Growth Stocks:

Building a Case for Momentum

How could a key facet of technical analysis help portfolio managers navigate the volatility of high-growth equities?

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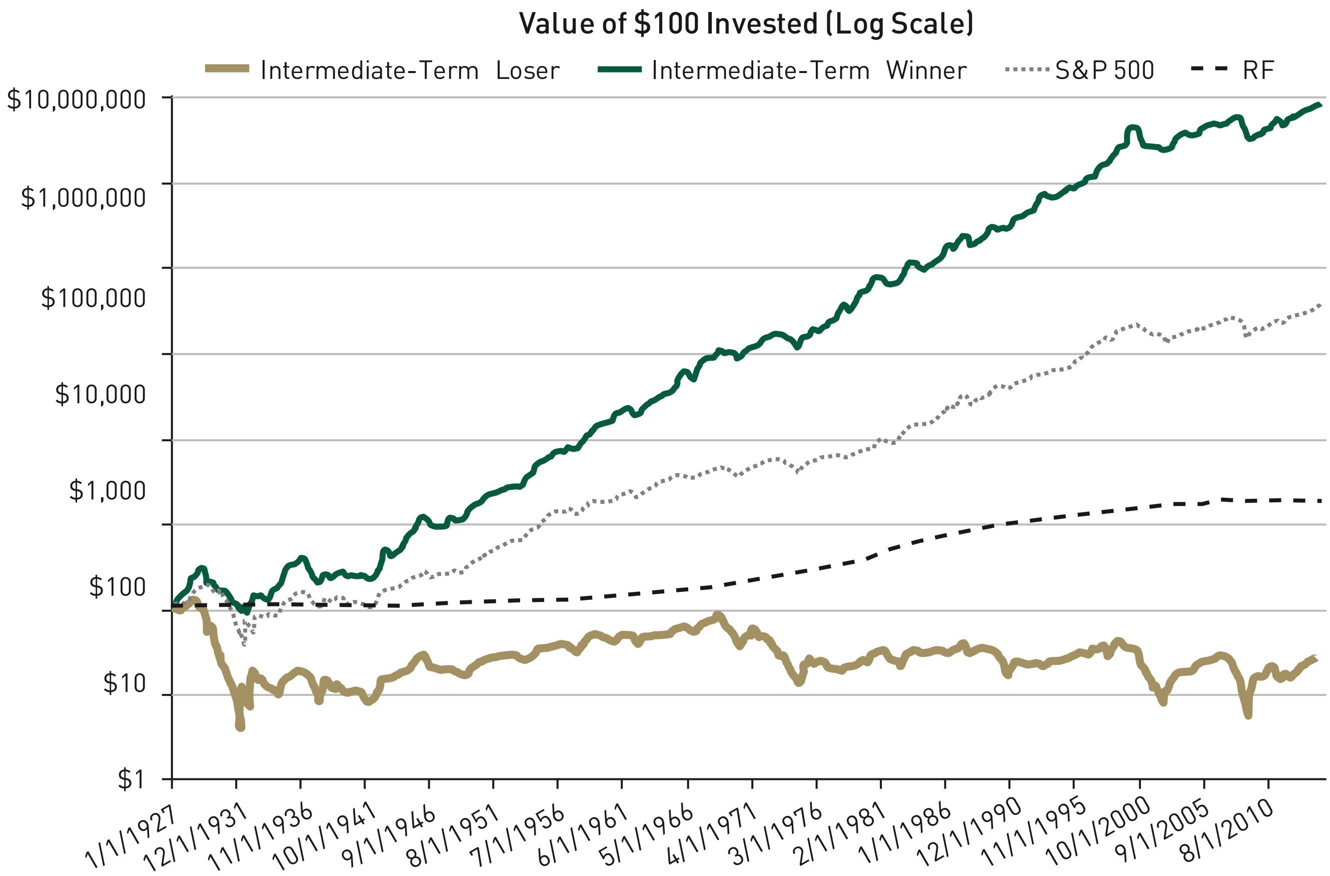
Chart 1. How Have High-Momentum Stocks Performed over the Decades?

"Winners" and "losers" versus the market and T-bills, 1927–2014



Source: Wesley R. Gray and Jack Vogel, *Quantitative Momentum: A Practitioner's Guide to Building a Momentum-Based Stock Selection System*, Wiley Finance, 2016.

Chart depicts returns from January 1, 1927, to December 31, 2014. For this study, intermediate-term past performance is measured over the previous year, ignoring the final month's return. Then, the study tracked performance over the following three months and measured the returns by category. The categories included an "Intermediate-Term Winner" portfolio (high intermediate-term return decile, value-weight returns); an "Intermediate-Term Loser" portfolio (low intermediate-term return decile, value-weight returns); the S&P 500® Total Return Index; and the risk-free (RF) rate of return (90-day U.S. Treasury bills). All returns are total returns and include the reinvestment of distributions (e.g., dividends).

The chart provided is the most recent data available. If more recent data were available the analysis may be significantly different. Hypothetical portfolios are unmanaged, are not investable, and returns are for illustrative purposes only, and do not reflect any management fees, transaction costs or expenses. The information shown is for illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

In Brief

- We believe that combining fundamental and technical factors is central to the goals of generating returns and managing risk.
- One of the key uses of technical analysis, in our view, is the exploitation of price momentum, the tendency of a security's price trend to persist.
- The influence of intermediate-term price movements on subsequent performance of high-momentum "winners" and "losers" (as defined) has been a particular focus of research.
- In our view, using technical analysis to identify momentum is one potential way to make the process of fundamental analysis of growth equities more effective.

As we have noted in the past, the growth investing team at Lord Abbett looks for companies that are at the forefront of innovation, and are disrupting established industries or creating new ones. We believe the market persistently underestimates the return potential of these high-growth companies that possess strong fundamental operating momentum.

"Wait," you might say, "I thought momentum only involved the direction of stock prices"—something that market technicians track as they sip double espressos at the Bloomberg terminal.

Actually, our approach incorporates both types. Since high-growth companies can be very volatile, we believe it's important to distinguish between the company's fundamental *operating momentum* and the stock's *price momentum*. (For more on the approach of combining operating and price momentum with growth stocks, listen to this podcast featuring Lord Abbett investment strategist Brian Foerster.) We think that technical analysis helps us bridge that gap. Combining fundamental and technical factors is central to our efforts to generate returns—and manage risk.

Getting to Know "Big Mo"

Simply put, price momentum is the concept that price trends for a security or defined group of securities have the tendency to persist, in either direction—an important aspect of technical analysis. The academic research argues back and forth as to why momentum exists, but we lean toward the view that the reason is likely based on human nature and the behavioral biases that we all possess.

Academic explanations for the existence of momentum cite irrational investor behavior arising from two primal emotions—greed and fear. Humans haven't changed much over the last few thousand years, and, from our viewpoint, they are not likely to change their ways anytime soon.

Investing can be very hard psychologically and emotional responses lead to certain biases that show up in stock prices. Researchers have observed a number of these particular mindsets. For example, the concept of *under-reaction* bias posits that investors may be slow to respond to positive news, allowing for future earnings revisions helping the price to continue to move higher. Investor trepidation in that situation could be seen as a reflection of "fear." On the opposite side of the coin, an *over-reaction* bias may be evident as investors chase stock prices too far—a classic example of "greed"—pushing valuations to levels that make them vulnerable to a future reversal.

Why Use Price Momentum Analysis?

The price momentum anomaly has long been a feature of markets; some research has looked back at more than 200 years of stock returns and found the existence and persistence of momentum. For our purposes, we'll examine the past nine decades. Chart 1 on the first page distills key findings of one study that looked at relative price momentum from 1927 to 2014.[1] Researchers Wesley Gray and Jack Vogel ranked each stock, annually, by their previous year's performance and created two buckets that they called winners and losers. Winners were the stocks that had price performance in the top 10% of all stocks for the last 12 months (excluding the final month of the measured period) and losers were the performers in the bottom 10%. Then, the study tracked performance over the following three months and measured the returns by category.

The performance difference between the winners and losers was dramatic. The winners beat losers by 18% on a compounded annual basis; the overall stock market, as represented by the S&P 500® Index, by 7% each year; and risk-free assets, as represented by 90-day U.S. Treasury bills, by 13%. [Of course, there is no guarantee that such performance could be duplicated in the future.] It is also important to note, in the context of asset allocation, that price momentum has historically displayed a negative correlation with value stocks, providing for better diversification of an equity portfolio.

What are the Risks?

We often get asked about the risks associated with momentum investing, and specifically about momentum crashes. The momentum factor can shift dramatically from stale leadership (when a momentum trend has passed its peak) to fresh leadership (a trend that has just begun an upswing) and during this transition the previous leadership risks underperforming, but eventually managers may find an opportunity to exploit that new leadership once it has been established.

One other key point: Momentum is agnostic. For example, high price momentum can be present in low volatility, defensive stocks. One such occurrence was the tech-led market correction during 2000–03. Consumer staples went down less, on a relative basis, than most tech stocks (not surprising, given staples' traditional status as a defensive sector), thus becoming high momentum stocks.

What tends to happen when the market recovers is that those defensive areas that held up better during the correction are not the first to move higher and end up lagging badly. In our view, this is where the momentum factor crashes. After the U.S. equity market reached its low point in the 2000–03 tech correction, the previously high-momentum consumer staples stocks dramatically underperformed the low-momentum tech stocks. Our process of using both absolute and relative momentum enables us to adapt as new leadership emerges, wherever that may be, and has the potential to help dampen the effects of future momentum crashes

Summing Up: An Important Tool for Growth Investing

Our investment process is premised on the view that the market persistently underestimates the return potential of high-growth stocks. This is partly a sign of the times, because the technology revolution is enabling innovation to proceed at a rapid pace. The most innovative companies tend to be growing at a significantly faster rate than the general economy, and, therefore, have the business momentum that can translate into persistent stock price momentum.

But an attempt to exploit this superior return potential is often accompanied by greater risk, so a fundamental research investment process must be reinforced with other tools. As a reminder, we lean toward owning strong momentum stocks. When fresh momentum arrives, we are inclined to add exposure; when formerly strong momentum peaks or turns stale, we are inclined to reduce or exit positions—basically, letting winners ride and cutting losers quickly. We aim to limit any potential damage by keeping the percentage of stocks in downtrends in our portfolios very small.

Using technical analysis to identify price momentum—absolute and relative, positive and negative, fresh and stale—is one potential way to make the process of fundamental momentum analysis of growth equities more effective. It is our belief that a disciplined and multifaceted approach, developed through years of rigorous collaborative research, is the key is to applying technical analysis properly and consistently. ■

[1] Wesley R. Gray and Jack Vogel, *Quantitative Momentum: A Practitioner's Guide to Building a Momentum-Based Stock Selection System*, Wiley Finance, 2016.

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Treasuries are debt securities issued by the U.S. government and are secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes. A **Treasury bill (T-Bill)** is a short-term U.S. Treasury debt obligation with a maturity of one year or less.

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Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

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