# The Wisdom Portfolio

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## *Term Investments*

Stan Weinstein used a very good rule of thumb to only be trading in stocks that have their prices above the 9-month moving average. In more literal terms, I take this to be a SMA109, and that cuts down the number of stocks by a large margin. The next two lines are the SMA40 * 1.02 and the EMA12, and with these two crossing over most trades can be cut down to a few per year with virtually every trade a positive one – and that speaks volumes!

The slope of the SMA40 sets the pace for the trades to be involved with and the incremental change in slope is a the second indicator of stocks to get investing with and when the EMA12 crosses under the SMA40 * 1.2 then it is time to move on to other stocks.

## *Long Term Trends*

Stan Weinstein wrote a classical book called “Secrets for Profiting in Bull and Bear Markets”. In this book he spoke of ‘phases’ of the share price and puts it very bluntly to only trade while the stock is in a general rising trend – and no other time. It is simple and straightforward, but very difficult to find the right technical tools to assist that to be the case.

Further, using Fundamental tools will not do any of this for you, as they don’t address the share price on the market. What the Fundamental tools can do is estimate what a share price could be, but that is not reality!

In general a share price starts then rises to a plateau the as the product that the company has matures. Once the product has matured, then the demand wanes and the share price falls with that scenario (so the fundamentals have some bearing)! If the company comes our with a new product and it is in demand, then the share price will move up again – it is that simple!

At about 1900 the biggest industry in Australia was Saddles and Bridles for horses. In the 1950s the big industry was in Iron and steel production. Now at 2004, there is barely a saddle maker and the biggest industry is in Communications and IT. The markets are continually moving. Australia has a high promise for bioengineering research – but typically in Australia, less than flattering political forces continually smother the development side of research.

Securities can rise and fall by up to eight times in value in a year, and typically good ones will provide a 200% swing in value, many will give better than 50%. Conversely many companies that are mature have plateaued out and consequently their share prices are virtually stable with a typical 15% variation over any year – barely useful for good investments!

Securities generally are also somewhat cyclic in that they move like the tide on a yearly basis – or slower, so you don’t need a short time constant moving average to track a share price to see if it is generally in an upward trend!

As there are nominally 365 days in the year, and 52 weeks then that leaves about 261 week days in the year. Take out about nine days in holidays and things like that and there are about 252 real trading days in the year.

Another approach is that each month has about 4 weeks in it of 5 working days and that is about 21 working days per month. Each year has 12 months and that means that each year has 252 working days! Roughly the answer is about the same either way you do it.

Stan uses a SMA based on 30 weeks, and that roughly equates to about 0.576 of a year. Considering that a year is about 252 real days then this comes out at about 145 days or a 145SMA.

A competitive sense would say that to get the ‘edge’ you need to have a slightly shorter time constant – that way you can beat your rivals to investing in a company that is on the ‘rise’. If you wanted to be ‘20% better’ then a marketing mind would think of a time constant of about 121 days.

With this approach in mind, it is not that difficult to set up an exponential moving average with a time constant of about 120 days and see what happens! Any good stock market graphing package would do this type of analysis for its breakfast. The better stock scanning application packages should be able to scan the shares and list those that qualify for this most basic of tests.

Once this is done about 30% of all stocks/shares will be in this category, and the other 70% can be forgotten, as they are not good shares to be in (as they are in general not increasing in value with time).

So much for the traditional Stock Broker using financial reports! Ask them which are the good shares and they will point you to the highest trading shares from the biggest companies. Why invest in AMP when it is falling from $17.00 to $4.50, or Telstra when it is falling from $7.00 to $3.00?

Wouldn’t it be better to invest in Caltex when it is rising from $3.00 to $7.50 over a year, and then over $20 the following year? A traditional Stock Broker needs good technical analytic backing to support their recommendations and frankly I have not seen that happen anywhere!

Well we might have 30% of the stocks from the first level of analytic sifting, but the results are ‘hairy’ as some will dip and bounce around the long term moving average, and this leads to many false rejection and acceptance conditions. Before I spoke about noise in terms of the prices fluttering on a daily basis and this factor makes this first level of analytic decisions somewhat indecisive. There must be a better way.

## *Doing the Math*

There really is not much difference between trading and investing except the length of the ‘term’, and then it all comes out in the wash. For several years I had never understood the old rule to put 80% of your funds into stable long-term growth stocks and the other 20% into more volatile stocks.

My interpretation is slightly different and it goes like: Invest with 80% and trade with 20%. Now to do that requires two fundamentally different sets of rules, and nobody told me that!

In trading the usual rule is to keep in securities that have a short-term positive trend and pull out as the market has turned down and seek elsewhere. Inevitably the market rights itself again technically, getting back can be quite expensive compared to longer-term investing.

Sometimes these rises are 'brick walls' – that is, the market on a particular share may jump by say 7% on opening and keep going! Good if you have invested and lousy if you are trading as you would not be holding it! But there is a deeper side to this:

If a security shows positive signs at say 16 c, and you notice it later at say 20 c, then the security has risen by 4 c or 25%. If it rises to say 25 c then it has risen about 56% from the 16 c entry level and only 25% from the 20 c point.

Both are excellent but let's go a little further! Lets say the stock has moved to 70c and peaked out so it is time to sell in any case if trading. From the 16c entry the gain is 337.5% and from the 20c entry the gain is 250%, and the difference is very substantial.

Put another way: with a base capital investment of say $25,000 the 16 c entry results in about $109,375 whereas the 20 c entry results in about $87,500 and both of these say a lot for patience and investing, specially when this can be over a about a six month period or longer!

With trading the typical gain would have been about 20% before pulling out and then re-trading with a smaller number of shares – and that is the unfortunate secret! When trading, it is usually to continue trading with a constant value investment, and peel the profits off.

In this case the trade would have started at about 16 c and pulled out at 25 c and then in again at 35 c (missed the sudden jump) and then sold out at 48 c, only to re-enter at 57 c and pull out at 53 c and then re-enter at 62 c and fell out at 74 c, but each time with $25,000 as the base investment.

The profits would be $14, 000. $9,250. -$1,900. $4,800. totalling $26,825 or including the capital investment, $51,825 and that is substantially lower than a longer-term investment!

## *The Wisdom Portfolio*

You will often hear people saying to put 90% of the funds into Blue Chip stocks and the other 10% into volatile stocks and it puzzled me for years! I always ask why but the answers seem to be spineless – or more of the "do as I say, and don't ask questions!" type of answers.

Blue Chips generally move like slugs – but they do move, and you have to be on the right ones – but which? Well that all comes back to technical trading with longer time constants!

There is no way that you can rightfully invest say $500k into a couple of small shares as the trades simply will not hold them and you will have the weeks trading in a day, but you can do this with the Blue Chips.

Hence a good reason to put at least 80% into Blue Chips, and they will also return a dividend – usually fully franked – meaning that the income from this dividend has already had its tax paid – so the dividend is tax free.

If the Blue Chip Stock moves up by 0.50% per day then that is 2.5% per week or 10% per month, and 10% of $500k is $50k for a month. Most people are not likely to earn $50k per month – or even $50k per year after tax!

Alternatively, with $50k invested in smaller stocks, you could make 20% per month and that is $10k compared to a Blue Chip possible return of say $5k. That is double what most Blue Chips can provide – but you have to be in it and hold it to get the return.

With Blue Chip stocks it is often better to look at these as a term investment that might be anything from 3 months to 5 years – but more likely more than a year at a time. Even with six good months in one year the return is typically a very healthy 60% per year, and that far exceeds anything that the financial institutions will give!

My thoughts on investing in securities is generally along these lines:

- Keep the number of variables to a minimum, and that means to primarily invest in securities that have known consistent high daily turnover value (volume * price). This means keep the proportion of speculative securities to less than 15% of the whole portfolio (and avoid any of the virtually non-trading "speculative" - securities).
- Always invest in $10,000 lots or greater because brokerage becomes significant - even for on-line Broking Houses like E*Trade and Commsec. This way there is some good degree of stability and with technical analysis the risk of getting into bad stocks should be minimised.
- Use a technical graphing package that you can use the indicators of your choice, and be able to adjust these indicators' settings so that they track with the cyclic nature of the security.
- Never invest in more than 10% of the average daily turnover value - you may not be able to get out when you need to!
- If in doubt – **stick with Blue Chips that have a <u>general positive trend</u>**!



**Comments and Corrections are welcome**