Alpesh Patel's February Newsletter

Exclusively for ShareScope Alpesh Patel Special Edition Subscribers

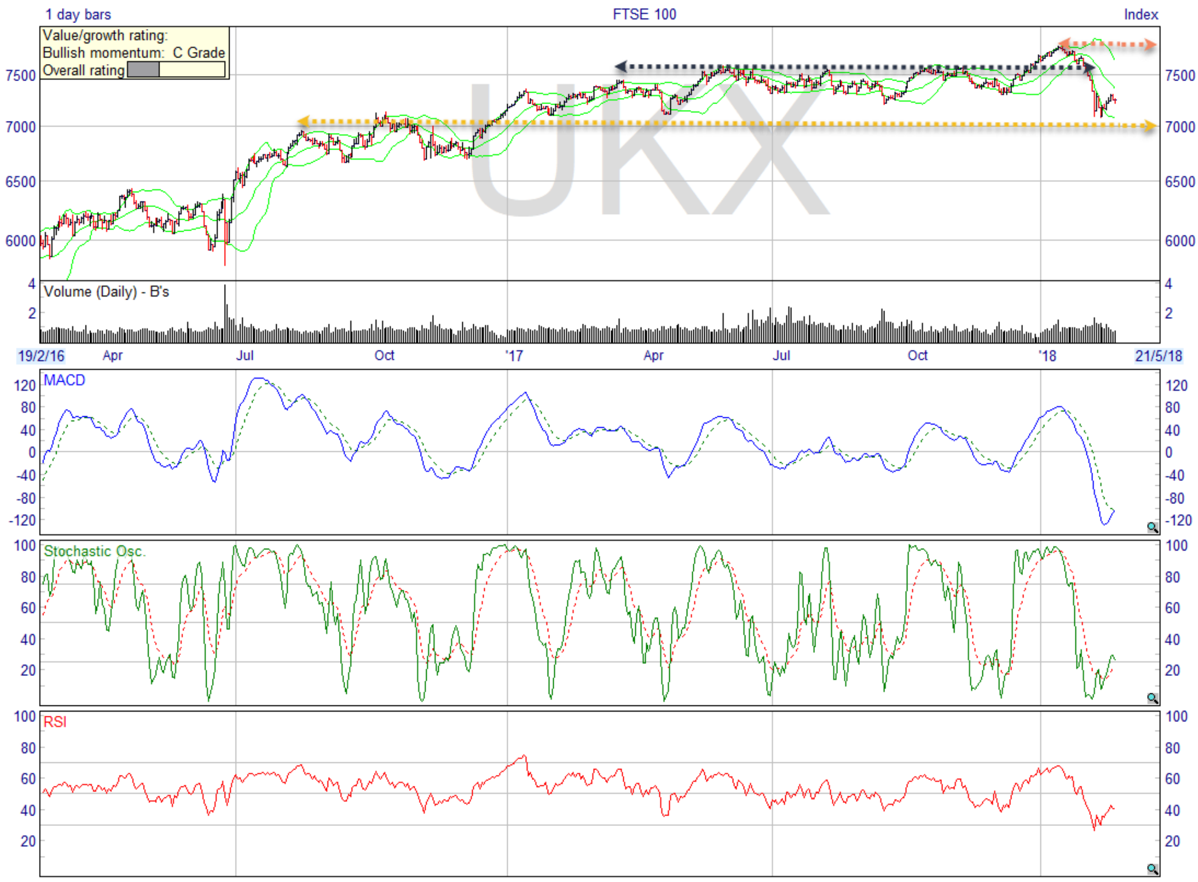
23 February 2018

Welcome to my February newsletter. I want to cover what to do in a crash. Will there be one? Which stocks looks best and, for trading, what is exciting and profitable at the moment?

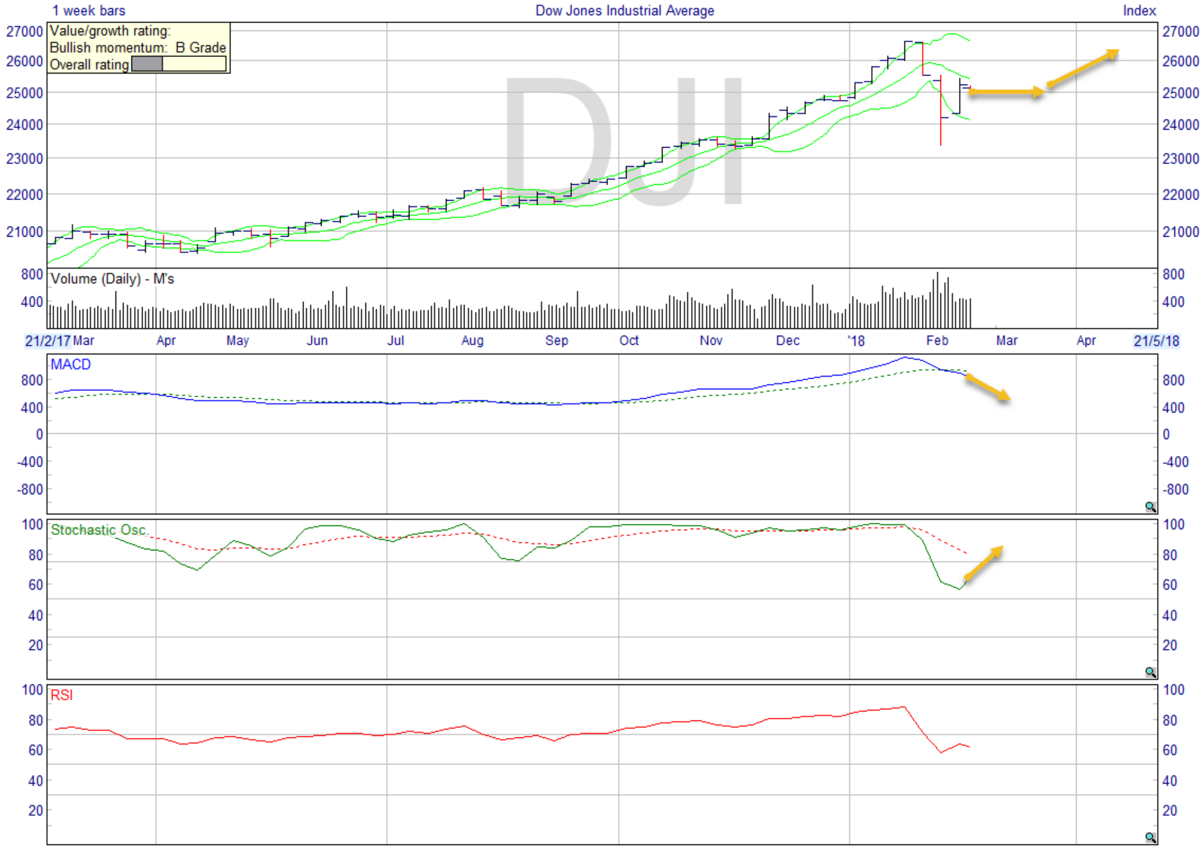
My view on the markets

It does not take a genius to tell you the market is expensive but it is also producing profits. So the bottom line is whilst you expect profit-taking dips, you also get buy on dips. And overall I am bullish.

I have marked in yellow the obvious support and in pink a sound target for the year and in blue a likely roadblock.

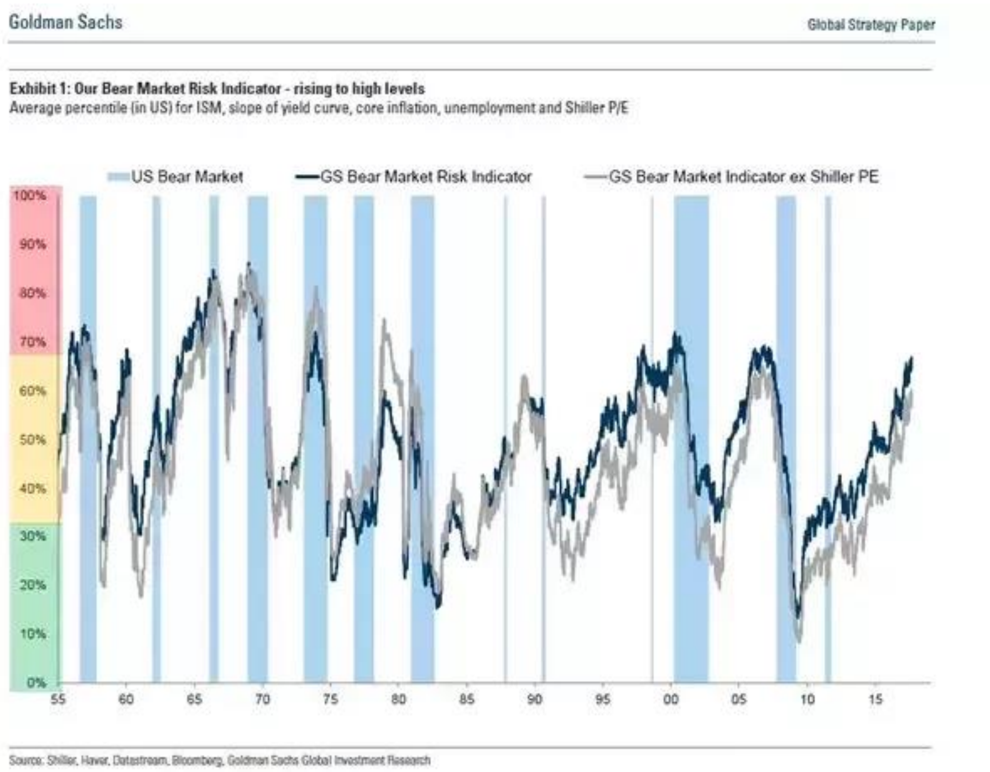


The downward momentum in the Dow will take a little longer to slow and turn upwards. Like a big tanker on the ocean, a 360 turn is rare.



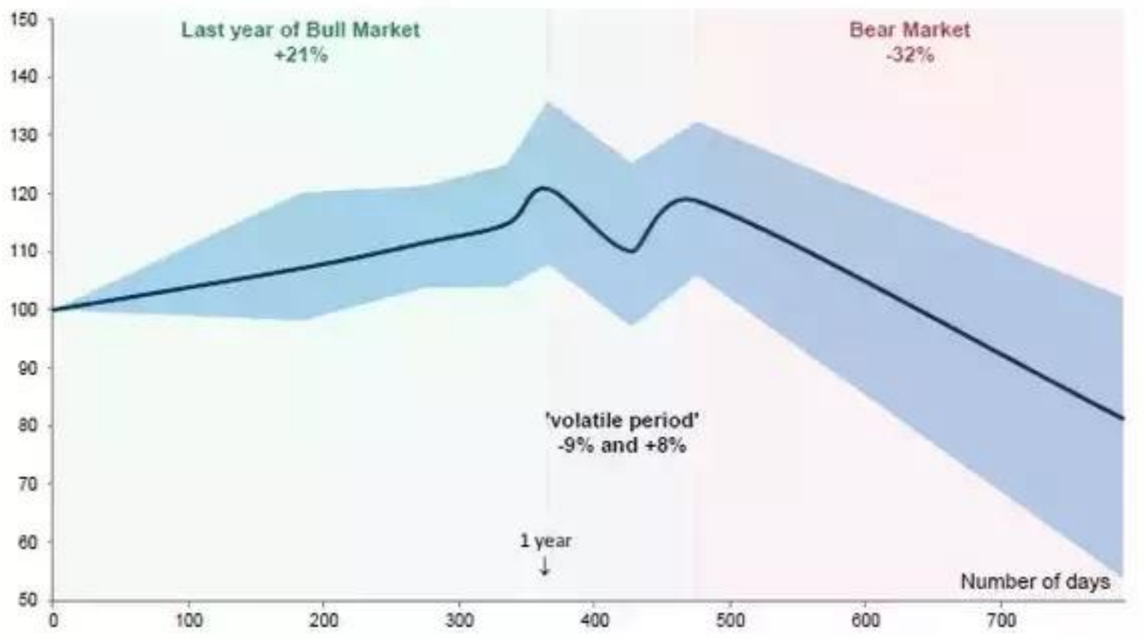
Top insights from the City

Here you can see how Goldman Sachs says we are overvalued.



Below is the warning pattern according to Goldman Sachs:

Exhibit 5: The 'typical' profile of the 'Bear Market Bounce'
Average returns and length of the S&P one year before and during a bear market (ex 1998)



Source: Bloomberg, Goldman Sachs Global Investment Research

And whilst Europe is not expensive, we in the UK will be dragged down by a US bear when it happens (probably 2019).

Exhibit 9: Valuations look very stretched in the US ...
S&P 500 valuation summary, data since 1976 for all metrics other than PEG ratio (1982) and free cash flow yield (1990)

S&P 500 valuation summary				
Valuation Metrics	Aggregate index		Median stock	
	Current	Historical %ile	Current	Historical %ile
P/E to growth (PEG)	1.4	88%	1.9	100%
EV / Sales	2.3	95%	2.8	99%
EV / EBITDA	11.6	88%	11.9	99%
Price / Book	3.2	86%	3.4	99%
Forward P/E	18.0	89%	18.3	97%
Free cash flow yield	4.3	46%	4.3	53%
Cyclically adjusted P/E *	25.8	87%	NA	NA
Median		88%		99%

** Based on operating earnings*

Source: Goldman Sachs Global Investment Research

Exhibit 10: ... but less in Europe
STOXX 600 Valuation summary, data since 2000 for all metrics other than PEG ratio (2002) and free cash flow yield (2006)

STOXX 600 valuation summary				
Valuation Metrics	Aggregate index		Median Stock	
	Current	Historical %ile	Current	Historical %ile
P/E to growth (PEG)	1.3	31%	NA	NA
EV / Sales	1.6	92%	2.0	95%
EV / EBITDA	9.1	87%	9.9	100%
Price / Book	1.8	57%	2.0	79%
Forward P/E	15.3	80%	16.1	94%
Free cash flow yield	5.4	69%	5.3	85%
Cyclically adjusted P/E	17.7	67%	NA	NA
Median		69%		94%

Source: FactSet, IBES, Datastream, Goldman Sachs Global Investment Research

My favourite Value/Growth picks this month

Applying the Value/Growth filter to the full LSE list, I see slim pickings – maybe a sign of overvaluation?

No.	Name	EPIC	Alpesh value/ growth rating
1	Plus500 Ltd	PLUS	9
2	Bonmarche Holdings PLC	BON	8
3	Haynes Publishing Group F	HYNS	8
4	easyJet PLC	EZJ	7
5	Smurfit Kappa Group PLC	SKG	7
6	TP ICAP PLC	TCAP	7

When I look at FTSE 350 list using the Alpesh Table (where the rules are slightly less strict) we have more companies to choose from:

No.	Name	Alpesh value/ growth rating	EPIC
1	Euromoney Institutional Inv	9	ERM
2	Investec PLC	9	INVP
3	Kingfisher PLC	9	KGF
4	Auto Trader Group PLC	8	AUTO
5	B&M European Value Reta	8	BME
6	Clarkson PLC	8	CKN
7	Close Brothers Group PLC	8	CBG
8	Dechra Pharmaceuticals P	8	DPH
9	Ferrexpo PLC	8	FXPO
10	GKN PLC	8	GKN
11	Hays PLC	8	HAS
12	Howden Joinery Group PL(	8	HWDN
13	IG Group Holdings PLC	8	IGG
14	JD Sports Fashion PLC	8	JD.
15	Just Eat PLC	8	JE.
16	KAZ Minerals PLC	8	KAZ
17	Old Mutual PLC	8	OML
18	Polypipe Group PLC	8	PLP
19	Rio Tinto PLC	8	RIO
20	Royal Dutch Shell PLC	8	RDSB
21	Royal Mail Group PLC	8	RMG
22	RPC Group PLC	8	RPC
23	Sky PLC	8	SKY
24	Softcat PLC	8	SCT
25	Spectris PLC	8	SXS
26	Vesuvius PLC	8	VSVS

But again, notice how there are only three '9' stocks and that reflects a more expensive market. It is not that growth or dividends have slowed but valuations that have risen.

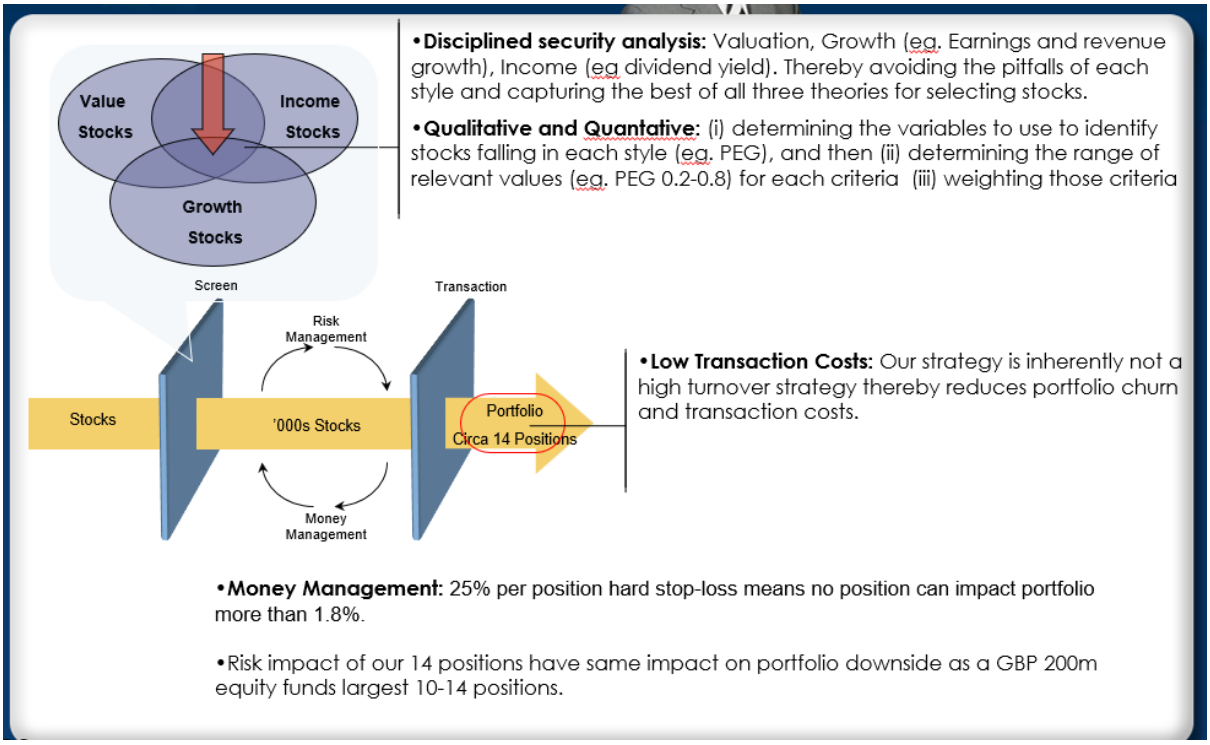
For the US, I have more to show you and those marked 'A' are ADRs i.e. overseas stocks listed in US – so very diversified.

No.	Name	Alpesh value/ growth rating
1	A - Mobile TeleSystems PJSC	10
2	Telefonica Brasil SA	10
3	Arthur J Gallagher & Co	9
4	A - Banco Macro SA	9
5	A - Banco Santander Chile SA	9
6	A - BanColombia SA	9
7	A - China Lodging Group, Limited	9
8	Cinemark Holdings Inc	9
9	A - Companhia de Saneamento Basicc	9
10	Cullen/Frost Bankers Inc	9
11	A - ICICI Bank Ltd	9
12	A - Infosys Ltd	9
13	A - Kookmin Bank ADS	9
14	Lockheed Martin Corp	9
15	MarineMax Inc	9
16	MCBC Holdings Inc	9
17	Meta Financial Group Inc	9
18	National CineMedia Inc	9
19	Sabre Corp	9
20	A - Ultrapar Participacoes SA	9
21	A - Vina Concha y Toro SA	9
22	Yirendai Ltd	9

Just a reminder…my favourite value/growth picks from January 2017 formed a portfolio which returned more than 30% over 12 months.

Alumasc	0
Arrow	42
CareTech	24
Conviviality	44
Galliford	-11
IMPAX	183
LionTrust	39
McColls	45
Vp	6.7
Mears	-9.7
Severfield	6.96
Watkin Jones	56.95
Plastics Capital	-4.9

If I were to summarise the Value/Growth approach it is this:



Value Growth Income: USP

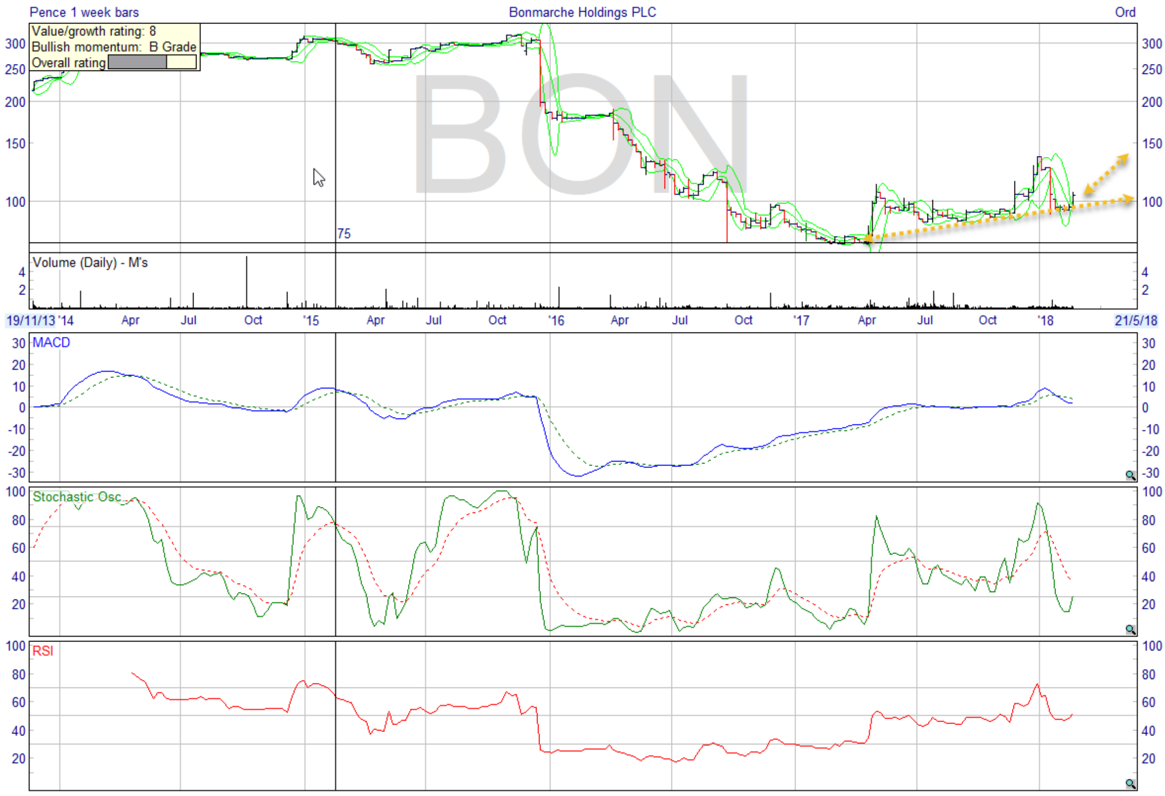
Downside of Traditional Styles & Other Funds	**Our way for generating maximising risk-adjusted returns**
Value Stocks: can remain undervalued for long periods. Can be excessively undervalued because business is not viable.	As our stocks are also growth stocks, they tend to be spotted earlier by big funds. We avoid extremely strongly valued, or strongly growing or strongly yielding stocks –as these too can be problematic.
Income Stocks: Yields alone do not ensure shareholder returns	Yields provide downside protection. If the stocks price should fall, yields increase, ensuring a floor to price falls. But growth and valuation criteria mean the company should get selected rapidly and rise again.
Growth Stocks: Can be over-valued and not exceed expectations causing price declines	Our stocks are already relatively undervalued so strong growth means expectations are usually exceeded resulting in strong price rises.
Exits based on entry criteria	We do not want to exit when our stocks are, say, fully valued. We want them to be overvalued when we exit. So our exits are based not on our entry criteria, but time – the optimal time, without back-test over-fitting, we think it takes for shareholder returns to be maximised, which based on VGI criteria is 12 months.

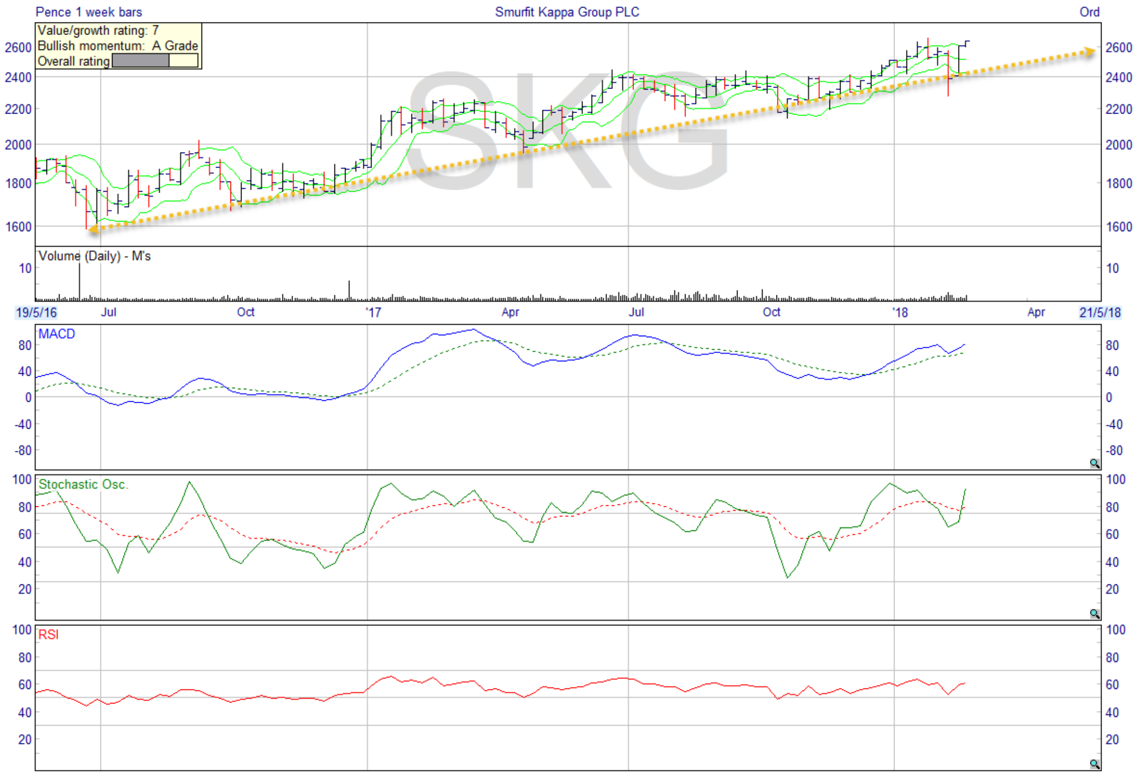
Value Growth Income: USP

Transaction costs cause cost drag due to large number of portfolio holdings	Our portfolio stocks have the same downside impact as the largest 10-20 holdings of a GBP200m fund. We don't need 100 holdings and the costs inherent in them to diversify away risk. But our concentration generates Alpha due to our stock selection skills.
Style Drift	By having a combination of styles we should 'smooth' the effects and downsides of any one style.
Poor bear market performance	Our stocks represent target 'flight to quality' stocks in bear markets.

My favourite Momentum/Value picks this month

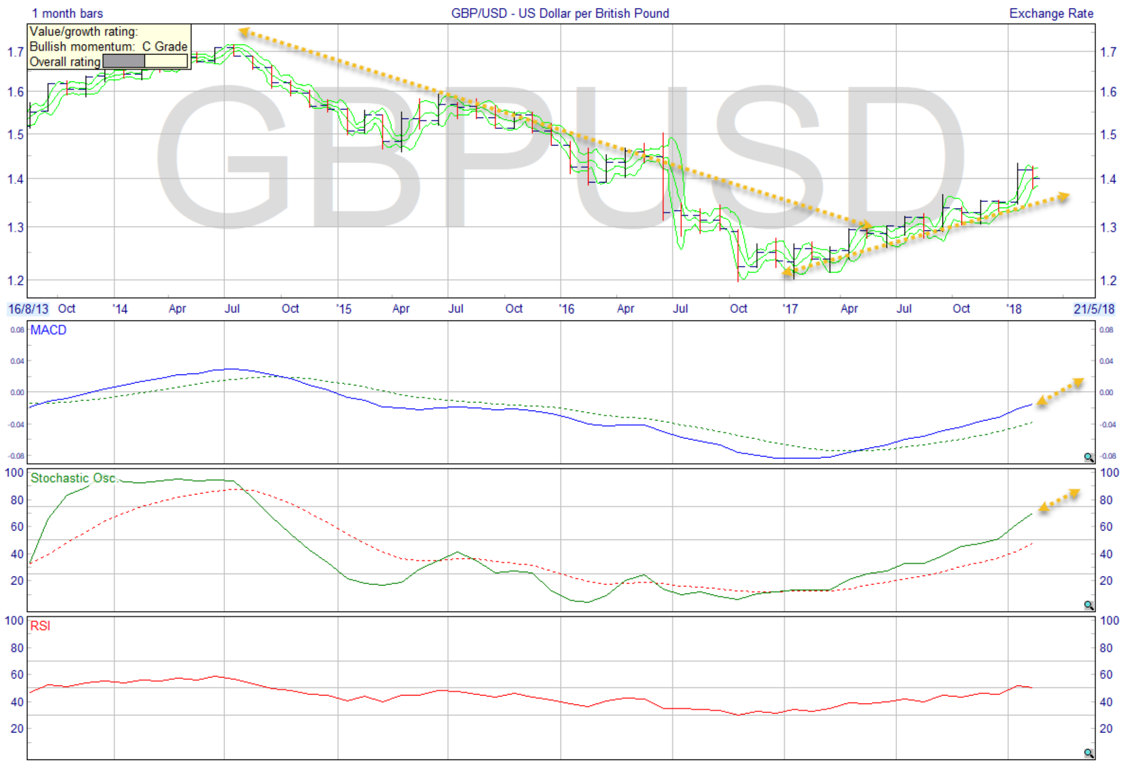
This filter uses our algorithms to find undervalued stocks showing some momentum. These are higher risk than VGI.



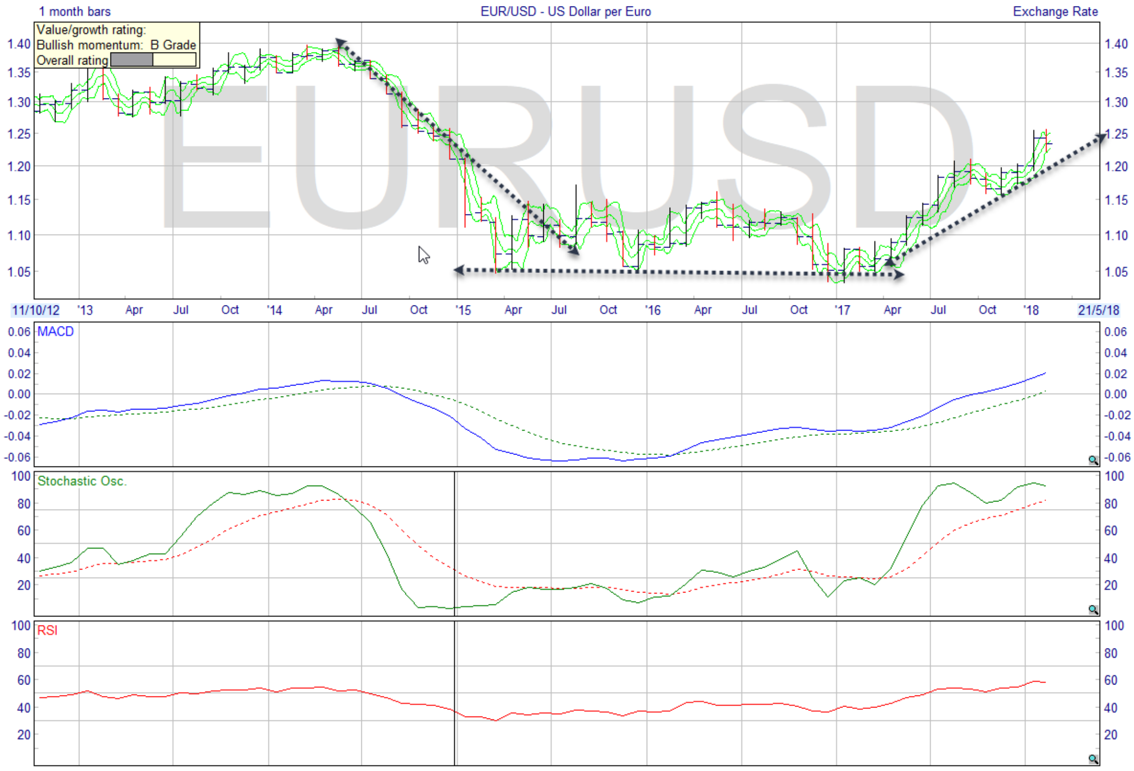


Top trades for this month

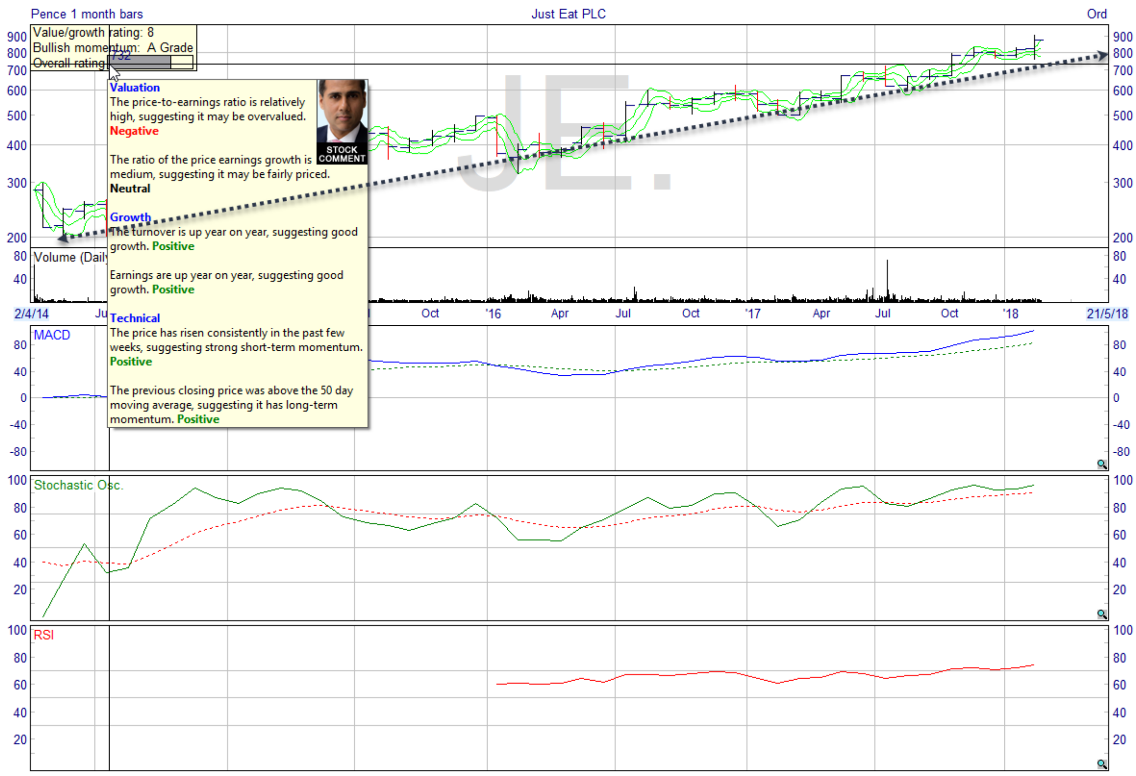
A bullish bias on GBPUSD despite some people being bearish. It does not mean with US rate rises (3 this year?) USD will not rise, but I think the GBP trend is strong.



And for EURUSD it is definitely long Euro for me



Also…just can't argue with JustEat. Easy to know when to exit too – if uptrend breaks. Simple trade.



If you really want to protect yourself from market falls then these ETFs look good. Too early in my view but keep an eye on them. Do please be aware though that short and leveraged ETFs are high risk and you shouldn't use them without fully understanding the risks.

Symbol	ETF Name
SH	ProShares Short S&P 500
PSQ	ProShares Short QQQ
RWM	ProShares Short Russell 2000
DOG	ProShares Short Dow 30
HDGE	AdvisorShares Ranger Equity Bear ETF
EUM	Short MSCI Emerging Markets ProShares
JDST	Direxion Daily Junior Gold Miners Index Bear 3X Shares
LABD	Direxion Daily S&P Biotech Bear 3x Shares
CHAD	Direxion Daily CSI 300 China A Share Bear 1X Shares

Symbol	ETF Name
DRIP	Direxion Daily S&P Oil & Gas Exploration & Production Bear 3x Shares
BIS	ProShares UltraShort Nasdaq Biotechnology
SPDN	Direxion Daily S&P 500 Bear 1x Shares
EFZ	Short MSCI EAFE ProShares
SEF	Short Financials ProShares
MYY	ProShares Short Midcap 400
SBB	ProShares Short Small Cap 600
YXI	ProShares Short FTSE China 50
ZBIO	ProShares UltraPro Short Nasdaq Biotechnology

Rich Trader, Poor Trader

You know, one of the most common questions I'm ever asked is what's the difference between rich traders (the 10% or 20% that make money) and the 80% that don't? What is it that of all the traders that I've examined, the professional traders, the hedge fund managers, and my own expertise and experience as well . . . What is that differentiates the two?

And I took the data that I could get from brokers who gave me lots of anonymized data on thousands of clients to see, is there a difference? Are men better than women? Is there a certain time of day you should be trading? Are there certain instruments?

Is it better to trade stops than forex than to do indices or gold or commodities? Do you make more money if you go short then you go long? Are there certain geographies that you should be trading some periods of time?

What if statistically, I can show you that out of a group of 500,000 traders, the ones who held on to a stop or a currency for more than 5 minutes were more likely to lose . . . Or more than an hour or more than 3 days or vice versa than those who held it for different periods of time?

What if you could have that little statistical edge? So we looked into all of this data. I'm going to tell you that actually one of the most surprising things is, the difference isn't that big between the winners and losers. Just as in life. It isn't that big.

Who Wins and How?

Let me take you through some of the issues, some of the differences that I found between the winning and losing traders. For instance, the poor trader they tended to have a few big losses. Losses where they lost in one trade more than 2% or even more than 1% of their total risk capital.

Whereas, for the rich trader, they rarely, if ever, had such losses. So how do you limit such losses? Well, one of the reasons that they're rich traders is that they have a small trading size. In other words, they trade a small amount relative to the total capital they have.

Also, they never added to their losing position. Another thing that we found the difference between winners and losers or the poor traders and the rich traders, is that winning trades in the case of poor traders were achieved by simply getting rid of a stop loss.

They were willing to take an unlimited loss in order to have that win, even if it was a small win. So they risked losing lots of money in order to have a small win. Whereas, a rich trader, they were happy to have winning trades because their stop loss got hit, even if, therefore, it meant that they had a lot of losing trades. But they were small losses because their stop loss was sufficiently tight, in order that they wouldn't have big losses.


Poor Trader
vs.
Rich Trader
Profit/Loss
Losses
A Few Big Losses
Losses
No Losses > 2% of Total Capital
Win/Loss
Winning trades achieved by removing stop losses
Win/Loss
Fewer winning trades because of stop loss
Profit
None because of big losses
Profit
Profitable because of stop losses which prevent big losses
Money Management
Bet/Trade Size
Regardless of market volatility
Bet/Trade Size
Based on market volatility
Tools
Good Broker
Mobile Trading
Mentor
Automated Indicator

Lose, but never big is the key

The rich traders focus was don't have big losses. That was a key difference. The other major difference was in terms of profit. Obviously, the poor trader—the losing trader didn't have profits overall. They might have a few winning trades that were profitable in themselves, but they didn't have profits overall because they had those big losses.

Whereas, the rich trader was profitable because their stop losses prevented big losses. That was the critical factor. What about money management? When it came to money management...The amount of money they put to a particular trade, the poor trader regardless of how volatile the market was—whether it was something as volatile as cryptocurrencies or the stop market or foreign exchange before a major election...

They backed the same amount of money in proportion to their total capital. But the poor trader didn't account for market volatility. Whereas, the rich trader, they reduced their trade size if the market was more volatile, more noisy.

So "How do you measure volatility?" There are all sorts of tools out there, like the Average True Range indicator which will allow you to do it.

But the rich trader had good mentors who are able to teach all of this as well. All of these are critical factors to success, but in terms of strategy was a critical factor as well.

A Strategy for Stopping Losses and Adding to Winners

Similarly, when it comes to stop losses in strategy, there was no clear strategy for the poor trader. The rich trader, used volatility-based stop loss. The more volatile the market, the further away the stop loss. The more volatile the market, the smaller the trade size in the case of the rich trader.

The poor trader, profits—they never added to their winning positions. Once they were in profit, they never added to those profitable positions.

Whereas, the rich trader, they would start with a small position so they didn't risk a big loss. If it got into profit, they would add more money to that trade because they were then risking the existing profits they had made. That was critical.

The Mind of a Trader

Finally, in trading psychology, the loser, they were unaware of things such as psychological biases. Whereas, for winners, they knew what biases were.

What's a bias? A bias is a kind of psychological traps we fall into, where we have prejudices, preexisting beliefs, and we only look for information which reinforces our preexisting belief on a position.

Let's say, therefore, we say, "No. No. No. I'm not getting out of this because 1 person in a 100 says I should still buy Sterling or still buy Dollars or the DAX or the DOW." And that inability to be objective is what absolutely kills you.

So what are the top tips for being a rich trader? First of all, add to your winning positions. That's critical. Trade a small size of your risk capital. Of your total risk capital trade a small size of that. Aim for short-term learning goals.

Always be looking to learn, learn and learn. And have a trading business plan. Develop that plan. Both in terms of returns and how many trades you are going to do? If only 50% are right, how much more money are you going to make on that than you're going to lose of that 50% that were wrong?

Personal Activities

It being Valentine's Day…

It being a complicated world, I try to simplify it…

Clearout…found this…

Was in India to give this speech…

And then there was this!