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Investing

Behind the Numbers Part 5: Price momentum

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Sometimes in sports we hear about a team's momentum, referring to its winning (or losing!) streak –and how winning teams tend to keep winning. Stocks experience the same thing. *Price momentum* is a stock's price performance over a specific period. If a stock's price is up 10% in the last month, then the one-month price momentum is 10%.

Somewhat analogous to a sports team, the premise behind price momentum is that winning stocks continue to win – at least, for the short term. If a stock price is increasing strongly, it might be a good investment, as typically it will continue to do well in the short term. That's where sayings like "Don't fight the tape" or "The trend is your friend" come from.

But buying stocks based purely on price momentum seems a bit reckless – especially if that stock has already gone up a lot. So why would we want to trust price momentum? First, it gives us information about the future prospects of a stock. After all, it's not just people talking up a stock that makes it go up; it's people actually buying the stock. You might say they're putting their money where their mouth is! Second, people are slow to adapt to changes and new information. If a company has earnings better than expected, people tend to assume it's just a one-time thing and are reluctant to believe that it'll happen again. Of course, the prices of high momentum stocks have already gone up, because of the initial surprise. But the initial move often understates the importance of the surprise, which means there still might be room to improve.

In previous articles we've discussed that we should usually avoid high price-to-earnings (P/E) ratio stocks. By nature, high momentum stocks can often also be high P/E (expensive), but they're not necessarily super-high P/E (super expensive). Even if the P/E is fairly high, the benefits of strong price momentum can outweigh the negatives of a more expensive valuation.

In a long-term study of price momentum, researchers divided all Canadian stocks into five groups, sorted them by price momentum and calculated the returns of each group. Here's how the returns looked from 1985 to 2018 (33 years):

Variable	Top Group	Bottom Group
1 Month Price Momentum	12.0%	-2.5%
6 Month Price Momentum	15.2%	-6.4%
12 Month Price Momentum	16.2%	-6.4%
TSX benchmark return: 8.1%		

Source: CPMS

As you can see, the overall results from investing in high price momentum stocks (the top group) are very good and outperformed the market. Conversely, the returns from stocks with low price momentum (bottom group) are relatively poor.

Now, it's easy to conclude that momentum investing is easy: Buy high price momentum stocks and avoid low price momentum stocks. But this is only part of the story. In past articles we've discussed how investing using only earnings momentum is accompanied by high volatility and turnover. Well, with price momentum, it's even more extreme! So, while the returns from price momentum are very good, we need to keep volatility and turnover in check. That's why we don't use momentum in isolation. Instead we combine it with other variables to get the best of both worlds, allowing us to achieve the returns without as much volatility and turnover. We'll talk more about this next time. ■

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