

Momentum and industry growth

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Abstract

In this paper, we find that individual stock momentum varies almost monotonically with industry growth. Firms in the highest industry growth quintile have significantly higher momentum compared to those in the lowest growth quintile. We find that the above-average growth group within each quintile has significantly higher momentum profits than the below-average group. Further, momentum profits of the highest industry growth quintile are always higher than those for the universe of firms, suggesting an economic benefit to stratifying firms based on industry growth and relative company growth intra-industry, while following a momentum investment strategy.

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1. Introduction

There has been a substantial body of recent literature documenting that the cross-section of stock returns is predictable based on past returns. [DeBondt and Thaler \(1985, 1987\)](#) find that long-term past losers outperform long-term past winners over the subsequent 3 to 5 years. [Jegadeesh and Titman \(1993\)](#) show that, over intermediate horizons of 3 to 12 months, a portfolio that purchases

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past winners and sells past losers has a positive abnormal return. This evidence suggesting that simple trading strategies based on past returns can be used to achieve abnormal returns has received a great deal of attention. Such “momentum” strategies have been found to yield abnormal returns not only in U.S. markets, but also internationally. Rouwenhorst (1998), using a sample of stocks from twelve European countries, finds that a portfolio that is long in medium-term winners and short in medium-term losers earns approximately 1%/month. In addition to academia, practitioners such as stock analysts and portfolio managers have come to subscribe to the view that momentum strategies are one way to “beat the market”, to such an extent that today, momentum investing constitutes a distinct style of investment in both the United States and elsewhere.

While the existence of momentum per se has been well documented, there is little agreement on the sources of profits of such strategies. Several explanations have been proposed for this apparently anomalous behavior in stock returns. The proposed explanations typically fall into one of the following three categories.

1. Those who argue that these results provide strong evidence against market efficiency: The original conjecture of Jegadeesh and Titman (1993) was that the market systematically underreacts to firm-specific information regarding its short-term prospects. Alternatively, it is possible that transactions by investors who buy past winners and sell past losers temporarily move prices away from their long-run values, thereby causing prices to overreact. This is consistent with arguments put forth by DeLong, Shleifer, Summers, and Waldmann (1990), that such overreaction is caused by rational speculators who indulge in positive feedback trading. More recently, a growing number of “behavioral” models have been proposed. These models suggest that momentum profits arise due to inherent biases in the way investors interpret information. Papers representative of this genre are Barberis, Shleifer, and Vishny (1998), Daniel, Hirshleifer, and Subrahmanyam (1998), and Hong and Stein (1999). While all three are behavioral models, momentum in the first model is an outcome of overreaction, while the last two models posit that momentum occurs due to underreaction – prices adjusting too slowly to news.
2. Those who argue that the returns to these strategies are compensation for risk: Conrad and Kaul (1998) argue that the profitability of momentum strategies can be entirely explained by the *cross-sectional* variation in mean returns of individual securities, rather than appealing to *time-series* predictability. More recently, Ahn, Conrad, and Dittmar (1999) utilize the stochastic discount factor methodology to study momentum trading strategies and conclude that momentum profits are not abnormal when judged against a non-parametric benchmark. These studies suggest that momentum profits are simply a manifestation of compensation for systematic risk factors that have yet to be included in extant asset pricing models. However, the preponderance of empirical evidence weighs heavily against a risk-based explanation.¹
3. Those who argue that these results are a product of data mining: Proponents of this argument maintain that momentum and other anomalies are simply the outcome of an elaborate data mining process. After all, return reversals and continuation are only two of the many patterns that

¹ Fama and French (1996) note that momentum effects cannot be explained by their three-factor model. Jegadeesh and Titman (1999) take issue with Conrad and Kaul’s methodology and argue against momentum being a manifestation of the cross-sectional variation in mean returns.

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