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INVESTMENT PERSPECTIVES

Momentum Investing – Don't Follow The Crowd

We are writing about momentum investing in this issue of our Investment Perspectives because we believe this is an important method of investing that everyone should understand. While many professional investors believe that momentum investing works and some are successful in implementing it, we believe that it is a questionable strategy for our clients.

Investopedia defines momentum investing as follows:

> *"Momentum investing is a strategy that aims to capitalize on the continuance of existing trends. The momentum investor believes the large increases in the price of a security will be followed by additional gains."*

The Perils of Momentum Investing

Momentum investing is exciting – it gives the investor a sense of being a "player" in the investment world. In fact, some investors have called this strategy "buy high" and "sell higher". The "hype" surrounding this type of investing can be addictive especially as the media trumpets its success on a daily basis. There can be a tremendous psychological lift, at least in the short-run, in investing in what is popular and is currently working.

David Dreman, a well-respected value investor, in his book entitled *Contrarian Investment Strategies: The Next Generation* states the following

> "A momentum investor buys stocks that are outperforming their industries or the market, and sells them when they lag. A momentum analyst can also follow various fundamental yardsticks, but emphasizes accelerating earnings growth quarter by quarter. Trouble is with the increasing popularity of this method, many managers are playing the same game. So much so that they jump on the same figures at the same time, jerking the price sharply. Thus, as momentum slows for a favored stock, everyone scrambles for the exit simultaneously and the stock tumbles."

As stock prices keep rising, momentum investors begin to disregard investment fundamentals (such as earnings, valuation and quality) and do not perform the necessary research prior to making an investment decision.

Following are two examples of momentum investing:

1. Technology Stocks − The significant appreciation of technology stocks from 1995 to March 10, 2000 was followed by an unrelenting loss of value over the next 18 months, with the NASDAQ Stock Exchange (comprised mostly of technology stocks) losing more than 75% of its value. As this appreciation reached its peak, concern about the very high price-earnings ratios, the lack of cash flow, and a host of other fundamental factors were largely ignored by momentum investors.

2. Single Family Homes − From the middle 1970's and especially from 2001 to the end of 2007, the prices of single family homes increased by many times their original cost. As home prices in many parts of the world reached levels that the average individual could not afford, momentum buyers focused primarily on their strong belief that they could always sell at a higher price whenever they chose. Quoting the S&P/Case-Shiller, Home Price Indices report of December 28, 2010:

    > "Home prices across the United States are back to the levels where they were in mid-2003. Measured from June/July 2006 through October 2010, the peak-to-current declines for the 10-City Composite and 20-City Composite are -29.7% and -29.6%, respectively.

    Starting in 2006, the number of enthusiastic potential home buyers decreased significantly, and banks and mortgage brokers became much more wary of initiating new loans. Additionally, as prices declined owners who were not able to afford their homes were forced to sell, declare bankruptcy, or await foreclosure proceedings.

Momentum investing starts out innocently with an investment or group of investments starting to do consistently well. But as prices continue to rise more dramatically, all types of investors become interested. In the mid-to-late 1990s and into early 2000, the talk at cocktail parties was how great everyone was doing – how much fun it was to invest. What would be the next great stock that would propel my portfolio even higher? Warren Buffett surmises that investors can become "like Cinderella at the ball − with no clocks, they are giddy participants that all plan to leave just seconds before midnight." Unfortunately, very few can get out of their investments just before midnight (at the top of the market) – the more normal result is significant loss in the value of their portfolio.

The Role of Institutions and Investment Consultants in Momentum Investing

Over the last several decades the investment community and financial markets have become increasingly dominated by large institutional investors such as foundations, mutual funds, endowments, and pension funds. Many of these institutional investors employ momentum investment strategies that have contributed to its growing popularity. This form of investing has also significantly increased the buying and selling activity (portfolio turnover) on the stock exchanges.

We have some inherent objections to how institutional investors who subscribe to some form of momentum investing operate. The behavior of these institutional investors is typically characterized by a heavy focus on, 1) short-term results and reaction to headline news events, and 2) a relative performance orientation, i.e. comparison of their portfolio's performance to other similar style institutional investors and a designated index, often on a daily basis. Both of these factors, in our view, are often detrimental to achieving sound, long-term performance results. **Believe it or not, these money managers are not overly concerned that their clients are losing money as long as they are outperforming other managers on a <u>relative</u> basis!** In other words, they may be performing poorly but as long as they are performing "less poorly" than their peers, they believe that they are doing a good job. Unfortunately, this type of thinking prevails when markets are down – it is the other (negative) side of relative returns.

This relative performance way of measuring results against a market index (such as the Standard and Poor's 500 Index) on a quarterly basis can mean that in a declining market, because a particular investor is only down 20 percent and the benchmark is down 22 percent, the manager will be handsomely compensated. A major concern that we have is if an investor's success or failure is strictly measured against this benchmark, particularly on a short term basis, there is the tendency to not deviate significantly in their investment strategy from the benchmark − even if there are investments that appear to be overvalued and have sizable downside risk. We believe this is the major reason for many institutional managers to not outperform the indexes over longer periods of time.

For mutual funds, momentum investing is also driven by the manager's efforts to maintain a high rating with services such as Morningstar (which many investors rely on to make their investment decisions) on a quarterly basis. A favorable rating tends to attract more investors, a desirable outcome for the management of the mutual fund company.

The role of investment consultants, who act as advisors to large pools of institutional assets, can often reinforce short-term thinking. Investment consultants often wield significant influence in determining the hiring and firing of money managers. One of the services they provide to institutions is an in-depth analysis of a manager's results on a quarterly basis. Since the penalties for poor short-term performance can be high (loss of a client's account, poor peer ranking, reduced status with an investment consultant, loss of a job, etc.) there is a bias toward conformity to consensus views even if it translates into mediocre performance results for the client.

<u>The Plusses of Value Investing</u>

Those of you who have been our clients over the years know that we follow a value investment approach to making our investment decisions. We constantly are seeking strong high-quality companies that are considerably undervalued, in our opinion, and who we believe are focused on implementing the necessary actions to improve their profitability and earnings which will eventually result in a higher stock price for that company.

Value investors like us, who do not subscribe to momentum investing, consider absolute performance-oriented investing to be a much more appropriate approach to investing our clients' funds. This approach is solely focused on achieving, on a long-term basis, a positive return vs. a relative return, on all investments. Of course we cannot always deliver positive results, but it certainly is our intention to make each of our buy, hold and sell investment decisions with this in mind. It is for this reason that we avoid investing our clients' money until we find an investment that meets our fundamental requirements. While we hold our results accountable to standard benchmarks (e.g. Standard & Poor's 500 Index) over the long-term and show these for illustration purposes, our investment decisions are driven by our assessment of the upside potential and downside risk of each investment, not on the relative weightings companies and industries hold in a benchmark index.

There are a number of important fundamentals that we look for before we will consider a new situation to be an attractive investment for our clients. For example, the company must have:

- Accurately assessed the main problem that has caused its stock price to decline.

- The necessary long-term perspective and strength of management to resolve their main problem. Additionally, management must be willing to "sacrifice" short term benefits that may temporarily improve their stock price and instead stay focused on longer-term foundation building.

- A strong balance sheet, typically with a low debt-to-capital ratio, e.g. relatively small long-term debt and an attractive and consistent free cash flow (money remaining after all normal operating expenses and capital expenditures).

Conclusion

Investing should not be thought of as a relative performance "derby". For all of our clients, investing is very serious business. As discussed in our Investment Perspective entitled "An In Depth Look at the HCM Research Process" (www.hutchinsoncapital.com/research-library.html) we continuously strive to adhere to a disciplined well-established approach to investing that has at its core objective the preservation of capital and the achievement of sound long-term performance results in both rising and falling stock and bond markets.

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

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