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MARKETS INSIGHT

July 12, 2013 5:48 pm

# Momentum investing is bad for your wealth

By Paul Woolley

Managers should focus on companies, not prices, says Paul Woolley

**T**he role of the finance sector is to channel savings into productive investment.

Institutions such as pension funds fulfil this role, acting as the collection point for savers' capital and setting the terms for how it is allocated. We innocently assume that our capital is directed to those sectors and companies with the best earnings potential. That way we receive the highest returns and the economy flourishes. The sad truth is that isn't how it works in reality. The bulk of investment is now conducted without reference to economic value.

There are only two basic strategies for managing equity portfolios in particular: fundamental investing – based on expected future cash flows – and momentum investing, or trend following, which considers only short-run price changes and disregards value. Fundamental investing calls for patience. Investors must wait either for prices to reflect the full value of the underlying business, or earnings to crystallise as dividends. Momentum investing delivers quick gratification – or not, depending on how long trends last.

Momentum demands a much higher level of trading as investors latch on to the latest winners. Reflecting its more widespread use, a typical fund's annual turnover has risen to about 100 per cent, with average holding periods at 12 months or less.

Momentum makes sense for the short-term investor and those keen to minimise short-term risk. But it comes with a wealth warning. First, momentum investors are always starting behind the game line, because they're buying shares that have already risen and selling those that have already fallen. Second, it means selling shares that disappoint, even though the lower price may now make them better long-term value. Third, momentum is highly sensitive to the luck of timing. Finally, it incurs high transaction costs.

Investing based on fundamentals wins in the medium and long run. Even moderately successful attempts to buy cheap and sell dear can enable investors to exploit the mispricing created by momentum traders. It is the optimal strategy for those with long horizons, such as pension funds and self-invested personal pensions.

It also demonstrates what should be the first law of investing: when it comes to choosing an investment strategy, the long run is not equal to the sum of the intervening short runs. Put simply, trying to achieve the best possible return each year is a recipe for doing badly in the long run.

Funds have ended up overusing momentum, often unwittingly. The most common cause lies in the guidelines they set for managers. The standard remit is for the manager to beat an index return subject to risk levels, usually defined in terms of divergence from that index return. The index itself – typically weighted by market value – is of course already subject to momentum swings generated by fund flows.

To comply with the risk constraints, the manager has to keep up with the fads of the market regardless of value. The less latitude he is given, the more he has to fall back on momentum. What appears as a prudent constraint actually penalises the long-run return of the fund.

The same outcome occurs when a manager seeks to minimise his own career risk, using momentum to keep his fund's return from diverging too greatly from that of the benchmark.

Then there is the overt use of momentum by many hedge funds. High fees and annual performance bonuses make both hedge funds and their clients impatient for quick results, with momentum the obvious tool. Not surprisingly, returns have been volatile, and in many cases poor.

An influence beyond the funds' control is that policy makers and regulators preach one thing and demand another. They criticise the short-termism of equity markets, but also insist on short-term, mark-to-market systems of valuation, forcing managers to use momentum.

Both pension funds and private investors need to be aware of the damage done to long-term returns by momentum investing and to focus instead on the fundamentals. A few simple rules will help:

- Use a growth-based benchmark, such as global GDP plus national inflation, instead of one based on market cap;
- Measure risk in terms of the variability of cash flows, not of market prices;



- Limit annual turnover to 30 per cent. Funds that persistently breach this should lose their tax-exempt status;
- Don't hire managers whose business model is based on trend-following;
- Funds that follow these rules will enjoy better long-run returns with lower risk regardless of what other funds are doing. And as funds increasingly invest in this way, financial markets will become more stable and capital will be supplied to assist growth.

*Paul Woolley is a senior fellow at the London School of Economics*

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