CHAPTER 1

INTRODUCTION

1.1 Background

There has been a huge debate among scholars for the last decades regarding the shifting paradigm from neoclassical into the one that currently well known as behavioral based paradigm. In neoclassical or traditional finance, efficient market hypotheses proposed by Fama (1970) has become the foundation as well as pillars. The basic assumption of efficient market hypotheses is that the movement of the price in the past cannot be used to predict the price in the future. According to Fama (1970), the price of stocks or bonds formed is basically a reflection from all available information. Meaning to say, price are quickly influenced due to immediate transformation or information. Therefore, there is no scope for abnormal return by investors or investors have no room to utilize the situation to get abnormal return under efficient market concept.

However, several years later many researchers criticized Fama (1970) by providing empirical evidences showing that there are psychological biases that consequently make investors behave irrationally in the market. The finding of Kahneman and Tversky (1979) was the first documented that not all investors are rational in making his/her investment decisions. Furthermore, the bias decisions are proven to be structured and systematic. Thus, contrary to the previous traditional

model, in behavioral based model did prove in achieving abnormal returns in the market. These challenges led to the introduction of behavioral finance theory.

The existence of behavioral finance in the literature created market anomaly. According to George and Elton (2001), anomaly is a term that is generic in nature and it applies to any fundamental novelty of fact, new and unexpected phenomenon or a surprise with regard to any theory, model or hypothesis. Shortly speaking, behavioral finance theory explains why investors make financial or investment decisions irrationally by combining their behavior as well as cognitive psychology with economics and finance. In contrast to traditional efficient market hypothesis, in behavioral finance theory, there is a possibility to beat the market by predicting and forming trading strategies in the market (Conrad & Kaul, 1998)

A trading strategy is defined as purchasing or selling securities in the stock market by using the previous security price at a particular observed period as its base. In recent years, many academic scholars as well as practitioners have done research and found some trading strategies can beat the market and give significantly abnormal profits (Conrad & Kaul, 1998). Two popular strategies currently being investigated as well as being applied by most practitioners are momentum and contrarian strategies. Both momentum and contrarian strategies are truly triggering a dramatic resurgence debate among academics scholars whether or not return on assets can be predicted by using past performance as its based. Momentum and contrarian

strategy showed that the anomaly in the market does exist and most importantly these strategies prove that the market is not efficient.

According to De Bondt and Thaler (1985), the contrarian strategy is a strategy of holding portfolios where each period the portfolio holdings are considered by a simple rule of buying past losers and selling past winners. The idea of this strategy is that investors or practitioners believed the trend of past loser stocks will reverse and the price will turn into the opposite direction. On the contrary, the momentum strategy is a strategy of buying past winners and selling past losers (Jegadeesh & Timan, 1993). The idea of this strategy is price continuation where the trend will not change and the price will follow.

De Bondt and Thaler (1985) were the first to document the phenomenon of long-term reversal in the US market. The past loser stocks have been proven to give abnormal returns for long investment horizons and also the past loser stocks successfully outperformed the long-term past winner stocks. Specifically, De Bondt and Thaler (1985) documented that firms with poor performance over the past three to five years have better performance in the future. Besides, this strategy can earn the following excess return of about 8% in the US market.

The works of De Bondt and Thaler (1985) was further being criticized among scholars. Some have argued that the results of theirs technically can be explained by the systematic risks of investor's portfolio and the size effect. Afterwards, Jegadeesh

and Titman (1993) documented the profitability of short-term momentum strategies where buying past winners and selling past losers successfully earned abnormal return. They found that in the short-term period of 3-12 months, the price will follow its trend or what is so called as price continuation. Thus, in the short-term period, abnormal return can be earned by using the momentum strategy. This result was obviously in contrast with the result of De Bondt and Thaler (1985) where they recommend to buy past losers stocks and selling past winner stocks in forming investors portfolios.

The success of both momentum and contrarian strategies in the market surely has attracted a high attention among academician's as well as practitioners. Many researchers have developed the works of De Bondt and Thaler (1985) and Jegadeesh and Titman (1993) regarding these strategies. Rouwenhorst (1998) tried to explore a broader spectrum by using 12 European Countries as his objects. He documented that price continuation is present in 12 samples of European countries. The similar work has also done by Schneider and Gaunt (2012) in Australian Stock markets where the results showed that the price continuation exists. The increase of the interest among scholars in exploring these anomalies surely enriches the literature. However, even if there has been many empirical and statistical evidence supporting the existence of these strategies, there are still few researches being conducted in emerging markets. Consequently, it makes a huge gap in the existing literature. The basis of those statements is that by nature there has been a high tendency of developed markets that

differs from emerging markets. Thus, the anomalies of efficient market hypotheses are supposed to be tested in the wider range especially in emerging markets.

There are several researches documented the presence of efficient market hypothesis anomalies as well as momentum contrarian strategies in emerging markets. Ali, Ahmad and Anusakumar (2013) documented momentum profits are found in Malaysia with 1-52 weeks holding period. Furthermore, Luxianto (n.d) documented that the momentum strategy is effectively applicable for the winner stock while on the other hand the contrarian strategy is effectively applicable for the loser stocks in Indonesian stock exchange. The argumentation as well as the description above showed the interest of researcher to conduct research and examine the presence of momentum and contrarian in Indonesian stock exchange. This research further is going to use two different testing methodologies to evaluate the robustness of the results. The first method is by using market adjusted model as abnormal return calculation to evaluate the effectiveness of both momentum and contrarian strategies. In addition, this study will add a more sophisticated model developed by Sharpe (1964) namely capital asset pricing model to evaluate the effectiveness of both momentum and contrarian strategies.

Very few researches examining the effectiveness of momentum and contrarian strategies in Indonesian stock exchange is becoming a high motivation for the researcher to conduct this research. Furthermore, this study will use the data of monthly stocks price in Eido index as samples that will make this study quite unique

since most researcher use LQ45 as their samples to analyze the phenomena in Indonesian Stock Market. Thus, this study surely will enrich the literature as well as fill the gap in the existing literature.

1.2 Problem Formulation

Since there is still limited scholarly works in South East Asian especially Indonesia that shed light on momentum and contrarian strategies with more robust methodology, the research questions for this research are then formulated as follows:

1. Does contrarian strategy effective to generate abnormal return in Indonesian stock market with different formation and holding period?
2. Does momentum strategy effective to generate abnormal return in Indonesian stock market with different formation and holding period?

1.3 Research Objectives

1. This research aims to examine the effectiveness of contrarian strategy to generate abnormal return in Indonesian stock market with different formation and holding period.
2. This research aims to examine the effectiveness of momentum strategy to generate abnormal return in Indonesian stock market with different formation and holding period.

1.4 Research Contributions

This research examines the effectiveness of momentum and contrarian strategies to generate abnormal return in Indonesian's stock exchange with different formation and holding periods which the researcher hopes that the research will give advantages as follows:

1. Enriching the literature

   This research is expected to fill the gap in the existing literature regarding the anomalies of efficient market hypotheses as well as the effectiveness of contrarian and momentum strategies since this study attempt to explore emerging market as its object.

2. Investors

   This research can be used as a reference and guidance to form a better portfolio as well as assessment of risk and return resulting from investment analysis.

3. Writer

   This research is expected to give a high value added for the researcher to enrich his knowledge in behavioral finance field and to continue to next level of study with linear discipline of science.

4. Future Researcher

Hopefully this research can attract considerable attention among scholars so that it may inspire other researchers to explore more about trading strategies in the stocks market.