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Momentum and contrarian strategies in international stock markets: Further evidence

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Abstract

Previous studies have shown that market participants underestimate earnings growth for past winner stocks, and that growth stocks are more sensitive to earnings surprises. These findings suggest implementing momentum strategies with growth stocks. This study investigates linkages between value versus growth investment styles and momentum strategies in international markets. In addition, we extend Jegadeesh and Titman (2001)-type tests, which attempt to distinguish between competing explanations of the momentum phenomenon, to international market indices. Our full sample results show that momentum profits are concentrated in the growth indices, and that there is evidence of short-term overreaction in these and other indices that is subsequently corrected. Our subsample results are mixed; there is some evidence that the profitability of momentum (but not contrarian) strategies persists in the post-December 1987 period. However, unlike the earlier period, there is no evidence that markets overreact and that these overreactions are subsequently corrected.

JEL classification: G11; G15

Keywords: Momentum; Value/glamour; International

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1. Introduction

In recent years, practitioners and academic scholars have found that some relatively simple trading strategies based on past cross-sectional stock returns yield significant abnormal profits. Researchers divide these strategies into two major categories: the contrarian strategy that relies on price reversals and the momentum strategy based on price continuations. For the U.S. Stock Market, DeBondt and Thaler (1985) investigate return patterns over extended periods of time and find that contrarian strategies perform exceptionally well over 3–5-year horizons. In contrast, Jegadeesh and Titman (1993) document that strategies that buy winner stocks and sell loser stocks (i.e. momentum strategies) generate significant positive returns (about 1% per month) over 3–12-month holding periods. In a comprehensive investigation, Conrad and Kaul (1998) find both momentum and contrarian profits in the U.S. market, depending on the time horizon investigated. Specifically, the contrarian strategy is profitable for short-term (weekly, monthly) and long-term (2–5 years, or longer) intervals, while the momentum strategy is profitable for medium-term (3–12-month) holding periods.[3]

Many studies have found that momentum strategies work in international stock markets, although findings have not been uniform.[4] Rouwenhorst (1998) examines twelve European markets' stock returns between 1980 and 1995. He finds that an internationally diversified portfolio of past medium-term winners outperforms a portfolio of medium-term losers by more than 1% per month after taking risk factors into consideration. He also presents evidence that European and U.S. momentum strategies have a common component suggesting that a common factor may drive the profitability of momentum strategies in both the U.S. and international markets. Echoing these findings, Schiereck et al. (1999) report substantial intermediate horizon profits to momentum strategies in the German market, and find that the German and U.S. markets behave very similarly. Van Dijk and Huibers (2002) link momentum profits in European markets to analyst behavior. Specifically, they find that analysts systematically underestimate earnings for strong price-momentum stocks, underestimate autocorrelation in earnings growth between consecutive years, and are in general too slow to adjust their earnings forecasts.[5] They suggest that further research should focus on the relative importance of the underreaction explanation for momentum. Hon and Tonks (2003) examine momentum strategies in the U.K. stock market. Interestingly, they report strong evidence for momentum profits out to 24-month horizons, but only for 1977–1996. They find no evidence of momentum profits in the earlier 1955–1976 period in the U.K.

In general, evidence for momentum profits is weaker in Asian markets. Chui et al. (2000) report evidence for momentum profits in these markets, but with the notable exceptions of those in Japan and Korea. Hameed and Kusnadi (2002) find virtually no evidence of momentum profits in the stock markets of six Pacific Basin countries, and although Kang

[3] Our study examines intermediate horizon (1–12 months) and long horizon (2–5 years) strategies. We do not focus on the very short horizon contrarian strategies (under 1 month) examined by Lo and MacKinlay (1990), Jegadeesh and Titman (1995), and others in the U.S. market. Numerous studies have examined these short-term reversal strategies in international markets; a recent article by Lee et al. (2003) contains a good review.

[4] The 3–5-year contrarian strategies of De Bondt and Thaler (1985) have received virtually no examination in countries outside the U.S. at the individual firm level. To our knowledge, only Schiereck et al. (1999) have examined such strategies, in the German market. They do not report significant contrarian profits.

[5] Chan et al. (1996, 1999) have reported very similar findings for U.S. markets.