

The Momentum train

Weekly Digest

5 March 2018

– Stephen Nguyen, CFA

Regular readers may remember that my last blog entry talked about value investing. The time before that I spent some time discussing quality investing. So, to round things off, I thought I would share my thoughts on momentum investing (not to be confused with company name and brand).

Last week, London was hit by the ‘Beast from the East’, that brought with it unseasonably low temperatures. Predictably, transport ground to a halt in the face of a few centimetres of snow. Snow is a useful analogy for momentum investing: imagine a snowball rolling down hill, gathering more snow as it goes, which in turn causes it to roll faster, and so on. In the same way, we observe virtuous cycles in companies’ performance: i.e. winners keep on winning.

As with most styles (or factors), there are various approaches to momentum investing. The simplest approach is price momentum. Rather than the intuitively appealing option of buying something that has fallen in price (and therefore ‘surely must go back up’), price momentum involves buying things that have already gone up in price “buy high, sell higher”. The other approach to momentum investing is to focus on company fundamentals, principally earnings growth; one is looking to identify companies whose earnings are growing at an accelerating rate, twinned with positive earnings surprises/revisions. Typically most momentum strategies pay attention to both of these factors. The emphasis on earnings growth is the reason why the name ‘momentum’ investing is often interchangeable with ‘growth’ investing.

Why does this style of investing work? The answer lies in human behavioural biases which are remarkably consistent

through time. The phenomenon can be explained firstly as an under-reaction effect: information tends to take longer than expected to become fully priced-in due to anchoring and conservatism by investors. We also observe herding among investors as a result of ‘FOMO’: the fear of missing out. Awareness of other peoples’ success can spur investors to jump on the back of rising trends and a natural propensity to extrapolate a trend further into the future exacerbates the effect on winning stocks to keep on winning.

The momentum premium can also be explained from a risk based perspective. Risk based arguments posit that the extra return is compensation for taking on the additional risk associated with momentum stocks which are typically deemed to be more volatile and carry a higher propensity for crashes. Both are plausible and intuitive explanations for the momentum effect. What is more important to the ‘practical’ investor however, is that this phenomenon has existed in financial markets for decades and is likely to remain as behavioural biases (and risks) tend to repeat over time.

Momentum investing has been dubbed the “idiot’s strategy”. In reality, identifying catalysts for virtuous trends takes a lot of skill, as does recognising when the momentum has faded. Momentum investing is a high turnover, time-heavy approach which requires the ability to assimilate news flows and data in a timely fashion in order to understand exactly when conditions change.

Momentum investing has been the standout equity style over the past decade. But like everything, trends come and go; eventually momentum’s momentum will fade. As a result, we advocate a balance of styles within investors’ equity allocations.

The Marketplace

- Brent crude fell 4.4% last week to \$64.6 a barrel
- Gold fell by 0.7% to 1320.3
- Global equity indices fall
- Global trade war looms following US metals protection announcement

Market Focus

US

- The Dow Jones fell 3% finishing the week at 24538
- Trump plans to apply a 25% tariff on steel and 10% tariff on aluminium on imports as part of his hawkish 'America first' trade policy with apparently no exceptions-drawing global condemnation
- US stocks had their worst month in two years
- The NASDAQ was down 1.2% to 6811
- Jerome Powell gave an upbeat assessment in his first testimony as the new Fed Reserve Chairman including a \$1.5 trillion tax package and the lifting of government spending caps.
- Consumer sentiment rose to 99.7% from 95.7% in January, the second highest level since 2004. Current conditions gauge rose to 114.9 from 110.5 in January
- The S&P index fell 2% to 2691.3

UK

- Maplin follows Toys R Us into administration as the UK high street picture remains challenging. Sports Direct mulls a potential takeover of Debenhams

- The FTSE fell by 2.4% on the week to stand at 7069.9
- PMI for services rose to a four month high at 54.5 in February, up from 53 in January
- Brexit talks in peril as EU draft deal seen as unacceptable. Theresa May gave another speech using more compromising language in a bid to set out the UK's position more clearly
- Mark Carney signals he wants to regulate cryptocurrencies and that they should be held 'to the same standard as the rest of the financial system'

Europe

- Manufacturing PMI fell to 58.6 in February. 2018 has seen the steepest rate of decline in two years though the overall growth picture remains strong
- Italian elections: a success for the populist anti-establishment parties including the Five-Star movement and Northern League. A new government is not expected to emerge for a few weeks
- EU promises to 'react firmly' to US trade protection measures
- The Euro Stoxx 50 index fell 3.4% to 3324.7

Asia

- China's response to US steel protectionism was officially muted, though insiders believe retaliation is on the cards
- The Hang Seng fell 2.25 to 30583
- The Nikkei fell 3.3% to 21181.6

Asset Class/Region	Currency	Currency returns			
		Week ending 2 March 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	-2.0%	-0.8%	0.9%	14.6%
United Kingdom	GBP	-2.4%	-2.2%	-7.4%	-0.7%
Continental Europe	EUR	-3.6%	-3.4%	-4.6%	1.9%
Japan	JPY	-2.9%	-3.4%	-6.0%	11.5%
Asia Pacific (ex Japan)	USD	-2.1%	-1.2%	0.5%	25.7%
Australia	AUD	-0.8%	-1.3%	-1.4%	7.2%
Global	USD	-2.3%	-1.3%	-0.4%	15.2%
Emerging markets equities					
Emerging Europe	USD	-3.4%	-2.0%	5.0%	25.5%
Emerging Asia	USD	-2.5%	-1.1%	1.1%	31.8%
Emerging Latin America	USD	-3.0%	0.0%	9.0%	21.8%
BRICs	USD	-3.3%	-1.0%	4.5%	35.4%
MENA countries	USD	-1.1%	0.0%	3.1%	2.1%
South Africa	USD	-5.3%	-2.3%	0.2%	28.5%
India	USD	-0.8%	-0.4%	-2.6%	22.0%
Global emerging markets	USD	-2.8%	-1.1%	2.2%	29.0%
Bonds					
US Treasuries	USD	0.1%	0.1%	-2.1%	0.4%
US Treasuries (inflation protected)	USD	0.4%	0.3%	-1.7%	1.1%
US Corporate (investment grade)	USD	-0.2%	-0.3%	-2.8%	2.7%
US High Yield	USD	-0.2%	-0.5%	-0.7%	3.4%
UK Gilts	GBP	0.6%	0.4%	-1.4%	-0.1%
UK Corporate (investment grade)	GBP	0.3%	0.2%	-1.8%	1.6%
Euro Government Bonds	EUR	0.3%	0.1%	0.0%	1.5%
Euro Corporate (investment grade)	EUR	0.0%	-0.1%	-0.4%	1.8%
Euro High Yield	EUR	0.1%	-0.1%	-0.4%	4.4%
Japanese Government	JPY	-0.1%	-0.1%	0.1%	1.0%
Australian Government	AUD	0.7%	0.5%	0.3%	3.5%
Global Government Bonds	USD	0.3%	0.6%	1.2%	8.2%
Global Bonds	USD	0.1%	0.4%	0.5%	7.9%
Global Convertible Bonds	USD	-0.7%	-0.3%	2.1%	8.8%
Emerging Market Bonds	USD	-0.1%	-0.2%	-2.9%	2.0%

Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	-2.0%	0.1%	-11.6%	-10.4%
Australian Property Securities	AUD	0.3%	0.2%	-7.1%	-5.0%
Asia Property Securities	USD	-1.3%	-0.4%	-0.1%	18.1%
Global Property Securities	USD	-1.7%	-0.2%	-5.8%	5.6%
Currencies					
Euro	USD	0.0%	0.8%	2.4%	17.2%
UK Pound Sterling	USD	-1.5%	-0.1%	1.8%	12.3%
Japanese Yen	USD	0.9%	1.1%	6.6%	8.4%
Australian Dollar	USD	-1.0%	-0.5%	-0.8%	2.5%
South African Rand	USD	-3.1%	-1.3%	3.8%	10.1%
Swiss Franc	USD	-0.3%	0.6%	3.8%	8.0%
Chinese Yuan	USD	-0.1%	-0.2%	2.6%	8.6%
Commodities & Alternatives					
Commodities	USD	-1.0%	-0.2%	1.3%	6.0%
Agricultural Commodities	USD	1.8%	0.2%	5.7%	-2.5%
Oil	USD	-4.4%	-2.1%	-3.7%	16.9%
Gold	USD	-0.7%	0.1%	1.1%	7.0%
Hedge funds	USD	-1.4%	-0.3%	-0.3%	3.5%

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