13,0),11,0))+2.618*
LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0))+1.618*LinearRegValue(LinearR
egValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0),5,0)) +
(1*LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7
,0),5,0),3,0)) )/16.326,2) < plot1[1] ,iff(round(
((6.854*LinearRegValue(close,13,0))+4.236*LinearRegValue(LinearRegValue(close,13,0),11,0))+2.618*
LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0))+1.618*LinearRegValue(LinearR
egValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0),5,0)) +
(1*LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7
,0),5,0),3,0)) )/16.326,2)+(2.5*AvgTrueRange(13))<plot1[1],round(
((6.854*LinearRegValue(close,13,0))+4.236*LinearRegValue(LinearRegValue(close,13,0),11,0))+2.618*
LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0))+1.618*LinearRegValue(LinearR
egValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0),5,0)) +
(1*LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7
,0),5,0),3,0)) )/16.326,2)+(2.5*AvgTrueRange(13)),plot1[1]),LinearRegValue(close,13,0))
```

### Plot2

```
iff( Summation(weightedclose*volume,13)>100000 and
(LinearRegValue(weightedclose,13,0)+LinearRegValue(LinearRegValue(weightedclose,8,0),13,0)+LinearR
egValue(LinearRegValue(LinearRegValue(weightedclose,5,0),8,0),13,0)+LinearRegValue(LinearRegValue
(LinearRegValue(LinearRegValue(weightedclose,3,0),5,0),8,0),13,0)+LinearRegValue(LinearRegValue(Lin
earRegValue(LinearRegValue(LinearRegValue(weightedclose,2,0),3,0),5,0),8,0),13,0))/5 <
(LinearRegValue(weightedclose[1],13,0)+LinearRegValue(LinearRegValue(weightedclose[1],8,0),13,0)+Li
nearRegValue(LinearRegValue(LinearRegValue(weightedclose[1],5,0),8,0),13,0)+LinearRegValue(LinearR
egValue(LinearRegValue(LinearRegValue(weightedclose[1],3,0),5,0),8,0),13,0)+LinearRegValue(LinearR
egValue(LinearRegValue(LinearRegValue(LinearRegValue(weightedclose[1],2,0),3,0),5,0),8,0),13,0))/5 and
HighestBar(weightedclose,Tperiod)=Tperiod-1 and plot2[1]=0 and
average(weightedclose,13)<average(weightedclose,21),Tperiod-1,iff(plot2[1]>Tperiod-2 and
average(weightedclose,13)<average(weightedclose,21) and plot3[1]< -24 and plot1 <= plot1[1] and
Summation(weightedclose*volume,13)>100000,plot2[1]+1,iff(average(weightedclose,21)<=average(weight
edclose,13) or Summation(weightedclose*volume,13)<100000 or plot1[1]<plot1 or plot3[1] > -
25,0,plot2[1])))
```

### Plot3

```
round(iff(plot2>0,iff( plot2<52,(5200/(plot2+1))*((LinearRegValue(weightedclose,13,0)-
weightedclose[plot2])/LinearRegValue(weightedclose,13,0)),100*((LinearRegValue(weightedclose,13,0)-
LinearRegValue(weightedclose[51],13,0) )/LinearRegValue(weightedclose,13,0))),0,0)
```

### Plot4

-25

## **Range Indicator - Rising Equities**

The range indicator overlays 3 lines on the price data and 'Scaling' must be set for 'Same as price data'.

### **Plot1**

```
round(
((6.854*LinearRegValue(close,13,0))+4.236*LinearRegValue(LinearRegValue(close,13,0),11,0))+2.618*
LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0))+1.618*LinearRegValue(LinearR
egValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0),5,0)) +
(1*LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7
,0),5,0),3,0)) )/16.326,2)
```

### **Plot2**

```
round(plot1+(3*AvgTrueRange(13)) ,2)
```

### **Plot3**

```
round( iff( plot1>plot3[1] ,iff(plot1-(2.5*AvgTrueRange(13))>plot3[1],plot1-
(2.5*AvgTrueRange(13)),plot3[1]),plot1),2)
```

## **Range Indicator - Falling Equities**

Once again, 'Scaling' must be set for 'Same as price data'.

### **Plot1**

```
round(
((6.854*LinearRegValue(close,13,0))+4.236*LinearRegValue(LinearRegValue(close,13,0),11,0))+2.618*
LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0))+1.618*LinearRegValue(LinearR
egValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7,0),5,0)) +
(1*LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(LinearRegValue(close,13,0),11,0),7
,0),5,0),3,0)) )/16.326,2)
```

### **Plot2**

```
round(plot1-(3*AvgTrueRange(13)) ,2)
```

### **Plot3**

```
round( iff( plot1<plot3[1]
,iff(plot1+(2.5*AvgTrueRange(13))<plot3[1],plot1+(2.5*AvgTrueRange(13)),plot3[1]),plot1),2)
```

## **Multiple Moving Average Indicators**

The MMA charts are created by using 3 separate indicators that each contain 4 plots.

### **Weekly MMA Indicator 1**

```
Plot1 = xaverage(close,3) Plot2 = xaverage(close,5) Plot3 = xaverage(close,7) Plot4 = xaverage(close,9)
```

### **Weekly MMA Indicator 2**

```
Plot1= xaverage(close,11) Plot2= xaverage(close,13) Plot3= xaverage(close,21) Plot4= xaverage(close,24)
```

### **Weekly MMA Indicator 3**

```
Plot1= xaverage(close,27) Plot2= xaverage(close,30) Plot3= xaverage(close,33) Plot4= xaverage(close,36)
```

## **Sector - Rate of Return**

### **Plot1**

```
200*(linearregvalue(close,52,0)-linearregvalue(close[26],52,0))/close
```



# Metastock Indicator Formulas

The following indicators have been adapted from the Supercharts formulas for use on Metastock by Simon Sherwood (Actvest@bigpond.com) Whilst they have been derived from the Supercharts formulas, they do not return identical values. All Indicator formulas and explorations are for use on weekly charts only.

## Rate of Return & Rate of Decline Indicators

$200 * (\text{LinearReg}(C,52) - \text{Ref}(\text{LinearReg}(C,52), -26)) / C$

## Exploration - Rate of Return

Rate of Return > 25

## Exploration - Rate of Decline

Rate of Decline < -25

## Range Indicator - Rising Equities

### Central Cord

$\text{LinearReg}(C,13)$ ;

### Lower Deviation

$\text{If}(\text{LinearReg}(C,13) > \text{PREV}, \text{If}(\text{LinearReg}(C,13) - (\text{ATR}(13) * 2.5) > \text{PREV}, \text{LinearReg}(C,13) - (\text{ATR}(13) * 2.5), \text{PREV}), \text{LinearReg}(C,13))$ ;

### Upper Deviation

$\text{LinearReg}(C,13) + (\text{ATR}(13) * 3)$ ;

## Range Indicator - Falling Equities

### Central Cord

$\text{LinearReg}(C,13)$ ;

### Lower Deviation

$\text{LinearReg}(C,13) - (\text{ATR}(13) * 3)$ ;

### Upper Deviation

$\text{If}(\text{LinearReg}(C,13) < \text{PREV}, \text{If}(\text{LinearReg}(C,13) + (\text{ATR}(13) * 2.5) < \text{PREV}, \text{LinearReg}(C,13) + (\text{ATR}(13) * 2.5), \text{PREV}), \text{LinearReg}(C,13))$ ;

## MMA Charts

Metastock users can either build MMA indicators or create an MMA template.

Short term group of exponential moving averages - 3, 5, 7, 9, 11 & 13

Long term group of exponential moving averages - 21, 24, 27, 30, 33 & 36

## Sector - Rate of Return

$200 * (\text{LinearReg}(C,52) - \text{Ref}(\text{LinearReg}(C,52), -26)) / C$

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