News

Momentum vs Fundamentals

Recent markets have been driven almost wholly by momentum. How far have fundamentals been left behind in the pricing of equities?

Ben Leyland

Robert Lancastle

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A Conversation with Ben Leyland and Robert Lancastle
Senior fund managers, JOHCM Global Opportunities and JOHCM International Opportunities

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Ben: For me, momentum investing is first and foremost about relative share price direction. So, if a company's share price has been rising and outperforming the market, that makes it a momentum stock. But it's important to think about a company's fundamentals too and whether it's growing well and delivering on its potential. If the fundamentals are looking good, that should drop through to cash flows.

Rob: But it's an oversimplification to say that companies with rising share prices must have improving fundamentals which justify those rising prices. One doesn't necessarily lead to the other.

Ben: We need to differentiate between fundamentals and price momentum when looking at opportunities and risks. A share price with momentum which isn't accompanied by strong fundamentals could be an overvaluation. Poor share price momentum accompanied by good fundamentals could be an interesting value opportunity.

Rob: And that's what we describe as the forgotten middle: lacklustre share prices accompanied by solid fundamentals.

Ben: Yes, precisely. We're after the unsung middle child of the investment landscape. But looking at the numbers over the past year, on a global basis, the only way to deliver excess return has been to invest in momentum. Quality and value have been in line with the market. So, we have to ask ourselves: why are we not following that trend?

There has been genuine momentum in the fundamentals of some tech and healthcare companies, which has driven price momentum. The key is whether that fundamental momentum is short-term but the market's pricing it in for much longer, ie, is the market pricing for perfection? That is a style of investing, and the skill comes in understanding when that fundamental momentum is slowing and selling down then.

Rob: We're less inclined to invest like that. We'd rather look for businesses with a well-regarded 10 year story. We're not looking for that top tier of growth, we want the forgotten second tier; a very good company with long-term fundamentals, but that perhaps isn't so strong in the short term.

Ben: We identify businesses which we believe are competitively advantaged and have tailwinds for the long term. We look for slow and steady fundamentals on a three-year view that then rise on a three to 10-year view. That's how we create value as long-term investors; we invest in areas that aren't as excited or noticed as the more momentum-driven areas of the market.

Rob: But it's crucial to bear value traps in mind. Sometimes when fundamentals are weaker, you see a fall in the share price. Optically, these stocks look like they're getting cheaper, but in the long run, it may not turn out to be a good deal after all. The question is, at what point are poor fundamentals evidence of deteriorating long-term fundamentals rather than just a short-term temporary headwind, which is creating an opportunity?

Ben: We spend a lot of time thinking about that. We don't want a portfolio of expensive winners - and the index is currently dominated by them - but we also don't want a portfolio full of optically 'cheap losers' because we run the risk of value traps. It's about striking a balance between companies which are moving in the right direction but not expensive yet, versus others which are executing poorly on a 12- month view, but as those headwind conditions aren't permanent, there's opportunity.

Rob: It's all a very careful and delicate balance. When we're looking for new opportunities for the fund, we take a variety of approaches but always look for equilibrium, which is often where the route to long-term investment success lies. I think it's wrong to conclude that in this environment any non-momentum investment idea is a poor investment idea.

Thank you very much.

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