

Market Insight



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The Momentum Effect: Is the End in Sight?

Executive Summary

- The recent upswing in stock prices has evolved into a momentum rally that is significantly disconnected from underlying equity fundamentals.
- As history has shown, momentum rallies tend to be short-lived and often brutal on the downside, with momentum factors losing as much as 27% of alpha in previous periods of volatility.
- Complacency in the current equity market leaves investors exposed to the potential for significant downside risk—this is particularly true for risky, more aggressive equity strategies, as well as passive equity strategies that, by their nature, have inherent momentum biases and no ability to manage market risks.
- At this stage of the cycle, we encourage investors to navigate this potential market risk by focusing on what has proven to outperform over the long term: systematically identifying stocks with strong fundamentals and attractive relative value.

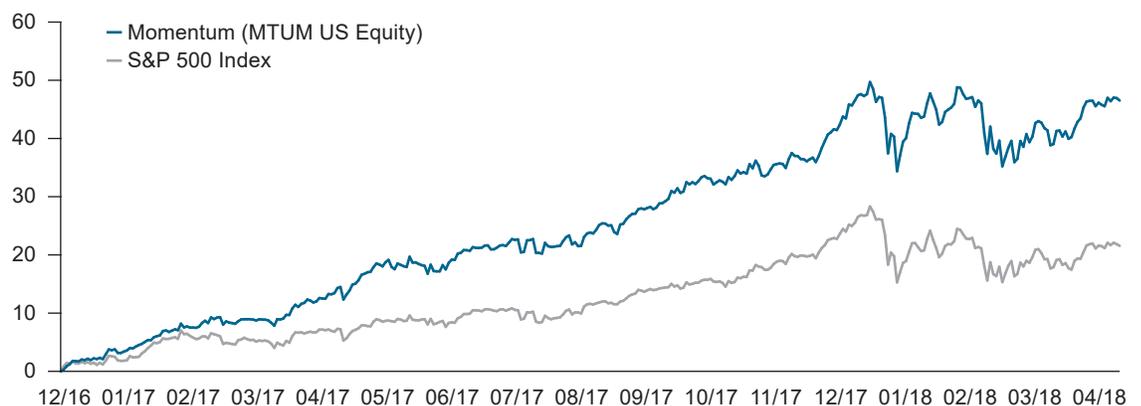
Even redwoods have their limits

“Trees don’t grow to the sky.” These are the words late financial journalist Louis Rukeyser used to describe the inevitability of down markets, a metaphor apropos of today’s equity environment. With no major downturns over the past nine years, the S&P500 has returned an astonishing 383% since March 5, 2009, or 18.6% per annum. Despite these all-time highs, sentiment remains bullish as we begin to emerge from a period of historically low interest rates.

While we are not forecasting a downturn, our analysis of recent stock market performance reveals reasons to be cautious. Stock indices are not necessarily moving higher because of generally strong company fundamentals. Instead, stocks are riding an extraordinary price momentum effect (figure 1). Why? The primary drivers are unprecedented post-financial crisis quantitative easing measures and massive inflows to passive investments, both of which ignore the underlying fundamentals of stocks. Additionally, traditional market indices are market value weighted, meaning they own more of the stocks that have been rising, creating a natural momentum bias.

Figure 1. Momentum soars to all-time highs — How long can it last?

Performance (cumulative % returns) of Momentum ETF (MTUM) vs S&P 500 since Jan-2017



Source: Bloomberg, Voya Investment Management.

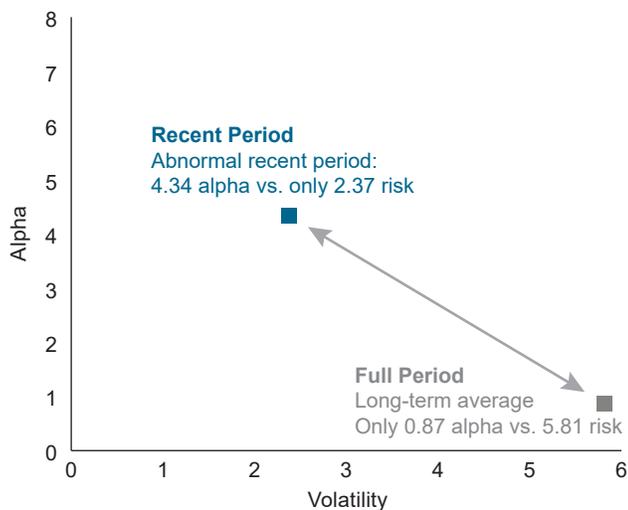
A mean reversion to the fundamental reality

As a purely technical factor, price momentum is the tendency for rising stock prices to continue to rise and falling stock prices to keep falling, with no fundamental company-specific drivers attached – only stock price momentum. Typically measured over a period of 6 to 12 months, price momentum strategies have historically delivered a slight premium (“alpha”) to market, albeit with heightened volatility. Academics often explain the alpha associated with momentum as investors “underreacting” to new information and jumping on a stock after it has started its surge, thus continuing the trend and compounding the effect.

An analysis of long-term annualized factor returns (Figure 2) shows that momentum has delivered slightly less than 1% of alpha with roughly 6% of risk. However, since the beginning of 2017, we have seen a significant deviation from this long-term norm, as momentum has delivered over 4% of alpha with less than 3% risk. Additionally, larger companies, which tend to underperform smaller companies over the long-term, have dramatically outperformed since the beginning of 2017. Therefore, we have clearly been in an environment where large-cap momentum stocks have been driving the market indices higher as investors pour money into passive index vehicles.

Figure 2. Recent momentum performance is a significant deviation from the norm

Momentum Factor Performance:
Full period (1997-4/30/2018) vs. recent period (2017-4/30/2018)



Source: Bloomberg, Factset, BARRA, Voya Investment Management

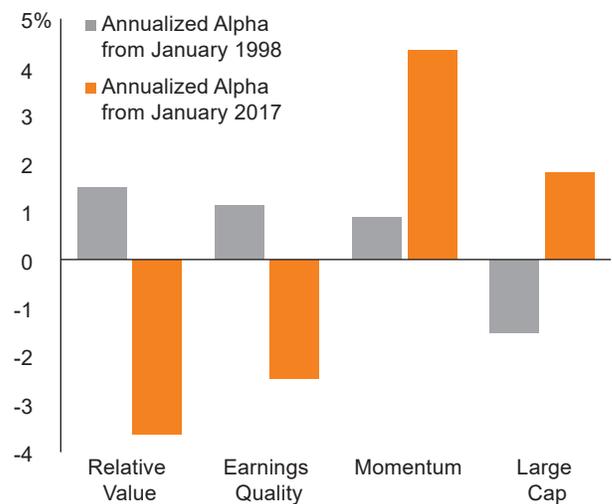
Meanwhile, historical measures of relative value (price/earnings, price/cash flow) have delivered roughly 1.5% alpha at around 3% risk over the long term, meaning it has been profitable and less risky to own relatively “cheap” rather than “expensive” stocks.

However, during this recent large-cap momentum rally, relative value factors have underperformed the broad market by almost 4%, which represents another significant deviation from the norm (Figure 3). Additionally, measures of earnings quality are down more than 2%, further evidence that investors are ignoring valuation and quality, and instead simply rewarding companies with rising stock prices and punishing stocks with declining prices. This phenomenon is likely being driven by the relentless flows into index funds and ETFs, given their large-cap, momentum bias.

When will company fundamentals matter again? While this is never easy to predict, history provides a useful guide. Over the past 20 years, there have been spectacular examples of momentum faltering and fundamentals taking hold, particularly after the tech sell-off of 2000 and the financial crisis in 2008-2009. In fact, momentum stocks lost an enormous 27% of alpha from mid-2008 through late 2009 and despite the recent run-up, have still not recovered that peak (Figure 4). Conversely, relative value factors generated strong returns after the tech bubble burst and have remained steady throughout, notwithstanding the recent bout of underperformance.

Figure 3. The current rally: Momentum wins as investors lose sight of fundamentals

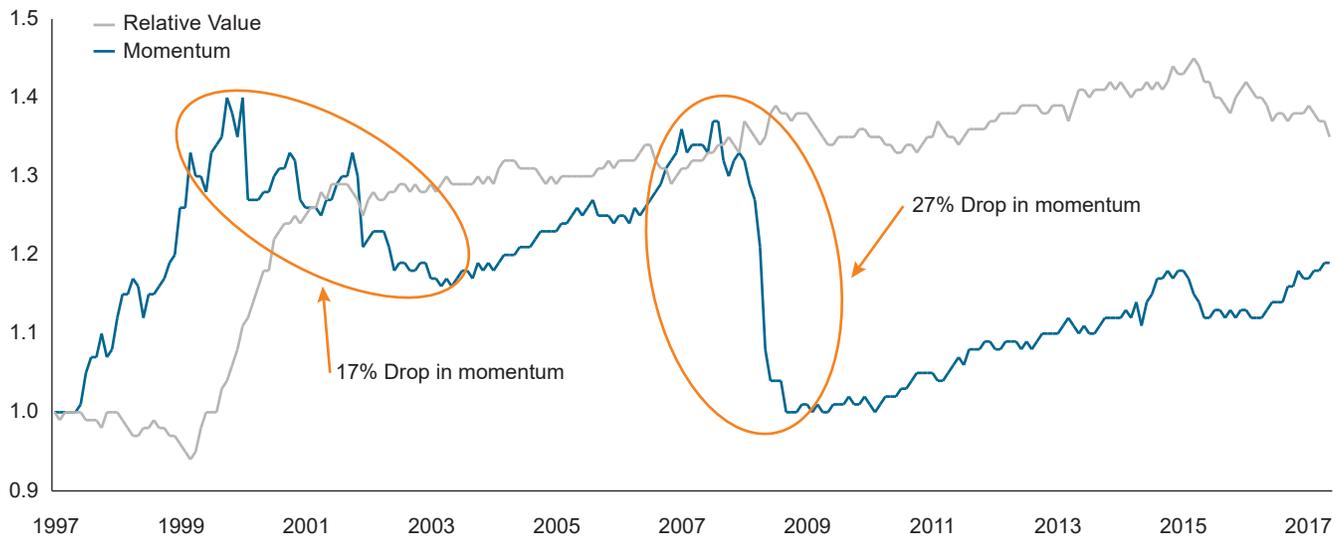
U.S. Factor Performance



Source: Bloomberg, Factset, BARRA, Voya Investment Management

Figure 4. What goes up...(momentum rallies have ended badly before)

Cumulative Factor Returns: Relative Value vs. Momentum



Source: Bloomberg, Factset, BARRA, Voya Investment Management

As momentum ebbs and flows, fundamentals remain

Previous momentum rallies have ended with a sharp move to the downside. Given the inherent momentum biases in broad market indices, passive equity investors have significant exposure to this downside risk potential. Risky, more aggressive active strategies can also leave investors with relatively more exposure to momentum bias and downside risk.

We continue to encourage investors to think long-term and diversify their core passive index exposure by using an active equity approach that combines valuation, quality, and growth signals. After all, if it is true that “trees don’t grow to the sky”, then at some point, mean reversion will take hold and factor returns will return to their long-term averages. When that happens, momentum will turn down, and fundamentals will begin to matter again, providing investors with tremendous stored alpha potential from factors that have historically delivered attractive long-term risk/reward profiles.

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