

Continuous overreaction, insiders trading activities and momentum strategies

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Abstract

The paper investigates the influence and explanatory power of aggregate insiders trading activities on momentum trading strategies. We find that insiders trading activities can predict cross-sectional returns and can strengthen the naïve momentum effects. The risk factors such as size and BM cannot explain the strong momentum effects in our refined momentum strategies. We interpret our findings as that the continuous overreaction causes the mediate term momentum effects and over pricing. In the long term, these overly priced stocks will be corrected with passing time. The correction of over pricing causes long-term reversals. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

A number of papers have provided evidence that the trading strategies based on past securities returns can beat the market. Jegadeesh and Titman (1993) show that the strategies by buying stocks with high returns over the previous 3–12 months and selling stocks with poor returns over the same time period can generate significant abnormal returns over a medium holding period of 3–12 months. A lot of explanations have been provided. Jegadeesh and Titman (1993) suggest that a

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more sophisticated model based on investor behaviour is needed to explain the anomaly, while some others as Conrad and Kaul (1998) attribute the source of the profits as the cross-sectional difference of mean stock returns. Grinblatt and Moskowitz (1999) proposed that the industry momentum is the key element in explaining the return persistence anomalies. However, we find that the industry factor does not sound that good in explaining our insiders trading activities refined momentum strategies. Grundy and Martin (2001) also document that industry momentum alone does not explain the profitability of momentum strategies.

Nowadays, more and more people don't believe that the investors act rationally as assumed in the classical asset pricing theory. Some researchers turn to look for the irrational explaining of the momentum effects. Most of these behavioural studies are based on the experimental cognitive psychology findings. Daniel, Hirshleifer and Subramanyam (Daniel et al., 1998) propose a continuous overreaction model based on two psychological findings: people are overconfident on the private signals and attribution bias. They attribute the momentum effects to the overreaction to the private signals and underreaction to the public signals and the eventual correction by public signals is the cause of long-term reversals. On the other hand, Barberis, Shleifer and Vishny (Barberis et al., 1998) propose that the short-term momentum effects and long-term contrarian effects are caused by the investors' falsely perceiving that there are two earning regimes. Hong and Stein (1999) propose another irrational model that does not rely on psychology findings. In their model, there are 'two boundedly rational agents': newswatchers and momentum traders. The underreaction of newswatchers causes short-term momentum effects. The early momentum traders will take the chance and profit by trend-chasing and push up/down the winner/loser's price further and attract more momentum traders enter in. These later entered momentum traders will push up/down the winner/loser's price too high and cause overreaction.

The motivation of the study is that if the momentum effects are the results of investors irrational reaction, how will they react on the insiders trading activities? The paper investigates the influence of insiders trading and explanatory power of these trading activities on the momentum effects. As described in some literatures, the insiders, such as executives and managers, should know much more about their own company than any outsiders. Many previous literatures have provided evidence that insiders trading activities can predict the cross-sectional returns. Seyhun (1992) shows that the aggregate insiders trading activity predicts cross-sectional future stock returns during the period 1975–1989. He attributes his findings as 'both the changes in business conditions as well as movements away from fundamentals contribute to the information content of aggregate insider trading'. Lakonishok and Lee (1998) also provide evidence that the aggregate insiders trading can predict the market movements over the period from 1975 to 1995. Consistency, we also find that the aggregate insiders trading activities contain valuable information in predicting cross-sectional stock returns during the period from 1985 to 1997. Hence, the insiders trading should be a good indication of how prospective the company is. In the study, we introduce the insiders trading activities in the naïve momentum strategy portfolio selection process to refine the naïve momentum

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