Editorial

Momentum

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My editorial for this issue is about momentum as indeed is one of the articles in this issue. Momentum is often seen as the one investment style for which efficient market theory cannot provide an explanation. Superior (or inferior) returns to value, growth or size are justified as a risk premium, that is, a form of compensation that the investor receives in return for enduring bankruptcy risk in the case of small or unpopular stocks or dividend uncertainty in the case of growth. The fact that these styles are sometimes predictable is explained by the fact that certain equilibrium models generate forecastable risk premia with the splendid property that exploiting the predictability will not increase utility in equilibrium.

Other anomalies of the kind typified by the Monday effect, 'sell in May and go away', and other calendar-related phenomena are usually shown not to hold with real trades and costs; similarly, many of the superior profits claimed in top US finance journal articles are based on wide universes of stocks and cannot be replicated by large asset managers.

So far so good, but where does momentum enter into this story? Well, if you want an equilibrium explanation for momentum, you need equilibrium in which some agents are rational but where others base their investment demands on various averages of past prices or returns. However, these agents are deemed to be 'irrational' for modelling their demands

in this way. This is truer of time-series momentum rather than cross-sectional or relative momentum. However, although a distinction is made between the two cases, the distinction is perhaps not too great, as the information used in ranking stocks for relative momentum strategies is really time-series information anyway.

We are left with this view, then, that it is irrational behaviour that drives momentum. From a time-series and economics perspective, my personal view about momentum is that herding and other forms of collective behaviour drive up demand in an environment of inelastic supply. This is a consequence of the population of agents constantly changing so that there are always some naive investors. This leads to explosive and unsustainable price growth that implodes at some uncertain point in the future. Investing successfully in momentum means to be able to diversify the portfolio of 'mini-bubbles' so that, overall, you do alright most of the time. This is what we see empirically, momentum strategies based on buying past winners succeed more often than they fail, but they are left-skewed so that, once in a while, you lose a lot of money. All your mini-bubbles burst at the same time.

Stephen Satchell