

Momentum Lost and Found in Financial Markets

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Abstract

Known as the relative-strength strategy of buying winner stocks and selling loser ones, the momentum strategy is prevalent among traders for its anomaly especially in the US market documented by many empirical analyses. Motivated by the failure of the strategy in certain major financial markets and assets, we propose an information diffusion model for asset pricing by which a price risk index is introduced to quantify the downside risk. We use the index to modify the momentum strategy by taking into account the price level of a security when forming the portfolio. The empirical results established for many stock markets worldwide and the US corporate bonds of investment grades demonstrate that the refined strategy not only achieves significant improvements over the traditional one, but also recovers the momentum phenomenon that has not been found by previous studies.