Trend & Momentum Investing

Should you consider these approaches?

Provided by Michael G. Krum

Most people invest passively. That is, they direct money into an investment account or portfolio that is passively managed. Passive investment management, characterized by long time horizons and very little buying or selling, certainly has its merits. It can also have serious demerits in a bear market or within a poorly performing sector.

Trend investing and momentum investing take different approaches. Both of these strategies involve active investment management. Both also involve some degree of market timing, a tactic that some investors reject outright.

However, neither trend nor momentum investing rely on hunches. They are both disciplined approaches, based on technical analyses of the market's direction and various market sectors. When things are going south (or north) in a sector or an industry, these approaches beg consideration as an alternative to a strict buy-and-hold (value investing) strategy. In fact, both trend and momentum investing are worth considering in all market climates.

How do these two approaches differ? In trend investing (sometimes called trend following), you use technical analysis to buy or sell a security based on sustained price movement. How close is the share price to its 52-week high or low? What does analysis reveal about the stock's short-term direction? If the direction is up, you buy and hang on; if the direction is down, you can short the position (or wait it out). [1]

Trend investing takes a distinct point of view about where the market is headed, and it is as much about when to sell as when to buy. A sensible trend follower will abide by a sell rule – which could consist of a trailing stop loss paired with a confirming indicator, for example.[1]

While trend investing centers on absolute price changes (changes in share prices weighed against changes in the market), momentum investing looks at share price changes relative to one another rather than relative to the state of the market. The goal of momentum investing is to find shares that are moving faster than the market.[1,2]

The momentum approach assumes that share prices that have outperformed others will continue to do so. It also assumes that poorly performing shares will continue to underperform. In other words, the winners will keep winning and the losers will keep losing. You may buy high through the momentum strategy, but you buy high with the belief that you can sell higher. Unlike a trend investing strategy, a momentum investing strategy takes no point of view about the direction of the market.[1]

These strategies are about playing not to lose as well as playing to win. They are also about taking advantage of the compound annual growth rate (CAGR), sometimes called the "time value of money." A buy-and-hold investor rarely sells at a market top, or when particular shares peak. He or she just hangs on, perhaps far too long. A successful trend or momentum investor can take incremental gains and reinvest them in other shares headed in the right direction; market timing of the best sort.

You may have heard the statement that a penny, doubled every day, becomes a sum greater than $10 million in 30 days. Even at a 25% daily growth rate, that same penny becomes $8.08 just 30 days later. These examples are perhaps extreme, but they highlight one objective of trend and momentum investing: the idea of capturing compounding growth through active investment management.[1]

These strategies need not be divorced from others. Momentum investing and buy-and-hold (value) investing are compatible; in fact, some investors adopt a blend of the two strategies for the long run. Some investors have been known to blend trend investing with contrarian investing (in which you buy and sell in contrast to prevailing market sentiment).

Both strategies are not for amateurs. They embrace market timing, and fundamentally, market timing requires you to be right twice. You have to recognize the auspicious time to sell and the auspicious time to buy. The small investor who tries these tactics solo, absent of supervision from investment professionals, risks a great deal.

Historically, both strategies have had merit versus the norm. A recent *Institutional Investor* article compared a simple trend following strategy versus a buy-and-hold strategy across the years 1900-2014. The trend strategy would have invested varying amounts into equities per month depending on the level of the cyclically adjusted price-earnings ratio (CAPE) for the S&P 500 at the start of each month. The variance would have been between a 50% equities position (moving money into cash) and 150% (borrowing from the cash position to buy more equities). When compared with an unchanging buy-and-hold strategy featuring 100% investment in large cap stocks, the trend strategy was actually less risky than buy-and-hold beginning in the 1960s and earned an average of 0.8% per year better than buy-and-hold over this 115-year span.[3]

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Citations.

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