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# Do local or global risk factors explain the size, value and momentum trading pay-offs on the Warsaw Stock Exchange?

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## Abstract

This article shows that momentum trading fails to generate significant profits beyond the 1-month holding period on the Warsaw Stock Exchange over the years 2002–2011. Size and value strategies are efficacious but have varying magnitudes over time: size premium diminishes in the second subperiod. Domestic, European and global pricing model specifications are challenged with strategy pay-offs to test the rational explanation for the profitability of these investment styles. The performance of the buy side of size and value strategies is captured by the market risk exposure but both single- and multi-factor models leave significant alphas of large and value portfolios. Domestic models outperform their nondomestic specifications: European CAPM performs better than its global analogue while nondomestic three-factor models perform similarly. Tail size and value portfolios are characterized by negative but mostly

insignificant loadings on European and global nonmarket risk factors that emerge from the negative relationship between Polish, European and global currency-adjusted small minus big (SMB) and high minus low (HML). It is further shown that after adjustment for fluctuations between USD and PLN, the magnitude and correlation structure between local and global risk factors change significantly.

Keywords:

size and value effects momentum trading global risk factors international asset pricing  
Warsaw Stock Exchange

JEL Classification:

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## Notes

<sup>1</sup> See footnote 1 in Hou et al. (2011) for a comprehensive reference list to internationally focused papers and Israel and Moskowitz (2013) for newest evidence. Given this handful of empirical support, the relevant scientific question has shifted from if to why the patterns in both local and internationally aggregated average stock

returns exist. The most famous competing explanations are characteristic-based, risk-based and behavioural approaches. Some other studies attach the patterns to the market microstructure, data snooping or data mining. van Dijk ([2011](#)) delivers a general overview of size effect interpretations. For the characteristic-based interpretation of size and value effects, see Daniel and Titman ([1997](#)). For the behavioral explanation of value effect, see Lakonishok et al. ([1994](#)). For the rational expectation-based interpretation of value effect, see Zhang ([2005](#)), Petkova and Zhang ([2005](#)) and Petkova ([2006](#)). The theoretical defence of momentum as a risk-related effect can be found in, e.g., Chordia and Shivakumar ([2002](#)). Also Kang et al. ([2011](#)) examine the momentum relation to macroeconomic variables. Data related arguments come from, e.g., Kothari et al. ([1995](#)).

<sup>2</sup> The list of stocks available for short selling on the WSE can be viewed at [http://www.gpw.pl/papiery\\_wartosciowe\\_dopuszczone\\_do\\_krotkiej\\_sprzedazy](http://www.gpw.pl/papiery_wartosciowe_dopuszczone_do_krotkiej_sprzedazy). However, even if short selling is restricted, for the purpose of portfolio management the short portfolio can be used to underweight assets relative to the market index (De Groot et al., [2012](#)). Size effect is shown to emerge from a tiny portion of microstocks, see Chan and Chen ([1991](#)), Fama and French ([2007](#)) and De Moor and Sercu ([2013](#)), among others. Regarding momentum trading, Hong et al. ([2000](#)), Grinblatt and Moskowitz ([2004](#)) and Lesmond et al. ([2004](#)) claim that profits yield from the short positions in small, illiquid stocks' related to higher transaction costs. The latter paper shows that transaction costs of small stocks are much higher than previously stated and that momentum 'paper profits' are spurious. However, Israel and Moskowitz (2013) argue that this evidence is sample specific. Furthermore, the value strategy was shown to be particularly strong among small stocks, see, e.g., Petkova and Zhang ([2005](#)), Fama and French ([2012](#)).

<sup>3</sup> [http://static.gpw.pl/pub/files/PDF/prezentacje/inwestorzy\\_gieldowi\\_ankieta\\_2011.pdf](http://static.gpw.pl/pub/files/PDF/prezentacje/inwestorzy_gieldowi_ankieta_2011.pdf) and [http://static.gpw.pl/pub/files/PDF/badanie\\_inwestorow\\_dane\\_na\\_www2012.pdf](http://static.gpw.pl/pub/files/PDF/badanie_inwestorow_dane_na_www2012.pdf).

<sup>4</sup> Along this article, I deem small, high book-to-market ratio and loser stocks as risky according to the multi-factor risk framework.

<sup>5</sup> The full period of available data spans 10 years from July 2002 till June 2011. However, first observations are used for calculation of momentum characteristic that

requires the pre-formation estimation. The last 12 months cannot be used to guarantee that each strategy pay-off is the return average of the same number of overlapping portfolios.

6 <sup>6</sup> [www.infostrefa.pl](http://www.infostrefa.pl).

7 <sup>7</sup> Around 70% of capitalization of the WSE is concentrated in 20 largest companies.

8 <sup>8</sup> Outperformance defined that way means that active stock selection is more profitable than passive investment in the market index, see also van der Hart et al. (2005). Lesmond et al. (2004) consider additionally the middle, nontraded portfolio, but the authors follow a different grouping technique.

9 <sup>9</sup> The public pension system reform in 1999 introduced the option to join the privately managed open-end pension funds that started to invest on the WSE.

10 <sup>10</sup> I use the value-weighted market returns for consistency with the CAPM assumption that the return to stocks measures the return to the aggregate wealth portfolio, Jagannathan Wang (1996). Further, available European and global market risk factors are value-weighted. See Hou et al. (2011) for the use of equal-weighted market return and Griffin (2002) for both.

11 <sup>11</sup> For the rationale behind small minus big (SMB) and high minus low (HML) factors, see, e.g., Fama and French (1993) and the website of Kenneth French [http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data\\_library.html](http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html). To facilitate the comparison with, e.g., van der Hart et al. (2005), I follow earlier studies and proxy global factors with American counterparts.

12 <sup>12</sup> <http://www.nbp.pl/homen.aspx?c=/ascx/archen.ascx>.

13 <sup>13</sup> Jegadeesh and Titman (1993) document an average monthly momentum profit of roughly 1% for the US market during their study period. However, their results hold for different investment windows.

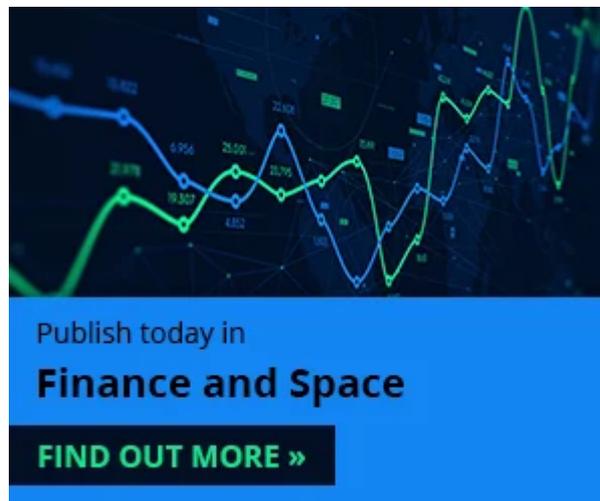
14 <sup>14</sup> Results are qualitatively similar for all three holding periods. For brevity, the results for the 1 and 12 months holding periods of size and value strategies are not presented in the article but are available from the author upon request.

15 <sup>15</sup> The correlation between currency-unadjusted US and Swiss (German) factors is 0.69 (0.79) for MRP, 0.20 (-0.19) for SMB and 0.32 (0.39) for HML over the period

1990–2005 (1995–2011). Also Rouwenhorst ([1999](#)) shows low correlation between market risk premiums on emerging markets and the global index return.

16 <sup>16</sup> The correlation between European (global) market risk premium and USD/PLN exchange rate changes is strongly negative  $-0.72$  ( $-0.62$ ). Over the discussed sample period USD depreciates from 0.26 to 0.32 USD/PLN with mean of 0.33 and SD of 0.06.

17 <sup>17</sup> Fama and French (2012) argue that the sample is meant to cover the wide spectrum of international small stocks, but it can be biased towards larger ones even if controlling for 90% of relevant aggregated market capitalization. Fama and French (2008) note that microstocks make 3% of the market capitalization in the NYSE/Amex/Nasdaq environment but 60% of the total stocks in number.



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