

Momentum Investing & Turbulent Markets Don't Mix



Charles Rotblut, CFA
AAI Journal Editor

Momentum indicators are commonly used to find winners. Winners are stocks with comparatively higher price returns. In normal market conditions, momentum indicators work well on an aggregate basis. Momentum indicators can lose their usefulness in turbulent market conditions, in the initial rebound period following a bear market or during slowing economic conditions.

I've noticed the "crashing" of momentum indicators as I backtest elements of the **new stock strategy** I've been working on. As some of you might recall, I'm developing a new strategy that combines value and momentum. The process has been going slower than expected, but I recently backtested components of the strategy through the financial crisis of 2008 and the spring of 2009. The data revealed periods where momentum indicators either didn't work or did more harm than good.

There are different momentum indicators, but I'll start with one that the anomaly called WML (winners minus losers) is most associated with: relative price strength. Relative price strength compares a stock's returns over a given period of time (e.g., 26 or 52 weeks) to all other stocks. The more a stock has appreciated relative to a broad market index or all stock universe, the higher its relative price strength is. Price performance is considered an anomaly, because if the market were efficient (meaning excess return cannot be realized through the analysis of individual securities), an investor should not be able to create a portfolio out of the stocks with the best relative price strength and realize a market-beating return. Yet there is research showing that stocks that have performed well in the past will continue to perform well over the next one to two years. Academic research also shows that a profit can be made by buying "winners" and shorting "losers," hence the WML acronym.

[Read more »](#)

More on AAI.com

- **Why Momentum Strategies Can Crash** – A study showed that fund momentum strategies particularly fail when the two-year market return is negative.
- **Money from Momentum: Positive Feedback Can Drive Returns** – The reasons why momentum works, as well as the anomaly's limitations.
- **Do You Adjust Your Momentum Strategies in Down Markets?** – See how members responded on the AAI.com Discussion Boards.

Not an AAI member? **Join today**

AAI Sentiment Survey

This week's rise in bearish sentiment puts pessimism within the 70 highest readings in the survey's history. Although optimism improved, bullish sentiment ranks remain within the range of its 60 lowest readings. **More about this week's results.**

What's Trending on AAI

1. **The Changes to Social Security Claiming Strategies**
2. **The Mathematics of Retirement Portfolios**
3. **Social Security Strategies for Couples**

The Week Ahead

Approximately 115 members of the S&P 500 will report earnings. Included in this group are Dow Jones industry average components Exxon Mobil Corp. (**XOM**) and Pfizer (**PFE**) on Tuesday and Merck & Co. (**MRK**) on Wednesday.

The first economic reports of note will be the January ISM manufacturing index, December personal income and saving, the January PMI manufacturing index and December construction spending, all of which will be released on Monday. Wednesday will feature the January ISM non-manufacturing index and the January ADP Employment Report. The first estimate of fourth-quarter productivity and December factory orders will be released on Thursday. Friday will feature the January jobs report—including the change in nonfarm payrolls and the unemployment rate—and January international trade.

Two Federal Reserve officials will speak: Kansas City president Esther George on Tuesday and Cleveland president Loretta Mester on Thursday.

Read more »

The **December AII Journal** features our popular tax guide. This annual guide helps investors stay up to date with the ever-changing tax regulations, including rules for preparing 2015 taxes and tax strategies for 2016. It will help you understand your current tax liability and what you can do to potentially lower your tax bill this year and next year. **Start your risk-free AII membership today** to get The Individual Investor's Guide to Personal Tax Planning 2015, and to **benefit** from everything AII has to offer.