Momentum vs. Reversal Strategies in Equity Hedge Funds

Discover the effectiveness of momentum vs. reversal strategies in predicting equity hedge fund performance.

Fund Investing, Simplified

Momentum vs. Reversal: Which Strategy Delivers Better Returns?

LONDON, UNITED KINGDOM, August 14, 2024 /EINPresswire.com/ -- Introduction

Asset managers employ a variety of strategies to generate returns for their investors. Among these, momentum and reversal strategies have garnered significant attention in both academic research and practical application. Momentum strategies are based on the idea that assets that have performed well in the past are likely to do so in the near future. In contrast, reversal strategies rely on the expectation that assets that have underperformed recently will rebound.

In this study, we examine whether momentum or reversal strategies are more effective in predicting the future performance of equity-focused hedge funds. By constructing portfolios based on past returns, we aim to determine which strategy yields better returns over different time horizons. Our findings suggest that momentum strategies are more effective in hedge funds that employ equity hedge strategies. This suggests that prices tend to increase over time, and constructing portfolios from past winners yields higher returns than from past losers. Additionally, the results indicate that momentum strategies provide a statistically significant edge in predicting hedge fund performance over 6- and 12-months timeframes. However, the average returns of momentum and reversal strategies do not show statistically significant differences over the short-term horizons of 1 and 3 months.

Methodology
To explore the effectiveness of momentum and reversal strategies, we analysed 340 equity-focused hedge funds from the HFR database, each with a minimum of 60 months of return data and at least $100 million in AUM, ensuring their significance as market participants.

Portfolio Name	Next 1-month Investment Return	Next 3-month Investment Return	Next 6-month Investment Return	Next 12-month Investment Return
Momentum Portfolio	3.59%	-0.88%	9.64%	19.53%
Reversal Portfolio	2.90%	-0.26%	3.96%	11.53%

Source: HFR, AlternativeSoft. Momentum and Reversal Portfolios were constructed using data from July 2022 to June 2023, with a 1, 3, 6, and 12-month holding period until Jun 2024.

Each portfolio includes 68 hedge funds (top 20th percentile for Momentum, bottom 20th percentile for Reversal).

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Portfolio Construction
Momentum Portfolio: We ranked the hedge funds based on their past 12-month returns and formed an equally weighted portfolio consisting of the top 20% of funds. This portfolio is designed to capture the continuation of positive performance.
Reversal Portfolio: We ranked the funds based on their past 12-month returns and created an equally weighted portfolio with the bottom 20% of funds. This portfolio aims to capitalize on the potential for these underperforming funds to rebound.

Portfolio Measurement
The performance of both portfolios was measured over the subsequent 1, 3, 6, and 12 months. Average returns for each time horizon were calculated to assess the relative effectiveness of the momentum and reversal strategies.

Statistical Analysis
To determine whether the differences in returns between the momentum and reversal portfolios were statistically significant, we conducted a t-test. This test evaluates whether the mean returns of the two portfolios are significantly different from each other, providing a basis for comparing the effectiveness of the two strategies.

Results
The results of our analysis reveal interesting patterns in the performance of momentum and reversal strategies across different time horizons. The average returns of portfolios over investment periods of 1, 3, 6, and 12 months are summarized in the table attached.

The findings indicate that momentum strategies generally outperform reversal strategies, with holding past winners yielding higher returns across most time frames.

Statistical Significance
The t-test results indicate that the differences in returns between the momentum and reversal

portfolios are significant at the 95% confidence level for the 6 and 12-month horizons. This suggests that momentum strategies offer a statistically significant advantage in predicting hedge fund performance for 6- and 12-month horizons.

Discussion

The findings of this study provide insights into the relative effectiveness of momentum strategies in the hedge fund market. Our results indicate that the momentum portfolio generally outperforms the reversal portfolio across 6- and 12-month time horizons. This suggests that hedge funds that have been in the top 20th percentile in the last 12 month are more likely to continue their strong performance in the next 6 month and 12 months, in line with the momentum hypothesis.

On the other hand, the reversal portfolio's performance suggests that hedge funds in the bottom 20th percentile in the last 12 month do not necessarily experience a significant rebound.

Implications for Allocators

For hedge fund allocators, the findings suggest that momentum strategies could be a more reliable approach to generating returns in the equity-focused hedge fund market. The optimal time to invest in a new equity long/short hedge fund is after it has been in the top 20% of its peer group for 12 months. However, it is essential to consider the potential risks associated with momentum investing, such as the possibility of sudden market reversals that can erode gains.

Conclusion

In conclusion, momentum strategies consistently outperform reversal strategies across 1m, 6m, and 12m horizons, with statistically significant differences over the 6m and 12m periods.

Future research could examine applying momentum strategies to other hedge fund approaches, like fixed income, macro, relative value, or CTA, to see if similar patterns emerge across different asset classes.

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