Relative Strength at Work, Vol. 8: The Sweet Spot Revisited

June 21st, 2018

Introduction

Over a year ago I wrote an article entitled 'Finding the Sweet Spot'. The premise of that piece was that if you're trying to make money in the stock market, your best odds of success lie with investing in companies doing well (what we called the **sweet spot**), and avoid companies that are struggling (in the **pain zone**) or just getting by (**muddling through**).

In that article we suggested that using a relative strength filter would help us in our decision making process. At the time, we showed that using this approach helped to improve investment returns.

But were we biased? Did we purposefully compare those four stocks because we knew their past performance and it supported our claims?

It's a fair question – one that you should always ask yourself when presented with any kind of claims of success.

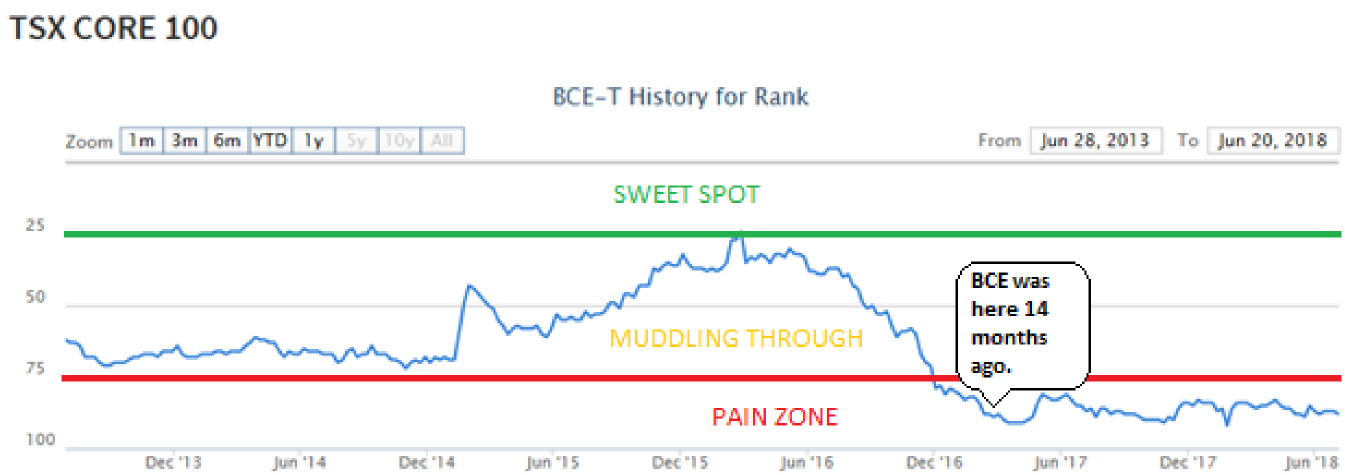
So let's have another look at those same 4 companies (BCE, Alimentation Couche-Tard, Cisco Systems, and Micron) almost 14 months later, and challenge the hypothesis that using this filter is as useful as we claim.

BCE

If you look where we ranked BCE in April of last year (see chart top of page 2), it had just entered the area we call the pain zone. Using only its share price relative to the other 99 Canadian companies in our Core 100 basket, BCE was a loser and a bit of a stinker.

Back then BCE's share price was $60.37. Today BCE is $53.98, about a -10% loss[(1)]. By comparison, the TSX Composite is up 3.8%[(1)] in the same time period.

So, the stock has been a bit of a disappointment. We know that, now. How could we have known this back then, so we could have sold and rotated the cash into something with better odds of a profit?

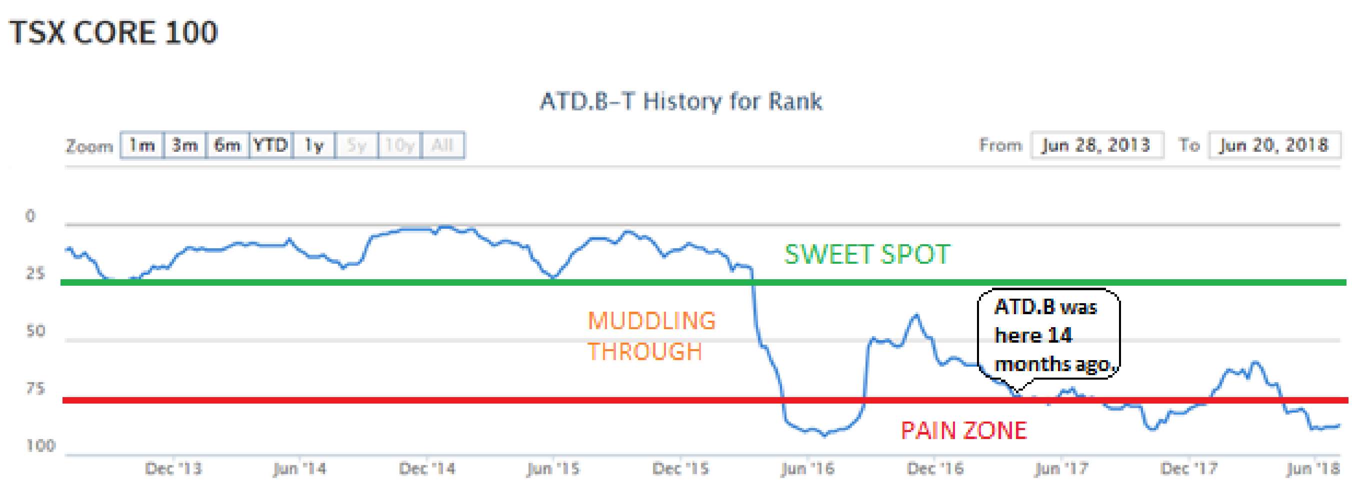


To wit, from last year's article;

"Find companies in the *sweet spot*, <u>avoid those</u> *muddling through* or <u>in the *pain zone*</u>, and good things will happen."

<u>Alimentation Couche-Tard</u>

Alimentation Couche-Tard operates Mac's and Circle K convenience stores (and others) globally. ATD'B's share price in that article last April was $60.83. From our perspective, the stock had left the sweet spot in April 2016 (after a very profitable 4 year run) and started to muddle through. Fast forward to today, and ATD'B is trading at $57.15. Not a disaster, by any stretch, but still an unprofitable outcome.



Again…

"Find companies in the *sweet spot*, <u>avoid those *muddling through*</u> or in the *pain zone*, and good things will happen."

Cisco Systems

Aha! Finally, something positive to talk about. Last April when we looked at Cisco the stock was trading at $32.95, and was smack in the middle of the muddle through zone (it was ranked 50 out of 100 stocks). You can see on the graph below that earlier this year Cisco did manage to briefly move into the sweet spot zone (a ranking of 25 or better out of the 100 stocks in the Nasdaq 100), but as of today it has not managed to stay there.

So was relative strength useful here?

Cisco today is $43.16. That is a total return of 31%, an impressive number compared to the results shown with BCE and ATD mentioned above. However, it may shock you to learn that the 31% return on Cisco is still only an average result compared to its benchmark, the Nasdaq 100, which gained over 33% in the same time period. Yes, relative strength is… relative.

In other words…

“Find companies in the *sweet spot*, <u>avoid those *muddling through*</u> or in the *pain zone*, and good things will happen.”

Micron

Last April we profiled Micron as a company in the in the sweet spot. At the time, it was $27.24 a share. Although the ride hasn’t been a smooth one, today MU is $59.44.

You will notice on the chart on page 4 that since our review of Micron last April, the stock has moved out and then back into the sweet spot a couple of times. A question then is whether the volatility in our measurement process affects the total return on the investment compared to a buy-and-hold approach?

For comparison, buying and holding Micron from last April until now would have returned 118%. By following our discipline and buying and holding Micron only when it is in the sweet spot (ranked 25 or higher out of a pool of 100 stocks), we would have earned 52.2% (2).

Why would we champion an investment process that, in this case, returned less than half of what a buy-and-hold approach would have returned?

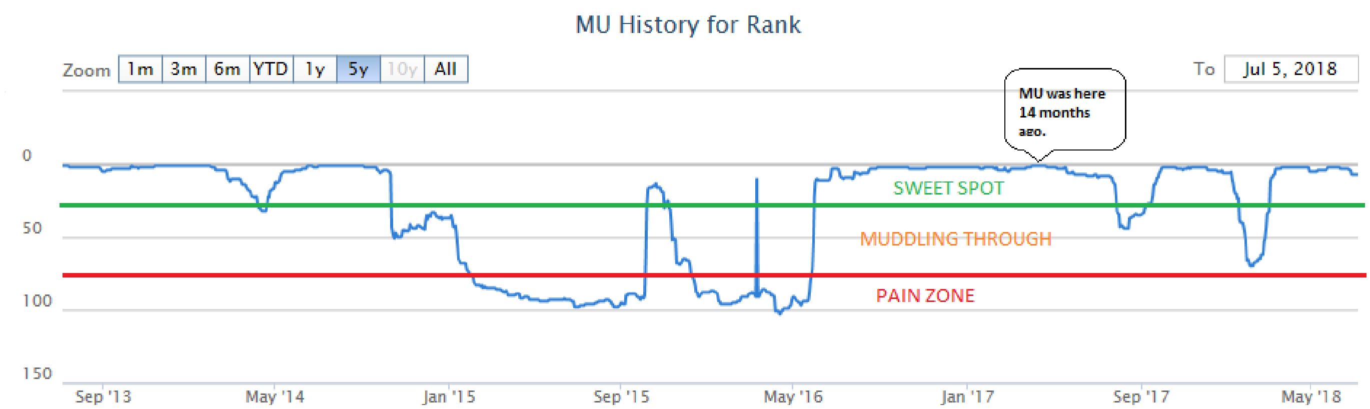
The answer is to manage risk. As important as making money is we're also trying to avoid losing money.

Every trend (and this is especially true of 'high growth' stocks) eventually ends. Dot.com stocks went up for years then flamed out and died a terrible death. Commodity stocks when up for years then they too flamed out. Homebuilder and Mortgage lending stocks … Energy stocks … Precious Metal stocks… you get the picture. Rinse and repeat, the themes evolve and change, but the behaviors stay the same.

The goal of our process is to earn an above average return and protect against large losses. Did we earn an above average return? Yes, 52% over 14 months, beating the Nasdaq 100 index return of 33%. Did we avoid any large losses? Yes, no losses here.

Do you own Micron in your stock portfolio? How about within any of your mutual funds – does Micron show up in the top 10 holdings? How did we know Micron could be a big winner?

Nasdaq 100 Matrix



As we've said before, we didn't know, for sure, but…

"<u>Find companies in the *sweet spot*</u>, avoid those *muddling through* or in the *pain zone*, and <u>good things will happen</u>."

Who always wins in Vegas? The House! Why? Because the odds, over time, are always in their favor.

It's your turn to be "The House."

Footnotes:

(1) Excluding dividends.

(2) In this example, we would have sold Micron every time it dropped out of the sweet spot zone and bought it back when it rose up into it. Returns calculated excluding transaction fees.

PI FINANCIAL
experience. driven.

CAMERON WOODS
PORTFOLIO MANAGEMENT
Make Every Year Count.

Have Your Cake and Eat It Too Investing

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