The Momentum Catch 22

Evidence-based investors want exposure to a factor like momentum because it is a powerful driver of returns; capturing it effectively is typically challenging due to high trading costs and turnover. Seeking a balanced approach that integrates momentum with other factors, especially at asset levels, can help capture the momentum premium more efficiently without the excessive costs.

Momentum is one of the best documented drivers of return in academic literature. Momentum states that stocks that have performed well in the recent past (last 6–12 months) tend to outperform over the next 6 months. The same is true on the downside; stocks that have recently performed poorly tend to continue to do poorly.

This out or underperformance can be significant but also very difficult to capture as an investor. Some managers go after momentum directly. They actively pursue this premium by buying winners and selling losers. The trouble with this approach is that portfolio turnover in the strategy ends up being over 200%. Because stocks may only exhibit momentum for a few months, the manager needs to constantly rotate the securities in the portfolio. This leads to significant trading costs (especially at higher AUMs) and potentially lots of short-term capital gains or losses which destroys the premium the manager is trying to capture.

Another common approach is to use momentum as a screen, a reason not to trade. For example, when a stock exhibits upward momentum you wait to sell it until that upward momentum dissipates. While this is a great way to capture part of the momentum premium without incurring any additional trading costs, the trouble with this strategy is that it has virtually no impact on performance. Why? Upward momentum is only applied on sales (not purchases) and downward momentum is only applied on purchases (not sales). Additionally, for low-turnover strategies (5–10% annually), momentum only impacts a fraction of the portfolio.

Alas, there is a better way. It lies somewhere between these extremes.

Material Momentum

The first way to improve on the implementation of momentum is to apply both up and down momentum to all trading activity. Momentum should be balanced against all the other premiums in every trade that is made. If you have two small value stocks and one is momentum up and the other is momentum neutral, you should prefer the momentum up security. Similarly, if there are two large growth securities and one is momentum down and the other neutral, you should prefer to sell the momentum down security. By incorporating momentum into security selection decision along with value and profitability as a driver of returns rather than as a screen, the investor can materially capture the momentum premium without increasing turnover or trading costs.

The second way to improve on the implementation of momentum is by having a smaller asset level and being nimble. More specifically, using the rebalancing methods inherent to ETFs to help pursue momentum.

Traditional mutual funds rebalance their holdings by buying and selling stocks on the stock exchange. ETFs can rebalance that way as well, but can also rebalance via custom baskets. In short, ETFs can work with market makers to exchange one basket of stocks for another. ETFs can exchange a handful of undesirable stocks (down momentum ones potentially) for more desirable stocks (up momentum ones potentially). This creates another avenue for fund managers to trade at a low cost and pursue momentum in a cost effective manner.

Market makers have limited balance sheets though, and thus, are not willing to do these exchanges for hundreds of millions of dollars. They are willing to do this on a smaller scale. If your AUM is lower, these custom trades can have a material impact on the makeup of your portfolio. By incorporating momentum into these trades, you can achieve a material momentum tilt at lower trading costs. Again, this is only possible at lower AUMs. Larger AUM firms would demand too much liquidity from market makers for this to be an effective strategy.

Momentum is a large driver of returns that asset managers have struggled to capture for decades. By factoring momentum into each trade decision intelligently and maintaining a lower AUM, this strategy can capture this elusive factor cost-effectively.

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