FOCUS ON FACTORS

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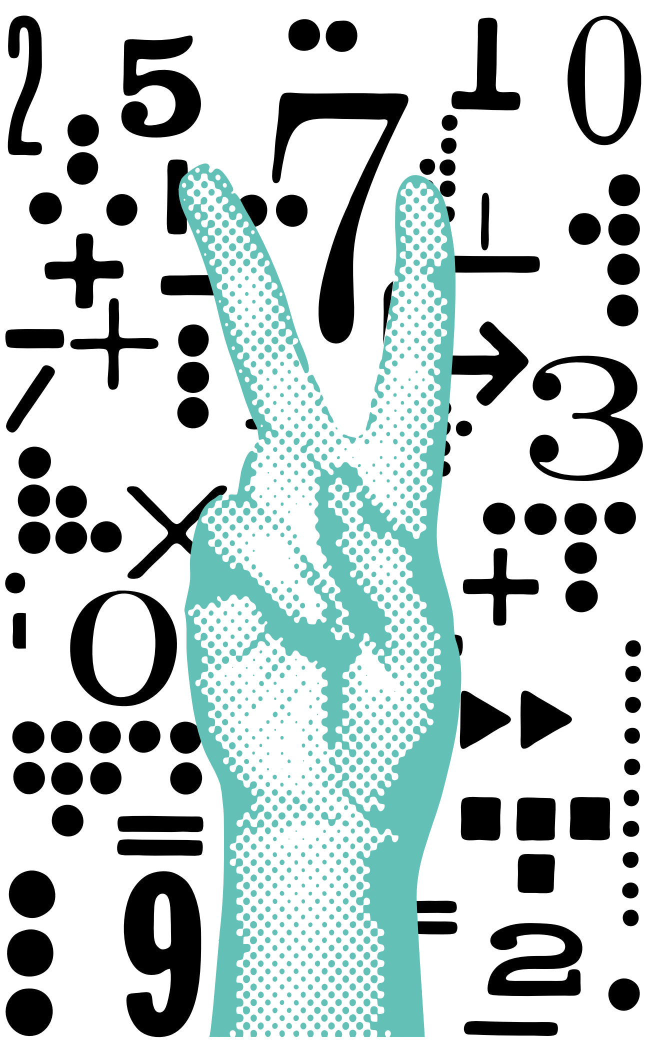
A series of articles that answer the most common questions about factor investing

WHAT YOU NEED TO KNOW ABOUT... MOMENTUM



Despite the cynicism, decades of evidence point to the Momentum premium's persistence, pervasiveness and survival of transaction costs

TOMMI JOHNSEN AND ELISABETTA BASILICO

Speaking about Momentum at the CFA Society of Chicago in 2017, Eugene Fama, a proponent of the theory of efficient markets, said the factor was 'a big embarrassment for market efficiency' that he 'hopes goes away' and that the concept is 'not exploitable.'

The facts say otherwise.

For example, Jagadeesh and Titman hatched the concept of cross-sectional Momentum in the 1993 article, 'Returns to buying winners and selling losers: implications for stock market efficiency.' They laid out a methodology for identifying a group of stocks with similar Momentum characteristics that produced superior returns.

More studies followed, establishing strong evidence of the robustness of the factor. The Momentum premium is persistent, pervasive, robust to different definitions and survives transaction costs. In 2017, 'Factor-based investing: the long-term evidence' by Dimson et al studied Momentum using 100 years of data across 23 countries.

From a practitioner's standpoint, the outperformance of

Momentum is strong and has been successfully exploited across asset classes in numerous quantitative strategies. However, for the average investor or investment professional, there are a number of questions that are often posed about the topic.

WHAT IS THE NARRATIVE BEHIND MOMENTUM?

Momentum is the tendency for a security's recent relative price performance to persist into the near future. That is, stocks with high past price returns tend to outperform stocks with low past price returns. However, like Value, researchers disagree on why the premium for owning Momentum stocks exists.

Some argue that liquidity risk explains at least a portion of those superior returns (Pastor and Stambaugh, 2003). Asness (1997) found that momentum is stronger among stocks with large growth opportunities and risky cashflows.

However, we think that behavioral explanations make the most sense and are most consistent with academic literature. Behavioral explanations go something like this: investors tend to do one of two things (maybe both). They either underreact to significant news about a security, or they overextrapolate strong growth rates too far into the future without much justification.

For the markets, the impact of investor psychology is to slow down the price reaction to this 'news.' This human reaction to sell quickly actually creates the Momentum premium because it keeps the price from moving to a fair market level immediately. Since this pricing anomaly is behavioral in nature, it will likely take a long time for it to be arbitraged away completely.

Finally, Eugene Fama himself wrote in 2008 that Momentum is the 'premier market anomaly.' That places it directly in the behavioral space, so why argue with him?

HOW HAS MOMENTUM FARED IN THE LAST 10, FIVE AND TWO YEARS?

Investors have been focused on the recent and prolonged underperformance of Value, but what about Momentum? Based on our research, it appears to have performed well across most countries and periods.

When we studied the performance of Momentum across 10 developed markets between 1995 and now, we found that Momentum outperformed in all but one – the exception being Japan.

Interestingly, Australia has been the clear winner for Momentum, over both the entire historical period and shorter time periods, followed by Germany and Canada. Meanwhile, the US produced the lowest positive spread for Momentum stocks, both over the entire history and over shorter time frames.

CAN WE TIME FACTORS SUCH AS VALUE AND MOMENTUM?

We know that the return performance of Value and Momentum is typically negatively correlated, so it follows that having both factors in a single portfolio will reduce the risk of a downturn in one of the other factors. In 2013, Asness et al documented a negative correlation (an average of -0.6) between Value and Momentum factors in the different markets and asset classes that they tested.

We can confirm this result in the equity markets with slightly lower correlations. In any case, this is a powerful finding because it provides guidance to investors on how to build more robust portfolios with exposure to a diversified set of factors.

> THIS HUMAN REACTION TO SELL QUICKLY CREATES THE MOMENTUM PREMIUM BECAUSE IT KEEPS THE PRICE FROM MOVING TO A FAIR MARKET LEVEL IMMEDIATELY

But what about the ability to time them? On this point, the academic jury is still out.

Some studies show that relative valuation does a good job of predicting the subsequent five-year performance of equity factors. Others counter that factor timing is difficult to achieve in practice. The methods used to evaluate the predictive power of relative valuation indicators don't consider frictions such as portfolio turnover and changes in fundamentals.

There is some hope for factor timing though. The AQR research arm recently proposed that individual factors can indeed be successfully timed based on their own past performance.

We recommend factor timers read the article, 'Factor momentum everywhere,' published in the Journal of Portfolio Management in 2019.

The academic debate continues. Stay tuned! ◇

Tommi Johnsen, PhD, and **Elisabetta Basilico, PhD, CFA,** are co-editors of academicinsightsoninvesting.com. Their book, *Smart(er) Investing: How Academic Insights Propel the Savvy Investor*, was published in December.