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Elston Insights

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Momentum sustains its outperformance

- Momentum factor continues to deliver
- Outperforms relative to Value factor and to market-cap weighted
- Factor overlay can help differentiate returns

Introduction to the Momentum factor

Factors are the broad persistent drivers of return that are used to analyse and explain equity market performance. Whereas the traditional Fama-French three factor model added the factors of Value and Size () alongside market risk factor ("beta") to decompose and explain equity returns.

Value factor is the theory that lower book value companies outperform higher book value companies.

Size factor is the theory that small capitalisation companies outperform large capitalisation companies.

But these are not the only "factor" styles for equity investors. Yield factor refers to companies with high dividend yield. Quality factor refers to companies with a high return on equity, steady earnings growth and low leverage. Min Volatility refers to companies whose share price have the lowest volatility. Momentum reflects the share price trend: shares with high momentum factor are those whose share prices are trending up. For an introduction to Factor investing, see our CPD module.

Whilst long-run "buy-and-hold" performance data shows Value performing well until 2005, since then, following the Global Financial Crisis and in the low interest rate era, Momentum has persistently outperformed Value. The inflation shock of 2020-22 was an exception, which saw a "great rotation" into Value, which has now arguably played out.

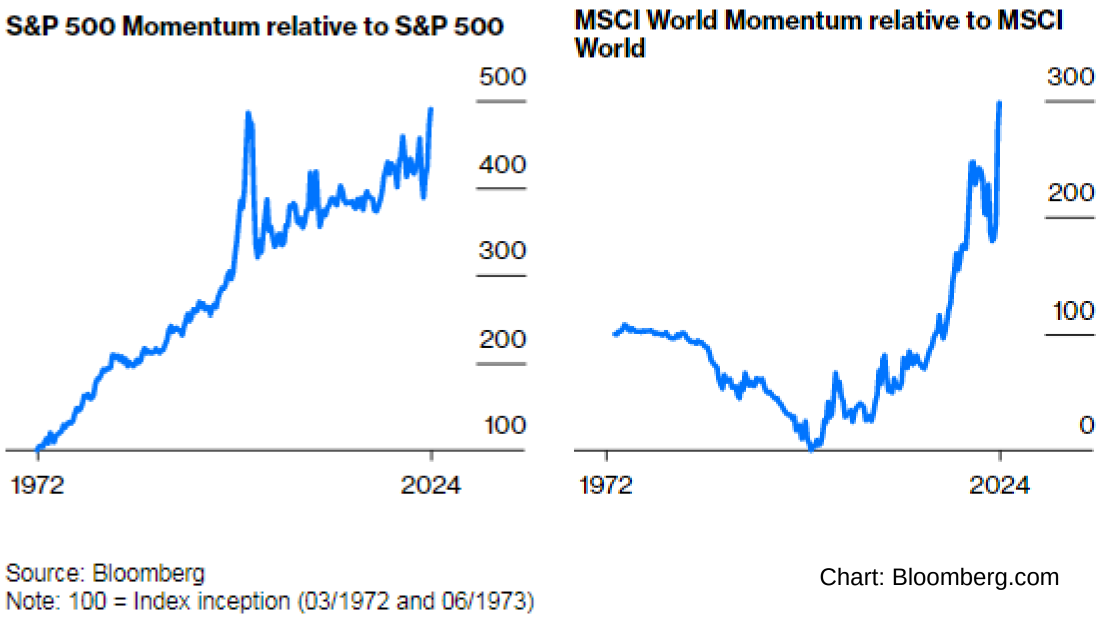
Different factors have primacy at different stages of the market cycle. Whilst perfectly "timing" exclusive factor allocations can be as challenging and potentially counterproductive as any market-timing strategy, "tilting" a portfolio towards a particular factor can help create a performance edge from an overlay perspective.

Regime change

Whereas Value-factor tends to outperform in a higher interest rate, higher inflation level regime, the potential shift to a falling interest rate, moderating inflation regime has been supportive to the Momentum factor.

Whether looking at the US equity market only or at the broader World Equity market, Momentum factor focused indices are outperforming their traditional market-capitalisation weighted indices which are the "parent index" from which factor indices are derived[1].

Fig.1.



By contrast, Value factor focused indices are persistently underperforming their traditional market-cap weighted parent. For "evidence-based" investors that adhere to an investment philosophy that relies entirely on the Fama-French model that focuses on Value and Size factors alone, this remains a painful experience since 2005.

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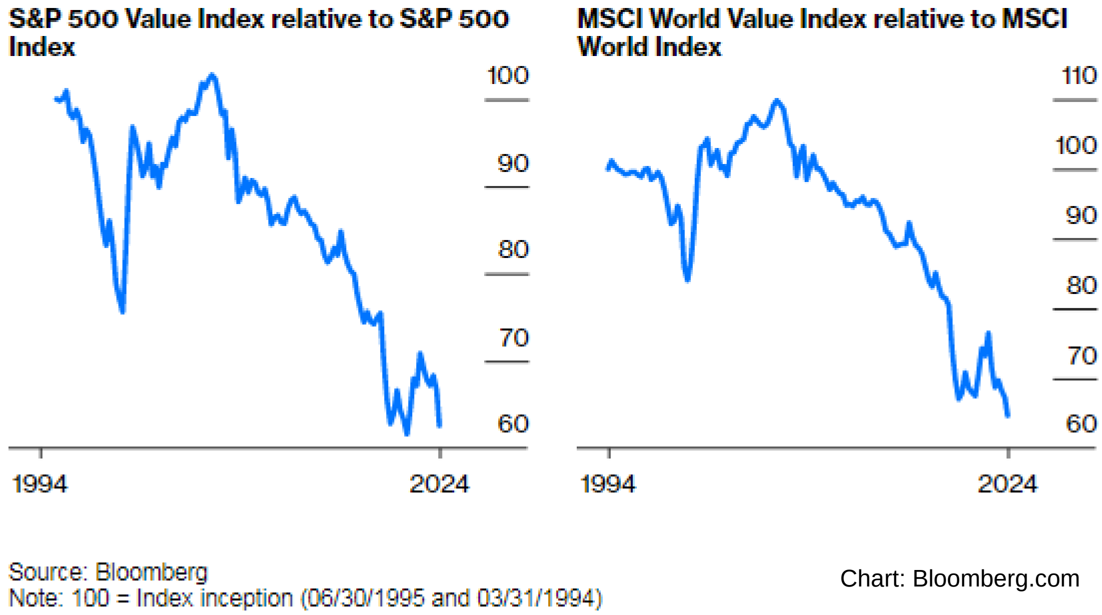
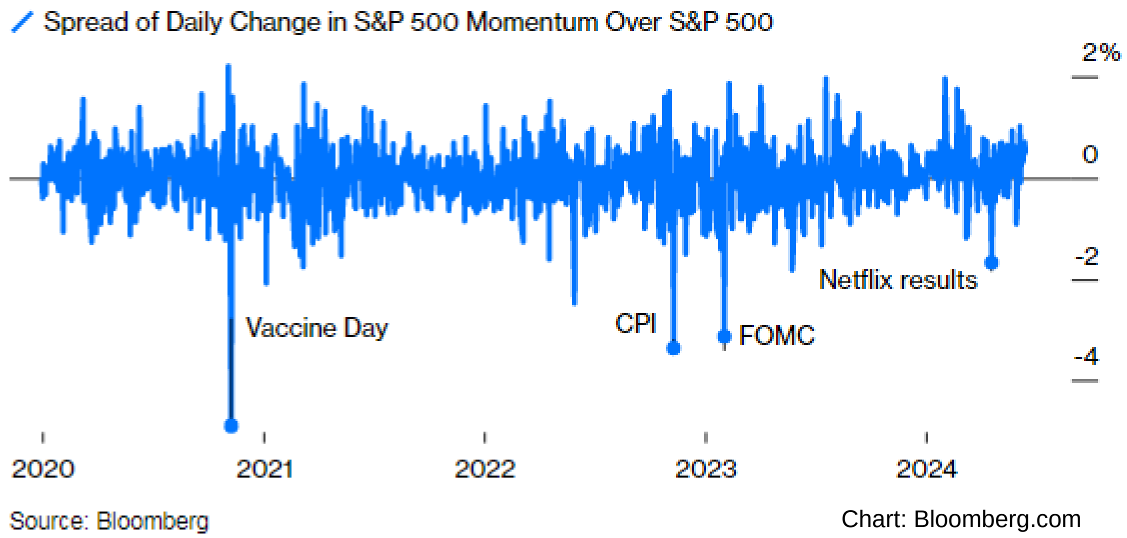
[1] https://www.bloomberg.com/opinion/articles/2024-06-17/us-stocks-momentum-drawing-mojo-from-ai-and-magnificent-seven

Fig.2.



The downside to Momentum factor is when it reverses, it can reverse more sharply than its parent index.

Fig.3. Momentum reversals



But if the broader regime for markets is upward trending, the larger size of these occasional set backs could be a price worth paying.

How is a Momentum index calculated?

Looking at the MSCI World Momentum Index methodology, it rebalances every 6 months and from the normal universe of MSCI World companies, it ranks as its largest holdings, those companies whose share prices have trended up the most over both a 6 month and 12 month period. It is shamelessly backward-looking recent-performance approach.

What is the evidence

But it is based on academic research. Academics first isolated the momentum premium in 1993, when UCLA scholars Narasimhan Jegadeesh and Sheridan Titman showed that strategies which buy stocks that have performed well in the past and sell stocks that have performed poorly in the past generate significant positive returns over 3-to 12-month holding periods[2]. The 6 monthly rebalancing process therefore "refreshes" the list.

Implementation

Whereas some active equity managers may have a momentum oriented philosophy, the rise of alternatively-weighted index methodologies means that a world equity momentum index has existed since December 2013 to benchmark those active momentum investors. Alternatively there are index-tracking ETFs that track those indices. Whilst the fund may be tracking an index and hence "passive" or "beta" oriented, because the index itself deploys a systematic active-like security selection methodology, it is sometimes known as "alternatively weighted", or "systematic" or "smart-beta" approach.

This is why we prefer the term "index investing" to "passive investing" as all investing requires active choices, even the design of index rules.

For asset allocators looking to implement a Momentum strategy there are both regional and world equity Momentum index funds and ETFs to choose from.

Bottom line

MSCI World Momentum has outperformed traditional MSCI World by 1.9% per annum since 1999 to 2023. It has been one of the best performing factors since 2005, and aside from the 2021-22 Value rotation, the return to a moderating inflation regime is underpinning Momentum once again.

Henry Cobbe, CFA

Head of Research, Elston Consulting

Further Reading

https://www.elstonsolutions.co.uk/insights/category/factor-investing

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[2] https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1540-6261.1993.tb04702.x

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