23 February 2016

Dumb Alpha: Accelerating Momentum

By Joachim Klement, CFA

Categories: Drivers of Value, Economics, Equity Investments, Guide, Portfolio Management

I used to consider momentum investing an insult to my intelligence. After all, why should prices go up just because they have gone up in the past?

Maybe this is what happens to you if you are bullied once too often in high school, but I have always taken the most pride in my non-consensus views.

Momentum investing is the exact opposite. You invest in the popular stocks of the day hoping that the views of the general investing herd are right. More appealing to me are value and contrarian investing because they seem so much more "intelligent." And in both of these investing traditions, success originates from betting against "the wisdom of the crowds."

Seemingly Stupid, But It Works

There is plenty of evidence that momentum investing works in the medium term.

While winning investments of the last three to five years tend to underperform as mean reversion kicks in and winning investments of the last month tend to underperform as well, winning investments of the last three to 12 months tend to outperform in the subsequent months.

As Cliff Asness and his associates at AQR summarize, this momentum effect has persisted for more than 200 years, exists across many different asset classes, and can be profitably exploited by almost every investor.

Today, dozens of systematic anomalies in asset returns are known, but many of them seem to be artifacts of data mining, as Campbell R. Harvey of Duke University and his colleagues have shown. Two of the few anomalies that survive their scrutiny: value and momentum.

Dealing with Momentum Crashes

The problem with momentum investing is that a market full of momentum investors will likely end up in a bubble as prices deviate more and more from fundamentals. In these circumstances, momentum investing will become very risky and investors might suffer severe losses from sudden changes in momentum that lead to so-called "momentum crashes."

Predicting bubbles and crashes is extremely difficult, but at the forefront of the current research is Didier Sornette at ETH Zurich. His research into log-periodicity and hyperbolic growth may be quite complex, but recently he and his associates published a paper that shows how one can improve the results of traditional momentum investing by looking at momentum acceleration.

They calculate a simple measure of past change in momentum — for example, the return over the last six months minus the return over the preceding six months — and show that this simple difference of momentums can predict future performance. Stocks with the highest acceleration (i.e., those that have increasing momentum) tend to have higher returns in the future than stocks with lower acceleration. The returns generated with a simple acceleration strategy tend to be higher than those generated by momentum strategies.

Creating Smarter Momentum Strategies

To me, this is like smart momentum investing because, effectively, this approach tries to identify trends right when they take off, before more and more investors jump on the bandwagon. As more investors follow a specific trend, the trend accelerates until the influx of fresh investors abates and the trend decelerates again. Acceleration may thus allow momentum investors to invest in a trend early and get out before it is too late.

The research on the acceleration factor is still in its infancy and my optimism may well be premature. After all, I am a person who frequently gets on a scale hoping that my weight has dropped only to find that the momentum has in fact accelerated in the opposite direction. But recent research from Morningstar indicates that the acceleration factor may not only be used to improve the returns of traditional momentum strategies, but may predict future episodes of negative skewness (i.e., market declines or even crashes).

What seems clear at this point is that acceleration is clearly a dumb alpha generator that is so simple it is hard to believe investors hadn't discovered it earlier.

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Wes Gray said:

Nice piece. Momentum is definitely an interesting –but unorthodox–concept in investing. Especially for value investors!

We looked at this concept and compared it so the “frog in the pan” momentum hypothesis. Acceleration isn’t as effective.

Here is our take on frog in the pan momentum if you are unfamiliar with the concept: http://blog.alphaarchitect.com/2015/11/23/frog-in-the-pan-identifying-the-highest-quality-momentum-stocks/

Regardless, interesting idea and nice post. Thanks for writing. wes

23 February 2016 at 08:02 Reply ↓

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Fred C Dobbs said:

Momentum crashes are caused by large losses on short positions when bear markets reverse sharply to the upside. They have happened only twice in the past 80 years and are a non-issue if you don’t short stocks.

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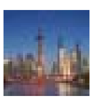

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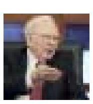

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