EMPYRION™

WEALTH MANAGEMENT

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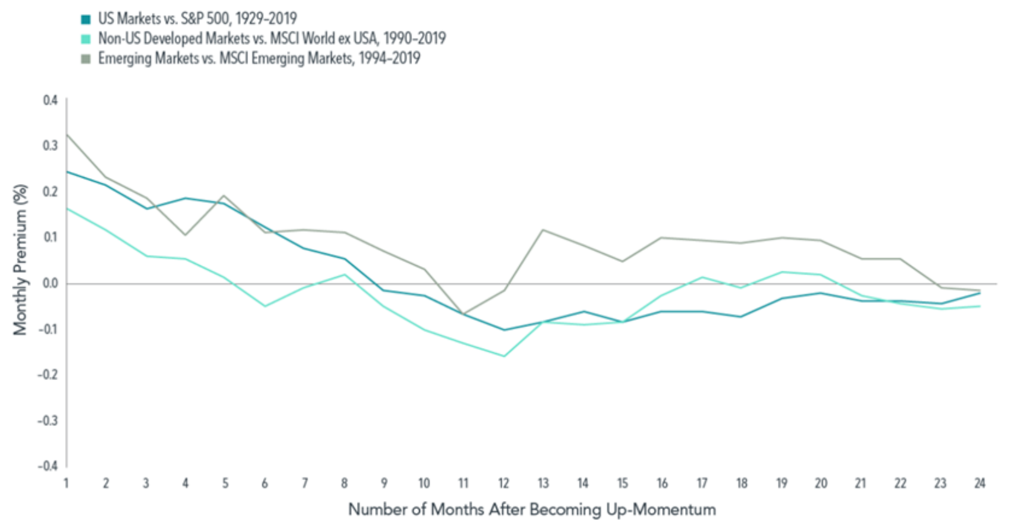
“Sell Your Losers and Let Your Winners Run”: Is Momentum a Reliable Guide?

Almost thirty years ago, investment researchers Narasimhan Jegadeesh and Sheridan Titman published a study in the Journal of Finance that reviewed results from an equity investing strategy involving buying stocks with good price performance or good quarterly results and selling those with poor performance or results. This strategy seeks to enhance returns on equity portfolios by capturing what is sometimes referred to as the "momentum premium," the supposedly stronger upside potential of stocks that are demonstrating positive momentum. The research by Jegadeesh and Titman outlined a more somewhat more nuanced approach to stock investing captured in the well-worn stock market proverb, "Sell your losers and let your winners run." On the face of it, this makes a certain amount of sense: a stock with positive momentum or positive earnings will tend to attract more positive attention from would-be buyers, which would indicate that its price would tend to keep rising—making it attractive to still more would-be buyers.

But does this approach really hold up in the light of ongoing financial research and today's computer-driven trading strategies? Certainly, there are advantages and disadvantages of following the call of momentum. On the one hand, momentum may deliver up to a 9.1% annual premium to stock portfolios, as documented by the Fama-French US Momentum Factor for the years 1927–2020. On the other hand, the strategy is often pursued in ways that involve extreme portfolio turnover—with accompanying trading and other costs—and may also be susceptible to exceptionally negative outcomes (for example, despite its long-term 9.1% addition to portfolios, the Fama-French US Momentum Factor yielded a heart-stopping -83.16% return in 2009). With such worrisome characteristics involved, is there really a way that momentum can be profitably utilized to boost portfolio performance?

Perhaps the first thing to understand about momentum is that, as with most investing strategies, it is neither an inevitable cure-all nor a sure recipe for disaster; the truth is generally somewhere in the middle. In order to understand how momentum factors can enhance portfolio performance, it's important to know that momentum may not be a useful indicator of long-term results. In fact, excess returns based on momentum often appear to dissipate over a relatively short period of time.

Average excess returns for up-momentum stocks vs. large cap market indices following rebalancing



SOURCE: Dimensional Fund Advisors. Past returns, including simulated returns, do not guarantee future results.

As the above chart shows, excess returns for US stocks identified as up-momentum during the period 1929–2019 (and over shorter periods for selected non-US markets) appear to fall to or below the level of non-momentum stocks within a relatively short period of time. For example, US stocks performing at a 0.25% momentum premium when compared to the S&P 500 had fallen to the same level as the broad market average after 9 months and were tracking below the market average after 12 months. Similar results may be seen for the global markets shown.

So, what's a momentum-seeking investor to do? Reap above-market returns for a few months, then sell the stocks when they become laggards, as in the chart above? Obviously, any strategy that involves high-velocity trading also typically incurs increased transaction costs and possibly unfavorable tax implications. And in fact, when we look at a selection of 24 funds that have attempted to outperform the market by capturing the momentum premium, we see that they have rarely been able to maintain out-performance over the long term, once all fees and expenses were taken into consideration. In fact, since their launch, only six of the 24 funds studied have averaged performance better than their Morningstar benchmarks, and these six have out-performed by an annualized average of 1.09%.

It seems that capturing the momentum premium in isolation from other factors may not be an effective long-term value-add for most portfolios. But that does not mean that momentum is meaningless or should be completely disregarded by long-term investors. Momentum can be profitably utilized in combination with other drivers of returns —value, profitability, market capitalization, and growth—to make informed decisions about additions to portfolios.

For example, a stock's momentum characteristics can be considered when buying or selling holdings in a portfolio in order to determine the best choices for adjustments to core investments. By favoring assets with up-momentum characteristics that also fit other dimensional criteria when adding to a portfolio, we can expect an additional "lift." On the other hand, when considering stocks that should be replaced, preference can be given to those with downward momentum characteristics, or at the very least, purchases of down-momentum stocks could be delayed in favor of adding up-momentum candidates. Similarly, sales of up-momentum stocks might be deferred until the favorable characteristics dissipate. Adding such a "momentum screen" to portfolio decisions can add meaningful return without incurring the costs associated with excessive trading activity.

Performance for simulated all-cap core allocations with and without momentum screens

	With Momentum Screen	Without Momentum Screen	Difference
US 1975–2020	14.0	13.9	0.1
Non-US Developed 1990–2020	6.3	6.0	0.3
Emerging Markets 1994–2020	7.1	7.0	0.1

SOURCE: Dimensional Fund Advisors. Past returns, including simulated returns, do not guarantee future results.

The chart above illustrates the results of using momentum characteristics to select additions to and deletions from simulated portfolios made up variously of stocks of all capitalization levels in the broad US market (1975–2020), international developed markets (1990–2020) and international emerging markets (1994–2020). Addition of a "momentum screen" resulted in additions to total return of 0.1%, 0.3%, and 0.1%, respectively, compared with portfolios with the same makeup but without the use of momentum screening. Further, these results are achieved without increased portfolio turnover, since application of the momentum screen will typically delay both buy and sell decisions. This is especially significant when considering how many momentum-focused funds underperformed their benchmarks, as mentioned earlier.

As a fiduciary financial advisor, Empyrion Wealth Management seeks to help clients utilize research-driven, evidence-based information to make informed decisions about their portfolios. Whether your investment philosophy embraces momentum, value, growth, or some other characteristic, we believe that the more you know, the better equipped you will be to both meet your most important financial goals and also experience the peace of mind that comes with having a well-designed strategy. To learn more about how we harness the power of information to help family stewards and others make better decisions, click here to read our whitepaper, "Family Stewards."

Stay Diversified, Stay YOUR Course!

SOCIAL MEDIA DIGEST

In case you missed them, here is a roundup of my latest posts on social media:

Don’t: respond to negativity. Do: spend quality time with family. If you’re looking for some ways to improve your physical and mental health in 2022, start with this list.

Start your financial year right with EWM digital investing! You’ll benefit from algorithmic rebalancing and a variety of tax-reduction techniques to help boost your returns and keep you on track toward achieving your financial goals.

What can you do when your married clients don't agree on important money matters like retirement timing, Social Security claiming, and risk tolerance? In this Think Advisor article, I weigh in.

Investors should never allow themselves to be distracted by the short-term “noise” around any investment. Their focus should remain firmly fixed on the long-term view.

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