TRADE of the MONTH

In some investments pairing two shares helps reduce the risk

Shorter-term trading is mostly a lot more risky than longer-term investing. One way to mitigate the short-term risk is to "pair trade". This entails equal nominal exposure to two stocks that are trending in opposite directions.

Given the uncertain nature of things at the moment, and the potential for the rand to keep weakening, IM has looked into the JSE's financial sector for potential short setups.

The reason for scouring this market is that if the rand continues to slide, financials will most probably suffer.

The standout stock for the "short" part of the pair is life assurer Sanlam, which also controls short-term insurance business Santam.

To balance that risk out, IM looked at the top performers on the market for potential longs. The top performers tend to be companies that do not really have any correlation with the rand and have large moats (margins of safety) around unique business models.

One of the few stocks still making 52-week highs fairly regularly is specialist financial services counter Transaction Capital. This company, which has built a viable business providing financing, insurance and other services to the local taxi sectors, is one of the few on the JSE about which directors are confident enough to pencil in double-digit growth.

IM has been a fan of this firm for some time and believes it is a fantastic business – so much so that for the "long" leg of this trade it will be best to take an ungeared position, in other words to have no futures or contracts for differences (CFDs). Just plain old vanilla equity.

Looking at the chart, IM would urge readers to note the trending outperformance of Transaction Capital versus Sanlam (it can be seen in the indicator beneath the price chart). But now might not be the best time to enter into this trade, even though the trending outperformance is clear.

Transaction Capital also recently broke out of a bull flag formation and, perhaps, more importantly, is in a strong uptrend. It is the kind of stock IM is happy to hold for long, as we believe in the growth prospects of this business over the long term.

Looking at the short leg of the trade, Sanlam, two charts appear noteworthy.

The first indicates a head-and-shoulders formation that targets the bottom of a range Sanlam has been trading in for a long time. At this stage it is difficult to know whether the range will break lower, though the setup to the lower end of the channel is encouraging.

The second chart shows the relative position of the two shares. One can see on this chart that Sanlam is underperforming Transaction Capital. Again, investors could perhaps wait for a bounce in Sanlam or a pullback in Transaction Capital if they want to time this entry perfectly. But the longer-term relationship is clear.

There are two ways in which this trade can be played.

The risk averse way: This would be to wait for the relative position of the two stocks to pare back a bit and then to enter the trade – in other words to wait for Sanlam to rally to about R80 and for Transaction Capital to come down to about R23.50. At those levels it would be a great entry for investors and a position that could be held for a few months.

The very risky way: If patience is not an investor's virtue, he or she could try to go short on Transaction Capital and long on Sanlam until the levels mentioned above are reached, and then to reverse the trade to go short on Sanlam and long on Transaction Capital (which is the trade we really want to be in).

Investors could strike the same idea twice in opposite directions if they are agile and disciplined enough.

This route is a lot more risky, and not advisable for novice traders to pursue. The best course of action for them would be the risk-averse approach, which may work out well even if there are a few tense moments initially.

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