"A Tug of War: Overnight Versus Intraday Expected Returns"

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Abstract

We decompose the abnormal profits associated with well-known patterns in the cross-section of expected returns into their overnight and intraday components. We show that, on average, all of the abnormal returns on momentum strategies remarkably occur overnight while the abnormal profits on the other trading strategies we consider occur intraday. These patterns are extremely robust across subsamples and indeed are stronger for large-cap and high-price stocks. Furthermore, we find that all of the variables that are anomalous with respect to the Fama-French-Carhart model have risk premiums overnight that partially offset their much larger intraday average returns. Indeed, a closer look reveals that in every case a positive risk premium is earned overnight for the side of the trade that might naturally be deemed as riskier. In fact, we show that an overnight CAPM explains much of the cross-sectional variation in average overnight returns we document. Finally, we argue that investor heterogeneity may explain why momentum profits tend to accrue overnight. We first provide evidence that, relative to individuals, institutions prefer to trade during the day and against the momentum characteristic. We then highlight conditional patterns that reveal a striking tug of war. Either in the time series, when the amount of momentum activity is particularly low, or in the cross-section, when the typical institution holding a stock has a particularly strong need to rebalance, we find that momentum returns are even larger overnight and more strongly reverse during the day. Both cases generate variation in the spread between overnight and intraday returns on the order of 2 percent per month.

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