Momentum investing is a popular strategy and cold hard numbers show it works admirably

Man versus machine

Olivier Zucker

The human brain is predisposed towards optimism, a trait which can be very damaging when it comes to investing. Growth and market potential are often exaggerated; risks and possible downturns are minimised and displaced. Emotions are often an investor's worst enemy, which is why we have developed an investment strategy – based on momentum – which leaves hopes and fears out of the equation.

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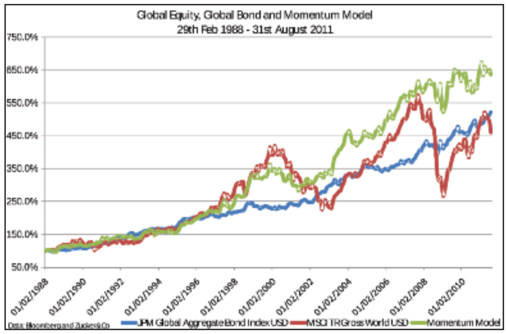
analysis, sentiment and expectations alone.

Free market signals

So what would happen if we put theory, market expectation and forward-looking predictive analysis aside? What would be left to guide our investment decisions?

One key factor is momentum, a source of information that is provided consistently and free of charge by the market itself.

Yet despite these advantages, the signals from momentum are still widely neglected.



An unexpected two decades

Equities provide better returns than bonds in the long run – at least according to conventional wisdom and the investment mantra. But just how long is the long run? Over the past 23 years, global bonds have actually generated higher total returns than global equities, yet most asset managers have stuck to an equity-biased framework throughout this period, leading to supposedly 'balanced' portfolios that held too many equities and too few bonds. The result of such a biased asset allocation has been lower returns with higher risks. All too often, investment portfolios have failed to live up to expectations.

In recent years, a static pro-equity bias has not worked well. For example, an investor who allocated funds to the equity market 10 years ago would hardly have expected these funds to deliver annualised total returns of just 3.6%*. Most investment strategists would have pointed to the long-term trend, and forecast annual returns in the high single digits.

In reality, few investors have maintained a completely static allocation and, with hindsight, it is easy to spot and regret missed asset allocation opportunities. If only, an investor might tell himself, I had switched from equities to bonds in early 2001 and again in October 2008, and then switched back again after the markets crashed. In practice, this is almost impossible to do when relying on

We have long been intrigued by the idea of using the power of market momentum to steer asset allocation decisions between equities and bonds. Flowing from that, over the past two years, we have been developing a systematic approach to asset allocation to ride out the peaks and troughs of the market cycle.

While the programming itself is complex, the basic idea is simple: to create a strategy that obliges us to reduce exposure to risky assets such as equities (and move into safer assets such as government bonds and cash) when equity momentum turns negative, and to reverse this when momentum turns positive again.

Benefiting from trends

To illustrate our findings, we have created a basic model to show the impact of re-allocating between equities and bonds on the basis of price momentum.

As the graph below illustrates, these models are invaluable in systematically steering us towards the better-performing asset class while avoiding the weaker one. As a result, portfolios based on this strategy would have avoided the worst of the falls in equity markets in 2001, 2008 and 2011, delivering better long-term performance.

The beauty of these models is they are self-correcting and prevent us from investing against market trends. This leads to a portfolio which focuses more on avoiding losses and preserving capital rather than sticking to riskier assets in order to generate (theoretically) higher returns.

Over the past six months we have been reminded again just how valuable such an approach can be – and against our own instincts.

Back in March, when our indicators turned against equities, we were decidedly unhappy. Along with the majority of investment strategists, we believed in the continuation of the global economic recovery and felt we were in a soft patch for growth, not a slump. But while analysts including ourselves were subjective and caught in their own thinking, markets were far more objective, pricing in future uncertainty coldly and precisely.

Disciplined approach

In both our analysis and experience, momentum works. Momentum-based models can form the basis of a much more disciplined investment process, avoiding the pitfalls of human emotions and biases while recognising market trends cannot be consistently forecasted in a predictable and reliable way. At a time when markets are choppy and volatile, and when there are plenty of reasons for both hope and despair, momentum-based strategies can help cut through the noise and provide a solid foundation for long-term investment success.

* BASED ON THE MSCI GROSS WORLD INDEX SEPT 2001 TO AUG 2011, IN DOLLARS.