



On the source of contrarian and momentum strategies in the Italian equity market

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Abstract

This paper investigates the source of momentum profits, while inferring the validity of the assumptions underlying rational and behavioural theories. Using a unique sample of securities listed in the Italian Stock Exchange from 1950 to 1995, we observe that buying better performing stocks in the previous 3–12 months and selling worse performing stocks over the same period yields significant profits in the short term (less than 1 year). Results also hold when conditioned upon different risk specifications. On the other hand, the continuation effect seems to significantly revert over a longer period. More importantly, in contrast with Conrad and Kaul [*Rev. Financ. Stud.* 11 (1998) 489], bootstrap and Monte Carlo simulations show that momentum profits are more likely to be generated by stock returns time series properties rather than by their cross-sectional differences. While the overall findings cannot reject the market efficiency hypothesis, we argue that behavioural theory may be a possible “story” to interpret the continuation effect.

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1. Introduction

Most practitioners firmly believe in the possibility to attain significant profits by identifying time series patterns in securities returns. A mount aggressive attack to this view has been raised from researchers always prompt to demonstrate how beating the market in a systematic way represent more often a “mirage” than a real prospect. At the same time, a puzzling phenomenon remains unsolved to date resisting different academic criticisms: the empirically ascertained profitability of *contrarian* and *momentum* strategies. Momentum portfolios, which entail long positions in past best performing stocks

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(winners) and short positions in past worst performing stocks (*losers*), have been proven to yield significant positive profits in the medium term (3–12 months). In contrast, a systematic reversal effect is found when a longer holding period (more than 3 years) is considered, and reversing the momentum strategy (i.e., buying past losers and selling past winners) results in production of profitable contrarian profits. These empirical findings, originally reported for the U.S. market in two seminal articles by De Bondt and Thaler (1985) and Jegadeesh and Titman (1993) and subsequently supported by a number of other works, turned out to be particularly provocative in their crucial undermining of the core concept of market efficiency. Therefore, in the following years, a critical understanding of these “anomalies” has become even more urgent, while two main directions have been taken by academics.

On one side, continuation and reversal effects have been conceived as a failure of rational models to explain investors' behaviour. New paradigms, able to depict a broader picture, have been proposed based on the assumption of psychological biases in the way individuals respond to new information.¹ According to the way investors are hypothesised to deviate from a rational behaviour, at least three broad approaches can be identified. First, Daniel, Hirshleifer, and Subrahmanyam (1998) argue that “overconfidence” and “biased self-attribution” cause individuals to overweight public relative to private information; following that an asymmetric response is expected according to whether public news confirm or disconfirm previous actions. Results would be attributed to “stock-selection skills” in the former case, generating the individual overreaction to news, and to “bad luck” in the latter case, generating the underreaction phenomena. In both cases, a delayed reaction is produced, generating the short-term continuation effect, which eventually reverses as soon as additional public information becomes available and stock prices approach their fair value. Second, while the “conservatism bias”² leads investors to underreact to firm-specific news, therefore generating the momentum effect, the “representative heuristic bias”³ leads investors to extrapolate prior performance to forecast future expected returns (Barberis, Shleifer, & Vishny, 1998). The latter bias in conjunction with the former is believed to generate the reversal effect. Finally, from a different perspective, in Hong and Stein's (1999) model investors are categorized as *informed* and *noninformed*. Informed investors trade using only future cash flow information, while noninformed investors trade on the basis of recent past price information and are ultimately responsible for the observed momentum effect. The information arrival eventually narrows the information gap between the two groups, resulting in the long-term mean-reversion effect. Empirical evidence in favour of this model is reported in Hong, Lim, and Stein (2000) where higher momentum profits are observed for firms smaller in size and with low analyst coverage. Similar results are exhibited in Grinblatt and Moskowitz (1999) for firms characterised by the scarce presence of institutional owners. All these are typically the

¹ See Hirshleifer (2001) for an extensive review and discussion of investors' behaviour and their influence on asset prices.

² In forming his belief, Edwards (1968) argues that individuals overweight new information in updating their previous knowledge.

³ This bias follows Kahneman and Tversky's (1982) idea that people continuously look for patterns in events even if they are in fact stochastic.

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