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Contrarian and momentum profitability revisited: Evidence from the London Stock Exchange 1964–2005

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Abstract

We provide evidence relating to contrarian and momentum profits for the LSE, using 64 strategies for all 6531 stocks traded from 1964 to 2005. Thorough analysis demands controlling for key potential (contradictory) explanations of the strategies' profitability which span psychological characteristics (e.g. overreaction/underreaction), excess risk, seasonality, size, and microstructure induced biases. Results provide a measurement of the miscalculations which occur when ignoring survivorship and microstructure biases. Contrarian/momentum profits cannot be explained by seasonality, size, or a single factor risk model. However, the Fama–French three factor model rationalises all contrarian profits. Important differences are found when examining a truncated sample period demonstrating the need to recognise that financial markets can change markedly through time.

JEL classification: G1

Keywords: Overreaction; Underreaction; London Stock Exchange

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1. Introduction

Over the past two decades, considerable attention has been devoted to analysing overreaction and underreaction, following the work of De Bondt and Thaler (1985) and Jegadeesh and Titman (1993) (henceforth, DT and JT, respectively). Overreaction (underreaction) is consistent with negative (positive) autocorrelation in stock returns, and evidence on either of these calls into question financial markets' efficiency at the most basic level. From numerous studies of both developed and developing markets examining these propositions, two stylised facts are evident: first, returns exhibit positive autocorrelation in the short to medium-term (3–12 months), interpreted as evidence of investor underreaction to news that can lead to excess returns from momentum trading; second, in the longer-term (3–5 years) negative autocorrelation is evident, indicating overreaction which can lead to contrarian trading profits. Michaely et al. (1995) find momentum evidence for the US, consistent with Rouwenhorst (1998) who finds medium-term returns continuation similar to JT for 12 European countries and Hart et al. (2003) who obtain similar results for 32 emerging markets. Ellis and Thomas (2004) also find medium-term return momentum to portfolios comprising companies from the FTSE 350 index for the period 1990–2003 and note the level of returns from momentum strategies is higher during this (volatile) period than has been the case in previous work. Early overreaction evidence for the US market (DT and Jegadeesh, 1990) is supported for other markets, while Clare and Thomas (1995) propose that any predictability in the UK is size-related. Dissanaike (1997) finds evidence of overreaction in the UK when looking at a shorter period (1975–1991).

In response to the large volume of evidence, researchers have attempted to provide explanations of apparent under- and overreaction consistent with market efficiency. Potential explanations include risk (Chan, 1988; Fama and French, 1996), size/seasonal anomalies (Zarowin, 1989, 1990), microstructure effects such as the bid-ask spread and non-synchronous trading (Jegadeesh and Titman, 1995) and survivorship bias (Lo and MacKinlay, 1990). However, the extant literature is inconclusive. For example, there are clear inconsistencies between Chan (1988), Dissanaike (1997), and Antoniou et al. (2006b) in relation to the role of risk, whether changes in risk between portfolio formation and holding periods drive contrarian profits and in the way to capture this. In relation to size, there is also contradictory evidence. For example, Ikenberry et al. (1995) for momentum and Clare and Thomas (1995) for contrarian strategies argue profits are due to smaller firms outperforming larger ones, irrespective of past performance. However, Antoniou et al. (2006a) show that contrarian strategies are more profitable for stocks at both extremes of the market capitalisation spectrum and not only for smaller ones. Similarly, the results of Galariotis (2004) suggest contrarian profits are not due to seasonality, whereas Dissanaike (1997) for contrarian and JT for momentum profits suggest seasonality explains part of the strategies' profitability. Finally, in relation to microstructure biases, Zarowin's (1989, 1990) results are contrary to those of Spyrou et al. (2007), who find microstructure biases do not explain findings. Thus, while considerable work has been undertaken examining momentum and contrarian strategies, the research is fragmented and the area calls out for further research examining these issues simultaneously for a consistent dataset.

This paper seeks to gain a fuller understanding of the extent to which momentum and contrarian strategies are profitable and to determine which, if any, of the potential explanations are valid, by undertaking a comprehensive out-of sample investigation of both under- and overreaction in the UK, over an extended recent period, and for the whole market. To this end, we examine a range of strategies (64 in total) involving different formation and holding periods, for all stocks traded on the London Stock Exchange (LSE) (6531 stocks) from 1964 to 2005. In addition, in recognition of the