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Combining Value with Momentum

Value-investors invest anti-cyclically in undervalued stocks; prior returns and technical analysis play a subordinated role. Momentum-investors, on the other hand, invest pro-cyclically in stocks with high prior returns. Studies have shown that both investment styles were able to generate long-term outperformances in the past.

There is no universally accepted explanation for the existence of such value and momentum premiums. One likely scenario is that behavioral-finance effects cause systematic undervaluations which value-investors capitalize on. Yet, some researchers make risk-based arguments, and show that value-stocks often have higher insolvency risks, and momentum-stocks have extreme crashes wiping out decades of previous outperformances. In fact, both value- and momentum-premiums are subject to pronounced cycles: As of October 2015, for instance, value-investors have suffered from an almost decade-long underperformance in the US. In light of these experiences, investors increasingly try to combine value- with momentum-factors.

For investors, combining value- with momentum-factors is easier said than done. This is because standard factor indices tend to dilute both effects through their relatively lax value- and momentum- definitions. Furthermore, both effects are especially pronounced for small-caps, which are underrepresented in most factor indices. Finally, the negative correlation between value- and momentum-premiums is hardly noticeable in a large number of factor indices. Since factor returns have a positive correlation in long-only portfolios, investors buying long-only factor indices are increasingly likely to incur value- and momentum-underperformances simultaneously.

In light of these circumstances, it seems to be possible to combine value- and momentum stocks more effectively. One idea is to buy value-stocks that are concurrently classified as momentum-stocks.

Pure momentum-stocks are not required to have an attractive valuation, which can cause highly overvalued stocks to be bought. On the other hand, a large undervaluation is worthless until other investors recognize the undervaluation and begin buying the stock, causing its price to appreciate. In fact, value-investors tend to invest too early, and often buy stocks that continue to depreciate. To improve investment timing, it might be advantageous to take into account momentum-indicators.

We have explored this possibility in a global study covering the period from 1986-2015, which will be published in the next few months. We have found that while pure value- or momentum-stocks have outperformed their benchmarks by about 4% per year before transaction costs, stocks that are simultaneously classified as value- and momentum-stocks have outperformed their benchmarks by more than double that amount. These combination-stocks generated

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higher returns than pure value- or momentum-stocks in all investigated regions, which suggests that value-investors might be able to improve their returns by taking account of momentum-indicators[1].

Ø Outperformance vs. Benchmark

Ratio	Value	Momentum	Combination
PE	4.9%	2.7%	10.0%
PC	4.7%	2.7%	9.8%
PB	3.0%	2.7%	**7.6%**
PS	2.9%	2.7%	7.4%
DivYld	4.5%	2.7%	8.7%
Mean	4.0%	2.7%	8.7%

Ø Outperformance vs. Benchmark (PB)

		Low		**Momentum**		High
		-3.1%	-1.1%	0.2%	1.2%	2.7%
Low	-1.7%	-8.9%	-3.6%	-1.5%	0.3%	1.2%
	-1.3%	-5.9%	-2.9%	-1.2%	0.2%	1.9%
Value	-0.4%	-3.5%	-1.4%	-0.3%	0.7%	2.4%
	0.4%	-2.6%	-0.5%	0.8%	1.5%	3.7%
High	**3.0%**	1.3%	1.8%	3.0%	4.3%	**7.6%**

The tables show the mean yearly outperformances of stocks in different value- and momentum-quintiles versus an equal-weighted benchmark. The universe consists of 39 countries from 1986-2015, and takes into account Look-Ahead and Survivorship-biases. All figures in USD and including dividends. Momentum is defined on the basis of the performance of the last 6 months. Data sources: Worldscope, I/B/E/S and own calculations.

[1] English version of FuW Article "Momentum und Value kombiniert" (Oct 2015)