

The Blue Chip Manual

**A Blue Chip Report subscription application form is located
on page 40 of this document.**

The Blue Chip Manual

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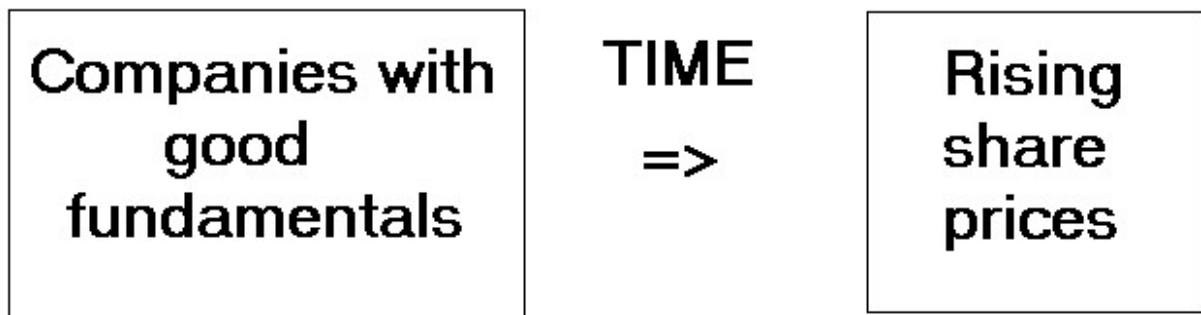
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Active Fund Management

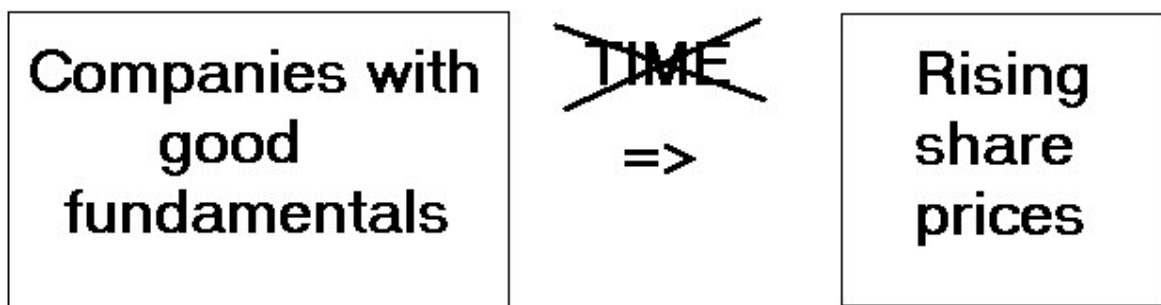
The following block diagram shows, in the simplest possible way, how and why share prices move up and down. Factors that effect opinion are released into the public domain and you and I, as individual investors or collectively through managed funds, react to this information by either buying up or selling down the share price.



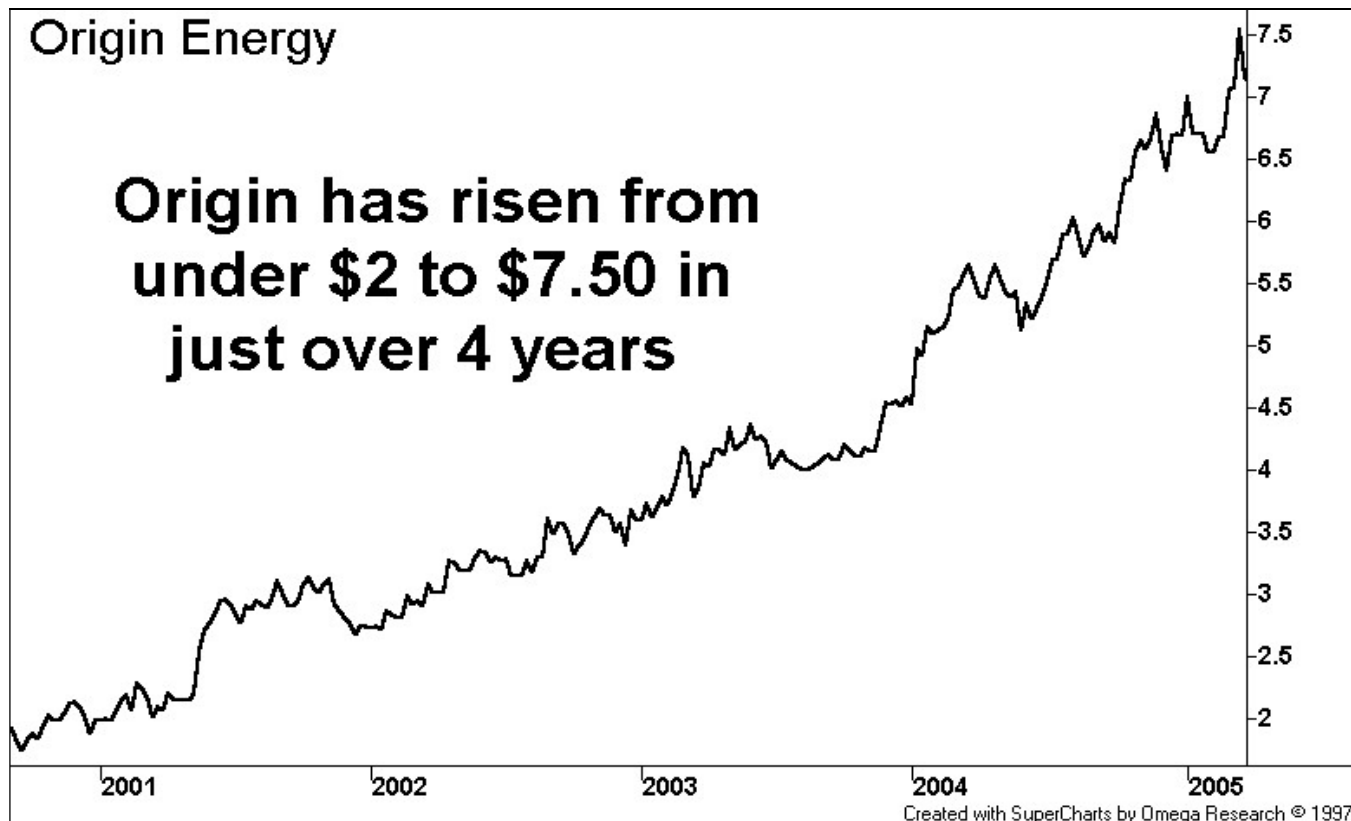
Factors that effect opinion include a company's asset backing, its debt level, its earnings growth, its profitability, its future prospects, its management and a lot more. All of these factors can be summed up by simply referring to them as a company's fundamentals. There are many other factors that effect opinion such as the behavior of the U.S. Stock market, local and overseas interest rates, the price of crude oil, etc. But undoubtedly the number one factor that effects peoples collective opinion about an individual company the most, and therefore has the greatest influence over its share price, is it's fundamentals. Hence the following block diagram defines the most commonly accepted and used philosophy when it comes to share trading.



If we buy companies with good fundamentals, given the passage of time, the share price will inevitably rise...that's the theory anyway. This trading technique is called 'Value Investing', where the idea is to locate undervalued companies and buy and hold them until the share price reflects fair value...at which point it becomes prudent to sell them. But what would you say if I said it was possible to eliminate the time factor out of the above diagram so it looked like this;



Value investing is in fact a passive way of share trading where you buy shares in a supposedly undervalued company and sit on them until the share price rises...it could take weeks (very unlikely), months (possible) or even years (very likely). So why not take an active approach and buy shares in fundamentally sound Companies where the share price is already rising, thus eliminating the need to wait. You don't have to buy shares that are going down in price or even sideways in price to find shares that represent fundamentally sound companies. The following charts are of fundamentally sound companies where the share price has been rising for years.



So by 'Testing and measuring' price activity we can eliminate the need to wait for share prices to go up. What's more, we don't have to do any individual research on each company because if we stick to only those companies that are included in the Standard and Poors ASX200 Index then it is reasonable to assume that they are fundamentally sound and institutionally backed.

After all, I like to sleep at night like everybody else and therefore I want to know that my money is invested in companies of large market capitalization which are traded by international investment houses via a globally recognised Index such as the Standard and Poors ASX200.

But if it is so simple then why isn't everybody doing it? Because, as stated earlier, the conventional approach which has been the accepted 'Norm' for many decades is to trade on a company's ability to generate profits rather than its share price movement.

The conventional approach does work and will continue to do so but, as some Boutique Fund Managers are now proving, the results from trading a company's fundamentals and testing and measuring it's share price activity is a lot more profitable. Hence, while the two are unquestionably interrelated, at the end of the day, as share traders, we buy and sell the share price and not a company's profits.

Being above Average

Another commonly held yet spurious line of thinking is that it's impossible to beat the market averages over time. Luckily for me my father, who is also a share trader, taught me that if you can't beat the market average, ie. the Index, then don't bother trying...you may as well put your money with a Fund Manager as they can achieve the market average for you.

So my mindset has always been that I can beat the market average and it's particularly easy if we are using a trend following approach to trading shares. Consider the following series of three numbers;

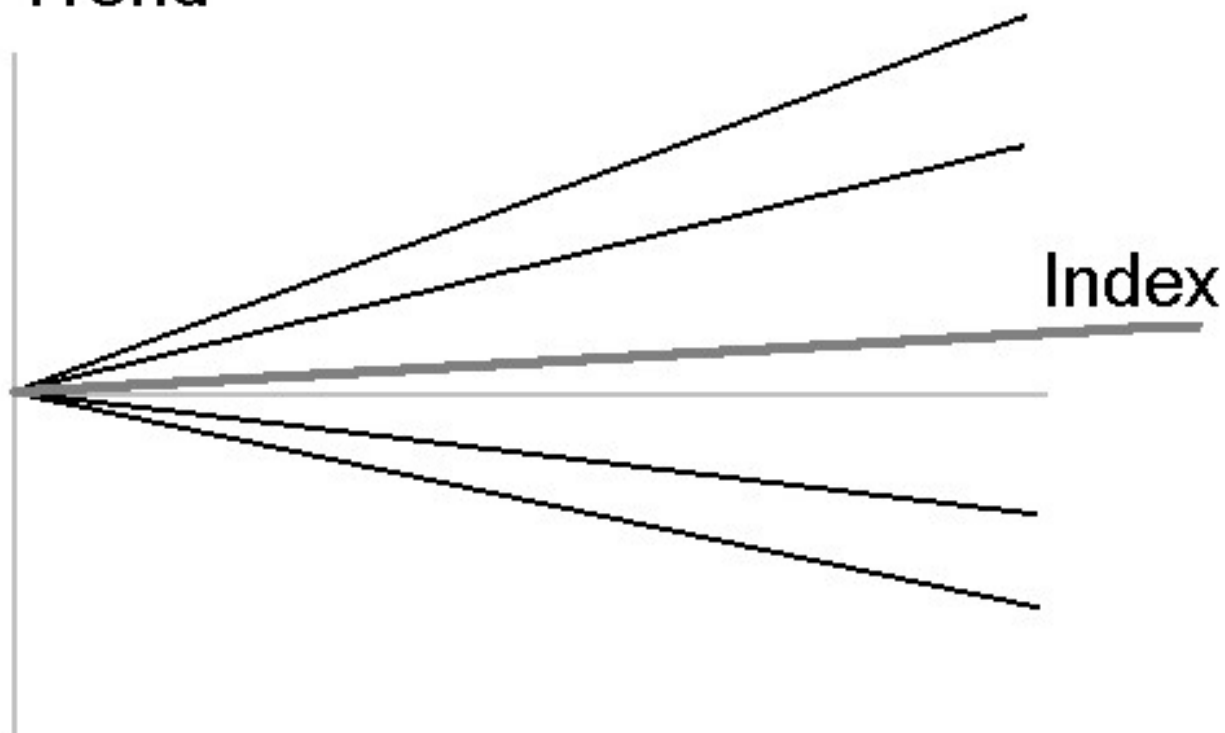
2 4 6 => **Average is 4**

In order to 'Beat' the above average of 4 we would have to manipulate this simple series of three numbers by eliminating the lowest value, namely 2. Thus we would have;

- 4 6 => **Average is now 5**

This method of beating or lifting an average is incredibly simple and fortunately we can apply the same logic to beating a market Index such as the Standard and Poors ASX200. But before we tackle the ASX200, let's pretend that we've created our own Index that only includes four individual shares. Two of our four member shares are trending up while the other two are trending down, as can be seen in the diagram at the top of the following page.

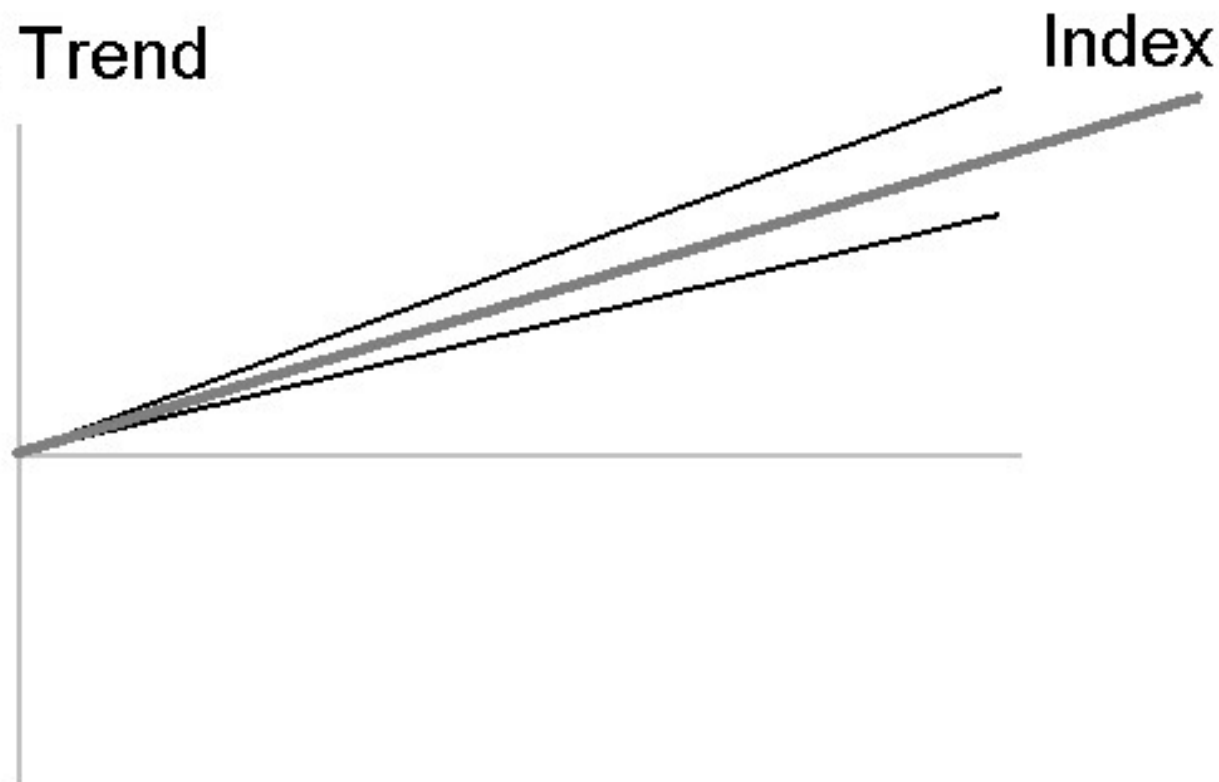
Up Trend



Down Trend

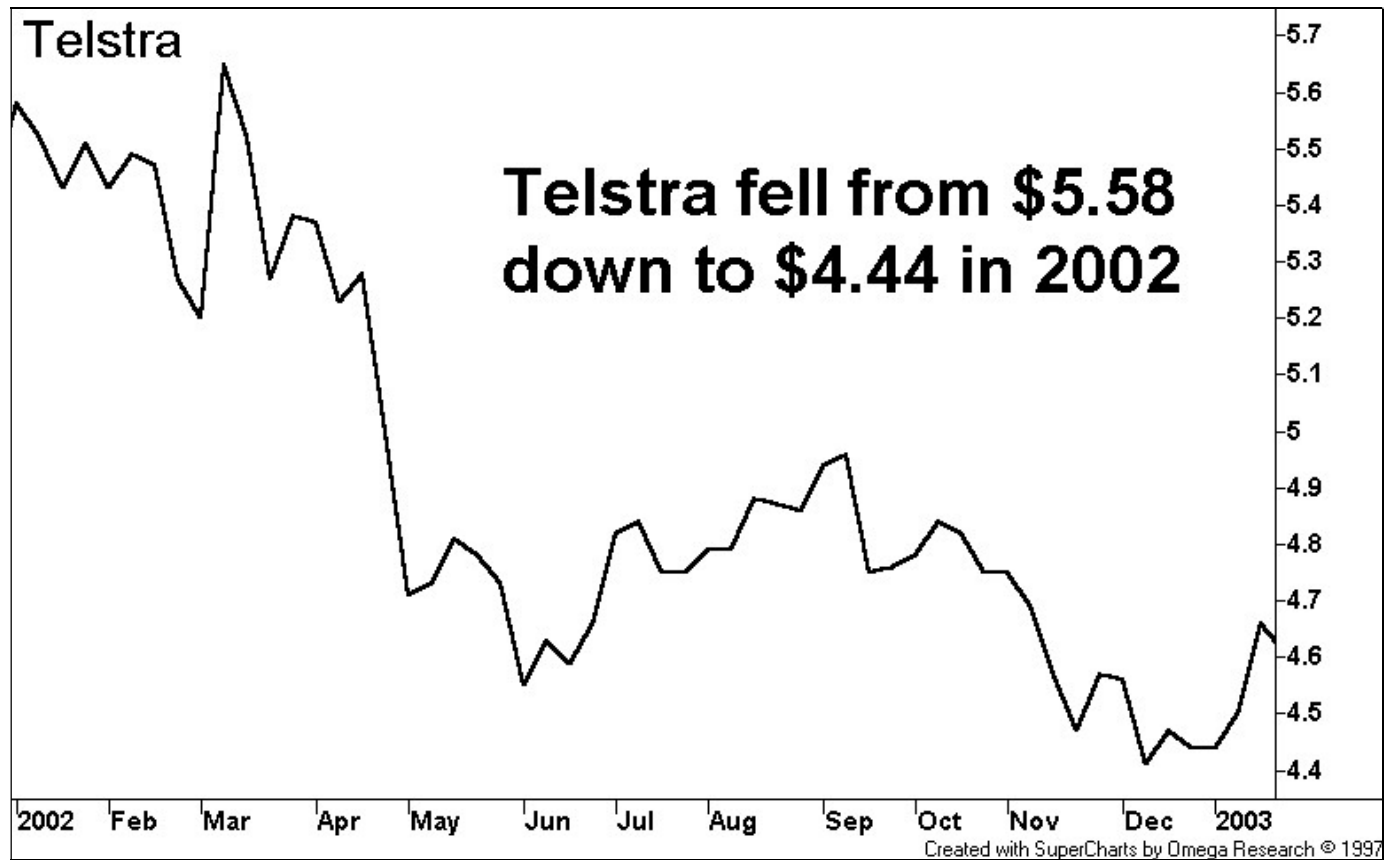
The Index in the above diagram is an average of all 4 trends and is trending slightly upwards. Applying the same method we used in the numeric example, you can see in the following diagram the impact it will have on our Index if we eliminate both the down trending shares.

Up Trend



Down Trend

Now let's look at a real world example of eliminating a down trending share from the ASX200 Index which is made up of 200 constituent shares of different weightings, depending on their market capitalization. One of these 200 shares is Telstra and the following chart shows how it fell just over 20% during the 2002.



The following chart shows the ASX200 Index falling down by 11% during the same period.



So logic therefore dictates that if we purchased every share that makes up the ASX200 Index minus Telstra then we would have beaten the Index...albeit by an insignificantly small margin. So why not take this logic further by purchasing a portfolio of shares from the Index which are all trending up much faster than the Index itself...its just good mathematical common sense.

Optimization not Timing

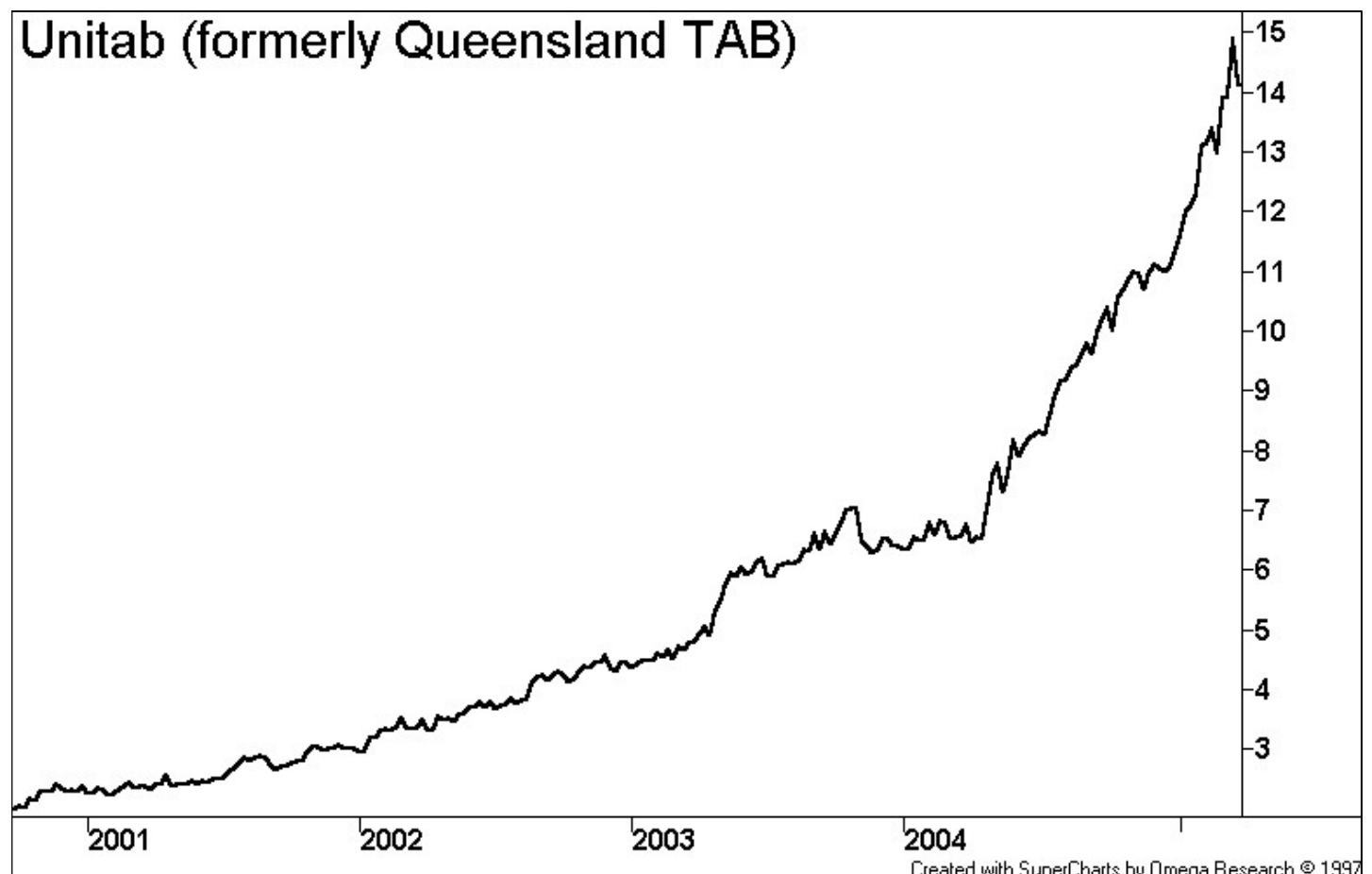
Fundamental analysis is the study of a Company's financials whereas technical analysis, also referred to as charting, is the study of a Company's share price activity. In order to beat the market averages, I employ technical analysis to 'Optimize' my Blue Chip portfolio.

This technique has absolutely nothing to do with 'Timing the Market' and hence the adage, 'It's time in the market...not timing the market' doesn't apply in this instance. There are charting techniques that do attempt to time the ups and downs of the Stock market but providing we can beat the cash interest rate of the day then we shall remain fully financially committed to the market.

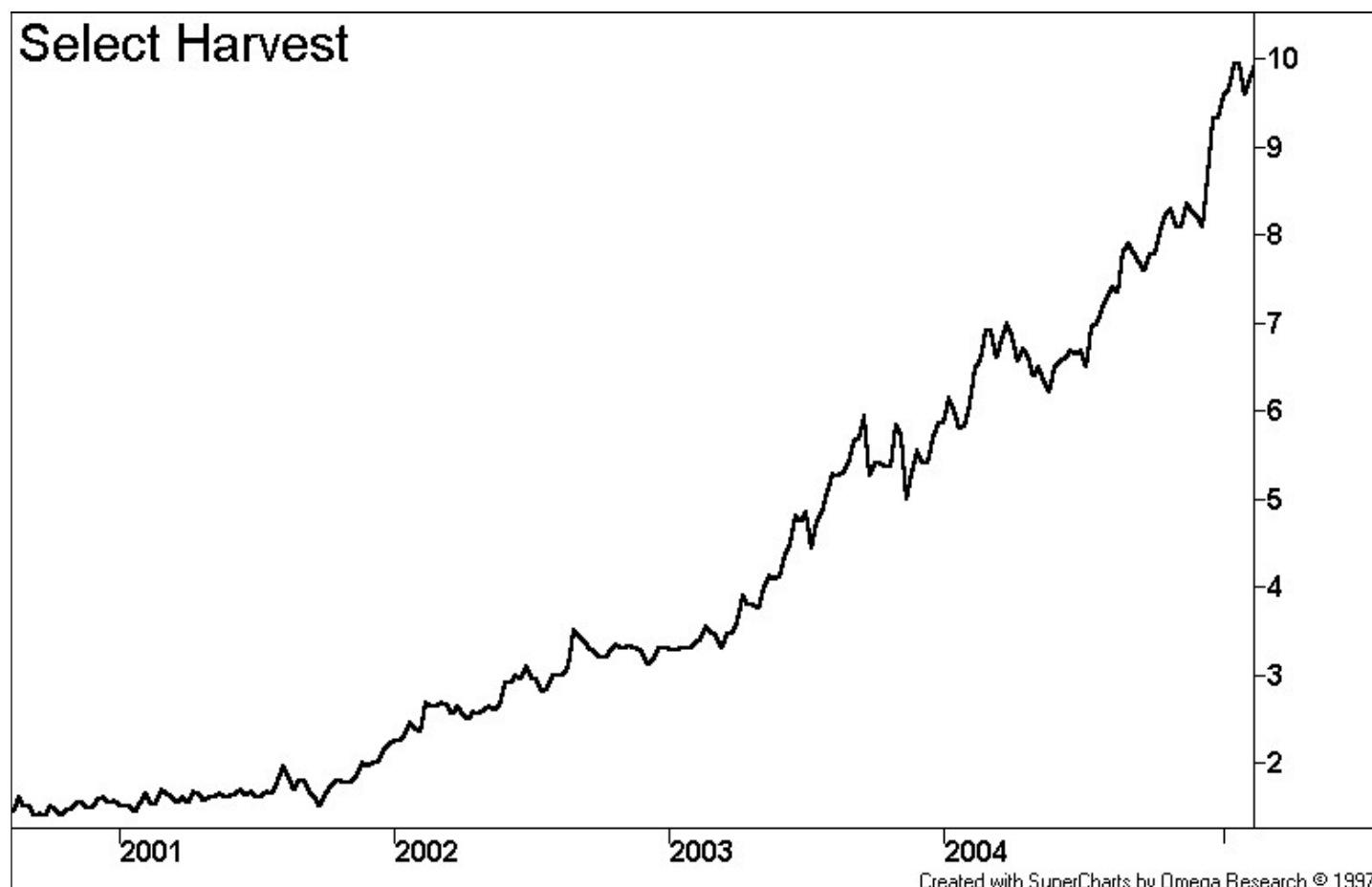
Of course if we can't beat the interest rate then our money is better off in the bank than in the Stock market because cash represents less risk than shares, but this is a rare circumstance.

Active Fund Management

Maintaining a portfolio of fundamentally sound, Blue Chip shares where the share price is rising at an acceptable rate of return is a type of, 'Active Fund Management'. Such is the robust 'Trend Following' approach explained in this manual which utilizes all the constituent shares in the ASX200 Index as its universe. Typical examples of the sort of shares that we want to identify and own with this trading technique can be seen below.



Select Harvest

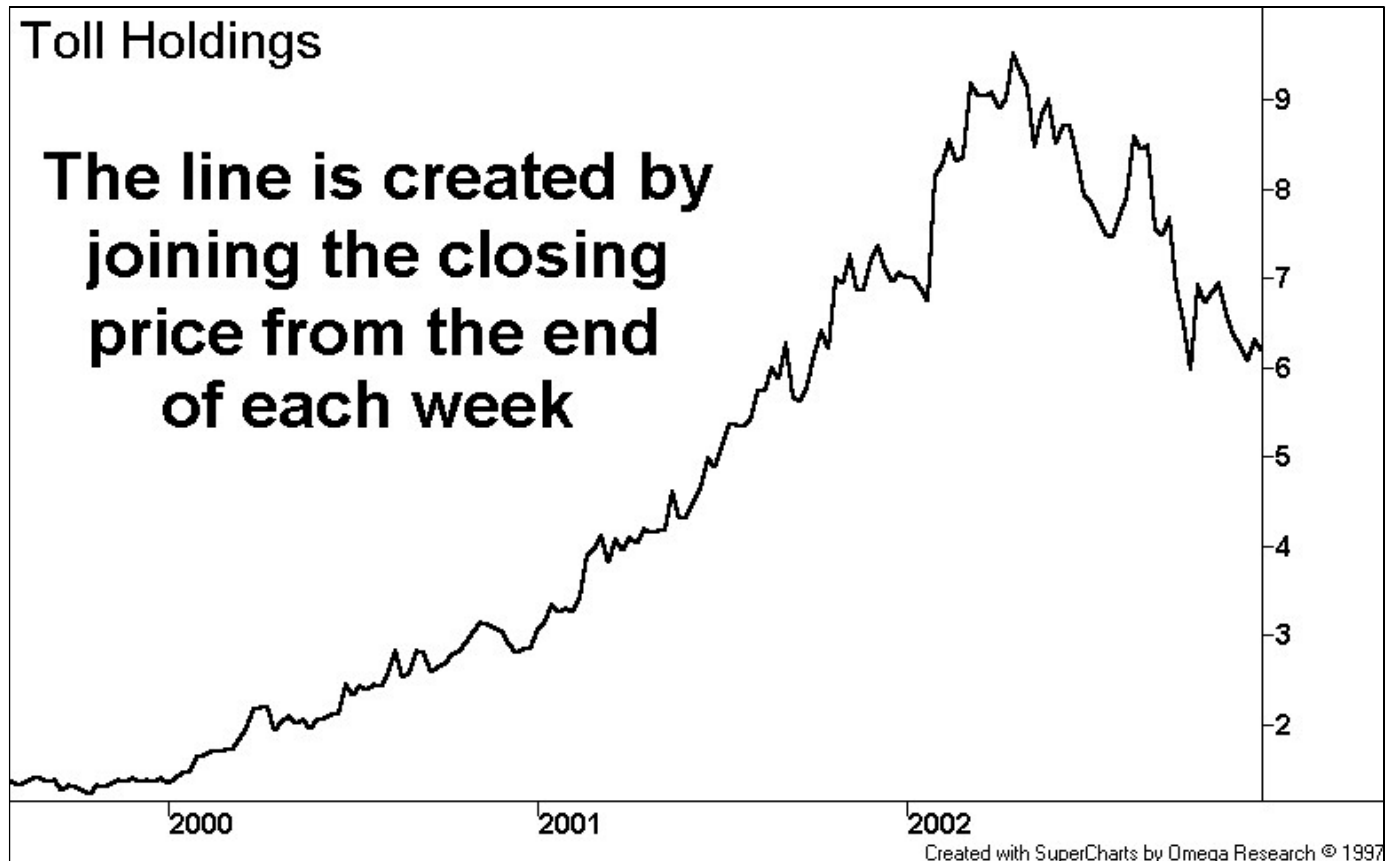


Centennial Coal



Entering the Market

Before we start dissecting the Standard and Poors ASX200 Index, share by share, we need to acquaint ourselves with the very basics of technical analysis. The charts I have been using thus far are referred to as weekly, 'Line on Close' charts because the line that represents the share price is created by connecting the price at the close of the market at 4pm each Friday afternoon. The following chart of Toll Holdings is a typical example of a 'Line on Close' chart which is also the most common type of price chart you will see in either the print or electronic media.



Moving Averages

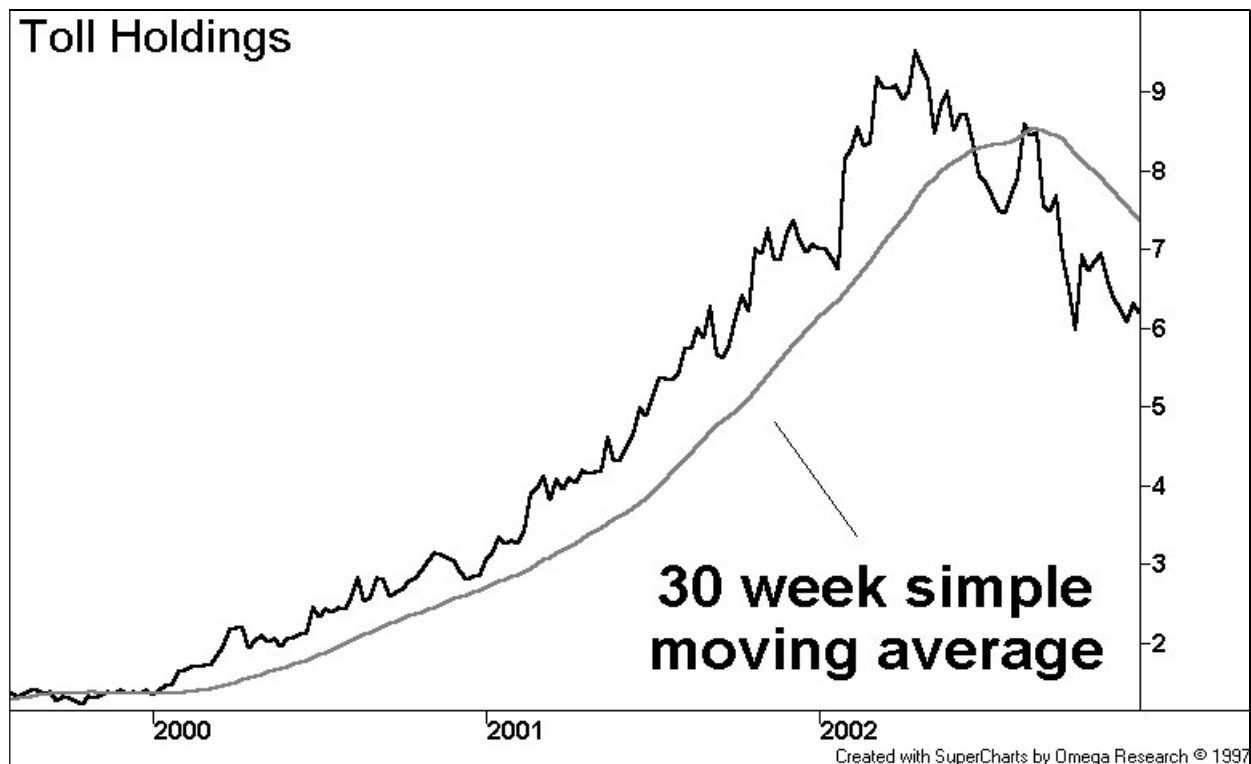
Because week to week price movements can bounce around quite considerably, it is very helpful to use a moving average to smooth out the price activity, thus removing unwanted short term volatility. The average price for any given week can be easily calculated by adding together the closing prices of 'X' number of weeks, up to and including the given week, and then dividing this sum by 'X'.

Example

The following formula would be used to calculate the average price for a 5 week period where week1 would be the most recent week and week2 would be the week before that and so on...

$$\text{5 Week Average} = \frac{\text{Closing Price for week1} + \text{week2} + \text{week3} + \text{week4} + \text{week5}}{5}$$

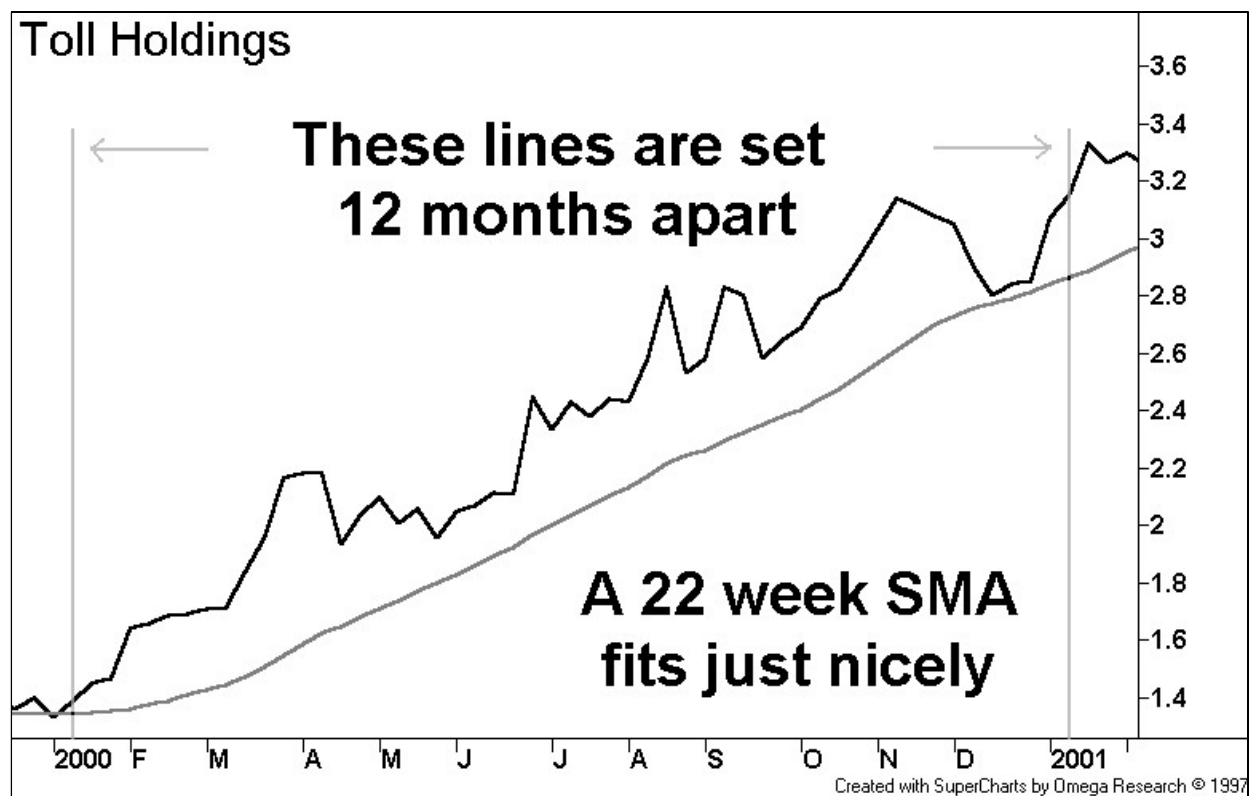
In using the above method we are calculating what is referred to as the 'Simple average' for a given 5 week period. As each new week occurs the simple average can be recalculated and then all the averages, which are plotted as a series of single points on a price chart, can be connected together using a single unbroken line which is referred to appropriately as a 'Simple Moving Average' or SMA. A 30 week SMA can be seen in the chart of Toll Holdings on the next page.



Curve Fitting

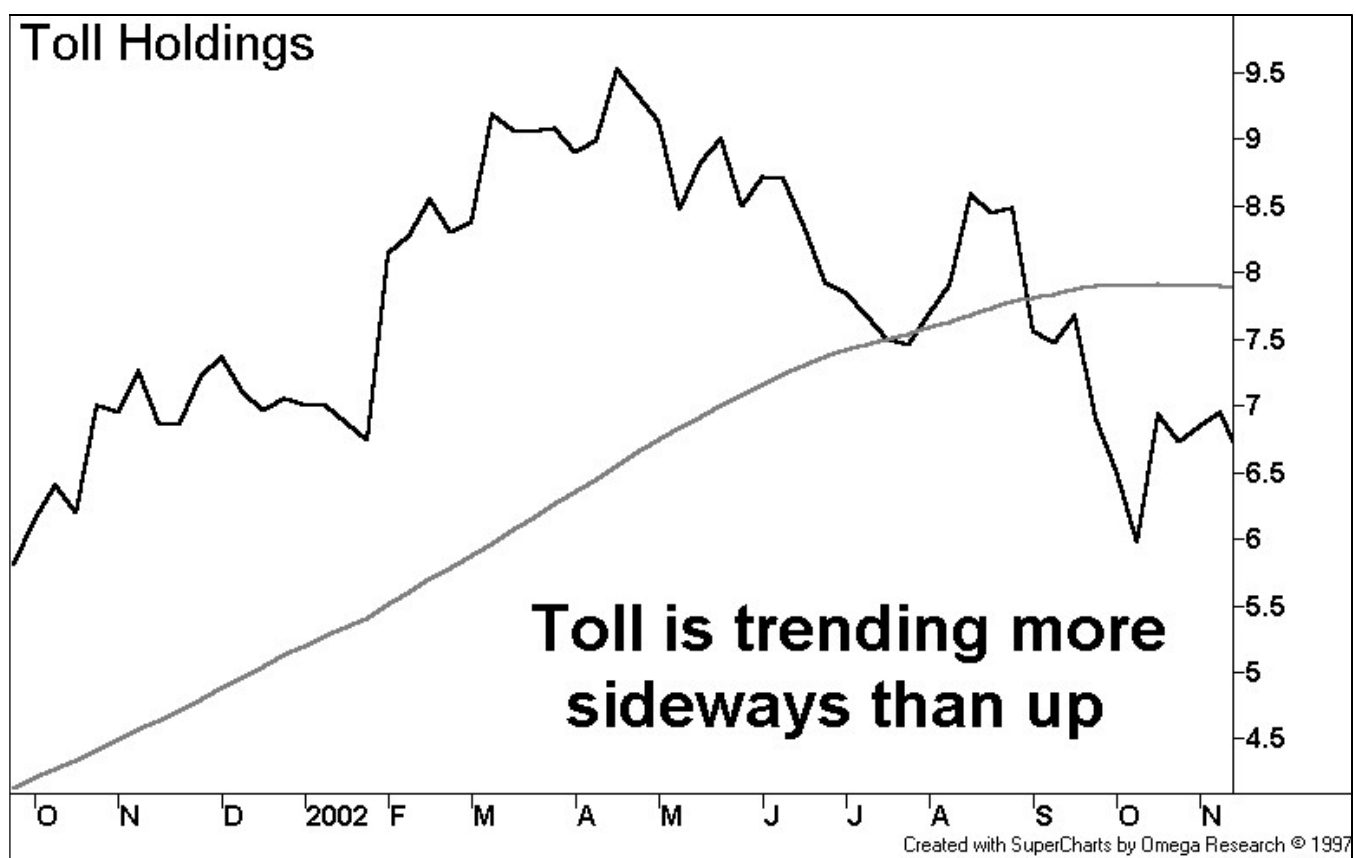
With this one basic charting tool at our disposal we are now ready to start analysing shares. The first task we have to perform is to 'Curve fit' an SMA to each share we wish to study by adjusting the time period...eg. change it from 15 weeks to 16 weeks and so on.

We want the moving average to reflect the behavior of the underlying price activity. This is done by varying the time period which will directly effect the position of the SMA line. We want to make the line sit just under, whilst not quite touching, the price activity for a time span slightly greater than 12 months. The SMA line in the following chart of Toll sits just under the price activity for a duration of more than 12 months when the time period is set to 22 weeks.



You can see that the moving average line, whilst reducing price volatility very effectively, does accurately reflect the overall trend in Toll Holdings over the 12 month period indicated on the chart. Note that the timeframe of, '12 months' is no accident because this is the actual timeframe which we want to operate in so therefore it is the minimum period of time that we need to analyse. What's more we can use any period for the moving average up to 52 weeks because this maximum parameter is also determined by our chosen timeframe.

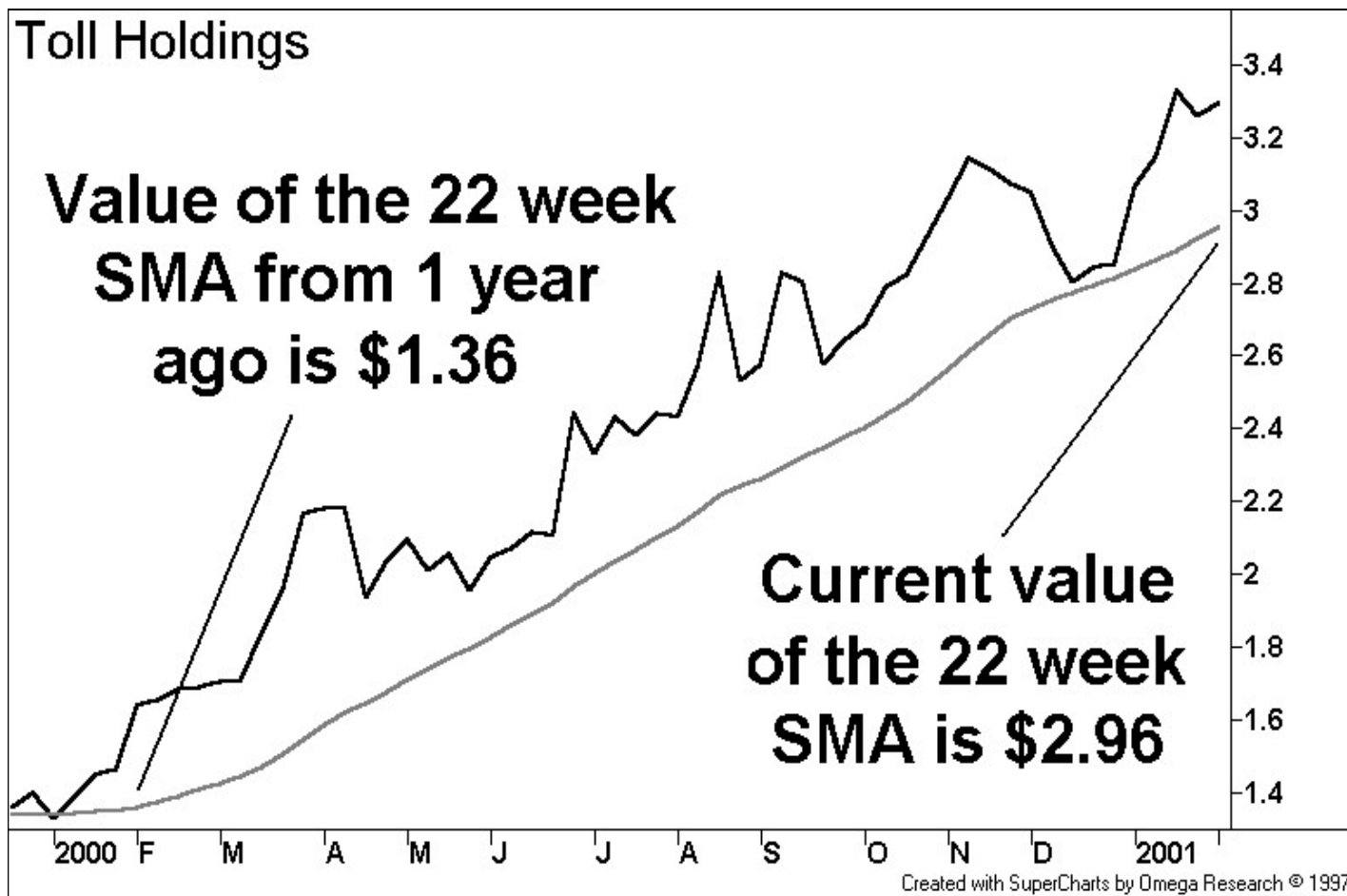
As we are exclusively interested in shares where the price activity is trending upwards, we can conveniently eliminate any shares where a 52 week SMA, which generates the most tolerant line, won't fit under slightly more than 12 months of price activity. This can be seen in the following chart of Toll Holdings and an SMA using our maximum time period of 52 weeks, where the price activity is trending more sideways than up. Thus, at this time we would have immediately overlooked Toll Holdings as a potential trading opportunity given that it's not an upward trending share by our definition.



Rate of Annual Return

Once we've separated out only those shares that are included in the ASX200 Index and trending upwards, we then need to compare them to each other. To do this we must measure their 'Rates of annual return' which, for the sake of convenience we will refer to as their, 'ROAR'. A share's ROAR, which is a proportional measurement, is calculated using the current value of a curve fitted SMA and its current trend, where the trend is defined as the rate of change in value in the SMA over the past 1 year.

It sounds a bit daunting but by studying the chart of Toll at the top of the next page and the corresponding calculation, you'll see that it's a fairly simple process. Using the chart of Toll from before, we need to note the current value of the 22 week SMA and the value of the 22 week SMA from 1 year ago.



Rate of Annual Return Calculation

Using just these two figures from the 22 week SMA we can determine the following;

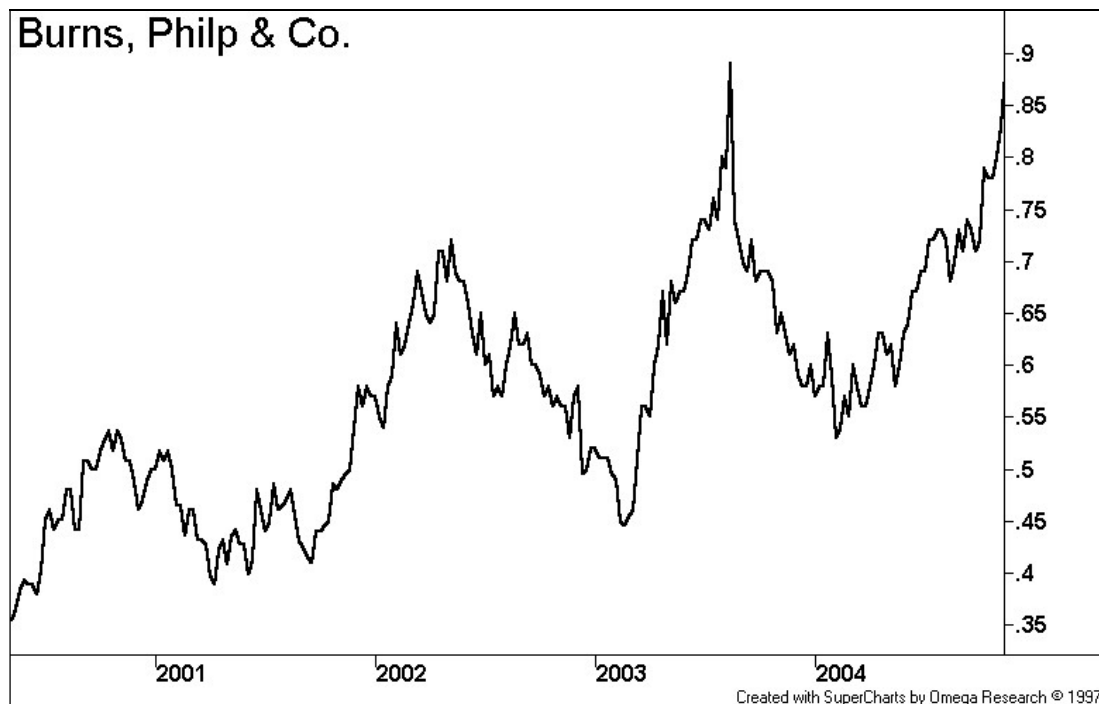
- The rate of change in price over the past 1 year period = $\$2.96 - \$1.36 = \$1.60$
- Therefore the rate of annual return as a percentage = $100 \times (\$1.60 / \$2.96) = 54\%$

Let's assume that we've analysed all of the shares in the ASX200 Index and tabulated their ROARs, so we can now prioritize them with respect to their anticipated profitability. The next step is a little more involved as we need to consider several factors at once when deciding what is the minimum amount of profit we are prepared to accept from the Stock market...an important consideration if we don't want our bank balances to go backwards.

Minimum Rate of Annual Return

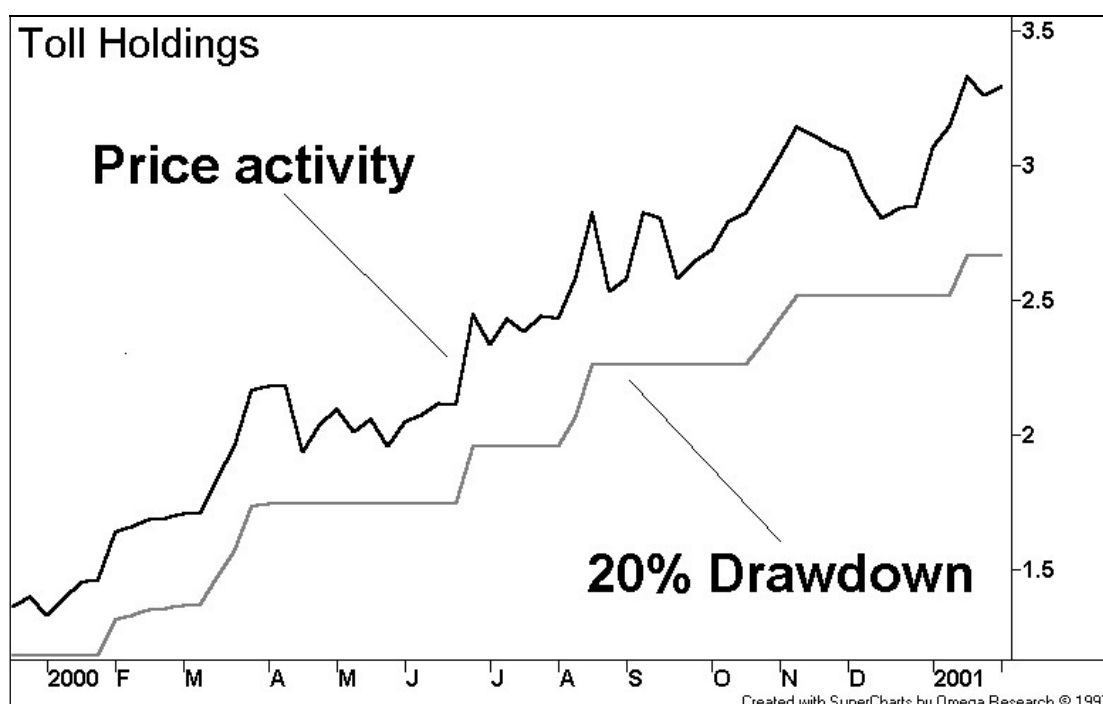
In order to determine what is the lowest tolerable 'Rate of annual return', we first need to ascertain what ROAR represents the break even point, because in fact it is not a ROAR of zero. But first we need to estimate the average life expectancy of a typical trade, ie. how long are we likely to hold each share for.

Interestingly this parameter is also largely a consequence of our chosen timeframe of 12 months because share prices love to trend up and down for fairly predictable periods of time. The chart of Burns, Philp and Company located at the top of the next page is a very illustrative example of a share trending up and down at regular intervals.

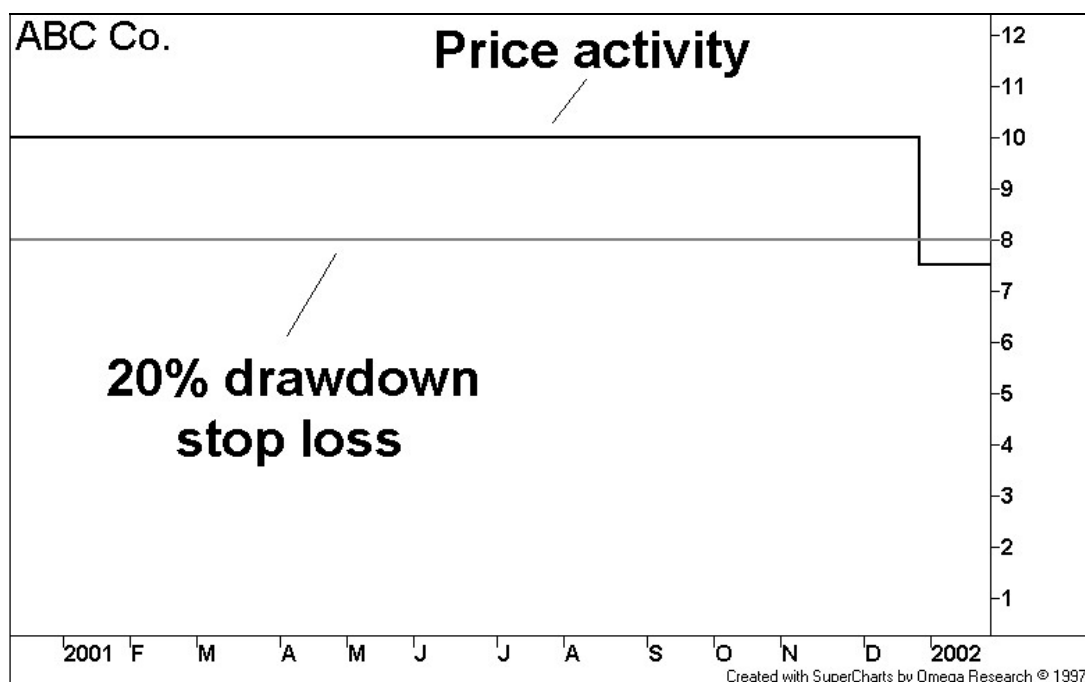


Another predictable feature is that the periodicity of these trends is usually 3 months, 6 months, 1 year, 2 years and so on. Based on this expected behavior of trends, we can reasonably deduce that if a share has trended up for just over 1 year then it will probably continue to trend until it reaches 2 years in duration...a period of slightly less than 12 months. Now, if you refer back to the earlier section in this section on 'Curve fitting' you will note that I said the SMA should sit just under, whilst not quite touching, the price activity for a time slightly greater than 12 months. This brings us to the estimate of the average life expectancy of a trend to be slightly less than 12 months...which for practical purposes we will approximate to be 1 year exactly.

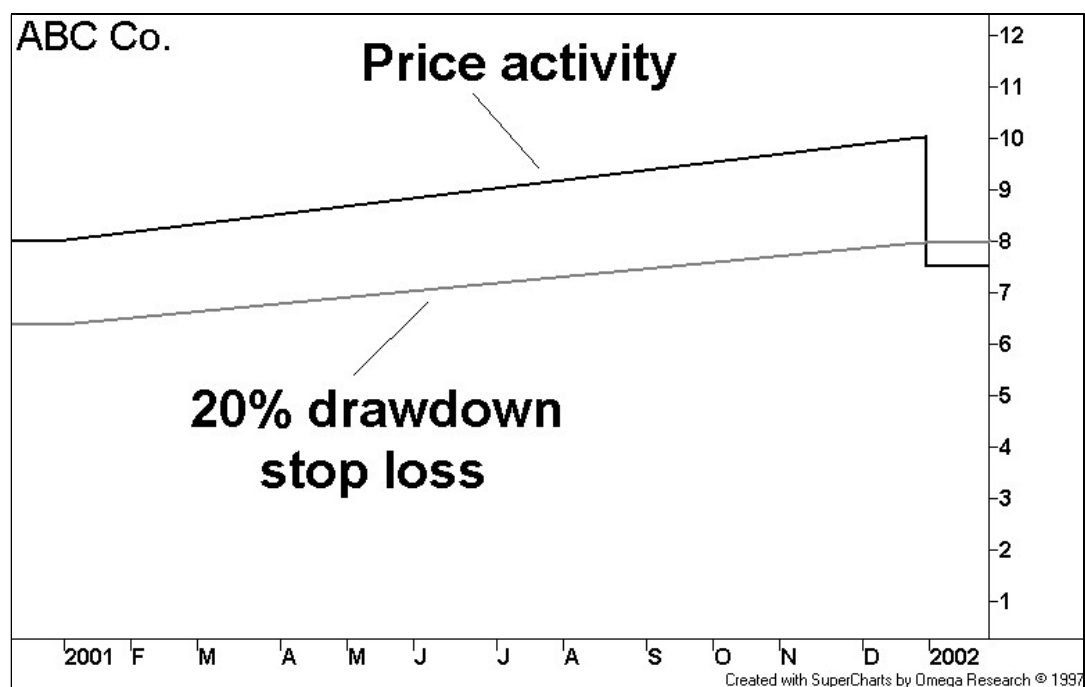
As you will shortly see, using an estimate in this instance is acceptable given that we are using it to determine a very helpful but non-critical aspect of our strategy...the break even ROAR. The next parameter we need to take into account is our stop loss which is very simply a 20% drawdown from the highest closing price in the past 12 months. The 20% drawdown price level can be represented by a line on a price chart, as seen in the following example of Toll Holdings.



You can see how the 20% drawdown level, which is our stop loss moves up each time the price activity makes a new high. Notice, however, that the stop loss doesn't fall when price activity retreats, thus locking in profits as the trend progresses. If we now work on the assumption of a life expectancy of 12 months per trade and knowing that our stop loss is a 20% drawdown then a rate of annual return of zero will result in a 20% loss over 1 year. The following chart of ABC Company graphically illustrates this inevitable outcome.



ABC Ltd's price activity moves sideways with a ROAR of zero at the level we can assume we bought it at of \$10 at the start of 2001, only to drop through the stop loss after 1 year. Hence a ROAR of zero will result in a loss of 20% in 1 year's time because our exit signal from the trade is a 20% drawdown which we anticipate will occur, on average, about 12 months after our time of purchase. Therefore to achieve a break even result over a 12 month period, the rate of annual return would have to be 25% in order to offset the inevitable 20% drop to our stop loss. The following chart shows the price activity rising from \$8 to \$10 over 1 year (a ROAR of 25%) only to collapse back through \$8 at the beginning of 2002.



Our 20% drawdown stop loss tracks along 20% behind the price activity, thus climbing to \$8 when the price activity rises to \$10, approximately 1 year after it started trending up ...a break even result. Now that we have determined our break even ROAR, we must add to it a rate of return that we would accept as a bare minimum return from our Blue Chip portfolio as a whole. As I stated in the previously, I won't expose myself to the general risk of owning equities unless I can achieve at least the same rate of return I would achieve from a cash investment.

Therefore my minimum return from the Stockmarket would need to be at least the Reserve Bank of Australia's cash interest rate target which can be found at www.rba.gov.au. At the time of writing the RBA cash rate target is 6.25% and therefore the minimum rate of annual return that I can tolerate when buying my Blue Chip shares is;

The break even ROAR of 25% plus the RBA cash rate target of 6.25% = 31.250%

There are two important points worth noting at this juncture; the first being that the RBA cash rate target will also be affected by our 20% drawdown stop loss but the resulting impact will be relatively insignificant and can therefore be ignored. As stated earlier, this is not a mission critical benchmark and we have already employed several approximations well before reaching this late stage of the calculation anyway.

The second point is that our strategy is to buy a share at say \$10 for example, watch it reach a high of about \$13 over the next 12 month period, only to sell when it falls all the way back down to about \$10.50. The reality of share trading is, '2 steps forward, 1 step back...2 steps forward, 1 step back...and so on'. Of course, the numbers used here were generated with the minimum ROAR and buying shares with rates of annual return around the 40% to 50% level is a far more common scenario...as you would see by looking at a copy of the Blue Chip Report.

Liquidity

So we have prioritized all of the shares in the ASX200 Index with respect to their ROAR and ensured that they meet our minimum requirements in terms of their anticipated profitability. But we have several more obstacles to overcome before we can actually get on the phone to our StockBroker. The first of these final considerations is the need to ensure that there is sufficient liquidity in the marketplace.

If you think of trading shares as being no different to trading any other commodity, be it tangible or intangible, then one of the great advantages share trading has is the fact that there is always a ready supply of both buyers and sellers. But it is possible to exhaust this supply if we don't ensure that there is an adequate amount of shares being traded in the marketplace before we enter it. This supply is what share traders refer to as liquidity and it is defined as the number of shares traded over any given period or the value of shares traded over any given period.

Examples

- If 1,000,000 shares were bought and sold over one week then the liquidity would be 1,000,000 shares per week.
- If these shares traded at an average price of \$10 over the course of a given week then the liquidity in terms of value would be $1,000,000 \times \$10 = \$10,000,000$ per week.

The liquidity in terms of value is also referred to as cashflow and it is this statistic that is of most interest to us. Without going into great detail, we need to ensure that our purchases or sales of any particular share do not exceed 5% of the average weekly cashflow.

This somewhat conservative benchmark will guarantee that we will always enjoy an easy passage either into or out of the marketplace as we intend to take up to 2 weeks to either enter or exit any given trade.

Example

- Assuming an average of 400,000 shares in 'ABC' Ltd. were traded each week at an average value of \$10 each then the average weekly cashflow would be \$4,000,000.
- Therefore 5% of the average weekly cashflow would be $0.05 \times \$4,000,000$ which equals \$200,000. Hence we would purchase no more than \$200,000 worth of 'ABC' Ltd. shares.

In the event that a share has insufficient liquidity then we should overlook it and move on as there will always be others to choose from. By ensuring that our purchases represent no more than 5% of the weekly turnover in any particular share, we will never find ourselves in the embarrassing situation of not having enough buyers or sellers to trade with...a bit like working in a well stocked retail store that rarely has any customers.

Position Risk

But even with the best laid plans things can and will go wrong and therefore we need to employ risk management in order to limit any potential losses we may suffer. Share traders are able to manage the risks involved in owning shares because they use clearly defined entry and exit prices. The potential loss in owning each share is referred to as position risk and successful share traders normally use what is commonly referred to as the 2% rule which states;

The total loss for any single trade must not exceed 2% of total capital

Your total capital is the current value of all shares held plus the total amount of cash on hand. By risking only 2% of our total capital on each share, it would take 194 consecutive losses to lose all of our money...a very safe level of protection even for the most conservative investor.

Example

- We are trading with \$500,000 total capital and using the 2% risk rule
- Let's say the closing price of a share is \$10 & the 20% drawdown stop loss is \$8 (We'll assume that we're going to buy the share at the closing price of \$10)
- The potential loss per share is $\$10 - \$8 = \$2$ and $2\% \text{ of } \$500,000 = \$10,000$
- Divide \$10,000 by \$2 to get the number of shares we can buy = 5,000 shares
- Therefore we would buy 5,000 shares at \$10 and sell at \$8...a loss of \$10,000

Diversification

The other risk we face is if we own too many shares, or rather Companies, that belong to a particular industrial sector. In this instance we will become vulnerable to what is technically referred to as, 'Sector specific risk'. It sounds fancy but all it really means is that we have too many eggs in the one industrial basket...so to speak.

Anyone who has studied the Australian Stock Market over a period of several years or more will have observed the propensity of individual industrial sectors to run hot or cold at different times. Several examples of this would be the Resources sector in the mid 1990s, the Technology sector during the late 1990's and the Energy sector, at the time of writing, in 2005. But in the Stockmarket, as in life, all good things must come to an end and although we've seen some industrial sectors run hot for periods of up to several years, they will inevitably cool off.

It is this, 'Cooling off' phase that has a tendency to hurt our bank accounts and therefore we have to seek a balance between being able to capitalize on a hot sector whilst not overexposing ourselves to the sector specific risk that it carries with it. Given that a 'Correction' is defined as being between a 10% to 20% fall in value and a 'Crash' is defined as being at least a 20% fall in value, then we would be reducing the impact of a sector crash to less than that of a correction if it were to effect well under half of our portfolio's total value.

In other words it would be very sensible to only own a maximum of 3 shares from any one particular industrial group. Hence if all 3 shares that belonged to a single sector were to 'Crash' then we would lose 20% (our drawdown stop loss) three times over which would equal 6% of our total capital. Not a desirable outcome but hardly a catastrophic one either. The Australian Securities Exchange provides the industry group for all publicly listed Companies at their website www.asx.com.au. Simply look up the share code in the 'Company Research' section.

The Top 10

Our efforts to this point will have reduced the ASX200 Index down considerably from its original 200 constituent Companies from which we can now select our portfolio of just the top 10 shares by their rate of annual return. Of course, don't forget to ensure that the top 10 shares don't include more than 3 Companies from the same industrial sector. In the event this does occur, which is quite likely, simply eliminate any unwanted shares from the overall list by beginning with those that have the lowest rate of annual return first.

There is a very good reason for our portfolio to contain exactly 10 individual positions as this is a direct consequence of the combination of our stop loss and our maximum tolerance towards risk. If our stop loss is a 20% drop in price and we want always to remain faithful to the 2% risk rule as described earlier, then we must allocate no more than 10% of our total capital to any individual position. The reason for this is very simple....20% of 10% equals 2%.

Example

Let's assume our total capital is \$1 Million and we're going to have 10 equal positions.

- So we'll buy \$100,000 worth of shares in 'TOL' as \$100,000 is 10% of \$1 Million
- If we sell our shares in TOL when they drop by 20% then we will have lost \$20,000
- As \$20,000 represents 2% of \$1 Million, we will have lost only 2% of our total capital

Also note that suffering a 20% drawdown from our actual purchase price is a worse case scenario because we will only occasionally be buying shares when they're making new highs. So now you can see that there is a very good reason for buying 10 equally proportioned positions when using a drawdown stop loss of 20%...it's the appropriate balance between performance and protection according to the 2% risk rule.

5 Simple Steps

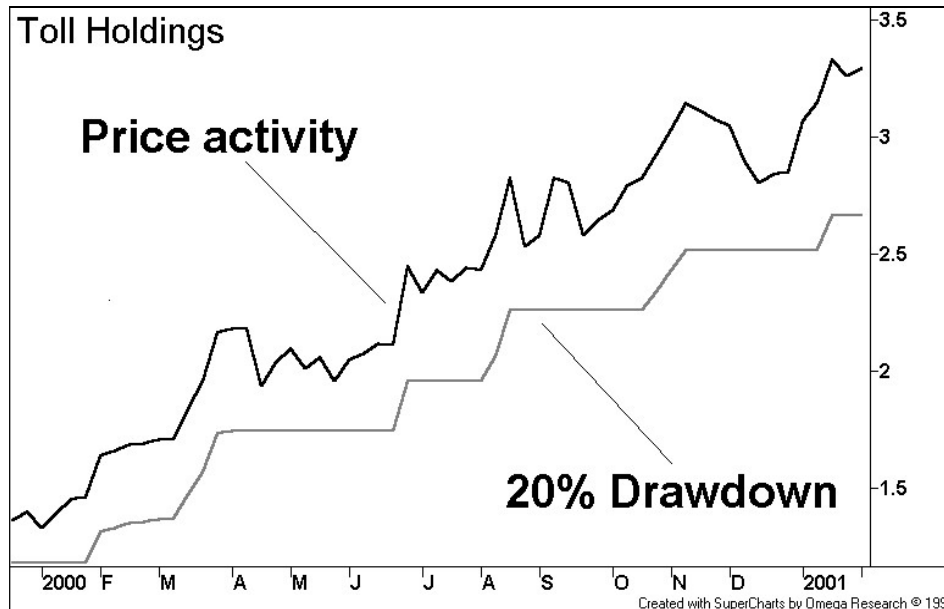
All the above steps that we take in deciding what shares to buy, and how many to buy, can be seen as a series of filters. Some of them are designed to optimize our portfolio's profitability whilst others are there to safeguard our financial wellbeing.

- | | | |
|-------------------|----|--|
| Curve fit an SMA | => | Adjust the period of a simple moving average so it sits just under slightly more than 12 months of price activity |
| Measure the ROAR | => | Using the SMA, measure the rate of annual return for every share in the ASX200 Index and prioritize them accordingly |
| Set Cutoff ROAR | => | Determine the minimum acceptable rate of annual return using the break even ROAR and the current RBA cash rate target |
| Measure Liquidity | => | Calculate 5% of the average weekly turnover of each individual share in terms of its cashflow |
| Take the Top 10 | => | Take the top 10 shares from the list, ensuring that there are no more than 3 shares from any particular industry and the liquidity in terms of cashflow is acceptable in each case
(Note: the number of shares per sector may vary from 2 to 4 depending on the prevailing market conditions – default = 3) |

By breaking the management process down into a sequence of 5 virtually mechanical steps like this, we go a long way towards eliminating the need for discretion. Now we need to complete our checklist by including the reasons for selling our shares.

When to Sell

Buying shares is relatively quick and easy with most of the management process being taken up with when to sell our Blue Chip shares. One of the reasons for this imbalance is because there are actually more motives for selling shares than there are for buying them and the obvious one for us to start with is the 20% drawdown stop loss that we've already discussed at some length in the previous section. The following chart of Toll Holdings shows how the 20% drawdown stop loss tracks along 20% below Toll's highest closing price.

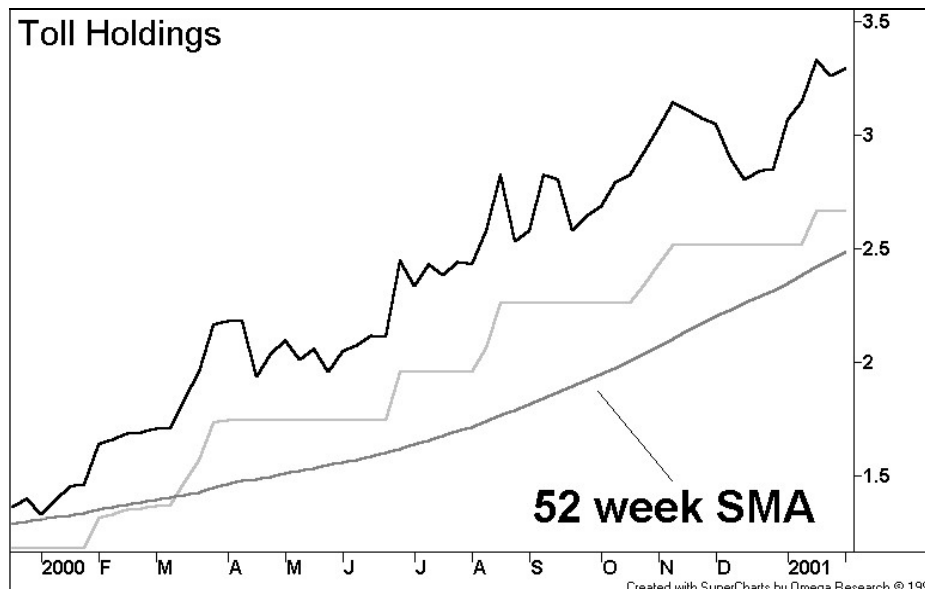


So the first addition to our checklist on the selling side is;

20% Drawdown Stop Loss => Sell if the price activity draws down more than 20% from the highest closing price in the last 12 months

Moving Average Stop Loss

This stop loss is actually the flip side of one of our entry conditions. Remember that we determined that the maximum period for our curve fitted simple moving average was 52 weeks. Therefore we can infer that if a share's price activity were to close below the 52 week SMA then it constitutes a sell condition. I have added a 52 week SMA to the chart of Toll holdings.



If a share is trending upwards at a reasonable speed then the 52 week SMA will typically be well below the 20% drawdown stop loss, as can be seen in the chart of Toll. But if the share is moving up slowly then the SMA stop loss will actually be higher than the drawdown stop loss, as can also be seen in the chart of Toll...near the left hand edge. Hence, it is necessary to employ both stop losses simultaneously and therefore the next addition to our checklist is;

Moving Average => Sell if the share price drops below the 52 week SMA
Stop Loss

ROAR Stop Loss

Moving right along, we now need to determine at what point the rate of annual return becomes unacceptable to us...and it isn't the same as our minimum entry rate of annual return. In fact our exit rate of annual return is the break even ROAR which we have previously determined to be 25%. Whilst we want to buy shares that will yield at least the RBA cash rate target, we are prepared to hold onto shares until they drop below the break even threshold. What's more, these two values cannot be identical as it will create a very irritating side effect.

Imagine for a moment that our minimum entry ROAR and our stop loss ROAR were both set at 30%. Then if a share's ROAR were to rise up to 30% we would buy it...and then immediately sell if it dropped down to 29% as that would constitute a breach of our ROAR stop loss. Then if it rose back to 30% we would buy it again and then if it dropped to 29% we would sell it again and so on and so on. Hence we will introduce an unwanted instability into our strategy unless we set these two parameters significantly apart from each other.

So by setting the ROAR stop loss to the break even ROAR, the RBA cash rate target acts as a buffer zone between our entry and exit ROARs, thus providing our trading system with the necessary stability. So our next exit rule reads as;

ROAR Stop Loss => Sell if the ROAR falls below 25%

Top 40 Stop Loss

If you recall from the previous section, using their ROAR values as a yardstick, we have chosen to place our money on the 10 fastest rising shares out of the entire Standard and Poors ASX200 Index. But as time has a tendency to erode a share's rate of return (all trends must come to an end sooner or later), it will also inevitably eat away at its ranking in the top 10. So in the same vein as our ROAR stop loss, we need to determine a minimum 'Ranking' benchmark that is set a considerable distance away from our entry criteria of the top 10 shares.

As this is really an exercise in optimization rather than survival, we have the luxury of setting the minimum ranking at any level we like, providing it doesn't lead to any unwanted instability. Given that our total population is 200 shares, a conservative balance would be to set the minimum ranking at 40 (the top 20% of the ASX200 Index) which is a comfortable distance away from our entry criteria of the top 10. Hence the next reason for selling a share is;

Top 40 Stop Loss => Sell if a share's ROAR falls outside the top 40

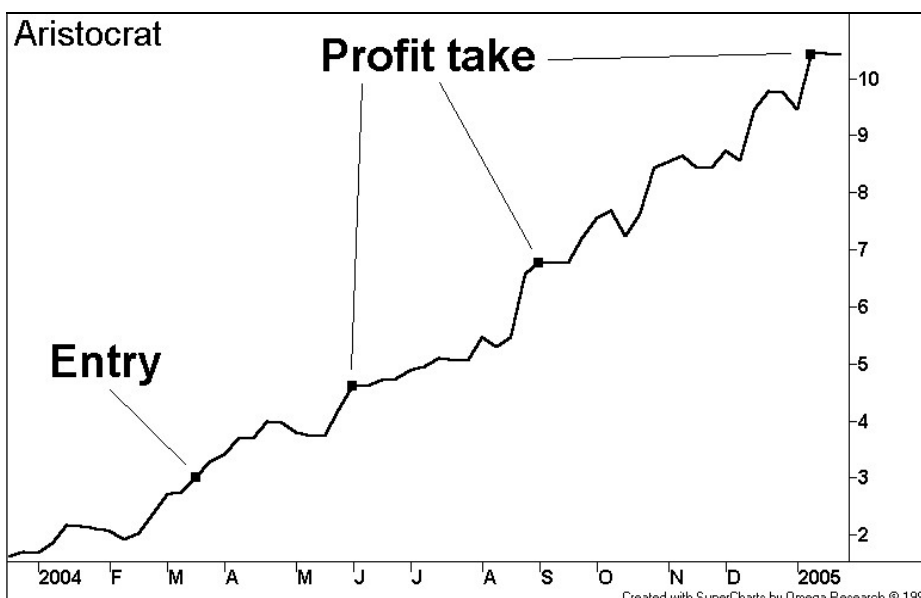
Taking Profits

As I mentioned earlier, our strategy entails buying shares that will rise in price, some quite considerably, and then fall back by approximately 20% before being sold. Whilst this is the inherent nature of our strategy, we can employ a very robust profit taking benchmark in order to periodically grab some profits off the top. I use the word 'Robust' because we'll find that if we pounce on our shares every time they rise in price then, once again, we will suffer unwanted instability. But the rapid growth in Aristocrat makes it an obvious target for profit taking.



So the trick here is to set a very high profit target level and also make it proportional to the performance of the rest of our portfolio. It needs to be a 'Relative' measurement because we wouldn't want to take profit from our shares if they were all collectively going up together in sympathy with a strong rising market. So rather than take profit when a share price rises by at least 50% from our purchase price, we will take profit when the share represents 15% or more of the value of our entire portfolio, ie. its risen from 10% to 15% of total capital.

We will take enough profit to put the share back to its original portfolio weighting of 10%. This will have the welcomed side effect of keeping our portfolio weightings fairly evenly trimmed. Assuming we bought Aristocrat at \$3.00 in March of 2004 and our total portfolio's performance was flat for the relevant period, then the following chart of Aristocrat shows when we would have taken profit by selling one third of the total position on each of three separate occasions.



Given that we purchased Aristocrat at \$3.00 and it reached a high of \$10.50, then waiting until the share price fell by 20% before selling it would have meant giving back \$2.10 to the market. This figure represents 70% of our original buy price of \$3.00...proceeds that we don't want to give back to the market so easily. So our profit taking benchmark joins the list of exit criteria;

Profit Take Sell => If a share's portfolio weighting reaches 15% of total capital then sell it down to a portfolio weighting of 10% of total capital

We have now finished compiling all of the mandatory rules for selling our shares. Whenever we sell a position, logically we would want to replace it with the fastest rising share available that conforms with all of our entry criteria.

Note that when buying shares we have to satisfy all of the entry criteria at once whereas a share must be sold if any of the above sell conditions are met. This makes managing the shares which we already own a more demanding task than buying them is...and there are a few other matters we need to consider as well.

Taking Cash

Unfortunately we don't get to take profits all of time as very few of the shares we own will be as obliging as Aristocrat. But that doesn't mean we can afford to go without money as the whole purpose of the exercise is to supply ourselves with an income stream which will support the lifestyle of our choosing. Hence, there will be times when we need to sell down our shares in order to take cash out to live on.

Taking cash can essentially be done at any time but it does require a moderate amount of common sense. Obviously it is not sensible to sell off shares in dribs and drabs as this can seriously inflate the cost of brokerage.

Your Stockbroker will certainly be happy but it would be far more sensible and cheaper to do some relatively simple budgeting so you execute as fewer transactions as possible. In other words, work out how much money you need to live on for the next 6 months and then take enough cash from your portfolio to cover the entire period.

Deciding which shares to sell down and by how much starts with a relatively simple computation to work out what our total capital will be after we've taken our cash out of the equation. We can then calculate what 10% of our new total capital will be and this will indicate to us what shares to trim back and by how much. The best way to illustrate how we go about this task is with a working example.

Example

Let's assume that the total value of all our open positions is \$800,000 and we want to take out \$50,000 to live on for the next 6 months as we're planning to go on an overseas holiday.

- Therefore our total capital after we take cash will be $\$800,000 - \$50,000 = \$750,000$
- Therefore 10% of our new total capital will be $10\% \text{ of } \$750,000 = \$75,000$

The following list is our portfolio before we've taken out our cash (total capital = \$800,000);

<u>Share</u>	<u>Value(\$)</u>
ABC	75,000
EFG	78,000
HIJ	83,000
KLM	97,000
LGT	75,000
MEQ	90,000
NIO	77,000
NOP	70,000
QRS	73,000
TUV	82,000

Given that our anticipated portfolio weighting per share will be \$75,000, we can commence selling back our shares to this level by starting with the largest positions first. Hence our portfolio after we've taken out our cash will look like this (total capital is now = \$750,000)

<u>Share</u>	<u>Value(\$)</u>			
ABC	75,000			
EFG	78,000			
HIJ	83,000	3 rd Sale	=>	Sell \$8,000 worth of HIJ
KLM	97,000	1 st Sale	=>	Sell \$22,000 worth of KLM
LGT	75,000			
MEQ	90,000	2 nd Sale	=>	Sell \$15,000 worth of MEQ
NIO	77,000			
NOP	70,000			
QRS	73,000			
TUV	82,000	4 th Sale	=>	Sell \$5,000 worth of TUV

Thus we will have taken a total of \$50,000 cash from our Blue Chip shares and improved the overall balance of our portfolio weightings into the bargain. Of course, we could achieve a better balance if we were to trim the positions more evenly across the entire portfolio but this would lead to higher brokerage costs, making it both an unnecessary and expensive practice.

Injecting Cash

Conveniently, this exercise is the exact reverse of 'Taking cash'. Firstly determine what your new total capital will be after you introduce your additional cash. Then, starting with the lowest positions first, build up each share to 10% of your new total capital. The only additional caveat I would add in this instance is that I wouldn't bother spending any amount less than 5% of my current total capital. I would deposit these small amounts in the bank until the balance represented at least 5% of total capital before I bothered to inject it into the market.

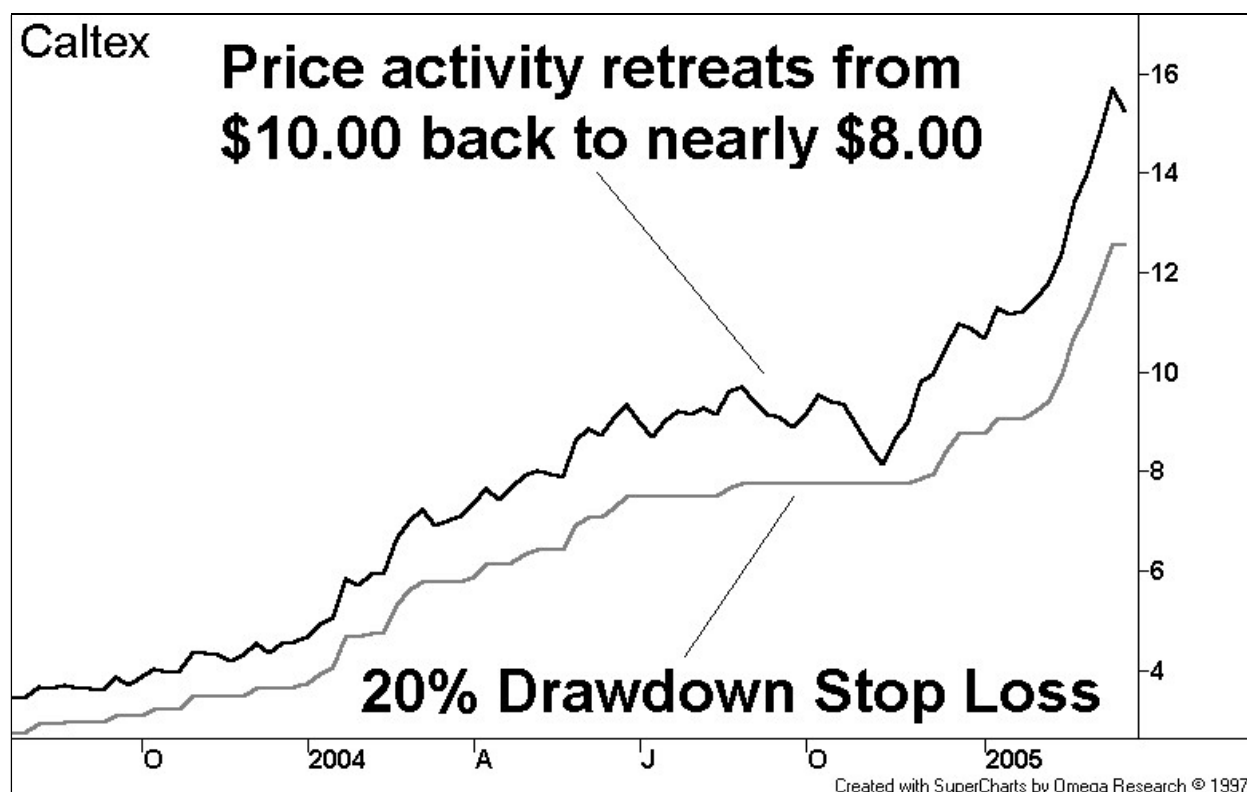
Optimization

If you've ever owned shares then you'll probably be familiar with the hollow feeling you can get when someone tells you how well their shares have done in the past week and you look at yours only to find that you've gone nowhere. Hence, the grass is always greener on the other side of the fence and we often find ourselves fighting the urge to constantly 'Tweak' our portfolio by shifting our money onto the latest winners. Unfortunately this is an all too common pitfall for the novice investor who can be easily seduced by the excitement of chasing, 'Hot stocks'.

Suddenly we've gone from being an investor to being a speculator, or even worse...a gambler. The reality is that there will always be shares that are going up in price while ours aren't and chasing these shares will seriously erode the benefit of using any well thought out investment strategy. The practice of constantly shifting money from one share to another will have a detrimental impact on our Blue Chip portfolio because of a phenomenon which mathematicians describe as, 'Random effect'.

The validity of probable outcomes depends largely on the sample size under examination. For instance, we all know that the probable outcome of tossing a coin is a 50/50 balance between getting a head and a tail. But this 50/50 balance will rarely equate to getting 1 head and 1 tail if we toss the coin just two times. Even when tossing a coin 10 times will we see a 50/50 result of 5 heads and 5 tails. But if we toss it 10,000 times then we will very likely generate a sample of data that closely approximates the 50/50 balance of 5,000 heads and 5,000 tails.

The same logic applies to the Stock market where short term share price movements are largely random and the science of probability and statistical analysis works far better on long term market behaviour. So if we constantly tweak our portfolios then we will derail our investment strategy by introducing random effect. The following chart of Caltex shows how even a very fast rising share can go sideways for long periods of time or even dip sharply downwards.



If you jumped out of Caltex when it dipped to about \$8.00 then you would have missed the subsequent rise in price to nearly \$16.00. It didn't breach our 20% drawdown stop loss and it consistently maintained a very high rate of annual return throughout 2004. But imagine the temptation to jump ship to another share when price activity started falling back from \$10.00.

Hence, the validity of probability increases with any increase in sample size and the impact of randomization increases with any reduction in sample size. So in order to allow the laws of probability a reasonable chance to work, I would suggest optimizing your portfolio at intervals of no less than 6 months. Bear in mind of course that our strategy self optimizes anyway and therefore periodic optimization is unnecessary....but if you're like me, you probably can't resist.

The Complete Checklist

While we could add more bells and whistles to our active fund management strategy, they would provide little if any benefit while increasing complexity and unnecessarily adding to our workload. So we can now present our final checklist including both reasons for buying and reasons for selling. (Note that this list only includes mandatory actions and not optional ones)

- | | | |
|--------------------------|----|--|
| Curve fit an SMA | => | Adjust the period of a simple moving average so it sits just under slightly more than 12 months of price activity |
| Measure the ROAR | => | Using the SMA, measure the rate of annual return for every share in the ASX200 Index and prioritize them accordingly |
| Set Cutoff ROAR | => | Determine the minimum acceptable rate of return by adding the break even ROAR of 25% to the current RBA cash rate target |
| Measure Liquidity | => | Calculate 5% of the average weekly turnover of each individual share in terms of its cash flow |
| Take the Top 10 | => | Take the top 10 shares from the list, ensuring that there are no more than 3 shares from any particular industry and the liquidity in terms of cash flow is acceptable in each case (Note: the number of shares per sector may vary from 2 to 4 depending on the prevailing market conditions – default = 3) |
| 20% Drawdown Stop Loss | => | Sell if the price activity draws down more than 20% from the highest closing price in the last 12 months |
| Moving Average Stop Loss | => | Sell if the share price drops below the 52 week SMA |
| ROAR Stop Loss | => | Sell if the ROAR falls below 25% |
| Top 40 Stop Loss | => | Sell if a share's ROAR falls outside the top 40 |
| Profit Take Sell | => | If a share's portfolio weighting reaches 15% of total capital then sell it down to a portfolio weighting of 10% of total capital |

Now that we've completed designing the management system, it's time to put it to the test by applying it to some real shares.

Portfolio Management

Let's take a test drive: the weekly process of managing your blue chip shares

This is the fun bit—turning the theory into practice. This chapter is a week-by-week simulation of how we would go about implementing our Active Fund Management strategy. As you will shortly see it only takes about ten minutes per week to actively manage your portfolio. Of course this assumes that we have good information at our fingertips and a quick and convenient way of monitoring what we're doing.

The Blue Chip Report

So before we begin, let's take a look at the Blue Chip Report which contains the weekly search results for our fund management strategy in an easy to read, single-page format. The Report lists up to the top 40 shares in the ASX 200 according to their rate of annual return, providing it's greater than 25 per cent. It also includes all the other important information we require to select and manage our Blue Chip portfolio. In the sample below, we can see that at this particular time, there were 29 shares that met the criteria (please note that the number of shares will vary depending on what the market is doing).

ASX200 Search Results			RBA Cash Rate Target = 6.00%		
Code	Company Name	Price(\$)	ROAR(%)	Cashflow(\$)	Industry Group
PDM	Paladin Resources	5.90	80.15	2339995	Energy
FMG	Fortescue Metals Group	9.53	75.40	996588	Materials
LHG	Lihir Gold	2.78	58.34	7621277	Materials
BKN	Bradken	6.22	51.61	567642	Capital Goods
AFG	Allco Finance Group	10.95	48.70	2124850	Diversified Financials
JST	Just Group	3.87	46.61	822709	Retailing
AWE	Aust. Worldwide Exploration	3.06	38.92	2586775	Energy
MGQ	Macquarie Goodman Gr.	6.72	38.40	8717893	Real Estate
UGL	United Group	14.64	38.32	1179668	Capital Goods
LEI	Leighton Holdings	21.35	37.38	2568492	Capital Goods
DJS	David Jones	3.47	36.98	1525426	Retailing
CSL	CSL	56.45	35.78	9617000	Pharmaceuticals & Biotech.
COH	Cochlear	55.30	35.46	3131183	Health Care
RIO	Rio Tinto	79.45	34.69	43036832	Materials
FKP	FKP Property Group	6.13	32.23	520587	Real Estate
OST	Onesteel	4.35	31.94	1843811	Materials
BHP	BHP Billiton	27.45	31.22	127267184	Materials
AXA	AXA Asia Pacific Holdings	6.50	30.46	3845767	Insurance
IRE	Iress Market Tech.	6.84	29.56	600162	Software & Services
OMP	Oamps	4.40	28.48	808818	Insurance
AMP	AMP	9.75	28.33	11310811	Insurance
QBE	Qbe Insurance Group	25.00	28.29	13385500	Insurance
AGK	Aust. Gas Light Co.	15.24	28.03	3852755	Utilities
ASX	Aust. Stock Exchange	35.73	28.01	5100948	Diversified Financials
BIL	Brambles Industries	12.54	27.96	24640170	Comm. Services & Supplies
CNP	Centro Properties	7.88	27.73	6178766	Real Estate
RMD	ResMed Inc.	5.69	27.53	3558785	Health Care
CRG	Crane Group	12.83	25.65	464588	Capital Goods
CML	Coles Myer	13.85	25.52	27548036	Food & Staples Retailing

The Blue Chip Report also contains regular market commentary by yours truly (see sample on the next page). This is a key component of the Blue Chip Report and provides essential information on when to buy, when to sell and when to take profits. It is important to read the

commentary each week to make sure you stay up to date with the state of the market and whether or not you need to take any specific action like profit taking.

Alan's monthly market commentary for November including guidance on when to buy and when to sell

The purpose of this market discussion is to enhance the active fund management strategy by including some discretionary analysis. While this opinion is intended to provide you with additional guidance, it is not a compulsory part of the strategy.

General comments

It appears that the festive season has come early to the stock market this year with what looks to be an October start to the Christmas rally. Global equity markets often rally in unison during the final quarter of the calendar year with volume being understandably light in the latter stage. So all things being predictably normal and barring minor pullbacks...it is a season to be jolly.

Given that we anticipate a strong market during November, we now have an ideal opportunity to both optimise and re-balance our portfolios. By optimise I mean that now is a good time to refocus our capital back up into the shares at the top of the share list. And while doing so, we should make sure that all of our 10 positions are evenly weighted at 10 per cent of total capital each.

Another thing that we need to do is keep track of our Blue Chip share portfolio. This can be done in a variety of ways, ranging from hand-written ledger sheets to an Excel spreadsheet to an online portfolio management service. How you do this is really up to you and there is no right or wrong way...but it is a very sensible idea to have some method of monitoring things. For this simulation, I'm going to use a very basic Excel spreadsheet.

Getting started

Initially we will assume that we have \$1 million in cash and no open positions. This means our total capital available is also \$1 million. Now let's have another look at the Blue Chip Report, which lists up to the top 40 shares in the ASX 200 index according to their annual rate of return, in descending order (Report from 3 November 2006 with the top ten highlighted).

ASX200 Search Results			RBA Cash Rate Target = 6.00%		
Code	Company Name	Price(\$)	ROAR(%)	Cashflow(\$)	Industry Group
PDN	Paladin Resources	5.90	80.15	2339995	Energy
FMG	Fortescue Metals Group	9.53	75.40	996588	Materials
LHG	Lihir Gold	2.78	58.34	7621277	Materials
BKN	Bradken	6.22	51.61	567642	Capital Goods
AFG	Allco Finance Group	10.95	48.70	2124850	Diversified Financials
JST	Just Group	3.87	46.61	822709	Retailing
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MGQ	Macquarie Goodman Gr.	6.72	38.40	8717893	Real Estate
UGL	United Group	14.64	38.32	1179668	Capital Goods
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COH	Cochlear	55.30	35.46	3131183	Health Care
RIO	Rio Tinto	79.45	34.69	43036832	Materials
FKP	FKP Property Group	6.13	32.23	520587	Real Estate

Entry conditions

But first things first. Before actually committing funds to the market you need to read my market commentary to determine whether or not now is a good time to get started. In the commentary for this particular Blue Chip Report it says...

The timing aspect is most critical when we first enter the market as we are exposing all of our capital to market risk in a single moment. We want our initial exposure to be positive and get us off to a good start or we will find ourselves trying to recover losses from the outset. November is typically a good time to establish a new portfolio given the likelihood of a Christmas rally. This 'likelihood' being further supported by the occurrence of the market low we had in September.

This is our green light to go ahead and enter the market. Please be aware that there may be times when you will have to wait to establish your blue chip share portfolio and this will be highlighted in the market commentary.

As they are at the top of the list, we know the companies that have been highlighted in the previous Report are the ten fastest rising shares in the ASX 200 index according to their ROAR. At this point we need to ensure that their ROAR is equal to or greater than the RBA cash rate at the time of 6 per cent (as shown at the top of the page) plus 25 per cent. This is our minimum entry ROAR and in this example, all of the top ten shares on our list qualify.

Next we must ensure that there is no more than four shares from any one industry group. In fact the closest we come to this maximum limit is three shares from the Capital Goods sector...which does not constitute a breach of our sector risk rule. If there were too many shares from one industry group then we would simply eliminate the share with the lowest rate of annual return in favour of the next best share available on the list, providing it meets all of our other entry criteria—including adequate liquidity.

The 'Cash flow(\$)' field is in fact 5 per cent of the average weekly turnover in terms of dollars and our allocation per share cannot exceed this amount. If it does, then we would have to eliminate the relevant share from our preferred list. Bradken (BKN) has the lowest turnover at \$567,642, which is still very acceptable to us because we will only be allocating \$100,000 to each share (given that 10 per cent of our \$1 million equals \$100,000). So we are now ready to purchase these top ten shares providing we have no other factors that we need to take into consideration.

Other considerations

Further considerations may include the advice of a full service stockbroker who may feel uncomfortable with one or more of these shares on the basis of information that lies outside the scope of our strategy. Now would be the time to include such counsel in the decision-making process and to possibly incorporate any other additional selection criteria if desired.

This could include the consideration of a company's financial wellbeing, the quality of its management, future prospect etc. But for our purposes, we'll assume all is well with the top ten shares from our list and proceed accordingly.

Buying shares

Now it's time to begin making our purchases. As I mentioned earlier, for the purpose of this simulation I'm using an ordinary Excel spreadsheet (see below) which shows how things look as we ready ourselves to dive into the market (I've already entered the top ten shares into my spreadsheet).

<u>Share</u>	<u>Price (\$)</u>	<u>Number</u>	<u>Value</u>	<u>%of Total Capital</u>
PDN				
FMG				
LHG				
BKN				
AFG				
JST				
AWE				
MCQ				
UGL				
LEI				
Total of Shares				
		Cash	\$ 1,000,000.00	
		Total Capital	\$ 1,000,000.00	

Taking the first share on the list (the one with the highest ROAR), we can see it has a price of \$5.90. We know that each position is going to be allocated \$100,000 (that is, 10 per cent of our total capital) and therefore we can calculate that we can purchase up to 16,949 shares of PDN. In reality you could round this down (or slightly up) for ease of calculations.

Please note that if we were using a full-service broker, he or she would only need to know the amount of money we wished to allocate to each position and would then determine the number of shares for us. It's also worth noting that for the purpose of this exercise, we won't be including any overheads such as brokerage or any income such as dividends.

Now, to complete the exercise, we do the same thing for the remaining nine shares. This will complete our Blue Chip share portfolio and use up all of our cash. Our Total Capital will still be \$1 million as this is the value of all our open positions, plus any cash.

<u>Share</u>	<u>Price (\$)</u>	<u>Number</u>	<u>Value</u>	<u>%of Total Capital</u>
PDN	5.90	16949	\$ 99,999.10	10.00
FMG	9.53	10493	\$ 99,998.29	10.00
LHG	2.78	35971	\$ 99,999.38	10.00
BKN	6.22	16077	\$ 99,998.94	10.00
AFG	10.95	9132	\$ 99,995.40	10.00
JST	3.87	25839	\$ 99,996.93	10.00
AWE	3.06	32679	\$ 99,997.74	10.00
MCQ	6.72	14880	\$ 99,993.60	10.00
UGL	14.64	6830	\$ 99,991.20	10.00
LEI	21.35	4683	\$ 99,982.05	10.00
Total of Shares				
		Cash	\$ 47.37	
		Total Capital	\$ 1,000,000.00	

So we've now committed ourselves to the market with our initial \$1 million cash reduced to a measly \$47.37. Now let's have a look at what we will have to do each week to monitor our Blue Chip share portfolio and see just how easy the week-by-week management process is.

Once we have established our portfolio, we need to check the Blue Chip Report each week to see if we need to take any further action. If a share triggers a stop loss condition, then we will need to sell it and find a suitable replacement. Or if my market commentary suggests profit taking, then it would be a prudent time to take profits.

Executing our stop losses

Of course the most important motive for checking our portfolio each week is to ensure that none of our shares have breached any of our stop loss conditions. We need to be on the look out for the following:

20 per cent drawdown stop loss => have any shares dropped below their 20 per cent drawdown stop loss?

Moving average stop loss => have any shares dropped below their 52-week SMA stop loss?

ROAR stop loss => have any shares dropped below the 25 per cent ROAR stop loss?

Top 40 stop loss => are any of our positions no longer in the top 40 shares?

In order to simplify the weekly management of our stop loss conditions, the Blue Chip Report will no longer list a share that has breached any of the above criteria. In other words the share will simply disappear from the list, indicating that it should be sold immediately.

Once we sell a share from our portfolio, we will then want to replace it with the share that has the highest rate of return on our list and also meets all the other necessary criteria. By 'other criteria' I mean that its liquidity is acceptable, it doesn't breach our sector risk, etc.

Moving on

After the Australian stock market ceases trading at 4.00 pm each Friday afternoon, a new Blue Chip Report is created and posted on the internet. It can usually be downloaded by Saturday morning and perused before trading recommences the following Monday morning. Following is an extract from the next week's Blue Chip Report. Once again I have highlighted our positions and you can see what happened in the week.

Some of our shares went up, most went down (now how often does that happen!) and some changed position. As a general rule you will find that the list remains fairly stable from week to week but don't let complacency sneak up on you...most investor's lose money when they are not paying attention. You will also note that the RBA cash rate target has increased to 6.25 per cent. This figure is immediately updated after any official interest rate announcements.

ASX200 Search Results			RBA Cash Rate Target = 6.25%		
Code	Company Name	Price(\$)	ROAR(%)	Cashflow(\$)	Industry Group
PDN	Paladin Resources	6.63	79.16	2734984	Energy
FMG	Fortescue Metals Group	9.13	73.66	871754	Materials
LHG	Lihir Gold	2.98	56.45	8259705	Materials
BKN	Bradken	6.16	51.07	572284	Capital Goods
AFG	Allco Finance Group	10.74	47.67	2073131	Diversified Financials
JST	Just Group	3.60	45.55	895914	Retailing
MGQ	Macquarie Goodman Gr.	6.64	38.81	8657997	Real Estate
AWE	Aust. Worldwide Exploration	3.03	37.93	2508039	Energy
LEI	Leighton Holdings	21.74	37.46	2537184	Capital Goods
UGL	United Group	13.55	37.43	1213639	Capital Goods
DJS	David Jones	3.36	36.93	1511871	Retailing
CSL	CSL	57.62	35.19	9315953	Pharmaceuticals & Biotech.
COH	Cochlear	56.53	34.76	3039038	Health Care
RIO	Rio Tinto	80.46	33.83	43692140	Materials
FKP	FKP Property Group	6.13	32.46	527061	Real Estate

Then, just for this exercise, I'll update my Excel spreadsheet to reflect what's happened.

Share	Price (\$)	Number	Value	%of Total Capital
PDN	6.63	16949	\$ 112,371.87	11.26
FMG	9.13	10493	\$ 95,801.09	9.60
LHG	2.98	35971	\$ 107,193.58	10.74
BKN	6.16	16077	\$ 99,034.32	9.93
AFG	10.74	9132	\$ 98,077.68	9.83
JST	3.60	25839	\$ 93,020.40	9.32
AWE	3.03	32679	\$ 99,017.37	9.92
MCQ	6.64	14880	\$ 98,803.20	9.90
UGL	13.55	6830	\$ 92,546.50	9.28
LEI	21.74	4683	\$ 101,808.42	10.20
Total of Shares			\$ 997,674.43	
			Cash \$ 47.37	
			Total Capital \$ 997,721.80	

We don't have to update our portfolio each week and sometimes it's best not to, especially if your 'happiness' is directly related to the growth of your total capital! Anyway, that's the week done and no action is required. Of course don't forget to check my commentary to see if I issued any specific instructions, that is, now would be a good time to take some profits, etc. Here's the next week's Blue Chip Report with our ten shares highlighted again.

ASX200 Search Results			RBA Cash Rate Target = 6.25%		
Code	Company Name	Price(\$)	ROAR(%)	Cashflow(\$)	Industry Group
PDN	Paladin Resources	6.03	78.39	3004285	Energy
FMG	Fortescue Metals Group	9.59	72.75	777958	Materials
LHG	Lihir Gold	2.85	55.40	8366417	Materials
BKN	Bradken	6.49	51.07	617876	Capital Goods
AFG	Allco Finance Group	10.91	46.90	2059426	Diversified Financials
JST	Just Group	3.61	44.54	923860	Retailing
MGQ	Macquarie Goodman Gr.	6.81	43.04	8807383	Real Estate
LEI	Leighton Holdings	21.55	37.52	2392437	Capital Goods
DJS	David Jones	3.57	37.35	1428575	Retailing
AWE	Aust. Worldwide Exploration	2.81	36.92	2479081	Energy
UGL	United Group	13.31	36.42	1281563	Capital Goods
IRE	Iress Market Tech.	6.95	36.05	637551	Software & Services
CSL	CSL	58.18	34.73	8917247	Pharmaceuticals & Biotech.
COH	Cochlear	54.65	33.97	2803926	Health Care
RIO	Rio Tinto	74.82	33.29	45098340	Materials
FKP	FKP Property Group	6.12	32.61	535213	Real Estate

All our shares are still there, meaning they are all still passing the requirements of our strategy. And again for the sake of this simulation, I'll go ahead and update my Excel spreadsheet

<u>Share</u>	<u>Price (\$)</u>	<u>Number</u>	<u>Value</u>	<u>%of Total Capital</u>
PDN	6.03	16949	\$ 102,202.47	10.35
FMG	9.59	10493	\$ 100,627.87	10.19
LHG	2.85	35971	\$ 102,517.35	10.38
BKN	6.49	16077	\$ 104,339.73	10.56
AFG	10.91	9132	\$ 99,630.12	10.09
JST	3.61	25839	\$ 93,278.79	9.44
AWE	2.81	32679	\$ 91,827.99	9.30
MCQ	6.81	14880	\$ 101,332.80	10.26
UGL	13.31	6830	\$ 90,907.30	9.20
LEI	21.55	4683	\$ 100,918.65	10.22
Total of Shares			\$ 987,583.07	
Cash			\$ 47.37	
Total Capital			\$ 987,630.44	

We can see now that the top ten shares have actually changed, albeit very slightly. This will happen as our shares move down the list, however as long as they are still on the Blue Chip Report, there is no need for us to exit any of the positions. Again no action is required.

I'll move on to the next week now....I've checked the commentary, nothing there on profit taking, so now I'm going to check to make sure all the shares in our portfolio are still in the Blue Chip Report. And I'll even update the spreadsheet so we can see how it's going.

ASX200 Search Results			RBA Cash Rate Target = 6.25%		
Code	Company Name	Price(\$)	ROAR(%)	Cashflow(\$)	Industry Group
PDN	Paladin Resources	6.91	78.31	3192569	Energy
FMG	Fortescue Metals Group	9.60	72.38	829304	Materials
MFS	MFS	4.13	62.97	762512	Diversified Financials
LHG	Lihir Gold	2.90	54.31	8529318	Materials
BKN	Bradken	7.05	51.23	666755	Capital Goods
AFG	Allco Finance Group	11.02	46.33	2303765	Diversified Financials
MGQ	Macquarie Goodman Gr.	7.14	44.11	5771701	Real Estate
JST	Just Group	3.52	43.52	1037289	Retailing
DJS	David Jones	3.87	38.11	1473870	Retailing
LEI	Leighton Holdings	20.88	37.52	2334127	Capital Goods
IRE	Iress Market Technology	7.03	37.02	640006	Software & Services
AWE	Aust. Worldwide Exploration	2.92	36.25	2575404	Energy
UGL	United Group	13.91	35.72	1499014	Capital Goods
CSL	CSL	60.25	34.55	8787911	Pharmaceuticals & Biotech.
COH	Cochlear	56.98	33.38	3119765	Health Care
FKP	FKP Property Group	6.06	33.00	578420	Real Estate

Share	Price (\$)	Number	Value	%of Total Capital
PDN	6.91	16949	\$ 117,117.59	11.46
FMG	9.60	10493	\$ 100,732.80	9.86
LHG	2.90	35971	\$ 104,315.90	10.21
BKN	7.05	16077	\$ 113,342.85	11.09
AFG	11.02	9132	\$ 100,634.64	9.85
JST	3.52	25839	\$ 90,953.28	8.90
AWE	2.92	32679	\$ 95,422.68	9.34
MCQ	7.14	14880	\$ 106,243.20	10.40
UGL	13.91	6830	\$ 95,005.30	9.30
LEI	20.88	4683	\$ 97,781.04	9.57
Total of Shares			\$ 1,021,549.28	
Cash			\$ 47.37	
Total Capital			\$ 1,021,596.65	

Again there's been some movement in the top ten as far as positions go but there's nothing more for us to do this week as all of our shares are still there.

I'll fast forward a bit now (by five weeks to be exact), but rest assured I've been checking the Blue Chip Report each week to make sure none of our shares have stopped out (that is, disappeared off the list). And there's also been nothing in my commentary about the need for profit taking or any other action...so let's see how things are at the end of the next month (December 2006).

ASX200 Search Results			RBA Cash Rate Target = 6.25%		
Code	Company Name	Price(\$)	ROAR(%)	Cashflow(\$)	Industry Group
PDN	Paladin Resources	8.90	79.37	4308122	Energy
FMG	Fortescue Metals Group	13.27	71.93	1543976	Materials
MFS	MFS	4.62	58.60	845548	Diversified Financials
IPL	Incitec Pivot	35.26	57.04	2544312	Materials
BKN	Bradken	8.00	52.40	766648	Capital Goods
LHG	Lihir Gold	3.12	51.05	9150568	Materials
AFG	Allco Finance Group	12.86	43.54	2335775	Diversified Financials
DJS	David Jones	4.17	41.51	1339447	Retailing
MGQ	Macquarie Goodman Gr.	7.60	40.87	6107755	Real Estate
IRE	Iress Market Technology	7.02	39.87	591506	Software & Services
JST	Just Group	3.70	39.35	953421	Retailing
BNB	Babcock & Brown	24.80	36.73	4897552	Diversified Financials
LEI	Leighton Holdings	20.22	36.67	1788724	Capital Goods
CNP	Centro Properties Group	9.10	35.70	5697501	Real Estate
CSL	CSL	65.37	34.11	8714827	Pharmaceuticals & Biotech.
FKP	FKP Property Group	6.58	33.19	546580	Real Estate
AWE	Aust. Worldwide Exploration	3.05	32.58	1439001	Energy
UGL	United Group	13.95	31.95	1987342	Capital Goods
OST	Onesteel	4.68	31.60	2032642	Materials
COH	Cochlear	58.00	29.96	2511268	Health Care

Now things have started to move and a couple of our shares are edging their way further and further down the list, but they are still there, so no action is required. We'll check the spreadsheet just to see how things are at this stage:

Share	Price (\$)	Number	Value	%of Total Capital
PDN	8.90	16949	\$ 150,846.10	13.15
FMG	13.27	10493	\$ 139,242.11	12.14
LHG	3.12	35971	\$ 112,229.52	9.79
BKN	8.00	16077	\$ 128,616.00	11.22
AFG	12.86	9132	\$ 117,437.52	10.24
JST	3.70	25839	\$ 95,604.30	8.34
AWE	3.05	32679	\$ 99,670.95	8.69
MCQ	7.60	14880	\$ 113,088.00	9.86
UGL	13.95	6830	\$ 95,278.50	8.31
LEI	20.22	4683	\$ 94,690.26	8.26
Total of Shares			\$ 1,146,703.26	
Cash			\$ 47.37	
Total Capital			\$ 1,146,750.63	

So far so good...in fact since we started our portfolio, eight weeks have passed by and things are looking pretty good. Now we'll skip forward a bit to a time when we will have something to do—three weeks on.

Next is the Blue Chip Report for week 12.

ASX200 Search Results			RBA Cash Rate Target = 6.25%		
Code	Company Name	Price(\$)	ROAR(%)	Cashflow(\$)	Industry Group
MRE	Minara Resources	6.05	103.32	2576094	Materials
PDN	Paladin Resources	8.15	80.71	5153704	Energy
FMG	Fortescue Metals Group	14.50	71.24	1606114	Materials
IPL	Incitec Pivot	37.29	60.09	1562036	Materials
MFS	MFS	5.17	57.53	1341370	Diversified Financials
SDG	Sunland Group	3.82	55.73	499174	Real Estate
BKN	Bradken	8.46	54.01	1083353	Capital Goods
LHG	Lihir Gold	2.89	48.48	9019509	Materials
DJS	David Jones	4.35	43.87	1421381	Retailing
AFG	Allco Finance Group	11.58	41.93	2471732	Diversified Financials
MCQ	Macquarie Goodman Gr.	7.03	40.33	7531018	Real Estate
CNP	Centro Properties Group	8.58	40.10	5454060	Real Estate
IRE	Iress Market Technology	6.90	39.82	481246	Software & Services
JST	Just Group	3.59	37.88	814610	Retailing
LEI	Leighton Holdings	20.75	35.84	1954935	Capital Goods
BNB	Babcock & Brown	25.75	35.75	4537152	Diversified Financials
CSL	CSL	67.04	34.53	8856268	Pharmaceuticals & Biotech.
FKP	FKP Property Group	6.75	33.62	588536	Real Estate
OST	Onesteel	4.75	31.51	2239069	Materials
QBE	QBE Insurance Group	29.83	31.15	15503094	Insurance
AGL	Aust. Gas Light Co.	17.28	31.13	2774583	Utilities
UGL	United Group	13.35	29.55	2226066	Capital Goods
BXB	Brambles Industries	13.35	28.76	31798982	Comm. Services & Supplies
PMN	Promina Group	7.27	28.76	15719601	Insurance
CGJ	Coles Myer	14.00	28.75	10854509	Food & Staples Retailing
AXA	AXA Asia Pacific Holdings	7.29	28.54	3338724	Insurance
COH	Cochlear	56.67	28.27	2464717	Health Care
RIO	Rio Tinto	71.65	27.88	43076184	Materials
ASX	Aust. Stock Exchange	37.84	27.77	4695700	Diversified Financials
GPT	GPT Group	5.30	26.29	9413380	Real Estate
AMP	AMP	10.33	25.78	11967133	Insurance

We can see now that one of our shares no longer appears in the Blue Chip Report. This means that it has triggered one of the stop loss conditions and now we have to exit that position. Regardless of how attached we have grown to the share in question, when following a system, it is important to stick to the rules (no matter how hard it might be, as our ultimate success depends on it).

The share in question is AWE so we'll now sell it from our portfolio (I've used the price from the previous week's Blue Chip Report to close the position). My commentary also includes some tips on selling shares as you can see in the following extract from the current Blue Chip Report:

Stick to the rules and don't hesitate to sell shares that disappear off the list (when shares disappear from the list it means a stop loss condition has been triggered and they should be sold in the next two weeks). Here's a helpful tip if you always seem to sell at the very bottom of the market (like me), avoid selling all of your shares in one day by spreading out your selling over at least three days. This way you'll never sell out at the very lowest price...crude but effective.

Share	Price (\$)	Number	Value	%of Total Capital
PDN	8.15	16949	\$ 138,134.35	12.41
FMG	14.50	10493	\$ 152,148.50	13.67
LHG	2.89	35971	\$ 103,956.19	9.34
BKN	8.46	16077	\$ 136,011.42	12.22
AFG	11.58	9132	\$ 105,748.56	9.50
JST	3.59	25839	\$ 92,762.01	8.33
MCQ	7.03	14880	\$ 104,606.40	9.40
UGL	13.35	6830	\$ 91,180.50	8.19
LEI	20.75	4683	\$ 97,172.25	8.73
				0.00
Total of Shares			\$ 1,021,720.18	
		Cash	\$ 91,548.57	
		Total Capital	\$ 1,113,268.75	

According to the latest commentary I can see that it's an acceptable time to be buying, so I'll purchase another share to replace AWE. The next highest share on the list in this case is MRE...so we'll add it to our portfolio.

I've checked the industry group and also the cash flow to make sure we are still within the requirements of the strategy and now I'll spend as much of the cash as I can, without exceeding 10 per cent of my total capital. In this case that wouldn't be possible as the cash available is less than 10 per cent of the total capital anyway.

Share	Price (\$)	Number	Value	%of Total Capital
PDN	8.15	16949	\$ 138,134.35	12.41
FMG	14.50	10493	\$ 152,148.50	13.67
LHG	2.89	35971	\$ 103,956.19	9.34
BKN	8.46	16077	\$ 136,011.42	12.22
AFG	11.58	9132	\$ 105,748.56	9.50
JST	3.59	25839	\$ 92,762.01	8.33
MCQ	7.03	14880	\$ 104,606.40	9.40
UGL	13.35	6830	\$ 91,180.50	8.19
LEI	20.75	4683	\$ 97,172.25	8.73
MRE	6.05	15131	\$ 91,542.55	8.22
Total of Shares			\$ 1,113,262.73	
Cash			\$ 6.02	
Total Capital			\$ 1,113,268.75	

Just to round things off a bit, I'll do one more week, which will mean we've been going for exactly three calendar months (November 2006 to January 2007 inclusive). Again I'll show you the full page of the Blue Chip Report so you can see how spread out the shares are (I've highlighted all of the shares, including our recent purchase—MRE).

ASX200 Search Results			RBA Cash Rate Target = 6.25%		
Code	Company Name	Price(\$)	ROAR(%)	Cashflow(\$)	Industry Group
MRE	Minara Resources	6.40	105.40	2665002	Materials
PDN	Paladin Resources	8.86	81.37	5232543	Energy
FMG	Fortescue Metals Group	14.96	71.01	1594615	Materials
IPL	Incitec Pivot	36.70	60.67	1527259	Materials
MFS	MFS	5.78	57.62	1506931	Diversified Financials
SDG	Sunland Group	3.83	56.58	518329	Real Estate
BKN	Bradken	8.75	54.51	1146106	Capital Goods
LHG	Lihir Gold	3.09	48.08	9156485	Materials
DJS	David Jones	4.36	44.70	1417392	Retailing
CNP	Centro Properties Group	8.86	41.67	5187682	Real Estate
AFG	Allco Finance Group	12.59	41.55	2484680	Diversified Financials
MGQ	Macquarie Goodman Gr.	7.18	40.22	7825862	Real Estate
IRE	Iress Market Technology	6.89	40.05	453703	Software & Services
JST	Just Group	3.57	37.44	823825	Retailing
BNB	Babcock & Brown	26.73	35.70	4729908	Diversified Financials
LEI	Leighton Holdings	21.04	35.39	2071030	Capital Goods
IFL	IIOF Holdings	11.50	34.91	258651	Diversified Financials
CSL	CSL	70.10	34.90	8636366	Pharmaceuticals & Biotech.
FKP	FKP Property Group	6.99	34.05	555183	Real Estate
QBE	QBE Insurance Group	30.30	31.60	15711063	Insurance
OST	Onesteel	4.65	31.55	2141474	Materials
AGK	Aust. Gas Light Co.	17.24	31.38	2720303	Utilities
PMN	Promina Group	7.33	29.44	14221933	Insurance
CGJ	Coles Myer	14.10	29.02	10012889	Food & Staples Retailing
BXB	Brambles Industries	13.31	28.93	31435222	Comm. Services & Supplies
UGL	United Group	13.36	28.71	2283018	Capital Goods
AXA	AXA Asia Pacific Holdings	7.35	28.56	3311505	Insurance
ASX	Aust. Stock Exchange	39.34	27.88	4717479	Diversified Financials
COH	Cochlear	58.06	27.77	2419213	Health Care
RIO	Rio Tinto	77.45	27.55	42457096	Materials
GPT	GPT Group	5.37	26.99	9138719	Real Estate
AMP	AMP	10.50	25.86	12058508	Insurance

And here's our final spreadsheet :

<u>Share</u>	<u>Price (\$)</u>	<u>Number</u>	<u>Value</u>	<u>%of Total Capital</u>
PDN	8.86	16949	\$ 150,168.14	12.95
FMG	14.96	10493	\$ 156,975.28	13.54
LHG	3.09	35971	\$ 111,150.39	9.58
BKN	8.75	16077	\$ 140,673.75	12.13
AFG	12.59	9132	\$ 114,971.88	9.91
JST	3.57	25839	\$ 92,245.23	7.95
MCQ	7.18	14880	\$ 106,838.40	9.21
UGL	13.36	6830	\$ 91,248.80	7.87
LEI	21.04	4683	\$ 98,530.32	8.50
MRE	6.4	15131	\$ 96,838.40	8.35
	Total of Shares		\$ 1,159,640.59	
		Cash	\$ 6.02	
		Total Capital	\$ 1,159,646.61	

Hopefully this will give you an idea as to what is involved in managing your blue chip share portfolio and just how easy this is with a tool like the Blue Chip Report. Once our portfolio is set up, it's just a matter of checking the report at the end of each week and then relaxing and forgetting all about the market until the following week!

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