Mixed momentum

Investment firms react to momentum differently by asset type.

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The study "Global Portfolio Recommendations: Changes to Investment Strategies and Subsequent Performance" (Bange, Khang, Miller) examined the international investment strategies of a panel of more than a dozen investment houses in North America, Asia and Europe from 1982 through 2001. The data came from surveys published in the Financial Report, a confidential newsletter purchased by The Economist, Ltd., in 1989. In the surveys, the investment houses recommended portfolio allocations among equities, bonds, and cash, as well as equity holdings across six country categories.

Tests were conducted as to whether changes in portfolio recommendations were related to the relative historic return performance among assets—that is, did the investment houses modify their recommended portfolio weights to benefit from the continued performance, or "momentum," of asset returns?

Gathering Momentum

There is strong evidence that, as a group, the surveyed investment houses adjusted their allocations to equities and cash in response to recent returns in these broad asset classes. These findings are consistent with the notion that the investment firms engaged in momentum trading.

In contrast to the findings concerning equities and cash, however, there is no statistical evidence that that the houses used a momentum trading strategy for bonds. To further investigate this finding, the research team subdivided the sample into two groups. "High-Bond Houses" were defined to be those that recommend bond holdings at a level greater than the sample mean, and "Low-Bond Houses" were defined to be those that recommend bond holdings at a level less than the mean.

Subsequent tests were consistent with the notion that Low-Bond Houses used momentum strategies for equities. For cash, test results were consistent with the notion of momentum trading for both High-Bond and Low-Bond Houses. For bonds, no evidence of momentum trading was found. However, there is a difference between High-Bond and Low-Bond Houses concerning bond allocations. Regardless of relative bond returns, the High-Bond Houses increased their recommended bond allocations while the Low-Bond Houses decreased their recommended bond weights.

Portfolio Performance

The performance of the recommended portfolio weights was compared to several static benchmark portfolios. In addition, several dynamic benchmark portfolios were employed. One of the dynamic portfolios was a "swap portfolio" that "swaps" the recommended weights to equities and bonds. A comparison of the returns of the recommended portfolio weights to a set of 1,000 returns generated by randomly shuffling the recommended weights also was conducted.

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The investment houses, as a group, had some skill concerning strategic asset allocation. The stock market crash of October 1987 may have had a profound effect on portfolio performance. Before the crash, the investment houses, as a group, exhibited skill. That is, they outperformed several static and dynamic benchmarks, including the "swap portfolio" and the shuffled weight returns. After the '87 crash, all of the benchmarks outperformed the recommended portfolio. The "swap portfolio" yielded the highest return and highest Sharpe ratio in the post-crash period. It appears that after the 1987 crash, the investment houses "overweighted" in bonds, which may have led to inferior performance. ▮