

Dual-Factor Investment Strategy: Market Trends and Performance Growth

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Abstract: The driving forces behind stock price increases are twofold: investor expectations for the future and market sentiment. Investors prefer stocks with growing performance as they are essentially investing in the future. Market sentiment, characterized by heightened enthusiasm for buying and selling stocks, contributes to remarkable gains in stock prices, with some sectors experiencing multiple consecutive limit-up movements. Against this backdrop, this study formulates an investment strategy that combines market trends and performance growth as dual factors. The research outlines the logic, specific implementation, timing of transactions, and risk management measures associated with this strategy. Using the optical communication sector as an example, the study tests the investment strategy and concludes that stocks with strong performance or anticipated growth, situated in trending sectors with sustained market conditions, are worth purchasing. Additionally, timing transactions strategically can yield favorable returns.

Keywords: Investment strategy, Market trends, Performance growth, Multi-factor investment model

1. Introduction

Since the opening of the Chinese stock market in 1990, it has evolved into the world's second-largest stock market. As of now, the A-share market in China boasts over 5,000 listed companies, with a total market capitalization exceeding ¥84 trillion. The number of securities investment accounts has reached 150 million, signifying the increasing influence of the stock market on public life. Despite significant volatility in stock prices in the Chinese market, the long-term trajectory is still influenced by the fundamentals of companies, specifically their ability to generate cash flow.

With the development of the Chinese stock market, advancements in technology, and increasing transparency, more investors are focusing on the fundamentals of companies. Fundamental investing operates on the principle that when a company's fundamentals are strong, its stock price will rise, and vice versa. When a company's fundamental value is reasonably assessed, the stock price often approaches or equals this value.

Within fundamental analysis, investors often pay close attention to the growth of a company's performance, which reflects the industry's vitality and the company's competitiveness. On the other hand, sectors that are generally in the market spotlight tend to exhibit favorable price movements. By primarily considering the inflow of funds into sectors over the short term, along with factors such as the sector's relative performance to the overall market, the volume-price relationship of the sector

index, the market structure of individual stocks within the sector, and the sector's policy, economic, technological, and social (PEST) factors, we determine whether a sector is in a trending spotlight.

Against this backdrop, this study addresses both performance growth and market trends, analyzing and selecting factors contributing to the performance growth of listed companies in the case study. Effective factors in the A-share stock market are chosen as the basis for investment decisions, leading to the establishment of a multi-factor quantitative investment model. This model is used to select valuable stocks for investment, and the study constructs and tests a dual-factor strategy that combines market trends and performance growth in trending themes.

2. Relevant Theories

2.1. Study on Performance Growth and Stock Price Changes

Investing in stocks means investing in the future, as a company's performance fully reflects its operational and future development conditions. Renowned value investor Warren Buffett primarily engages in long-term investments in companies with promising future development prospects.

Joos and Lang analyzed the relationship between the profit margins of listed companies in Western capitalist countries such as Germany and the UK and changes in stock prices [1]. Kane, Marcus, and Noh revealed the relationship between stock market volatility and corporate market returns [2]. Based on regression analysis, Beaver and W.H. proposed a correlation between two financial indicators, earnings per share (EPS) and net asset value per share (NAVPS), and stock prices [3]. Li Zhaobin found that positive performance announcements in various sectors of the A-share market have an overall positive impact on stock prices, while negative announcements have an overall negative impact, with the latter being more pronounced in each sector [4]. Wang Xi, using event study methodology, discovered that performance announcements can influence stock prices, with positive announcements causing a positive reaction and negative announcements causing a negative reaction in stock prices [5].

2.2. Study on Market Trends and Stock Price Changes

A market trend refers to events, industries, or themes that attract widespread attention and discussion in a specific time and area. When a trend receives attention, stocks related to the relevant industry may become popular, sparking investor interest and enthusiasm, leading to an increase in stock prices. To study the relationship between trends (short-term sector fund inflows) and stock price growth, we have demonstrated that the price increase in stocks from trending sectors is greater than the overall market's price increase.

2.3. Multi-Factor Stock Selection Model

The core of factor-based stock selection is finding effective factors. Effectiveness refers to factors that can significantly distinguish between stocks with high and low future returns, and portfolios selected based on such factors can generate significant excess returns. By quantifying financial indicators, stock market performance, industry status, and other information, and integrating these using mathematical tools, a factor model capable of effectively explaining and predicting excess returns is constructed.

Alpha factors can be viewed as statistical regularities exhibited in large samples, but not all statistical regularities can become alpha factors. Some quantitative investors may fall into the trap of over-mining data and overfitting models. They often pursue so-called "statistical regularities," even if a factor can well "explain" historical stock returns, this relationship is often just a logically unrelated statistical correlation, lacking the ability to predict the future. Behind each alpha factor, there should

be logical support, and this logic will change with market and time, hence this paper primarily explores a factor stock selection model based on performance growth.

3. Establishment and Testing of Investment Strategy

3.1. Assessment of Company Performance Growth

The assessment of whether a company's performance can grow involves both internal and external factors. Internally, considerations include the company's operational strategy, competitiveness, and profitability. Externally, factors such as the industry's vitality, national policies, and the technological level of industry development are taken into account.

3.2. Assessment of Market Trends

The most direct indicator of whether the market within a sector has become a trend is the volume and price changes in that sector. As the intrinsic mechanism of the stock market is the flow of funds, if funds flow into certain sectors, speculation in these sectors becomes lively, resulting in continuous upward trends. Conversely, if market funds continuously flow out of certain sectors, stock prices in these sectors decline, and the trends retreat. Typically, market trends can be judged from two perspectives: the volume and net inflow of funds within the sector and the volume-price relationship of the sector index, as well as the market structure of individual stocks within the sector.

3.3. Timing Trading

Under the influence of the dual factors of trending themes and performance growth, the overall strategy for timing trading is as follows:

Step 1: Utilize changes in sector trading volume, net inflow of funds, volume-price relationships, and the market structure within the sector to determine if the sector's trend is sustained.

Step 2: If the sector's trend continues, buy into companies with performance growth but whose trends have not yet taken the lead.

Step 3: If the sector's trend continues, identify individual stocks with leading performance growth that experience pullbacks with reduced volume, implementing a strategy of continuous day trading.

3.4. Testing of the Dual-Factor Investment Strategy—Case Study of the Optical Communication Sector

Step 1: Determine if the sector's trend is sustained.

① From the sector's trading volume, net inflow of funds, and volume-price relationship:



Figure 1: Candlestick chart for the Optical Communication Sector from May 15 to June 20



Figure 2: Candlestick chart for the Overall Market from May 15 to June 20

Comparing the candlestick charts of the Optical Communication Sector and the overall market index during the specified period, it is evident that the trading volume in the Optical Communication Sector significantly increased, daily trading was active, the sector index showed a substantial increase, and fund inflow was very apparent. In contrast, the overall market experienced little change in trading volume, and the index slightly decreased during this period, indicating that the Optical Communication Sector was the market's trading hotspot.

From the volume-price relationship, starting from April 7 and continuing until May 14, there was a contraction in volume to a local low, and from May 15 onwards, there was a sharp upward trend with simultaneous volume-price increases, indicating a good anticipation of the sector's positive trend.

② From the market structure:

Within the Optical Communication Sector, Linktel Technology, Zhongji Innolight, and Tianfu Communication are leading stocks.



Figure 3: Candlestick chart for Linktel Technology from May 15 to June 20



Figure 4: Candlestick chart for Zhongji Innolight from May 15 to June 20



Figure 5: Candlestick chart for Tianfu Communication from May 15 to June 20

The leading stocks opening the upward space for the Optical Communication Sector indicate a favorable market within the sector. The volume-price relationship for these leading stocks from May 15 to June 20 is characterized by price increase and stable volume, with moderate volume increases indicating that the leading stocks maintained their positions, likely continuing to lead the sector positively. Stocks such as Xinyisheng and Guanqiao Technology also followed the trend, indicating a very favorable market within the sector.

From these assessments, it is expected that the sector's trend will continue.

Step 2: If the sector's trend continues, buy into companies with performance growth but whose trends have not yet taken the lead.

① Taichenguang

Taichenguang, during the period from November 2022 to May 16, had a significantly lower increase compared to other concept stocks in the Optical Communication Sector. Therefore, it was expected to play a catch-up role in the trend. Buying this stock around June 6 aligned with our investment strategy. In just two weeks from June 8 to June 20, the stock price doubled, which was very satisfactory.



Figure 6: Candlestick chart for Taichenguang from May 15 to July 26

Step 3: If the sector's trend continues, identify individual stocks with leading performance growth that experience pullbacks with reduced volume, implementing a strategy of continuous day trading.

Zhongji Innolight is a leading stock in the Optical Communication Sector, serving as a market leader. For leading stocks in the Optical Communication Sector, such as Zhongji Innolight, one can engage in high-selling and low-buying strategies, continually reducing costs, and even implementing intraday day trading strategies.

On the evening of July 11, 2023, the company announced its performance forecast for the first half of 2023. It is expected to achieve a net profit of ¥5.5 billion to ¥6.7 billion, a year-on-year increase of 11.69% to 36.05%; after deducting non-recurring gains and losses, the net profit is expected to be ¥5.2 billion to ¥6.4 billion, with a year-on-year increase of 17.31% to 44.38%. The performance is good, consistent with the anticipated growth, making it a viable purchase.

We use the candlestick chart for Zhongji Innolight from May 15 to July 26 as an example:



Figure 7: Candlestick chart for Zhongji Innolight from May 15 to July 26

On May 23, the stock price fell, and the adjustment was accompanied by a significant reduction in volume, indicating a buying opportunity.



Figure 8: Analysis chart for Zhongji Innolight on May 23

On May 30, the stock volume rose significantly, indicating a sell opportunity, as the subsequent trend was likely to experience an adjustment.



Figure 9: Analysis chart for Zhongji Innolight on May 30

On June 7, the stock price fell, and the adjustment was accompanied by a significant reduction in volume, indicating another buying opportunity.



Figure 10: Analysis chart for Zhongji Innolight on June 7

On June 19, the stock volume rose significantly, indicating a sell opportunity, as the subsequent trend was likely to experience an adjustment.



Figure 11: Analysis chart for Zhongji Innolight on June 19

On June 28, the stock price fell, and the adjustment was accompanied by a reduction in volume, indicating another buying opportunity.



Figure 12: Analysis chart for Zhongji Innolight on June 28

On July 13, the stock volume rose significantly, indicating a sell opportunity, as the subsequent trend was likely to experience an adjustment.



Figure 13: Analysis chart for Zhongji Innolight on July 13

4. Conclusion

Based on the operational results, the investment strategy that combines market trends with performance growth has been generally successful, and utilizing this strategy can yield satisfactory

returns. On one hand, sectors in market trends generally experience favorable increases. However, it's important to note that stocks in trend might not necessarily possess absolute competitiveness; their inclusion in the trend could be influenced by speculative activities or other factors, leading to unsustainable stock growth. To validate the authenticity and sustainability of a trend, a more objective factor is required—performance. This is because performance growth reflects a company's operational situation, the vitality of its industry, and the company's competitiveness. When making investment decisions, considering the combined impact of both factors allows for a more accurate assessment of stock trends.

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