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## Editorial Comment

Topic: Online tipster gives blue chips a shock - The Weekend Australian Business Section  
From: Gary Stone, Managing Director ShareFinder Investment Services  
Date: Friday, 16 February 2007

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### Disgraceful Standards in the online stock tipping industry

With reference to the article in the Weekend Australian on 10-11 February, 2007 entitled "Caught in the net: online tipster gives the blue chips a shock".

The article ends with a suggestion from David Foster from WHK Greenwoods, auditor of one of the online stock tipster's, that a standard methodology be used by all the providers in the industry to measure past performance. Gary Stone, Managing Director of ShareFinder, would welcome such a move, however, he fears that the marshalling of it would merely add further levels of compliance onto providers that won't "catch the dishonest ones in the net" anyway.

Gary Stone's view is that whilst the rewards from investing are more than merely financial returns, in dimensions that only those that have taken the journey will understand, returns are what catch investors' attention so providers' focus is on just that, past performance. It is this focus, amongst other things, that drives their misrepresentation and dishonesty in portraying past performance results. Stone hopes that articles such as this one will play a role in educating consumers and will motivate them to understand more about investing such that self regulation through education can be given a chance to work rather than layers and layers of compliance bureaucracy being imposed on the industry.

Gary Stone says: "The first and biggest area of explicit misrepresentation by 'the providers' in the industry is that of NOT including brokerage when portraying past performance. The people that run the tipster organisations have sufficient knowledge about the stock market to know the huge affect that brokerage has on ongoing returns and on past performance tables. The longer the period that returns are measured over the bigger the absolute affect on performance.

The fact that ASIC or any other compliance organisation does not specifically stipulate that brokerage must be included in past performance tables does NOT exonerate providers from omitting it. When it comes to active investment in the stock market, paying

brokerage is as normal as day follows night, unless they believe they are above paying their trading dues.”

Besides ShareFinder, he knows of only one other ‘provider’, Huntley’s, that does include brokerage but it is limited to details on their portfolios, not their individual historical stock recommendations which are not measured on a closed trade basis. All the others, such as Fat Prophets, Invest4profit, Intelligent Investor, Australian Stock Report and many others, **exclude** brokerage from their historical performance tables.

Stone uses Australian Stock Report as an example to illustrate the huge difference that excluding brokerage makes to claimed past returns. All providers that exclude brokerage from their historical performance tables overstate their historical performance by large proportions.

On their website, as at 12 February, Australian Stock Report displays the following shares performance report:

<b>Hypothetical Portfolio: No brokerage</b>					
	<b>Jan-03</b>	<b>Jan-04</b>	<b>Jan-05</b>	<b>Jan-06</b>	<b>Jan-07 Current</b>
	\$50,000.00	\$74,621.89	\$101,729.13	\$188,188.20	\$248,114.01
<b>Percentage Return:</b>					
<b>Start Balance</b>	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>	<b>Year 4</b>	<b>Overall</b>
-	49.24%	36.33%	84.99%	31.84%	396.23%

Stone has taken the liberty of adding the “No brokerage” phrase otherwise this table was copied verbatim from ASR’s public domain website. Anyone can download the entire trade history that contributes to these results (complete with typo’s on some exit dates) and do their own analysis. ASR, as do all providers, shows a disclaimer similar to one below which they probably feel meets their compliance commitments even though their past performance results are gravely misrepresented by omitting brokerage.

**Important Information:** Due to the significant diversity in the fees charged by Stockbrokers, this data does not include any execution or settlement costs such as brokerage or ACH fees. In other words, the data reports performance which doesn't take into account transaction costs. You should check with your Stockbroker what fees might be incurred in executing the trades suggested by our Reports.

Now let’s examine their performance assuming a brokerage rate of \$25 per transaction which is possible, on average, with online brokers if you do more than 6 – 10 transactions per month, but is likely to be higher, on average for most investors.

<b>Hypothetical Portfolio: Brokerage at \$25 / transaction</b>					
	<b>Jan-03</b>	<b>Jan-04</b>	<b>Jan-05</b>	<b>Jan-06</b>	<b>Jan-07 Current</b>
	\$50,000.00	\$61,222.65	\$82,047.38	\$141,137.59	\$187,503.33
<b>Percentage Return:</b>					
<b>Start Balance</b>	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>	<b>Year 4</b>	<b>Overall</b>
-	22.45%	34.01%	72.02%	36.19%	275.01%

A mere difference of \$60,610.68!! As times passes, the absolute lie becomes bigger!! 420 trades were completed to achieve these results meaning that the actual total brokerage paid was only \$21,000!! This is the power of compounding working against you!!

Stone says that he has yet to meet an active investor that has believed the huge affect that brokerage has over a large sample of trades when he has first pointed it out to them.

Using Etrade, one of the brokers mentioned in last week's article, you might pay around \$32.95 per transaction.

Hypothetical Portfolio: Brokerage at \$32.95 / transaction					
Jan-03	Jan-04	Jan-05	Jan-06	Jan-07	Current
\$50,000.00	\$59,131.84	\$76,291.04	\$127,551.28	\$168,236.33	\$168,236.33
<b>Percentage Return:</b>					
<b>Start</b>					
<b>Balance</b>	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>	<b>Year 4</b>	<b>Overall</b>
-	18.26%	29.02%	67.19%	35.18%	236.47%

Now the difference is \$79,877.66 in overall returns, \$19,266.98 less than paying \$25 brokerage even though the additional brokerage paid was only \$6,678!! The 1<sup>st</sup> year performance has shrunk from 49.24% return to 18.126% because in that year the most trades were transacted.

Stone's message is: "The main lesson that readers should take out of this article, besides the exposing of gross misrepresentation, is the power of compounding and the lost opportunity that occurs when paying higher brokerage rates. As your portfolio value increases so does your position size per trade which, in turn, increases returns through the re-investment of profits. This is the holy grail of active investment."

There is another small little matter that Stone addresses with ASR's past performance table which he says is either knowingly exploiting their target audiences' lack of knowledge or displays ASR's ignorance about the power of money management (he sincerely hopes that it is the former which, although unacceptable in its own right, is the lesser of the two evils).

ASR's website states: "The system is slightly flawed because occasionally (very rarely) we have more than 10 positions open - so technically we can't put 10% of our funds into 11 or 12 trades."

Stone: "Now I didn't take the time to enter every trade into a robust portfolio manager which, in my opinion as an investor, should be a stock standard part of their service. However, because of their comment, I think it is safe to assume that there are times (only one is required) where they have more than 10 open trades in the results shown on their website. This means that the performance records that they portray would be impossible to achieve because the investor would run out of capital before they could enter trade 11, 12 or beyond."

Stone maintains that any half decent method should know historically what the maximum number of open positions to allow for. Catering for a maximum number of 11 open positions would theoretically reduce each position down to 9.09% instead of

10% of current portfolio value although in live trading it would actually be less. Using the more realistic brokerage rate of \$32.95 the table now looks like this:

Hypothetical Portfolio: Brokerage at \$32.95 / transaction, Pos Size 9.09%					
Jan-03	Jan-04	Jan-05	Jan-06	Jan-07	Current
\$50,000.00	\$57,410.01	\$71,102.87	\$111,636.13	\$142,829.39	\$142,829.39
<b>Percentage Return:</b>					
<b>Start</b>					
<b>Balance</b>	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>	<b>Year 4</b>	<b>Overall</b>
-	14.82%	23.85%	57.01%	30.82%	185.66%

The difference is now \$105,284.62 and overall profit is \$92,829.39 instead of \$198,114.01!! Point made.

Stone continued: "If we allowed for 12 open positions and reduced position sizes to 8.33% the total return would decrease even more. Now you are learning about the power of money management, the most important part of active investment after compounding. Who is to say that a position size of 12.6% on one trade and 6.79% on another and so on, wouldn't provide better returns when sized according to specific well researched risk management rules? Why 10% per position?"

None of the providers' seem to make any mention of money management and portfolio management – they merely provide stock tips leaving investors to work out the most important and difficult part of active investment for themselves – position sizing and risk management.

Stone maintains: "At some stage active investors need to rise above the stock picking mindset to that of portfolio management and learn that an edge in the market is not based only on how many winners you pick but mainly on how large the winners are relative to the losers that you pick and how efficiently you turn over your capital to make profits from your re-invested profits, that is, compounding.

The point is that a good entry and exit system should provide money management processes that will keep an investor's portfolio capital allocated according to their risk management rules. Merely making the statement that they have taken trades which would have been impossible for an investor to fund with portfolio capital should not let them off the hook for misrepresenting past performance results."

Discussing the topic of active investment results cannot be complete without mentioning slippage. Slippage is the difference between the signal price and the price that an individual trade is transacted at. The shorter the term that the average trade lasts the bigger the affect that slippage will have. None of the 'providers' make any mention of slippage on their websites.

Stone: "In 12 years of trading systems design and many more in trading I have yet to find a system that will experience positive slippage over a statistically relevant sample of trades. This means that ASR's past performance will be even more difficult to emulate by those perusing their website.

Nojin's Invest4profit uses the next intraday traded price after the signal price as his recorded transaction price. This is ridiculous. Maybe a handful of his subscribers would achieve this. The majority would experience large slippage from his audited results."

On the topic of fewer transactions being recommended by certain providers Stone had the following to say: "Comments made by Nojin and Littlewood regarding their service being designed for every recommendation to be traded by their subscribers displays naivety about market liquidity. Especially if their specialty is at the micro-cap end of the market where the Rivkin Report has historically made its mark. A little arithmetic would help them and their subscribers understand the problem before they get burnt really badly in the market.

Let's look at a well known stock like Ten Network (TEN) and assume that there is a buy recommendation at \$3.40 which is emailed/SMS'ed to 2000 subscribers who have been advised to take every recommendation by their provider. Let's also assume that all 2000 subscribers decide to act on this recommendation. Because recommendations are few and far between they each decide to invest \$10,000. Some may do this on margin through a CFD provider. The total value of orders to hit TEN on the market would be \$20 million. That's fine until you become aware that TEN averages around \$4.7 million in traded value per trading day. Getting orders for around 30% of daily traded value would easily move a market let alone over 4 x the average daily liquidity for a stock.

Such volume could cause a stock to move many percentage points causing most subscribers to pay as much as 10% more than the signal price. The same would occur when selling. A person that is aware that such volume will hit the market may decide to act before the 'rush' to profit from the impending price move."

What other stocks would be affected? In Stone's view, all stocks listed on the ASX bar around 20 to 30 stocks would not have sufficient liquidity to handle such trading volume in one hit. "You can imagine how stocks with market caps of less than \$150 million trading a few \$100,000 a day would be affected."

Stone concluded: "These are simple traps that investors need to be aware of. Commonsense and learning will expose these traps, not more compliance. However, merely being aware of these traps will not ensure success in the market. More research, understanding and establishing of sound investing habits will be required.

Investors need to learn and understand that risk drives returns and is not merely a by product of the ongoing battle to get higher returns. Successful investors understand this and hence focus on the informed management of risk through money management instead of rate of return. The paradox is that the more that you focus on managing risk the better the returns that you will make over the long term. And vice versa, the more you focus on returns the worse you will do over the long term. Investors need to establish processes and decision support systems that focus on managing risk and the returns will take care of themselves."

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For further comment:

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ShareFinder is Australia's number #1 mechanical share investment solutions company. Founded in 1995 ShareFinder Investment Services began as one of the pioneer vendors of share market charting and fundamental analysis tools in Australia before becoming the only company in Australia that provides mechanical trading systems for their customers. Our flagship technical analysis product, Market Master, was developed by PrimeCharts who has been developing leading edge trading software since the mid 80's. Gary Stone has researched and designed proven long, medium and short term share trading methodologies for do-it-yourself investors.