Should you invest in alpha or momentum funds in India?

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Alpha and momentum indices in India have generated stellar returns compared to the broader market indices in the short- and long-term periods. They have been in the spotlight in the last one-year with fund houses launching passive funds tracking these indices.

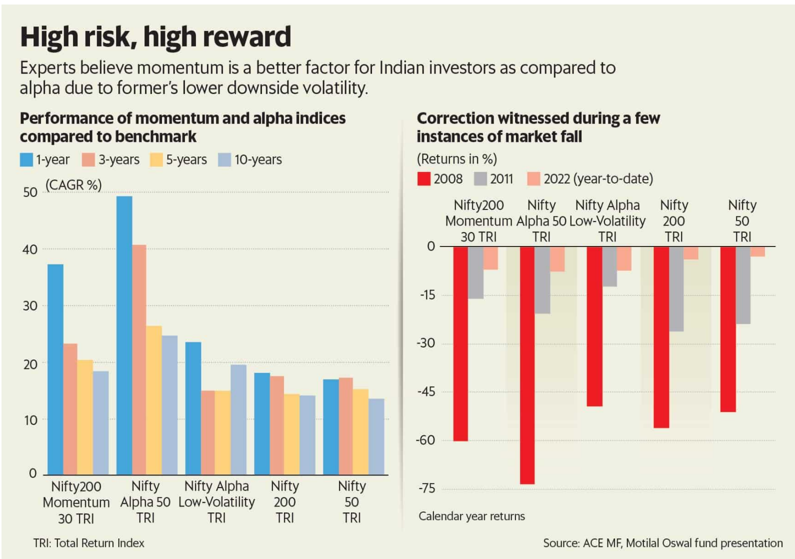
Momentum factor considers stocks that have outperformed recently and are likely to outperform in the near future. Apparently, there is no explanation as to why the momentum factor works. But its ability to generate superior returns has given it the title - 'the premier anomaly' (to efficiency of markets).

The alpha strategy considers stocks with high alpha, or excess returns over the benchmark. Thus, this strategy picks stocks that generate high alphas over a defined period.

Both alpha and momentum indices are made up of stocks that have done well in the recent past. "Alpha and momentum are based on similar principles but are implemented differently," said Anoop Vijaykumar, fund manager at Capitalmind.

Higher downside risk

In India, the popular indices based on alpha and momentum themes are Nifty 200 Momentum 30 Index and Nifty Alpha 50 Index. Motilal Oswal, Kotak and UTI Mutual Funds have launched passive funds based on these indices in the last one year.



The Nifty 200 Momentum 30 Index gives exposure to 30 high momentum stocks across large and mid-cap stocks within the Nifty 200 Index. While the Nifty Alpha 50 Index is a much-diversified index having 50 stocks across the large-, mid- and small-cap space with highest alphas from the top 300 companies. The steep run-up in the mid and small-cap space over the last two years is reflected in the returns generated by this index.

IT, consumer goods, financial services, metals, power and chemicals are the sectors that currently have higher sector weights in these indices. Financial services, which is a dominant sector in the parent indices with minimum 30% share, constitutes only 10-12% in the momentum and alpha indices.

These indices have outperformed other benchmark indices in various time-frames with a significant margin (see table). However, proving that higher return comes with higher risk, these indices witnessed a severe correction during the market downside (as shown in the second table). These indices experience higher volatility as well. The variation in price movements, measured by standard deviation of each of these indices, is higher at about 21% for the one-year ending 28 February. This is against 16.3% recorded for their parent indices—Nifty 200 and Nifty 50.

Who can invest?

Investors who are comfortable with potential high volatility on the downside can consider investing in these. Experts encourage investing in momentum style because of its ability to contain losses compared to the alpha index during market corrections.

“Alpha tends to outperform in certain years with quite a margin, but it tends to lose a lot as. Based on the returns for 15 years, momentum has shown better performance than alpha and lower downside volatility, which is why I think momentum is a better factor compared to alpha," said Vijaykumar from Capitalmind.

The higher downside risk of alpha index could be on the back of higher exposure to mid and small-cap space compared to momentum. “Momentum is good in a way that it focuses on top 200 companies, which have better corporate governance and good liquidity," said Anish Teli, managing partner of QED Capital Advisors LLP.

Every investing strategy comes with its own merits and demerits. The Nifty’s momentum index has underperformed other benchmark returns not just when the markets correct but also in the recovery market cycle. Holding the investments for a longer timeframe will help in generating decent returns, as per experts.

“If somebody has a time horizon of ten-plus years and can tolerate some volatility, the momentum index can work pretty well," added Vijaykumar.

“It’s ideal that investors purchase these funds through SIP or STP so that the volatility can be managed better when the markets go down as well," said Vishal Dhawan, founder and director of Plan Ahead Wealth Advisors.

Experts also suggest pairing this strategy with other low volatile strategies. “Combination of a momentum and normal index work well for investors who are aggressive," said Dhawan. Thus, if you have already invested in any of the broad-based index, you can consider momentum investing to some extent to boost returns.

“For conservative investors, who might find momentum very uncomfortable, they can combine momentum with low volatility fund, so that downside is protected a little better," concluded Dhawan.

One should be cautious of investing in multi-factor index funds such as Alpha low-volatility index.

“When you combine factors, you could end up in a situation where you could pick up stocks which are not the best in either of the factors. There could be half weightage to each factor and you end up with a stock which is not the most alpha or the lowest volatile one," added Vijaykumar.

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