INVESTMENT EXECUTIVE

# Patience is a key factor

Reports of the death of momentum investing – and other factor-based strategies – have been greatly exaggerated

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Momentum is dead. At least that's what several studies published in the first half of this decade suggested. Back then, momentum – the well-documented tendency of stocks that have outperformed over the past three to 12 months to continue to outperform for a short period – was no longer generating excess returns reliably.

Fast-forward to the present, and momentum has delivered the highest excess returns globally of all the major factor strategies – including value, small-cap, high-dividend yield, low-volatility and quality – during the past few years.

From Jan. 1, 2016, through Aug. 31, 2018, the 16% annualized return of the MSCI world momentum index outperformed the MSCI world index by a hefty 5.2% a year (in Canadian dollars). In Canada, the 14.2% annualized return of the Morningstar Canada target momentum index outpaced the S&P/TSX capped composite index by 2.3% a year.

The reports of the death of momentum investing had been greatly exaggerated – and momentum is not the only factor-based strategy that has been pronounced dead prematurely. The classic misdiagnosis occurred in the late 1990s, when growth stocks soared and many investors believed the excess returns from value stocks were a thing of the past.

Who could've blamed them? In the U.S., growth stocks delivered a stunning 31.1% annual return from Jan. 1, 1995, to Dec. 31, 1999, outperforming value stocks by an enormous gap of 8.9% a year (based on the Russell indices, in U.S. dollars).

Frustrated investors and financial advisors dumped their value stocks in droves. Then, when the "tech wreck" struck, value stocks raced ahead. By the end of the next business cycle, in November 2007, value stocks had earned a 12.9% annualized return since Jan. 1, 1995 – a 3.7% premium to the 9.2% return of growth stocks and a 1.5% premium to the market, overall.

Every factor-based strategy has periods of underperformance, and some of those periods can be extraordinarily lengthy. Small-cap stocks, in particular, provide evidence of this trait. In the U.S., small-cap stocks underperformed large-cap stocks for much of the 1990s; in Canada, small-cap stocks have lagged for much of this decade.

Unfortunately, most investors simply are not patient enough to wait five or more years for a strategy to bear fruit.

Baltimore-based ***Legg Mason Inc.***'s 2016 *Global Investment Survey* found that 52% of investors over the age of 40 consider the "long term" to be five years or less. Millennials were worse: 62% believe the long term to be five years or less. These findings explain why the average holding period of a U.S. equity mutual fund is only about four years.

Remaining committed to any factor-based strategy during a prolonged performance drought will test the will of even the most steadfast investor. Factor-based investing is simple, but it's not easy.

The solution for advisors implementing factor-based strategies is to use the full spectrum available. Outperforming strategies can compensate for underperforming factors.

In recent years, for example, momentum's higher excess returns would have more than fully offset value's underperformance.

A growing assortment of ETFs pursuing factor-based strategies in Canada and the U.S. makes this diversification possible at a low cost.

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