

TUTORIALS IN APPLIED TECHNICAL ANALYSIS

A publication of Guppytraders.com Pty Ltd ACN 089941560
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The Australian Internet Trading Weekly

Weekly for Monday April 28, 2003 Based on Wednesday's Close 17 pages

With contributions from A Gibbs, P Rak

Guppy Trading Essentials Chart pak, Metastock, Ezy Charts & SuperCharts. Data from JustData, Paritech, MarketCast & Keyquotes.

Stocks mentioned in this issue

UEL, MIM, AFI, CFDs, NAB, TLS, XJO, ENV

Note. The more computer icons appearing after a section heading, the more advanced the material.

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CHANGE OF PLAN

TRADING METHODS

THE DARVAS BOX

Darvas applies a filter to price movements to help determine which price moves are significant, and which are not. The filter is established by upper and lower limits of a Darvas box.

The top of the Darvas box always starts with a new high. This high must be followed by 3 days that are lower. The bottom of the Darvas box can only be calculated after the top of the Darvas box has been confirmed. It is constructed in the opposite way to the top of the box. It uses as its starting point the lowest low that occurs AFTER the top of the Darvas box is established. It is again a 4 day pattern, but it starts 1 day after the top of the box pattern. This means it takes a minimum of 5 days for a Darvas box to be identified for both top and bottom.

Despite the best planning, there are times when the plan is fundamentally altered by the course of subsequent events. The most frequent cause of this in the last year has been the announcement of unexpected profit downgrades. The case study UEL trade which was designed to illustrate the application of the Darvas trading technique has now come to an abrupt end because of a fundamental change. During the week the takeover offer for UEL was confirmed at \$3.15. This known future price, completely changes the nature of this case study trade and leaves us with several dilemmas.

The takeover provides a short term cap to prices. We can reasonably expect that by accepting the offer that we can get out at \$3.15. This would deliver a \$2,192 profit, or around a 10% return. This is an adequate return for the trade. However the return does not reflect the true application of the Darvas trading technique. This technique calls for an exit only if there is a close below the bottom of the Darvas box. An exit at \$3.15, based on the takeover offer price, is not an exit that is consistent with the Darvas approach.

The takeover offer, with its known future price, distorts the trading behavior of the current stock holders, and of potential future stockholders. The trade is now a takeover style trade where



the typical pattern of behavior is an initial offer, followed by a higher offer, and perhaps by a third higher offer. The time between the announcement of the offer and the final acceptance can be many months. During this period the stock moves into an entirely different trading pattern. The MIM chart is an example of this. The key takeover points include the period of rumor, confirmation and any subsequent offers.

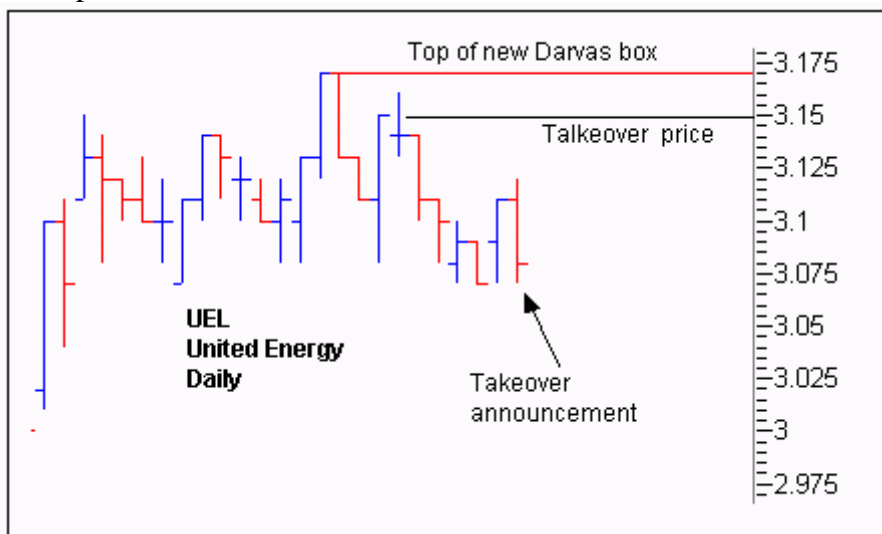
It is not our intention to turn the case study UEL trade into an example of a takeover trading strategy. If we were applying this style of strategy then we would have timed the entry conditions on different factors. The entry based on

the Darvas trading technique is not consistent with this.

We have little choice but to end this trade by accepting the proposed takeover price of \$3.15. If the takeover proceeds then this price is achievable even if the market price does not reach this level. However the finalization of the offer may take several months, and this ties up our trading capital. If traded prices do reach this level, then for case study purposes we will exit the trade purely to free up trading capital.

Typically a takeover offer is further sweetened with a higher price, extra benefits etc. In this case study trade we will ignore these incentives.

The risk in this trade has now changed entirely. A new risk is that the takeover might not go ahead. If this is the case then it will not be possible to get out at \$3.15. If the takeover looks in doubt then the price of UEL will fall and we will need an effective stop loss mechanism to prevent damage to our trading capital. As a standby stop loss method we continue to use the bottom of the current Darvas box. If the bottom of a new Darvas box is created by price action in the coming weeks then we will lift the stop loss to this level.



The completely changed nature of this trade has forced us to both limit the risk and the reward in closing this case study trade. It is not the best trading solution. It is the best exit solution consistent with the application of the Darvas trading technique. In the newsletter our purpose is to show readers the consequences of a disciplined approach to implementing a trading technique. This does

sometimes take us out of a case study trade at a less than optimal exit. This is one of those occasions.

SETTING BARRIERS

INDICATOR REVISION

AVERAGE TRUE RANGE

The average true range (ATR) indicator was developed by Welles Wilder. It is a measure of the true ranging activity of a stock. Most times when we talk about range we mean the difference between the high and the low for the day. This gives us an idea of how volatile the stock is. This measurement does not tell us who is in charge of the price – bulls or bears.

The ATR indicator measures only the range of prices set by the strongest players in the markets. It does this by comparing the distance from yesterday's high, and the distance from yesterday's close to today's low. This is combined with the distance from today's high and low. These figures are averaged to give the Average True Range of price movements between the end of yesterday's trade and the close of today's trading.

Last week we examined a lazy way of taking advantage of the general market rise by using a Listed Investment Company (LIC). Some of the LICs generate returns of between 12% and 19% for the same period when the XJO grew by 10%. This means that for the same level of risk – tracking the XJO – and for the same level of execution risk – the ability to buy and sell at our preferred price – traders can collect a larger return by trading an LIC rather than an Exchange Traded Fund. Getting the best return for an equivalent level of risk is one of the keystones of trading success.

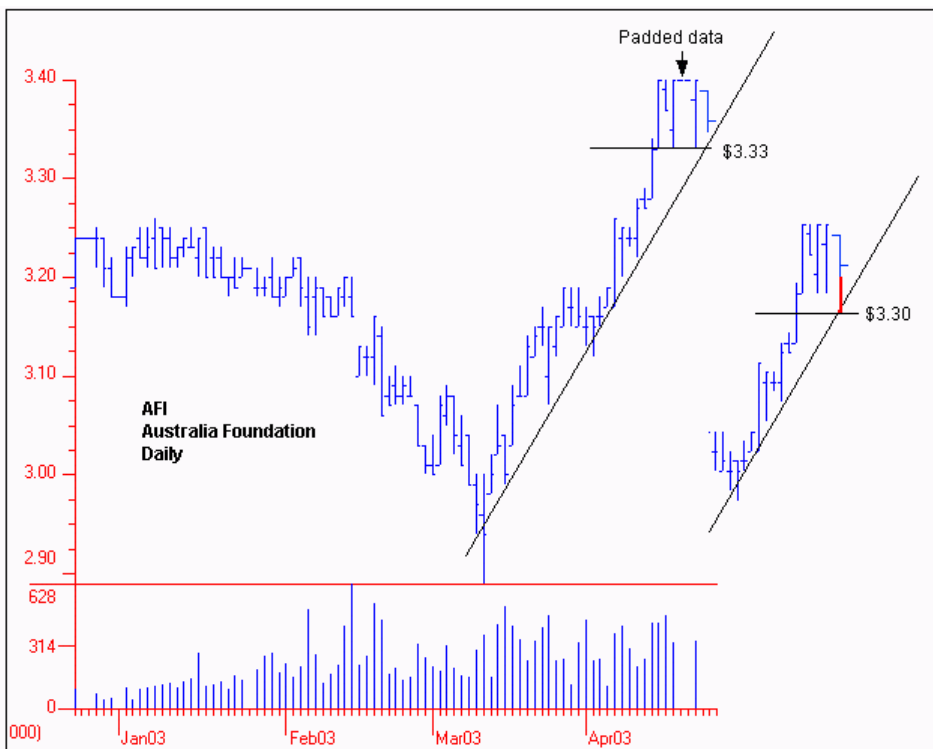
For case study purposes we suggested we would add AFI at around \$3.30 as part of a market pullback. Stop loss conditions are set on the value of the straight edge trend line. This simple statement has a number of implications. They are:

- The correct role of the trend line in terms of the Easter and Anzac day break
- How long the entry conditions remain valid
- What happens if there is no pullback to the suggested entry price

The straight edge trend line has two roles to play. First, it defines the trend. A close below the trend line suggests that trend may have ended. If this close occurs before we make an entry then we might ignore the trade. A close on, or near the value of the trend line provides the trader with an entry opportunity at a slightly cheaper than expected price.

The second role for the trend line is after the trade has been opened. The proposed trading plan uses the trend line as a stop loss trigger. A close below the trend line is now a signal to exit the open trade. Plotting the trend line correctly becomes an important part of the management of this trade.

The plot is complicated by the large number of holidays in this critical period. These are non-trading days because the exchange is closed. Most data providers supply padded data for this period. Either the closing price from Thursday is repeated on Good Friday and Easter Monday, or the complete Thursday bar – open, high, low and close – is repeated on the two non trading holidays. They provide this padded data because some trading techniques, particularly Gann approaches, require a full calendar stream of data. Generally either the data supplier, or your charting software, will give you the option of



showing, or hiding the padded data.

We have discussed the broader issue of padded data in earlier newsletters and it is not our intention to repeating this discussion. For the record, we do not use padded data, but we recognize that for many traders the issue is not particularly important. For the case study entry with AFI the issue is important because it effects the placement of the straight edge trend line which we intend to use to help in decision making.

The left hand chart shows AFI with padded data. The most recent trading day, Wednesday, is very close to the trend line. This puts pressure on Thursdays trading to close above the trend line. This relative placement of the trend line and the bars for each trading day suggests that this trend has paused and that it must resume quickly of price action is to remain above the trend line.

If we already own the stock, then this price action must remain above the line to avoid triggering a stop loss exit. The next 3 to 5 days have no choice but to trend upwards if this trend is to remain intact. There is little time for movement.

Additionally, the placement of the trend line means that any move below \$3.33 is now a break below the trend line. Our proposed target entry level of around \$3.30 is now inconsistent with the trend because this price would now be below the trend line.

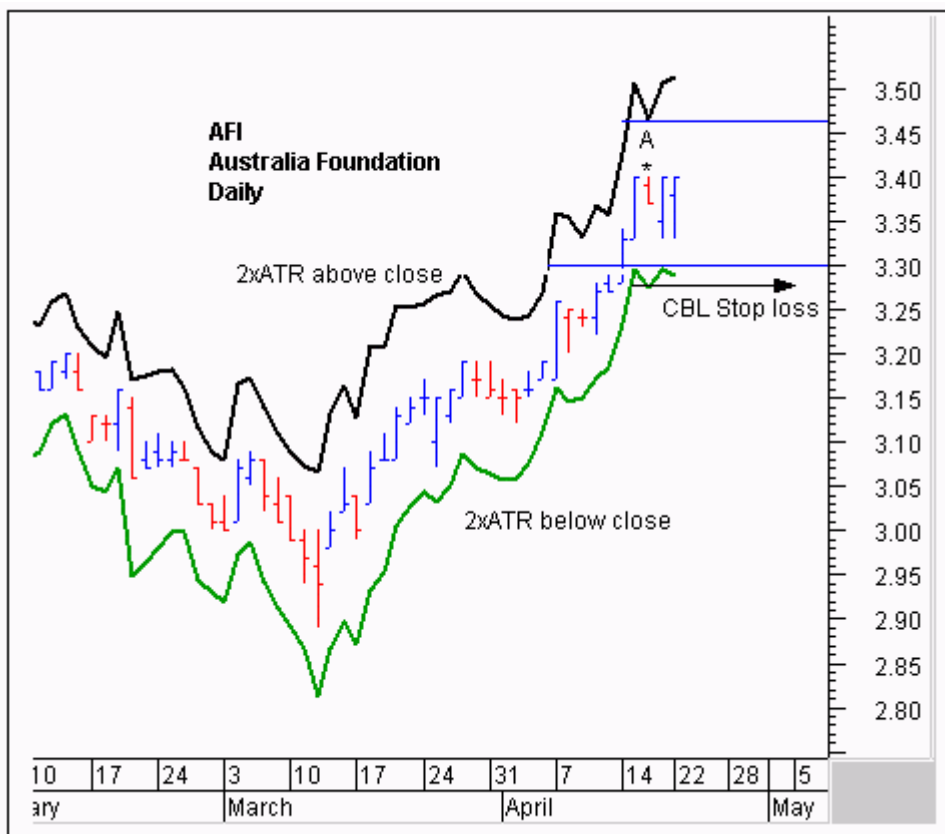
Contrast this need for immediate action with the chart on the right hand side. In terms of time there is room for 3 days of new price action before the price display moves to the right and intersects the straight edge trend line. There is more room, and time, for price action to develop. As shown by the red line, prices could still fall as low as \$3.30 on Wednesday and remain consistent with the up trend. Although we will need to lift the proposed entry price for the following trading days, the entry price remains achievable.

In contrast, it is not achievable when we include the padded data.

The placement of the trend line provides an answer to the second question : How long the entry conditions remain valid? The objective is to avoid chasing prices higher and we do this by setting an entry based on a pullback to the underlying trend. When the trend is defined by a straight edge trend line then the value of the line – and hence our lowest possible entry point – changes over time. Using non-padded data, it is possible to enter at \$3.30. By the end of this week, and moving into the next trading week the lowest

possible entry price will lift to \$3.33 or higher. The proposed entry price remains valid as long as it does not constitute a break below the trend line.

In answer to the third question - What happens if there is no pullback to the suggested entry price? - if there is no pullback then we must set a high price which puts a limit on how far we are prepared to chase the stock. We also need to lift the proposed entry point, and we start with several approaches to this.



The straight edge trend line provides one solution. Another is to apply a count back line calculation to set the lowest acceptable entry price. This is calculated from the day marked with an * and it acts as a stop loss point at \$3.28. We use the * day rather than either of the two following days with equal highs because this gives the highest CBL result. If we used the next two equal high days as a starting point this would effectively lower the CBL stop loss point to \$3.27. The first rule of a stop loss calculation is that once set, the stop loss is never lowered.

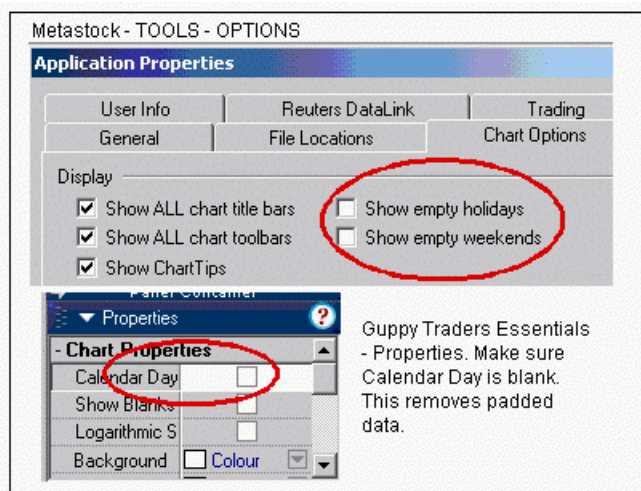
The second way of setting the lowest possible entry point is to apply a 5 day 2xATR calculation. This plots the value of the ATR below the close. This is the standard application of the 2xATR as a continuous stop loss. The Metastock formula is $CLOSE - (2 * ATR(5))$. The most recent high value is used as the trigger level. In this case, it sets the lowest possible entry price at \$3.30 as shown by the lower line. This is also consistent with the value of the straight edge trend line.

- Setting an upper target for the proposed entry is more difficult. We have three options.
- Buy at the best price possible on the day because we believe the trade and trend is sound.
- Look for short term resistance and buy below this level.
- Set an upper limit on the trend by using a straight edge trend line, or some other calculation related to trending price behavior.

In a rising market we run the risk of missing out on the trade completely if we hesitate too long. The hoped for pullback might not come and if we are too mean, we end up missing out on the trade. Our preferred technique is to use short term resistance as a guide. This triggers a buy order at any price above \$3.40. We use the contingent buy order to implement this trade. Once the short term resistance level is established, in this case by four days of trading activity, we also start looking for a cheaper entry point between this level and the value of the trend line. This is implemented by placing a buy order lower down the order line at \$3.35 which in this stock is just above the short term support level.

An alternative technique is a further application of the 2xATR approach. Here the 2xATR value is added to the value of the close. This is the way the 2xATR is used as a trailing stop for short-side trades. The Metastock formula is $CLOSE + (2 * ATR(5))$. Once the trade is identified the most recent low value of the 2xATR calculation is used as the entry signal. This is shown as point A. A price move above this value, \$3.46 triggers an entry signal. This can be managed using a contingent buy order. This is a useful technique to apply to a trending stock where there is no other price action that suggests a logical buy point. We had considered applying this to AFI, but the development of the short term resistance level has offered a better way of setting an upper target for the entry.

For the case study portfolio we add 6,000 AFI at \$3.35 for a total cost of \$20,100. The objective is to show how this LIC is traded as a proxy for the activity of the broader market index. The straight edge trend line provides the stop loss condition. It is activated by a close below \$3.33. This figure will rise as the trend develops.



There are several solutions to the problem of padded data. The most common are to use a charting program that will allow you to turn off padded data. The screen extract shows how it is done with Metastock and Guppy Traders Essentials. If your charting program does not allow you to do this, then it is necessary to locate the data files and manually delete the padded days. The good news is that you only need to do this with the single file where the data padding issue has an impact of your trading decision. If we were trading AFI that it is important to remove the data padding because of the way prices are related to the straight edge trend line.



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TRADING OFF MARKET CONTRACTS

By A Gibbs

SUBJECT SUMMARY

OFF MARKET TRADING CONTRACTS

An off market trading contract (OMTC) is a third party product like an over-the-counter derivative. It is a derivative because its value depends upon the performance of an underlying security. However, it is not a derivative like an Exchange Traded Option because it is not created by an exchange. Nor is it an instrument like a warrant which is created by a third party such as a banking institution, and listed for trading on the exchange. These instruments are traded in a market that is quite separate from the stock market.

A useful way of thinking about them is to compare them with betting on the TAB. The TAB allows clients to bet on the outcome of a race. The race is not conducted by the TAB. Bets are paid out on the results of the race. The bet is a derivative instrument created by the TAB which is related to the action of the underlying horse race.

The settlement of these bets is also similar. If your horse wins a race, you get to collect the money from the bet. You do not get to own the horse, or a share in the horse. What happens to the horse after the race is irrelevant because you have no entitlement to it. Your only entitlement is to the proceeds of the bet which depends on which horse won the race.

The OMTC style instrument is the same. Traders work with the action of the selected security. Their trading activity does not give them the right to own the security at any time. This is the important difference between OMTC s and options and warrants. We cannot stretch the TAB analogy too far because the settlement procedures for losing OMTC trades are different and require a different type of risk management.

Informed traders who have read about Jesse Livermore in the book **Reminiscence of a Stock Operator** may recognise an apparently similar, but unregulated, structure of the stock betting 'bucket' shops where Livermore started his trading career. There were an early OMTC. These services provided clients with a means to 'bet' on the action of stock prices with a derivative-style OMTC product, but without the same degree of leverage. As Livermore showed, there are always opportunities.

Contracts for Difference (CFD) offer an exciting new alternative to trading share futures. Internet based technology, global accessibility and sophisticated order platforms are making this type of trading more viable than ever. A contract for difference is simply a contract on a stock where you specify the number of shares on the contract and put up margin of 5%. That is what I call leverage! Novice's beware, this can be a quick way of losing money...fast, unless you follow the rules.

The advantages of tailoring a contract

size to your specific risk parameters are huge when it comes to money management. It allows for the seamless and continuous compounding of returns. A 5% margin also allows a greater use leverage than ever before, more than we would safely ever need. Using leverage means that short term trading becomes a viable option to trade large Australian blue chip stocks such as National Australia Bank (NAB), NCP, BIL etc. Another advantage is that we are able to trade both long and short positions with absolute ease. Great!

The main risk is execution. We are dealing with an unregulated market where the company the CFD company takes the other side of your position rather than another trader or market maker or Stock Exchange authority. This increases risk on highly leveraged positions. If you cannot get the fills you need, you lose.....BIG, especially on short term trades carrying large positions. Guaranteed stops may eventually be the best option as your account grows. I have heard mixed reports about CFD's, but so far most have been positive. Anyhow, below is a system designed specifically for trading these instruments!

In a nutshell this is two different systems on two different stocks. The focus here is on NCP and NAB. The systems outlined below are both short-term trading models using a price pattern filter with a volatility breakout entry, a chandelier trailing stop, a stop loss and some serious money management rules. Both systems take advantage of heightened levels of emotion, both take advantage of panic selling or eager buying. We want to jump on for the ride trading these changes in sentiment reflected in the numbers.

System 1 is called AG_NAB: It trades National Australia Bank and follows the short-term trend. I have disclosed the tradestation code below.

System 1. AG_NAB

{Tradestation Coded Entry}

Inputs: GSV(2.0), Cents(0.3);

Vars: Median(0);

Median=(High-Low)/2+L;

If close > Median then

Buy Open next Bar+Average(high-open,5)*GSV+0.02 stop;

If c<Median then Sell Open Next Bar-Average(open-low,5)*GSV-0.02 stop;

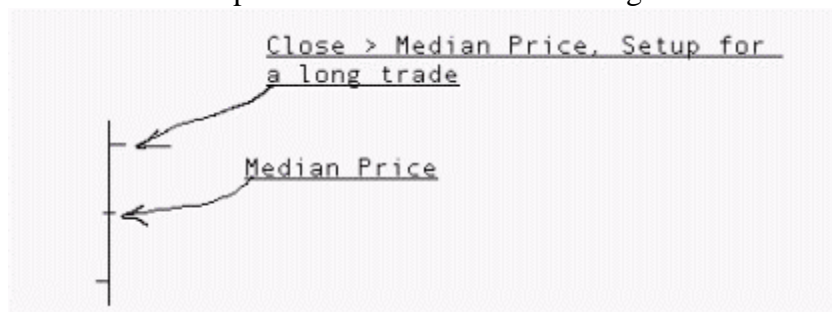
This is the entry. Make no mistake, the entry is important in short-term systems, it is less important in long term trend following systems. The entry is almost as important as simplicity. Simplicity is very important for a system to be trade-able in real time. This entry is simple.

The Price Pattern Filter:

This is the trade set-up: The price pattern filter simply requires:

- a close above the median price for the day as the first filter for long trades,
- a close below the median price for the day as the first filter for a short trade.

This set-up ensures that we are following the short-term trend. (The median price is simply the high minus the low divided by two plus the low.)



The bar illustrates the setup for a long trade i.e. a close above the median price. Step two requires a volatility breakout to decide on the exact buying point.

The Buying Point

The volatility breakout method that I like the most is called the GSV technique. I introduced it to my arsenal after reading a Larry Williams book (about 3 year ago now) and have been experimenting with it ever since. GSV stands for Greatest Swing Value and measures how far the buyers have been able to push the market up from the open (over the past five days) and also measures the distance that sellers were able to push the market down from the open (over the past five days). The distance from

the High to the Open is known as the Up Swing Value (USV) and the distance from the Open to the Low gives us a Down Swing Value (DSV).

If our filter is true i.e. the close was above yesterday's median price then today we would like to see a lot of very eager buyers before we take a position, therefore what we do is find out the average of the (High - Open) over the past five days. This gives us the amount buyers were able to push the market up (from the open).

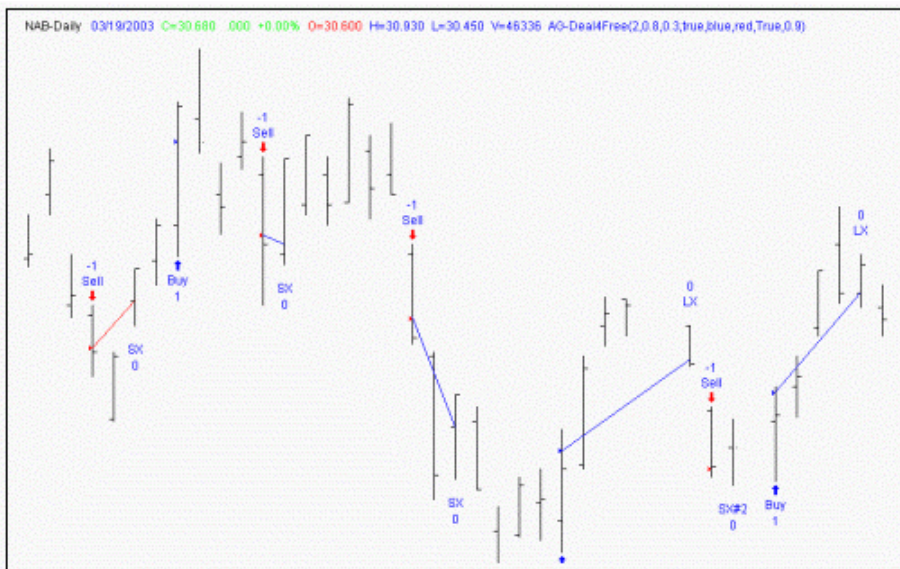
The table below shows the previous five days price data from NAB

Date	Open	High	Low	Close	Median
19-Mar-03	3060	3093	3045	3068	3057.5
18-Mar-03	2990	3070	2985	3068	2986
17-Mar-03	2935	2938	2905	2935	2906.5
14-Mar-03	2910	2950	2907	2940	2912
13-Mar-03	2867	2891	2850	2855	2868
Average	2952	2988	2938	2973	

From the table the average of the high minus the open over the past five days is 36 (2988-2952). I want to see twice as many eager buyers and an aggressive change in volatility before I take a position. Therefore we want to buy at tomorrow's Open + twice the USV (36*2). There we want to buy at tomorrow's open + 72

cents using a *stop entry order* or BUY ON STOP!. If tomorrow NAB opens at \$30.00 we buy at \$30.72 on stop. This order would be placed into the trading platform as soon as the market opens. The current number is very high due to the fact that the market has been moving upwards over the past three days. Several large range days where the market has closed higher than where it opened have also

contributed to the large number. This is good, there is a fair chance that the move will run out of steam so only very aggressive buying will result in an entry. Obviously the entry gets a lot closer when market are moving down or if there are narrow range days. Obviously with such stringent entry conditions we do not get triggered all that often. Next week we examine how these tactics are applied to short side trades.



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READERS QUESTIONS – DOES YIELD GIVE AN EDGE?

TRADERS GLOSSARY

FUNDAMENTALS

Fundamental analysis falls into two sections. The first is a general understanding of the market and the forces of supply and demand. Such analysis often leads traders into examining counter cyclical stocks.

The second approach looks at the financial features of individual stocks. This attempts to identify stocks which are expensive or cheap in relation to their true value. This includes such financial ratios as PEs, Net tangible Assets, Dividends etc. This method is used to identify potential trading candidates.

Many traders then match this analysis with specific charting techniques designed to get the best possible entry. Good trading also matches this analysis with good money management. The objective is to buy the stocks at about the same time as the trend begins to change direction.

We have been receiving many questions about dividends and dividend yields. Some traders, and investors, use this figure as a way of selecting a group of stocks that may provide potential trading candidates. This is a useful trading strategy, and next week we will discuss how it is combined with an effective dividend trading strategy based on historical performance and dates. However, that is not the focus of these notes.

Dividends and dividend yields are used in a different way by traders and it is useful to separate their approaches from the understanding applied by many investors. Broadly speaking, the dividend can be seen as a payment for the use of your capital. If you left money in a bank account then you receive an interest payment in return. Leave your money in a company, and you receive a dividend payment which is considered to be broadly equivalent to the interest received in cash deposits. This is an imprecise generalization, but it does underpin a great deal of classical economic and market theory. When dividends are low and interest rates are high money leaves the market and goes into cash. The dividend rate, in theory, must be higher than the cash rate to compensate for the risk of being in the market before investors will switch from cash to stocks.

Dividends are also viewed by some investors as a cash stream of compensation for staying with a company through thick and thin. In this view, dividends are a little like rent. This becomes a dangerous comfort when the price of the stock continues to fall because the investor sometimes considers the dividend as some form of compensation for this fall, and therefore as some type of protection against the capital loss. Traders disagree with this approach, but it is important to appreciate the reasoning because it helps set the conditions

which we operate in.

The dividend yield is calculated as follows: The company's dividend per share is divided by the share price and converted into a percentage. Although not directly comparable to the cash rate of interest, it is often used in this way.

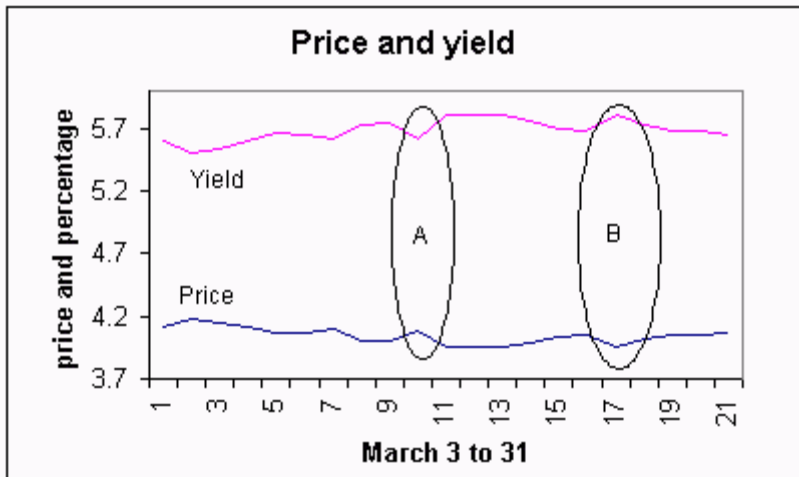
Unfortunately, this calculation is treated as if it is objective, immutable and somehow a rock of stability in an otherwise fluid world of valuations. Peter Temple writing in **Magic Numbers** reinforces this view. He regards the markets pricing of a stock as 'subjective' and recommends that this price should be compared "with the *objective numbers* the accountants have produced." (Our emphasis) The idea that the market price is somehow 'wrong' is a steady theme in many investment books. The opposite is also true, and the idea that the market price is always 'right' is a steady theme in trading books and this newsletter.

The difference in approach is important because it provides the trader with an edge. The first part of the edge comes from a better understanding of the limitations of using dividend yield as a measure of investment success. The second edge comes from making good use of the way many other people in the market will react to lure of dividend yield.

There are two very significant errors that creep in when talking about the impact of dividends on investment activity. The first is the extent to which the role of dividend is vastly exaggerated. Here is an opportunity to test you assumptions against reality. In the US market, the ancestral home of dividends, what percentage of listed stocks pay dividend? The common answers range around 80%. This common thinking is reflected in our own distaste for stocks that do not pay dividends. The speculative stocks are considered to be extra risky because they don't pay dividends. Strongly

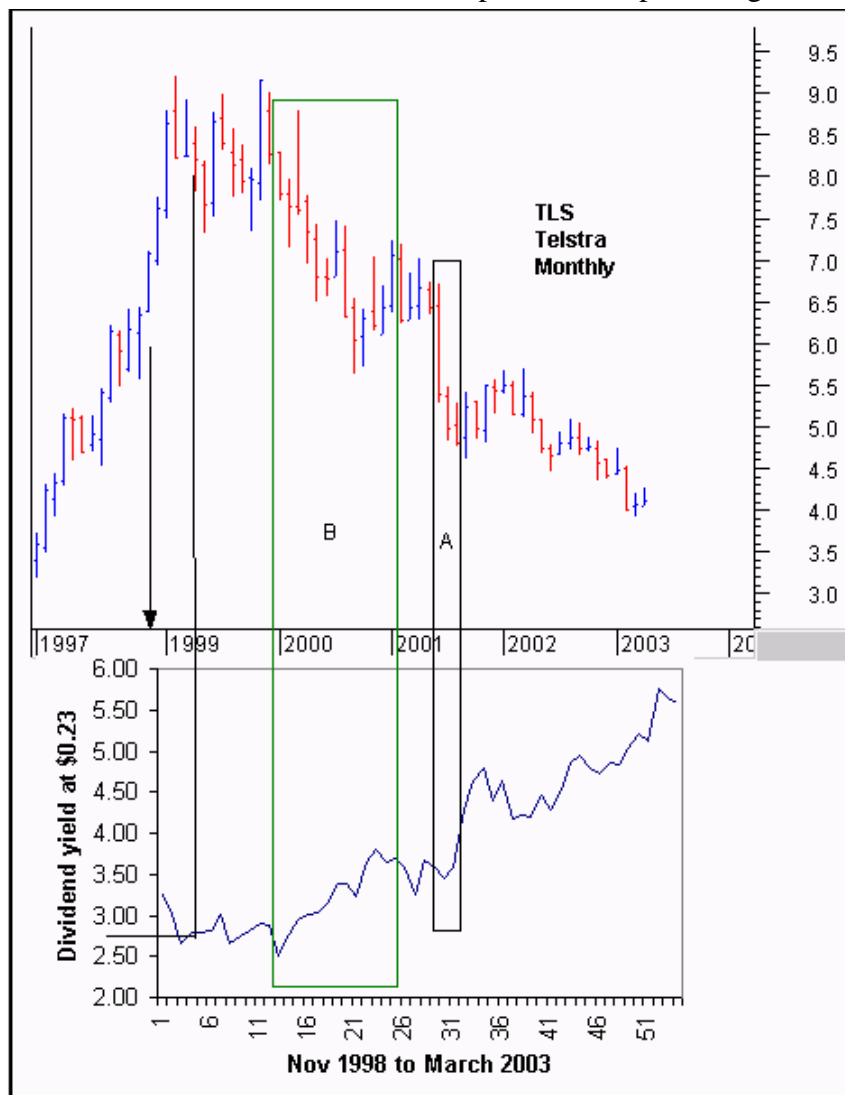
performing mid cap stocks are not recommended for investment portfolios because they do not carry dividends. Poorly performing stocks like AMP and TLS are recommended for investment portfolios partly because they carry the income protection provided by dividends.

The correct answer, provided by Steven Vines in **Market Panics** is that over 80% of listed US stocks DO NOT pay dividends. Our focus on dividends and they role they play in investment activity does not match the reality of the market. Understand this, and we already have an edge over our competitors.



The second important error is a failure to understand the fluid nature of the dividend yield calculation. Some people start to consider buying a stock like TLS at \$4.07 because the dividend of \$0.23 provides a very attractive current dividend yield of 5.65%. This 'absolute' figure is taken from the current issue of **Shares** magazine. The figure is accurate, but misleading. It is calculated by taking the quoted TLS share price of \$4.07 and dividing it into the dividend per

share value of \$0.23. The result is expressed as a percentage to arrive at a 5.65% yield.



The only 'absolute' figure in the calculation is the dividend per share. It remains at \$0.23 for all of March. Unfortunately the share price for TLS does not remain stable. It varied from a high of \$4.20 to a low of \$3.92. The yield calculation is sensitive so a change in the share price has an important impact on the yield. The yield over 20 trading days in March varies from 5.5% to 5.81%. This calculation is not as solid as it looks. The key relationship is that when prices rise, the yield falls, as shown in area A. When prices fall, the yield rises, as shown in area B.

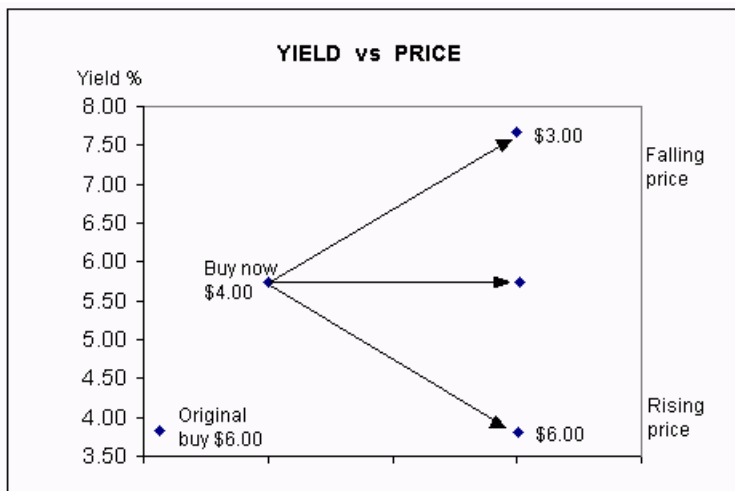
Hardly a big deal when trading is considered over a single month, but significantly misleading when applied to a 1 or 3 year time frame. For the purposes of this example we are leaving the dividend at \$0.23 to the entire period.

The dividend does not change, but the dividend yield varies between a low of 2.5% to a high of 5.8%. The yield is not a fixed value, and nor it is a value

that changes slowly. It is directly related to the volatility of the stock. The higher the price volatility, the more difficult it is to use yield as a means of compensation for price movements. Volatility can be expressed in two ways. The first is short term volatility, measured perhaps over a 3 month period. Area A highlights an extreme with a yield move from 3.49% to 4.2% in a 3 month period.

The second is longer term volatility, measured over a 12 month period. This is shown in area B, with a change from a low of 2.5% to a high of 3.8%. This is considered a useful growth in yield as it compensates for a fall in the TLS share price in this period.

The point we want to establish here is that yield is a variable figure that is very dependent upon the price performance of the underlying share. Blue chip bargains which offer excellent yields are considered by many as good buying opportunities. This feeling, created in part by financial magazines and commentators, is important because it encourages many people to come back into the market. However, buying for yield is a winning strategy in only one scenario.



We start with a current price of \$4.00 and a dividend of \$0.23. This gives a yield of 5.75%. We ignore the taxation implications in these calculations as they vary from trader to trader. If the price rises to \$6.00 then the yield falls to 3.83%. In this situation the fall in the yield is well counterbalanced by the appreciation in the share price. The trader gets a capital gain, and a dividend payment.

However, buying into a low priced stock as it moves into an up trend brings its own substantial rewards that have nothing to do with dividend yield. It makes

more sense to buy the stock for capital appreciation. If we set out to trade the trend, then we are not lulled into a false sense of security by deluding ourselves that yield will compensate for the erosion of profit once the trend starts to decline. Instead, as trend traders, we are prepared to make a clean break and sell the stock.

As a yield play, this strategy fails, even though it is ultimately a profitable strategy. If new investors come into the market chasing yield and their buying is sufficient to create a new up trend then there is, in reality, an entirely different trading opportunity develops.

If the price of the stock falls, in this case to \$3.00, the dividend yield rises to 7.67%. This 25% loss in capital is slightly reduced by a 7.67% dividend yield. This is a losers strategy. The investor bought because the yield was good at \$4.00 and the yield has increased as the price fell. However the rate of collapse in price and his capital outstrips any benefit he may receive from the dividend.

The yield strategy is only effective in its own terms if the price remains the same, or moves sideways in a narrow trading band without developing a trend. In this example, if the price remains at \$4.00 the yield remains at 5.75%. There is no capital appreciation from an emerging trend, and there is no capital destruction created by a falling trend. If investors are chasing yield then the strategy works most effectively when prices move sideways.

If prices start to trend upwards then the benefit of the yield is reduced and the most effective way to take advantage of the trend change is to apply active trend trading strategies.

As an extension of this analysis we should also note the way the yield story encourages people to hold onto existing shares. Feedback from audience discussions confirms that many people who purchased TLS around \$6.00, and who still hold onto it, now feel compensated because the yield has increased to 5.65%. This increase in yield encourages them to hold onto the stock and this helps create a support floor. Traders use these support floors as a base for trading strategies. The investor forgets that he paid \$6.00 for the share, and the current dividend provides only a 3.83% yield rather than the current yield figure of 5.65% based on the TLS March price of \$4.07.

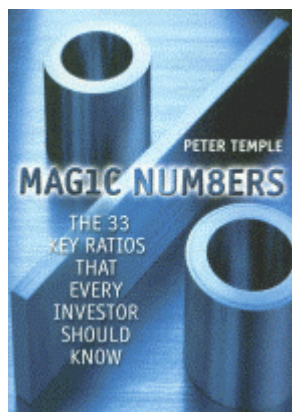
Where is the edge in this analysis? The edge comes from understanding where a crowd is likely to form, and how it is likely to behave. If we become part of the crowd we commit the same errors. If we observe the crowd, we can participate in the action generated by the crowd. A mob of cattle on the move in the outback is always accompanied by a swirling column of kite hawks. As the cattle move they stir up insects, small reptiles and other small creatures. The kite hawks use the activity of the mob of cattle to find the opportunity to pick up a steady feed of insects. The cattle may think they are being driven towards water even though they are being driven to the slaughterhouse. The kite hawks don't care about where the cattle are headed because they focus on exploiting the opportunities created by the movement of the mob – or in our case, the crowd.

There is a danger in participating in the buying activity based on the false assumption of dividend yield. There is an opportunity in working alongside the crowd to develop and exploit a different range of opportunities based on the crowd activity.

The increase in questions about the importance of dividend yield reveals an underlying current of investor behavior. Armed with good charting and technical analysis traders can avoid the distraction of these apparently objective but imprecise, yield calculations and concentrate on trading in a pool of increasing liquidity. If yield buying is strong enough to develop a change in trend, then we can implement effective trend trades. Our trading edge comes from a better understanding of the reality behind the common market myths.

Although we regard the 'magic numbers' used in fundamental analysis in the same way as all magic – a misleading sleight of hand – we do recommend Temple's book, **Magic Numbers**, as an excellent source of information on the 33 key financial ratios that are used by others in assessing the market. Understand how they think, and they may guide you to different types of opportunities created by their own crowd behavior.

BOOK REVIEW – MAGIC NUMBERS by P Temple



All magic is based on illusion, and these 'magic' numbers are no exception. They are presented as the essential ratios and calculations required to assess the health of companies prior to investment decisions. All the calculations are based on figures which Temple describes as "objective" but which he concedes include "accounting distortions which must be stripped out" and admits that "the numbers can be fudged, smoothed and manipulated." Price doesn't lie, but accountant's and auditor's figures have a very poor history of accuracy.

Despite this, the book is an excellent coverage of the 33 key ratios and calculations used by investors and fund managers. This book should be in the library of every one of them as it explains the concepts clearly and accurately. It is a very good reference book.

It groups these ratios into five sections - Market based numbers; Income numbers; Balance sheet numbers; Cash flow numbers; and risk, return and volatility numbers. It is this final grouping that is of most interest to traders.

Each set of numbers contains a definition, where to find the necessary information, a theoretical example of the calculation, a practical example, and a short section of the significance of the number. This is a basic reference book for fundamental investors.

CHART BRIEFS - ENV

By Petra Rak

The weekly price bar chart of ENV shows an upward trend, which commenced in August 2002 around \$0.82, and is currently trading under a resistance level around \$1.05. The chart also shows that this trend is the third shorter-term trend within an overall long-term upward movement, which commenced in July 2000. The trend has been fairly smooth, with resistance/support levels developed around \$0.93, \$0.98 and \$1.05.

It is this last resistance level that we are interested in, as it has capped price movement in ENV since February this year. In the last two months, ENV has remained in a consolidation band between

\$0.98 and \$1.05, but is still within the upward trend. We are interested in identifying opportunities that may develop.

TRADING METHODS

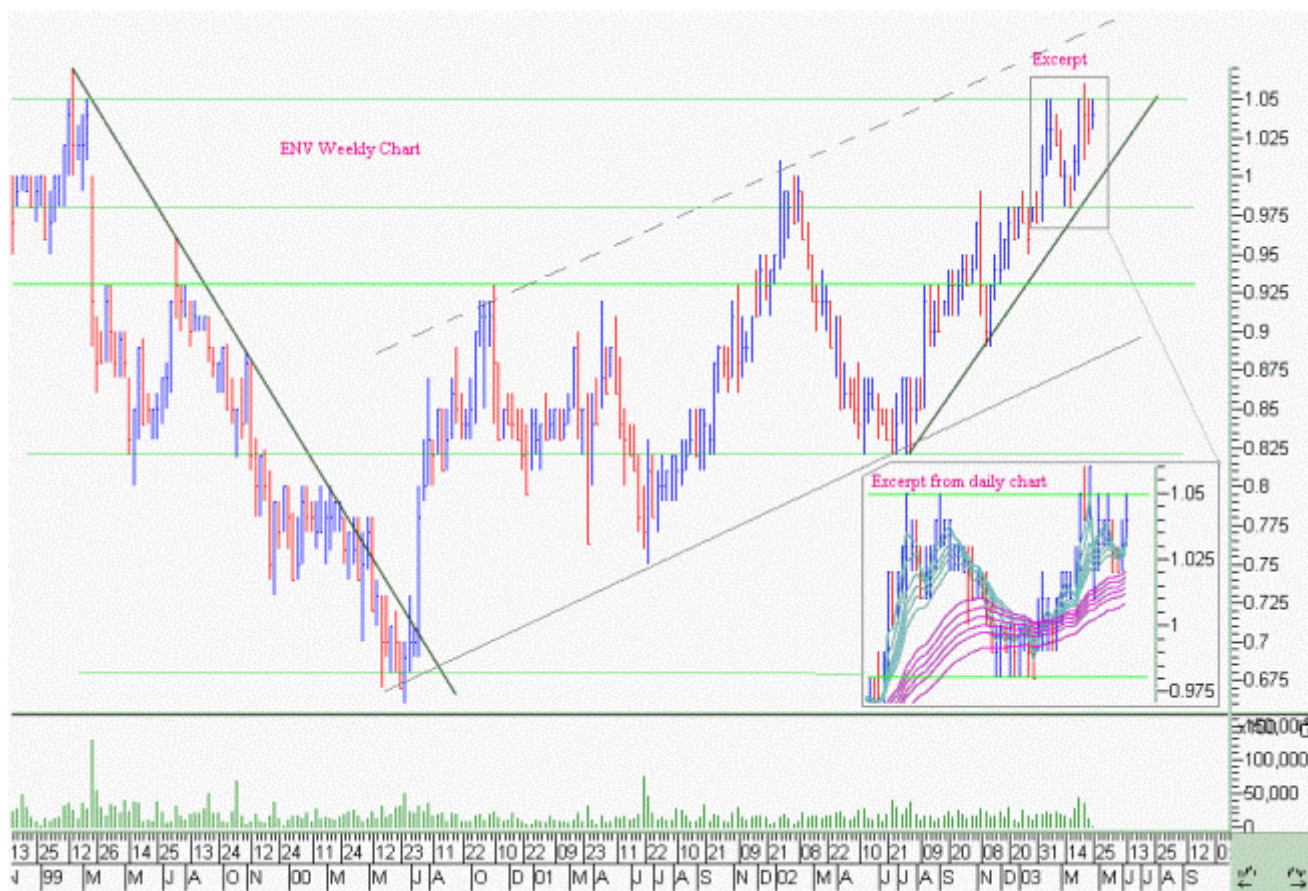
CHANNEL TRADING

Channel trading is created when there are clearly defined support and resistance levels. Price movements rebound between these levels. Traders buy at the support level and sell at the resistance level. Many channel trades are part of a prolonged sideways price movement. Trend channels are created when the stocks trend upwards and two parallel trend lines can be plotted. These also act as support and resistance levels. Traders buy on support and sell on resistance. These trades are more profitable as the resistance level moves upwards over time.

UP CONDITIONS

Likely opportunities will result from the upward trend, so our first point of interest is how persistent the trend is. Key tools for this are the Guppy MMA, resistance levels and trend lines.

The trend is still in place, as indicated by the unbroken trend line and the Guppy MMA, which shows that though the short term MMAs have converged, the long-term MMAs are still upturned and well spread. Further, the ability of prices to repeatedly hit a resistance while moving underneath it tends to be a bullish signal.



A break above the \$1.05 resistance will signal the continuation of the upward trend and will take price development into blue-sky territory. Generally, blue-sky stocks are traded without predetermined target levels and are managed in accordance with parameters such as % profit targets, stop losses and the Guppy MMA. Here however, it is necessary to consider the characteristics of the long-term upward movement, which may cap the current upward trend around \$1.10 by operating as an up sloping trading channel.

Hence, traders need to consider whether likely targets present rewards appropriate to the risk of any trades, particularly considering that the trend in ENV is relatively shallow in % increase terms (to date, the current upward trend represents a 22% increase). Traders may therefore prefer to place ENV on a watch list for new future trends within the long-term upward movement.

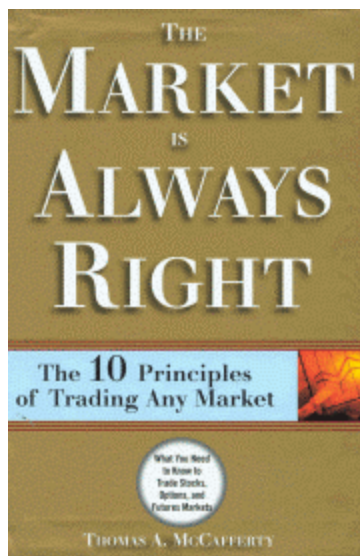
DOWN CONDITIONS

Continuation of the consolidation band and a consequent break of the trend line will signal the end of the current upward trend. Traders will watch for the trend line defining the long-term upward movement to hold, and another upward trend to develop. Risk management tools such as the CBA stop loss should be applied to all trades.

BOOK REVIEWS – THE MARKET IS ALWAYS RIGHT by Tom McCafferty

SUBJECT SUMMARY TRADING BOOKS

Many trading books are expensive. There is nothing more annoying than spending \$80 to \$120 on a trading book only to find that it is not particularly useful. The objective in these book reviews is to give you some idea of the content and usefulness of new trading books as they are released. All reviews are based on our reading of the book. The comments are not culled from the back cover copy. If we review a book, it means we have read it. Our focus is on the more expensive books because these are the ones where we really do not want to make a purchasing mistake. The reviews are written from the perspective of a trader. These reviews, and reviews of over 230 trading books are also posted on the web site under the Traders Reading button.



I picked up this book with some reluctance. I am wary of claims that a book can deal with the market with 7 rules, or 10 principles. With this book I was pleasantly surprised. It offers some useful insights into the basic principles of trading. It also provides good practical examples of these processes in action.

Mc Cafferty explains why it is important to specialize in the trading tactics you decide to use. He shows clearly how trading is quite different from betting, or gambling. He underlines the need for continual coaching to ensure that your trading edge remains sharp, and on target. Coaching comes in many forms, and includes the traditional idea of a coach as well as continuing education and revision.

He makes the very valid point that top performers such as Tiger Woods have specialist coaches. Even at the top of their game, they do not expect to go on winning without errors. Traders are the same. Staying at the top requires constant practice and specialist coaching to help overcome the inevitable lapses in our success rate.

He raises some interesting issues about trading as a lonely pursuit. He suggests that some people benefit from a group atmosphere because group pressure encourages them to stick with their trading

rules.

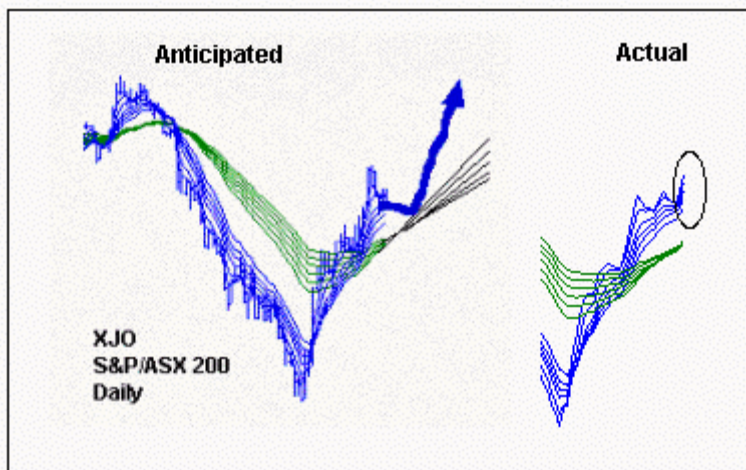
This is an interesting book that provides some new food for thought for experienced traders. It also is a very good starting point for those who are interested in taking a more pro-active role with their investing, or with trading.

NEWSLETTER OUTLOOK – RIDING THE BULL

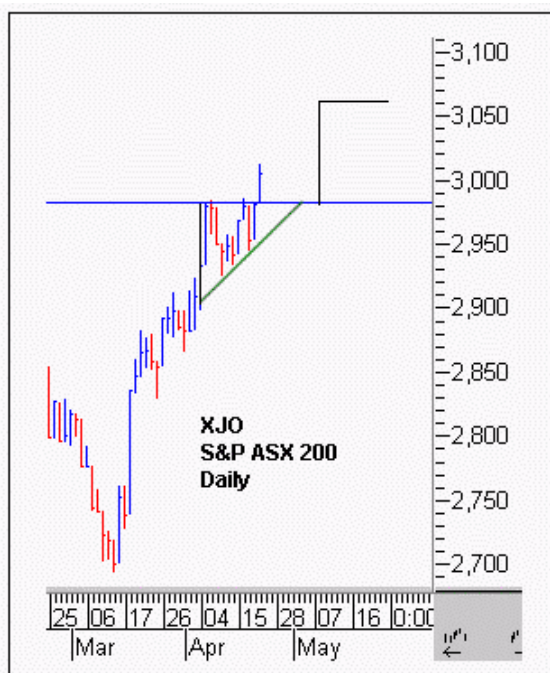
OK, we are convinced. The up-trend is sustainable. The retreat over Easter was quite small and the rebound breakout on Wednesday was convincing. This initiated the case study AFI trade using a Listed Investment Company to trade the trend break. We still look on this as a bullish rally running into June when the traditional tax driven sell off is likely to cause a market decline.

The Guppy Multiple Moving Average indicator from last week with the XJO shows the type of recovery behavior we expected to accompany the setting of a new up trend. On the MMA display we looked for two features. The first was an expansion of the long term group of averages as the short term group of averages collapses. If this new up trend is valid, then we expect to see investors come

into the market to take advantage of the temporary drop in prices. This should lead to some expansion of the long term group of averages, as shown by the black lines.



Instead the pullback by the short term group of averages was quite small. A look at the developing pattern on the XJO bar chart helps underline why this might be so. The market picture is distorted by the reduced number of trading days in this period. The past 10 trading days have seen the development of an upward sloping triangle. The rally on Wednesday was a breakout above this triangle pattern. The projection target is 3,060. We do apply these targets with caution to indexes. The index reflects the



activity of 200 stocks, and this dilutes the impact of crowd emotions. Chart pattern projection targets are more reliable with individual stocks when we are dealing with just a single crowd. They are useful with indexes, but not quite as reliable.

Despite this, the upwards break, and the reaction of the Guppy Multiple Moving Average suggests that a strong up trend rally is developing. Traders will look for individual stocks that reflect this enthusiasm.

Joining the rebound gives traders an 8 to 10 week window of opportunity. The potential pullback and rebound provides a range of opportunities in individual stocks. Traders will look for weakness in current trends as a potential rebound point. These can be located using the price oscillator style searches discussed several weeks ago.

Each week we make a choice about the material we include and the subjects we cover. The selection is based on our outlook for the current and coming market. Our objective is to illustrate effective trading strategies that readers can apply to current market conditions.

We do not identify recommended individual stocks. We identify opportunities and appropriate trading methods for them. Our outlook is not a forecast. It is a probability framework. Use it as just one part of the other information you are reading about the market. Our summary outlook will be included each week.

NEWSLETTER NOTES

HIH INSURANCE



Despite the avalanche of analysis on the HIH insurance collapse, we feel the need to add just a little more. The analysis contains one glaring omission and let one significant financial industry group off scott free without comment. It does not address the failure of highly paid fundamental analysts to identify problems with HIH Insurance in the weeks, or months, or years leading up to the collapse. This means either those at the helm of HIH were too smart for the analysts or the analysts are not as good as they would like us to believe.

The chart extract of the last 12 months of HIH shows how easy it was to decide that something was very wrong with Australia largest of the blue chip insurance companies. Investors and traders must ask themselves this question: If fundamental analysts were unable to identify this world class disaster in 2001

then do we have any evidence that they have improved their skills sufficiently to identify any similar disasters now?

We believe the answer is ‘No.’ We also believe the solution to avoiding a disaster like HIH Insurance is a better understanding of how to use a chart, and the tools of technical analysis to identify, assess and manage risk. This newsletter is dedicated to teaching those skills.

EARLY NEWSLETTER

Two long weekends in a row is an Australian Christmas present. This newsletter is again based on Wednesdays close. We like holidays too, and we know many readers will relax over the weekend, so we have produced this early edition.

REASONS FOR NOT SUBSCRIBING TO THE NEWSLETTER #7

I do my own research and paper trading

If you are really serious and consistent about this then you do not need to read the newsletter. However many people find some difficulty with the three essential elements of trading success. Time, discipline and money.

It takes time to do research because so much of it is wasted on what turns out to be fruitless paths. Time, after work, with family is too important to waste travelling down unproductive research paths. The newsletter travels these paths, bringing in skills that you may not have time to develop. You can start with results and make better decisions about how you spend your time in the market.

Discipline, or lack of it, is what makes dieting so perennially permanent. It takes discipline to diet. Even when time is available, it takes discipline to update paper trades every day, to compile and evaluate results. This is one of the appealing features of off-the-shelf trading systems. It’s a pity they so often fail.

The newsletter tracks trading approaches with discipline every week. You can concentrate on the evaluation rather than the drudgery of compiling data every day because we do it for you.

Money, or want of it, is a barrier to trading. We can’t help you with this but the newsletter does model ways and methods which improve your probability of making money in the market and keeping it.

NEWSLETTER CASE STUDIES PORTFOLIO

PORTFOLIO CASE STUDIES - MONEY MANAGEMENT

Starting cash position \$100,000 - no brokerage or slippage 2% of risk = \$2,000

NOTE Entered date is the **newsletter date** which contains the case study discussion.

Stock	Price	Qty	Pur Value	Close	Cur Val
UEL	\$2.930	6,850	\$ 20,071	\$ 3.0800	\$ 21,098
		Newsletter date	27-Jan	Open Profit	1,027.50

Dividend 685.00

Total return 1,712.50

Darvas box Darvas stop loss

Percentage 8.53

plus dividend @ \$0.10 = \$685

Stock	Price	Qty	Pur Value	Close	Cur Val
AFI	\$3.350	6,000	\$ 20,100	\$ 3.3600	\$ 20,160
		Newsletter date	28-Apr	Open Profit	60.00

Proxy for XJO Trend line stop Percentage 0.30

SUMMARY MONEY MANAGEMENT

Overall profit to date since July 1, 2002 = \$69,770 or 69.7% return on trade equity.

Profit 2001/02 = 71.3% return on trade equity. Profit 2000/01 = 59.2% return on trade equity.

Profit 99/00 = 111.2% return on trade equity. Profit 98/99 = 102% return on trade equity.

Profit 97/98 = 94% return on trade equity. Profit 96/97 = 66.5% return on trade equity.

Direct investing in the stockmarket can result in financial loss.

Historical results are no guarantee of future returns.

SIX TO TWENTY ONE - A CASE STUDY IN AGGRESSIVE GROWTH

Starting cash position \$6,000, Nov 2002. Profits are pyramided.

SPECULATIVE POSITION - starting capital \$2,000

Stock	Price	Qty	Pur Value	Close	Cur Val
PTD - sold	\$1.260	4,454	\$ 5,612	\$ 1.4000	\$ 6,236
		Newsletter date	7-Apr	Open Profit	623.56

Flag trade starts at top of flag Percentage 11.11

BLUE CHIP POSITION - starting capital \$4,000

Stock	Price	Qty	Pur Value	Close	Cur Val
UEL	\$2.930	1,564	\$ 4,583	\$ 3.0800	\$ 4,817
	Entered		27-Jan	Open Profit	234.60
				dividend	156.00
				Total return	390.60
				Percentage	8.52

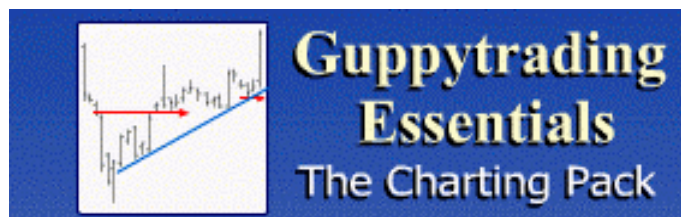
Darvas, add Jan 27

Plus dividend \$0.10 = \$156

SUMMARY - SIX TO TWENTYONE

Starting capital	6,005
Current combined value	11,481
Current profit	5,476
Return %	91.19

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With the Guppy Tool Pack, traders are now able to access all the Guppy tools and use them simultaneously with other charting programs. This means you can have your favourite charting program running, and then switch to the Guppy Tool Pack to apply count back lines, Darvas boxes, rounding top analysis etc to the same stock in both packages. The find function in the Guppy Tool Pack means you can locate the stock anywhere in alphabetical data files simply by typing in the code. The Guppy Tool Pack is designed as an addition to your existing charting program and this is reflected by the lower cost.

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