**Relative Strength** is the #1 investment return factor no one wants to talk about. The reasons are not entirely clear to me, but perhaps it is because it is too simple. It does not require a CFA to forecast earnings or to determine an economic model. It does not require a CPA to attempt to assess valuation. It does not require an MBA to assess strategic business decisions. In short, it does not play to the guild mentality wherein only certain "masters of the universe" have the elevated intellect, knowledge, and background to invest successfully.

Although relative strength is simple, I am not suggesting that it is easy to implement. Losing weight is simple too: eat less, exercise more. That does not make it easy to do. Relative strength, probably like most successful investment strategies, requires an inordinate amount of discipline – and tolerance of a fair amount of randomness. Like most games that are easy to learn, but difficult to master – chess would be an apt example – proficient use of relative strength also requires deep study and experience.

*“Simplicity is the ultimate sophistication”* – Leonardo da Vinci

Perhaps no investment method better exemplifies the virtue of simplicity than relative strength. You do not need a complicated, multi-factor quant model. You need only one piece of data – price --- and a robust measurement of performance. Then, buy what is performing and hold it until it is no longer performing. Simplicity!

There are critics who believe that relative strength is too simple, too naïve to work. They would prefer to analyze reams of data to try to determine (i.e. guess) what will happen next. Relative strength measures what is happening now. What is, is. We cannot change the past and we all can look forward to an uncertain future.

Strong stocks have outperformed weak stocks for decades.*** If the stock market were really a random walk, this would not be the case.

Managing a relative strength portfolio is not complicated. The challenge is emotional. In fact, this is the challenge with all investing. Volatility is a part of any return factor. It is because of volatility that investors can earn a risk premium at all. It should be embraced when it appears, rather than feared.

Successful investors need four abilities:

1: Interest in the process
2: Understanding of the laws of probability and a working knowledge of statistics
3: A firm grasp of financial history

Even if you have these first three, it will all be for naught if you do not have the fourth one

4: The emotional discipline to execute the planned strategy faithfully, come hell, high water, or the apparent end of capitalism as we know it.

***Academic research validating this statement available on request
What Are the Pitfalls to Using Relative Strength?

- **RS forces us to do what is unnatural**
  
  I have to say that many times when we see a relative strength change, either to positive or negative, it doesn't seem to follow conventional wisdom or the headlines of the day. In fact, there are many times in which you simply can't find fundamental reasons as to why a change is happening - but it is happening just the same. What I have found over the years is that the reasons for the change often become apparent much later; too late to capitalize on any movement in the markets. Of course it doesn't make for great cocktail party banter to say you sold XYZ because its performance was no longer keeping up to that of the market or its peer group. It sounds much more impressive to say you sold it because "the inventory numbers have decreased for the last two months and this was coupled with the decreasing order flow which in turn is going to mean these companies are going to have trouble meeting their earnings expectations ..." or something like that.

- **Hold Onto the Winners Long Term – Sell the Losers Quickly**

  Everyone likes to be right. If you are in doubt, think back to the last time you told your child they did something wrong. They will have a million excuses as to why they are right and you are wrong. Or, think back to the last argument you had with your spouse. My guess is that it only ended because one of you was willing to say, “I'm sorry” for the sake of homeland harmony and a warm dinner on the table, but really both parties walked away thinking they were right. It’s not different in the stock market. When managing a relative strength portfolio what we find is that only 55% to 60% of the trades will be “right.” That is they will outperform the market on a relative basis. It’s not so much the number of winning trades but rather the size of the winning trades that makes the biggest difference to success in this business; such as holding on to those 20% of the trades that turn into big home runs. Like owning Real Estate from 2000 to 2005 or owning Energy from 2002 to mid-2008. It takes tremendous willpower to hold onto that winning trade for the bulk of the run because whenever we take a small profit we are affirming to the market “we are right -- we won the argument.” Conversely, we don’t want to hold the losing trade in the portfolio because that drags down performance, but to book that small loss admits “we were wrong" and we’ve established that no one likes to do that. Adopting RS strategies, and coping with it over time, means coming to grips with the idea that it is okay to be wrong ... we are going to be wrong plenty, but it is NOT okay to stay wrong. This is why we find that 80% of the profits in a relative strength strategy come from just 20% of the trades. Those 20%, which we call outliers, will control your success in this business and RS is one approach that clusters those 20% in the positive territory.
Tough to Hold Course at the Turning Points

I have never seen a methodology that picks the exact top or the exact bottom. Maybe they exist and I just haven’t seen it or been exposed to it yet, it would stand to reason that such a strategy would be kept under lock and key somewhere safe. As for the Point & Figure methodology, it is a trend following system and is willing to forfeit the hard-to-catch tops and bottoms. The methodology is designed to find trends, and then stay with those trends as long as it is working for us. What signals us that a trend is no longer working is a period of underperformance. It doesn’t have to be a prolonged period of underperformance, but it must be a meaningful divergence from the broader market just the same. With the relative strength tools we believe we have struck an appropriate balance between giving back a little off the top (or bottom) and not being too trigger happy on each subtle move that allows us to identify important trend changes. That doesn’t mean turning points won’t be uncomfortable, and that is one of the "cons" to this approach, as this is when we find that relative strength portfolios tend to underperform. No strategy is ever going to outperform every single quarter. But the reason for the underperformance is a key component to picking a strategy you want to use. The underperformance in a relative strength strategy is due to the fact the portfolio is adjusting to new trends emerging in the market. While hard to do, the periods of underperformance and higher than usual turnover are typically the best spots to add money to relative strength strategies. Investors always want to get in on the “beginning of a trend” but are also often unwilling to commit to a strategy that has just endured a period of underperformance. In reality, the portfolio is typically not struggling at all, but rather adapting to the new currents of the market, but that doesn't make it fun.
• **Choppy markets are very frustrating**

As mentioned above, no strategy outperforms in every single market. It is important to identify when and why your strategy is going to struggle. For instance, if you are evaluating a Growth strategy this type of strategy is going to struggle during periods where Value is leading the charge. For strategies that concentrate in a specific style box, they could be out of favor for years at a time. In the aforementioned example, Value led the charge in the markets from 2000 to 2008, so choosing a strategy which concentrated on Growth would have likely struggled for an eight or nine year period. A Relative Strength strategy on the other hand is going to cross style boxes. When Growth is in favor the portfolio will contain more growth oriented stocks and ETFs and then shift to a Value focus when that asset class comes into favor. The Relative Strength strategy is nimble with respect to finding market leadership. This is an important key to the strategies success but it also helps us understand when to expect some underperforming quarters. Relative strength performs best in “trending” markets. Choppy markets, or periods of time when there are no consistent long-term RS signals, typically present tough stretches for any RS-based portfolio. Choppiness tends not to be sustainable over a long period of time though. Rather thematic changes will emerge with a handful of sectors or asset classes outperforming others and relative strength will seek out this leadership. Relative Strength strategies tend to perform best when there is a large differential between the best and the worst performing within your inventory. A look at the best and worst performing sectors each year shows that, on average, we see divergence of over 100% each year during the last decade. The difference between the best and worst performing countries is over 130% per year for the last decade as well. There are of course years when the differentials narrow but the long-term benefits of a relative strength strategy suggest that riding out these stretches is the proper course. The investor is typically more than fairly compensated as the model adapts in a systematic fashion, unveiling new trends after a period of choppiness.

• **Requires us to remain disciplined**

Who do you think will see the best results: Those that rush to the gym on January 1st to start shedding the holiday pounds, or those who are at the gym regularly throughout the year? Obviously, the latter will reap the benefits of disciplined behavior. This same concept can be applied to relative strength. It’s not glamorous going to the gym every day and grinding it out on the treadmill but that is what will keep you in shape. Relative Strength aims to build a portfolio that remains strong compared to the market over the long stretch, not just for the month of January. You will achieve the best results relative strength has to offer if you are consistently utilizing and implementing it. Again, it’s not for everyone. It’s not necessarily exciting because most often there are few changes to the portfolio (2008’s volatility was an exception), and when the changes come there are no fireworks, no TV reports on the sector or the commodity or asset class. It is the ability to day in, and day out, implement the system that leads to its success. It is so easy to be swayed by the barrage of information that comes at us everyday in the financial world. The news headlines are splashy, the videos and interviews are convincing, but in the end they aren’t proven to provide timely investment advice. 

“I stick to the playbook so my clients can S.W.A.N.”