WeekendInvesting

POWER of MOMENTUM

What is Momentum?

Momentum is simply a high probability phenomenon that an asset continues its past performance. So a rising stock tends to keep rising and a falling stock will tend to keep falling. The persistence in performance is what is known as momentum.

Think of Newton's first law for analogy *: " An object at rest stays at rest and an object in motion stays in motion with the same speed and in the same direction unless acted upon by an unbalanced force."*

How is Momentum measured?

Momentum is usually measured in terms of Rate of Change of market price in the past specified period either on a absolute basis or relative to other stocks or indices/benchmarks. There are many others ways of defining and momentum.

What is Momentum investing?

Momentum Investing is simply a way of allocating the portfolio across a diversified no of stocks (or asset classes) which satisfy the criterion of positive momentum. Momentum investing can be done in a long only (No shorts) fashion or can be done in a long-short format also. At weekendinvesting.com we use long-only strategies on NSE stock portfolios diversified from 10 to 50 stocks as per the product.

What explains the continued performance of Momentum investing?

Researchers have tried to explain this phenomenon for several decades without success (Jegadeesh and Titman, Moskowitz and many others). Herd Mentality, Confirmation bias, under-reaction and over-reaction to fundamental news etc have been used to hypothesize this anomaly.

Nobel prize winner and Father of finance “Eugene Fama” describes momentum as a robust anomaly disrupting the Efficient Market Hypothesis. In his own words he said “Momentum is Pervasive”. The other major anomalies are value and size of company.

Why isn’t everybody doing it?
While the risk adjusted returns from momentum have been superior to other factor based investing, there are many reasons why it has not gone mainstream.

Some are :
1. It is too simple to believe, that it works. Complex is seen as better.
2. It is counter intuitive – Buy High and Sell Higher vs conventional Buy low and Sell Higher.
3. It does not satisfy the human ego of “beating or front-running the market”, rather one has to follow the market here.
4. There is more “perceived risk” associated with it as it is usually thought of as trading which is not true.
5. Many conventional strategies actually are “momentum in disguise” – any trend following strategies, or others that follow earnings growth etc are placing the same principles on other attributes vs. the price.

Are there benefits of combining conventional investing with Momentum Investing?
Yes, research has found that there are portfolio benefits if your value oriented assets are combined with momentum as they have some positive correlation. Likely, at highs of the market your momentum portfolio will do very well and at bottoms or ranged market the value one should. One should try to introduce 10-20-30% of the portfolio towards momentum and enhance allocation to momentum after experiencing the advantages.

What is discretionary vs non discretionary investing/trading?
Discretionary investing is a non-systematic way of investing where there is no set rules and the decisions of asset allocation, asset choice, period of holding, risk taken are a function of the fund managers discretion. A non discretionary system is on the other hand a mechanical system where defined rules are used to construct the portfolio as per the decided methodology, position sizes, entry and exit strategies etc. There is no

discretion in the hands of the manager nor does emotion or behavior play any role. Momentum Investing is done as a non discretionary system.

What does Tactical Allocation mean?

In common terms when you move from one asset class to another based on a strategy it can be termed as a Tactical Allocation Strategy. In all weekendinvesting.com strategies, we use Tactical allocation to move from equity to liquid funds or vice-versa as and when the system allocates.

Will the excess returns diminish over time as more and more people use Momentum?

While this is theoretically possible, momentum excess returns have existed for hundreds of years and there is no research evidence of it or any other anomaly fading away anytime soon in the future.

What are the tax advantages or disadvantages of Momentum Investing vs Long term Investing?

Most of the transactions will result in a short term (less than 12 month holding period) and hence will be subject to the 15% Short-term capital gains tax vs the 10% Long-term capital gains tax. We believe the advantages far exceed this additional tax hit.

For any queries or references to research you can reach me at Alok@weekendinvesting.com