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Recognizing Momentum: A Possible New Twist to Value Management

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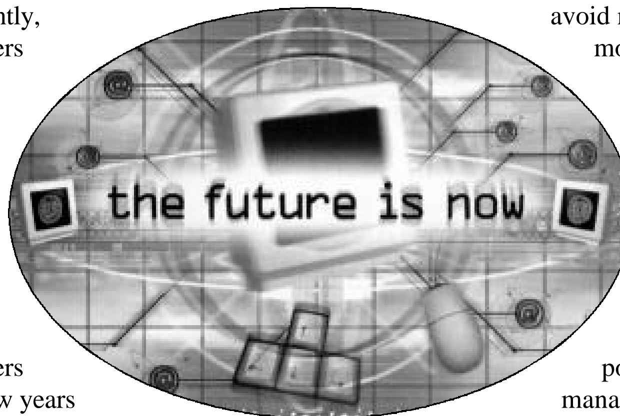
Equity investment management is often classified into a number of different styles, the simplest being growth and value. Under a growth style, the manager selects securities that often display characteristics of a good financial story, high stock price potential relative to earnings, abnormally high growth expectations, and new companies or companies in a vibrant or new industry entailing at least some degree of hope.

For a value style, managers select securities that display a solid product line, a reasonable stock price relative to earnings, reasonable to good cash flow, and a price lower than fundamentals would suggest. Companies in this category are often quite mature and well-established.

Either style has its merits and each appeals to different investors. The growth style suggests greater return in exchange for greater volatility (and hence risk). A value style suggests a limited downside, but also would imply a somewhat more limited upside as opposed to growth, both taken together to imply less risk.

Growth style management has been more appealing than value for quite some time, at least until the recent market sell-off. Many years had shown dramatically high returns in the growth category relative to value. A value approach may also be looking for some "reversion to the mean" or relative valuation in prices, perhaps also sparked by a catalyst, whereas a growth approach implies that there is no mean. In market corrections, value managers point out, correctly, that they suffer less decline, since their securities are better tied to fundamentals and reality—not hope. The lack of information or uncertainty that often characterizes growth can allow for valuations to go too far in either direction. Investors still participating in growth during corrections, will often second-guess this aggressive strategy and may be tempted to bail out, given that portfolio declines can be so dramatic.

Until recently, value managers were always perceived to provide less return than growth. Were the returns provided by value managers in the past few years commensurate with risk, and were value managers perhaps missing something? Is there a characteristic in growth management that should also be monitored in value management?



What Was the Major Underlying Theme in Past Years—And the Theme in the Recent Market Sell-Off?

The past several years were marked by impressive equity returns in the United States—double-digit returns for most sectors most of the time. Portfolio managers and pension funds increasingly looked for reasons as to why their equity mix should be tilted higher. It was getting to the point that many individual investors saw no need for bonds in their portfolios (even older investors), and investors even neglected the bluest of blue chips. If one wanted even higher returns, the key was to restrict the number of issues purchased to as few as possible, as long as the issues were the right ones. What many investors were doing (whether implicitly or otherwise) was riding the trend, or what some may term "playing momentum." That is how one can make the most money. Successful portfolio managers, whether they admit it or not, take advantage of positive momentum in their purchases, and in downturns, sell to avoid negative momentum. Momentum is a factor in both up and down markets, but unfortunately too many investors and portfolio managers get seduced disproportionately by fundamentals.

Surprisingly for everyone, including myself, all equity issues were hit badly in the recent market sell-off, and major companies, including the four horsemen of the NASDAQ, got hammered by over 50% declines each. Too much price damage was done in such a short time horizon. The big losers were also the momentum plays where the large returns were mainly achieved the past number of years. One of the really educational elements of the market sell-off was the general psychology of many investors leading up to it. A 20% minimum return was expected annually. Any new idea or product innovation was also quickly packaged as an IPO and lapped up with reckless abandon by an eager public. But why not—it seemed that every time a stock came out as an IPO, its price would double within weeks (especially if it was considered to be one of the new-tech variety). Bonds were simply a bad idea for most people. And anyone taking advantage of this prevailing psychology did get rich. Unfortunately, when the markets began to sell-off this last time, no one really worried, as it happened

over and over again with a happy ending. Investors were conditioned. Any fear of recession would only be temporary and the U.S. economy was invincible.

I would often hear of people who were unwilling to sell a stock with a small decline, now selling at 60–80% losses, and these sales would often be in fairly good companies (the lousy companies declined usually over 90%). It did not even make sense anymore—a good company will come back, just give it some time. However, psychology is a funny thing—it can get you to buy high on hope, and get you to sell low on fear. What we saw was increasingly negative psychology in the recent sell-off.

Ignoring Momentum Ignores an Important Value Component

In a typical equity universe, perhaps one-third of the stocks might be classified as growth, another one-third as value, and the remaining one-third might fall into either category. For those securities that fall into one category but not the other, there could be some desire to bring these securities into the opposite category, but criteria may be specific as to their exclusion.

A high-growth stock may represent some value to a value manager, but because of a high P/E or other fundamental measure, they by necessity must be excluded. Or a value stock has increasing market activity, which may suggest a breakout to higher prices, but a growth manager may not be able to buy it due to fundamental growth parameters being too conservative. Of course, investment policies have to be so specific; otherwise the style bias could be defeated. But what would make either a growth or value manager, who cannot include a security of the opposite category in his/her portfolio, still wish to buy such an investment?

In reviewing security action over time, it must be understood that fundamentals are only a rough guide as to where a security price would be. We see fundamental arguments being used for bond prices, relative currency values, economic prospects, consumer confidence, etc. and hear the contention that something is wrong with the marketplace when fundamentals are being ignored.

For example, European finance ministers have long been touting that the Euro currency is severely overvalued, and likewise we hear the same argument from Canadian officials regarding the Canadian dollar. We saw the price for crude oil several years ago going to around $10 US a barrel, and saw that it was too cheap at the time, and then the price almost reached $40 a barrel a few years later and argued that the price was too expensive, based on reasonable market fundamentals. Yet prices often do not “revert to the mean” as is hoped, or at least not as quickly as our time frame would suggest. What is therefore going wrong with the marketplace, or are the fundamental approaches to valuation wrong?

When analyzing how some have made vast fortunes in investing, we come to realize that certain principles must be remembered in investing. Securities can never be too cheap to keep going down (witness the early 1930s) or can never be too expensive to keep going up (witness the late 1990s). In addition, behavioral issues or biases, which may have nothing to do with fundamentals may often be at work in the investment process. One parameter that is often missing in traditional market valuation is momentum. Speculators understand this principle well—it does not matter where the price is, or whether the price is considered cheap or expensive, but rather where it is going as suggested by market action, and what will be the possible signs as to when to get out. However, momentum is hard to characterize and measure, unless one knows what to look for. That is a subject for another discussion. Market technicians understand the principle well. Risk control in tandem with momentum plays must be evaluated carefully.

In portfolio management, the investment manager is not interested in playing the momentum game, contrary to a speculator. Playing momentum can be both dangerous and nerve wracking, but also quite rewarding. Momentum should be taken seriously when reviewed over a longer term, and should be an additional component when evaluating a stock or portfolio. For example, a value manager may have omitted Microsoft for years based on traditional valuation factors, and lost a good appreciating stock. Even though Microsoft suffered severely in the year 2000–2001, if the portfolio manager bought it a few years earlier, the more recent decline would have still not taken the manager to an overall loss from inception. And if the manager has a good framework established for determining when a security is losing momentum, then even a major decline can be avoided. It can also cut the waiting time before one makes a certain level of profit.

Momentum should be an important additional key in evaluating both growth and value security candidates. If interest is waning in buying the stock, then it is probable that things may be coming to an end, or at least stalling. However, until that happens, substantial gains can be made. Reversion to the mean can be a very long time in coming, and any catalyst to generate an interest in the stock may not materialize quickly.

My main argument is that momentum should be an additional parameter reviewed in the investment decision. Attaching a weight to momentum can improve the performance of both growth and value managers, and probably will have a greater significance on the latter's results.

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