Relative Strength at Work, Vol. 1: Apple versus NVidia

February 15th, 2017

Introduction

Last week we gave a brief overview of relative strength investing – how it works, why it works, and the peace of mind it brings to the decision making process. For those of you that missed it, a copy of that article can be found on our website here: Relative Strength Defined: How This Simple Process Can Change Your Life.

Admittedly, we made some pretty big claims:

1. That using relative strength can help an investor make more money *and* reduce the risk of suffering a large loss.
2. That this process can help with security selection by bringing investments to your attention that have increased odds of a profitable outcome.
3. That it can automate your buy and sell decisions so that you can spend more time living your life and less time fretting over what to do when surprises inevitably happen.

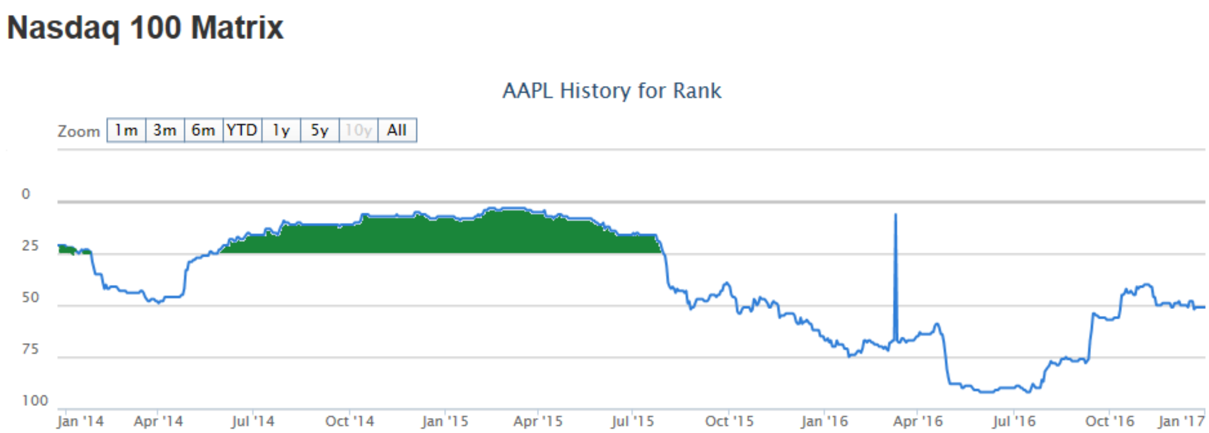
In this edition of 'Relative Strength at Work' we are going to have a look at how this process works when applied to Apple(APPL) and NVidia(NVDA). We are using Apple as an example of a popular, widely-held U.S. security, and NVidia as less well known, niche Technology company (they make graphic cards for computers).

What we want to determine is this: does using relative strength add value?

Let's find out.

Relative Strength Test Part 1: Apple

Below is a chart[1] showing Apple's relative strength within the Nasdaq 100 over the last three years (Jan 1, 2014 - Dec 31, 2016). As mentioned in last week's article, the chart simply shows how strong Apple's stock price is relative to the other 99 stocks in the NASDAQ 100. A ranking of #1 would indicate the Apple is the strongest stock within the index while a ranking of #100 means Apple is the weakest stock



We can see from this chart that Apple was showing strong relative strength for a brief period of time in Jan 2014 and a more sustainable period of demand from May 2014 to July 2015 (areas highlighted in green). Since July 2015 Apple has shown relative weakness compared to the other stocks within the NASDAQ 100 Index.

Remember, from a pure relative strength point-of-view, all we care about is:

1. We want to own stocks that are *in-demand*.
2. For a stock to be considered *in-demand* it has to get into and stay in the top 25th percentile of all the securities we are comparing it against.

So despite how much we may love Apple products, or believe in the long-term profitability of Apple as an investment, using this approach we would only be buying Apple once it gets above the 25th percentile, and we would be selling it if it drops back below the 25th percentile[2].

Following this systematic approach means we would have taken the following actions:

Buy Date	Buy Price	Sell Date	Sell Price
Jan 2nd, 2014	$79.38	Jan 28th, 2014	$72.55
May 20th, 2014	$86.39	July 31st, 2015	$121.30

If we had started with $10,000, using this approach we would end up with **$12,837**, or a 28% gain. So the period of time Apple showed relative strength (above 25th percentile) resulted in a respectably profitable outcome.

But more importantly, how did using this approach manage our risk of loss?

Apple fell below the 25th percentile on July 31st, 2015, signaling a lack of investor demand. In the ensuing 20 months, Apple stock continued to show relative weakness and the total return (ex-dividends) during this time period was -4%. In other words, the period of relative weakness (below the 25th percentile) was not a productive time to own the stock.

Think of it this way. We all have a limited amount of money to invest and we all have a limited amount of time to achieve our financial goals.

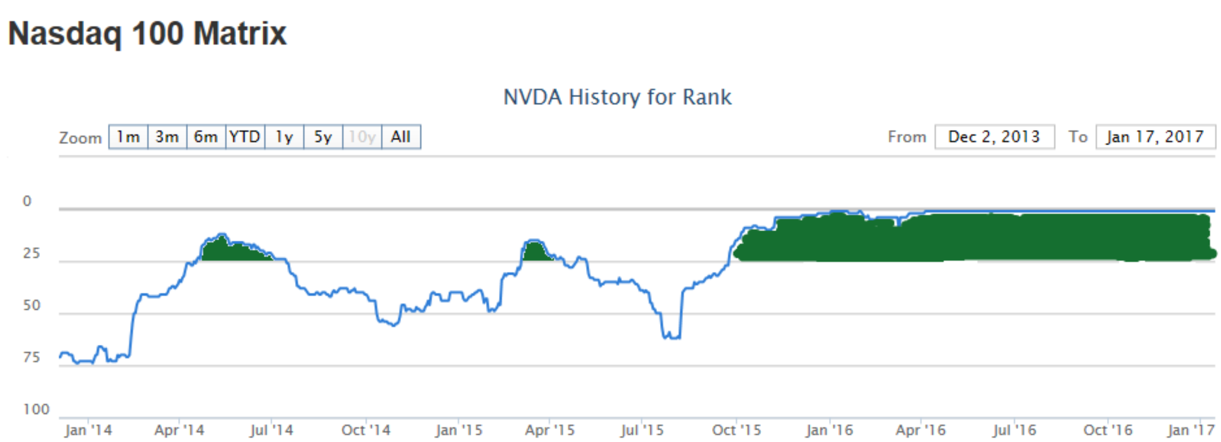
Using this simple relative strength strategy an investor could have achieved a 28% return in Apple during the 15 months it was demonstrably *in-demand* and avoided the -4% loss when Apple was *in-supply*.

Another reason to avoid owning stocks that are measurably i*n-supply* is to reduce opportunity cost.

What do we mean by opportunity cost? When we hang on to an underperforming investment it costs us *twice*. *Once* because of the loss on the investment we're holding, and *twice* because of the missed opportunity on the investment that could have been profitable for us, had we sold and reinvested the cash successfully.

Relative Strength Test Part 2: NVidia

Now let's look at NVidia using the same relative strength methodology.



On the chart above[1], we can see that NVidia had two brief stints over the 25th percentile (mid '14 and early '15) before the trend in relative strength became fully established.

Following the same simple investment approach we used earlier with Apple, we are going to buy NVidia when it gets above the 25th percentile (*in-demand*), and sell it when it drops below the 25th percentile (*in-supply*). The results are summarized on the table below:

Buy Date	Buy Price	Sell Date	Sell Price
Apr 15th, '14	$18.45	July 16th, '14	$19.35
Mar 5th, '15	$22.86	Apr 16th, '15	$22.49
Sep 24th, '15	$23.44	Dec 31st '16[3]	$106.74

In this case, our $10,000 initial investment would be worth **$46,959** – or a 370% gain.

Did using relative strength help us make money with NVidia? Clearly, yes.

Did it help us to manage the risk of loss? We would have experienced a -1.6% drawdown on the early 2015 position – a minor loss with a negligible effect on a diversified portfolio.

Did it help draw our attention to a company and an opportunity we'd otherwise be completely unaware of? Absolutely![(4)]

Conclusions

Using a pure, relative strength approach would have directed us to own Apple during its period of relative strength (capturing a 28% gain), and avoiding it during its period of relative weakness (-4%). We would also have fully participated in the 370% gain in NVidia, and despite the huge run we would still be owners of the stock today.

A few other observations to consider:

1. Both Apple and NVidia provided investors with a higher rate of return during the periods of time they showed strong relative strength as compared to when they showed relative weakness.
2. Using relative strength draws attention to stocks that have the potential to be one of the "Vital Few" instead of sticking with or buying investments due to product affiliation, brand recognition, or indecision-paralysis.
3. Your time and money are limited resources. Using relative strength helps focus your money into investments that have higher odds of working for you right away.
4. Using a relative strength approach not only tells you *what* to buy, it tells you *when* to buy it, and *when* to sell it. This forced buy/sell discipline prevents premature evacuation – selling a winner too soon because you can't resist the temptation to lock in the gain.
5. Trends, once established, persist. We can see two primary relative strength trends in Apple (one positive achieving +28% over 15 months, one negative losing -4% over 20 months), and one in NVidia (positive for 15 months returning +370%).

As we wrap up this 1st edition of 'Relative Strength at Work', we hope it helps illustrate how this unique and simple investment process can help you achieve your own unique and significant goals. Try it and see – it will help you to 'Make Every Year Count'.

Send us your questions and feedback – we'd love to hear from you. We can be reached at dcameron@pifinancial.com and jwoods@pifinancial.com, or Toll-Free at 1-877-405-2900.

Footnotes

(1) Chart created via Dorsey Wright and Associates.

(2) In reality, we don't buy securities just because they cross above the 25th percentile – since we are fully invested (when indicators are bullish), we would need a position to trigger a sell before we would have the cash (and a reason) to buy.

(3) We are using a sell date of Dec 31st as it represents the last day of the comparison period. There is no reason from a relative strength perspective to sell NVidia at that time.

(4) We bought NVidia in both our stock portfolios when the cash became available – at $28.66 in North American Growth and $47.22 in the Focus Stock Portfolio.

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