Are contrarian investment strategies profitable in the London Stock Exchange? Where do these profits come from?

Antonios Antoniou
Centre for Empirical Research in Finance,Department of Economics and Finance, University of Durham, 23-26 Old Elvet, Durham DH1 3HY, UK.

Emilios C. Galariotis*
Centre for Empirical Research in Finance, Department of Economics and Finance, University of Durham, 23-26 Old Elvet, Durham DH1 3HY, UK.

Spyros I. Spyrou
Athens University of Economics and Business,
Department of Accounting and Finance, Patission 76, 10434, Athens, Greece,

Abstract

Given the lack of evidence in the literature regarding UK short-term contrarian profits and their decomposition, this paper investigates the existence of contrarian profits for the London Stock Exchange (LSE), and decomposes them to sources due to common factors and to firm-specific news, building on the methodology of Jegadeesh and Titman (1995). Furthermore, in view of recent evidence that longer-term contrarian profits in the US are explained by firm characteristics such as size and book-to-market equity, the paper decomposes shorter-term contrarian profits to sources similar to the ones in the Fama and French (1996) three-factor model. For the empirical testing, size-sorted sub-samples that are rebalanced annually are used, and in addition, adjustments for infrequent trading and the Bid-Ask bias are made to the data. The results indicate that contrarian strategies are profitable for UK stocks and more pronounced for extreme market capitalization stocks (smallest – largest); the profits persist even after the sample is adjusted for market frictions, such as infrequent trading and bid-ask bias, and irrespective of whether raw or risk-adjusted returns are used to calculate them. Further tests indicate that the magnitude of the contribution of the delayed reactions to contrarian profits is small, while the magnitude of the contribution of investor overreaction to firm-specific information to profits is far larger (consistent with the findings of Jegadeesh and Titman 1995 for the US).

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Corresponding author: E. Galariotis, Department of Economics and Finance, University of Durham, 23-26 Old Elvet, Durham DH1 3HY, UK. Email: Emilios.Galariotis@durham.ac.uk , telephone: ++44 (0)191 3741823, ++44 (0)191 3779250. Fax: ++44 (0)191 3747289

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