Momentum Investing: Building an Outperforming Portfolio

When it comes to investing, many people talk about long-term investing but end up tracking their portfolios far too frequently. As a result, most retail investors remain confused about the difference between investing and long-term investing. What is bought with a short-term view often turns into a "long-term investment" simply because prices fall.

This confusion usually revolves around the most important questions: what to buy, when to buy, how long to hold, and when to exit. While consistency in any approach is important, I advocate a different and more objective framework - - - Buy and Hold Momentum.

The idea is simple: invest in momentum, not in individual stocks.

Momentum investing is a proven, scientific approach supported by decades of empirical research. Numerous academic studies have documented momentum as one of the most persistent market anomalies. Even proponents of the Efficient Market Hypothesis acknowledge momentum as among the most robust and well-researched anomalies in financial markets.

I have explained this concept in detail in my book, **Master Momentum Investing & Trading Strategies.**

Whether it is fundamental analysis, technical analysis, quantitative methods, or any other approach, at a broader level there are only two primary styles of investing: Reversal (Value) and Momentum (Growth). In simple terms, they can be described as buy low, sell high and buy high, sell higher.

Momentum can be understood as both a philosophy and a belief that stocks which have performed well tend to continue performing well, while stocks that have underperformed are more likely to continue underperforming over time.

Momentum Investing Strategy

Identifying and investing in individual stocks, by itself, does not make us successful even if some of those stocks deliver strong returns. Every investor, including newcomers, has seen stocks that have performed exceptionally well. The real question is: what about the portfolio? This is where most investors struggle.

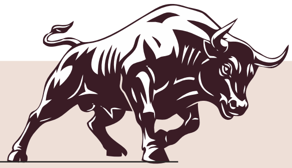
True success lies in building and managing a portfolio, not in focusing on individual stock stories. This shift in thinking is easier said than done, but it is the key to long-term success.

To effectively follow this approach and build a long-term winning portfolio, a minimum investment horizon of three years is required. A five-year horizon is even better, and anything beyond that is ideal.

The Momentum Investing strategy rests on four core pillars: Breakout, Pullback, Trend following, and Out-performance.

Breakout

Since we are building a long-term investing strategy, we use the 52-week high breakout rule to identify buying opportunities. A 52-week period represents a full market year, making it a meaningful benchmark for long-term breakouts. Stocks that make a new yearly high usually do so for strong underlying reasons, often supported by



improving fundamentals and market participation.

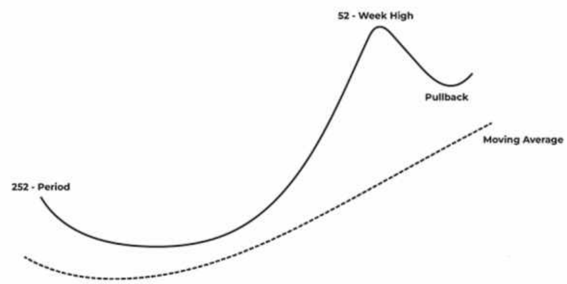
Pullback

When one looks for reversals in stocks that are in a downtrend, it is classified as a reversal trading approach. In contrast, when the broader momentum is bullish and we look to buy a fundamentally and technically strong stock that has corrected temporarily, the approach is called a pullback.

Because the overall momentum remains strong, I consider pullbacks are an integral part of a momentum investing strategy. We will consider stocks that are trading within a 20% retracement from their 52-week high as potential candidates. These stocks offer opportunities to enter at a temporary correction while their long-term momentum remains intact.

Trend Following

The stocks we invest in must be in a clear long-term uptrend. The 200-EMA (Exponential Moving Average) is a widely used tool for identifying long-term trends. As part of our process, we consider only those stocks that are trading above the 200-EMA, in conjunction with the breakout and pullback criteria.



This turns out to be an investing strategy to identify stocks with following rules:

- Stocks at or within 20% of 52-week high
- Stocks above their 200-EMA

> “ It is good to have an end to journey towards, but it is the journey that matters in the end ”
>
> - Ursula K. Le Guin

Ranking

When you run a scanner based on the above strategy, it will typically generate a large number of stocks especially during a bull market.

To construct a focused and effective portfolio, further filtering is essential. To achieve this, we rank the shortlisted stocks based on their one-year performance. Since there are approximately 252 trading sessions in a year, the ranking is done using 252-day returns.

Rebalance

The portfolio is rebalanced at a fixed frequency either monthly or weekly, based on your preference. Choose a specific date and follow it consistently.

For example, assume you create a 20-stock portfolio on 1st January based on the above strategy. Do not track or interfere with the portfolio until 1st February. On 1st February, run the scanner again using the same rules and identify the top 20 ranked stocks.

Any stock currently in your portfolio that no longer appears in the top 20 ranks will be exited. These positions will be replaced with stocks that are now in the top 20 but were not part of the existing portfolio. This disciplined process ensures that the portfolio continuously holds stocks with strong momentum and systematically exits underperformers even if it means booking a loss.

A key principle to remember - do not track individual stock P&L. The focus should always remain on the portfolio, not on individual positions.

To reduce unnecessary churn, we introduce an exit buffer. The exit rank is set at double the portfolio size (a 100% buffer). For a 20-stock portfolio, the exit rank would be 40. Stocks that fall below rank 40 are exited and replaced with stocks from the top 20 ranks.

Portfolio size

The 20-stock portfolio is used here only as an example; the portfolio size can be adjusted based on the investment universe.

It is recommended to maintain separate portfolios for large-cap stocks, mid-cap stocks, small-cap stocks, micro-cap stocks, and ETFs, rather than combining them into a single portfolio.

As a general guideline:

- If the investment universe consists of more than 300 stocks, a 20-stock portfolio is recommended.
- If the universe size is between 100 and 300 stocks, a 10-stock portfolio is appropriate.
- For large-cap stocks and ETFs, a 5-stock portfolio is recommended.

Momentum Investing Plan

All above rules that we discussed can be adjusted as per your choice. Put together, it becomes a Momentum Investing Plan. I call it MIP-1. Rules are as follows:

- Breakout & Pullback: 20% from 52-week high
- Trend: Above 200-EMA
- Rank: Higher 252-period performance
- Portfolio size: 20-stock portfolio
- Allocation: Equal
- Rebalance: Monthly Rebalancing
- Exit Rank: 40 (100% buffer)
- Reinvest on Rebalance date

If we backtest this strategy from 1st Jan 2001 to 30th September 2024 on Nifty 500 Index. The statistics are as follows:

- Ave Monthly Churn: 5.01
- Positive Trades: 46.67%
- CAGR: 29.66%
- Max DD: 45.13%
- Ave Return: 38.47%
- Median Return: 35.61%
- Positive Years: 75%
- Positive Months: 64.91%
- Sortino Ratio: 1.93
- Sharpe Ratio: 0.63
- CAGRM: 2.00

During the same period, the Nifty delivered a CAGR of 13.54%, while the Nifty 500 generated a CAGR of 14.80%. To put this into perspective, ₹1 invested over this period would grow to around ₹26 at a 14.80% CAGR, whereas at a 29% CAGR, the same ₹1 would grow to nearly ₹480.

This shows why small differences in CAGR create massive differences in long-term wealth because compounding does the heavy lifting.

This clearly demonstrates that meaningful outperformance is possible with a momentum-based approach. However, achieving higher returns must go hand in hand with managing and reducing drawdowns.

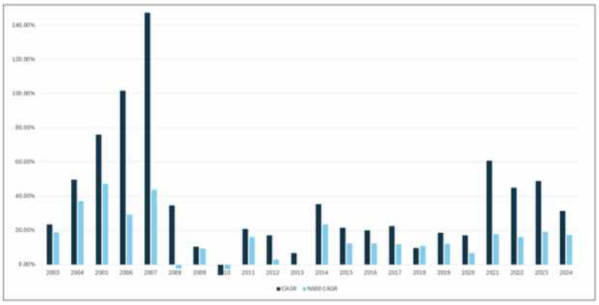
Based on further research, I propose a benchmark-oriented strategy, which I call the MIP-12 Strategy. The rules of this strategy are as follows:

- Market Trend Filter: Nifty 500 index 20-EMA
- Breakout & Pullback: 50% from 52-week high
- Trend: Above 200-EMA
- RS: Ratio above 200-EMA against Nifty 500 Index
- Ranking method: Volar
- Rank: Higher 252-period performance
- Portfolio size: 20-stock portfolio
- Allocation: Equal
- Rebalance: Monthly Rebalancing
- Exit Rank: 40 (100% buffer)
- Reinvest on Rebalance date

Volar is a Volatility adjusted returns method of ranking stocks. Market trend filter above Volar helps in reducing drawdown and improving returns. Below are the backtested statistics of above strategy:

- Ave Monthly churn: 3.64
- Positive Trades: 51.16%
- CAGR: 32.52%
- Max DD: 28.19%
- Ave Return: 42.73%
- Median Return: 38.8%
- Positive Years: 75%
- Positive Months: 64.56%
- Sortino Ratio: 2.57
- Sharpe Ratio: 0.58

- CAGRM: 2.20



This strategy has outperformed the Nifty on a three-year rolling return basis starting from 2001, except when the portfolio was initiated at the market peak in January 2008. Even in that case, the strategy outperformed over a five-year horizon. In fact, there has been no five-year period in which this strategy has not outperformed. Of course, past result doesn't guarantee future success.

That said, this strategy can be improved further. It is designed as a benchmark strategy, not as a final or recommended one. I strongly encourage you to add your own ideas and backtest them independently to build conviction.

You may incorporate your preferred technical setups and even fundamental filters into the existing rules. I like to call this the "tadka strategy" - adding your own flavour to a robust base.

We have built a comprehensive backtesting mechanism for this on the Definedge platforms. I recommend that you experiment with it yourself to gain first-hand conviction. Our platform, Momentify, allows you to create and manage such strategies with near-automatic adjustments. There are no platform charges and no brokerage fees.

Conclusion

The objective here is simple: to help you become your own fund manager. A good fund manager needs four things: knowledge, tools, conviction, and discipline.

The knowledge has been shared through my work at the InvesTrade conference and in my book. Definedge's tools and backtesting capabilities help build conviction. Momentify supports discipline through systematic execution. However, the right mindset must come from within.

I strongly believe that a disciplined investor or trader can outperform even those who are more knowledgeable and better resourced.

Finally, continue investing in the manner you are comfortable with today. This is simply a new approach - investing in momentum. Study and backtest before implementing it. Many Momentify users have designed excellent strategies of their own. As a result, they are able to follow their strategies with greater conviction and discipline. The same framework can also be applied to trading, which we will explore in the next article.

Editor's Note: Presented at AIF's 11th Annual Conference, held at Indore in 2025.

About the Author

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Prashant Shah is one of the few professionals in the industry to hold multiple prestigious and globally recognized designations. With over two decades of experience in market research and practice, he has developed numerous innovative concepts for trading and investing. A renowned author, Prashant, has written five best selling books on trading and investing. Prashant is the co-founder and CEO of Definedge. He is a member of AIF since 2015.