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Momentum effect in Australian equities: Revisit, armed with short-selling ban and risk factors



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ABSTRACT

It is well documented that past winning stocks continue to outperform past losing stocks in numerous equity markets. However, existing Australian evidence on the momentum effect is contradictory and limited, partly due to differences in empirical designs, sample periods and stock populations. We assess the momentum profitability over the most eligible stocks which are constituents of the S&P/ASX200 index. These stocks represent the principal equity investment universe for institutional investors and managed funds due to their sufficient size and liquidity which make the momentum trading strategies practical and implementable. By incorporating the short-selling ban during the global financial crisis, we find evidence of return persistence. The momentum effect is most pronounced amongst winning stocks for longer holding periods. Upon further exploration we find that neither an industry-driven momentum effect nor common risk factors can fully account for the momentum effect.

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1. Introduction

A simple investment strategy of buying stocks, which have outperformed their peers in the immediate past (“winners”) and shorting stocks which have underperformed their counterparts (“losers”), has been shown to generate appreciable returns, both economically and statistically. That a stock’s past performance is an ex-ante indicator of its future returns is of interest to both academics and practitioners. For the academic, it presents a fundamental challenge to one of the cornerstones of modern financial theory, market efficiency, and the application of traditional asset pricing models; for the practitioner, it is a supposed near risk-free arbitrage opportunity.

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Jegadeesh and Titman (1993) (hereafter JT) first publicised return continuance or momentum amongst stock returns in their 1965–1989 sample. They find that a zero-cost momentum portfolio (WML, winners minus losers) that buys (sells) the top (bottom) decile of stocks ranked by returns for the past six months and holds the positions for six months (6, 6)¹ generates average profits of 0.89% per month. Jegadeesh and Titman (2001) extend their sample to the 1990s from their previous study and find strikingly similar results to their earlier study. Other papers confirming the profitability of the momentum trading strategy in the US market include Hong et al. (2000) and Lewellen (2002). Grundy and Martin (2001) document a risk-adjusted abnormal monthly return of 1.34% tracing back to the 1920s. Rouwenhorst (1998) and Griffin et al. (2003) document significant abnormal returns resulting from the momentum trading strategy in many European countries. Furthermore, evidence of stock momentum profits has also been found in the UK (Lui et al., 1999; Hon and Tonks, 2003), Spain (Forner and Marhuenda, 2003), and a number of emerging markets (Rouwenhorst, 1999).

In search of the sources of the momentum effect, Moskowitz and Grinblatt (1999) (hereafter MG) claim that momentum in individual stock returns reported by JT is driven by momentum in industrial or sector returns. In other words, MG industry momentum effect is almost solely responsible for the JT individual stock momentum. In addition, George and Hwang (2004) demonstrate that the 52-week high momentum strategy of buying (selling) stocks whose current prices are nearest (farthest) from their 52-week high is even more profitable than JT's past return-based momentum strategy and MG's industry-based momentum strategy.

Although the momentum effect is pervasive and profound across numerous international equity markets, there is limited and inconsistent evidence in regard to the existence of the JT individual stock momentum profits in the Australian Securities Exchange (ASX). Whilst examining the autocorrelation of individual stock returns based on one-month prior return ranking and one-month holding period (1, 1), Gaunt and Gray (2003) find that the winners outperform the losers by 6% over the sample period 1974–1998. They suggest that the momentum seems to be driven by smaller stocks since they fail to find evidence of momentum profits amongst the large capitalisation stocks in the subsample. In contrast, Hurn and Pavlov (2003) report evidence in support of the profitability of the JT individual stock momentum. They report that the momentum portfolio produces a return of 5–7% (2–3%) for the one-year (six-month) holding period. Further, in contrast to Gaunt and Gray's findings, they report stronger momentum in the larger stocks, after splitting the sample into the largest 50 stocks and the rest into two groups.

Using daily returns of the constituents of the All-Ordinaries index, Demir et al. (2004) examine the JT individual stock momentum strategy and find that their WML yields significant returns ranging from 5.34% (180, 30) to 1.38% (30, 180) per month, which are higher than the more common results found in the US and European markets. Interestingly, they report that the small stocks appear to exhibit greater momentum. This finding contradicts the findings of Hurn and Pavlov (2003).

Such inconclusive results in empirical momentum studies on Australian stocks were further consolidated by Durand et al. (2006). They failed to find evidence in support of the momentum effect, rather, evidence of return reversals was reported, in which the winner portfolio underperforms its loser counterpart. Brailsford and O'Brien (2008) reassess the JT individual stock momentum profitability by examining a broad cross-section of all ASX-listed stocks for the period 1979–2005. They report that the JT momentum strategies do not produce statistically significant profits, and any excess returns from the JT momentum strategies are driven by the continuing underperformance of the loser stocks. Their findings cast doubt on the practical implementation of any momentum trading strategies. In contrast, Bettman et al. (2009) find that the profitability of the JT momentum strategy is statistically significant and robust to short selling and liquidity restrictions.

Based on the above, although the extant literature reports significant excess profits across numerous equity markets, existing Australian evidence is clearly contradictory and limited. Brailsford and O'Brien (2008) ameliorate the disparity in the literature by investigating the relationships between stock momentum profits in the Australian market. They suggest that the seemingly inconsistent profitability results achieved with the JT momentum strategy are partly due to differences in empirical designs, sample periods and stock populations.

¹ In a (J, K) momentum trading strategy, each month investors form a portfolio based on stock's past J-month returns and hold the position for K months.

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