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Momentum Investing at Momentum

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Last week my colleague Gary Moglione shared his thoughts on the advantages of adopting a contrarian stance or going against the crowd when it comes to investing, which can be very rewarding if investors can exercise patience and take a long-term perspective. This approach is commonly referred to as value investing, where the underlying concept involves seeking undervalued assets. However, there are other approaches to investing which can also generate strong returns if you have the required skill set and mentality. Simply put, the converse of the contrarian approach is known as momentum or growth investing. Both investment styles aim to harvest factor risk premia, whether it be value or momentum. Over the long-term, both approaches have generated above market returns but they are cyclical in nature. For instance, in 2021 and 2022 we saw value outperform its growth counterpart, while in 2020 and for most of the previous decade we witnessed phenomenal performance of momentum and growth stocks. So, which approach should investors adopt?

As with all equity styles or factors there are multiple approaches to momentum investing. The most basic is price momentum. Price momentum involves buying stocks that have already experienced price increases based on the belief that stocks which have performed well in the past will likely continue to perform well and vice-versa for underperforming stocks. This strategy is effectively buying past winners and selling past losers – fairly straightforward.

The other common approach to momentum investing is to focus on company fundamentals, such as earnings growth. The emphasis on growth is the reason momentum investing is often used interchangeably with growth investing. Typically, these strategies look to identify companies with sustainably high earnings that are also growing at an accelerated rate. These companies would also tend to exhibit positive earnings surprises or revisions.

The momentum risk premium or the momentum effect is well documented and has been around for decades. Momentum investing challenges the conventional wisdom of the Efficient Market Hypothesis (EMH), which broadly states that stock prices at any given time should reflect all publicly available information and assumes that all investors are rational, meaning that garnering additional returns is nigh on impossible.

However, this belief in efficient markets doesn't hold, as this type of strategy has proven to reward investors with above market returns consistently over the long-term.

Why does it work? Many explanations are offered for why this phenomenon exists; however, most can be explained by behavioural biases. Investors either overreact or underreact to information in a way that is remarkably consistent through time. The underreaction effect causes information to take longer to be fully priced in, as analysts fail to revise earnings forecasts sufficiently in response to new information. Overreactions to market events can result in excessive declines in prices following bad news, while underreactions lead to miserly increases following positive news.

The so-called disposition effect is another popular theory – it says that investors' fear of potential losses causes them to sell winners too early whilst holding onto losers longer in the hope of an eventual recovery – this relates closely to the concept of loss aversion. Lastly, herd mentality or fear of missing out (FOMO) is another phenomenon which can spur stock prices to gather momentum, as investors jump on a rapidly rising trend, something we've seen recently with AI-related stocks.

Momentum investing often sounds simple to exploit, but in reality, it is a highly nuanced strategy with a high propensity for crashes. This added risk is another reason cited for momentum investing's success: it is a reward for accepting higher levels of risk. Identifying trends and catalysts in stocks requires skill and experience – but it is equally important to recognise when the momentum or trend has waned, as knowing when to exit positions is crucial to capturing the full momentum effect. It is therefore operationally challenging due to its inherently high turnover nature, hence not one for the novice investor. We advocate gaining exposure through third-party specialists and we have invested with some of the best momentum and growth managers for many years.

As with any equity style or factor, there are better and worse times to adopt a momentum strategy, but, in our view the best way to ensure a smoother investment journey is to hold a blend of different styles through the cycle.

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