What is ‘momentum’ in finance?

Most of us have heard this expression in a physics class when we learned Newton’s laws - a moving object keeps moving along its direction of travel, unless acted upon by some other agent or force. In investing, we talk in terms of price momentum - asset prices continue to move in the same direction they are doing now, unless something else, some news or change in sentiment intervenes, and makes it change direction. Just as classic momentum had both direction and magnitude, price momentum of any instrument can be either positive or negative (direction) and can vary in strength (magnitude).


Watching Momentum in action - looking at Markets

Its easy to see momentum as it plays out. So, we have ***bull markets***, periods of rising asset prices, when they seem to keep rising, and they tend to continue for some time until a turning point is reached.

The ensuing ***bear market***, in which asset prices fall, exhibits a similar phenomenon in which the price declines persist much longer than many believe possible.

‘Momentum’ in academia and the marketplace

Price momentum is not a new concept.

Most traders rely heavily on momentum, but they are too often focused on short-term momentum. At Monogram we would say that those who are hasty miss reaping the benefits of longer trends and pay out what we consider to be too much in transaction costs and commission.

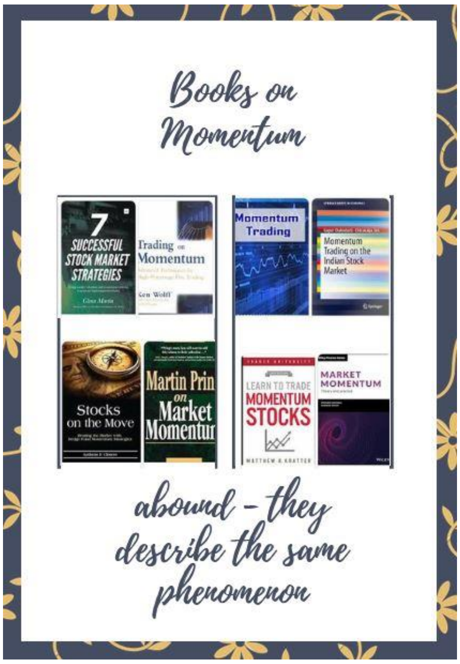
We know from experience that if you can learn to apply momentum to investing, you can do well and find yourself fairly consistently on the right side of the market. Those who have learned to harness the power of momentum consider it the single greatest tool for achieving consistent returns.

The Monogram momentum model was first developed in Cazenove, and an ex-Goldman Sachs executive joined to run it for a couple of years, and then sold the IP to a new management team, who retained key staff, but adjusted the model. The acquirer adopted the Monogram brand name and is taking it forward. The academic component of the management team has stayed with the model - Prof Stephen Thomas heads up the MBA at Bayes business school in the heart of the City of London.

‘Beating the market’, or ‘steady as she goes’?

The concept of momentum has been studied by academia for decades. Most participants have seen mathematicians, ‘quants’, and geeks around the world venture off in search of a way to consistently beat the market. Nearly every theory that academia has studied with regard to predicting and outperforming the market has failed. That too is well known.

All except for one that is … momentum. Research bears this out.



There are many resulting books on momentum, and a host of academic studies and papers discussing the findings of multi-decade studies. Nearly all of them come to the same conclusion: Momentum is the one market anomaly (see works on behavioural finance[i] which explains why they occur) which persists.

If applied well, momentum-based investing can give a consistent return on investments. The biggest risk would appear to be people withdrawing funds at a moment which is too consistent with the rest of the market's overall behaviour.

Why do price anomalies occur?

The academic community admits that price momentum exists as a market anomaly; they are less certain about why. One of the main theories put forth that is gaining assent relates to behavioural finance. This is the theory that the economy, markets, and asset prices are all driven predominantly by human behaviour. Human beings don't behave rationally. Yes, we are talking about everyone, including portfolio managers, traders, institutional investors, and we don't rule out board members of fund management organisations. Our irrational behaviours play out in ways which are capable of being observed and predicted. Hence the science of behavioural finance.

Even irrationality has a pattern

You too have undoubtedly noticed a strange phenomenon - a larger number of investors than you would think possible tend to buy when stock prices are too high and sell when they are too low. We ourselves are no exception. We know that this is emotionally driven behaviour - and one of the driving forces behind price momentum.

When the stock market is in rally mode, people chase the market, not always coming in at a low enough price to make a big gain. When we see a falling market, many sell their investments near the bottom of a financial crisis, feeling low and losing heart that they have somehow got their stock selection wrong. Collecting up these reactions, is what we see as 'volatility'. We have all watched the market deteriorate suddenly, and seen the fear set in, at which point we said enough is enough, and sell our positions.

An investment in Monogram is a form of 'safeguard' against this emotional behaviour which collectively manifests itself as the 'momentum' in markets.

Portfolios seeking an 'alternative'

The Monogram model looks for the point at which a market is showing signs of changing momentum, either losing it, or increasing it. It will then invest in (or sell) that market at the next dealing point.

This turns out to be a useful response to investors' perceived need for an 'alternative' way to invest - given recent experience; many investors find market gyrations unnerving.

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The Monogram Board invests in momentum, because it knows that we all need something in our portfolio, which is an alternative to how the rest of the market behaves.

During the pandemic year 2021, it returned a 14.8% gain over the year, for its existing investors.

See the last few months performance on this page.

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[i] behavioural finance is the study of the influence of psychology on the behaviour of investors or financial analysts.