

Momentum: No Small Matter

Momentum in its simplest form suggests that recent winners will continue to do well, while recent losers will continue to underperform.

Momentum has been long recognised as a strategy that outperforms in various global markets¹. The bulk of these findings have, however, been based on large cap stocks, and within this segment momentum has shown diminishing returns in recent years.

Small cap segments of the market can, and often do, behave differently than their larger cap counterparts. Blue Orbit’s research process focuses specifically on small caps and small cap data sets, to ensure that our findings are designed to work in these unique market segments.

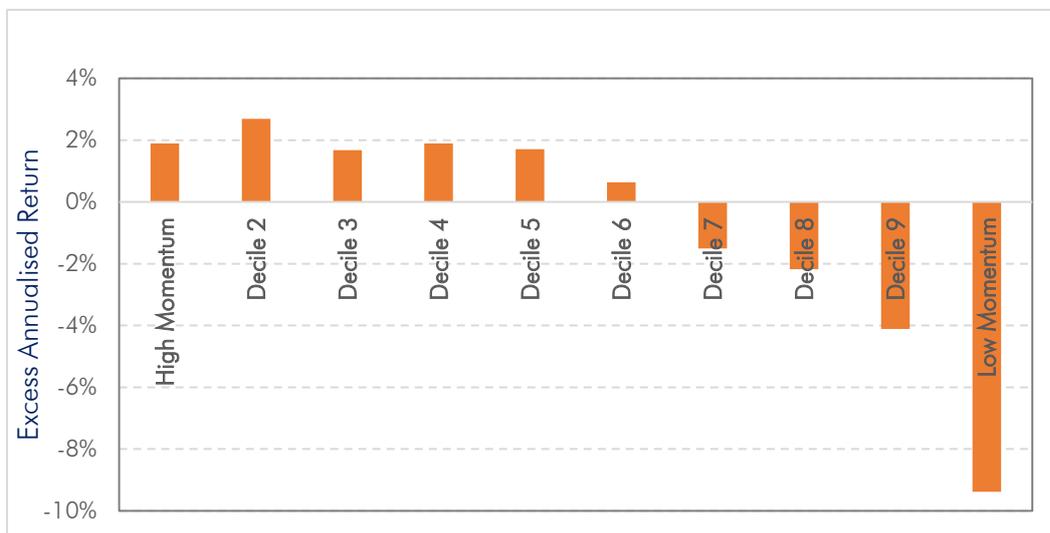
In this paper, we take a closer look at momentum in the global small cap universe, to see if and where this strategy can add outperformance².

Momentum: does it work in global small caps?

To test momentum’s effectiveness, we have taken our universe of global small cap stocks and grouped them by 12-month historical momentum, to see what the excess returns would be for each group over a 20 year period. This analysis has been performed on a long-only basis – in our analysis we are interested in what is achievable within the constraints of a long only strategy.

Looking at the small caps universe as a whole over a 20 year period, there is clear evidence of momentum at work. Higher momentum stocks (represented in figure one by deciles 1-6) outperformed lower momentum stocks (deciles 7-10); the excess annual returns are significant.

Figure one: Global small caps – momentum performance



Source: Factset, MSCI.

Data covers the period 31/05/2000 -30/04/2020, with monthly rebalancing.

Note: we have used 10 groups (deciles) for the Benchmark universe, due to the large number of stocks. For smaller sample sizes with fewer stocks, we have only used 5 groups (quintiles).

¹ Jegadeesh and Titman (1993)

² References in this paper to the global small cap universe or the Benchmark refer to the MSCI World ex Australia (Small Cap) Index.

Importantly, the benefits of avoiding the worst performing stocks are large – those stocks that have done poorly continue to do very poorly when compared to the broader universe.

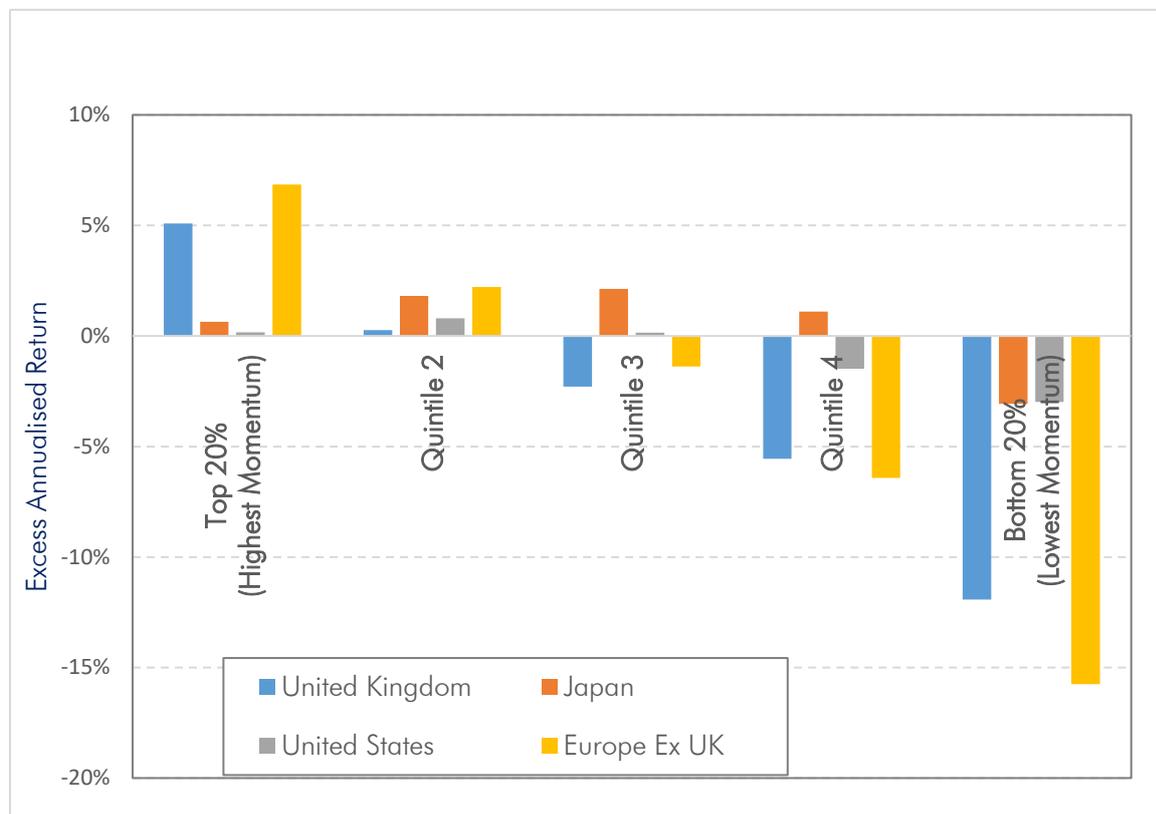
This evidence of the momentum effect in small caps fits with our observations of small caps as a less efficient market universe, where the conditions are more accommodating of a strategy like momentum to outperform.

Country specific momentum in small caps

While the high level results are encouraging, for a global strategy we not only focus on what works overall but dig deeper to see whether these results hold up within different countries and regions. Again, it is important to run this research within the small cap segment, rather than accepting previous conclusions from data run in the large cap universe, as our findings may be different.

In figure two, we have mapped the returns of different momentum groups within several countries and regions within small caps. We can see that the momentum effect continues within regions, however the size and profile of performance does differ.

Figure two: Regional breakdown of momentum returns



Source: Factset, MSCI.

Excess returns are shown relative to each country/region's individual benchmark.

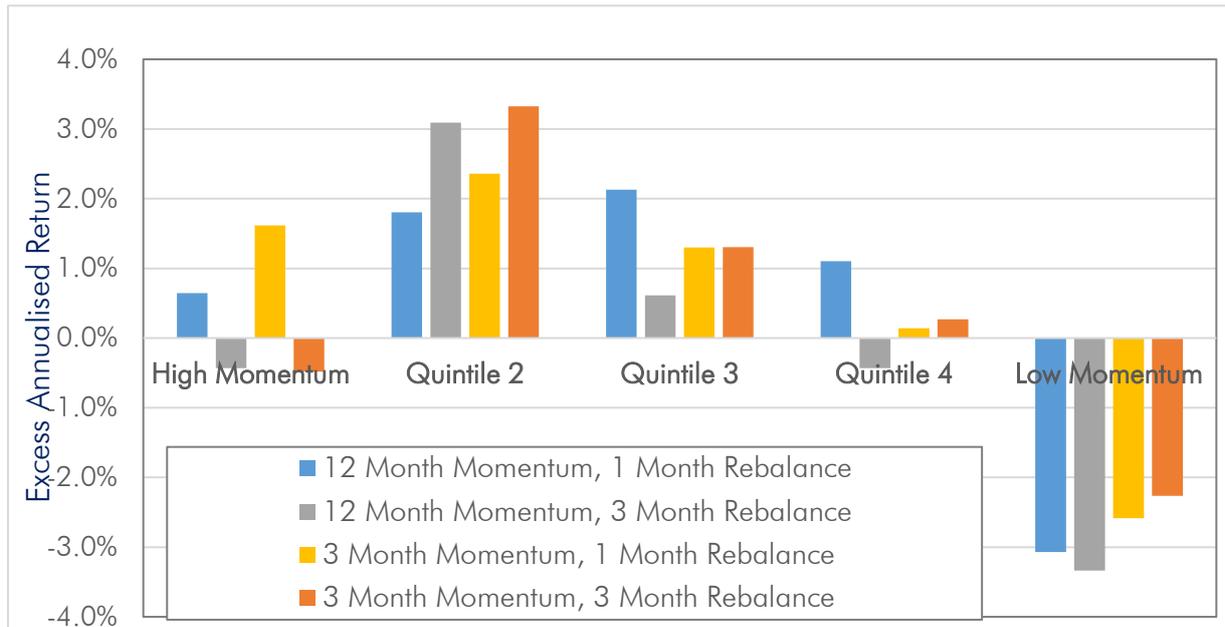
Within US small caps, the momentum effect does exist, but is much smaller than within other regions. Europe and the UK both show large positive returns for high momentum groups and very large negative returns for low momentum groups. Within these regions, you ignore momentum at your peril!

Japan- the exception that proves the rule?

Another interesting finding here is around the performance of momentum in Japan. It has been a truth academically acknowledged that momentum does not work in Japan³. However in small caps we do see evidence of a momentum effect.

Figure three illustrates a deeper look at momentum within Japan. We have examined two different lengths of momentum history (12 months and 3 months) and also two different rebalancing frequencies for the strategy (1 month and 3 months).

Figure three: Japan and momentum



Source: Factset, MSCI.

In the highest momentum group of stocks in Japan, you can obtain positive returns through a momentum strategy- but will need a shorter rebalancing frequency.

However for stocks with moderately good momentum, outperformance is consistent and strong even with a longer rebalancing frequency. In all cases, avoiding poor momentum names will add value.

Conclusion

Our findings highlight the importance of conducting research specifically for small caps, rather than taking conclusions from the large cap universe and applying them.

There are country specific nuances to how and where momentum works globally. However, we do find compelling evidence of momentum effects across the major global regions in small caps. In particular, avoiding poor momentum stocks is a strategy that works well across all regions.

Having a strong understanding of the differences in momentum across different countries, is a critical first step before looking to implement a momentum strategy in any portfolio. At Blue Orbit, we believe in conducting continuous, targeted research specifically for the small cap stock universe.

³ See: Asness, Moskowitz and Pedersen (2010), Fama and French (2010), and Griffin, Ji and Martin (2003).

References

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