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Momentum returns and information uncertainty: Evidence from China



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ABSTRACT

A recent theory of information uncertainty (IU) postulates a negative (positive) relationship between IU and future returns (momentum returns). We extend this theory by showing that its predictions could be conditioned by differences in behavioral biases induced by culture. We find that greater IU does not necessarily result in lower future returns in China unlike in the U.S. In fact for some IU proxies, high IU firms have higher future returns. Second, we confirm earlier evidence of a weak momentum effect in the Chinese stock market which is consistent with the low level of individualism among Chinese investors reported in the literature. Third we find that momentum returns of firms with greater IU are not necessarily higher than firms with lower IU.

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1. Introduction

Jiang et al. (2005) propose a theory of information uncertainty (IU) that predicts a negative relationship between IU and future returns as well as a positive relationship between IU and momentum returns, the returns of a trading strategy of buying recent winners and selling recent losers. They argue that the level of IU is positively correlated with both investor overconfidence and arbitrage costs and that these combined effects produce lower future returns and greater momentum returns for firms with high IU. Both predictions of the theory are empirically confirmed by Jiang et al. (2005) for the U.S. stock markets. Zhang (2006) also documents a positive relationship between IU and momentum returns using IU proxies not used by Jiang et al. (2005). We extend Jiang et al.'s (2005) framework by accounting for differences in behavioral biases

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induced by culture and suggest that that the impact of IU on average stock return and momentum could be conditioned by these differences.

IU refers to the ambiguity of new information as it relates to firm valuation. There will be more ambiguity related to new information if new information of some firms is less knowable than for other firms, because of the nature of their business or their operating environment. The hypothesized relationships between IU on one hand, and future and momentum returns on the other, are rooted in investor overconfidence and underreaction. The behavioral literature on overconfidence and underreaction (Daniel et al., 1998, 2002; Odean, 1999) posit that investors have a natural tendency to overweight the value of their private signals and *underreact* to public information such as earnings reports and past stock returns. Such underreaction naturally leads to price continuation or momentum. Further, this psychological bias is said to be heightened in environments characterized by high IU (Daniel et al., 1998, 2002; Hirshleifer, 2001). If pessimistic investors are kept out of the market by short-selling constraints (Miller, 1977), the price of high-IU firms will be driven by optimistic investors who eventually overpay for such stocks. The subsequent correction in the price of high-IU firms then results in lower future returns. Therefore the theory predicts a negative relationship between IU and future returns. Further, since investor underreaction is stronger when there is more uncertainty, the theory also predicts that momentum returns will be higher for high-IU firms.

Though momentum returns have been documented in several markets around the world (see for example, Chui et al., 2010; Griffin et al., 2005; Rouwenhorst, 1998; Rouwenhorst, 1999), there are significant cross-country differences in their magnitude. Chui et al. (2010) show that these cross-country differences can be explained by cultural differences. In particular, they find that countries scoring low on Hofstede (2001) individualism index tend to exhibit lower momentum returns. This index reflects the degree to which individuals focus on their own abilities as a way of differentiating themselves. Several studies argue a strong link between individualism and overconfidence and self-attribution bias (see Chui et al., 2010, for an excellent review) the latter two being the main drivers of the momentum effect in the Daniel et al. (1998) model. China ranks among the lowest countries in terms of the individualism index. Therefore we expect momentum returns to be smaller in China compared with the U.S. which ranks highest in individualism.

Overconfidence and biased self-attribution have been traditionally regarded as universal tendencies. However, recent studies in the psychology literature have questioned this universality. For example, in a meta-analysis of 91 comparisons Heine and Hamamura (2007) find that 88 reveal less self-enhancing attribution bias among East Asians (specifically, those in Confucian cultures, such as Chinese, Koreans and Japanese) compared with Westerners. In fact, most of the methods used in those 91 comparisons reveal no self-enhancing attribution bias and in some cases even suggest the presence of biased self-criticism.

Apart from being characterized as less individualistic and less-self enhancing than their U.S. counterparts, related studies in the psychology literature also find that Asians (Lee and Seligman, 1997) and Asian Americans (Chang, 1996, 2002) tend to be more pessimistic than European Americans.

We suggest that differences in behavioral biases induced by culture could condition investor response to IU. In particular we postulate that investor reaction to IU will differ according to the investor's initial predisposition. If Chinese investors are less overconfident, suffer less from biased self-attribution, and generally pessimistic, we postulate that increased IU will accentuate their 'underconfidence' (instead of boosting overconfidence) and will become more self-critical rather than self-enhancing, nullifying the prediction of Jiang et al.'s theory (2005) or worse lead to opposite results. Therefore we hypothesize that greater IU in the Chinese stock markets will not necessarily lead to lower future returns and higher momentum returns. We test our hypotheses with stocks traded in the Shanghai Stock Exchange (SHSE) of China.² Following Jiang et al. (2005) we employ a combination of portfolio-level analysis and firm-level cross-sectional regressions (Fama and MacBeth, 1973), and use five proxies for IU, namely, firm size, firm age, volatility, volume turnover, and implied duration.

First we find that consistent with our hypothesis, greater IU in the Chinese stock market does not necessarily result in lower future returns. In fact we find that for some of our IU proxies, high IU firms have higher future returns. Second, we confirm evidence from earlier studies of a relatively weak momentum effect in the

² The SHSE was established in December 1990 and is considered the largest emerging stock market by market capitalization. The SHSE is characterized as having a large number of small-cap stocks, a large number of share classes, a dominance of retail investors and strict regulation of IPOs by the government (see Gao, 2002). The SHSE is also different from the U.S. and other developed stock markets because it is not entirely open to foreign investors. However, from 2004, foreign investors were allowed to trade in all shares of SHSE, with some restrictions (see Jun Lin and Chen, 2005).

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