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NBFCs

Investors can profit from the growth of NBFCs that are well-placed to benefit from India's growth story

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Special Report

RRG: Tool To Track Investments And Identify Opportunities

Chartist **Karan Bhojwani** explains meticulously how Relative Rotation Graphs not only help investors protect and book profits at the right time but also help identify in advance which stocks and sectors may do well

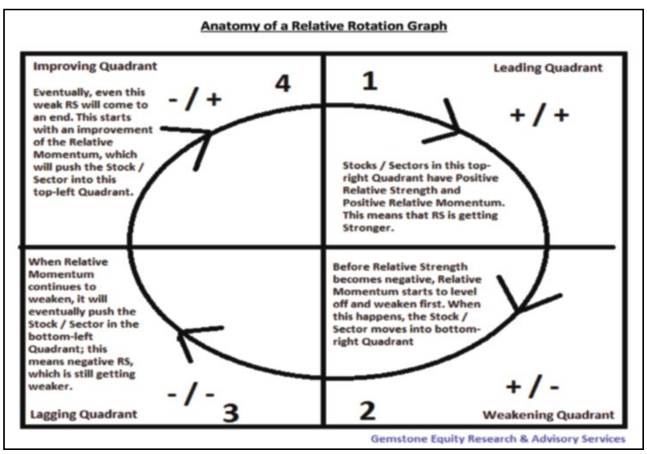
The stock market is a place where there are large number of stocks to choose from for trading or investment purpose. Also, there are numbers of sectors to choose from. Hence, the stock market becomes a jigsaw puzzle for traders or investors as they fail to draw the conclusion which sector or stocks are best for investment or trading purpose out of the huge universe of the sectors. Historically, we have seen that a particular sector may perform well during a particular period and it may be a leader, but the same sector may be a laggard in a next investment cycle. The latest example which comes to mind when we talk about leaders turning laggards is the pharmaceuticals sector. Since the year 2011, the pharmaceutical sector had saw a bull run and it outperformed the market hands down.However, since the second half of the year 2015, things turned gloomy with issues of regulators and inspections hurting the sector and, as a consequence, turning this sector a laggard. So as an investor or trader, it is important to understand when to rotate in or out of a particular sector, because in investing or trading it is important to be with the trend, since if you go against the trend you'll blow your account. So, now comes the critical question: how do you know when to rotate in or out of a particular sector? To help our readers understand the most crucial piece of the puzzle, we have penned down a special report which will give you an idea when to rotate into or out of a particular sector.

Traditionally, the concept of relative strength has been one of the most popular ways of determining which sectors are worth watching. Basically, the relative strength is calculated by taking the ratio of one security's price over another. We need to point out that this should not be mistaken with RSI—Relative Strength Index. RSI is a single security indicator which measures strength of that security against itself,whereas, RS—Relative Strength is used to measure the strength of two securities or Indices against each other. It compares two indices or two securities and, therefore, it is also known as "Comparative" Relative Strength. Another tool that investors often use is Momentum. This too is a single security indicator. The greatest drawback of using Relative Strength and Momentum analysis individually is that they study two securities at a time and this requires studying hundreds of securities for selection of investments. Further, this approach works only when one stock is analysed against the benchmark at a time. They do not compare more number of securities with a given benchmark.

However, trading has evolved and many experts have developed tools and methods to analyse this complex situation to determine what stage of the investment cycle we're in and to help allocate a portfolio accordingly. In the year 2004-2005, there was a model designed by Julius de Kempenaer named as Relative Rotation Graphs or RRGs, while working as a sell-side analyst for an investment bank in Amsterdam. Specifically, he was defied with two issues while delivering specialized/quantitative research on European sectors. To start with, institutional customers were considerably more interested in relative performance. Rather than directional forecasts, customers needed to know where to be overweight and where to be underweight in their equity portfolios. Further, these institutional customers confronted a huge data over-burden that made it hard to watch out for the comprehensive view. So, they required a tool that would obviously isolate the pioneers from the slow pokes. So Julius de Kempenaer developed Relative Rotation Graphs or RRGs to solve these problems with colour-coded quadrants, a ranking table and a feature that makes it easy to separate the leaders from the laggards.

WHAT IS RELATIVE ROTATION GRAPHS OR RRGS?

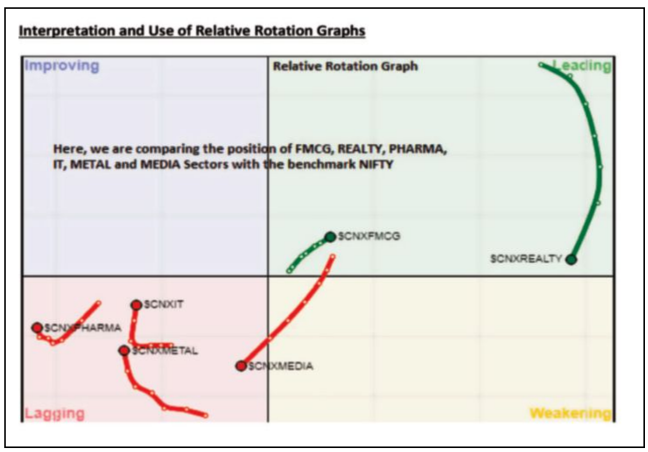
Relative Rotation Graphs or RRGs, as they are commonly called, are a unique visualization tool for relative strength analysis. Investors can use RRGs to analyze the relative strength trends for several securities against a common benchmark, and against each other. The real power of this tool is its ability to plot relative performance on one graph and show true rotation. We have all heard of sector and asset class rotation, but it is hard to visualize this "rotation" sequence on linear charts. RRGs use four quadrants to define the four phases of a relative trend. True rotations can be seen as securities move from one quadrant to the other over time.



Four quadrants are represented as follows:

1. Leading quadrant: A sector/stock in the leading quadrant has strong relative strength and strong relative momentum.
2. Weakening quadrant: A sector/stock in the weakening quadrant has strong relative strength but weakening momentum.
3. Lagging quadrant: A sector/stock in the lagging quadrant has weak relative strength and weak momentum.
4. Improving quadrant: A sector/stock in the improving quadrant has weak relative strength but improving momentum.

Milan Vaishnav, CMT, Technical Analyst at Gemstone Equity Research & Advisory Services shares his views on Relative Rotation Graphs or RRGs Investors often have options whether to invest or not to invest and stay in cash. However, for most fund managers and professional investors, not investing is not an option. At this point, focus shifts to "Relative Returns" from "Absolute Returns" and a fund manager or an Investor would often like to know, apart from directional forecasts, where should he be overweight and where to be underweight in their equity portfolios. Second, these investors face an enormous information overload that makes it difficult to keep an eye on the big picture. In short, they need a tool that would clearly separate the leaders from the laggards. This is precisely where Relative Rotation Graphs come into picture.



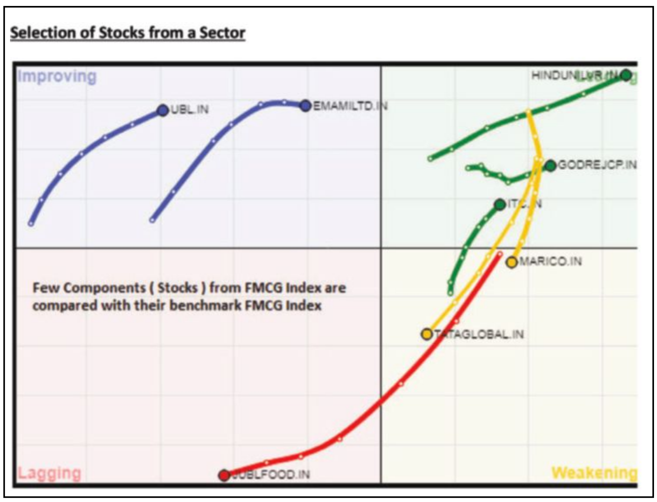
In this figure, we have compared six sectors – FMCG, realty, pharma, IT, metal and media with the benchmark NIFTY with a 6-week trial. The interpretation that we can have from the above picture is interesting. We see that both realty and FMCG sectors are in the Leading Quadrant of the Relative Rotation Graph. However, their trail or their trajectory will lead us to different interpretation. Realty, though it remains in the leading quadrant is very fast losing its Relative Momentum. In the coming days, it may move to the Weakening Quadrant, while it continues to lose Relative Momentum.

On the other hand, the trail of FMCG sector shows a positive directional bias. It shows that while Ratio/Relative Strength is positive, Relatively Momentum too is rising. So, even though both realty and FMCG sectors are in the Leading Quadrant, investors or fund managers will have to consider reducing positions in realty while continuing to remain overweight on FMCG.

We now see positions of IT and mediasectors. Again, both these sectors are in the Lagging Quadrant. However, given their trail, this too will lead us to different interpretation. The metalsector, as we can see, is steadily continuing to lose Relative Momentum. At the same time, the Ratio/Relative Strength too is weakening. Fund managers andinvestors may either initiate shorts or may continue with their short positions in the metalsector.

On the other hand, the IT sector is witnessing sharp improvement in the Relative Momentum and, in the coming days, it may see itself in top-left "Improving Quadrant" over the coming week. For investors and fund managers, this is the time to book profits on their short positions in the IT sector.

SELECTION OF STOCKS FROM A SECTOR



(Note: The above picture is only Illustrative and for the purpose of understanding only. This does not amount to stock-specific recommendation and should not be used for making any Investment related decisions)

Once an Investor identifies a sector on which he should be overweight, a logical question that arises is which stocks from the selected sector should he be bullish on.
The same principles that were used for selection of sectors will be used for selection of stocks too. In the above illustrative example, an investor or a fund manager can chose to remain overweight and increase long exposure in Godrej Consumer Products, ITC or Hindustan Unilever, while he would reduce his positions in stock such as Tata Global and Marico and even go on to initiate shorts on stocks like Jubilant Foods.

PAIR TRADE IDEA GENERATION:

RRG can also be used for pair-trade idea generation. The most obvious strategy is to be or to go long on the sectors or elements that are crossing into or have just crossed into the top-right quadrant, and to be or to go short on the sectors or elements that are crossing or have just crossed into the bottom-left quadrant.

The importance of the application of Relative Strength analysis through the use of RRGs is that it can aid investors at every level of the decision-making process, from asset allocation to selection of individual equities. Usually, the more active traders will use shorter timeframes, while long term-oriented market participants will want to use weekly or even monthly timeframes.

Fixed income investors can use RRGs to determine which type (government or corporate), region, or credit-level to pick, and on which part of the curve. Forex traders can use an RRG showing a number of currencies against a base currency to generate
trade ideas.

CONCLUSION:

RRG – Relative Rotation Graphs have time and again proved extremely useful tool to very effectively spot sector rotation. RRGs not only help Investors protect and book profits at the right time but also help identify upcoming sectors and move their investments to such sectors. They show which sectors are leading, which are losing momentum, which are improving and are likely to lead the next phase of rally.

In a way, we can say that RRG presents a Big Picture in One Picture. The biggest advantage of this type of visualization is that it shows the user the relative positions of all elements in a universe, not only against a benchmark but also vis-`a-vis each other. In this way, RRG serves as a monitoring tool that investors can use to monitor their universe or their portfolio and determine whether their holdings are still on track to outperform their benchmark.

Note: "Relative Rotation Graphs™" and "RRG Charts™" are registered trademarks of RRG Research.