Research gives new insight into capitalizing on momentum investing

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Every investor is chasing the answer to one question: When should I buy stocks and when should I sell them? It's the elusive formula for timing the market. New research co-authored by Albert "Pete" Kyle, the Charles E. Smith Chair Professor of Finance at the University of

Maryland's Robert H. Smith School of Business, shows how markets gain momentum and how investors can make better decisions based on it.

"Investors want to buy the stock that's going to go up, and they want to sell the stock that's going to go down," says Kyle, whose paper, "Beliefs Aggregation and Return Predictability" with Anna A. Obizhaeva of the New Economic School in Moscow and Yajun Wang of Baruch College, is conditionally accepted by the *Journal of Finance*. The research examines how people's understanding of the market could make asset returns predictable.

If everyone trading in the market thought the same way and had access to the same information, then they'd all interpret new information the same, agreeing on what it means and buying, selling or holding accordingly. That would make everyone believe that market returns are impossible to predict, says Kyle, because prices would instantaneously adjust to new information as all traders reacted the same way.

But that's not the way people in the market operate. Even when investors have the same information, they may not interpret it in the same way. For example, the past performance of a stock.

"For returns to be predictable based on past prices, you must have what we call positive autocorrelation or negative autocorrelation," Kyle says. "Positive autocorrelation says that if a price has been going up in the past, it will likely go up in the future. That says if you want to beat the market, you should be a momentum trader."

But, prices don't always trend in one direction. "It's possible that if prices have gone up in the past, they'll go down in the future. Traders that take that approach want to sell the things that are going up and buy the things that are going down—what we call contrarian traders," says Kyle.

"Most people tend to be momentum traders, and they tend to be momentum traders over the wrong horizon."

So how can traders get it right?

Contrarian traders can make profits by paying attention to noise traders, who buy the most buzzed-about stocks and push the prices up, but then eventually sell. "Noise trading tends to make contrarian trading profitable—that is, you sell when the noise traders are buying and pushing the prices up, and buy when prices fall as the noise traders liquidate their positions," Kyle says.

He and his co-authors were interested in how markets can get momentum—to make it profitable to buy stocks as they are going up in price and sell stocks going down.

They look, again, to noise traders, but when they buy steadily over time.

"People don't anticipate that that's what they are doing," he says. "It comes as a surprise that these noise traders keep on buying and it comes as a surprise that prices keep on going up. People don't really think that there is momentum, but there is. They don't understand the market properly."

Traders' different approaches to buying and selling come from the way they interpret news and information they get about the market. And it's the differences in individual approaches across traders that creates momentum in the market, says Kyle.

"If we all agree, you probably don't get momentum unless we are all wrong," he says. "People get signals and they disagree over how important the signals are. So if there's a news announcement, some people may think it's meaningless and has no effect on a stock's price.

Others might think it's bullish and want to buy; others may think it's bearish and want to sell."

When everyone is trading on the way they personally interpret information—and assume everyone else is wrong—it seems like contrarian trading because everybody is trading against everybody else.

"But what our paper shows is that, contrary to what intuition might suggest, this contrarian mentality actually leads to momentum in prices," Kyle says.

You get enough momentum to explain some of the anomalies that we have seen historically in returns, he says.

"People in the market have beliefs about how the market is working. And those beliefs can be mutually inconsistent and create some surprises—some very ugly and costly surprises."

Kyle points to a key mistake many retail investors make, backed by evidence from other professors' research: selling winners too soon and hanging onto losers too long. The paper's findings offer a critical lesson for investors who want to capitalize on market momentum:

"If you buy a stock and it goes up a little bit, you should hang onto it. The momentum might last longer than you think. Don't take your gains too quickly. Hang on to them and let them ride for a while. On the other hand, there is evidence that you should take your losses quickly, exploiting shorter-term momentum. If you buy a stock and it goes down, then it's got negative momentum and you should sell it quickly."

"That's a way of timing the market that is empirically different from what many retail investors actually do," Kyle says "When they sell the winners, they are missing out on profits. When they hang on to losers,

they are just compounding their losses. Our model would be consistent with telling investors not to be momentum traders because they may do it over the wrong horizon."

More information: Albert (Pete) S. Kyle et al, Beliefs Aggregation and Return Predictability, *SSRN Electronic Journal* (2018). DOI: 10.2139/ssrn.2639231

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