

Momentum, reversal, and the trading behaviors of institutions[☆]

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Abstract

We identify two types of momenta in stock returns—one due to returns relative to other stocks and one due to firm-specific abnormal returns, where abnormal is determined by a stock's idiosyncratic return variation. Despite similar performances over the first year, these momentum portfolios perform dramatically differently beyond year one. Relative-return momentum reverses strongly; abnormal-return momentum continues for years. This complexity in return momentum challenges the current theories of momentum. We propose that both momenta are consequences of agency issues in the money management industry and provide empirical support for this economic rationale of momentum in returns. Incentives induce institutions to chase relative returns and to underreact to firm-specific abnormal returns.

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1. Introduction

Momentum in stock returns presents one of the strongest challenges to the efficiency and rationality of financial markets. Why does buying stocks with the highest returns over the prior six to twelve months and shorting stocks with the lowest returns generate robust profits?¹ Thus far, risk-based explanations have had little empirical success. As a consequence, most theories of momentum rely on behavioral and cognitive biases of investors.²

We present findings that challenge the most prominent theories of momentum while providing support for a new agency-based rational explanation suggesting that institutions play a role in generating momentum in returns. First, we document that there are two types of momenta—one due to returns *relative* to other stocks and one due to firm-specific *abnormal* returns, where abnormal is determined by a stock's own idiosyncratic return variation. Our motivation for isolating these types of momenta is based on two findings in the literature. One, the profits to the standard relative-return momentum portfolios reverse on average in the long run (two to five years after formation), suggesting an overreaction to relative returns. Two, abnormal returns following corporate events such as earnings surprises, dividend changes, share repurchases, stock splits, and seasoned equity offerings continue for years without reversing, suggesting an underreaction to firm-specific news.³ Consistent with these other results, the two types of momenta we identify perform dramatically differently after the first year of their holding periods, revealing a complexity to momentum that current theories cannot accommodate. Second, we show that the trading of institutions contributes to both types of momenta in ways that are consistent with their incentives as money managers, thereby supporting an economic rationale for momentum in returns. Agency issues provide a parsimonious and rational theory of momentum that is consistent with our new empirical facts.

To examine the two types of momenta, we construct portfolios based on firm-specific abnormal returns and raw returns independently and then separate the stocks with abnormal-return momentum from the stocks with relative-return momentum. Relative-return-momentum stocks are identified as those in the extreme deciles of prior six-month returns, as introduced by Jegadeesh and Titman (1993). Abnormal-return-momentum stocks are identified as those with firm-specific residual returns more than one standard deviation from zero. Both momentum portfolios generate significant and robust profitability in the first twelve months of their holding periods. We find that relative-return momentum reverses strongly in months thirteen through sixty with average profits around *negative* 40 basis points per month. In contrast, abnormal-return momentum

¹Following Jegadeesh and Titman's (1993) seminal study, Rouwenhorst (1998, 1999), Griffin et al. (2005), Grundy and Martin (2001), and Schwert (2003) find momentum in stock returns throughout the world, in U.S. returns before 1960, and even in U.S. returns after the publication of Jegadeesh and Titman's (1993) results.

²Fama and French (1996), Moskowitz (2003), Cooper et al. (2004), and Liu et al. (2003) find that momentum cannot be captured by various measures of factor risks. Lewellen and Shanken (2002) and Brav and Heaton (2002) note that rational learning under uncertainty can generate momentum, but this theory has yet to be tested. Chan et al. (1996) and Grinblatt and Han (2005) suggest that momentum is due to underreaction to firm-specific news. On the other hand, Daniel et al. (1998), Hong and Stein (1999), and Barberis et al. (1998) suggest that momentum is due to overreaction to firm-specific news.

³Lee and Swaminathan (2000) and Jegadeesh and Titman (2001) find long-run reversal for momentum portfolios. A list of studies finding post-event continuation in returns is provided in the appendix of Daniel et al. (1998). In addition, Chan (2003) finds long-run continuation in returns following headline media news.

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