

All-Season Investment Strategy II: Using Cross-Asset Momentum As A Downside Protection Mechanism

January 30, 2012 | includes: [AGG](#), [AMJ](#), [EFA](#), [GLD](#), [GSG](#), [IEF](#), [IWM](#), [JNK](#), [SHY](#), [SPY](#), [TIP](#), [TLT](#), [VNO](#), [VWO](#)

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Henry Ma

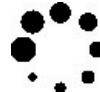
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Disclosure: I am long VWO, SPY, IYR, HYG, EFA, AMJ, TLT, TIP, AGG, IWM, VNO, GSG, IEF.

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Offense wins games, defense wins championships.

In this second part of the three-part investment strategy series, I will introduce another mechanism - cross-asset momentum to protect your portfolio and profit during market downturns. Momentum strategy has been used to generate consistent returns by commodity trading advisors (CTA) for decades. The strategy has performed particularly well in the prolonged bear markets. Therefore, it can be a very useful tool for downside protection. I will discuss how to build cross-asset momentum strategy into your portfolio management process to limit your downside risks.

Momentum strategy works for various reasons. Most notably,

- Economies and markets follow up and down cycles, which last for a long period of time. Table 1 shows that most of the bear markets in the past 70 years, especially the deep declines, lasted one to three years. A well-designed momentum strategy, which takes advantage of the market persistence, should be able to avoid a large part of market declines.
- Capitalism rewards winners. Strong companies become stronger, weak companies become weaker or extinct.
- Human beings normally under-react or overreact to the market changes. Under-reaction forms the initial market trend, then overreaction extends the trend.

Table 1: Bear Markets

Starting Month	Ending Month	% Decline	Period (Months)
8/30/1929	6/30/1932	-67%	35
2/26/1937	3/31/1938	-50%	13
9/29/1939	4/30/1942	-31%	31
5/31/1946	11/29/1946	-22%	6
12/29/1961	6/29/1962	-22%	6
11/29/1968	6/30/1970	-29%	19
12/29/1972	6/30/1974	-43%	21
8/31/1987	11/30/1987	-30%	3
3/31/2000	2/28/2003	-44%	35
10/31/2007	2/27/2009	-61%	16

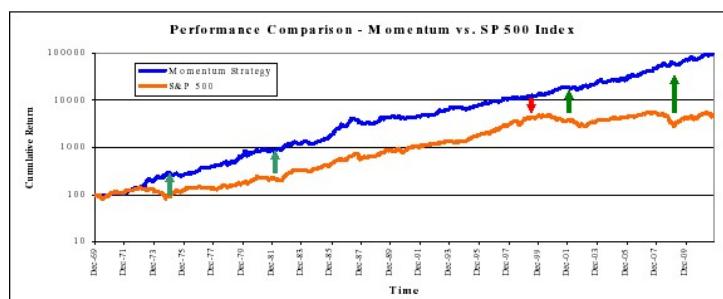
Momentum is normally defined by the past performance over a given period. There is no theory to pick the best time period for momentum calculation. I will use 3, 6, 9, and 12-month returns and rank each asset class based on its combined score. Then I select two of the assets with the strongest momentum over those periods to create an equally-weighted portfolio. The portfolio I created includes two of the 14 ETFs:

- **SPY:** S&P 500 Index
- **IWM:** Russell 2000 Index
- **EFA:** MSCI EAFE Index
- **VWO:** MSCI Emerging Market Index
- **VNQ:** MSCI US REIT Index
- **AMJ:** J.P. Morgan Alerian MLP Index

- [GLD](#): SPDR Gold Trust
- [GSG](#): S&P Goldman Sachs Commodity Index
- [JNK](#): Barclays Capital High Yield Index
- [AGG](#): Barclays Capital US Aggregate Bond Index
- [TIP](#): Barclays Capital Inflation Protection Treasury Index
- [IEF](#): Barclays Capital Treasury Index
- [TLT](#): Barclays Capital Long Term Treasury Index
- [SHY](#): Barclays Capital Short Term Treasury Index

The back test results of the strategy with the past 40 years of data are very impressive. It successfully limited the downside risks in the bear markets of 1972-1974, 2000-2003 and 2007-2009, though it underperformed slightly during the strong bull markets in the late 1990s (see Figure 1). Over the 40-year period, the strategy outperformed S&P 500 index by 7.5% with a much lower drawdown (see Table 2). More importantly, most of the outperformance occurred in the bear markets.

Figure 1: Performance of Momentum Strategy vs. S&P 500 Index



(Click to enlarge)

Table 2: Performance Statistics: Momentum Strategy vs. S&P 500 Index

Portfolio Statistics		
	Momentum	S&P 500 Index
Average Monthly Return	1.5%	0.9%
Monthly Standard Deviation	4.4%	4.5%
Annualized Return	18.1%	10.6%
Annualized Standard Deviation	15.4%	15.7%
Sharpe Ratio (Risk-free Rate = 5.5%)	0.8	0.3
Maximum Drawdown (Loss)	21%	51%
Expected Time to Recover (yrs)	1.2	4.8

Let us look at the performance of the strategy in more detail during last decade, when we experienced two steep bear markets (see Table 3). The momentum strategy made significant profits in the two bear markets. From the standpoint of capital protection and risk reduction, the strategy serves the purpose well.

Table 3: Annual Returns in the Past 13 Years: Momentum Strategy vs. S&P 500 Index

Year	Momentum Strategy	S&P 500 Index
1999	26.8%	21.0%
2000	15.1%	-9.1%
2001	15.2%	-11.9%
2002	3.2%	-22.1%
2003	31.4%	28.7%
2004	12.0%	10.9%
2005	2.7%	4.9%
2006	30.6%	15.8%
2007	28.4%	5.5%
2008	25.8%	-37.0%
2009	13.2%	26.6%
2010	15.4%	15.1%
2011	17.9%	20%

In summary, I have introduced another strategy that can be built into your portfolios to avoid market downturns and protect your capital. To help investors, I will update the recommendations from the momentum strategy in my blog www.allseasoninvesting.com.

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