

Chasing trends is a dangerous game

By Paul Woolley

Momentum is a losing strategy for long-term investors

Big investors currently pursue two very different strategies when appointing external managers. Their traditional approach is to hire fund managers for portfolios benchmarked to market indices with risks quite tightly controlled. They are simultaneously increasing their allocations to hedge funds, measured against cash and free to take every liberty under the sun.

Both approaches generally produce disappointing results, especially for long-term investors such as [pension funds](#). As it happens, this is for related reasons.

In the standard format, the manager is appointed to invest in equities or bonds with the objective of beating the representative index. Risk is specified in terms of divergence of the total return on the portfolio compared with the index return. Constraining this “tracking error” is seen as a prudent way to clip the wings of managers whose ability is uncertain, but there are drawbacks.

An index is a suitable benchmark only in the theoretical world of efficient markets where prices are set on the basis of expected future cash flows. In the real world, prices also respond to fund flows driven by a host of extraneous influences unrelated to fundamental value. An index weighted by market capitalisation will therefore give misleading signals, causing the manager to invest most in overvalued stocks and least in the cheap ones.

To comply with their risk limits, managers must ensure that portfolio weights do not stray far from market weights. This means chasing trends, in effect a momentum strategy, and the tighter the tracking error the less scope they have to buy cheap and sell dear.

Momentum is a losing strategy for long-term investors. Trend followers are by definition late for the party and leave well after it is over. Moreover, holdings that disappoint are sold even though they may now be more attractively priced. And luck is needed to get the timing right. By comparison, even a moderately successful attempt using fundamental value wins out in the medium and long term.

Little wonder that this standard product delivers such poor returns.

Freedom squandered

[Hedge funds](#) are seen to offer an alternative model, seemingly free of these disadvantages. Their returns are measured on an absolute basis, against cash,

and they are free to run concentrated portfolios and take additional risk through leverage and shorting.

But these freedoms are then squandered by the strategy most follow. Although, on the face of it, hedge funds can focus on getting the best return, those that hire them are uncertain of the manager's competence and diligence.

So, while hedge funds have no formal restrictions, they feel the need to demonstrate their ability by delivering early gains. This is best done by using the quick results that can come from jumping on the bandwagon of the latest price trends. High charges, including short-term performance fees, also make both client and manager impatient for speedy results.

Hedge funds make extensive use of momentum both by their own admission and as evidenced by high turnover and short holding periods. The pattern of returns is also a giveaway: erratic and widely dispersed performance across funds as each tries to time treacherous momentum plays. It is no surprise that hedge funds in aggregate have delivered money-weighted returns below that of US Treasury bills over two decades.

Ironically, asset holders are choosing between the conventional index-hugging approach blighted by the enforced use of momentum, and a product whose principal tool is momentum, turbocharged by leverage. The only difference is that the role of momentum is to reduce risk in the first case, but to gain return in the second.

The solution is for asset holders to revise the contracts they write with both types of manager. They should replace market-cap-weighted benchmarks with ones based on cash, or cash flows. They should specify and monitor strategies with greater awareness of the pitfalls, and limit turnover as a handy way of minimising momentum-driven trading.

Code of best practice

Asset holders may complain that they can only buy what managers offer and that hedge funds are unlikely to change their ways given their rich pickings from the present arrangements. But there is more at stake here than a redistribution of wealth among individual funds or between funds and their agents.

Capital markets driven by momentum are not conducive to the efficient allocation of capital, nor to the stability of the financial system. If asset holders fail to act, policy makers must give leadership. A code of best practice issued by the International Monetary Fund or Financial Stability Board would be a good start.

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