



▶ Introduction

To make it easier for our busy readers to scroll directly to the items they are interested in without having to read through all the material, we list the issues covered in this module:

- **The four primary stock market trading types**
- **Fundamental School and the Technical School**
- **Trading strategies mostly applied in the markets**
- **Other trading strategies also often used**
- **Some less used trading strategies**

If you are interested in accumulating useful information about stock market investments you may want to copy this module and add it to the others published in order to build your own manual of useful tips to assist you with successful investments in the equity markets.

The statistics and historic performance used in the examples are based on historic averages and we attempted to be as accurate and fair as possible in each scenario or illustration.

- **The four primary stock market trading types**

- * **Traders**

Any person who is authorised to buy and sell stocks on the Securities Exchange is referred to as a securities trader.

Most traders are stock brokers who buy and sell stock on behalf of their clients.

You may, however, enter into an arrangement with a stock broker company whereby you may do your own trades on a "live" website facility provided by them on the Internet.

This type of arrangement is referred to as online trading and using this option may bring about great savings in costs that could add considerably to your eventual trading gains made.

(More on this in the module on "Tyranny of Costs")

- * **Jobbers**

Jobbers are often also referred to as day traders and they usually have a very short investment horizon. They focus on momentum plays and their typical approach will be to buy stocks that display strong upward movements (or downward moves where they short it) in the morning and sell it again before the market closes that same day. Apart from strong nerves, one needs to have considerable knowledge and insight to momentum and other short-term trends or allied factors in the markets.

These day traders are professionals and ordinary investors should rather stay clear of this approach.

* **Stags**

They focus mainly on new share listings when it becomes available with a view to an almost immediate sale and profits. They bargain on many of these new stocks to become oversubscribed and then bail out as soon as the high demand starts to taper down as it often does.

* **Investors**

These are long-term investors who favour a value investment approach.

They seek out good quality companies with promising long-term earnings potential and they generally have an investment horizon of around three to five years or even longer.

They are not frequent traders and their gains are often deemed to be of a capital nature by SARS which allows them a Capital Gains Tax status. This in itself can have a massive positive impact on their eventual long-term gains in their portfolios.

To them steady reliable growth, good dividends, low transaction costs and favourable tax benefits are very important.

They are very cautious about derivatives and other leveraged products on the market and generally steer away from these instruments.

The approach and services of Valana (Pty) Limited are focused on this group of investors.

■ **The Fundamental School and the Technical School**

There are basically two schools of thought as to how one should analyse and select stocks.

- ☀ **The fundamental approach** where the focus is on *bottom up* business, financial and company internal factors and elements. This is a bit like a numbers or actuarial approach to the many performance aspects of the business, but also allows for some review of softer issues such as the management team, value systems in force, corporate responsibility, market monopoly, how moated the company is to attack by its competitors, perceived business integrity, etc.

This approach also considers *top down* business environmental issues such as economics, industry trends, forex movements, commodity prices, consumer trends, interest rates, business confidence, other trend measurement instruments, etc.

- ☀ **The technical approach** where the focus is on charting and associated technical performance trend analysis. The supporters of this analysis approach mostly use technical indicators and other oscillator instruments such as:

- Bollinger Bands
- Linear Regression (mean reversion)
- Relative Strength Index (RSI)
- Slow Stochastic Oscillator (SST)
- MACD (moving average convergence divergence indicator)
- Momentum Oscillator
- Volatility Indicator
- Volume Histograms
- Moving Averages (for different periods)

Many investors, of course, to some extent make use of both these approaches. Most of the fundamental supporters, however, will be quick to point out that they only use technical indicators to assist with timing issues and that they will seldom use it to actually select a stock for investment.

We found that short-term traders seem to be more in favour of charting tools than long-term investment orientated players.

During the Valana research we also found very few really successful traders (market gurus or wizards) who recommended charting as a reliable stock selection tool.

In fact, from predictions made by supporters of these different schools as recorded by us and then checked after a few months to evaluate these predictions we found that the fundamental analysis supporters far outperformed the chartists with the accuracy of their predictions.

■ Trading strategies mostly applied in the markets

☀ **The "Big Gun" strategy**

Investors using this approach mainly concentrate on the Top 40 big cap companies and they often have only limited knowledge of other lesser known mid cap and small cap companies listed on the market.

Brokers tend to favour this strategy and trade on dips and rallies of these big cap companies which also usually have a high trading liquidity (often traded).

A big cap company is one with more than R1bn market capitalisation (shares x price)

A mid cap company is one with less than R1bn but more than R300m market cap

A small cap company is one with less than R300m market capitalisation

☀ **The Growth strategy**

Investors using this strategy are mainly concerned with growth and future earnings and performance potential.

These investors spend time identifying mid cap and even small cap companies with exciting and innovative products and business plans that may do exceptionally well in the near future.

These investors seldom favour big cap companies, because they know that exceptional growth is unlikely or fairly remote with those big cap companies.

These investors place considerable value on future earnings potential, which is not always the best approach to stock selection and this is probably the reason why *value* and *dividend* orientated investors seem to do better over the long-term.

☀ **The Value strategy**

These investors have a serious long-term view to investments and they are mostly concerned with verified embedded value in high quality companies with future promise.

They also see trading as buying into companies rather than just buying shares.

They tend to ignore unsubstantiated rumours and other unreliable market noise or media hype related to these companies.

These investors have clearly defined investment strategies and they base their decisions on verified enterprise fundamentals and environment developments.

They also tend to use only credible and knowledgeable sources to assist them in their decision-making outside and beyond the normal media channels and discussions.

These investors firmly believe that value will always pull them through over the long-term.

☀ **The Dividend strategy**

These investors are often in high tax brackets and mainly focus on investing their funds in the stock of companies with good dividend components and track records.

They consider a regular dividend income stream as important and seek a good real return.

These investors also realise that when buying into a good dividend stock one usually gets that stock at a considerable discount to the price you actually paid for it.

Considerable research has been done to evaluate good dividend companies as investment opportunities and all the findings have been very much in favour of good dividend stocks generally outperforming other stocks.

It is also interesting to note that during the past two years which included a serious market crash, 15 of the most popular preference shares only dropped 1% in capital value and gave an average tax-free dividend return of 11.05% per annum.

Some of the more important findings were:

Over the long-term good dividend stocks will perform several times better than good growth stocks (especially if the latter has a poor dividend track record).

Over a period of only five years good dividend stocks may represent a 50% discount on the original price paid for that stock.

With good dividend stocks it is possible to earn a tax-free dividend after a few years that may be more than the actual amount originally invested in the stock.

An example of such a situation would be Impala Platinum. If one bought this stock in 1997 even before the 1998 crash, the normal dividend paid in 2008 would have been equal to a 232% annual tax-free yield on the original price paid for the stock in 1997.

🔔 In 1980 if one invested R10,000 in each of the following USA "Jewel" dividend stocks, Pepsi, Philip Morris and Johnson & Johnson and you reinvested the dividends paid your original R30,000 investment would have been worth R21,500,000 in 2004 and that excludes the immense gain on the currency differential one would have obtained.

If you include the considerable currency gain your original R30,000 investment would have been worth a staggering R122,550,000 in 2004.

■ Other trading strategies also often used

☀ **The Catalyst strategy**

These investors, who are really more traders than investors, seem to favour the old well-known "trend is your friend" strategy and they focus on cyclic dips and rallies in the markets.

They are also sensitive to moves in interest rates, foreign exchange and commodity prices and often use these catalyst trends to select stocks to buy or sell.

Their favourites seem to be cyclic sectors such as commodities, construction, financial, consumer and other catalyst sensitive stocks.

This strategy can be risky to the average private investor and should rather be left to people who have the time, skills and facilities to be involved full-time in this approach to the markets.

☀ **The Stop Loss strategy**

These investors usually have a very conservative and risk adverse approach to the markets.

This strategy is favoured by many stock brokers, fund managers and financial consultants and is often referred to as a risk containment strategy.

This stop loss strategy comes in two formats:

The **trade stop loss** and the **trailing stop loss**.

With the **trade stop loss** one selects a percentage drop from the buy price you are willing to tolerate, for example 15% below the price paid. This type of stop loss may be applied to stock where one is not certain about the value content of the specific stock such as uncertain speculative ventures.

With the **trailing stop loss** one selects a percentage drop you are willing to sacrifice from the highest price the stock achieved since you bought it. This type of stop loss can be very effective with stocks held for more than three years (if less than three years there may be undesired tax implications).

The problem with stop loss strategies is that if a temporary dip in the market triggered the stop loss you may have sold the stock too soon and it may be difficult to again enter the market at the right price (re-entry dilemma).

In fact, if one excludes the serious six or so market downturns during the past 30 years, this strategy if applied to all your shares probably would have contained your gains more than it would have contained your losses during the period.

It may be wise to rather avoid using stop loss strategies with volatile stocks such as resources stocks, unless you allocate a high stop loss and this may be counterproductive to the original purpose of the stop loss. If one uses a stop loss strategy it should also be flexible enough to allow for good dividends involved in price volatility.

Warren Buffet is rumoured once to have said that as far as he is concerned stop losses are only for people who did not do their homework and, therefore, have no idea or evidence whether they bought into value or not.

Apparently he said it sounds like buying a house for \$1m and then telling the estate agent if they can only get \$850,000 for the property they should sell it.

Stop losses, by its very nature, is a bit like teaching your child to fall from a bicycle rather than teaching the child to ride the bicycle.

We, at Valana, strongly recommend that one should consider having a **trading stop loss** only on stocks such as recently listed small cap ventures or other stocks bought for speculative purposes and a **trailing stop loss** mainly on stocks held longer than three years and which are historically not very volatile.

However, it is critical to always utilise stop losses when derivative trading is done, such as when shorting strategies are applied.

☀ **The Hedging strategy**

This is where the investor makes use of the many hedging options available on the markets today. This strategy became quite popular amongst some investors during the past few years.

Many of these hedging techniques require considerable knowledge and insight to such strategies and should probably be left to the experts (more info in a later Module on Hedge Funds and other derivatives).

However, there are some less risky techniques to be used by the ordinary investor to hedge against serious market downturns, such as:

- "shorting" some stocks held to neutralise up or down movements
- increasing your weighting in good defensive stocks (as rated by Valana)
- increasing your weighting in dual listed or other Rand Hedge stocks
- increasing exposure to "safe haven" instruments such as the NewGold ETF
- increasing holdings in preference shares and corporate debt instruments

One should remember that hedging works both ways, if you apply hedging strategies during the "good" times you may be hedging against profits rather than losses. Therefore, it is Valana's view that hedging should mainly be considered if dark clouds start gathering on the horizon.

☀ **The Jobbing strategy**

These players are also referred to as day traders and they focus entirely on short-term dips and spikes in share prices.

They are the people who are nailed to their "live" computer screens and quickly buy and sell stock often purely on temporary momentum, short cycles, other trends and perceived or anticipated changes in market sentiment.

They generally tend to complete all trading cycles (buy and sell) in a single day and they had a very good day if they end up with a 2% gain for the day.

These players are also inclined to use technical indicators like charting more often than most other players.

■ **Some less used trading strategies**

☀ **The "Stag" strategy**

These players focus mainly on pre-listings and newly listed stocks. They rely on many of these stocks to become oversubscribed and then they bail out as soon as the initial demand for the stock starts tapering down.

The research done by Valana on the potential opportunities with pre-listed stocks strongly indicate that investors should rather steer clear of these offerings no matter how good the hype or prospectus may seem or appear to be.

☀ ***The "Global Lag" strategy***

These are a special breed of traders who only play the markets if the "lag" indicators are favourable. They favour a Jobbers approach to the markets and they also tend to make use of charting.

They wait for some primary offshore markets to close very well up and then the next morning they buy big into some highly liquid selected local stocks, favoured by the charts, especially those with dual listings (also listed on other primary global markets).

They usually have price margin targets of around 3% and they sell as soon as it is reached.

During the first six months of 2009 there were 25 such trading occasions identified by the Valana research team who applied this strategy simply to assess its validity. The average income that would have been earned on a R1m base play would have been R29,775 per day. This would have given such players approximately 74% average gross return on their investments over the six-month period.

As our local markets show a great tendency to follow the big offshore markets these lag players believe that this strategy is almost guaranteed to succeed.

The Valana team did not experience a loss on any of the 25 days where the strategy was triggered and implemented, but we still reserve our opinion as to its long-term merits.

☀ ***Other weird approaches***

Some people believe that there is no merit in any model or strategy and that one may as well use a dart board to select the stocks for investment.

Fortunately, Valana can report that during all our research and interviews over the eight years we could not find a single person who used this dart board strategy successfully.

Another weird strategy we came across is where one buys the best and the worst stock in each sector, but to us this seemed to be too much a "what you lose on the swings you win on the merry-go-rounds" technique and we certainly cannot recommend it.

However, some of the weird strategies that Valana uncovered in its research, when tested, actually showed amazing results, such as:

During 2000 to 2003, if one simply bought 100,000 shares in every stock that dropped to 1c (mostly perceived as being useless) during that period, you would have ended with 44 stocks at a total cost of ±R54,000 (including transaction costs).

In January 2005, seventeen of these stocks still traded on the JSE and if you sold all those stocks at its ruling price at the time, you would have ended up with around R217,000 which would have given you a gain of ± 300% at the end of the five-year period and this does not include any benefits you may have received where some of these stocks were delisted or merged with other listed companies during the period.

Not a bad return on "useless" stocks!

General Comments

Most successful investors may use several of these strategies depending on the ruling investment environment and market conditions or scenarios at the time, but the value and dividend strategies seem to be the ones they mostly favour.

In the next module we will deal with some identified characteristics of successful investors.

Module 5
30 November 2009

Valana Stock Market Investment Sense