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Avoid emotion and get rid of the dogs

Peter Strachan

A NUMBER of readers have asked me to explain how to go about finding share trading opportunities and what criteria I use to select stocks that might move rapidly in the share market.

This follows strong performances in the market by a few stocks mentioned earlier this year, including gold mine developer Integra, lithium project developer Galaxy, and junior oil company Mosaic.

While the question is easy to formulate, the answer comes with 26 years of experience in capital markets and is difficult to distil into a short column such as this. There are libraries of books devoted to the topic and there are many ways of getting started.

Firstly, let me say that if I knew all the answers, I would be living in the south of France somewhere with my feet in a bucket of champagne, instead of writing this column. So while I am not holding myself out as some sort of market guru, nevertheless I think I understand enough of the techniques used to be able to give a reasonable summary.

The first thing to understand is that no-one consistently makes money trading in the market. Sure, some folk have a good year or two, but the market is a great leveller. After a few wins, traders usually become too cocky, forget to be humble in the face of the market and inevitably lose the lot. Inevitably, traders sell too early, hold their dog stocks and get too emotionally involved with their investments.

The real winners in stock markets are those who search out value and invest for the long term. Investors such as Warren Buffett show that long-term outperformance of the market is possible.

There are two broad categories of investor. It's a sort of rich man-poor man divide. The poor man wants to work the market to his advantage to make money, but inevitably ends up converting his hard-won capital into brokerage. The market will not be worked. It has its own agenda, as we have witnessed during the past 18 months.

Traders who may have made a few bob on a speculative iron ore or uranium play during 2006 and 2007 have almost certainly given all their gains back to the market over the past two years. Traders tend to make an investment and then sit around trying to urge the shares to move higher.

They will trade momentum, buying a stock that is rising and chasing stocks to high prices, which inevitably leads to a rapid price fall. Some resort to the internet chat rooms in an effort to create a bit of buy-side interest in their favourite stock, in the hope that others will buy and push up the share price.

A patient investor or rich man does not need the market to make money. He is willing to wait and let the market work for him. When he sees exceptional value, he swoops, but he does not have to trade incessantly.

So the first rule is to let the market work for you and don't ever try to second-guess the market. If there is a company whose business model looks good, watch and wait until a buying opportunity arises. If it does not arrive, no stress, as there is always another opportunity in the market, just around the corner.

The best trading situations are in stocks that are already trading at a discount to fair value. They may be takeover targets, leveraged to commodity price movements or tightly held by a supportive group of shareholders. This trading mode involves protecting your downside risk by buying shares in a company that trades below real net asset values.

If you buy a company like this and it continues to weaken, there is less stress because you know that the underlying value is ultimately secure.

Recently I recommended Carnarvon Petroleum while it traded at around 30 cents per share, saying that its underlying value for cash and oil resources in the ground was at least 65c/share. Since that call the company has made a significant oil discovery and the shares now trade at closer to 60c/share.

Another example is beleaguered local engineering company RCR Tomlinson. Despite providing assurance to the market that its operating issues are being addressed and are under control, RCR continues to report a series of profit downgrades leading to a share price collapse.

The company has also kept a low profile about the arrival of its new managing director, who has only this week arrived to take the reins, just as it signs a significant and long-term design and construct project for BHP Iron Ore.

With this knowledge of 'trouble at mill', we can look deeper for hidden value. The company has a net tangible asset base worth 80 cents per share, mostly industrial property.

Even if the value of its inventories and receivables are discounted by 30 per cent, the shares are still backed by 48c/share of real asset value, compared with a trading price closer to 38 cents. The company has the capacity to generate revenue of about $600 million a year when times are good, from which earnings of $20 million to $24 million or 16-19c/share should be possible.

While earnings of $7 million, or 5.5c/share are forecast for FY 2009, the company clearly offers

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situational value, not perhaps for a rapid trade (unless it is taken over), but a patient hold over two to three years.

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Much can be gleaned by looking at a company's share price chart. At the most basic level, is it moving higher or going lower or just going sideways? Chartists look for patterns within the share price movements of companies to detect common formations such as triangles, wedges, pennants, and flags. These common share price patterns give a clue to whether the share price is going to move higher or if it may be changing direction.

Another common chart pattern is the trading gap. This occurs when a share price closes at one price and the next trading day it opens a few cents higher or lower than the last price, creating a gap in the share price chart. What we see time and again in this pattern is that eventually, the share price will trade up or down to 'fill in' the gap.

A classic case is IT service company Service Stream, which has Telstra as its main client. Last February, Service Stream gapped down from 45 cents to 40 cents and continued on to 24 cents, following Telstra's disastrous handing of its bid for the national broadband network. It was clear to Briefcase that Service Stream would eventually trade up between 40 and 45 cents, which it did in early April, before continuing to 60 cents.

Other factors to watch include most importantly, the quality of a company's management and its access to cash. Even the best products and business models require adequate funding to achieve their goals. A company may look cheap on the basis of the underlying value of a development asset, such as an oil field, but without funding the share price will wallow. A classic case of this sort is Nexus Energy, which owns the valuable Crux condensate resource, but lacks the immediate funding to ensure that it can be developed in a reasonable timeframe.

■ *Peter Strachan is the author of subscription-based analyst brief StockAnalysis. Further information can be found at Stockanalysis.com.au.*

RICH PICKINGS: A patient investor doesn't need to work the market to make money, he is willing to wait and let the market work for him.

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