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ABSTRACT

Price momentum strategies have historically generated high positive returns with little systematic risk. However, these strategies also experience infrequent but severe losses. During 13 of the 978 months in our 1929-2010 sample, losses to a US-equity momentum strategy exceed 20 percent per month. We demonstrate that a hidden Markov model in which the market moves between latent "turbulent" and "calm" states in a systematic stochastic manner captures these high-loss episodes. The turbulent state is infrequent in our sample: the probability that the hidden state is turbulent is greater than one-half in only 20% of the months. Yet in each of the 13 severe loss months, the ex-ante probability that the hidden state is turbulent exceeds 70 percent. This strong forecastability accentuates the price momentum puzzle.

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1 Introduction

Relative strength strategies, also known as price momentum strategies, have been and continue to be popular among traders. Quantitative strategies used by active money managers often rely on some form of momentum.¹ Even those who use fundamental analysis appear to incorporate momentum into their trading decisions.²

Price momentum in stocks can be described as the tendency of those stocks with the highest (lowest) past return to subsequently outperform (under-perform) the broader market. Price momentum strategies exploit this pattern by taking a long position in past winners and an equal short position in past losers. These strategies produce high abnormal returns on average, but also generate infrequent and large losses.

Over our sample period of July 1929 through December 2010, our baseline momentum strategy produces monthly excess returns with a mean of 1.12%, a standard deviation of 8%, and with little systematic risk as measured by the standard CAPM or the Fama and French (1993) three factor model: the estimated CAPM α of the strategy is 1.44%/month, and the Fama and French (1993) three factor α is 1.70%/month. The maximum attainable sample monthly Sharpe Ratio increases from 0.15 for a portfolio of the three Fama and French (1993) factors to 0.28 when the three factors are augmented with the momentum strategy.

However, the momentum strategy returns have an empirical distribution that is both highly left skewed and significantly leptokurtic. There are thirteen months with losses exceeding 20%. In its worst month the strategy experiences a loss of 79%. Were momentum returns generated from an *i.i.d.* normal distribution with mean and variance equal to their sample counterparts, the probability of realizing a loss of more than 20% in thirteen or more months would be 0.04%, and the probability of incurring a loss of 79% or worse would be 9.95×10^{-24} .

The pronounced leptokurtosis of the empirical distribution of momentum strategy returns suggests that these returns may be drawn from a mixture of normal distributions. We therefore develop a two state Hidden Markov Model (HMM) – a variant of the regime switching

¹See Swaminathan (2010), who further estimates that about one-sixth of the assets under management by active portfolio managers in the U.S. large cap space is managed using quantitative strategies.

²Jegadeesh and Titman (1993) motivate their study of price momentum by noting that: “. . . a majority of the mutual funds examined by Grinblatt and Titman (1989; 1993) show a tendency to buy stocks that have increased in price over the previous quarter.”

model of Hamilton (1989) – in which the hidden state can be “*calm*” or “*turbulent*.” The states are persistent: successive months are more likely to be in the same state. Also, as we shall show momentarily, the joint distribution of the momentum-strategy and stock-market excess returns differs significantly across the two states, facilitating our estimation of the HMM parameters. As we shall show, the HMM model we propose is generally consistent with the time series of momentum returns: when returns are generated by our switching model, the probability of realizing a loss of more than 20% in 13 or more months in a sample of 978 months increases from 0.04% to 90%. The probability of incurring a loss of more than 79% increases from 9.95×10^{-24} to 0.02%.

The time variation in joint distribution of momentum and market returns has been discussed in the literature from a number of perspectives: Kothari and Shanken (1992) and Grundy and Martin (2001) observe that the market beta of momentum strategy returns is a function of past market returns. Rouwenhorst (1998) uncovers a nonlinearity in the momentum-market return relationship using methods suggested by Henriksson and Merton (1981). Boguth, Carlson, Fisher, and Simutin (2011) evaluate potential biases in estimating the momentum strategy alpha that may arise due to this nonlinearity. Daniel and Moskowitz (2011) observe that momentum strategies incur severe losses when the stock market recovers sharply following severe declines, and note the relationship between this nonlinearity and past market returns and volatility.

These empirical findings suggest that the sensitivity of momentum returns to stock market excess return – that is the beta of momentum returns – depends both on past realizations of market excess returns, and on the contemporaneous market excess return and its volatility. Typically, severe market declines and sharp recoveries occur during volatile market conditions, and high volatility periods tend to cluster together and persist. That suggests that the joint distribution of momentum and stock market returns depend on whether the market is volatile or calm. This leads us to use a HMM to describe the joint behavior of momentum and market returns. In our HMM specification, the joint distribution of momentum return and stock market return depends on the hidden state. This parsimonious HMM specification performs better than the other specifications we consider in predicting when large losses are more likely.

Based on this HMM specification, we infer the hidden state of the economy by observing changes in the relationship between momentum returns and market excess returns. Consistent

with the extant findings in the literature, we find that when the hidden state is “*turbulent*,” momentum strategy returns have both a strongly negative beta and the characteristics of a written call on the stock market index. These two features in particular allow us to accurately assess the hidden state.

Our estimation reveals that the distribution from which returns are drawn is more volatile when the market is in the unobserved turbulent state. We find that all the thirteen months with losses exceeding 20% occur during one of the 199 turbulent months when the probability of the market being in the turbulent state exceeds 50%. The probability of observing a loss of 20% or more in thirteen of 199 turbulent months is 60% ³and the large momentum strategy losses become less black swan-like.

A GARCH model of time varying volatility is not as successful as the hidden regime switching models in identifying time periods when large losses are more likely to occur. Our findings are consistent with Ang and Timmerman (2011) who argue in favor of using regime switching models to capture abrupt changes in the statistical properties of financial market variables.

We find that the monthly Sharpe Ratio of momentum returns in months with a predicted probability of being in the turbulent state exceeding 50% is -0.03. When those months are avoided the monthly Sharpe Ratio becomes 0.30, more than twice that for all the months. Momentum becomes more of an anomaly⁴, especially since the HMM based out of sample forecasts are about as good or better.

The rest of the paper is organized as follows. We provide a brief review of related literature in Section 2. We develop the econometric specifications of the HMM for characterizing momentum returns in Section 3. We discuss the empirical findings in Section 4 and examine alternative specifications in Section 5. We conclude in Section 6.

2 Related Literature

Levy (1967) was among the first academic articles to document the profitability of stock price

³Based on 1,000,000 simulations of 199 months each using estimated model parameters and realized probabilities of the unobserved underlying state being turbulent

⁴As Hansen and Jagannathan (1991) observe, the high Sharpe Ratio portfolios pose a challenge to standard asset pricing models.

momentum strategies. However, Jensen (1967) raised several issues with the methodology employed by Levy (1967). Perhaps as a consequence, momentum received little attention in the academic literature until Jegadeesh and Titman (1993), whose long-short portfolio approach has proven rigorous and replicable. A number of studies have subsequently confirmed the Jegadeesh and Titman (1993) findings using data from markets in a number of countries (Rouwenhorst, 1998), and in a number of asset classes (Asness, Moskowitz, and Pedersen, 2008). As Fama and French (2008) observe, the “abnormal returns” associated with momentum are “pervasive.”

Korajczyk and Sadka (2004) show that historical momentum profits remain positive after accounting for transaction costs. Chabot, Ghysels, and Jagannathan (2009) find that momentum strategies earned anomalous returns even during the Victorian era with very similar statistical properties, except for the January reversal, presumably because capital gains were not taxed in that period. Interestingly, they also find that momentum returns exhibited negative episodes once every 1.4 years with an average duration of 3.8 months per episode.

The additional literature on momentum strategies is vast, and can be grouped into three categories: (a) documentation of the momentum phenomenon across countries and asset classes (b) characterization of the statistical properties of momentum returns, both in the time-series and cross-section and (c) theoretical explanations for the momentum phenomenon. We make a contribution to (b). In what follows we provide review of only a few relevant articles that characterize the statistical properties of momentum returns, and refer the interested reader to the comprehensive survey of the momentum literature by Jegadeesh and Titman (2005).

Our work is directly related to several other papers in the literature. First, a number of authors, going back to Jegadeesh and Titman (1993), have noted that momentum strategies can experience severe losses over extended periods. In particular, Griffin, Ji, and Martin (2003) document that there are often periods of several months when momentum returns are negative.

In addition, a large number of papers have explored the time-varying nature of the risk of momentum strategies. Kothari and Shanken (1992) note that, for portfolios formed on the basis of past returns, the betas will be a function of past market returns. Using this intuition, Grundy and Martin (2001) show that beta of momentum returns become negative when the

stock market has performed poorly in the past. Rouwenhorst (1998) documents that momentum returns are nonlinearly related to contemporaneous market returns – specifically that the up market beta is less than their down market beta.⁵ Daniel and Moskowitz (2011) find that this non-linearity is present only following market losses. Building on Cooper, Gutierrez, and Hameed (2004), who show that the expected returns associated with momentum profits depends on the state of the stock market, Daniel and Moskowitz (2011) also show even after controlling for the dynamic risk of momentum strategies, average momentum returns are lower following market losses, and when market volatility is high. They find evidence of these features not only in US equities, but also internationally, and in momentum strategies applied to commodity, currency, and country equity markets. Finally, they show that the factors combine to result in large momentum strategy losses in periods when the market recovers sharply following steep losses.⁶

3 Data and Econometric Specifications

3.1 Data

Price momentum strategies using stocks have been constructed using variety of metrics. For this study we utilize the (12-2) momentum strategy decile portfolio returns available at Ken French’s Data Library.⁷ These portfolios are formed at the beginning of month t by ranking each stock based its cumulative return over the 11 month period from month $t-12$

⁵To our knowledge, Chan (1988) and DeBondt and Thaler (1987) first document that the market beta of a long-short winner-minus-loser portfolio is non-linearly related to the market return, though DeBondt and Thaler (1987) do their analysis on the returns of longer-term winners and losers as opposed to the shorter-term winners and losers we examine here. Rouwenhorst (1998) demonstrates the same non-linearity is present for long-short momentum portfolios in non-US markets. Finally Boguth, Carlson, Fisher, and Simutin (2011), building on the results of Jagannathan and Korajczyk (1986) and Glosten and Jagannathan. (1994) note that the interpretation of the measures of abnormal performance in Chan (1988), Grundy and Martin (2001) and Rouwenhorst (1998) is problematic.

⁶Ambasta and Ben Dor (2010) observe a similar pattern for Barclay’s Alternative Replicator return that mimics the return on a broad hedge fund index. They find that when the hedge fund index recovers sharply from severe losses the replicator substantially under-performs the index. Also, Elavia and Kim (2011) emphasize the need for modeling changing risk for understanding the recent weak performance of quantitative equity investment managers who had over two decades of good performance.

⁷http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html The specific momentum decile portfolios we use are those designated by “10.Portfolios_Prior_12.2.” Data for the CRSP value-weighted market return and the risk-free rate is also taken from this data library.

Table 1: SAMPLE MOMENTS OF MOMENTUM AND MARKET EXCESS RETURNS

This table presents estimates of the first four moments of the monthly return distribution for ‘mom’, the zero-investment momentum portfolio used in the study, and for the CRSP value weighted stock portfolio net of the risk-free rate, $R^M (= r^M - r^f)$. The sample period is 1929:07-2010:12.

	MEAN	STD.DEV	SKEWNESS	KURTOSIS
R^{mom}	1.12%	8.03%	-2.47	21.03
R^M	0.57%	5.50%	0.18	10.48

through month $t-2$.⁸ The decile portfolio returns are the market-capitalization weighted portfolio of the stocks in that past return decile. Most of our analysis will concentrate on the zero-investment portfolio which is long the top past-return decile, and short the bottom decile. The long-short returns are defined as the difference between the top and bottom decile returns.

3.2 Characteristics of Momentum Returns

3.2.1 Descriptive Statistics

Table 1 presents estimates of the moments of the monthly momentum strategy returns, and of the CRSP value-weighted portfolio return, net of the risk-free rate. The monthly momentum strategy returns averages 1.12% per month over this 978 month period, with a monthly Sharpe Ratio of 0.14. In contrast, the realized Sharpe ratio of the market over this period is only 0.10. Moreover, the alpha of momentum strategy is 1.70% per month with respect to the Fama and French (1993) three factor model. When the three Fama and French factors are combined with the momentum portfolio, the maximum achievable Sharpe Ratio rises to 0.28. Note that this is also considerably higher than the maximum Sharpe Ratio achievable with only three Fama French factors, 0.15.

While the momentum strategy has a higher in-sample Sharpe Ratio than the stock index portfolio, Table 1 shows that it exhibits strong excessive kurtosis and negative skewness. The excess kurtosis is also evident from the infrequent but very large losses to the momentum

⁸Skipping one month after the return measurement period is done both to be consistent with the momentum literature, and so as to minimize market microstructure effects and to avoid the short-horizon reversal effects documented in Jegadeesh (1990) and Lehmann (1990).

strategy during the 978 months in the sample period. Given the low unconditional volatility of the momentum strategy, if returns were normal the probability of observing a month with a loss exceeding 42% in a sample of 978 months would be one in 25,000, and the probability of seeing five or more months with losses exceeding 42% would be almost zero. Yet the lowest five monthly returns in the sample are: -79%, -60%, -46%, -44%, and -42%, a rare black swan like occurrence from the perspective of someone who believes that the time series of monthly momentum returns are generated from an *i.i.d.* normal distribution

When returns are simulated using our estimated HMM, the kurtosis is 8.64 for momentum return and 6.11 for market excess return. Simulated momentum returns exhibit some negative skewness, though not as much as in the sample data. Under the HMM model, large losses to momentum strategy become higher: The probability of losses exceeding 40% in five or more months increases to 1.5% from almost zero; and the probability of losses exceeding 20% in thirteen or more months increases to 90% from 0.04%.⁹

In Section 3.3 we describe a hidden Markov model, based on the framework of Hamilton (1989), which we use to capture the behavior of momentum returns. Specifically, we model momentum returns with a mixture of normal distributions where the parameters of the normal distributions depend on the hidden state and contemporaneous market states in possibly nonlinear ways to accommodate the negative skewness of momentum strategy returns. Even though the distribution of returns – *conditional on the hidden state and the current market* – is normal, this model is able to capture the unconditional skewness and kurtosis of the momentum returns to some extent, and the probability of large losses become much more likely.

In what follows we first describe some of the salient characteristics of the joint distribution of momentum strategy and market returns documented in the literature. These features suggest that the beta of momentum strategy returns differs across turbulent and calm market conditions providing a rationale for hidden Markov model specification we use.

3.2.2 Momentum Beta and the Formation Period Market Return

Grundy and Martin (2001), building on the observation of Kothari and Shanken (1992), argue that the momentum portfolio beta will be a function of the market excess return over the

⁹Based on 1,000,000 simulations, in each of which 978 monthly momentum returns are generated.

measurement period.¹⁰

The intuition for the Kothari and Shanken (1992) result is as follows: if the market excess return is negative over the measurement period then, from a Bayesian perspective, the firms which earned the most negative return – *i.e.* the past losers which moved down with the market – are likely to have a higher beta than the past winners. Because the momentum portfolio is long past winners and short past losers, the intuition of Kothari and Shanken (1992) and Grundy and Martin (2001) suggests that the momentum portfolio beta should be negative following bear markets – when the market excess return was negative over the measurement period – and positive following bull markets.

We define the down market indicator I_t^D as having the value of one when the sum of the market excess returns $r_{m,t}$ in the formation period was negative,¹¹ *i.e.* when:

$$I_t^D \equiv \begin{cases} 1 & \text{if } \sum_{s=t-12}^{t-2} R_{m,s} < 0 \\ 0 & \text{otherwise} \end{cases} \quad (1)$$

This suggests the following specification for the joint distribution of momentum and market excess returns:

$$R_t^{\text{mom}} = \alpha + (\beta^0 + \beta^D I_t^D) R_t^M + \epsilon_t. \quad (2)$$

Estimation of this specification over our full sample yields:

	α	β^0	β^D
estimate	1.19	0.12	-1.27
t-stat	5.88	1.35	-8.37

where the t-statistics are computed using standard errors that allow for conditional heteroscedasticity. Consistent with the findings in the literature noted above, β^D is economically and statistically significant, and abnormal return (intercept), controlling for the dynamic market risk, is still significantly positive.

¹⁰See pp. 195-198 of Kothari and Shanken (1992).

¹¹We follow Grundy and Martin (2001) and use the arithmetic sum of the market excess returns during the formation period instead of the compounded total return during the formation period.

3.2.3 Momentum Beta and Contemporaneous Market Returns

As pointed out in Section 2, a number of authors have observed the nonlinear nature of the relationship between the returns on past-return sorted portfolios and contemporaneous market returns.¹² In the language of Henriksson and Merton (1981), momentum’s up-beta is far less than its down-beta. We capture this option-like feature of the momentum portfolio with the following specification:

$$R_t^{\text{mom}} = \alpha + (\beta^0 + \beta^U \cdot I_t^U) R_t^M + \epsilon_t, \quad (3)$$

where I_t^U is an indicator variable which is 1 when the contemporaneous market return is positive, and is zero otherwise:

$$I_t^U \equiv \begin{cases} 1 & \text{if } R_t^M > 0 \\ 0 & \text{otherwise} \end{cases} \quad (4)$$

Estimation of this specification over our full sample yields:

	α	β^0	β^U
estimate	3.27	-0.07	-0.93
t-stat	6.29	-0.64	-3.35

Notice that the estimated up-beta of our momentum portfolio is lower than the down-beta by 0.93, and is again strongly statistically significant. Also, here it is important to note that the estimated α is no longer a valid measure of abnormal performance, since the contemporaneous up-market indicator uses *ex-post* information.¹³

3.2.4 Dependence of Beta on Market Volatility

Boguth, Carlson, Fisher, and Simutin (2011) note the presence of a significant covariance between momentum’s market beta and market volatility leads. Extending the approach of Jagannathan and Wang (1996), they calibrate the magnitude of the bias arising from this covariance.

¹²See, in particular, footnote 5.

¹³See Jagannathan and Korajczyk (1986) and, more recently, Boguth, Carlson, Fisher, and Simutin (2011).

To see whether volatility timing exists in our sample of momentum returns, we estimate the following regression equation:

$$R_t^{\text{mom}} = \alpha + (\beta^0 + \beta^U \cdot I_t^U + \beta^\sigma \cdot \hat{\sigma}_t^M) R_t^M + \epsilon_t, \quad (5)$$

where I_t^U is defined as in (4) and $\hat{\sigma}_t^M$ is the sample standard deviation of daily returns for the value weighted portfolio during the month t . Estimation of this specification over our full sample yields:

	α	β^0	β^U	β^σ
estimate	3.12	0.52	-1.07	-30.17
t-stat	7.57	2.72	-4.40	-3.36

Notice that an increase in the contemporaneous volatility of market excess returns significantly decreases the beta of momentum returns. As in the previous subsection, the estimated α is not a valid measure of abnormal performance, since the contemporaneous up-market indicator and the realized daily standard deviation uses *ex-post* information.

3.2.5 The State Dependence of Momentum’s Optionality

Daniel and Moskowitz (2011) find that momentum portfolios incur large losses when the market recovers sharply following bear markets. For example, the worst five months with the largest losses on the momentum portfolio we discussed have the pattern in Table 2, consistent with the observations in Daniel and Moskowitz (2011).

Table 2: PATTERNS OF HISTORICAL MOMENTUM CRASHES

MONTH	R_t^{mom}	R_t^M	$R^M(t-24, t-1)$
1932/8	-78.96	37.60	-68.35
1932/7	-60.11	33.72	-75.45
2009/4	-45.89	11.05	-44.11
1939/9	-43.94	15.96	-21.50
1933/4	-42.33	38.37	-59.46

Daniel and Moskowitz (2011) note that reason for this pattern is in part because the written call-features of momentum noted in the literature is particularly strong in bear markets. Daniel and Moskowitz (2011) therefore develop a specification in which beta of the momen-

tum portfolio depends both on the long-term past return of the market, and the market's contemporaneous return. Consistent with this, we define two indicator variables. First, we define the bear-market indicator to be equal to 1 if the sum of the market excess returns over the preceding L months is negative¹⁴ :

$$I_t^B \equiv \begin{cases} 1 & \text{if } R^M(t-L, t-1) < 0 \\ 0 & \text{otherwise,} \end{cases} \quad (6)$$

For most of this analysis, we use $L = 24$, consistent with Daniel and Moskowitz (2011).

This motivates the following specification for the momentum return generating process.

$$R_t^{\text{mom}} = \alpha + \begin{pmatrix} \beta^0 \\ +\beta^B \cdot I_t^B \\ +\beta^R \cdot I_t^B \cdot I_t^U \end{pmatrix} R_t^M + \epsilon_t \quad (7)$$

Following Daniel and Moskowitz (2011), we set $L = 24$. Estimation of this specification yields:

	α	β^0	β^B	β^R
estimate	1.71	0.19	-0.96	-0.80
t-stat	8.36	2.83	-7.52	-4.19

As can be seen from the above table,

- $\beta^0 = 0.19$, i.e., the point estimate of the baseline beta is positive and statistically significant, though small.
- $\beta^B = -0.96$, i.e., the momentum beta is significantly negative following bear markets.
- $\beta^R = -0.80$, i.e., the momentum beta is much more negative when the contemporaneous market recovers following a bear market.

3.2.6 Summary

The sensitivity (beta) of momentum strategy return to stock market excess return depends on the return on the market during the momentum portfolio formation period; whether the

¹⁴As before, we follow Grundy and Martin (2001), we use the arithmetic sum of the market excess returns instead of the compounded total return.

market has declined severely during the past two years; the volatility of the market; and the contemporaneous return on the market. One reason we see these patterns is due to the fact that losers tend to be stocks that are highly levered and their returns have pronounced option like features during times when the stock market is depressed. With the result the beta of momentum portfolio becomes large and negative, especially when the market recovers sharply going forward, resulting in momentum crashes. Since the market is often turbulent during such time periods, we assume that there is a single hidden state variable that can capture all these effects, providing a rationale for the hidden Markov model of momentum returns we describe in the next section.

3.3 A Hidden Markov Model of Momentum Strategy Returns

Let S_t denote the unobserved random underlying state of the economy, and s_t the realized state of the economy. We assume that there are two possible states, one is Calm (C) and the other Turbulent (T). Our specification for the momentum portfolio return generating process is as follows:

$$R_t^{\text{mom}} = \alpha(S_t) + \left(\beta^0(S_t) + \beta^U(S_t) \cdot I_t^U \right) R_t^M + \sigma_{\text{mom}}(S_t) \epsilon_t^{\text{mom}}. \quad (8)$$

Here ϵ_t^{mom} is *i.i.d.* $\mathcal{N}(0, 1)$, and $\sigma_{\text{mom}}(S_t)$ denotes the standard deviation of the momentum strategy residual return. Note that the volatility of the residual return is a function of the hidden state. The specification in (8) is the same as the one in (3) except for the dependence of model parameters on the hidden state. We do not explicitly model the dependence of the momentum beta on I_t^D , $\hat{\sigma}^M$ or I_t^B as in the specifications in (2), (5) and (7). Since we expect the hidden state to sufficiently summarize the relevant market conditions, we let the model parameters to be a function of only the hidden state.¹⁵ In addition, we allow momentum beta to depend on contemporaneous market excess return in nonlinear ways, i.e., be a function of the up market indicator variable, I_t^U defined in (4), in order to capture the option-like features of momentum returns.

We further specify that the mean and the variance of the market excess return are also

¹⁵As we will see later, letting beta depend on past market returns and volatility does not improve the model's performance.

functions of the hidden state, specifically

$$R_t^M = \mu(S_t) + \sigma_M(S_t) \epsilon_t^M, \quad (9)$$

where $\epsilon_t^M \sim i.i.d. (0, 1)$.

3.4 Maximum Likelihood Estimation

We estimate the parameters of the hidden Markov model using the maximum likelihood method described in Hamilton (1989). We begin by defining the vector of observable variables of interest at time t , Y_t , as:

$$Y_t = (\mathbf{I}_t^U, R_t^{\text{mom}}, R_t^M)',$$

We let y_t denote the realized value of Y_t . S_t denotes the unobservable random state at time t which, in our setting, is either *calm* or *turbulent*. s_t denotes the particular realized value of the state at date t . $\Pr(S_t = s_t | S_{t-1} = s_{t-1})$ denotes the transition probability of moving from state s_{t-1} at time $t-1$ to state s_t at time t .¹⁶ Finally, \mathcal{F}_{t-1} denote the information set at time $t-1$, *i.e.*, $\{y_{t-1}, \dots, y_1\}$.

The evolution of the two hidden states are determined by the transition probabilities from one state to another. In our estimation, we set $\Pr(S_0 = s_0)$ to the unconditional probabilities, corresponding to the transition probabilities.

Suppose we know the value of $\Pr(S_{t-1} = s_{t-1} | \mathcal{F}_{t-1})$. Then, $\Pr(S_t = s_t | \mathcal{F}_{t-1})$ is given by:

$$\begin{aligned} \Pr(S_t = s_t | \mathcal{F}_{t-1}) &= \sum_{s_{t-1}} \Pr(S_t = s_t, S_{t-1} = s_{t-1} | \mathcal{F}_{t-1}) \\ &= \sum_{s_{t-1}} \Pr(S_t = s_t | S_{t-1} = s_{t-1}, \mathcal{F}_{t-1}) \Pr(S_{t-1} = s_{t-1} | \mathcal{F}_{t-1}) \\ &= \sum_{s_{t-1}} \Pr(S_t = s_t | S_{t-1} = s_{t-1}) \Pr(S_{t-1} = s_{t-1} | \mathcal{F}_{t-1}), \end{aligned} \quad (10)$$

The third equality holds since the transition probabilities depend only on the hidden state. We can compute the expression on the right side of equation (10) using the elements of the

¹⁶Here, we use $\Pr(x)$ to denote the probability of the event x when x is discrete, and the probability density of x when x is continuous.

transition probability matrix, $\Pr(S_t = s_t | S_{t-1} = s_{t-1})$ and $\Pr(S_{t-1} = s_{t-1} | \mathcal{F}_{t-1})$.

Next, we can compute the joint conditional distribution of the hidden state at time t , s_t and observable variables at time t , y_t as follows.

$$\Pr(y_t, S_t = s_t | \mathcal{F}_{t-1}) = \Pr(y_t | S_t = s_t, \mathcal{F}_{t-1}) \Pr(S_t = s_t | \mathcal{F}_{t-1}) \quad (11)$$

The second term of this expression, $\Pr(S_t = s_t | \mathcal{F}_{t-1})$, is given by (10). The first term is the state dependent likelihood of y_t which, under the distributional assumptions from (8) and (9), is given by

$$\begin{aligned} \Pr(y_t | S_t = s_t, \mathcal{F}_{t-1}) &= \frac{1}{\sigma_{\text{mom}}(s_t) \sqrt{2\pi}} \exp \left\{ -\frac{(\epsilon_t^{\text{mom}})^2}{2} \right\} \\ &\times \frac{1}{\sigma_M(s_t) \sqrt{2\pi}} \exp \left\{ -\frac{(\epsilon_t^M)^2}{2} \right\} \end{aligned} \quad (12)$$

where

$$\begin{aligned} \epsilon_t^{\text{mom}} &= \frac{1}{\sigma_{\text{mom}}(S_t)} (R_t^{\text{mom}} - \alpha(S_t) - \beta(S_t, I_t^U) R_t^M) \\ \epsilon_t^M &= \frac{1}{\sigma_M(S_t)} (R_t^M - \mu(S_t)). \end{aligned}$$

The likelihood of y_t given \mathcal{F}_{t-1} is:

$$\Pr(y_t | \mathcal{F}_{t-1}) = \sum_{s_t} \Pr(y_t, S_t = s_t | \mathcal{F}_{t-1}). \quad (13)$$

where the joint likelihood is be calculated using equation (11).

Finally Bayes' rule gives the state probability at t as a function of the contemporaneous information set:

$$\begin{aligned} \Pr(S_t = s_t | \mathcal{F}_t) &= \Pr(S_t = s_t | y_t, \mathcal{F}_{t-1}) \\ &= \frac{\Pr(y_t, S_t = s_t | \mathcal{F}_{t-1})}{\Pr(y_t | \mathcal{F}_{t-1})} \end{aligned} \quad (14)$$

Using (14) to compute $\Pr(S_t = s_t | \mathcal{F}_t)$ and the algorithm described above, we can compute

$\Pr(y_{t+1}|\mathcal{F}_t)$. In this way, we can generate the likelihood $\Pr(y_{t+1}|\mathcal{F}_t)$ for $t \in \{0, 1, \dots, T - 1\}$ and compute the log-likelihood $\mathcal{L} = \sum_{t=1}^T \log(\Pr(y_t|\mathcal{F}_{t-1}))$ given specific values for the unknown parameters that we need to estimate. Now consider the log likelihood function of the sample given by:

$$\mathcal{L} = \sum_{t=1}^T \log(\Pr(y_t|\mathcal{F}_{t-1})), \quad (15)$$

which may be maximized numerically to form estimates of the parameter set

$$\Theta = \left\{ \begin{array}{l} \alpha(C), \beta^0(C), \beta^U(C), \sigma_{\text{mom}}(C) \\ \alpha(T), \beta^0(T), \beta^U(T), \sigma_{\text{mom}}(T) \\ \mu(C), \sigma_M(C), \mu(T), \sigma_M(T) \\ \Pr(S_t = C|S_t = C), \Pr(S_t = T|S_t = T) \end{array} \right\}.$$

We estimate the model parameters by maximizing the log likelihood given by (15), *i.e.*,

$$\Theta_{ML} = \arg \max_{\Theta} \mathcal{L}(\Theta), \quad (16)$$

and use quasi maximum likelihood standard errors for inference.

4 Empirical Results

Table 3 summarizes the maximum likelihood estimates of the model parameters. The baseline beta β^0 is positive for the unobserved *calm* state and negative for the unobserved *turbulent* state. β^U , which captures the written-call like characteristic of the momentum portfolio, is present in both states but much stronger in the *turbulent* state. The momentum return beta during up-markets is $-0.11 (= \beta_C^0 + \beta_C^U = 0.41 - 0.52 = -0.11)$ in the *calm* state, significantly smaller in magnitude than $-1.54 (= \beta_T^0 + \beta_T^U = -0.26 - 1.28 = -1.54)$, the corresponding value of beta in the *turbulent* state. While both the calm and turbulent states are persistent, the probability of remaining in the calm state starting from the calm state is higher.

Table 4 provides the t-statistics for the difference in parameter values across the *calm* and the *turbulent* states. β^0 , the baseline beta, is much higher in the *calm* state. β^U – the parameter that captures the written call feature of the momentum strategy return is

Table 3: MAXIMUM LIKELIHOOD ESTIMATES OF HMM PARAMETERS

This table presents the parameters of the HMM model, estimated using the momentum strategy and the market excess returns over the full sample. QML standard errors are used to compute t-statistics. The ML estimates of α , σ_{mom} and σ_M are each multiplied by 100. The maximized value of the Log-Likelihood is 3.01×10^3 ; and the value of BIC is -5.93×10^3 .

PARAMETER	HIDDEN STATE			
	CALM		TURBULENT	
	MLE	t-STAT	MLE	T-STAT
$\alpha (\times 10^2)$	2.04	6.98	4.02	3.37
β^0	0.41	2.59	-0.26	-1.63
β^U	-0.52	-2.46	-1.28	-4.31
$\sigma_{\text{mom}} (\times 10^2)$	4.32	15.49	11.05	11.62
μ	0.98	6.24	-0.70	-1.14
$\sigma_M (\times 10^2)$	3.62	24.62	9.04	9.42
$\Pr(S_t = s_{t-1} S_{t-1} = s_{t-1})$	0.97	57.87	0.92	15.39

accentuated in the *turbulent* state, resulting in a large negative momentum strategy beta in up-markets. The volatility of the market excess return as well as the residual return of the momentum portfolio are significantly different across two hidden states. They are more than twice as volatile in the turbulent state when compared to the calm state. These differences in parameter values across the two hidden states help us infer the hidden state based on past observations on momentum and market returns. The hidden state being persistent helps in forecasting which state is more likely to prevail in the immediate future.

Table 4: DIFFERENCES IN PARAMETER VALUES ACROSS HIDDEN STATES

	MLE	T-STAT
$\alpha_C - \alpha_T$	-1.99	-1.60
$\beta_C^0 - \beta_T^0$	0.67	3.07
$\beta_C^U - \beta_T^U$	0.76	2.01
$\sigma_{\text{mom}}^C - \sigma_{\text{mom}}^T$	-6.73	-6.95
$\mu_C - \mu_T$	1.68	2.55
$\sigma_M^C - \sigma_M^T$	-5.42	-5.97

Table 5 gives the number of positive and negative momentum strategy returns exceeding a threshold level when the predicted probability of the next month being in the turbulent state

is p or more, where p takes any of the values from 10% to 90% in steps of 10%, for various threshold levels. Each entry represents the fraction of the months with large gains(losses) exceeding a given threshold level during months when the underlying state is *turbulent* with a probability exceeding p .

It is natural to classify months as being turbulent when the unobserved underlying state is *turbulent* with a probability exceeding 50%. When we estimate the model using the entire sample, all 13 months in which the momentum strategy losses exceed 20% occur during months in which $\Pr(S_t = T|\mathcal{F}_{t-1}) > 50\%$.¹⁷ However, there are 11 months in which the momentum strategy return exceeds 20%, and only 8 of those 11 months have $\Pr(S_t = T|\mathcal{F}_{t-1}) > 50\%$. That is, the predicted probability of the next month being in the turbulent state is more informative about the likelihood of large losses than large gains.

Next, we examine the out of sample performance of the hidden Markov model to identify months when large losses to the momentum strategy are more likely based on ex ante information in real time. For that purpose we use an expanding window to estimate the model parameters and that gives us real time predicted probability of the next month being in the turbulent state for 400 months. In particular, for each month $t = T - 399, \dots, T$, we estimate the model parameters using maximum likelihood using data for the months $\{1, \dots, t - 1\}$. The first out-of-sample month is September 1977 and the last is December 2010.

From Table 6 we can see that, over the out-of-sample period, there were 5 months in which the momentum strategy lost more than 20%. All of these large losses occurred during the 79 months when the probability of the market being in the turbulent state exceeds 50%. Indeed, *all of these losses occurred when the turbulent state probability exceeds 90%*. In contrast, it is difficult to predict when large gains are more likely: There were 4 months in which gains exceeded 20%, but only 2 of them occurred during months in which the probability of being in the turbulent state exceeded 50%. Note also that *none of these large gains were realized when the turbulent state probability exceeded 90%*.

This asymmetry is probably due to the fact that momentum crashes tend to occur when the market recovers from steep losses but there are no corresponding gains when market continues to depreciate instead of recovering. Interestingly, during the three consecutive

¹⁷There are a total of 199 months, out of a total of 978 months in the sample, in which $\Pr(S_t = T|\mathcal{F}_{t-1}) > 50\%$.

Table 5: LARGE MOMENTUM STRATEGY LOSSES/GAINS IN TURBULENT/CALM MONTHS
– IN SAMPLE

Pr ($S_t=T \mathcal{F}_{t-1}$) IS MORE THAN	# LOSSES CAPTURED/TOTAL #LOSSES					# OF MONTHS
	$\leq -10\%$	$\leq -12.5\%$	$\leq -15\%$	$\leq -17.5\%$	$\leq -20\%$	
90%	19/53	16/35	14/31	10/21	7/13	87
80%	27/53	24/35	21/31	17/21	12/13	131
70%	30/53	26/35	23/31	18/21	13/13	158
60%	31/53	27/35	24/31	19/21	13/13	188
50%	32/53	27/35	24/31	19/21	13/13	199
40%	34/53	28/35	25/31	20/21	13/13	225
30%	37/53	29/35	26/31	20/21	13/13	252
20%	40/53	31/35	28/31	20/21	13/13	291
10%	43/53	33/35	30/31	21/21	13/13	342

Pr ($S_t=T \mathcal{F}_{t-1}$) IS MORE THAN	# GAINS CAPTURED/TOTAL #GAINS					# OF MONTHS
	$\geq 10\%$	$\geq 12.5\%$	$\geq 15\%$	$\geq 17.5\%$	$\geq 20\%$	
90%	21/66	12/41	6/26	4/14	3/11	87
80%	29/66	18/41	12/26	7/14	5/11	131
70%	33/66	22/41	16/26	10/14	8/11	158
60%	39/66	27/41	18/26	10/14	8/11	188
50%	40/66	28/41	18/26	10/14	8/11	199
40%	40/66	28/41	18/26	10/14	8/11	225
30%	44/66	29/41	19/26	11/14	9/11	252
20%	47/66	31/41	20/26	11/14	9/11	291
10%	50/66	31/41	20/26	11/14	9/11	342

months in 2009 during which momentum experienced large losses, the probability of the turbulent state exceeded 0.97, as can be seen from Table 7.

The association between large losses and the turbulent state probability is further illustrated in Figure 1 using the entire sample and in Figure 2 using an expanding window in real time. The vertical axis is the realized momentum return and the horizontal axis is the predicted probability of the month being in a turbulent state. As can be seen, the scatter plot fans out with lot more dispersion when we move from the left to the right, providing a visual measure of the ability of the hidden Markov model to predict months when large losses are more likely. Note that months losses exceeding 20% per month occur when the probability

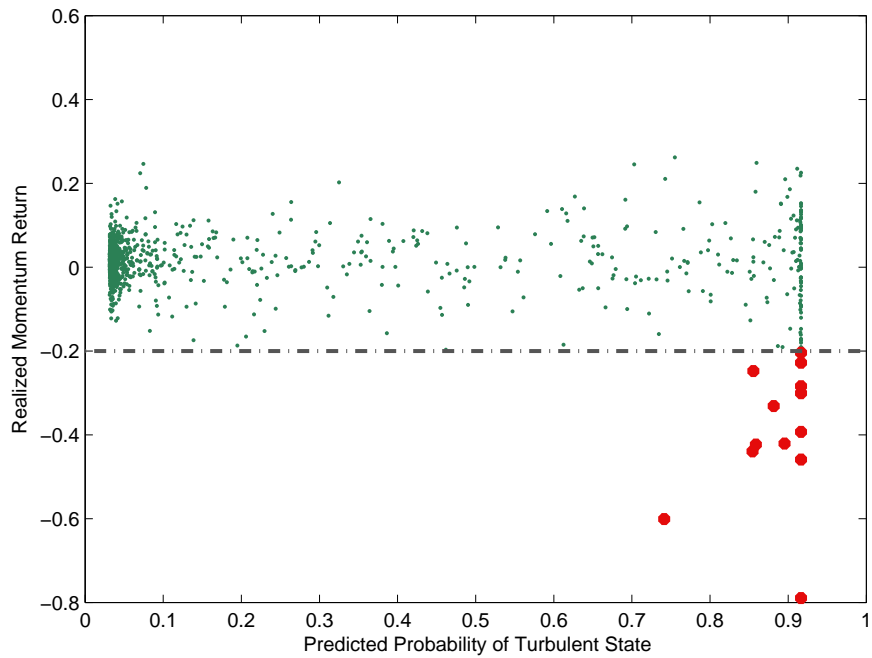


Figure 1: Momentum Returns & Probability Of Hidden State Being Turbulent (In-sample)

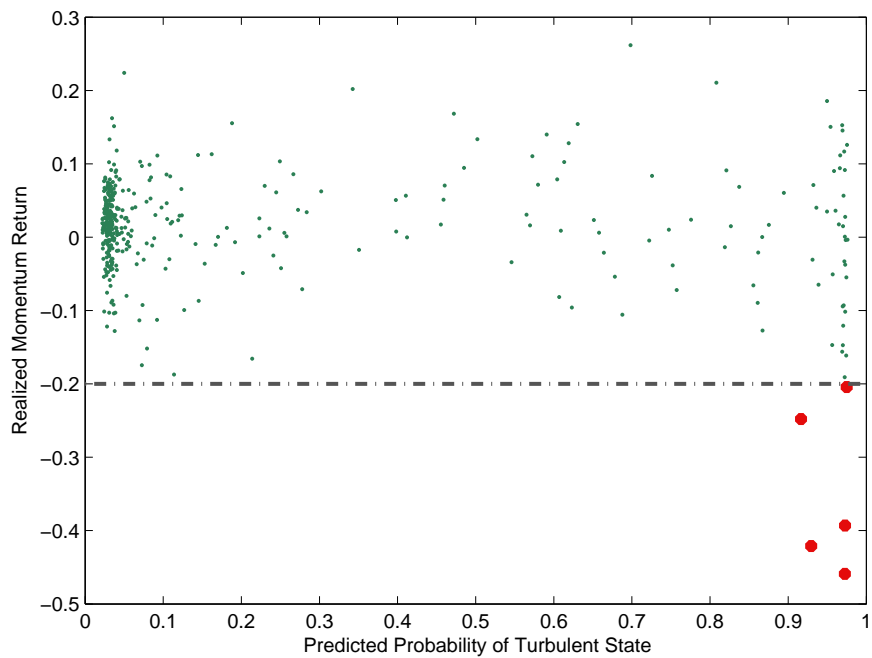


Figure 2: Momentum Returns & Probability Of Hidden State Being Turbulent (Out-of-sample)

Table 6: LARGE MOMENTUM STRATEGY LOSSES/GAINS IN TURBULENT/CALM MONTHS
– OUT OF SAMPLE

Pr ($S_t=T \mathcal{F}_{t-1}$) IS MORE THAN	# LOSSES CAPTURED/TOTAL #LOSSES					# OF MONTHS
	$\leq -10\%$	$\leq -12.5\%$	$\leq -15\%$	$\leq -17.5\%$	$\leq -20\%$	
90%	12/26	10/16	8/12	6/7	5/5	41
80%	13/26	11/16	8/12	6/7	5/5	53
70%	13/26	11/16	8/12	6/7	5/5	59
60%	14/26	11/16	8/12	6/7	5/5	72
50%	14/26	11/16	8/12	6/7	5/5	79
40%	14/26	11/16	8/12	6/7	5/5	86
30%	14/26	11/16	8/12	6/7	5/5	91
20%	15/26	12/16	9/12	6/7	5/5	107
10%	16/26	13/16	10/12	7/7	5/5	132

Pr ($S_t=T \mathcal{F}_{t-1}$) IS MORE THAN	# GAINS CAPTURED/TOTAL #GAINS					# OF MONTHS
	$\geq 10\%$	$\geq 12.5\%$	$\geq 15\%$	$\geq 17.5\%$	$\geq 20\%$	
90%	7/29	5/18	3/12	1/5	0/4	41
80%	8/29	6/18	4/12	2/5	1/4	53
70%	8/29	6/18	4/12	2/5	1/4	59
60%	12/29	9/18	6/12	3/5	2/4	72
50%	15/29	11/18	6/12	3/5	2/4	79
40%	16/29	12/18	7/12	3/5	2/4	86
30%	17/29	13/18	8/12	4/5	3/4	91
20%	18/29	13/18	8/12	4/5	3/4	107
10%	21/29	14/18	9/12	4/5	3/4	132

being in the turbulent hidden state exceeds 70%, both in and out of sample. In the out of sample period, all of the large losses and no large gains are realized when the turbulent state probability exceeds 90%, occur

As can be seen from Panel A of Table 8 the distribution of momentum returns depend on whether the hidden state is more likely to be turbulent or calm. The estimated Sharpe Ratio of momentum returns in months when the hidden state is more likely to be calm is more than double the estimated unconditional Sharpe Ratio. If we classify the sample with the threshold level of 50% predicted probability for the hidden state being turbulent, then out of the 978 months 199 months are turbulent and 779 months are calm. The average momentum

Table 7: PROBABILITY OF HIDDEN STATE BEING TURBULENT DURING MOMENTUM CRASHES – OUT OF SAMPLE

DATE	$\Pr(S_t = T \mathcal{F}_{t-1})$	R_t^{mom}
MAR 2009	0.9728	-39.32
APR 2009	0.9726	-45.89
MAY 2009	0.9723	-19.08

return is negative in turbulent months, but not statistically different from zero. Strikingly, the average return in turbulent months is a full 2%/month lower than the average in calm months, and this difference increases as the threshold probability increases. Momentum returns and almost three times more volatile in turbulent months, compared to calm months.

For comparison, we also report the corresponding statistics for the market excess return in the panel B of table 8. While market volatility is quite different in calm and turbulent states, the average returns are almost equal in calm and turbulent months, consistent with the observations in Breen, Glosten, and Jagannathan (1989).

The properties of momentum and market returns during the out of sample period is summarized in Table 9. With the threshold level of 50% for the probability for the month being in the turbulent state, about 80% of the sample months are classified as *calm* and 20% of the months are classified as *turbulent*. The characteristics of momentum returns for the out-of-sample months are similar to that during the in-sample results. As we increase threshold level for the probability of the underlying state being turbulent in a given month, the sample mean of the momentum returns during turbulent months decrease while the sample mean of the market excess returns increase. With the threshold level of 90% for the probability for being in the turbulent state, which classifies 10% of the 400 out-of-sample as *turbulent*, the Sharpe ratio of momentum returns for turbulent months becomes, -0.26. The Sharpe Ratio of market returns during those months is 0.38, rather high. This is to be expected since momentum crashes tend to occur when the market recovers, as observed by Daniel and Moskowitz (2011).

Figure 3, plots the time series of the estimated predicted probability of the hidden state being turbulent in a given calendar month along with an indicator as to whether it is recession month according to NBER. As can be seen, there is not much of a relationship between the

Table 8: RETURNS IN TURBULENT AND CALM MONTHS

Months with $\Pr(S_t=T|\mathcal{F}_{t-1})$ exceeding the threshold level are counted as *turbulent* and other months are counted as *calm*.

PANEL A: MOMENTUM RETURNS
FORECAST STATE

$\Pr(S_t=T \mathcal{F}_{t-1})$	CALM				TURBULENT			
	MEAN	SD	SR	MONTHS	MEAN	SD	SR	MONTHS
10%	1.64	4.62	0.35	636	0.16	11.99	0.01	342
20%	1.62	4.82	0.34	687	-0.06	12.67	-0.00	291
30%	1.58	4.93	0.32	726	-0.20	13.36	-0.01	252
40%	1.58	5.05	0.31	753	-0.43	13.89	-0.03	225
50%	1.53	5.14	0.30	779	-0.47	14.54	-0.03	199
60%	1.54	5.17	0.30	790	-0.62	14.86	-0.04	188
70%	1.59	5.32	0.30	820	-1.30	15.72	-0.08	158
80%	1.54	5.91	0.26	847	-1.60	15.79	-0.10	131
90%	1.35	6.79	0.20	891	-1.27	15.79	-0.08	87

PANEL B: MARKET EXCESS RETURNS
FORECAST STATE

$\Pr(S_t=T \mathcal{F}_{t-1})$	CALM				TURBULENT			
	MEAN	SD	SR	MONTHS	MEAN	SD	SR	MONTHS
10%	0.68	4.10	0.17	636	0.37	7.45	0.05	342
20%	0.61	4.25	0.14	687	0.49	7.71	0.06	291
30%	0.56	4.31	0.13	726	0.60	8.02	0.08	252
40%	0.55	4.32	0.13	753	0.64	8.33	0.08	225
50%	0.61	4.39	0.14	779	0.44	8.60	0.05	199
60%	0.55	4.40	0.13	790	0.65	8.75	0.07	188
70%	0.50	4.45	0.11	820	0.95	9.22	0.10	158
80%	0.52	4.63	0.11	847	0.94	9.38	0.10	131
90%	0.56	5.07	0.11	891	0.65	8.82	0.07	87

Table 9: RETURNS IN TURBULENT AND CALM MONTHS (OUT OF SAMPLE)
Months with $\Pr(S_t=T|\mathcal{F}_{t-1})$ exceeding the threshold level are counted as *turbulent* and other months are counted as *calm*.

PANEL A: MOMENTUM RETURNS									
FORECASTED STATE									
$\Pr(S_t=T \mathcal{F}_{t-1})$	CALM				TURBULENT				
	MEAN	SD	SR	MONTHS	MEAN	SD	SR	MONTHS	
10%	1.63	5.10	0.32	268	0.40	11.14	0.04	132	
20%	1.59	5.30	0.30	293	0.20	11.88	0.02	107	
30%	1.54	5.37	0.29	309	0.15	12.60	0.01	91	
40%	1.61	5.45	0.30	314	-0.20	12.74	-0.02	86	
50%	1.72	5.49	0.31	321	-0.80	13.05	-0.06	79	
60%	1.83	5.55	0.33	328	-1.53	13.31	-0.11	72	
70%	1.87	5.82	0.32	341	-2.55	13.65	-0.19	59	
80%	1.84	5.81	0.32	347	-2.84	14.29	-0.20	53	
90%	1.82	5.93	0.31	359	-4.03	15.39	-0.26	41	

PANEL B: MARKET EXCESS RETURNS									
FORECAST STATE									
$\Pr(S_t=T \mathcal{F}_{t-1})$	CALM				TURBULENT				
	MEAN	SD	SR	MONTHS	MEAN	SD	SR	MONTHS	
10%	0.70	6.79	0.10	268	0.74	6.42	0.12	132	
20%	0.61	6.90	0.09	293	0.99	6.00	0.16	107	
30%	0.71	7.10	0.10	309	0.73	4.96	0.15	91	
40%	0.68	7.05	0.10	314	0.83	5.07	0.16	86	
50%	0.66	7.00	0.09	312	0.93	5.11	0.18	79	
60%	0.59	7.02	0.08	328	1.24	4.74	0.26	72	
70%	0.58	6.95	0.08	341	1.50	4.71	0.32	59	
80%	0.53	6.98	0.08	347	1.89	3.90	0.48	53	
90%	0.61	6.88	0.09	359	1.63	4.25	0.38	41	

month being in an NBER recession and the associated probability of the state being turbulent.

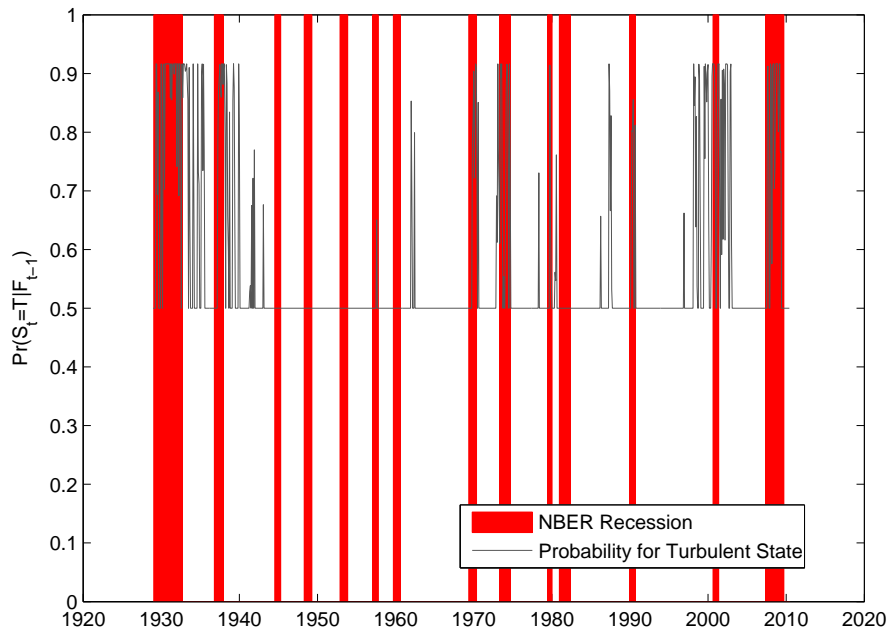


Figure 3: **NBER Recessions & Probability Of The Hidden State Being Turbulent**

We also examine the association between the probability of the state being turbulent in a given month and likelihood of a momentum crash during that month using the following Probit model:

$$\Pr(R_t^{\text{mom}} < \text{THRESHOLD LOSS}) = \Phi(a + b \Pr(S_t = T | \mathcal{F}_{t-1})) \quad (17)$$

where Φ is the CDF of standard normal distribution and THRESHOLD LOSS is a critical level that defines a momentum crash. This specification helps us evaluate whether $\Pr(S_t = T | \mathcal{F}_{t-1})$ is related to the left tail of momentum returns. We consider $\text{THRESHOLD LOSS} = -10\%, -12.5\%, -15\%, -17.5\%$. Table 10 gives the estimated parameter values and the associated t-statistics for the Probit model in equation (17) for the in-sample as well as the out-of-sample estimates of $\Pr(S_t = T | \mathcal{F}_{t-1})$. Except for the case when $\text{THRESHOLD LOSS} = -20\%$ out-of-sample, b , the coefficient on $\Pr(S_t = T | \mathcal{F}_{t-1})$, is positive and statistically significant. The statistical insignificance for $\text{THRESHOLD LOSS} = -20\%$ out-of-sample, is probably due to there being too few months

with large losses during the out-of-sample period. Interestingly, the size of b monotonically increases as we lower `THRESHOLD LOSS` from -10% to -20% , indicating that the probability of *more* extreme losses are *more* likely when $\Pr(S_t = T | \mathcal{F}_{t-1})$ is high.

Table 10: PROBIT MODEL OF MOMENTUM CRASHES

THRESHOLD LOSS	IN SAMPLE		OUT OF SAMPLE	
	a	b	a	b
-10%	-2.11 (-19.08)	1.40 (7.41)	-1.89 (-13.20)	1.16 (4.49)
-12.5%	-2.60 (-15.35)	1.84 (7.47)	-2.34 (-11.44)	1.51 (4.81)
-15%	-2.67 (-14.62)	1.84 (7.03)	-2.42 (-10.89)	1.40 (4.08)
-17.5%	-3.24 (-9.60)	2.33 (5.45)	-3.01 (-7.34)	1.84 (3.53)
-20%	-5.04 (-3.20)	4.13 (2.29)	-7.14 (-1.56)	6.14 (1.28)

5 Alternative Specifications

In this section, we examine alternative specifications for the stochastic process governing the temporal evolution of momentum returns and market excess returns. We relax the mean equation in the regime Switching model and let the beta of the momentum return to depend on past market conditions. We find that the more general specification is not necessarily better in terms of identifying months when large losses are more likely. We also evaluate a bivariate GARCH model of momentum and market excess returns.

For HMM, consider the following extended specification:

$$R_t^{\text{mom}} = \alpha(S_t) + \begin{pmatrix} \beta^0(S_t) \\ + \beta^D(S_t) I_t^D \\ + \beta^U(S_t) I_t^U \\ + \beta^R(S_t) I_t^B I_t^U \end{pmatrix} R_t^M + \sigma_{\text{mom}}(S_t) \epsilon_t^{\text{mom}}. \quad (18)$$

$$R_t^M = \mu(S_t) + \sigma_M(S_t) \epsilon_t^M, \quad (19)$$

Comparing to the equations (8) and (9), the above specification differs in that the beta of momentum portfolios can depend on past market conditions. We consider variations of the HMM specification by restricting the model parameters as given below:

$$\begin{aligned}
\text{Main:} & \quad \beta^R = 0, \beta^B = 0 \\
\text{Alt-1:} & \quad \text{No Restriction} \\
\text{Alt-2:} & \quad \beta^U = 0 \\
\text{Alt-3:} & \quad \beta^U = 0, \beta^R = 0 \\
\text{Alt-4:} & \quad \beta^U = 0, \beta^R = 0, \beta^B = 0
\end{aligned}$$

Alt-1 is the most general specification. Alt-2 is similar to the specification in Daniel and Moskowitz (2011). Alt-3 captures the effects documented in (Grundy and Martin, 2001). Alt-4 corresponds to the market model. Note that Alt-2, Alt-3, Alt-4 and Main are nested within Alt-1. For I_t^B as in (6), we consider $L = 12, 24, 36$.

We also estimate the bivariate GARCH model given below:

$$R_t^{\text{mom}} = \alpha + \left(\beta^0 + \beta^U \cdot I_t^U \right) R_t^M + \sigma_{\text{mom},t} \epsilon_t^{\text{mom}}. \quad (20)$$

$$R_t^M = \mu + \sigma_{M,t} \epsilon_t^M, \quad (21)$$

where ϵ_t^{mom} and ϵ_t^M are drawn from i.i.d standard normal distributions, and $\sigma_{\text{mom},t}$ and $\sigma_{M,t}$ evolve according to the bivariate GARCH process given below:

$$\sigma_{\text{mom},t}^2 = \sigma_{\text{mom},0}^2 + p_1 \sigma_{\text{mom},t-1}^2 + q_1 \left(\sigma_{\text{mom},t-1} \epsilon_{t-1}^{\text{mom}} \right)^2 \quad (22)$$

$$\sigma_{M,t}^2 = \sigma_{M,0}^2 + p_2 \sigma_{M,t-1}^2 + q_2 \left(\sigma_{M,t-1} \epsilon_{t-1}^M \right)^2 \quad (23)$$

Table 11 gives ML estimates of the parameters for the various specifications given in (20), (21), (22) and (23).

For the bivariate GARCH model, using the estimated parameter values, we compute $Std(R_t^{\text{mom}} | \mathcal{F}_{t-1})$, the conditional volatility of the momentum return for each month and use it as a measure of the tail-risk of the momentum returns.

In Figure 4 we plot the realized momentum return in a month against its standard deviation according to the bivariate GARCH model. A comparison of Figure 4 with Figures 1

Table 11: GARCH MODEL PARAMETER ESTIMATES

MEAN-RETURN			GARCH OF MOM			GARCH OF MKT		
	MLE	T-STAT		MLE	T-STAT		MLE	T-STAT
α	2.11	8.83	$\sigma_{\text{mom},0}^2$	3.46	3.82	$\sigma_{\text{M},0}^2$	0.69	2.99
β^0	0.19	2.97	p_1	0.63	11.05	p_2	0.85	41.68
β^U	-0.55	-5.56	q_1	0.34	5.35	q_2	0.13	5.98
μ	0.71	5.37						

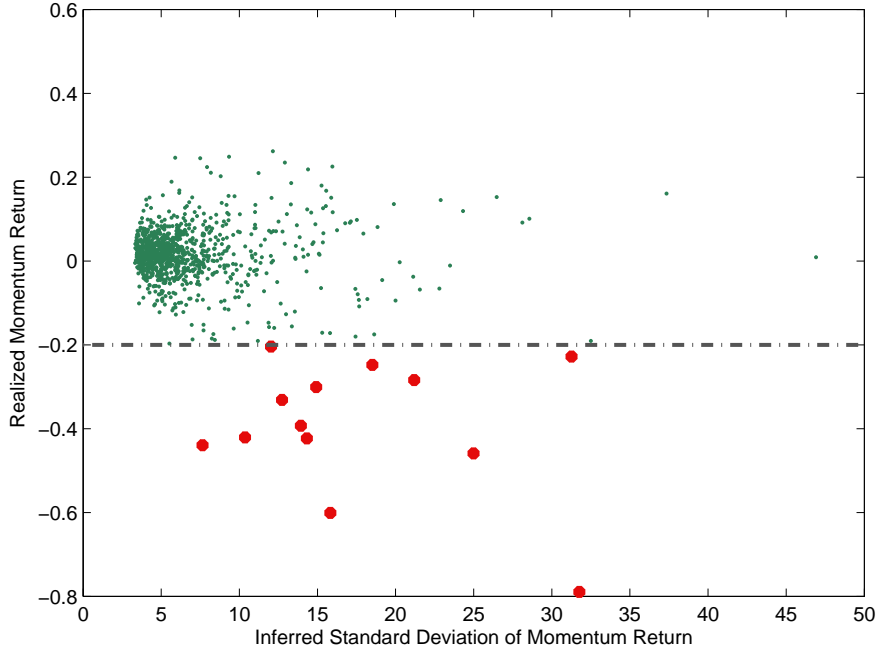


Figure 4: **Realized Momentum vs GARCH forecast of Volatility**

and 2 indicates that the association between momentum losses in a month and the riskiness of the month as measured by the standard deviation of momentum return during that month is not as strong for the bivariate GARCH model.

For comparing different models, we count the minimum number of months to be classified as *turbulent* such that all months with large losses (exceeding a threshold) occur during those *turbulent* months. Let i_t denote the predicted level of tail-risk in a month: $i_t \equiv \Pr(S_t = T | \mathcal{F}_{t-1})$ for HMM and $i_t \equiv Std(R_t^{\text{mom}} | \mathcal{F}_{t-1})$ for GARCH. For each threshold level of large loss \underline{L} , we pick an $\underline{i(L)}$ such that months exceeding the threshold level of loss \underline{L} occur during months with $i_t > \underline{i(L)}$ that are classified as being turbulent. We then count the

number of *turbulent* months corresponding to each threshold loss \underline{L} . We view the model that require classifying fewer number of months as being *turbulent* to capture months with large momentum losses as better.

Table 12 reports the number of months, the negative of a measure of a model to identify months when large losses are more likely. For extreme losses exceeding 20%, HMM specifications are much more effective than GARCH. Among HMM models, for $L = 12$, Alt-1 and Alt-2 require smaller number of months than the Main Model, but the differences are small. For out-of-sample months, the Main Model classifies 40 months as turbulent months, in contrast to 87 months classified as turbulent months with GARCH model. Also, among various HMM specifications, the Main HMM performs as well or better.

In Section 4, we observed that the relation between the probability of large gains and the probability of the hidden state being turbulent was weaker the corresponding relation for large losses. We therefore compare the sample mean of momentum returns during months for turbulent and calm months. If an indicator for the momentum risk can detect large losses only, the sample mean will be significantly negative for turbulent months.

The properties of momentum returns during turbulent months – i.e., months when the probability for the hidden state being turbulent(HMM criterion) or conditional standard deviation of momentum returns(GARCH criterion) are sufficiently high to identify all months with losses exceeding a given threshold level – are reported in table 13. Interestingly, with a -20% threshold loss, with HMM, *less* months are classified as turbulent; the sample mean of momentum returns during turbulent months is *lower*; and the sample standard deviation of momentum returns during turbulent months is *higher*, when compared to the GARCH model.

For out-of-sample months, the differences becomes more significant. With the threshold loss of -20%, *less* than a half months are classified as turbulent with HMM when compared to GARCH. The sample mean of momentum returns during the 40 turbulent months is -3.51% per month for HMM. With the GARCH model, the average momentum return is -0.11% per month during the 87 months classified as being turbulent. Furthermore, as we lower the level of threshold loss from -10% to -20%, the standard deviation of momentum returns during turbulent months increases much more for HMM when compared to GARCH.

Table 12: Comparison of Models: Number of Turbulent Months to Capture Large Losses

THRESHOLD LOSS	MODEL	IN SAMPLE			OUT OF SAMPLE				
		L=12	L=24	L=36	L=12	L=24	L=36		
-10%	Main	941					381		
	Alt-1		965	959	964		389	384	388
	Alt-2		970	960	962		382	388	385
	Alt-3	970							383
	Alt-4	951							382
	GARCH	942							396
-12.5%	Main	570							205
	Alt-1		497	495	499		201	201	204
	Alt-2		506	464	484		223	199	210
	Alt-3	557							250
	Alt-4	601							246
	GARCH	480							185
-15%	Main	368							147
	Alt-1		378	378	390		147	152	149
	Alt-2		399	379	388		164	150	162
	Alt-3	422							173
	Alt-4	420							179
	GARCH	480							157
-17.5%	Main	292							123
	Alt-1		274	276	275		125	119	122
	Alt-2		286	283	281		140	122	127
	Alt-3	300							145
	Alt-4	323							160
	GARCH	480							133
-20%	Main	148							40
	Alt-1		147	153	156		51	52	54
	Alt-2		145	184	156		50	49	52
	Alt-3	176							48
	Alt-4	154							41
	GARCH	236							87

Table 13: HMM vs GARCH: NUMBER OF TURBULENT MONTHS TO CAPTURE LARGE LOSSES (IN SAMPLE)

THRESHOLD LOSS	HMM			GARCH		
	# OF MONTHS	MEAN	STD	# OF MONTHS	MEAN	STD
-10%	941	1.11	8.16	942	1.08	8.16
-12.50%	570	0.97	9.89	480	0.60	10.56
-15%	368	0.19	11.64	480	0.60	10.56
-17.50%	292	-0.05	12.65	480	0.60	10.56
-20%	148	-0.92	15.26	236	-0.10	13.37

Table 14: HMM vs GARCH: NUMBER OF TURBULENT MONTHS TO CAPTURE LARGE LOSSES (OUT OF SAMPLE)

THRESHOLD LOSS	HMM			GARCH		
	# OF MONTHS	MEAN	STD	# OF MONTHS	MEAN	STD
-10%	381	1.25	7.78	396	1.23	7.65
-12.50%	205	0.86	9.71	185	0.43	10.12
-15%	147	0.45	10.83	157	0.58	10.57
-17.50%	123	0.42	11.34	133	0.66	11.02
-20%	40	-3.51	15.22	87	0.11	11.98

6 Conclusion

Momentum strategies are widely used by active quantitative portfolio managers and individual investors. These strategies generate large positive returns on average with little systematic risk as measured using standard asset pricing models and remain an anomaly.

In this paper we examine the monthly returns of a widely examined equity price momentum strategy. Over our July 1929 - December 2010 sample, the strategy excess returns average 1.12%/month, and yield an alpha of 1.70%/month with respect to the Fama and French (1993) three-factor model. Momentum strategy returns, when combined with the Fama and French factors, gives rise to a portfolio with a monthly Sharpe Ratio of almost 0.28.

However momentum strategies also suffer infrequent, but large losses. Over our sample, there are 13 months in which losses exceed 20%/month. The probability of such an event occurring if momentum strategy returns were independently and normally distributed would

be 0.04%. We show that such periodic but rare large loss episodes can be captured by a two state hidden Markov model, where one state is turbulent and the other is calm. We find that it is possible to predict which of the two hidden state the economy is in with some degree of confidence. All the 13 months with losses exceeding 20%/month occur during turbulent months, *i.e.*, months when the predicted probability of the hidden state being turbulent exceeds 0.5. The probability of 13 months with losses exceeding 20% increases to 60% and momentum losses are less Black Swan-like. Momentum returns averaged -0.47%/month during turbulent months, with a Sharpe Ratio of -0.03. When such turbulent states are avoided, the momentum strategy's monthly Sharpe Ratio increases to 0.30 – slightly more than double the unconditional Sharpe ratio of 0.14. The striking performance of the price momentum strategy in the calm months poses still more of a challenge to standard asset pricing models.

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