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# "Momentum Factor Premiums Are Behavioural In Nature"

## What is your outlook on the Indian equity markets over the long term?

The Indian equity markets have always rewarded investors who have the patience and give investments time to work in the market. We are a fast growing economy with a well-regulated equity market and this combination has translated into wealth creation through publicly listed firms. In addition, we believe that a factor-based investment approach has the potential of outperforming the benchmark over the long term as well. Our research suggests that a factor-based approach would have delivered superior risk-adjusted returns in the past and we expect that to continue in the future.

## Can you highlight the strategy behind factor investing? How does the consistency of factors relate to the world of investing?

Factor investing involves taking exposure to risk-adjusted return premiums that can be harvested over the medium to long term. The most commonly used factors are value, quality, momentum, low volatility and size. These premiums exist due to either strong economic rationale or behavioural anomalies. The value factor is an example of the former and involves buying stocks for cheaper than their intrinsic value and making a return when these stocks appreciate. Momentum factor premiums are behavioural in nature and signify the persistence of stocks with strong price momentum in upward or downward trend. Even though factor premiums can deliver high risk-adjusted returns, they are susceptible to cyclicality in their returns in the short term due to various reasons.

Value stocks may not do as good as growth stocks when the economy is booming and rates are very low with easy credit availability as was the case in the recent past. Factor premiums also tend to have low or negative correlation to each other. So, combining two or more factors in a multi-factor approach provides a smoother risk-adjusted performance through the benefit of diversification. Using global data, many factors have been back-tested over a 100-year period to show the persistence of these premiums over various business cycles and macro events. This consistency gives investors extra comfort as they know that the strategy works over the long term and is a powerful risk-adjusted concept for wealth creation.

## Quant funds are ideal for which type of investors? What are the key benefits investors can derive from investing in quant funds?

Quant funds can refer to funds following a variety of strategies using mathematical models. If we look at only the quantitative rule-based factor funds, globally they have been successful for both institutional and retail investors and form a sizable portion of the asset allocation. The key benefit of a rule-based approach is that the emotional bias is eliminated and the strategy can be back-tested over a long period of history. This gives us good insight into how the rules would have performed over various market cycles given there is no inherent bias in picking stocks based on emotional reaction to that moment and given that all the stocks are picked using set parameters. Rule-based funds have proven to generate high risk-adjusted returns and help in the long-term continuous wealth creation for an investor.

## Can you shed some light on the significance of following a momentum approach in factor investing?

The momentum factor is a behavioural factor which involves buying stocks that have gone up in value over a defined period of time. The idea behind momentum is that this upward or downward trend would continue for some more time and can be used to generate return. Momentum has worked very well across both developed markets and Indian markets over the past many years. But the factor also comes with a much higher volatility compared to others in the short term, even though it provides a high risk-adjusted return over a long term. It is susceptible to high drawdowns in bearish markets. The factor also has a much lower persistence which means that the portfolio of momentum stocks needs to be churned at a higher interval to capture this premium effectively. Momentum when combined with other factors such as quality or value provides a much smoother risk-adjusted return given the low correlation between the factors.

## How should retail investors navigate the current market volatility with mutual funds?

The biggest fear any investor has is the concern of having invested in the peak of the market before it crashes, thus causing significant wealth erosion. Looking at the past markets for guidance, we have already seen that even if an investor was unlucky and invested at the top of all the major market crashes, there was decent wealth creation by being patient over the long term. Our research further shows that by continuing an SIP through the entire market cycle of peaks and troughs, i.e. by being patient and consistent, wealth creation is a distinct possibility. One approach that retail investors could take is by staying on the course with their SIPs through all market conditions even when the markets get volatile. Time in the market has rewarded more generously than timing the market.