Discussion of “Daily Momentum and New Investors in Emerging Stock Markets”

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Key insights/observations

- The paper documents that momentum is observed at daily intervals and reversals are observed at weekly and monthly intervals
  - This pattern is observed in several emerging markets
- They provide insights about why this might be the case by looking at the trades of both retail and institutional investors on the Shenzhen stock exchange
  - They document trading behavior by unsophisticated retail investors that is "consistent" with them generating daily momentum
- I would like to see a model that provides a bit more structure
  - Understanding daily momentum and longer reversals might be a bit challenging

Gratuitous self-cites about investor composition, momentum and reversals

Chui, Subrahmanyam, and Titman (RoF, 2022)

- The composition of investors matter
- B shares exhibit yearly momentum but weak monthly reversals
- A shares exhibit strong monthly reversals but not yearly momentum

Luo, Jegadeesh, Subrahmanyam, and Titman (RFS, Forthcoming)

- When monthly reversals are strong, momentum is weak
- The composition of investors in strong reversal/weak momentum countries tend to be more retail

➢ Investor composition drive return patterns

A few more relevant cites

Du, Huang, Liu, Shi, Subrahmanyam, Zhang (Management Science, forthcoming)

- High priced stocks in China and other emerging markets exhibit significant yearly momentum
- These are stocks that are traded more by institutions
- Do low priced stocks exhibit daily momentum?

George, Hwang and Li (PACAP, 2023)

- Chinese stocks exhibit momentum in non-February months
- Retail investors buy losers (lottery stocks) after Chinese New Years

What do we think we know?

- In most emerging markets, like China, we do not see strong evidence of momentum at yearly intervals as we do in more mature markets, like the U.S. and Europe
- A plausible explanation is that noise trades of retail investors, who tend to be more important in these markets, tend to offset the momentum effect
- There is, however, evidence of yearly momentum in subsamples in which retail traders are likely to be less important

Then why do we observe daily momentum in emerging markets?

Theoretical Framework

Three Players

1. Informed but overconfident investors
   - The combination of risk aversion and overconfidence can lead to underreaction

2. Noise traders
   - Generate reversals if they trade randomly
   - At least partially offsets the momentum generated by the overconfident informed
   - Depends on their holding period

3. Rational market makers/quant traders
   - If they are risk averse, they dampen but do not eliminate the mispricing generating by the other players

Initial thoughts

The previous literature suggests that weekly and monthly reversals are generated by retail (noise) traders

Can noise traders simultaneously generate daily momentum, monthly reversals and offset yearly momentum?

What are the possible mechanisms?

- Short-term positive feedback trading
- Serially correlated order flow
- Short-term negative feedback traders providing too much short-term liquidity
  - Market makers may not anticipate that some of the order flow may be informed
- Stale limit orders

Can we estimate a causal relationship between daily momentum and retail trading?

"For a group's trading to act as a catalyst for daily momentum, we would expect the group's current trading activity, in response to a stock's past day return, to amplify the stock's current day return. In other words, there should be a positive correlation between the stock's current day return and the interaction between its past day return and the group's current day trading. Furthermore, this interaction should also be linked to a subsequent price reversal in the stock."

What is the causal interpretation of c_3 ?

$$
\begin{aligned}
Ret_{i,d+1} =& Constant + c_1 Ret_{i,d} + c_2 Netbuy_{i,d+1} + c_3 Ret_{i,d} \times Netbuy_{i,d+1} \\
& + c_4 Ret_{i,d-5\to d-1} + c_5 Ret_{i,d-21\to d-6} + Controls_{i,d} + \epsilon_{i,d+1}.
\end{aligned} \tag{2}
$$

Concluding Thoughts

- Its remarkable that we are still uncovering new facts about the serial correlation of stock returns
- We now have overwhelming evidence that investor composition materially affects return patterns
  - Indicative of various behavioral stories
  - Incredible that these patterns persist
  - Suggests that we also need a limits to arbitrage story
- Perhaps, we should look more carefully at the long and short side of these momentum trades
  - Its straightforward to arb the underpriced stocks
  - Not easy to arb expected short-term declines – especially in emerging markets