MONOGRAM

NEWSLETTER: Why Momentum? *June 2017*

Performance.

The Fund returned 0.81% in May, bringing the year-to-date return to 5.64%. Global Equity markets (ACWI) rose 1.9%, Developed ex-US (EAFE) Equity was up 3.1%, US Equity (S&P) up 1.1%, while US Investment Grade Bonds and High Yield Debt were down a -0.2% and Gold -2.2%.

Why momentum?

Recently Pablo Fernandez wrote a research paper (*"Is it Ethical to Teach that Beta and CAPM Explain Something?"*[1]) asking whether it was ***Ethical*** to teach that anchor of modern finance, the Capital Asset Pricing Model (CAPM). His basic premise is that since the CAPM is so overwhelmingly rejected in virtually all empirical tests, which professor can honestly stand up in front of her students and deliver it with integrity and confidence – or, more likely, are they repeating it because they themselves were taught it, and it is in every textbook…?

Virtually no professor we know sees it as more than an eloquent framework for thinking about risk and expected returns.

The opposite is true for ***Momentum***: researchers are now blessed with behavioural finance, and its numerous insights from psychology, to give some sort of theoretical succour to an empirical phenomenon which has extensive support over long-periods of history, different asset classes, and different geographies. Indeed over 200 years ago the great British economist, David Ricardo, is often alleged to have made indirect reference to it: cut short losses and let profits run.

The most basic trend-following strategy is time series momentum — going long markets with recent positive returns and shorting those with recent negative returns, though many practitioners forego the short selling part of it as often it will add to volatility of returns with no net benefits. Hurst et al[2] (AQR, 2014) use historical data to construct a time series momentum strategy back to 1903 and find that the strategy was consistently profitable over the next 110 years.

In a separate study, Moskowitz et al[3] (2012) find that time series momentum has been profitable on average since 1985 for nearly all equity index futures, fixed income futures, commodity futures and currency forwards. Such findings reinforce the underlying investment philosophy of the CTA (Commodity Trading Advisor) sector of hedge fund investing, albeit with highly varying frequency of trading from monthly to second-by-second.

An alternative to time-series momentum is cross-section momentum, where we organise assets at a point in time ranking them from best to worst performing over some recent time period (maybe a year). A portfolio is then formed of, say, the best performing 10% of assets and this is held for a period of time, perhaps a month, then the process is repeated at regular intervals, the idea being that 'winning' assets continue to perform well relative to 'loser' assets… until they do not!

[1] Available at: https://ssrn.com/abstract=2980847

[2] A Century of Evidence on Trend-Following Investing. Brian K. Hurst, Yao Hua Ooi, Lasse H. Pedersen. AQR White paper.

[3] Time Series Momentum, Journal of Financial Economics. Tobias J. Moskowitz, Yao Hua Ooi, Lasse Heje Pedersen.

This strategy was tested on individual US equities by Richard Thaler (of 'Nudge' fame) in the 1980's and by us in the 1990's for the UK: it works!

MONOGRAM uses a mixture of time-series and cross-section momentum in a hybrid known as 'Dual' momentum. This involves examining a set of often related asset returns (possibly different equity markets) over a past period (say a year), and picking the best performing one – this is a feature of *cross-section* momentum.

But there is one more step still to come, which is where the '*dual*' comes in: we ask if that best performing asset has beaten a risk-free asset, say cash. If the answer is 'no', then we place that portion of the portfolio in cash. If it is 'yes', then that portion of the portfolio is invested in the best performing of the selected group of risk assets.

If this all sounds rather easy indeed then we must think about what we have **not** discussed in detail: which risky assets will we consider; how do we a priori group them for ranking performance; what past data period do we examine their performance over; how often do we re-examine the performance and reconsider portfolio composition; are there refinements to these rules we can consider; and not least, which instruments do we use to represent the asset classes?

However, there are a few simple ideas which we know are key to successful performance:

i) Do ***not*** trade too often – which also means do not consider too many assets in any one group or there will be too much switching between them and churning of the portfolio.

ii) Realise that it is the willingness to switch into ***Cash*** to protect wealth in bear markets which is the most important single feature in wealth *accumulation* and *protection.*

It is probably fair to say that point (ii) is anathema to many wealth managers who think that diversifying among asset classes is enough to protect and accumulate wealth for their clients – it's not! Witness the performance of multi-asset funds in any crisis.

The **MONOGRAM** approach is of particular relevance for those who are consuming out of a pot of wealth, whether it be family offices, endowments, high-net-worth individuals, or those with retirement in mind. Why? Because the move into cash reduces the chance of large drawdowns, which in turn allows ***substantially higher withdrawal rates*** through the decumulation phase and indeed facilitates a better *accumulation* experience as well. More on this next month…

Positioning and outlook.

For the month of May our indicators favour Emerging Market Equity, Developed ex-US (EAFE) Equity, US High Yield, US Investment Grade Bonds and Gold.

About MONOGRAM

MONOGRAM Capital Management is an investment boutique founded in 2014 and headquartered in London. We take an innovative empirical, evidence-based approach to investing and believe there are fundamental, identifiable, persistent, and exploitable sources of return; risk is the permanent impairment of capital (peak-to-trough drawdown) and not volatility in its various forms. There are two options for investors to access MONOGRAM's investment strategy. Investors can invest in the Luxembourg Domiciled MONOGRAM Fund or in MONOGRAM's bespoke segregated managed account, provided the investors meet the minimum subscription requirements. Further details are available on request.

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