Relative Strength Defined: How This Simple Process Can Change Your Life

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Introduction

Our philosophy in making money is simple – buy what's working, avoid what isn't.

It sounds straight-forward, but does it work?

Will following this approach help you secure a comfortable retirement? Once achieved, will it protect as well as grow?

Our belief is that using a relative strength driven investment approach adds value in both identifying new growth opportunities and managing risk of loss.

In the past, we've talked about how we manage money in broad strokes in our newsletters, website, and quarterly commentaries. However, I sometimes feel that the elegant simplicity of a relative strength investment process doesn't get the credit its due.

So this year, I am committing to publishing no fewer than one article a month illustrating the practical application of relative strength investing; why it works, how it works, and real-life examples of the strategy at-work in our portfolios.

It would be easy to underestimate the value of what we are about to share – especially for more fundamentally driven investors. Sometimes it sounds too simple to work as well as it does. All I can say is that for the first 12 years of my investment career, I was a fundamentalist. Some years were good, some were not so good. Using a relative-strength investment strategy over the last 3-4 years has enabled Dave and I to achieve results that I believe would have been unattainable using my previous industry-standard investment approach.

So let's begin.

Why it Works

Back in Economics 101 I learned that prices are determined by supply and demand. If prices are rising, demand must be greater than supply, and we want to participate. If prices are falling, supply is greater than demand, as we want to avoid these situations. This rule applies to both the stock market itself and to individual stocks.

If the investment demand for a stock persists we will see the price go up over time, creating an uptrend. These rising trends have the potential to last for years at a time. Piggy-backing these strong uptrends are a simple yet effective way to generate large compound returns.

The difficulty most investors have with this concept is the 'how' part. *How* do I measure whether a stock is in an uptrend or a downtrend? *How* can I tell when supply is greater than demand and vice-versa?

The truth is there are multiple methods for doing so. We are not experts in all of them. We are, however, experts in the approach that we use (as we should be).

How it works

To implement a relative strength strategy in an investment portfolio, we first need to choose a universe of securities we are considering for purchase.

For instance, our Focus Stock Portfolio can invest up to 25% of its capital into stocks listed on the NASDAQ 100 Index. So the first thing we do is to put those 100 stocks into a pool for analysis.

Next, we compare each stock in the pool to the other 99 stocks based on a simple price-based metric (like trailing 6 month returns), and then rank them from highest to lowest.

We know from our research that the most important factor in capturing outperformance in any pool of securities is to stay in the top 20-25th percentile. In other words, we only care that the stocks we buy and hold are ranked anywhere from #1 through #25. It doesn't matter where the stock is ranked in the top 25, as long as it stays in the top 25 day after day, week after week, month after month.

If a security falls out of the top 25, it is sold and another position is bought from within the top 25. This process of monitoring, selling, and buying is how the portfolio is continually invested in the stocks with the highest odds of being profitable, as we are only holding them while they are *in-demand* (Econ 101 again).

I used to believe that I had to track all the fundamental changes related to the stock I was invested in – earnings growth, cash-flow analysis, merger & acquisition potential, government regulation, competitor risk, and so on.

In reality, all those inputs are already being assessed by a legion of analysts and professional money managers who are likely much smarter than I am – so instead, I learned to follow price. No matter what the research report says, investors can only do one of three things; buy, do nothing, or sell. These actions are reflected in the price of the stock, and over time, the price trend will tell you in an unbiased fashion whether it is *in-supply* or *in-demand*.

The Emotional Payoff of Eliminating Indecision

Our experience as money managers has been that incorporating relative strength into our investment strategy has significantly improved returns.

But in truth, there is a far greater benefit to this approach than pure profit.

It's peace of mind.

Managing other people's money can be a stressful responsibility at times. And there is no greater emotional turmoil than dealing with an investment that has gone bad. Should we wait and see what happens? Buy more while it's 'cheap'? Hang on and wait for the anticipated recovery (fingers crossed)?

What about the emotional stress of missing a big opportunity? How many investors have uttered regrets over "If I only I had bought more. If only I had known how high it could go."

Following a rules-based, disciplined relative strength approach eliminates indecision. We know our process doesn't work all the time, and are prepared for that. We know because we hold winners for long periods of time while they are working we can get some big wins every year. We know that because we sell our losers quickly we avoid the big losses. And the small wins and small losses simply balance out the mix.

And it's infinitely repeatable. We don't have to predict what oil will do this year, or gold, or technology, or health care, or the economy. Whatever the dominant trend is, it shows up in our research. And if all the dominant trends are pointing down, that shows up too.

Peace of mind. It's a beautiful thing.

Summary

1. Relative strength is a price-based investment strategy. Buy/sell decisions are based solely on how the price of a stock is behaving relative to the other stocks being eligible for purchase in the portfolio.

2. Our odds of success are improved by the fact we are only investing into companies whose share price is showing consistent strength compared to the available alternatives.

3. Our odds of suffering large losses are reduced, as stocks are sold while the losses are relatively small.

4. The whole process of investment selection and buy/sell decisions is 100% driven by rules – freeing us from the typical emotional distress of making decisions with incomplete information. We accept that we are always acting with incomplete information about the future. So rather than cling to a 3rd party expert opinion that confirms the outcome we are hoping for, we realize the most reliable choice is to follow what the market is telling us to do. It pays to be a good listener.

Next week, I will show our first practical example of the relative strength approach by comparing Apple (APPL) with NVidia (NVDA), and the huge financial benefit to using this strategy.

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CAMERON WOODS PORTFOLIO MANAGEMENT

Make Every Year Count.

Investment Managers

Jeff Woods, *CIM, B. Eng.*
Portfolio Manager

Phone: (250) 405-2917
Email: jwoods@pifinancial.com
Website: www.cameronwoods.ca

David Cameron, *CIM, Hon B.Sc.*
Portfolio Manager

Phone: (250) 405-2916
Email: dcameron@pifinancial.com
Website: www.cameronwoods.ca

PI Financial Corp. www.pifinancial.com

620-880 Douglas Street, Victoria, BC, V8W 2B7
Toll Free: 1 877 405 2900 | Phone: 250 405 2900 | Fax: 250 405 2911