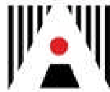

ANALYTICS INVESTMENT ADVISORS, LLC

Momentum Revisited

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In my commentary on January 15, 2011 "Buy – Don't Hold (Part 2)" I tested the notion that there is no statistically significant relationship between investment returns and relative strength (momentum), but rejected the null hypothesis when it was revealed that approximately 70% of investment returns in a random sample of exchange traded funds (ETFs) was explained by relative strength. Samuel Lee comes to a similar conclusions in his article "A Case for Momentum" in the March 2011 issue of *Morningstar ETFInvestor*. The following remarks summarize Mr. Lee's point of view and present several additional observations.

- Numerous studies have documented momentum in virtually all stock markets and asset classes. For example, Narasimhan Jedadeesh and Sheridan Titan published a study in 1993 showing that a strategy of holding the top 10% of U.S. stocks ranked by trailing 12-month returns, and shorting the bottom 10%, produced excess annual returns of 12% from 1965 to 1989 ("Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency, *The Journal of Finance*, Vol. 48 No.1, March, 1993, pp. 65-91).

- Momentum is a serious challenge to the efficient-market hypothesis (EMH) which states that market prices quickly reflect all public information and that future returns cannot be predicted from past returns. Contrary to the EMH, evidence of momentum has become stronger over time and has remained a profitable strategy since its discovery.

- Tightening bid-ask spreads of ETFs and the advent of free trading of ETFs allow the small investor to reap momentum profits by turning over their accounts without exorbitant fees, especially in tax-deferred accounts. The fact that momentum pervades all sector, country and regional level indices also allows trading ETFs to be a profitable strategy.

- Momentum may be due to investor bias. Investors, tend to predicate new price estimates on old prices which prevents prices from fully reflecting new information; while also being hesitant to realize losses and too quick to sell winners. Both biases prevent prices from immediately reflecting new information, thus diminishing the timeliness assumption of the EMH.

- So while momentum is omnipresent, it may not be an appropriate strategy unless: 1) utilized in tax-sheltered accounts, 2) trading cost are low, and 3) investors are disciplined.

Given that a momentum strategy may deviate from the market, the potentially high behavioral cost due to a of a lack of discipline can be minimized with a statistically sound application of stop orders in conjunction with exchange traded funds (see Commentary "ETFs and Stop Orders", June 5, 2010). Momentum is not an unusual strategy. Without momentum and the market's ubiquitous waves of pessimism and optimism, value investing would not be possible. Momentum exploits investor behavior and its implementation is deceptively simple.