Introduction to Momentum Trading

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On paper, momentum investing seems less like an investing strategy and more like a knee-jerk reaction to market information. The idea of selling losers and buying winners is seductive, but it flies in the face of the tried and true Wall Street adage, "buy low, sell high."

In this article, we'll look at momentum investing and its benefits and pitfalls.

Key Takeaways

- Momentum investing is a trading strategy in which investors buy securities that are rising and sell them when they look to have peaked.
- The goal is to work with volatility by finding buying opportunities in short-term uptrends and then sell when the securities start to lose momentum.
- Then, the investor takes the cash and looks for the next short-term uptrend, or buying opportunity, and repeats the process.
- Skilled traders understand when to enter into a position, how long to hold it for, and when to exit; they can also react to short-term, news-driven spikes or selloffs.
- Risks of momentum trading include moving into a position too early, closing out too late, and getting distracted and missing key trends and technical deviations.

The Father of Momentum Investing

Though not the first momentum investor, Richard Driehaus took the practice and made it into the strategy he used to run his funds. His philosophy was that more money could be made by "buying high and selling higher" than by buying underpriced stocks and waiting for the market to re-evaluate them.

Driehaus believed in selling the losers and letting the winners ride while re-investing the money from the losers in other stocks that were beginning to boil. Many of the techniques he used became the basics of what is now called momentum investing.

Precepts of Momentum Investing

Momentum investing seeks to take advantage of market volatility by taking short-term positions in stocks going up and selling them as soon as they show signs of going down. The investor then moves the capital to new positions. In this case, the market volatility is like waves in the ocean, and a momentum investor is sailing up the crest of one, only to jump to the next wave before the first wave crashes down again.

A momentum investor looks to take advantage of investor herding by leading the pack in and being the first one to take the money and run.

Elements of Momentum Investing

Trading momentum markets require sophisticated risk management rules to address volatility, overcrowding, and hidden traps that reduce profits. Market players routinely ignore these rules, blinded by an overwhelming fear they'll miss the rally or selloff while everyone else books windfall profits. The rules can be broken down into five elements:

1. Selection, or what equities you choose
2. Risk revolve around timing in opening and closing the trades
3. Entry timing means getting into the trade early
4. Position management couples wide spreads and your holding period
5. Exit points require consistent charting

To increase the likelihood of choosing an investment that is liquid and volatile, pick individual securities, rather than mutual funds or ETFs, and make sure they have an average trading volume of at least 5 million shares per day.

Momentum Security Selection

Choose liquid securities when engaging in momentum strategies. Stay away from leveraged or inverse ETFs because their price swings don't accurately track underlying indices or futures markets due to complex fund construction. Regular funds make excellent trading vehicles but tend to grind through smaller percentage gains and losses compared with individual securities.

Seek out securities that trade more than 5 million shares per day whenever possible. Many popular stocks meet these criteria, but even low float issues can turn into highly liquid instruments when news flow and intense emotional reactions draw in market players from diverse sources.

Keep watch for the "flavor of the day," when new products, divisions or concepts capture the public's imagination, forcing analysts to throw away calculations and re-compute profit estimates. Biotechs and small to midsize technology companies create a generous supply of these story stocks.

Momentum trading deviates notably from the investment strategy of buying low and waiting for a stock to rise.

Tight Risk Control

The risk side of the equation must be addressed in detail, or the momentum strategy will fail. The pitfalls of momentum trading include:

- Jumping into a position too soon, before a momentum move is confirmed.
- Closing the position too late, after saturation has been reached.
- Failing to keep eyes on the screen, missing changing trends, reversals or signs of news that take the market by surprise.
- Keeping a position open overnight. Stocks are particularly susceptible to external factors occurring after the close of that day's trading – these factors could cause radically different prices and patterns the next day.
- Failing to act quickly to close a bad position, thereby riding the momentum train the wrong way down the tracks.

Perfect Entry Timing

The best momentum trades come when a news shock hits, triggering rapid movement from one price level to another. In turn, this sets off buying or selling signals for observant players who jump in and are rewarded with instant profits. Another batch of momentum capital enters as the trade evolves, generating counter swings that shake out weak hands. The hot money population finally hits an extreme, triggering volatile whipsaws and major reversals.

Early positions offer the greatest reward with the least risk while aging trends should be avoided at all costs. The opposite happens in real-world scenarios because most traders don't see the opportunity until late in the cycle and then fail to act until everyone else jumps in.

Position Management

Position management takes time to master because these securities often carry wide bid/ask spreads. Wide spreads require larger movement in your favor to reach profitability while also grinding through wide intraday ranges that expose stops—even though technicals remain intact.

Choose your holding period wisely because risk increases the longer you stay positioned. Day trading works well with momentum strategies, but it forces players to take larger positions to compensate for the greater profit potential of multi-day holds. Conversely, it is best to reduce position size when holding through multiple sessions to allow for greater movement and stop placement further away from the current action.

Profitable Exits

Exit when the price is moving rapidly into an overextended technical state. This overextended state is often identified by a series of vertical bars on the 60-minute chart. Alternately, the price could pierce the third or fourth standard deviation of a top or bottom 20-day Bollinger Band.

Tighten up stops or consider a blind exit when technical barriers are hit like a major trendline or previous high/low. Exit or take partial profits when crossovers signal potential trend changes.

Benefits of Momentum Investing

Momentum investing can turn into large profits for the trader who has the right personality, can handle the risks involved, and can dedicate themselves to sticking to the strategy.

Potential for High Profits Over a Short Period

There are lucrative profits to be made from momentum investing. For example, say you buy a stock that grows from $50 to $75 based upon an overly positive analyst report. You then sell at a profit of 50% before the stock price corrects itself. You've made a 50% return over the course of a few weeks or months (not an annualized return). Over time, the profit potential increase using momentum investing can be staggeringly large.

Leveraging the Market's Volatility to Your Advantage

The key to momentum investing is being able to capitalize on volatile market trends. Momentum investors look for stocks to invest in that are on their way up and then sell them before the prices start to go back down. For such investors, being ahead of the pack is a way to maximize return on investment (ROI).

Leveraging the Emotional Decisions of Other Investors

According to Ben Carlson of the blog A Wealth of Common Sense, the entire idea of momentum investing is built around chasing performance. However, momentum investors do this in a systematic way that includes a specific buying point and selling point. Rather than be controlled by emotional responses to stock prices like many investors are, momentum investors seek to take advantage of the changes in stock prices caused by emotional investors.

Drawbacks of Momentum Investing

However, for every silver-lined cloud, there may also be rain. Momentum investing also has several downsides. The same risk-return tradeoff that exists with other investing strategies also plays a hand in momentum investing.

Like a boat trying to sail on the crests of waves, a momentum investor is always at risk of timing a buy incorrectly and ending up underwater. Most momentum investors accept this risk as payment for the possibility of higher returns.

High Turnover

High stock turnover can be expensive in terms of fees. Even though low-cost brokers are slowly putting an end to the problem of high fees, this is still a major concern for most rookie momentum traders.

Time Intensive

Momentum investors have to monitor market details daily, if not hourly. Because they are dealing with stocks that will crest and go down again, they need to jump in early and get out fast. This means watching all the updates to see if there is any negative news that will spook investors.

Market Sensitive

Momentum investing works best in a bull market because investors tend to herd a lot more. In a bear market, the margin for profit on momentum investing shrinks in accordance with increased investor caution.

Will It Work for You?

Momentum investing can work, but it may not be practical for all investors. As an individual investor, practicing momentum investing will most likely lead to overall portfolio losses. When you purchase a rising stock or sell a falling stock, you will be reacting to older news than the professionals at the head of the momentum investing funds.

They will get out and leave you and other unlucky folks holding the bag. If you do manage to time it right, you will still have to be more conscious of the fees from turnover and how much they will eat up your returns.

The Bottom Line

Momentum trading is not for everyone, but it can often lead to impressive returns if handled properly. It takes severe discipline to trade in this type of style because trades must be closed at the first sign of weakness and the funds must be immediately placed into a different trade that is exhibiting strength.

Factors, such as commissions, have made this type of trading impractical for many traders, but this story is slowly changing as low-cost brokers take on a more influential role in the trading careers of short-term active traders. Buying high and selling higher is momentum traders' enviable goal, but this goal does not come without its fair share of challenges.