Market-beating Returns through Momentum Investing

By Matthew Tuttle, CFP®

For many people the term “momentum investing” might bring up images of rapid fire hedge fund trading strategies and high risk market timing. However, momentum strategies have been used over the years by a number of money managers to achieve market beating returns. Momentum very simply means investing in the areas of the market that are appreciating the fastest and avoiding the areas that aren’t. This flies in the face of the typical advice given by financial advisors that investors should have a static portfolio of a number of different asset classes. This article will show a simple momentum based strategy that any investor could implement that would have substantially outperformed the market over the past 12 years.

The Asset Allocation Fallacy

Traditional asset allocation theory advises that investors spread their money among several different asset classes. At any point in time some of these asset classes will be “hot” and others will be “cold”. The idea is that investors cannot figure out ahead of time which will be which so the best bet is to buy all the asset classes across the board. This will generally cause you to lag in an up market as the underperforming asset classes weigh down the outperforming ones, but the theory assumes that it will protect you in a down market. Anyone who had a “diversified” portfolio in 2002 or 2008 realized that they may have not gone down as much as the market but they still suffered massive losses.

Why Momentum Works

Conventional market wisdom holds that markets are either efficient and/or random. If all buy and sell decisions were made by emotionless computers then this would probably be the case. However, human beings trade in markets and humans are ruled by fear, greed, and ignorance. This causes trends in the market to be persistent. The “smart money” identifies an undervalued area of the market and moves in driving up prices. Eventually other investors start to see this and they buy as well, further moving prices up. Eventually fear kicks in and money moves out of this asset class into something else and the process starts all over again.

The Theory

Every sound trading strategy needs to start with a theory that you can then either prove or disprove. In developing my simple momentum investment system my theory is that investors should be able to capture momentum in various asset classes to beat the market. To test this I decided to use five Rydex sector funds- Banking, Biotech, Energy, Precious Metals, and Technology. The next step is to develop the strategy. I figured that every month I wanted to buy the one fund out of the five that had the best performance over the past three months. I could have chosen 1 month, 6 months, 12 months, etc but I figured that one month would be too short and anything longer than three months would have me missing out on the early part of some large months so I settled on three months. The next step was to backtest this strategy to see if it works. To test the strategy I downloaded prices for each of the funds going back to 9/30/1998. I then started in 1999 assuming that I would buy the fund that had done the best from 9/30/98 to 1/1/99. Then every month I would re-evaluate, if the fund I was currently in was the top three month performer then I would keep it, if not, I would sell it and buy the top performer. Below are the results compared to what the S&P 500 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 would have had over $50,000 more than just buying the S&P 500 (this does not include the impact of any taxes or fees or the fact that the S&P 500 is an index and I cannot invest directly in an index).

Room for Improvement

Right out of the box the results of this strategy are impressive, but there are definitely some areas that I 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. I could also expand the number of sectors, buy more than one sector at a time, test different periods other than 3 months, etc.

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

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