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Contrarian investment strategies work better for dually-traded stocks: Evidence from Hong Kong

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ABSTRACT

We investigate the profitability of contrarian investment strategies for equities listed on the Hong Kong Stock Exchange (HKEX), which are separated into cross-listed firms and firms listed only in Hong Kong. We also investigate the relationship between stock returns and past trading volume for these equities. We report significantly higher contrarian profits for the period investigated and find that this is a persistent feature of stock returns for cross-listed companies. We also document that contrarian portfolios earn returns as high as 8.01% per month for the dually-traded companies and just 1.83% for only HKEX-listed firms. We find that volume has only a limited ability to explain contrarian profits. All extreme profits disappeared after adjusting for the Fama and French three-factor model.

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1. Introduction

Lo and MacKinlay (1990) defined a contrarian portfolio investment strategy as one that exploits negative serial dependence in asset returns. They identified a strategy that generated profits that were unrelated to market forces by purchasing historically poorly performing securities and selling historically well-performing securities in the United States. De Bondt and Thaler (1985) were among the first to suggest the idea of contrarian profits; they challenged the notions of market efficiency and rational market behaviour by arguing that contrarian profits were the result of the psychological aspect of individual naïve investors who tend to pay more attention to recent information and less attention to prior data, resulting in

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stock prices overreacting¹ and deviating from their intrinsic values. They argued that prior losers generally out-performed the market, while prior winners under-performed. Hence, investors could buy the losers and short sell the winners to earn an abnormal profit.

Research on identifying profitable contrarian strategies has expanded rapidly in recent years, and many studies have documented the profitability of contrarian strategies in various countries. For instance, Brouwer et al. (1997) found contrarian profits in a portfolio of four European countries (France, Germany, Netherlands and the United Kingdom). Mun et al. (1999) showed that short-term contrarian portfolios in France and Germany work better than long-term portfolios. Forner and Marhuenda (2003) provided evidence of lucrative long-term contrarian strategies in the Spanish stock markets. Recently, Novak and Hamberg (2005) observed contrarian profits on non-financial Swedish stocks. Antoniou et al. (2005) found that negative serial correlation is present in the Athens Stock Exchange (Greece), and this again leads to short-term contrarian profits.

Turning to the Asia Pacific region, Kang et al. (2002) found statistically significant short-term contrarian profits in China. Chin et al. (2002) found that contrarian strategies produced superior returns in New Zealand. Yoshio et al. (2002), later substantiated by Chou et al. (2007), found that a one-month contrarian strategy concentrating on low trading volume stocks would be effective in Japan. Hameed and Ting (2000), on the other hand, documented a significant relation between contrarian return profitability and trading volume in the Malaysian stock market. While contrarian profits were evident in Malaysia, they admitted that the strategy might not produce economically significant profits if transaction costs were considered. In a similar vein, Lo and Coggins (2006) and subsequently Monagle et al. (2006) reported contrarian profits in Australia.

Otchere and Chan (2003) studied the De Bondt and Thaler (1985) version of the contrarian strategy and found that arbitrageurs could not earn excess profits from overreaction in Hong Kong. They observed a small but significant degree of overreaction in Hong Kong prior to the Asian financial crisis. Otchere and Chan (2003) also documented that price reversals were more pronounced for winners than for losers. They noted a delay in price reversal and argued that cultural factors may account for the small size of the price reversal as well as the delay or lack of reversal. Leung and Li (1998) observed that prior losers out-performed prior winners in Hong Kong during the subsequent test in the reversal period. Fung (1999), also using the De Bondt and Thaler (1985) approach, showed that loser portfolios of the 33 stocks in the Hang Seng Index, on average, outperform the winner portfolios by 9.9% one year after their formation periods. However, Fung's study was limited to 33 stocks and failed to consider that a substantial number of companies in Hong Kong are cross-listed in other overseas stock exchanges. Given the large number of companies with foreign listings in Hong Kong, it is important to study how foreign listing affects contrarian profits in this particular market. While this provides a rationale for setting our study in the Hong Kong market, it is worth noting that no study has investigated the impact of dually-traded stocks on contrarian investment profits.

The literature on the profitability of dual listing companies shows that these companies generally provide negative returns [see Chowdhry and Nanda (1991), Khan et al. (1993), and Hauser and Levy (1998)]. According to Chowdhry and Nanda (1991), when a security is traded in more than one market, it provides more opportunities for informed investors to exploit the private information. In the process of information exploitation, market makers offer pricing information at reduced costs and in a timely manner. As a result, the expected returns of the informed investors are diminished. In a similar vein, Hauser and Levy (1998) studied a small number of dual-listed companies and showed that their stock prices tend to overreact to new information and noise. They observed return volatility differentials across markets and argued that the different trading mechanism may account for this difference. One key point that stands out in the dual listing literature is that this category of firms breeds losers, which, in turn, are good sources for contrarian profits. Whether the losses of dual-listed companies translate into contrarian profits is currently unknown, and the primary objective of our work is to explore this question.

The Hong Kong Stock Exchange (HKEX) provides an ideal testing ground for the above theory as Hong Kong is renowned for its openness²; is a good example of an integrated market,³ with a particularly large number of firms listed overseas; and evidence exists of information transmissions with other nations.

¹ Other researchers who have contributed to this debate are Lehmann (1990) and Jegadeesh and Titman (1993).

² See Wei et al. (1995).

³ Numerous studies have documented the integration of the Hong Kong market; namely, Johnson and Soenen (2002), Cheung et al. (2003), Bhoocha and Stansell (1990) and Corhay et al. (1995). Tsang and Ma (2000) found that, essentially, Hong Kong was closely integrated with the rest of the world.

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