

EQUITIES

Table of Contents

1.	Coordinator's Introduction by Owen Richards, AIA Member	Page 1
2.	Investing & Trading in the Coming Market by Owen Richards	Page 2
3.	<i>Active Investing</i> book reviewed by Tim Kottek, AIA Member	Page 7

* * * * *

COORDINATOR'S MESSAGE

By Owen Richards

This edition of the Equities Bulletin is essentially an essay entitled Investing and Trading in the Coming Market and has my thoughts on what we might expect in ASX market conditions in the near future. The article quotes the old saying, 'Prediction is difficult, especially when it involves the future' and adds '...of course I have no better idea than anyone else; so please feel free to accept or reject any or all of what follows.' However it is an honest assessment as to where I see the ASX heading and how AIA members might approach it. I trust that some readers may find it useful.

Owen Richards is a member of the AIA.

* * * * *

Owen Richards resigns as the Equities Bulletin Coordinator

After some three and a half years and almost 30 issues, this will be Owen Richards' final Equities Bulletin. For those of you who regularly read his articles I am sure you will agree his input will be missed. The AIA would like to take this opportunity to thank Owen for his invaluable input and to wish him well for his ongoing trading and other activities.

Obviously we are now looking for interested persons to take on this role and if you would like further information please email Silvana Eccles at silvana.eccles@investors.asn.au or telephone 07 5527 9283.

Thank you Owen☺

INVESTING & TRADING IN THE COMING MARKET

By Owen Richards

Are We There Yet, Dad?

My Financial Advisor rang today and asked when it would be convenient to have our scheduled SMSF quarterly meeting. Again I indicated that we are still primarily in cash and couldn't see much use in meeting to discuss equities at all at this time. Our holdings in managed funds remain a problem but selling out of them now is not an option, and we have earlier decided that once we see a 'reasonable' return on them we will get out of managed funds entirely and into Exchange Traded Funds instead. The trading (speculative) account is still in US dollars and is at least now holding its own.

Well, what is going to happen? There seems to be a general consensus that we are at or very near the bottom of the market, and that even capitulation may be likely. This latter term is borrowed from the military and signifies investors 'surrendering' or 'giving up' completely. The investors (almost all of them) sell all their stocks because they just want to get out of the market. The sole motivation for selling is to seek shelter in 'safe' investments such as bonds or under the mattress. The selling frenzy is painful, but relatively quick. Genuine capitulation involves extremely high volume and sharp declines and is usually indicated by panic selling. Well, we shall see. We may just end with a market-bottom whimper rather than a capitulation bang¹

Of greater interest is the question of how and when the market will return. As the old saying has it, 'Prediction is difficult, especially when it involves the future'. And of course I have no better idea than anyone else; so please feel free to accept or reject any or all of what follows.

Some pundits are looking at the recovery of the markets following the correction of 1986 and earlier, for guidance as to how the recovery from the current situation might evolve. This suggests the possibility of a significant bear rally bounce this year/next year, leading into a long period (ten years?) of the ASX ranging back and forth and somewhere between the current low and the high of the bear market bounce, until the next real bull market comes along. A diagrammatic representation is shown as Figure 1.

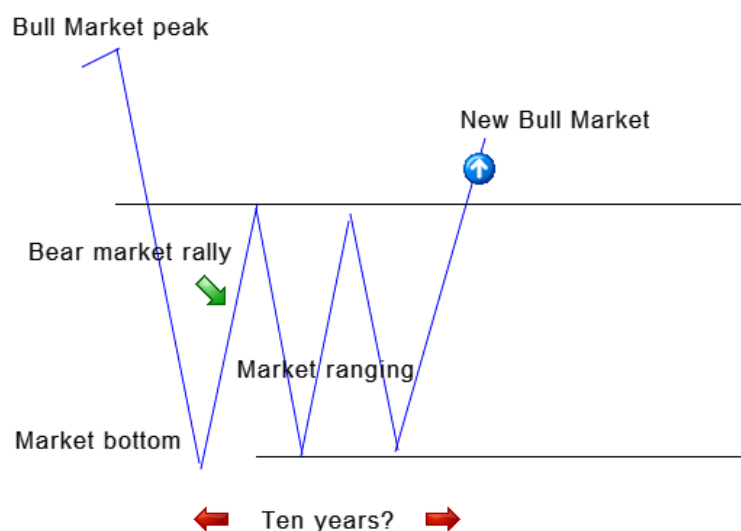


Figure 1: Possible scenario for ASX recovery

¹ Since I wrote these words, the ASX has rallied almost 17% (Fri 27 Mar). However, I am sticking to my guns to suggest that we have not necessarily seen either 'the' bottom or the start of 'the' bear market rally. The possible collapse of this rally could be the precursor to capitulation. By the time that you read this, we should know either way.

How Will This Affect the Investor?

This scenario seems plausible to me and I certainly think that this, or something like it, is how things will play out in equities in the years ahead. We are looking into a secular (extended) bear market which will occasionally rally but essentially range until a bull market breakout in possibly eight to ten years time.

The point has been made before in these pages that it's not enough to 'buy and hold' (and/or its best mate, to 'value invest') if you don't have enough years left in your life to wait for the market to return. This is what was said in the AIA Equities Bulletin of December 2008:

'The difficulty that I have always had with value investing [i.e. the Ben Graham model, or to just 'buy and hold'] is whether people (like you and me) who have taken most of their lifetime to accumulate sufficient capital (usually their superannuation) to invest, will have enough time left to patiently await the market's pleasure, which value investing usually requires.

'The average 60-year-old man who wants to retire at age 65 (which is relatively early these days) and die with 50% of his assets remaining, has about a sixteen year investment horizon. A comparable 60-year-old woman has a 19-year horizon. For every year that you're under 60, you can add an extra year to these figures.

'When you realise that the ASX has had occasions when it has had a **decade-long return of less than one percent**, it's not surprising that many older investors want as much as they can out of the market while they can. And we just might be looking down the barrel of another such decade!

'However, if you are in your thirties and have no health risk factors, you have an investment horizon of about fifty years. If you can then accumulate a modest sum of capital, value investing will probably prove quite worthwhile. ~~For the rest of us, I suggest a judicious mix of both growth and value investing remains a fair compromise for our remaining days as investors.~~ *[Emphasis in the original. Square bracket content and Strikethrough added]*

It remains to be seen whether the market's return will follow the bear market rally/ten year ranging scenario outlined above. But if (like me) your time is limited, I suggest that it would be prudent to accept either this or a similar template to plan your investing approach in the years ahead. And it is for this reason that the Strikethrough has been applied to the last sentence of the quote above. It should now be obvious that the bull market to which we became accustomed over the last few years is unlikely to be seen again for some time. This suggests that we need to cut our new suits from a different cloth for a while, and the following paragraphs are offered for the, well, more mature-aged investor.

Some Considerations for Investors

A passive Buy and Hold is unlikely to be profitable for the coming decade, unless you are seeking only dividend returns and these are likely to diminish until business conditions improve. The classic Ben Graham/Warren Buffett value investing approach will be equally suspect. Sure, if you hang on to them long enough they will probably come good, but is this going to be appropriate for your own shorter-term requirements?

The fundamental analysis of individual prospects will assume greater importance. Businesses must have manageable debt levels, as well as achieve sufficient cash flow from operations in order to fund their activities. The demise of Babcock and Brown is an unhappy case in point. We saw its share price fall from over thirty dollars in June 2007 to last trade at just over thirty cents before going into receivership. Debt, poor cash flow and difficulties in raising additional finance all contributed to its fall. The financial health of companies, characterised by manageable debt levels and good cash flow, will be more important than ever.

The hitherto popular investing styles of growth investing and trend following will require careful monitoring. It will no longer be enough to expect the market to go up and up and up. If the market rallies substantially, you will need to be ready for its likely reversion to its primary trend down. This suggests the use of a Stop Loss; as either a stop held mentally or an actual stop with your broker.

A Stop Loss does not have to be complicated. It can be as simple as two moving averages on the S&P ASX 200 (XJO). An example is shown at Figure 2, which displays the weekly XJO over the last two and a half years (the black line). Two simple moving averages have been applied; a slow moving average of sixty weeks (red) and a faster moving average of twenty weeks (green). Whenever the red line crosses above the green line, it may be time to sell your positions down. Yes, I know that there are false alarms, and you may also want to play with the moving averages to better suit your risk profile. But any shortcomings with this are better than giving all of your profits back to the market.

Of course, more tailored methods for individual stocks are possible including Average True Return based Stop Losses or similar volatility-based systems. If you haven't used a Stop Loss before or feel uncertain about its use, read up on it. There is plenty of advice on the Internet and elsewhere. If you follow a growth or trend-following system provided by an external provider, ensure that the system includes advice on when to exit.



Figure 2: Two Simple Moving Averages applied to the Weekly S&P 200 ASX (XJO). The Black line is the XJO. Consider lightening your portfolio when the Green line crosses under the Red

Managed Funds or an Alternative?

For what it's worth, some general observations are that firstly, investors should examine the possibility of moving out of Managed Funds and into Exchange Traded Funds (ETF). Managed funds are usually touted by vested interests, such as (some) Financial Advisors, who receive a trailing commission – which you are paying -- in virtual perpetuity.

The argument is that managed funds provide a measure of diversification to your equities portfolio, especially when structured around overseas shares. While managed funds have their benefits, the vaunted professional expertise of the managers has not been particularly evident during the recent correction.

You can reasonably question also whether managed funds are worth the many fees which you might have to pay. These can include an entry fee, an exit fee, transaction costs, performance fee and a switching fee as well as the MER and the euphemistic 'advisor service fee' (AKA trailing commission). Managed funds are not particularly flexible and moving in and out of them can be both difficult and costly.

On the other hand, an ETF combines some of the better characteristics of both shares and managed funds. They offer investors exposure to a portfolio of shares or other assets (like managed funds) through buying and selling units, through the ASX, as if they were shares. The ASX ETF market segment provides both Indexed ETFs and Actively Managed ETFs.

The ASX Indexed ETFs typically offer low management fees through their low operating cost structure. The fund manager has a minimal administrative overhead, as investors wanting to buy or sell units can only do so on the ASX. Additionally, as the Index is typically tracking a share market index, this minimises the turnover of underlying shares in the portfolio. Once the target investment portfolio is established, there is also no continuing need for the ETF manager to undertake research, since the portfolio composition is determined by the index.

Actively Managed ETFs provide access to a much broader range of investment management styles, strategies, asset classes and operational practices than indexed ETFs. Additionally, actively managed ETFs can usually accept cash applications, which means investors can buy units directly from the fund manager as well as being able to buy and sell units already issued on the ASX. Check the ASX website for further details on available ETFs.

Hedge Funds

My second general observation concerns Hedge funds (or Absolute return funds, which is what the ASX now prefers to call them). These funds aim to deliver returns in both rising and falling markets (i.e. absolute returns) by a number of mechanisms; hedging, arbitrage, leverage, dealing in low liquidity or distressed stocks and, of course, by short selling.

While Hedge funds may look to be well suited to the market which is envisaged, there has been a clear statement from the new administration in the US that all large hedge funds will soon come under federal supervision for the first time. While the precise regulations have yet to be advised, it's clear that this somewhat shadowy industry will not have the same freedom which it has enjoyed in the past. The Australian regulators (*me too, me too!*) will probably not be too far behind the US.

It's further likely that the local regulators will provide particular curbs on short selling which will be a major handicap to local hedge fund managers. They will also be unlikely to be able to raise the sort of money they need to get the leverage which they have enjoyed in the past. When these likely restrictions are added to the poor performance of many Hedge funds, the current payout to hedge-fund managers of two percent of their assets plus 20 percent of their profits, and that investors can be locked into investments for six months to a year, they need to be looked at carefully.

Finally, while many investors have lost significant amounts and have had to revise their retirement objectives, and may be looking to recover their wealth quickly, it is salutary advice to remind members not to get into investments which seem, 'too good to be true'. The recent Bernie Madoff case and his \$15 Billion Ponzi scheme demonstrates that they are still around. You can bet that sharp operators here and elsewhere will recognise the desperation among some investors and tailor schemes to separate them from their money. Don't be one of them.

Trading in the Coming Environment

'... (Trading) is a pattern recognition numbers game.' Mark Douglas, *Trading in the Zone*

Many AIA members with a SMSF which are still in the accumulation phase maintain two retirement accounts. The major one is the SMSF itself which is fenced in by rules and regulations as to what the investor can or cannot do to keep its tax advantages and is generally considered inviolate. The second account, which can be substantial, is available for rainy days, holidays and house maintenance or repairs and the like.

A number of members choose to trade in the market with this account and it is to these traders (speculators) that these remarks are addressed. In the same way that investors may need to reconsider their approach in the likely markets ahead, I suggest that speculators should do also and consider moving their equities trading to a swing trading system.

Swing trading relies upon the tendency of the market to ebb and flow and may be more appropriate to the expected ups and downs of the ASX outlined earlier. A share moving up in price will pause and fall back in price, and then likely push to new highs. Each time it falls in price or breaks out from one or two pauses, the swing trader takes the opportunity to get long when it returns to its prior trend. A similar process is followed for stocks in a downtrend.

Swing trading seeks short-term opportunities to go long at a relative low, or get short at a relative high, with the expectation of closing the position within several days or, occasionally after a week

or so. Swing trading involves a longer time horizon than day trading, but avoids holding an open position much beyond a couple of weeks.

Swing trading systems usually include both a bullish and bearish outlook, allowing the speculator to diversify their trades for changing market conditions. This helps to protect a trading portfolio against losses due to changes in overall market trends. The swing trader will use Stop Loss orders to prevent any one trade from creating a sizable account loss and most traders will also establish a pre-defined profit stop.

A profit stop exits the trade once the stock reaches a pre-determined price level. Other traders will hold their position as long as the trend continues, so as to maximize their profits from a sustained rally or market decline. A trailing stop loss is used to close out the trade once a counter move occurs. Sound money management techniques are essential and you must, of course, be prepared to trade either long or short with equal facility. Although they are not my cup of tea, CFDs may well be the appropriate vehicle for the speculator.

Conclusion

For those investors and others who have come into the market in the last few years it seemed reasonable to assume that the market would continue pretty much as it had since we started. While corrections were expected occasionally, there were few among us who would have expected the savage treatment that we have received over the past year or so.

This paper argues for recognition among AIA members that our investment and trading world has changed and that we may need to revise the way we view that world and structure our approach accordingly. But no-one has a crystal ball and, of course, everyone has his /her own opinion, although many that we encounter have a vested interest in selling us goods and services which supports their position. This is my opinion and it is offered solely on the basis that it may be useful to some readers.

* * * * *

BOOK REVIEW – ACTIVE INVESTING

Reviewed by Tim Kottek

Title: ***Active Investing: How to Manage Your Portfolio like a Professional in less than One Hour a Week***, Revised Ed
Author: Alan Hull
ISBN: 9781 7421 68630
Publisher: Wrightbooks, Brisbane, 2009
RRP: \$29.95

The book is a revised edition and as such includes some material not included (or perhaps missed by this reviewer) in the previous edition. One is the inclusion of a chapter on short selling. I heard Alan speak around October 2007 and clearly state that it was time to be or get out of the market. On page 153 of the book the reasoning behind that statement is; "Do not open new positions when both the All Ords and the Dow have their 10 day moving average below their 30 day moving average."

The purpose of the book is to make it clear that investment is about making money by taking personal action.

I appreciate the journey through what makes the market tick providing a conceptual framework in the first half of the book. This is followed by a detailed exposition of the steps needed to implement an investment system.

The evolution of markets, their participants, and a distinction between investment and asset management starts the book. There is a focus on the requirement to treat investment or asset management as a business and how to accomplish the roles of governance, strategy, and implementation for this business of investment. A strength of the book is that it is neither orange (fundamental focus), nor green (technical focus) finding a place for both in what he terms "Dynamic Analysis" which is the link between the two parts of the book.

The second half of the book can be used as a guide on how to use his newsletter, or can be used by the reader to develop their own process. Contrary to some writers he makes the formulae of the indicators he has developed public and this is of special value to those who want to develop their own process as well as to anyone who wants to understand what they are doing, and isn't that all investors! There is enough in this book to develop a disciplined active investment process. This is illustrated by the "guest authored" chapter 12, a week by week description of actions to be taken.

My conclusions on reading this edition are that (1) there isn't a profession with a vested interest in making money for me, (2) if I do nothing and am lucky I will get nothing, and (3) if I take responsible action I shall survive and maybe prosper.

Tim Kottek is a member of the AIA.

This bulletin is produced by the:

Australian Investors' Association
PO Box 2477
Fortitude Valley BC Qld 4006
Tel: 1300 555 061 Fax: 07 3257 3932
Email: aia@investors.asn.au
Web: www.investors.asn.au

Disclaimer

This Disclaimer is made for the purposes of the Corporations Act 2001 as amended by the Financial Services Reform Act 2001 ("the Acts").

The Australian Investors' Association

The Australian Investors Association ABN 75 052 411 999 ("AIA") is a non-profit association that aims to assist investors become more knowledgeable and independent. In furthering its aims the AIA offers general information through its **publications**. The AIA has no Australian Financial Services Licence ("AFSL") under Part 7 of the Corporations Act 2001 as amended.

Does not contravene the Acts

The AIA, its officers, agents, representatives, and employees do not hold an AFSL and does not purport to give advice or operate in any way in contravention of the Acts. The AIA, its officers, agents, representatives, and employees exclude all liability whatsoever, in negligence or otherwise, for any loss or damage relating to this publication to the full extent permitted by law. The AIA has a policy that does not permit the endorsement or recommendation of any product or service regulated by the Acts.

Provides Information only

This **publication** has been prepared as an information **publication** without consideration of any *reader's* specific investment objectives, personal financial situations or needs. Because of this, no reader should rely upon the information and/or recommendations contained in this **publication**. Readers should, before acting on any information contained herein, consider the appropriateness of the information, having regard to their objectives, financial situation and needs.

The AIA believes that the material contained in this **publication** is based on the information from sources that are considered reliable and is accurate when issued. However, the AIA does not warrant its accuracy or reliability. All views and information expressed by the AIA, its officers, agents, representatives, and employees are for the purposes of discussion only.

If this **publication**, or any information, relates to the acquisition, or possible acquisition, of a particular financial product, the reader should obtain a product disclosure statement relating to the product and consider that statement, and should consult a licenced person before making any decision about whether to acquire the product.

The opinions expressed in this **publication** are those of the authors and do not necessarily reflect the views of the AIA.

Copyright: All rights reserved. No re-publication or copying in any way, including electronic means, may be made without the prior written consent of the AIA.