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A two-stage study of momentum investing in Asia: A case of cognitive dissonance?

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ABSTRACT

This two-stage study investigates a puzzle involving professional investors in Asia, and suggests that it could be a case of cognitive dissonance. Historical data generally shows that momentum strategies yield poor results in Asian markets, but many investors still adopt them. The first stage of the study tests these strategies at the country level for 50 stock markets around the world, including 9 markets in Asia. It finds that they would have been profitable with global portfolios, but not with portfolios focused on Asia. The second stage involves interviews with 25 institutional investors in Hong Kong, and finds that nearly all of them use momentum strategies even when they are investing in Asia. They do this because they find these strategies work; because higher volatility in recent years has increased momentum effects; and because they are subject to pressures that force them to follow the trend. This study adds to our knowledge of how professional investors make their decisions, and complements the findings of other studies that show momentum strategies have been successful in many markets around the world, but are not always profitable in Asia.

1. Introduction

Mainstream finance theory is generally based on equilibrium models that assume markets are efficient in processing information and that, as a result, prices quickly adjust to reflect fundamental values. However, historical data shows that prices often diverge from fundamental values and a large number of studies have been carried out to determine why this should be. For example, one stream of research shows that strategies based on momentum would have been profitable for investors over the past 20 years. Notable studies in this group include [Jegadeesh and Titman \(1993, 2001, 2011\)](#) who found that relative strength momentum strategies earned positive returns in the main U.S. stock markets, and studies by [Rouwenhorst \(1998\)](#), [Grundy and Martin \(2001\)](#), and [Moscowitz et al. \(2012\)](#) who found that they would have been profitable in other national markets.

These earlier studies generally use quantitative methods and historical price data. Very few ask the investors themselves what they actually do. However, in a recent study, one of the authors of this paper interviewed institutional investors in Hong Kong and found that most of them use momentum when they form their investment strategies ([Pirie and Chan, 2015, 2016](#)). They do this because it produces results; because they believe that momentum effects have increased in recent years; and because others expect them to follow the trend.

Most previous studies on momentum focus on individual stocks. This study takes a different approach, and considers the effects of momentum strategies at the country index level for 50 markets around the world. It also reports the results of a qualitative study that involved face-to-face interviews with professional investors in Asia, a region in which quantitative studies have obtained different

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results from the rest of the world.

The next section reviews some relevant literature. Subsequent sections describe the methods used, discuss the findings, and summarise the conclusions.

2. Literature review

This section reviews some relevant literature, starting with the Efficient Market Hypothesis (EMH) that plays an important role in mainstream finance. Following this, we review some empirical studies that show momentum strategies would have been profitable in earlier years and in doing so contradict the EMH. Finally, we review some of the literature on cognitive dissonance which we suggest as a possible reason for this anomaly.

2.1. Efficient market hypothesis

An important assumption in economics is the idea that people make their decisions on the basis of rational expectations. Related to this in the field of finance is the EMH, which was initially proposed by Fama (1965). This suggests that financial markets process information efficiently and incorporate it quickly and completely into current prices. Consequently, markets follow a random walk and so investors should not be able to earn consistent abnormal returns in the long run by using available information.

Fama (1970) suggests three versions of the EMH:

- A weak version in which all historical data is incorporated into prices, including past prices and trading volumes.
- A semi-strong version in which all publicly-available information is incorporated into prices, not only historical data.
- A strong version in which all relevant information is incorporated into prices, not just historical and publicly-available data.

Fama acknowledged the strong version was an extreme case, and said he did not expect it to be literally true.

Momentum strategies are usually based on historical data. Consequently, if they result in abnormal returns, they contradict the weak version of the EMH. The next section reviews some empirical studies that test such momentum strategies.

2.2. Empirical momentum studies

The seminal study is Jegadeesh and Titman (1993). In this study, the authors adopt an investment strategy that ranks the individual stocks listed on the main U.S markets on the basis of their returns in past periods ranging from 3 to 12 months. They label the top ten percent ‘past winners’, the bottom ten percent ‘past losers’, and form equally-weighted portfolios by buying the past winners and selling the past losers. Their study shows that this relative momentum strategy generates significant returns in nearly all holding periods ranging from 3 to 12 months, although some of the returns dissipate in subsequent years. In a later study, Jegadeesh and Titman (2001), the same authors extend their original work with another 9 years of data and they find their momentum strategy continues to be profitable.

Many other researchers followed their lead and tested their relative momentum strategy at other times and in other markets. As an example, Rouwenhorst (1998) found similar results in twelve European stock markets using historical data from 1980 to 1995. He also showed that returns in these markets correlate with returns in the U.S. markets, and he suggested this may be due to a common factor. In another study designed to examine the risks and possible sources of momentum profits in the U.S. stock markets, Grundy and Martin (2001) found that relative momentum strategies generated abnormal returns consistently over the whole period from 1926 to 1995.

Another body of research examines the profitability of a time series or absolute momentum strategy which is related to the cross-sectional or relative strength momentum strategy of Jegadeesh & Titman, but different from it. Jegadeesh & Titman’s strategy compares past returns on different assets or asset classes, and uses the results to allocate funds between them. Time series or absolute momentum strategies examine the past returns of the same asset or asset class, and uses the results to time buy and sell decisions. An example of this approach is Moskowitz et al. (2012) who find significant absolute momentum profits in each of a wide range of financial markets from 1965 to 2009. They investigate a strategy in equity index, commodity, currency, and bond futures markets that goes long when momentum is positive and short when it is negative, and they find that it generates consistent profits in all these asset class markets over this whole period.

Other recent studies show that momentum has continued to be profitable in other settings. Examples include Bird et al. (2017) who found that both absolute and relative momentum strategies have been profitable in 24 well-developed markets; Ji (2016) who showed that momentum has been profitable in Australia over a period of 100 years; and Tajaddini et al. (2015) who found that both price and earnings momentum strategies have been profitable in the New Zealand market.

These and many others studies provide strong evidence that investment strategies based on momentum would have been profitable in previous years, which suggests of course that markets have not been weak-form efficient. However, they also identify cyclical patterns because the returns tend to dissipate over the longer term. This presents a dilemma for professional investors. On one hand, most of these investors believe that prices adjust to reflect fundamental values. On the other hand, they know that empirical evidence shows that momentum works. As a result, they are faced with information that is inconsistent with their basic beliefs, and this leads to a feeling of cognitive dissonance.

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