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MOMENTUM AND DOWNSIDE RISK

Abstract:

We examine whether time-variation in the profitability of momentum strategies is related to variation in macroeconomic conditions. We find reliable evidence that the momentum strategy exposes investors to greater downside risk. Momentum strategies deliver economically large and statistically reliable negative profits in bad economic states when the expected market risk premium is high, whereas positive profits in good economic states when the expected market risk premium is low. Our results are robust to alternative constructions of momentum portfolios, out-of-sample estimation of the expected market risk premium, and after controlling for the January effect, lagged market return, and investor sentiment effect.

Keywords:

Momentum; Economic state; Expected market risk premium

JEL Classification: G12, G14