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Momentum: Best Stock Tactic

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In 2002 and 2008, the investment tide went out. And as Warren Buffett famously predicted, we learned who was swimming naked. Both times, it was the practitioners of Modern Portfolio Theory. Had they followed another strategy, involving momentum, their performance would have been a lot better.

After getting hammered twice and experiencing a lost decade, investors are now clamoring for a different approach. They want the investing version of the Holy Grail: Protection from large losses with attractive returns in an up market.

Modern Portfolio Theory [1] (MPT) is a mathematical construct that attempts to diversify your assets so they move independently of each other, balancing reasonable safety and decent returns. It assumes that investors act rationally. During the 2008 financial crisis, when almost everything went down and people panicked, MPT's reputation suffered.

Tactical asset allocation is a better alternative. TAA can encompass a number of different approaches. At our firm, we combine four different tactical approaches:

- Trends. Buy an asset when the trend is up and sell it when the trend reverses.
- Short-term counter trends. Buy into weakness and sell into strength over the short-term.
- Inter-market analysis. Use one market to predict the movements of another.
- Momentum. Buy the top-performing markets or sectors. This is the heart of TAA.

Most advisors will quickly dismiss a purely tactical strategy, fearing that its execution is too difficult or that they will be mislabeled as market timers – those who think they can get in and out of the market just before things change. But thinking this way, they miss out on capturing one of the most significant sources of excess return: momentum.

Momentum is the documented tendency of investments to persist in their performance. Stock and bond sectors that outperformed other sectors during a time (one month, three months, six months, etc.) tend to continue to outperform. More than 300 academic papers were published showing that momentum outperformance exists in just about every asset class.

If momentum is such a great strategy, then why aren't more people using it? Look back a few hundred years, when it was official church doctrine that the sun and planets orbited around the earth. That was not considered theory. It was taught as fact. Any other idea, no matter how well supported, was heresy. That is the state of the financial services industry today. It has so much invested in the idea of MPT that, if it were proven that it didn't work, such evidence would be devastating.

The problems with MPT

MPT is pervasive because there are a number of powerful arguments in its favor:

1. In an MPT-based portfolio, you made money every year from 1982 to 1999.

2. You lost money in 2002 and 2008, but those years were just anomalies (the proverbial 100-year storm).

3. If you held on for the 10 years from 2000 to 2010, you didn't make much, but you didn't lose either, so MPT is safe for long-term investors.

While on the surface these arguments make sense, a deeper inspection shows some serious flaws:

1. The 1982-99 bull market was one of the biggest we have ever seen. Any strategy that recommended stock-buying made money. MPT, like everything else, benefited from an up market.

2. Losing years 2002 and 2008 were not flukes. It is human nature to create bubbles in asset classes that eventually burst. Human beings are ruled by emotions. Greed and ignorance cause bubbles to form, and fear causes them to burst. Until we all become Vulcans, bubbles will continue to form and burst. (Unless you believe that the government can head off bubbles in the future. If you do, I have a bridge to Brooklyn to sell you.)

3. Not making any money for 10 years is not a successful investment strategy. No matter what age you are, the opportunity cost of missing 10 years of returns is enormous.

Why momentum works

Conventional market wisdom is split between two theories: That the markets are efficient or random. If emotionless computers made all buy-and-sell decisions, this would probably be the case. However, human beings trade in markets, and they are ruled by fear, greed and ignorance. This causes trends in the market to be persistent.

Typically, trendsetters identify an undervalued area of the market and move in, driving up prices. Other investors see this and buy as well, further moving prices up. Eventually fear kicks in, money moves out of the asset class into something else and the process starts all over again.

Every sound trading strategy needs to start with a theory. Mine is that investors can capture momentum in various asset classes to beat the market. To test this, I used five Rydex sector funds: banking (RYKAX [2]), biotech (RYOAX [3]), energy (RYEAX [4]), precious metals (RYMPX [5]) and technology (RYTAX [6]).

Every month, I bought the one fund out of those five that had the best performance over the past three months. I could have chosen one, six or 12 months, but I settled on three months because I believed that one month is too short and that anything longer than three months will miss out on the early part of large moves.

The next step was to back test this strategy to see if it worked. I downloaded prices for each of the funds going back to Sept. 30, 1998. I started in 1999, assuming that I would buy the fund that had done the best from the three months preceding Jan. 1, 1999. Then every month, I re-evaluated. If the fund I was currently in was the top three-month performer, I kept it; if not, I sold it and bought the latest top performer.

Below are the results compared to what the Standard & Poor's 500 stock index did over the same period:

Year	Momentum Strategy	S&P 500	Outperformance/ Underperformance
1999	10.23%	21.04%	-10.81%
2000	2.96%	-9.10%	12.06%
2001	-5.96%	-11.89%	5.93%
2002	-36.58%	-22.10%	-14.48%
2003	42.28%	28.68%	13.60%
2004	12.03%	10.88%	1.15%
2005	36.94%	4.91%	32.03%
2006	6.26%	15.79%	-9.53%
2007	21.86%	5.49%	16.37%

2008	-46.24%	-38.49%	-7.75%
2009	15.43%	23.45%	-8.02%
2010	42.23%	12.78%	29.45%
Growth of $100,000	$168,837	$118,246	

If I put $100,000 into this simple strategy, I had over $50,000 more than if I had just bought the S&P 500. (This does not include the impact of any taxes or fees, and it ignores the fact that the S&P 500 is an index, and one cannot invest directly in an index.)

The results of this strategy are impressive, but there are definitely some areas that could improve. For example, the losses in 2002 and 2008 are substantial. To alleviate this, I could put in a hedging component using moving averages, we could decide not to enter a buy order when a fund is below its 50-, 100- or 200-day moving average. I could also expand the number of sectors, buy more than one sector at a time, invest in assets in other countries, purchase bonds and test different periods other than three months.

Markets are not efficient or random. They have trends that are identifiable, and investors can use these trends to achieve market-beating returns.

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