Why Momentum Stocks Have Lost Their Momentum

By Daren Fonda  Feb. 15, 2019 7:30 a.m. ET

The perils of factor investing are coming into focus again. Factors are things like value, momentum, quality, and low-volatility. Scores of ETFs tilt toward these factors, aiming to beat the market or provide diversification benefits.

Yet a new research paper, co-authored by Rob Arnott of Research Affiliates and Duke University finance professor Campbell Harvey, makes a case that factor investing is much harder than it looks.

The paper is called Alice’s Adventures in Factorland, and its summary says it all: “Many investors develop exaggerated expectations about factor performance as a result of data mining, crowding, unrealistic trading cost expectations, and other concerns.”

Investors are often led to believe that a factor-heavy portfolio is more diversified, the authors write. But diversification can vanish under certain economic scenarios when returns become more closely correlated, they write. “Factor investing is a powerful tool,” they conclude, “but understanding the risks involved is essential.”
Those risks are evident in factor returns this year, which are all over the map.

Over the last two weeks, quality and small caps have outperformed, while momentum, low beta and value have trailed the market, according to a report out Thursday by Mayank Seksaria, chief macro strategist at Macro Risk Advisors.

One might expect low beta and value to underperform in a strong market. But investors might expect momentum to be a winner, emphasizing higher-beta stocks that rise more than the market overall.

Yet momentum doesn’t work so well when market leadership shifts rapidly. Indexes that tilt toward momentum typically rebalance based on trailing returns over a period of months—emphasizing stocks that had the strongest momentum on the premise that they’ll keep working. When the market pivots toward different sectors or factors, however, momentum can be caught flat-footed.

Momentum has now become a proxy for defensive sectors such as health care, consumer staples, and utilities, according to Seksaria. Those sectors outperformed in the fourth quarter of 2018 as the S&P 500 took a 13.5% dive. But defensive sectors are lagging this year as tech and other cyclical sectors have led the rally.

Momentum’s defensive crouch is now showing up in the iShares Edge MSCI USA Momentum Factor ETF (Ticker: MTUM), one of the largest momentum ETFs on the market with $8.3 billion in assets. The ETF conducted an ad-hoc rebalancing in January, pushing its exposure to utilities, consumer staples, and health care to 51% of the portfolio, up from 12% late last year, according to Dave Dierking, an ETF analyst, writing on Seekingalpha.

“As recently as November, the ETF looked very much like a growth fund,” he writes. Indeed, the ETF held more than 40% of its portfolio in tech, including stocks such as Microsoft (MSFT), Visa (V), and Intel (INTC), he notes. Tech is now just 17% of the portfolio. And stocks such as Amazon.com (AMZN), Apple (AAPL), Mastercard (MA), Boeing (BA), Nike (NKE), and Netflix (NFLX) have vanished, he writes. Health care, meanwhile, has reached 33% of the ETF, up from 9%.

Those changes are hurting the ETF’s performance. It’s up 8.3% this year versus a 10.1% gain for the S&P 500. It’s also trailing the S&P 500 over the past six months with a loss of 3.7% versus a 1.4% loss for the index, including dividends.
Dierking doesn’t necessarily view MTUM’s changes as a negative; the ETF should do well if the markets lose momentum and turn down, and he argues that a more defensive posture “may be warranted” given the global economic slowdown already underway.

Nonetheless, if there’s a lesson in all this it’s that factor investing takes plenty of patience. Investors should be willing to go through long stretches of underperformance if they eventually hope to outperform.

And as the academics note, trying to time factor bets may just take you down an Alice in Wonderland rabbit hole.

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