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Momentum Profits and Investor Behavior

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Abstract : Profits earned from relative strength strategy of zero-cost portfolio i.e. taking long position in winner stocks and short position in loser stocks from recent past are termed as momentum profits. In recent times, there has been lot of controversy and concern about sources of momentum profits, since the existence of these profits acts as an evidence of earning non-normal returns from publicly available information directly contradicting Efficient Market Hypothesis. Literature review reveals conflicting theories and differing evidences on sources of momentum profits. This paper aims at re-examining the sources of momentum profits in Indian capital markets. The study focuses on assessing the effect of fundamental as well as behavioral sources in order to understand the role of investor behavior in stock returns and suggest (if any) improvements to existing behavioral asset pricing models. This Paper adopts calendar time methodology to calculate momentum profits for 6 different strategies with and without skipping a month between ranking and holding period. For each J/K strategy, under this methodology, at the beginning of each month t stocks are ranked on past j month’s average returns and sorted in descending order. Stocks in upper decile are termed winners and bottom decile as losers. After ranking long and short positions are taken in winner and loser stocks respectively and both portfolios are held for next k months, in such manner that at any given point of time we have K overlapping long and short portfolios each, ranked from t-1 month to t-K month. At the end of period, returns of both long and short portfolios are calculated by taking equally weighted average across all months. Long minus short returns (LMS) are momentum profits for each strategy. Post testing for momentum profits, to study the role market risk plays in momentum profits, CAPM and Fama French three factor model adjusted LMS returns are calculated. In the final phase of studying sources, decomposing methodology has been used for breaking up the profits into unconditional means, serial correlations, and cross-serial correlations. This methodology is unbiased, can be used with the decile-based methodology and helps to test the effect of behavioral and fundamental sources altogether. From all the analysis, it was found that momentum profits do exist in Indian capital markets with market risk playing little role in defining them. Also, it was observed that though momentum profits have multiple sources (risk, serial correlations, and cross-serial correlations), cross-serial correlations plays a major role in defining these profits. The study revealed that momentum profits do have multiple sources however, cross-serial correlations i.e. the effect of returns of other stocks play a major role. This means that in addition to studying the investors` reactions to the information of the same firm it is also important to study how they react to the information of other firms. The analysis confirms that investor behavior does play an important role in stock returns and incorporating both the aspects of investors’ reactions in behavioral asset pricing models help make then better.

Keywords : investor behavior, momentum effect, sources of momentum, stock returns
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