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Richemont (CFR)

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Trading opportunities are abound, provided one knows where to look and how to take advantage of such opportunities. Thus, finding a particular trading idea is actually not the hardest part! There is a plethora of trading ideas doing the rounds, whatever the cost. Importantly, trading strategies need to be back-tested. The fundamental question is how does one identify if there is an opportunity around a particular stock? Highly profitable trading strategies take advantage of few basic stock market phenomena. Generally, stock prices and returns evince three main attributes that define their "behaviour". Stock prices and their returns would broadly be governed by; mean reversion, some random walk and therefore an indiscernible path of a particular stock and momentum/ trending behaviour. Mean reversion implies that returns are anti-persistent, while trending returns point to a persistent pattern. On the other hand, random returns display some degree of "independence". Truly, participants are spoiled for choice! The question may well arise; where to from here? As usual, EAR takes the road that is less travelled by! To carefully examine return series behaviour, EAR applies the Hurst Exponent (H). As mentioned in the January 2017 Fixed Income Report and subsequent Equity Research Notes, an H of less than 0.5 suggests that returns of stock prices revert to a particular average; an H that is equal to 0.5 suggests that the returns are random in terms of their behaviour and an H of more than 0.5 suggests that the returns tend to reflect some trend (upward or downward trend) and therefore there is some momentum underlying the stock price. When the returns are trending, the stock price would display an upward/downward trend (sometimes referred to as positive or negative dependence) "for some time even though such a trend can be interrupted by some violent shock/noise to the system. Long only (or long term) investors would appreciate persistent positive returns, whilst those who short sell a particular instrument would prefer persistent negative returns.

In EAR's screening of the Top 40, Richemont evinced some trend in terms of its daily returns for the month of March and the first few weeks of April, with an H of 0.52 on its returns. Admittedly, the degree of persistence was not excessive. For investors who trade on some momentum, Richemont's returns were trending between March and April, although the trending returns were accompanied by some significant excess volatility. In modelling parlance; the fractal nature of stock prices was, at times, prominent with regards Richemont's returns. On average, the trending daily returns worked in favour of long only investors most of the time throughout the observed period. Therefore, there was some degree of positive dependence. In drilling further down to understand the behaviour of the returns over the observed period, EAR's analysis suggests subsequent returns were not recurring as these differed from preceding returns. This suggests that each return over an observed period was different from the preceding one. However, it was observed that the daily returns ranged between of -2.5% and 5%. As a Rand hedge investment, Richemont's stock price was strongly correlated to major currency pairs as well as the gold price. However, the returns of these major currency pairs and the returns of the gold price were not strongly correlated to Richemont's stock returns; this suggests that major currency pairs' returns and gold price returns were not the key driving factors behind Richemont's stock returns. Therefore, the persistence in returns might have

been generated by a herd like behaviour of investors.

What Then?

The notion of regime switching is somewhat basic to financial markets with concerted efforts to predict bull and bear markets. Narrowing it down, momentum trading strategies would ideally search for some "turning point" which would characterise some reversal of a persistent trend. The modelling of "regime switches or shifts" can be enhanced by conditional volatility models or the broader Bayesian probabilistic modelling framework. Momentum can be generated by some "relaxed diffusion" of information and this can be observed in the returns' series behaviour. In some instances, a momentum strategy could be due to some Post Earnings Announcement Drift (PEAD) which was not the case for CFR. For EAR, the type of dependence that was observed is considered important (i.e. important dependence), hence the application of the "*filter rule*". In its simple form, a filer is the change required in the price of a stock that would inspire trading action (i.e. short or long). In essence, we are searching for entry and exit points. Even so, how "low" is low and how "high" is high? EAR's approach excludes trading size and transactions costs. The approach entails the modelling of different "filters" so as to determine the indicative turning point. In responding to the question of how "low" is low and how "high" is high; EAR would "consider going long on Richemont if the expected filter is lesser than the immediately preceding trending return by some expected threshold filter. On the other hand, consider bucking the trend (short sell the stock) if the expected filter is higher than the immediately preceding trending return by some threshold filter. Currently, EAR's intra-day "filtered" call (for the subsequent trading session) on CFR is a short sell under various filter thresholds. Be that as it may, an intraday filter threshold of no less than -0.02% could indicate a trigger to go long on this stock, more so if this transpires during Monday (24th April) morning's trading session. Such a regime switch would require well thought out stop loss levels. This does not constitute a trading advice as this is EAR's view!

Table 1: Filters for the Week Ahead (CFR)

Indicators	Normal Trading Conditions	Trade Direction	Noisy Market Conditions	Trade Direction
Turning Points/Signals	-0.50%	Long	-0.96%	Long
Filter Thresholds	-0.80%	Long (Tight Stop Loss)	-1.40%	Long

Source: Bloomberg and EAR's Workings

Table 2 Filters for the Week Ahead (CFR)

Indicators	Normal Trading Conditions	Trade Direction	Noisy Market Conditions	Trade Direction
Turning Points/Signals	0.50%	Short	0.96%	Short
Filter Thresholds	0.80%	Short (Tight Stop Loss)	1.40%	Short

Source: Bloomberg and EAR's Workings

Tables 1 and 2 present different EAR's multiple filters under different "trading regimes". Such filters could very well transpire during various intraday trading sessions. All the same, such high filters were modelled on the basis of end of day (closing) prices. Under what we classify as mellow/normal trading conditions; the resultant signal filter of-0.5% triggers a long position on CFR. Under the same trading regime, filter thresholds of around 0.8% would trigger a short position and this would require some prudent risk management approach; amongst others, tight stop loss levels. Positions that are informed by the 0.5% filter may be complemented by a comprehensive expected risk to reward ratio peculiar to the position. CFR returns were far from following conventional assumptions of being characterised by some "white noise". Thus, the expected path of future returns is characterised by some huge random shocks which could lead to excessive returns or losses. Such huge random shocks constitute "noisy trading conditions". It is under such trading regimes that filter signals of 0.96% would indicate a shout for a short position. Filter thresholds of around 1.40% may be considered with vigilance and maximum drawdowns and drawdown durations could complement that particular trading idea.

Conclusion

There is a lot to trading than meets the eye! Be that as it may, the journey can be stimulating and some of the lessons would require an individual to personally enrol to this thrilling game and not rely on far-fetched gimmicks. This is the first of EAR's trading notes.

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