



## Brainy's GEMS (or PoW!)



23 August, 2009

It has taken me a number of years of reading text books and newspapers, attending lectures and seminars, and watching news reports, to hear and see a number of useful “tips” or observations about the markets. In hindsight, I wished someone had been able to tell me all these things a few years ago. My investing career would have been somewhat smoother.

So, I have written them all down to remind me of them from time to time, but also to share with the newish investors and traders. Then you can have the opportunity to fast-track your knowledge of the share market and how it works, and some of its secrets that otherwise take a long time to learn.

This document is in Sixth Draft form only. But I thought I should make it available for others to benefit. Eventually I might package it up with other information and offer the total package for sale (watch my web site <http://www.robertbrain.com>). In the meantime it is free.

I have called this document a list of “gems” because they are only small, but they are very precious. I have also called them “pearls of wisdom”. None of these gems are mine, but they are all pearls of wisdom (or “PoW” for short). The acronym “PoW” is very apt, because it is easily possible to suffer a knock-out type of Batman “kapow” punch that could take you out of the market.

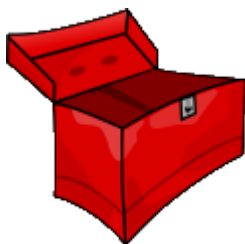
*The standard financial disclaimer applies:*

**There is no guarantee that there is any truth in any of these “gems”.  
They might all be just little jokes.**

You should not take any action on anything that you read in this document.

***“May your losses be small, and may your profits run like blazes.”***

## *Robert B. Brain*



**Brainy's Gems** is just one of many tools in [Brainy's Share Market Toolbox](#) arsenal of weapons to help you tackle the share market.

### **NOTE:**

There is no intention to provide investment advice, and information presented does not take into account the investment objectives, financial situation and/or particular needs of any person or class of persons.

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## 1 Important considerations

First off in my list of share market gems are some important considerations.

### 1.1 *The share market is like an elephant*

This is my favourite Gem. The share market is like an elephant for the following reasons:

- The market, like an elephant, is large and cumbersome, is comprised of many parts, and is rather complex. If you get up close and look at the detail, it is not so simple. If you ask two blind people to feel different parts of an elephant and describe their observations, they will provide different descriptions. Likewise, because the total share market includes a large range of products (eg. equities, commodities, currencies) as well as derivative products (eg. CFDs, warrants, options), people who study different parts of the market will describe different features and observations.
- It's behaviour can be unpredictable. It often moves slowly, but can move very fast. An elephant is like this. The share market can be docile at times and for a while, and then it can move a long way very quickly. When the market falls, it can fall heavily and quickly (*down by the elevator*).
- Looking at a very small portion of the market is okay (eg. the eye of the elephant); but it is very useful to also step back and look at the bigger picture. In the market, step back to look at individual stocks over longer time periods (daily, weekly, monthly, etc.). You might be surprised at a different observation of trend. Also take a look at the performance and behaviour of the overall market index (XJO or XAO in Australia), and the relevant sub-indices (*a rising tide lifts all boats*).
- If you get in the way of either an elephant or the market, you might get trampled.

### 1.2 *Only invest in something that you understand*

In order to maximise your chances of success, and help to minimise the risks, it is important to understand as much as you can about both the investment type that you are considering, and the investment method.

If you are looking at investing in a company's shares, it is very helpful to understand something about the both company and the industry they are in, and the general state of health of the industry in today's economic climate.

If your intended investment method is to purchase shares using an online broker, then it is very helpful to understand the online buy/sell process, and any options that might be available (eg. conditional sell orders).

(If you don't understand the rules of the game, it is hard to be consistently successful.)

### **1.3 Never bet the house**

Take care not to bet a large portion of your capital in one hit. If you risk 100% of your capital on one investment, and it falls by 50%, then to get your money back it has to increase by 100% — and that is very unlikely. So, keep your “capital at risk” to a small amount — between 2% and 10%.

### **1.4 Pyramid your buys**

After you buy a stock, if it proves successful, you could purchase another parcel of the same. But remember to stay within the constraints of your documented Investment Plan, or your Trading Plan and Strategy.

### **1.5 Dollar cost averaging? — NOT!**

After you buy a stock it might fall in price. You could buy more so that your average entry price is lower than the first buy price. But is it really a good idea to buy a falling stock? Especially if it is in a confirmed down trend? This does not seem at all sensible.

### **1.6 Maintain perspective**

*Question:* “A company's stock price dropped significantly today” — is this good or bad?

*Answer:* It depends on what has happened: (a) in the last few days; (b) over recent weeks; (c) over recent months; regarding news, etc. So, step back and look at the bigger picture. Look at a longer time frame, and look at the market index for a bigger picture.

### **1.7 Remember your Investment Plan (or Trading Plan)**

When the market (or one stock) is up (or down) significantly, just remember what your investment plan says. Don't take any drastic action without considering your documented plan and strategy.

### **1.8 Buy low, sell high**

The ideal situation to aim for to achieve good capital returns on share trading is to buy when the share price is low, and sell when it is high. In practice, this can be much harder than it seems. Of course, for short selling, the converse applies — buy high and sell low.

### **1.9 Keep your eye on the ball**

If you want to be an active investor / trader (as opposed to a passive one), then make sure to keep your eye on the ball.

It is important to monitor your position according to your documented Plan and Strategy. If the strategy says to review the positions each week, and adjust stop loss positions accordingly, then make sure to do it. Otherwise you might be giving away profits (or you might be extending your losses).

If your strategy says to monitor the positions, and place a sell order on certain criteria, then you might not notice a severe price dip below your nominated stop.

### **1.10 Risk analysis**

Another option when considering an investment is a traditional risk analysis. Step back and ask: “What is the worst thing that might go wrong with this investment? and what are the chances of that happening?”

For example, if the company has a history of surprising the market with bad news (earnings downgrades), then perhaps they will continue this track record. Another sudden bad news announcement could send the stock down significantly.

## **2 Strategies for investing and trading**

### **2.1 The trend is your friend**

A lot of people say that “the trend is your friend”. Identify a trend, buy it into and follow it. But make sure to sell out as soon as the trend is finished.

### **2.2 Time in the market is more important than timing — NOT!**

This has to be one of the biggest cons of all time. If I were an advisor who earns trailing commissions from your funds that are invested through me, or if I were a fund manager who earns commissions based on the amount of capital I have invested, then I would be keen for you to leave your money with me for the long term — so that I can receive my commissions regardless of the performance of the invested money.

In reality, though, take a look at the market over the very long term. There are periods of serious under performance where the market suffers significant losses. If you can avoid these periods, then your investment just might produce better returns over the longer period.

Also see the Gem “18 year property cycles”.

### **2.3 Buy on weakness**

Buy when the share price dips temporarily during a strong up trend.

### **2.4 Beware the “up-chase”**

It is very tempting to buy shares in a stock with a strongly rising share price. However, it often happens that a sharp share price increase is followed by a tapering off in price, and then a fall or at least a consolidation period. In extreme cases, the sharp price rise is overdone and the price falls significantly. If you buy into one of these because the price is rising sharply and you are afraid of missing out on some profit, and then the price plummets, then you end up losing money on the deal. This is a common occurrence with new investors.

### **2.5 Buy on rumour, sell on fact**

Sometimes it happens that people know something about a company, coinciding with a share price rise. And once everyone knows about it, the price falls away. Hence, it can sometimes be useful to “buy on the rumour” of good news, and then sell when it is proven to be factual and it hits the newspaper headlines.

## **2.6 Watch the news**

Some people believe that the news will not help them in making their investing or trading decisions, and that it is the share price chart and purely technical analysis that will help them decide.

But, it can be useful to keep an eye on the news of the day for news events that might influence the market and influence share prices. The news might forewarn of some price moves to come, and prompt you to watch some stocks or market segments more closely.

You might even find some way to factor news observations into your trading strategy.

## **2.7 Trade on Index adjustments**

Each of the stock market indexes, and sub-indexes, comprise a number of stocks based on certain criteria. As time goes by, some stocks in an index might no longer qualify for inclusion in an index, and others that were not in an index might now qualify.

On a periodic basis, the companies that are listed in an index are reviewed for suitability, and some are removed from the index, and others are added to the index. This adjustment can provide trading opportunities as fund managers adjust their own holdings.

# **3 Emotions and psychology**

## **3.1 Fear and greed**

Two most powerful emotions that come into play in investing and trading are fear and greed. It is very beneficial to understand these emotions, and how they can affect investing performance.

The infamous Warren Buffet says: *"Be fearful when others are greedy, and greedy only when others are fearful"*.

## **3.2 Calmness**

Trying to make investment or trading decision while feeling tense, or concerned, or ill at ease about something can make the outcome not so favourable. For an optimum decision environment, it is important to be calm and accepting.

# **4 Time-of-Year observations**

## **4.1 As goes January, so goes the year**

Sometimes referred to as the "January barometer", or "January effect". It has been observed since the early 1970s that in well more than 50% of the time, the market performance in January is an indication of the likely market performance for the rest of the year. (Originally based on the S&P500.) However, some statistical analysis has concluded that it cannot be relied upon for trading purposes.

#### **4.2 Sell in May and go away**

The months of May to October are renowned for poor returns on the market. Hence the saying “sell in May and go away” — until October because November and December often have good returns.

#### **4.3 The weekend and holiday sell-off**

Some traders do not like to hold positions over a weekend, or holiday period, so they sell down their share holding on the last trading day (often on Friday).

#### **4.4 Europe holidays in August**

Much of Europe goes on holiday in August each year for their “summer vacation”. As a result, August tends to be a seasonally weak month for commodities and equities.

#### **4.5 June tax-loss selling**

If stocks have been under performing in the weeks leading up to the end of June (in Australia), then some people will sell off their stocks to realise a capital loss for tax purposes. This can potentially reduce their tax bill (seek professional guidance). This can depress the stock market during this period, and can create buying opportunities in late June and early July.

#### **4.6 September (and October) — a bad month?**

Historically, September is perceived to be a poor month in the markets. It is reported that between 1985 and 2008 Australian shares fell on average 0.3% in September (source:- AMP Capital Investors).

The financial panic of 1873 at the end of the US railroad boom was in September. The Russian financial crisis in 1998 and the Asian financial crisis a year earlier both peaked during September.

The terror attacks on New York of 9/11 took place in September, resulting in a share market plunge. It has been suggested that the market rout was exaggerated due to an already weak state of the market.

In September 2008, Wall Street investment bank Lehman Brothers went bankrupt, Merrill Lynch was merged with Bank of America, and insurer American International Group ran into trouble.

One touted reason for this is that fund managers in the US come back from summer vacations with a fresh perspective and start off loading unwanted stocks (source — Tribeca Investment Partners).

Another possible reason is tax-loss selling in the US. This could be because many US mutual funds have a financial year that ends in October, so they might sell losing stocks in order to reduce their capital gains tax bill. This is much like the possible situation in Australia at end of June.

## **5 General observations**

### **5.1 Past performance**

Past financial performance is not a guarantee of future returns.

### **5.2 The 18-year property cycle**

A phenomenon has been observed regarding real estate prices since 1800, primarily in the USA, but also applying in other key countries. Phillip Anderson has studied this for many years, and runs a business providing advice, and in 2008 published a serious text book "The Secret Life of Real Estate — How it moves and why". More information is available on his web site: <http://www.businesscycles.biz/>

I have to stress the seriousness with which this 18-year cycle phenomenon should be taken. The underlying reasoning for the cycle is fundamental, and very profound.

### **5.3 Fund Manager returns**

Beta fund managers aim to achieve the same as an index.

Alpha fund managers aim to achieve better.

Historically, alpha fund managers in general do beat the index by a small amount.

### **5.4 "Smart money"**

There is this thing called the "smart money"....(text still to be written).

### **5.5 Big end of town**

The so called "big end" of town has weight in the market....(more text to add).

### **5.6 How to invest a large amount without anyone noticing**

The so-called "big money" with large amounts to invest are very conscious of the fact that if they were to make sudden buys (or sells) of a large parcel of shares in a company, then the market could interpret the transaction and end up impacting on the share price.

So, the way to buy/sell large amounts is to do it in small bits. Sometimes this can be seen if you watch the market depth screen of a stock during the day. Sometimes there are strange-sized share parcels being bid for (or offered), repeatedly during the day.

### **5.7 When Wall Street sneezes, other markets catch a cold**

The US economy and stock market are so large that events that happen there can have some sort of flow-on effect to other economies and markets around the world.

So, when Wall Street sneezes, other markets catch a cold.

### **5.8 Up by the stairs and down by the elevator**

The market falls more quickly than it rises. Likewise for individual stocks — they fall more quickly than they rise. When you look at the price chart, it often happens that the upward leg of the chart is rather gentle (over the long term – more easily seen

on a weekly or monthly chart), but any significant sell off tends to be rather severe showing up on the chart as a steep decline.

### **5.9 Broker recommendations and valuations**

At any one point in time, multiple brokers / analysts might issue a recommendation or share price valuation for a particular stock; but different brokers can issue widely different recommendations or valuations. And these might be valid for only a short period of time (until circumstances change).

### **5.10 Confessional season profit warnings (May-June and Nov-Dec)**

On the Australian stock market, May and June are referred to as the “confessional season” because there is a higher number of profit warnings than in other months. Goldman Sachs JBWere says that about 25% of warnings since 2000 (until May 2008) have occurred in these months. The same can apply in November December.

This is because listed companies are obliged to report their accounts to the market within 60 days of the end of their half-year reporting period, and most Australian listed companies have financial reporting calendars at end of June and end of December.

Also see “*Sell in May and go away*”.

### **5.11 Reporting season opportunities**

The reporting season (typically about February and about August) can provide good opportunities to make some money on the good news contained in the company reports. It is also a good time to potentially lose money by betting the wrong way on potential news outcomes.

### **5.12 P/E – Price/Earnings Ratio**

Historical average.....(still to write text)

Caution: historical P/E versus forecast P/E

### **5.13 Profit takers – they do exist**

Watch out for the “profit takers”. They will sell a stock and take profits, possibly resulting in a price fall. It does happen.

### **5.14 Bull Bear market durations**

Analysis from Zurich Australia shows that for the All Ordinaries index (S&P/ASX All Ordinaries – XAO) from February 1970 to February 2007, the average bear market was just 14 months compared with 42 months for a bull market.

## 6 Commodities

### 6.1 Supply and demand equation

The fundamental economic principle of supply and demand certainly applies more often than we think. The world's stock markets are very aware of the global supply levels of key resources products (ie. gold, silver, zinc, lead, copper, etc.).

If the markets believe that the global stock pile of any of these products is getting too low, then it affects the global price. This in turn can affect the stock price of any miner or producer who processes these products.

### 6.2 Global prices impact local stocks

A number of commodities are traded on global exchanges (eg. crude oil, gold, etc.). When the commodity price on the global exchanges rises (or falls), there tends to be an impact on local related stocks. For example, when the global price of crude oil falls (for whatever reason), Australia's oil producers suffer a stock price drop.

### 6.3 VIX – Chicago Board Options Exchange Volatility Index

The VIX (Volatility Index) is a measure of the implied volatility of stock options for the US's S&P 500 index. A higher figure suggests increased volatility and nervousness in the US market, which can be more difficult to trade. A lower figure suggests less volatility and a calmer market which can be easier to trade.

### 6.4 Gold and \$US

Gold tends to do well when the US dollar is weak, when stock markets are under pressure, and when the oil price is high. It often happens that a rise in the US dollar, results in a fall in gold prices (and vice versa).

Conversely, gold tends to fall in value when the US dollar is stronger, the oil price falls, and commodities fall.

### 6.5 Australian iTraxx index

<http://en.wikipedia.org/wiki/iTraxx> )

### 6.6 Libor

The London Inter Bank Offered Rate (LIBOR) — is the current global benchmark that indicates the interest rate paid by banks to borrow funds (has recently – April 2008 – been described by critics as out of date). The Libor relies on information supplied by 16 of the world's biggest banks, and is the average interest rate being charged. An alternative being touted is the Overnight Index Swaps (OIS), which are interest rate sensitive securities that are actively traded between financial institutions.