Barberis and Shleifer (2003) argue that style investing generates momentum and reversals in style and individual asset returns, as well as comovement between individual assets and their styles. Consistent with these predictions, in some specifications, past style returns help explain future stock returns after controlling for size, book-to-market and past stock returns. We also use comovement to identify style investing and assess its impact on momentum. High comovement momentum portfolios have significantly higher future returns than low comovement momentum portfolios. Overall, our results suggest that style investing plays a role in the predictability of asset returns.

1. Introduction

Barberis and Shleifer (2003) present a parsimonious model in which investors allocate capital based on the relative performance of investment styles. Their model generates a rich set of predictions, some of which have received empirical attention. First, style-level return-chasing behavior generates both style and asset-level momentum. Barberis and Shleifer (2003) argue that the evidence in Moskowitz and Grinblatt (1999), Lewellen (2002), and Haugen and Baker (1996) is consistent with the profitability of style-level momentum (see also Teo and Woo, 2004). Second, they show that style investing generates excess comovement of assets within styles. Consistent with this, Barberis, Shleifer, and Wurgler (2005) show that when a stock is added to the Standard & Poor’s 500 index, its comovement with the index increases (see also Greenwood, 2008; Boyer, 2011). Finally, they show that style-based investing can generate momentum in individual asset returns at intermediate horizons and reversals at longer horizons. In their words:
“If an asset performed well last period, there is a good chance that the outperformance was due to the asset’s being a member of a ‘hot’ style... If so, the style is likely to keep attracting inflows from switchers next period, making it likely that the asset itself also does well next period” (pp. 183–184). It is this hitherto unexplored connection between style investing and asset-level return predictability that we investigate in this paper.

A simple way to test whether style investing is responsible (at least in part) for asset-level return predictability is to see if past style returns have any predictive power in the cross section. We identify styles using the now ubiquitous size and value-growth grids, and then estimate Fama and MacBeth (1973) regressions of future stock returns on size, book-to-market ratios, past stock returns, and past style returns. We find that between 1965 and 2009, over one, three, six and 12-month future return horizons, style returns measured over the prior 12 months are significant predictors of future returns. We subject this basic result to a series of robustness checks. In some (but not all) specifications, style returns measured over the prior six months are also significant predictors. If we construct size breakpoints using NYSE stocks instead of all stocks, the slope coefficients on style returns are similar in magnitude and retain their statistical significance. If we limit our sample to all-but-tiny stocks (those above the 10th percentile in NYSE size), style returns remain statistically significant using 12-month prior style returns. However, if we use six-month prior returns, style returns are important only in explaining longer horizon future returns. We do not find predictability of past style returns among big stocks only (those above the median NYSE size), implying that style returns based on value-growth alone do not help explain cross-sectional variation in returns among large stocks. The slopes on style returns are stronger in the second half of our sample period (1988–2009). Prior to that, the coefficients of past style returns are mostly indistinguishable from zero. In that latter period, which coincides with increased use of size and value categorization in mutual funds and institutional portfolios, the slopes on style returns are large and reliably positive.

Although the Fama-MacBeth regressions are suggestive of the role of style investing, a prediction of Barberis and Shleifer (2003) allows us to specifically identify its impact; namely, that style investing generates not only return for the lowest comovement tercile (C1) is 0.71% per month. This increases to 0.96% for the second tercile (C2) and 1.15% for the highest comovement tercile (C3). The difference of momentum returns between C3 and C1 is large: 0.44% per month with a t-statistic of 2.98. Estimates of alphas based on the Fama and French (1993) model display a similar pattern. These return differences are generated from both the short and long side of the portfolio strategy. Winner portfolio returns increase and loser portfolio returns decrease as comovement increases.

Our comovement-based tests drop tiny stocks and are robust to using value-weighted returns, dependent sorts, and measuring comovement using various windows, lags, and style cut-offs. Perhaps the most serious concern with the comovement-based tests is that of spurious correlations with other variables known to influence momentum. Size and book-to-market ratios are obvious candidates (Hong, Lim, and Stein, 2000; Lakonishok, Shleifer, and Vishny, 1994; Asness, 1997; Fama and French, 1996). Another possibility...
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