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journal homepage: [www.elsevier.com/locate/frl](http://www.elsevier.com/locate/frl)Intermediate-term momentum and credit rating<sup>☆</sup>

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## ABSTRACT

This study examines the relationship between intermediate-term momentum and credit risk. Credit risk is approximated with Standard & Poor's (S&P's) credit ratings. With a sample of S&P credit rated firms, I show that intermediate-term momentum is profitable independent of firms' credit rating. Further, I show that the difference found in U.S. between intermediate-term and short-term momentum is mainly driven by high-grade firms.

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## 1. Introduction

Momentum literature begins with the discovery by Jegadeesh and Titman (1993) that investors can earn economically and statistically significant abnormal profits by buying past outperformers and selling past underperformers.<sup>1</sup> Further, in a recent paper Novy-Marx (2012) suggests that buying/selling intermediate-term (*months t-12 to t-7*) outperformers/underperformers also create abnormal profits.

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<sup>1</sup> Studies have found robust momentum: in time series (Moskowitz et al., 2012), in industries (Moskowitz and Grinblatt, 1999), in most asset classes (Asness et al., 2013), on international equity markets (Rouwenhorst, 1998; Griffin et al., 2003) and under economically distressed periods (Arsahanapalli et al., 2006). Even though, the robustness of momentum is empirically proven the explanation for the phenomenon is still debatable. In this debate there are both rational (e.g. Johnson, 2002; Sagi and Seasholes, 2007) and behavioral (e.g. Daniel et al., 1998; Hong and Stein, 1999) explanations to the momentum profits.

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Moreover, according to his finding the profits from the intermediate-term strategy are even larger than the profits from buying/selling short-term (*months t-6 to t-2*) outperformers/underperformers. Because of the controversial finding by [Novy-Marx \(2012\)](#) several papers have examined the robustness of the difference discovered between intermediate-term and short-term momentum. First, [Yao \(2012\)](#) shows that intermediate-term momentum performs better in January than short-term momentum further she suggests that is the reason for the finding by [Novy-Marx \(2012\)](#). Second, in an international study [Goyal and Wahal \(2013\)](#) find no robust evidence from any country suggesting that intermediate-term momentum is superior to short-term momentum, with one exception the U.S. Third, [Gong et al. \(2015\)](#) argue that the short-term reversal is longer than accounted for in the study by [Novy-Marx \(2012\)](#) when this longer short-term reversal is accounted for the difference between intermediate-term momentum and short-term momentum disappears.

Since the original momentum finding by [Jegadeesh and Titman \(1993\)](#), the robustness and driving forces of momentum have been of interest among researchers. A stream of literature has shown that momentum returns are higher for firms with specific characteristics. Characteristics which increase momentum profits are: low market capitalization ([Hong et al., 2000](#)), low analyst coverage ([Hong et al., 2000](#)), high analyst forecast dispersion ([Zhang, 2006](#)), high market-to-book ratio ([Daniel and Titman, 1999](#)) and high credit risk ([Avramov et al., 2007](#)). My interest for the impact from credit risk originates from [Avramov et al. \(2007\)](#), who show that the credit risk effect absorbs the size, analyst coverage and dispersion effect in capturing momentum returns. In addition, credit risk and size are positively correlated further [Avramov et al. \(2009\)](#) suggest a potential link between credit rating and analyst forecast dispersion. Possibly, credit risk is the common factor in all these momentum return increasing characteristics. Furthermore, in the asset pricing anomaly literature, [Avramov et al. \(2013\)](#) point out that many anomalies exist only among high credit risk firms. Further, they suggest that anomalies only existing among high credit risk firms can be hard for investors to profit from due to limits to arbitrage. A limitation to arbitrage can be that high credit risk firms are costly to trade for investors since these firms are illiquid and more likely to be short-sale constrained.

As mentioned, [Avramov et al. \(2007\)](#) show a strong link between credit ratings and short-term momentum. According to them only the high credit risk firms have significant short-term momentum profits. Because of the strong relationship between anomalies and credit ratings, especially the link between short-term momentum and credit ratings, it is important to investigate if a similar relationship exists between intermediate-term momentum and credit ratings. Moreover, understanding the relationship can improve the understanding of the puzzling evidence that intermediate-term outperforms short-term momentum.

In this paper I investigate the relationship between intermediate-term momentum and credit ratings. For this analysis, I have sampled 4447 Standard & Poor (S&P) credit rated stocks over the time period December 1984 to December 2011. As in [Avramov et al. \(2007\)](#), [Avramov et al. \(2009\)](#), [Avramov et al. \(2013\)](#), I use S&P's credit ratings as an approximation of credit risk. This paper gives two contributions to the existing momentum literature. First, intermediate-term momentum is significant for a wide range of firms independent of the firms' credit rating. This result supports [Novy-Marx \(2012\)](#) view that intermediate-term momentum is more robust than short-term momentum.

Second, I show that the difference between intermediate-term and short-term momentum only exist among high and medium credit rated firms. [Goyal and Wahal \(2013\)](#) and [Gong et al. \(2015\)](#) argue that the return difference between short-term and intermediate-term momentum found by [Novy-Marx \(2012\)](#) occurs because of a longer short-term reversal than what [Novy-Marx \(2012\)](#) accounted for further when accounting for the longer reversal the return difference disappears. Regarding this issue, I find that high-grade firms have a strong short-term reversal, but the difference between intermediate-term and short-term momentum is still significant for high-grade firms after controlling for the short-term reversal. My findings suggest that intermediate-term momentum is profitable for a wider range of firms than short-term momentum. Further, I show that the difference that [Novy-Marx \(2012\)](#) found between the two momentum strategies is driven by firms with a high credit rating.

This is *prima facie* evidence that the optimal momentum strategy for each firm depends on the firm's credit rating. In a recent study, [Antoniuo et al. \(2013\)](#) connect the momentum phenomenon with cognitive dissonance and sentiment. Possibly, investors underreact to news more persistently when they receive negative news regarding low credit risk firms due to cognitive dissonance. The

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