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CASE STUDIES

"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

Jack L. Treynor

MOMENTUM STOCKS

Investment Dynamics had a research staff of six. Their director, Ossie Spencer, was fond of pointing out their task was seeing opportunities other investors failed to see. But there are thousands of stocks; Ossie's staff did not have the time to do imaginative research on all of them. More times than Ossie cared to remember, their research had arrived at the conclusion that nothing in a company was happening that other investors were not already aware of.

What Ossie felt he needed was a way to focus his limited resources on a few stocks other investors were likely to be wrong about. He admitted that his solution was probably flawed, but he felt it was better than no solution at all: Focus on stocks that other investors disagreed about, then devote analysis to determining which side was right. When investors disagreed sharply about the prospects for a company, some of them had to be wrong.

And Ossie had a theory about how to locate the big disagreements: if one group was long a company's stock, the other group would be short. But then every time news moved the stock price it would reward one group and penalize the other. And the bigger the disagreement, the bigger the respective bets and the bigger the wealth transfer.

Ossie reasoned that equilibrium price depended, not only on investors' opinions, but also on their wealth. If the disagreements, hence the bets, were big enough, the wealth shift due to news would lead to a further price shift. Price changes, instead of being strictly random, would exhibit momentum.

Ossie explained to his analysts that, by focusing on momentum stocks, they would be focusing on precisely these stocks where the active bets, hence the disagreements, were biggest.

Questions:

1. How does Ossie choose which momentum stocks to focus on?
2. Aren't some of the various potential sources of disagreement-factual, analytical, philosophical– easier to resolve than others?

3. Which is more important for profiting from disagreement: understanding why the right side is right, or why the wrong side is wrong?
4. What if Ossie's analyst determines that the wrong side of the argument is more persuasive?
5. When his analyst has successfully identified the flawed thinking behind the disagreement, what is the next step? How does Ossie cash in?
6. Aren't the stocks with big disagreements more likely to have adversarial trading motives? Should Ossie warn his trading desk?
7. Will Ossie's analysts need special skills for this work? Special training? How does he measure their performance?
8. How do you measure the research alpha on a momentum stock?