

Project Proposal

Project title

“Industry Momentum Based Trading Strategy”

Project idea

The efficient-market hypothesis (EMH) states that asset prices fully reflect all available. However, it has been disputed both empirically and theoretically. An efficient market will reflect newly available information in a few minutes, even seconds. However, if only half of that information is reflected in the stock price immediately and the remaining half takes several days, then the market is less than fully efficient. Inefficiency opens up profitable opportunities that take advantage of valid anomalies or mispricing, if appropriate trading strategy is implemented. More important than individual monetary reward, trading based on anomalies will improve market efficiency with the associated benefits of superior resource allocation and enhanced social welfare.

There is extensive empirical evidence to suggest profitability of trading strategies based on buying and holding winner stocks, however, there is other evidence to suggest that momentum among individual stocks actually arises from industry momentum. Once individual stock returns are adjusted for industry effects, momentum-based trading strategies are much less profitable and largely insignificant. This means that the primary reason for momentum is trends in industry. Therefore, this paper will adopt and empirically evaluate the industry-momentum-based trading strategies proposed by Vijay Singal in his book “Beyond the Random Walk: A Guide to Stock Market Anomalies and Low-Risk Investing”, using the most recent data. If trading strategies based on this anomaly haven’t wiped out the market inefficiency, that is, momentum is persistent till now, assuming large enough of smart investors have already implemented momentum-based trading strategies, then behavioral finance could be the ultimate explanation to justify the anomaly.

Papers to read

- Dellva, Wilfred L., Andrea L. DeMaskey, and Colleen A. Smith. 2001. Selectivity and Market Timing Performance of Fidelity Sector Mutual Funds. *Financial Review* 36(1), 39–54.
- Grundy, Bruce D., and J. Spencer Martin. 2001. Understanding the Nature of the Risks and the Source of the Rewards to Momentum Investing. *Review of Financial Studies* 14(1): 29–78.
- Jegadeesh, Narasimhan, and Sheridan Titman. 1993. Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency. *Journal of Finance* 48(1), 65–92.
- Moskowitz, Tobias, and Mark Grinblatt. 1999. Do Industries Explain Momentum? *Journal of Finance* 54(4), 1249–90.
- O’Neal, Edward S. 2000. Industry Momentum and Sector Mutual Funds. *Financial Analyst Journal* 56(4), 37–49.

Teammate(s):

I will NOT have other teammates, instead, I will work on myself. I’ve emailed Professor Parzen for permission.

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