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Volatile marketplace provides opportunities to build investment portfolio momentum

We all understand that stock market fluctuations are a fact of life but that doesn't stop investors' hearts from beating faster when markets are unsettled. Negative media reports further increase tensions, causing knee-jerk reactions and irrational behavior. Calm investors use this to their advantage and profit from the emotional swings of the jittery.

One way is by incorporating momentum investing into an overall portfolio strategy. The basic premise of this approach is that large increases in the price of a stock will be followed by additional gains. The same applies on the flip side for declining values. The strategy takes advantage of the impact of behavioral finance, and seeks to capitalize on the continuance of existing market trends.

Some parts of behavioral finance have been likened to jumping on the bandwagon, where investors who are considering a stock purchase use short-term performance as a confirming signal. Likewise, long-term investors look to recent performance as validation of their original thesis for purchasing the stock. This "follow the herd" mentality, with investors buying into a rising stock simply because they don't want to lose out on a perceived opportunity, ultimately drives prices up. Momentum investors seek to profit from it.

Momentum investing isn't only about continually rolling into stocks that have been outperforming. Research shows that it can be a viable strategy for long-term investors. Consider the Morningstar Canada Momentum Index, which is comprised of 30 Canadian companies and is screened for above average returns on assets and equity, with an emphasis on upward earnings estimate revisions and technical price momentum indicators. The index has returned 17.03% over the last 10 years. The S&P/TSX Composite index had returns of 9.66% over the same period.

Momentum investing is not without risk and is certainly not for the faint of heart. Although some momentum portfolios have good long-term track records, this investing style tends toward high volatility. The constant rebalancing and the frequent trading also add significantly to the fees and other costs, and the strategy's high turnover generally makes it inefficient from a tax perspective.

To balance the risks, investors should combine a momentum strategy with a value approach. The two strategies are negatively correlated, generally resulting in lower volatility and superior returns over the long-term. As well, adding value keeps investors from buying hype. Rather, they look for the momentum trends but also ask whether they are actually solid investments.

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Continued from Page 1

An easy way to incorporate the strategy into a portfolio is to add exchange-traded funds into the mix. For instance, investors could purchase the First Asset Morningstar Canada Momentum ETF (TSX: WXM) and the First Asset Morningstar Canada Value Index ETF (TSX: FXM). The former uses price momentum as a core component of its screening process while the latter screens for price-to-earnings ratios, cash flow ratio, price-to-book value and sales, and earnings estimate revisions.

Investors who decide against ETFs and instead want to try momentum investing on their own, should allocate only a small portion of their portfolio and be prepared for volatility.

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