

Opinion

Why Mixing Momentum and Value Can Yield Alpha

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The benefits of value investing are well known in the investment industry. Indeed, value stocks, or stocks with low valuation multiples, have been shown to outperform stocks with high valuation multiples - and the market - over the long run. However, many investors never get to realize the full extent of the outperformance provided by value stocks.

That's because realizing the full extent of the value premium requires a long-term perspective and commitment. But complications can arise when value stocks perform in cycles. Periods of pronounced underperformance often make it difficult for investors to "stay the course" and many bail out at exactly the wrong time. What can be done to mitigate the degree of short-term underperformance of value investing and improve investors' willingness to stay invested?



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It is our belief that this deficiency can be addressed through adding to the mix another investment style known as "momentum investing," which aims to capitalize on the continuance of existing market trends. That strategy possesses performance attributes that provide significant diversification benefits when combined with value. Academic research has shown that momentum stocks, or stocks with high returns within trailing 12-month periods, outperform stocks with low returns within trailing 12-month periods, over the next three to six months. A portfolio that is rebalanced every month to hold only high momentum stocks therefore outperforms low momentum stocks, as well as the market, over the long run. More importantly, momentum stock returns are negatively correlated with the returns of value stocks. Historical analysis shows that when value stocks underperform the market, momentum stocks on average have a tendency to outperform the market. The reverse also tends to be true. In fact, Westpeak's research shows that momentum and value stocks rarely underperform the market simultaneously.

These return correlation properties suggest that combining value with momentum should offer investors a significant opportunity to mitigate the magnitude of short-term underperformance, without sacrificing long-term returns. Indeed, our research shows that the degree of underperformance of a combined value and momentum portfolio of stocks is about 50% lower than that of a portfolio of value or momentum stocks alone. Reduced magnitude of short-term underperformance should enable investors to stay invested for the long term to realize the full potential of combined value and momentum investing.

Why momentum and not growth? As the "anti-value" style, growth has had a lengthy history of serving as a counterpoint to value in portfolios. In fact, many people are advised to own growth index portfolios to boost returns. In practice, however, this may prove counterproductive. Our research shows that, in competitive economies, the earnings growth of large groups of stocks systematically trends in the short run, reverting back to the market average in the long run. Current growth indices force investors to buy stocks with high expected growth rates. These stocks subsequently experience downward revisions to expected earnings growth rates, causing their valuation multiples to contract and their returns to be lower. It is, therefore, not surprising that widely available research shows that growth indices consistently underperform value and core indices.

But isn't equity investing all about growth? Absolutely. And growth that actually pays off is exactly what value and momentum investing captures and delivers. Momentum investing delivers the returns associated with the trending behavior of short-term earnings growth. Value investing, on the other hand, delivers the returns associated with the reversion to the mean of long-term earnings growth. As such, combining momentum and value is a better way of capturing the growth potential of equities than the traditional "growth" style.

The idea that momentum investing is a style that merits more attention is gaining ground in the investing industry. Morningstar has said it will begin giving stocks a momentum score. This may ultimately lead to a new investment style category.

Through a combined value and momentum approach, investors can significantly reduce the degree of short-term underperformance while maintaining exposure to two powerful sources of market outperformance. Combining value and momentum is an innovative approach that investors may find well-suited for today's unpredictable and volatile markets.

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Risk:

Investing in growth stocks involves certain risks, in part because the value of securities is based upon future expectations that may or may not be met. Value stocks may fall out of favor with investors and experience periods of lackluster performance as compared to the overall markets.

Before investing, consider the fund's investment objectives, risk, charges, and expenses. Visit ga.natixis.com or call 800-225-5478 for a prospectus or a summary prospectus containing this and other information. Read it carefully.

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