

Quality Asset Management

Grow Your Wealth with Peace of Mind

What Causes Momentum?

By Gil Hanoach, January 13, 2007

What is Momentum? Momentum is the tendency of stock prices that went up recently to continue going up, and the tendency of stock prices that went down recently to continue going down.

How can you use Momentum to make money? You can look for stocks that increased in value recently, and invest in them with the expectation that they will keep increasing in value. Similarly, you can look for stocks that declined in value recently, and sell them short with the expectation that they will keep declining in value. This technique provides the potential of making money during up and down markets.

Why is there Momentum? Momentum exists because people tend to believe that what happened recently will be true in the future. They see a stock that went up significantly and view it as a good stock that is worth buying. Similarly, when people see a stock decline, they view it as a bad stock that is not worth buying. People imitate what others did before making momentum the "herd effect".

A magnified effect. The longer stock prices increase without any change in direction, the more they become overvalued. The longer this happens, the more people get excited and continue the momentum. When this period becomes very long, the danger is magnified proportionally.

A great example is the increase in Large Growth US Stocks in the 90's. Their price went up so far out of line with the value of the companies that a significant crash occurred in 2000 to correct it. Another example for the opposite direction is the decline from 2000 to 2002. The stock prices declined so much that by early 2003, a dramatic increase started to correct the decline.

Does Momentum work? Momentum works more often than not. Usually stocks keep going in the same direction they went recently. But this does not continue forever. Every run up or down in stock prices changes direction once in a while. In order to use the momentum effect beneficially, you have to accurately predict the turning points. Specifically, you need to sell the stock before it starts declining, or buy back (the reverse of short selling) the stock before it starts increasing in value. The latter is critical because the loss from a short sell can be unlimited!

Conclusion. Since it is very difficult to consistently predict the turning points of the market, it is very difficult to consistently outperform the stock market by counting on the momentum effect.

To Summarize

Our basic intuition and instincts are our biggest enemies in investing! By setting them aside and using cold logic, you can benefit from financial peace of mind at all times. It is best to create a portfolio and stick to the allocation at all times.

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