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Avoid Momentum Crashes

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Momentum strategies, which ride investments that are rising, are a good way to maximize returns. But this method has a weakness: Momentum investing is prone to steep reversals. The way to avoid this is to stick to index mutual funds and exchange-traded funds, and couple that with another technique called trend following.

Momentum investors usually buy individual stocks showing high returns in the past several months. Or they go long on high-flying stocks and short weak stocks. Those strategies have shown remarkable performance over the years. However, these strategies also tend to crash every once in a while.

As investors pile into a strong stock, the company's valuation can get way beyond where it should trade. The fall that follows is just as spectacular as the climb. Long/short investors have also seen times when their shorts do well and the leaders reverse tack.

Momentum crashes are primarily a phenomenon related to individual stocks. That's why my firm uses index funds and ETFs, because they offer greater diversification. We don't really go short anything. While indexes do get frothy at times, they don't do so to the same extent that individual stocks do. Of course, momentum investors in indexes can still suffer drawdowns by buying the strongest index in a bear market. You still lose money when you buy the best of the worst.

Adding trend following to momentum can alleviate a lot of these issues. The terms are often used interchangeably but they are different concepts. Momentum involves buying the strongest asset classes, sectors, etc., regardless of direction. If they are going down, you buy the one that is losing the least. Trend following involves only buying assets that are in an uptrend. Anything that falls is sold and whatever is rising is bought. Combining these strategies can increase the returns and decrease the risk of a plain momentum strategy.

In a major market crash, it's best to be in gold, cash, Treasuries or inflation-protected Treasuries. Wait for the bottom. Once you see an uptrend, then it makes sense to buy it and sell once it turns back down.

Since hindsight is 20/20, here is a back-tested example of this strategy used on the Standard & Poor's 500 stock index between Sept. 29, 2003, and Sept. 14, 2012. If you followed a pure momentum strategy, your average annual return was 9.14%. The biggest peak-to-trough drawdown was 14.24%, and your MAR ratio, a measure of risk-adjusted return, 0.62. In your worst month, you take a hit of minus 11.82%.

If you tailored that momentum strategy with trend following, you stayed in cash during September 2003, which was a down month for the S&P. You waited for the S&P 500 to hit an uptrend before you bought. You moved back to cash when it was in a downtrend.

The result was better than from pure momentum. You enjoyed an average annual return of 10.35%, your maximum drawdown was 8.67%. Risk-adjusted returns were better as well. The MAR ratio for this strategy was better, too: 1.19.

Most importantly, this strategy doesn't suffer such an awful short-term crash. In the worst month for this strategy over that time, you have a 4.02% decline. If you put your money into gold or other safe-haven assets while the S&P slides, you might have made even better returns.

Clearly, this model shows that a momentum strategy plus trend following vastly outperforms pure momentum and avoids major blowups. It also blows right past a traditional buy and hope strategy.

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