Change vs. Momentum

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"Momentum strategies today are buying airlines instead of artificial intelligence; cruises over cloud; and steel instead of software. But we know that the pendulum can swing very quickly." Alger Client Portfolio Manager Kevin Collins explains why Alger favors investing in innovation and change over the siren song of momentum.

ALEX BERNSTEIN: Hello, I'm Alex Bernstein and you're listening to the Alger Podcast, Investing in Growth and Change. With the reopening of the economy, the recent focus on cyclical and value companies has caused many investors to consider a particular strategy called momentum investing. Which is not something we do here at Alger. Instead, we pursue companies that are experiencing Positive Dynamic Change. But honestly, the confusion between these two styles of investing is understandable. Here to break this subject down with me is Alger Client Portfolio Manager Kevin Collins. Kevin, thanks so much for joining me this afternoon.

KEVIN COLLINS: Thanks, Alex.

ALEX: Kevin, just to start off, what exactly is momentum investing?

KEVIN: Yes. Momentum investing can be any one of a variety of different styles where investors are seeking to access momentum in order to enrich themselves. At its heart, it's the tendency for stock prices to persist in their current pattern either up or down. If a stock is ascending through time, the most likely future outcome is that it will continue to rise, and the same can be said for share prices in decline, that they will continue to decline.
So, it's an important style of investing. It's been one of the very few types of investing that has driven investor returns not just in the stock market but in other asset classes as well over extended periods of time, long after being identified by researchers as a rewarding investment strategy.

Relative strength is a big type of momentum investing, and I think the most common approach to momentum is just to compare a recent stock price to its own price a year ago, and if that recent stock price is higher, then continue to hold or buy more shares. That is the essence of momentum investing.

ALEX: Is there a specific timeframe associated with momentum investing?

KEVIN: There are all sorts of different timeframes. Some people have very short holding periods who utilize this strategy. Others have longer ones. I think the most common one is from two months ago, compare the recent price of two months ago to that of a year ago.

ALEX: Why is momentum investing so important to investors? Is it mostly because they're looking at something that's been successful in a very specific period of time, and they're saying, well, clearly that's a winner?

KEVIN: Yes. It's a phenomenon that has been exhibited in many different types of market environments, in many different asset classes and different time periods. It's a natural phenomenon found in all sorts of conditions in life and in the world.

ALEX: But there are some significant down sides to momentum investing as well. Is that right?

KEVIN: Absolutely. Momentum is very fickle. As soon as that price changes course, the position will be sold to embrace a different stock which is exhibiting those momentum characteristics, that strong upward-sloping trajectory from the bottom left of your computer screen to the upper right. It wants to align with a hot stock, and if that stock is not getting hotter and continuing to rise, it changes course and then embraces a new stock. So, you can be constantly shifting, and you can miss important moves.

ALEX: Kevin, is it accurate to say that today, momentum is currently aligned with value and cyclicals, and that's why investors may be paying so much attention to them?

KEVIN: Absolutely. There's a great deal of investor excitement about the reopening economy, the very strong growth rates that are being printed broadly speaking, and then particularly the very easy year-over-year comparisons and resulting growth numbers that were realized by areas like travel where there was that sudden stop last year, and now we're seeing just tremendous, albeit very fleeting, we believe, growth numbers.

ALEX: Now, Kevin, one of the things you've heard investors say–and in fact it's why we're having this conversation–is that some people believe that Alger is a momentum investor. So, let me ask you–is Alger a momentum investor?

KEVIN: No, Alger is not a momentum investor. We're interested in the future. And Alger compares future operating results to its current stock price. Momentum compares a stock price to its past price trend and Alger believes that a company's future operating fundamentals are ultimately the biggest determinant of a company's share price direction and investor return, not sentiment. Alger believes that the best investment opportunities are in companies that offer strong, persistent growth over many years. We forsake what's happened in the past to look forward and embrace what will happen in the future.
So that's why Alger wants to look forward. We want to anticipate the direction of that business result. Is it going to be improving? Is it going to be degrading? And we believe that through time the share price will follow that path. So, over extended periods of time, we believe that the share price parallels the operating fundamentals.

ALEX: So, by looking closely at a company's fundamentals, Alger is taking a much deeper dive than just kind of looking at whatever that company's current pricing is?

KEVIN: Absolutely. That's the great benefit to embracing change. When there's change, there's lot of uncertainty. There's volatility, differing opinions, and you well know that Alger invests a lot of resources in developing human capital and money-making analysts that go about testing and vetting a company's operating plan, talking to industry sources including competitors, suppliers, regulators and customers; we want to know what the future of that business is like and how does that future look relative to the prevailing consensus wisdom. And if there's a difference there, we feel like we've got an investable opportunity.
We want to align with companies that are driving change through unique intellectual property or a competitively advantaged business model, companies that are recasting an industry or creating a new industry. We believe that embracing change is very lucrative through time because change begets growth. Growth begets higher stock prices. We talked about how share prices will follow or parallel growth through time. In change conditions, so often Wall Street will underestimate the magnitude of growth associated with change as well as the duration of growth associated with change. It's at the heart of that inefficiency of investors' inability to recognize or embrace change that we believe we are able to generate returns for our clients.

ALEX: Why do you think there's so much confusion between these two different philosophies? Investing in change versus investing in today's current price?

KEVIN: We get that question an awful lot, Alex, and I believe it's because the price charts of those two philosophies often look quite similar. So, we know that momentum is going to exhibit persistent, positively trending stock charts because, in point of fact, that's the requisite condition for a momentum strategy's holding. However, change-driven stocks often exhibit that very same strong chart action.
Remember when I said that we believe a share price will parallel its company's operating fundamentals. If a company is winning in its marketplace, and it's realizing strong, consistent earnings growth, it's likely that company's share price would look quite like a chart that would be purchased by a momentum strategy. So therein lies the confusion.
Brad Neuman, Alger's director of market strategy, always says that momentum looks to the past and that Alger looks to the future. But there are going to be periods when momentum and growth diverge from each other and we've seen that play out a lot.

KEVIN (continued): Momentum will shift away from growth due to geopolitical events, macroeconomic cycles that make broad corporate profit growth either more abundant or more scarce. When growth is abundant, investors tend to bid cyclical companies or value companies that are really benefited because normally they're very low growth and usually quite unattractive from a growth perspective, but when they get that tailwind of cyclicality, the growth rates pick up. Growth becomes more abundant. It's easier to access for investors and they bid cyclicality.

So, the current market environment with the reopening economy in the wake of the successful vaccine rollouts would be one of those periods.

Right now, investors and therefore momentum strategies are buying these value and deep cyclicals today rather than innovation. So, they're buying airlines, not artificial intelligence. They're buying cruises, not cloud. They're buying steel and not software and we strongly prefer these very persistent, durable growth opportunities that can move independently of a broad economic cycle.

ALEX: Currently, investors are very focused on the reopening of the economy but can you talk about some of the more historical examples when momentum diverged from growth and change?

KEVIN: Yes, absolutely. We have seen that play out many times through various cycles and significant backdrop events, geopolitical events. Again, it all relates to the relative attractiveness of growth and how abundant growth is across the economy. So, when value and cyclical companies are temporarily advantaged by government policy, their growth rates are going to inflect and show improved relative strength and therefore momentum investors would start to bid those stocks. We mentioned before some fleeting times where the benefit is temporary.

I remember in 2016 when Donald Trump won the presidency and talked about implementing a corporate tax package that would reduce the corporate tax burden and investors got very enthused about bidding domestic-oriented business models, even those that were being disrupted by technology and innovation. So, broadline department store retailers were bid heavily while online ecommerce companies, those large tech platform companies were shunned and we saw in the wake of the holiday very disappointing retail sales numbers, extremely disappointing, down year over year. And many of these department stores had to fire large swaths of their employee base. So that highlighted a big lesson and underscored what we believe at Alger to be the case, that it's very important to look at forward operating fundamentals and not to let sentiment dictate what your investment allocations will look like.

ALEX: Kevin, why do you think the lesson about momentum investing is so important today?

KEVIN: Well, we'll see how much longer momentum remains aligned with value, because right now growth is so easy to access. It doesn't matter which industry or which company because we're anniversarying the economy's sudden stop during coronavirus. As more difficult economic comparisons begin to emerge in 2022 from this reopening we're experiencing today and fiscal stimulus starts to diminish through time, growth is going to become more difficult to find and, therefore, it's not hard to envision momentum sentiment turning away from value and deep cyclicals and embracing innovation-led secular growers as we move towards next year.

We know that the pendulum can swing very quickly as just over a year ago you couldn't give away a barrel of oil, and now when I go to fill my car up at the gas station, I'm paying over three dollars a gallon at the pump. So, I'm looking forward to that time again, Alex, when Alger and momentum are moving together again.

ALEX: Kevin, thanks so much for joining me this afternoon.

KEVIN: Genuinely, thanks, Alex. It's great to interact with you, and it's always so smooth and easy.

ALEX: And thank you for listening. For more of our latest insights, please visit www.alger.com.

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