

Gray, Wesley R. PhD. & Vogel, Jack R. PhD. – Quantitative Momentum

Wiley, 2016, [Equity Investing] Grade



Momentum investing works - period. I thought momentum was all about buying stocks that have gone up, and coming from a value background I found it a bit idiotic, but little did I know about the quantitative world behind all of this. This might not be as much of an epiphany for you as it was for me, but this book opened my eyes to a world that I was extremely unfamiliar with. If you, like me, find yourself reading the same old Graham-mantras over and over just reiterated by different authors, this is most probably something you should read.

The book is split in two parts where the first part is all about understanding momentum - what momentum really is, why it works and why it should continue to provide a sustainable edge going forward. The second part is all about the craft of constructing a momentum-based portfolio based on academic proof. To be fair *Quantitative Momentum* is a...quantitative book. It's packed with graphs, tables, numbers and references to academic studies. Although its academic nature, the book is written by two PhD's – go figure, the book is an unexpectedly pleasant read. I had no problem keeping up despite generally reading the book on my busy and chaotic morning commute.

The authors start off with explaining what momentum is, and more importantly, why momentum works. They argue that momentum investing and value investing both work because they are essentially just two different sides of the same behavioral bias-coin. Maybe the reason that active portfolio management actually works is that we humans are overly skeptic in nature. The authors write: "*Value investing's edge is often characterized as pessimism in the presence of poor short-term fundamentals, which causes stocks to become too cheap relative to future expectations. Perhaps momentum investing's edge could be characterized as pessimism in the presence of strong short-term fundamentals, which causes stocks to remain too cheap relative to future expectations.*"

The authors are not trying to make people pick sides with this book, rather they are trying to

convince value investors that a quantitative momentum approach would bring great balance to the overall portfolio composition.

The book is packed with "good stuff" but one of my favorite takeaways is the concept of "frog-in-the-pan-momentum" where the path a momentum stock takes makes a big difference going forward. The point is that a stock with lower volatility, but strong uptrend, can continue to have a strong trend while staying under the radar of most value investors. On the opposite side, a volatile stock which spends every other day on the scoreboard of best/worst performers will constantly be in the eye of investors and will therefore have a higher probability of having its trend interrupted by active investors trying to correctly value the asset.

Another key concept for me was that of mean reversion in different time series. That things mean revert in nature is hardly news, but shouldn't mean reversion work against momentum to cancel out the effect? Well, yes and no. The authors find that stocks mean revert in shorter and longer time periods (under 1 month and over 1 year) but follow the momentum trend in medium-term time periods. Basically, stocks that have gone up the most the last month will tend to mean revert and go down the most in the coming month, and vice versa. On the other hand, stocks that have performed the best over the last 12 months will typically continue to perform well over the coming month or months. In the authors' stock-selection-model they solve these contradictory concepts by looking at momentum for the past 12 months, while ignoring the last month, thereby using both the medium-term-momentum while also taking the mean-reversion-effect into account.

For those already praying to the momentum god, this is a great book filled with ideas and proofs to improve their momentum stock selection. For the community of Graham-believers, me included, this book is a definite must-read.

Olle Qvarnström, August 22, 2018