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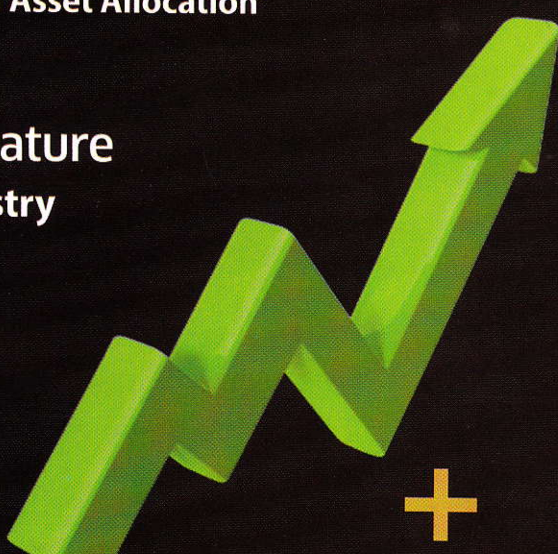

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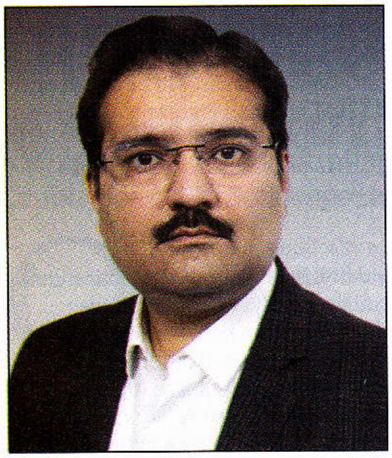


Milan Vaishnav
Technical Analyst and Founder of Gemstone Equity Research, Equity Research Asia and Chart Wizard FZE

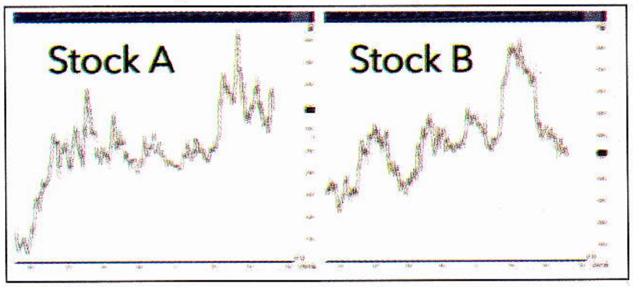
Outperform The Benchmark Using Relative Strength

A very simple and humble tool called relative strength indicators goes a long way in making your portfolio highly resilient in turbulent times and strongly outperforms in times of rising markets, says Milan Vaishnav, ***Technical Analyst and Founder of Gemstone Equity Research, Equity Research Asia and Chart Wizard FZE***

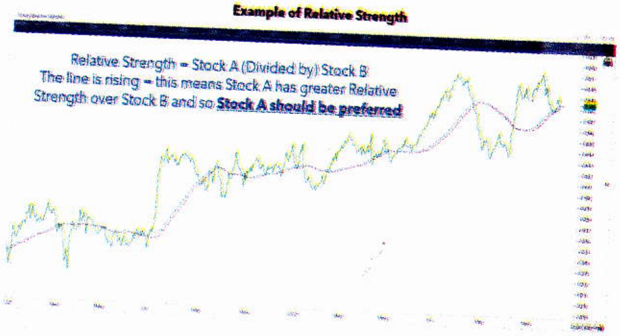
As an investor, have you ever wondered why the stock that you purchased with an anticipation of delivering higher returns resulted into a failed breakout? Have you ever experienced a situation where the stock that you have been invested in for a long period has not gained in line with the markets or a stock that you are holding has lost significant value while the markets have just consolidated? If the answer to the above question is in the affirmative, then perhaps you have missed out on looking at one of the simplest tools in technical analysis, namely, relative strength.

The concept of relative strength (RS) is pretty much simple: this is one of the staple tools from the toolbox of technical analysts. People often confuse it with Relative Strength Index (RSI), which is completely different altogether. Also known as the 'price relative indicator' or 'relative strength comparative', it is commonly referred to as 'relative strength line' or just RS line. The primary and basic use of this indicator is to compare two securities or assets with each other and one can use it to compare the performance of one index with another index, one stock with the index, one stock with another stock, etc.

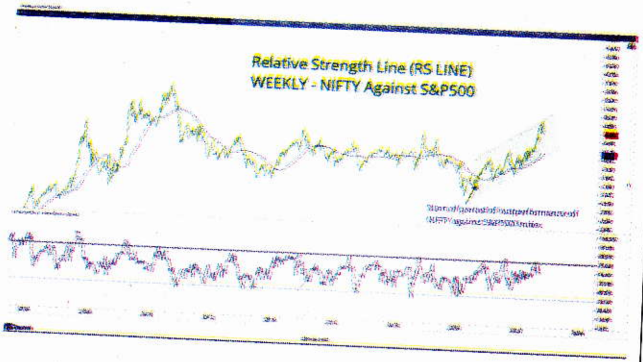
This indicator is used to determine which sector or stock is doing better during a broader market decline or if they are showing weakness when the markets in general are moving higher. The calculation of the RS line is simple. One can simply measure relative strength as follows: Relative Strength = Base Security divided by Comparative Security. For example, if one is faced with a choice of whether to invest in Stock A or Stock B, one can use this concept of measuring RS to decide which of the two stocks is doing better.



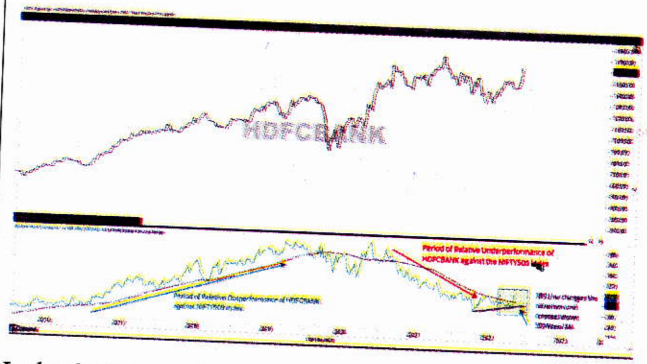
We would just divide the price of Stock A by Stock B and if the like is rising, it would mean that Stock A enjoys a strong relative strength and it should be bought instead of Stock B. Let us understand this with an example. If we are made to decide based on just the price chart of two stocks, A and B, it would be difficult to choose between the two stocks when it comes to buying just one of them. So, to help ourselves decide which stock to invest in, we will use the RS tool to compare the relative strength of these two stocks by comparing them to each other. To do this, we will just divide the price of Stock A by the price of Stock B. We get the following chart.



The RS line that we get after dividing the price of Stock A by Stock B is rising and therefore we would prefer to buy Stock A and not Stock B. What we saw here is a theoretical example. However, let us apply and understand this concept with a practical example. If a global investor is faced with a choice of investing in either Indian or US equities, he would definitely choose India over the US. This decision in hindsight becomes a lot easier as we all know that the Indian Nifty 50 has shown outright relative outperformance against the US S and P 500 index. However, the application of the RS indicator would have made this task even simpler.



The RS line of Nifty against S and P 500 shows how it changed its direction at the end of 2020, crossed above the 50-week MA, and has stayed in the upward rising trajectory. The beginning of the change of direction of the RS line gave us a signal well in advance that the period of outperformance of the Indian markets over the US markets has started. Comparing two instruments against each other remains the primary use of the RS indicator. However, investors can also use it for trend identification and analysis. They can subject the RS line regular method of trend analysis by identifying the direction of the move, spotting resistance and support, and also identifying the broader trend by applying a moving average of their choice to the RS line.



In the chart shown above, the trend identification and analysis of the relative strength line help us to understand the periods of relative outperformance and underperformance of the stock against the broader Nifty 500 index. It shows how between 2016 and 2020 the stock relatively outperformed the Nifty 500 index. It underperformed from 2020 until recently against the benchmark. Now, the RS line is seen reversing its direction and trajectory and has crossed above the 50-week MA and this would indicate a likely beginning of a phase of relative outperformance of the stock.

Conclusion

The majority of the time, this staple tool of technical analysis is often overlooked by investors. While making an investment decision in any stock, we fail to check if the stock is just doing well individually or if it is also performing better than the broader markets. Investing in a stock with a rising relative strength line with help you stay invested in a relatively outperforming stock. Finding a stock whose relative strength line is changing its direction from down to up and confirming a trend change will give an early indication of the initiation of a period of relative outperformance of the stock against the broad markets.

We all stay in a connected world. When there is a general weakness in the global equity markets, we have a similar weakness in the domestic equity markets as well. However, the major benefit of applying and regularly using relative strength analysis in day-to-day investment decisions is that it helps investors stay invested in much stronger stocks. Stocks that have a strong and rising relative strength advance more and do better than the broad markets when the markets are rising. More importantly, in declining markets, stocks having rising relative strength will show a lot of resilience to the weakness in the broad markets. Analysing relative strength must be made a habit.