ThinkAdvisor

MAY 13, 2014

## 10 Myths About Momentum Investing: AQR Capital

*AQR Capital researchers and a University of Chicago professor aim to bust 10 persistent myths about momentum investing*

*A new paper by AQR Capital Management seeks to lend intellectual respectability to oft-derided momentum investing.*

A new research paper by quant hedge fund manager Clifford Asness and colleagues at his AQR Capital Management seeks to lend intellectual respectability to oft-derided momentum investing, which is often seen as a high-risk trader's game rather than a legitimate portfolio strategy.

The University of Chicago's Tobias Moskowitz joined Asness and his AQR colleagues Andrea Frazzini and Ronen Israel in authoring the paper titled "Fact, Fiction and Momentum Investing."

Momentum investors seeking to purchase securities that have performed well relative to peers and shun (or short) relative underperformers. The authors aim to refute 10 myths questioning the efficacy of this approach. Here is a "Cliff's Notes" version of the 26-page paper.

**Myth #1: Momentum returns are too "small and sporadic."**

The authors note that momentum's return premium is evident over 212 years of U.S. market data and can be seen in studies covering 40 other countries and more than a dozen other asset classes (e.g., bonds, currencies, commodities).

Over the 86 years between 1927 and 2013, for example, the spread of recent winners over recent losers averaged 8.3% a year.

They show there are many ways to slice and dice momentum, but they conclude:

"It's undeniable that far from being 'small,' momentum returns are large, large after basic risk adjustment (Sharpe ratio), and larger than other major factors, even those occasionally being promoted by the exact same crowd calling momentum 'small and sporadic.'"

**Myth #2: Momentum cannot be captured by long-only investors as "momentum can only be exploited on the short side."**
Using Kenneth French's data, the authors show that almost half of momentum's premium comes from the long side. Under a particular momentum investing approach, the authors find that the long side even contributed most of the returns. They cite one comprehensive study finding that both long and short sides of momentum investing were equally profitable over 86 years in the U.S., 40 years of international data covering equities and five other asset classes.

**Myth #3: Momentum is much stronger among small-cap stocks than large-caps.**
The paper's authors find that momentum investing's premium is significant among large-cap stocks — an effect only slightly less in magnitude than found in small-cap stocks.

Given that this charge is often lobbed by value investors, the authors find it ironic that it is in the realm of value investing that the value premium disappears among large-cap stocks.

**Myth #4: Momentum does not survive, or is seriously limited by, trading costs.**
While one might intuitively think momentum, because of its higher turnover, is costlier to implement, the authors, citing a study using a unique AQR Capital data set containing more than $1 trillion of live trades from 1998 to 2013, say this is not so. The reason stems from the fact that careful institutional traders know how to reduce trading costs, whereas some academic papers reference the cost estimates bearing on average investors, which are 10 times larger.

**Myth #5: Momentum does not work for a taxable investor.**

Similarly, the idea that higher turnover translates to greater tax effects makes some initial intuitive sense. Yet they find the tax burden to be similar—even potentially lower—than that of value.

One reason for this is that momentum, by holding onto winners and selling losers, is "biased to be tax advantageous" since it favors long-term capital gains, avoids short-term capital gains and realizes short-term capital losses.

In contrast, value strategies have high exposure to tax-inefficient dividend income.

"Since the premium for momentum is quite a bit higher than for value, yet they face similar tax rates, the after-tax returns to momentum are also higher than for value," the authors write.

**Myth #6: Momentum is best used with screens rather than as a direct factor**.
Some critics of momentum, who demean the approach as a "hot potato," nevertheless want to first select securities based on value criteria, and only then allow momentum as a secondary screen. The authors call this "an attempt to have your cake but denounce it too!"

The paper argues that such an approach is a backhanded, but suboptimal, way to acknowledge the validity of long-term data establishing the success of momentum investing.

**Myth #7: One should be particularly worried about momentum's returns disappearing.**
Any strategy has its seasons of relative success and failure; 1999-2000 was a tough time for value investing. That critics would therefore challenge only "momentum is odd to say the least, especially given the strength and stability of momentum's historical record"—across time, geography, security type and given the strategy's large return premium.

**Myth #8: Momentum is too volatile to rely on.**
Again, every strategy has its "dark times," and the paper's authors note the late 1990s were tough for value investors. So too was 2009 (when a plunging market suddenly reversed itself) difficult for momentum investors (especially those who relied solely on momentum in contrast to the authors' oft-stated preference for combining momentum and value factors).

The authors analyze Sharpe ratios to show that momentum is a superior strategy specifically on a risk-return basis. They also note the imperative of investing for the long term in a diversified portfolio as a means of getting through the dark periods.

They write: “Of course, any decent researcher knows far better than to point to one bad period for a factor with long-term success (success that, again, includes that bad period) and impugn it while letting other factors have a free pass regarding events in their own histories."

**Myth #9: Different measures of momentum can give different results over a given period.**
The authors raise the by now familiar objection that the different-measures charge can be used with any strategy. One can measure value through earnings-to-price, cash-flow-to-price or book-to-market value.

**Myth #10: There is no theory behind momentum.**
The paper’s authors again note that a multiplicity of theories — usually falling under the risk-based or behavioral categories — is debated with respect to size and value premiums as well.

While the theories are debatable, the data is undeniable. “We discovered the world wasn’t flat before we understood and agreed why,” the authors quip.