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Information Percolation, Momentum and Reversal

Daniel Andrei*

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Abstract: We propose a joint theory of time-series momentum and reversal based on a rational-expectations model. We show that a necessary condition for momentum to arise in this framework is that information flows at an increasing rate. We focus on word-of-mouth communication as a mechanism that enforces this condition and generates short-term momentum and long-term reversal. Investors with heterogeneous trading strategies—contrarian and momentum traders—coexist in the marketplace. Although a significant proportion of investors are momentum traders, momentum is not completely eliminated. Word-of-mouth communication spreads rumors and generates price run-ups and reversals. Our theoretical predictions are in line with empirical findings.

JEL classification: G11, G12, G14.

Keywords: Asset pricing; Momentum; Information percolation; Equilibrium.

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