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REVERSE RESEARCH WHITE PAPER

prodigy INVESTMENT MANAGEMENT

Invest well. Celebrate life.

Background

The conventional method of research essentially revolves around hosting a team of analysts who cover various industries or sectors from automobiles to media to pharmaceuticals, etc. These analysts provide in-depth and up to the minute information and analysis based on which investment decisions are made. This requires a vast number of expensive and highly skilled personnel providing 24/7 analysis of the coverage area. Even then, it becomes almost impossible to cover the entire market due to monetary or skilled resource constraints.

Unconventional approach

Reverse Research (RR) looks to go the other way around, by letting the Market define, based on proprietary indicators and screening, the research coverage area at a point in time and thus indicating a revolving coverage of a finite number of scrips and sectors that the system defines as worth researching for a given time frame. While this approach sacrifices bottoms and tops, it compensates by ensuring that no significant scrip or sectoral move occurring will go unnoticed, giving the RR team the signal to proceed with the next stage of research which may be then done in the conventional manner.

While from the second stage research may be conducted in the conventional manner in which business and scrip analysis is done, RR believes that analysis needs to be conducted in an optimal fashion, that provides enough data to make a buy or sell decision, and that more research is not necessarily better research. In fact, RR believes that too much analysis, and extremely close tracking of businesses, actually results in the loss of objectivity, and the weakening of the researcher's ability to take a contrarian call on the business. This approach allows for compact teams to cover the entire market, as the coverage area keeps evolving.

Separating 'Noise' and 'Signal'

At the heart of RR is the use of proprietary price based indicators founded on Secular Relative Strength Comparatives and Moving Average based studies that in essence signal when long term trends in certain scrips or sectors have formed, and the reason behind which will now be worth understanding. Further screening produces what is 'noise' and what is 'signal' to make up the coverage pool.

RR has used the philosophy of Ed Seykota, Gerald Loeb, Nicholas Darvas and the CANSLIM process of William O' Neil as the foundation of this methodology. This philosophy espouses that it is necessary to accommodate what the market and individual scrips tell us about itself at every point in time in forming an opinion about the future.

Any experienced trader knows when a sector or scrip is outperforming. But when does a spike become an actionable signal? At what point does the outperformance become secular in nature? The system removes the uncertainty, and help convert intuition into a process.

We all have prejudices. Often we can subconsciously see what is happening, but we choose to ignore the same due to preconceived beliefs. The system helps to overcome these biases by capturing the signal in a formal report. The truth is there in black and white, now we can choose to act or ignore.

Part Technical, Part Fundamental

The first part of RR is a pure trend following system. It is the second part that makes it fundamentally oriented as well and gives it a unique character. RR does believe that the ability to create and hold onto large positions, for the larger move, in the face of volatility, increases with a reasonable understanding of the fundamentals.

Ed Seykota has said 'Money is ultimately made by being on the right side of a trend', and this is true, no matter which school of investing you belong to. So how does one determine what is a trend? Conventional technical analysis would look at trend lines, moving averages, supports and resistances. RR looks at the same studies but on its proprietary Relative Strength Comparative (RSC) indicator, which is the most powerful tool of understanding where the 'action' is.

Systemic and Non-Systemic Strength

Every price action comprises two elements, the 'systemic' or market strength; and the 'non-systemic' or intrinsic strength. Systemic strength is the force that pervades the entire market, 'the tide that lifts or lowers all boats'. Non-systemic strength or intrinsic strength is the force of the fundamentals (or expectations) of an individual scrip or sector that creates its own up or down move, independent of the market strength. RR looks to separate the two, suppress the systemic strength (noise) and extract the non-systemic strength (or weakness) and act on that 'signal' alone. Our RSC indicators study the market over daily, weekly and monthly degrees to determine where the 'signal' is favourable. The larger the degree (timeframe), the stronger is the 'signal'. It is from this pool that the scrips to be researched further are picked up based on recent earnings, liquidity, general environment, corporate announcements and analysts' projections.

RR will often make an initial entry at this point itself if the signals so demand, as markets wait for none. Research takes time to reach a firm conclusion, and the next entry (or position reversal), or allocation size is adjusted subsequently based on the research results.

Market Direction of Paramount Importance

While this is the work done at the scrip and sector level; as the early proponents of this method realized, ultimately one cannot go against the larger force of the market itself. No matter how strong the intrinsic strength of an individual sector or scrip, if the direction of the market itself is strongly in one direction, it is safer and sensible to not go against the market direction. Thus, for a long only fund, if the secular market direction were down, it would make sense to not go long, even if the individual scrip suggested so. There will be exceptions to the rule, but this would be the general thought process. Alternatively, if the signal and the research suggested going long, the position size could be adjusted to accommodate the discord in the market direction. So, if the broader market trend is secularly down, then RR would try to create cash, size positions to half their normal size and in general downplay all 'buy' signals from the system. The indicators used to determine market direction are convention studies such as moving average convergence divergence, fifty day moving average, two hundred day moving average etc.

Reversion to Mean

Reversion to mean is a powerful and ubiquitous force. It is nature's way of keeping things in balance. Essentially this means that over time all things return to their long term average. All indicators need to be read in the overall context in which they occur, that is, all things considered. Thus, the RSC of a scrip can be a risky signal if it occurs when the scrip is too far away from its long term averages. The RSC can then actually be a trap, as should a correction occur, these scrips may actually become the most vulnerable to reversion to the mean and outperform on the opposite side. It is therefore better to adopt a conservative approach and ignore fresh RSC highs that occur when the scrip is more than approximately 50% above its 200 EMA.

Risk Management

As with any system or methodology in the market, one has to always account for the failure of the signal. RR has separated the risk management function from that of the Chief Investment Officer (CIO). Thus an independent desk monitors the loss of strength beyond a predetermined level, the weakening of the overall market or scrip direction, the breaching of predetermined price levels. As far as possible, RR prefers not to work with rigid stop loss levels, but, rather with levels that adjust to the environment. However, once a reversal is triggered, the Risk Manager can independently exit the position. Conversely, RR sets parameters beyond which fresh participation in a matured move is prohibited.

Relative Strength as a Lead Indicator

Experience tells us that ever so often price captures the collective market wisdom well before the same becomes evident in newspaper headlines. Almost always market leadership changes with every cycle. It becomes extremely difficult for even a team of analysts to capture which scrips and sectors will form the leadership in the next up move, because so often the same is hidden by the market volatility and media noise. However, by being able to suppress this noise and neutralize the market volatility, the RSC indicator is able to capture those spaces in the market where secular relative strength is emerging, and like a magnifying glass, focus the organizational resources on those sectors alone, to the exclusion of sectors not participating.

While RR seeks to work in the 'now' and avoids being predictive, in our humble opinion, relative strength works as an excellent lead indicator of the ensuing price action in a scrip. The logic for this is that any scrip possessing intrinsic factors that create an up move, be it a change in earnings trajectory, changes in the regulatory environment, favourable raw material prices, corporate developments etc., almost immediately witnesses the activity of insiders, management associates or by 'smart' money, who are the early movers striving to take advantage of the developments before 'public' awareness catches on. This demand results in the scrip displaying intrinsic strength which gets captured by the RSC. In conditions of gloom and volatility, the scrip begins to fall slower than the market fall. The adverse sentiment acts as a leash on the scrip, as the uninformed public sell to the insiders. Once sentiment turns, the selling lifts but the demand persists, unleashing the scrips upwards. Darvas said, 'an insider is an insider till he acts on his knowledge. Once he does so his actions become evident to all, and he ceases to bean insider'. The RSC is a wonderful tool to detect insider activity.

Using the RSCs as a First Check

Often we receive information or a research report about a scrip from contacts. The RSC provides a good first check as to whether or not one should proceed with the idea or not. Even if the information is solid, one does not want to be too early into an idea, and then wait for the move to start, if at all. One can do the research and be ready, if one likes, pending the signal from the RSC. This way, one can ensure that one's funds are at work at all times in performing scrips. In an ideal situation, an investor would have coverage of a certain number of scrips, but would hold only those where the RSC was in 'active' mode.

Types of RSCs patterns

Out of all the RSC patterns we have studied, the Lifetime High is the most powerful. We define life time as ten years. We have found these to be excellent long term buy signals for the investor who has a buy and hold type of philosophy, with low churn. Interestingly, all multi-baggers have rung the bell on the lifetime RSC reasonably early in their moves, before proceeding to run and run.

RSCs that break out of narrow consolidation patterns are also excellent guides to impending price action. We have also obtained good results using moving averages of RSCs to signal directional change. We need to distinguish between 'active' and 'passive' RSCs. 'Active' RSCs are those that are accompanied by price change in the same direction, with good scrip volume. 'Passive' RSCs are those that result from the scrip price not moving in the direction of the market, but displaying little change, with low volume. 'Active' RSCs are what we consider. We ignore passive RSCs.

System Back-Testing

No system should expect to produce favourable outcomes unless it is back-tested, and the results of that back-testing are positive. We have back-tested the first part of our system and risk management processes over the period 2000 to 2009 with favourable results. We would be happy to share our RSC based screens, indicators and risk management processes as we believe external inputs can make our system better.

System Extension to Indices, ETFs, Geographies and Asset Classes

We have also applied the system to all the Sectoral Indices on the BSE and the NSE, as well as the Mid, Small, narrower and broader Indices to determine which parts of the Market are displaying secular strength or weakness. This provides yet another slice or view of the Market to examine.

George Soros said that currency is the existential choice. We all have to hold our assets in a certain currency. We have thus started applying our system to different asset classes such as USD, Gold, World indices etc. to capture the existential element of our assets.

This thinking can also be extended to commodities. The change in the sugar and tea sectors was reflected in Sugar and Tea stocks, which had begun to secularly outperform in early 2009, well before the markets turned.

While we may not be able to easily invest overseas or change the currency in which we hold our assets, yet we can understand when equity assets are no longer the best choice and shift out of the same. As Jesse Livermore said, one doesn't have to be in the market always.

More than Half the Battle

In our opinion, knowing what to research is more than half the battle. Getting the idea to the desk to research is always the bigger challenge, as resources and time are finite. Doing research is also not difficult for an experienced researcher. Often, in the first fifteen minutes of a management meeting, we become clear as to whether or not an idea is investment worthy.

To build a machine that throws out ideas regularly and captures the underlying shifts in opinion is a huge advantage. Or to have a small pond, in which one can go after big fish.

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