Signs of Trouble

Some years ago, I wrote an article (*This Stock will Self-Destruct*)and gave a presentation on how to anticipate and avoid stocks that ***crash and burn***, taking their stockholders' capital down the drain with them. This was based primarily on the charts. I picked a number of charts of stocks that had failed and showed that there was plenty of warning on the charts, sometimes for a year or more in advance. In one case a stock had been falling for over two years before a fraud was discovered. I have included this article at the end of this one.

However, the charts are not our only weapon. We can also read the financial news every day. I have read *The Australian Financial Review* (AFR) daily since I was at university doing Economics back in the early 1960s. It has been a wonderful investment in its own right. By reading the news about companies (not just the reports on what some journalist thinks was why the market rose or fell yesterday), a picture builds up and there are many signals that trouble may be ahead – what Dr Alexander Elder calls ***engine noise***, only he picks it up on the charts. On Wednesday 13 June 2012 Dominic White wrote an article in the AFR headed *Ten Signs that the Writing is on the Wall* that highlighted the fundamental analysis signals of trouble. This list rang so true to me that I thought I would list them below. It is a good idea to print them out and put them on the wall near your computer screen. This is the list:

1. Heavy gearing and fancy debt instruments.
2. An unstable boardroom and directors selling shares.
3. Lavish corporate expenses.
4. Over-expansion.
5. You cannot explain to a 10-year-old what the company actually does.
6. Qualified accounts/emphasis of matter.*
7. Profit warnings and [heavily] discounted share issues.
8. Net cash outflows and negative current assets.
9. Fancy hedging instruments.
10. Other clues in the financial statements.

*Emphasis of matter is auditor-speak for a warning (so you cannot sue the auditor if things go wrong). It is one step short of an outright qualification, meaning that the company is in danger of not being able to meets its debts when they fall due or continue as a going concern.

This Stock Will Self-Destruct

Over the years I have collected many quotations about trading, investing and the markets. Reviewing some of them recently, I came across one of my favourites, which seemed particularly apposite as we head into difficult times in world share markets:

It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it. Ralph Waldo Emerson

I have been trading and investing since the late 1960s. For many years I just educated myself about the share market and built up experience that leads on to skill and hopefully some measure of wisdom. During 1993, many people I knew bought shares in a bull market and were proud to tell me that they had large paper profits. However, by mid-1994, as a bear market wrung the excesses of 1993 out of overvalued share prices, I was dismayed to hear that many of them had accumulated substantial paper losses on the same holdings.

I had sold all my holdings as the bull market played out its last days and could not understand that so many of these people had not done likewise. It was around this time that I first began to write seriously about investment and trading strategy in the hope that I might pass on something of what I had learned over the years.

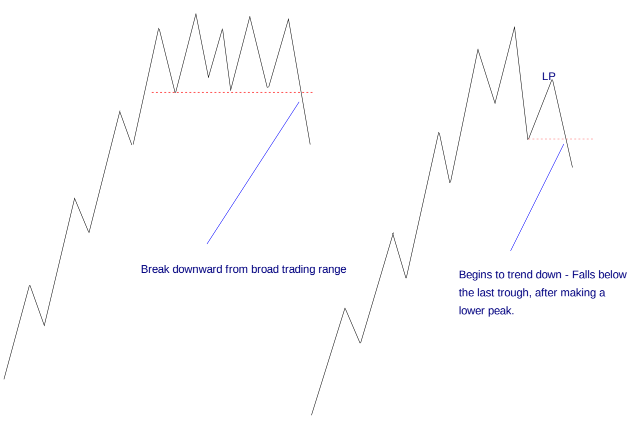
One of the more important ideas I had built into my trading psyche is that paper profits are real profits. Paper profits are not, as many people think, “the market’s money”, with which we are somehow allowed to take bigger risks because it is not really ours. This is where the Emerson quotation comes in. If we have good profits from the bull market, the real skill is in making sure we keep most of them intact.

The associated key idea is that paper losses are real losses. The market does not care what we paid for something. A share is only worth what we can sell it for. The Emerson quotation comes in here too, because, not only do we have to ensure that we keep most of our profits, but we need to ensure we do not lose too much of our capital. What use are profits on one share, if we lose a lot of our capital on another one?

One of the features of bear markets is that some good investment grade stocks will “self-destruct”. These disasters come out of left field for most investors, because they wait for someone to tell them it is going to happen. However, once everyone knows a company is in dire trouble, it is too late to sell – the price will already have fallen.

There is one way to know that something is wrong. That is by using charts of share prices. There are always those who know earlier, or are better able to read the signs. They start getting out. We can see their footprints on the price chart in time to also save most of our capital. I can remember very few companies failing over the years with no notice given on the price chart, if we knew what to look for.

There are really only two patterns to look for, though there are additional fine details that can be learned by studying technical analysis. However, if we just know the two patterns, and get the hell out of any stock that develops them, we should avoid the major disasters.



The two patterns are shown in the diagram.

The left hand pattern is where we get a large distribution area form on the price chart. The share price will go basically sideways for months, or even a year or more. Everything is all right, we think. It is not going up any more, but it is not going down, is it? However, one day it does go down. It breaks below the lows of the big trading range and usually this is the signal that a major downtrend will develop. It is always best to stand aside until a better chart pattern forms again. Yes, occasionally, with hindsight, it will have been better not to sell. However, exceptions do not prove anything. We are playing a game of probabilities and the odds are against a stock that breaks down from such a pattern, which technical analysts call a “reversal pattern” with good reason.

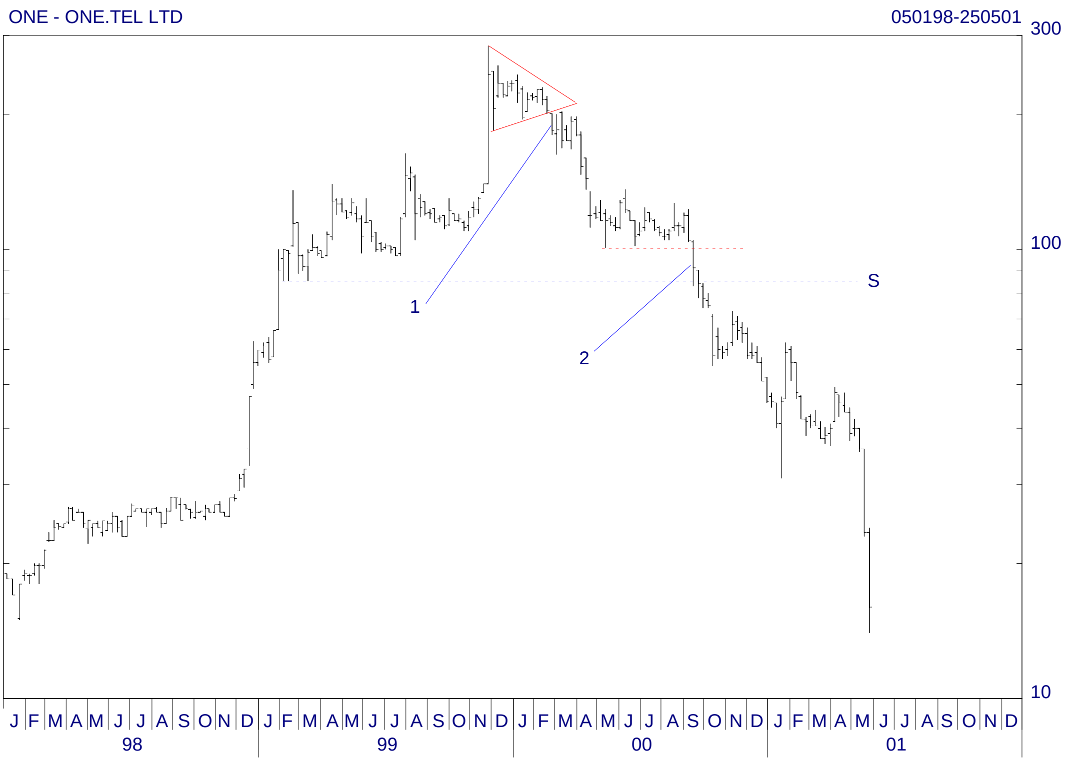
Sometimes these patterns form classical textbook shapes, but all we really need to know is that once a distribution pattern has formed and broken down, it is time to run, not walk, for the exits. Distribution patterns, by the way are formed when professional investors sell to the “mugs”. It is better to be with the pros than with the amateurs.

The right hand pattern is where there is no large distribution pattern formed. Instead the trend just reverses to down. The definition of an uptrend is that the price makes successive higher peaks and higher troughs. A downtrend, which is our main concern here, is when the market makes lower peaks and lower troughs. So, if the market makes a lower peak and then falls below the last trough, we will have a downtrend in place by definition.

Now, sometimes the chart is difficult to read. It is not clear whether the fluctuations in price are big enough to be peaks and troughs. The general rule is that if we are a trading, we get out just in case, but if we are investing we might give it the benefit of the doubt.

But remember something very important – trading and investing decisions are not made using only an “on” button or an “off” button. We can always reduce or expand our positions in stages. It is not all-or-nothing.

Now let us look closely at three of the recent “self-destructing” stocks to see how we might have seen it coming on the chart. The most recent failure was One.Tel.



The One.Tel weekly chart shows its price action from the start of 1998, shortly after it was listed. Shareholders enjoyed an amazing ride from 21 cents on listing to a peak of $2.84. The trick was not to give it all back. There were two really clear signals and some minor ones.

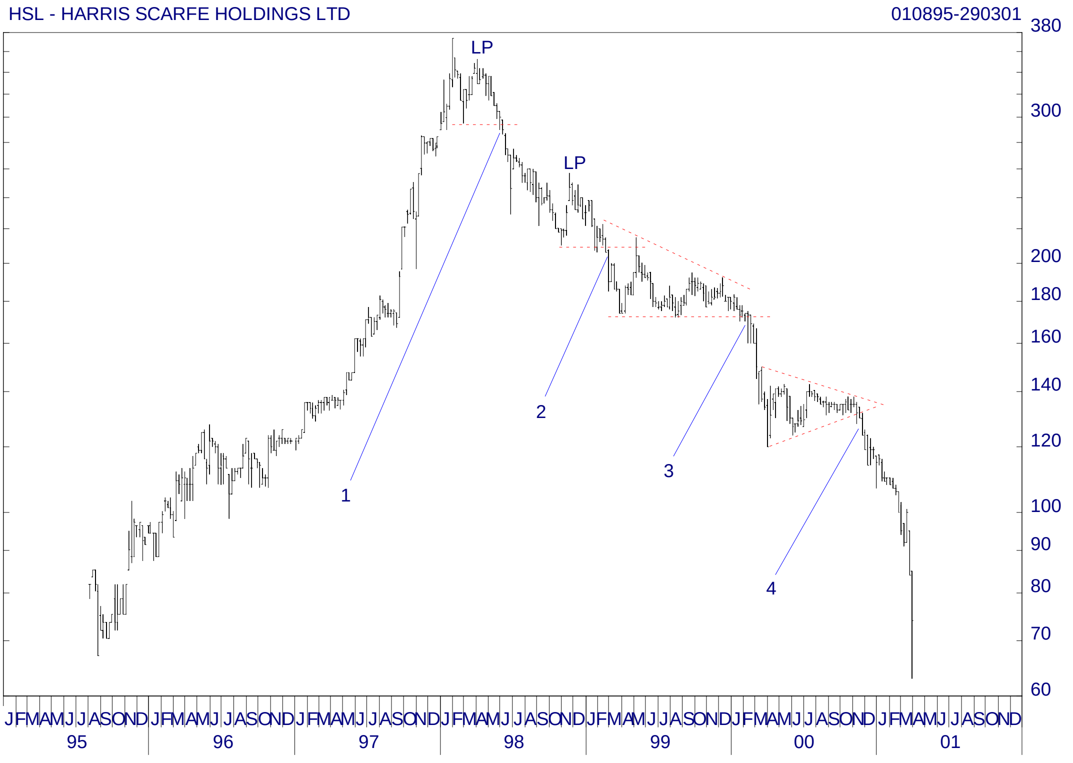
The first of the clear signals is numbered 1 on the chart and was to sell on the break below the symmetrical triangle pattern that formed at the top. Up until then, One.Tel had always broken out upwards from patterns of this size, so this was a clear signal that something different was afoot.

Even if this signal had been missed and shareholders had hung on loyally in the hope that the strong support levels formed by the trading in 1999 would hold, there was a second crystal clear signal. This is numbered 2 on the chart and was given as One.Tel plunged below a broad trading range and also violated the very lowest support level from 1999, marked with a dotted line labelled S on the chart.

In case readers are inclined to dismiss this analysis as clever use of hindsight, I am on record in Shares Weekly #26 on 9 September 2000 as warning readers that a break down out of the trading range would be a signal to bail out of One.Tel.

Before One.Tel, was the failure of Harris Scarfe Holdings (HSL). Do I hear objections that there are allegations of fraud? Yes, that may be the reason for the failure of this once proud company. However, it actually allows us to prove a stronger case. If it was fraud (and this is still open to question), it might have meant that the perpetrators deliberately concealed the problems. If the chart could show evidence in such a case, might it not be a strong argument in favour of this method?

The weekly bar chart shows HSL from near its cyclical lows in 1995 through a great uptrend, its reversal and on down the slippery slope to oblivion. There were two clear warnings to get out. The first is numbered 1, where HSL formed what was to become its high point, formed a lower peak (LP) and moved below the previous trough.

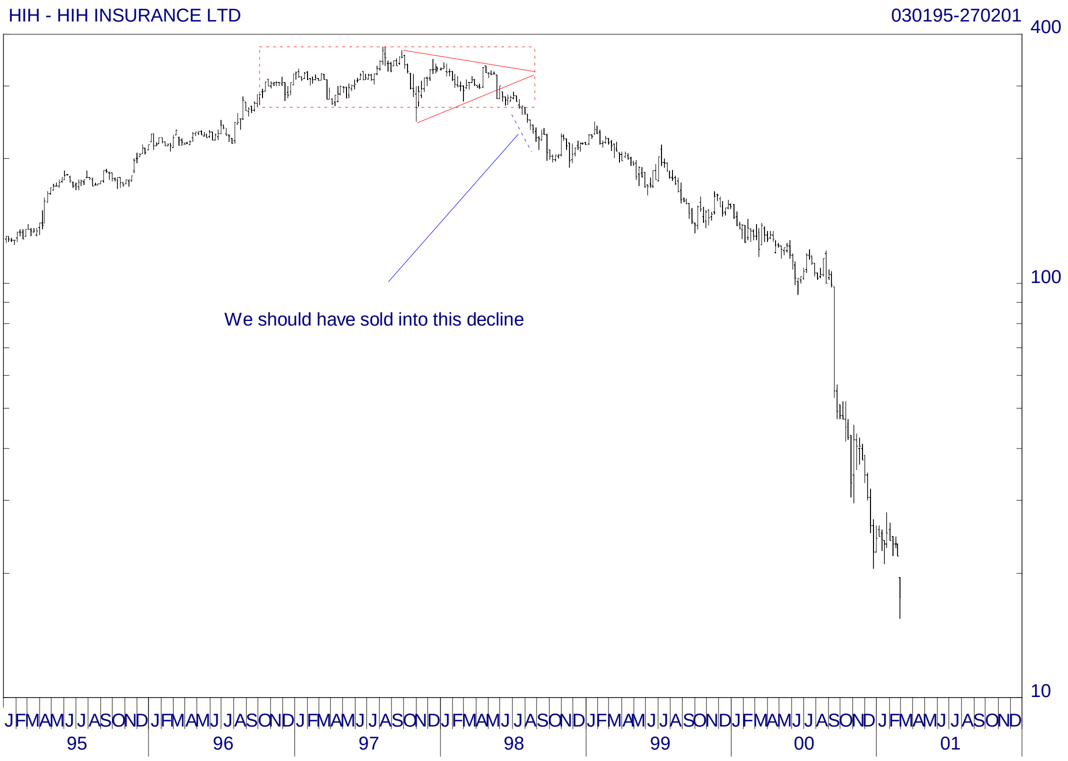


However, some investors would have given it the benefit of the doubt at signal 1. This might have been no crime, but to have ignored signal 2, when HSL again made a lower peak and fell below the last trough, is to ignore the plainest picture of a downtrend.

Later, there were two clear signals from continuation patterns. Continuation patterns confirm the trend - in this case a downtrend. At 3 was a break out of a descending triangle and at 4 a break out of a symmetrical triangle.

Even more notorious than the failure of One.Tel and Harris Scarfe, was the death dive of HIH Insurance . However, this debacle should have been avoided by anyone with an elementary knowledge of the patterns that scream SELL! The HIH Insurance chart features an almost textbook example of one of the two diagrams shown earlier. Did you see it?

From late 1994 through to well into 1997, HIH Insurance was generally trending up. However, as 1998 wore on, it was clear that a large churning trading range was forming. The last part of it was in the form of a symmetrical triangle, delineated with solid red lines on the chart. With these triangles, the breakout direction usually indicates the destination of the ensuing trend, so this was a clear signal.



However, it was not really necessary to know this. All that was really necessary was to see the large trading range. Now, its boundaries are open to debate, but its existence should not have been. Just pull back from the chart and partly close your eyes so that only the main shape of the chart is visible. It should be clear to anyone that HIH Insurance had stopped going up and had been going sideways for some time. Don't worry about the shape of the trading range; just see a wide sideways pattern.

Marked on the chart is a decline from that pattern. The dashed red line shows a reasonable view of the boundaries of the trading range. The lower boundary is arguable. It might be seen as lower, say through the extreme low of the spike down in the centre of it. However, somewhere along the decline marked with a dotted blue line, it became undeniable to anyone that HIH Insurance had broken below the range.

That was all we had to see. The uptrend music had stopped some time ago and the band was breaking into a funeral march. Gradually the band was drowned out, as HIH Insurance began a screaming death dive that could have been avoided by acting on a clear signal nearly three years earlier.

Clearly, an elementary knowledge of charting could have saved shareholders from all three of the disasters discussed above. The lesson is to look at the chart of a stock before you buy it. Only buy a stock if its price is trending upward. Then monitor the chart of every stock you own. If you see one of these signals, even long-term holders should consider selling their holding progressively as evidence mounts that the stock is in trouble.

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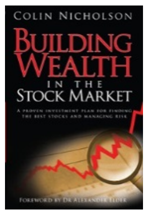

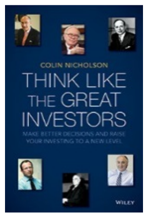

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