



FACTOR / STYLE INVESTING

Understanding Momentum and Reversals

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Stock momentum, long-term reversal, and other past return characteristics that predict future returns also predict future realized betas, suggesting these characteristics capture time-varying risk compensation. We formalize this argument with a conditional factor pricing model. Using instrumented principal components analysis, we estimate latent factors with time-varying factor loadings that depend on observable firm characteristics. We show that factor loadings vary significantly over time, even at short horizons over which the momentum phenomenon operates (one year), and that this variation captures reliable conditional risk premia missed by other factor models commonly used in the literature. Our estimates of conditional risk exposure can explain a sizeable fraction of momentum and long-term reversal returns and can be used to generate even stronger return predictions.

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