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ASSET ALLOCATION WITH TIME SERIES MOMENTUM AND REVERSAL

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ABSTRACT. To capture the well documented time series momentum and reversal in asset price, we develop a continuous-time asset price model, derive the optimal investment strategy theoretically, and test the strategy empirically. We show that, by combining market fundamentals and timing opportunity with respect to market trend and volatility, the optimal strategy based on time series momentum of moving averages over short-time horizons and reversal significantly outperforms, both in-sample and out-of-sample, the S&P500 and pure strategies based on either time series momentum or reversal only. The results are robust for different time horizons, short-sale constraints, market states, investor sentiment, and market volatility.

Key words: Momentum, reversal, optimal asset allocation, performance

JEL Classification: G12, G14, E32

1. INTRODUCTION

Short-run momentum and long-run reversal are two of the most prominent financial market anomalies. Though market timing opportunities under return reversal are well documented (e.g., Campbell and Viceira, 1999), time series momentum (TSM) that characterizes strong positive predictability of a security's own past returns has been explored recently in Moskowitz, Ooi and Pedersen (2012). With the mountainous empirical evidence, a fundamental and theoretical question is how to optimally explore time series momentum and reversal simultaneously in financial markets. This paper aims to answer this question theoretically and test the result empirically. We first introduce an asset price model to incorporate momentum and reversal components. By solving a dynamic asset allocation problem, we derive the optimal investment strategy that combines momentum and mean reversion, which includes pure momentum and pure mean-reverting strategies as special cases. By estimating the model to the S&P 500 index, we demonstrate that the optimal strategy outperforms, measured by the utility of the optimal portfolio wealth and Sharpe ratio, not only the strategies based on the pure momentum and pure mean-reversion models but also the S&P 500 index.

Theoretically, to the best of our knowledge, this paper is the first to examine the effect of the moving-average time horizon of TSM on the performance of the optimal portfolio. Empirically, TSM is measured by various moving averages over different time horizons with fixed look-back periods and the time horizons play a very important role in the performance of momentum strategies. This has been investigated extensively in the empirical literature (e.g., De Bondt and Thaler, 1985 and Jegadeesh and Titman, 1993). In particular, for a large set of futures and forward contracts, Moskowitz et al. (2012) find that TSM based on the moving average of the past 12 months persists for between one and 12 months and then partially reverses over longer time horizons. However, a theoretical understanding of the effect of various time horizons on the performance of momentum strategies is still missing. The asset price model developed in this paper takes the time horizon of TSM into account explicitly, which helps to examine the effect of time horizon on the performance. As a result, the historical prices underlying the TSM component

affect asset prices, leading to a non-Markov process characterized by stochastic delay differential equations (SDDEs), which is very different from the Markov asset price process documented in the literature. The SDDEs, recently introduced into financial market modelling, can explicitly characterize important role of the time horizon effect in price behaviour and financial market stability (He and Li, 2012, 2015).

For Markov processes, the stochastic control problem is most frequently solved using the dynamic programming method (Merton 1971). However, solving the optimal control problem for SDDEs becomes more challenging since it involves infinite-dimensional partial differential equations. One way to solve the problem is to apply a type of Pontryagin maximum principle, which has been developed recently by Chen and Wu (2010) and Øksendal et al. (2011) for the optimal control problem of SDDEs. By exploring these latest advances in the maximum principle, we theoretically derive the optimal strategy for CRRA utility function. In particular, for log-utility, we derive the optimal strategy in closed form, which enables us to examine thoroughly the effect of moving averages over different time horizons.

Empirically, we estimate the model to the S&P 500 index and examine the performance, measured by the utility of portfolio wealth and Sharpe ratio, of the optimal strategy derived. We demonstrate that the performance of TSM strategy can be significantly improved by combining with market fundamentals, while the performance of mean-reverting strategy can be significantly improved by combining with TSM. Essentially, in contrast to the TSM strategy based on trend only, the optimal strategy takes into account not only the trading signal based on momentum and fundamentals but also the size of position associated with market volatility, while momentum trading in the empirical literature only considers the trading signals of price trend and takes a constant position to trade. Without considering the fundamentals, such pure momentum portfolio is highly leveraged, and hence suffers from high risk, under-performing the optimal strategy. Also, by ignoring the TSM effect, the pure mean-reverting strategy based conservatively on fundamental investments leads to a stable growth in the portfolio wealth, but is not able to explore the price trend, especially during extreme market periods, and hence under-performs the optimal portfolio. We further demonstrate the robustness of the performance of the

optimal strategy with respect to different sample periods, out-of-sample predictions, short-sale constraints, market states, investor sentiment, and market volatility. More importantly, based on the estimated model, we examine the effect of different time horizon of the TSM on the performance of the optimal portfolio. Consistent with Moskowitz et al. (2012), we show that the optimal strategy based on the estimated model performs the best when the moving averages of TSM component is based on past 9 to 12 months. We show that in general the moving averages over short-run, six months to two years, better explain market returns, leading to better performance of the optimal strategy.

This paper is closely related to the literature on reversal and momentum. Reversal is the empirical observation that assets performing well (poorly) over a long period tend subsequently to underperform (outperform). Momentum is the tendency of assets with good (bad) recent performance to continue outperforming (underperforming) in the short term. Reversal and momentum have been documented extensively for a wide variety of assets. On the one hand, Fama and French (1988) and Poterba and Summers (1988), among many others, document reversal for horizons of more than one year, which induces negative autocorrelation in returns. Mean reversion in equity returns has been shown to induce significant market timing opportunities (Campbell and Viceira 1999). On the other hand, the literature mostly studies cross-sectional momentum following the influential study of Jegadeesh and Titman (1993). The predicting power of moving averages on the short-run momentum and long-run reversal has been well documented empirically in cross sectional and time series momentum literature. In particular, the moving averages based on the past returns over short-time horizons (say, 3 to 12 months) predict short-term (3 to 12 months) returns positively, while the moving averages over long-time horizons (say, 3 to 5 years) predict long-term (3 to 5 years) returns negatively (e.g., De Bondt and Thaler, 1985, Jegadeesh and Titman, 1993, and Moskowitz et al., 2012). More recently, for a large set of futures and forward contracts, Moskowitz et al. (2012) find that TSM based on the moving average of a security's own returns over the past 12 months persists for between one and 12 months and then partially reverses over longer time horizons. Through return decomposition, they show that positive

auto-covariance is the main driving force for TSM and cross-sectional momentum effects, while the contribution of serial cross-correlations and variation in mean returns is small. This demonstrates that the time horizons of the moving averages and holding periods play important roles in the performance of strategies involving momentum trading. Some behavioral models have been developed to explain the momentum, however, “*the comparison is in some sense unfair since no time horizon is specified in most behavioral models*” (Griffin, Ji and Martin, 2003).¹ Therefore examining the effect of time horizon on the performance of the optimal strategy is important. Asness, Moskowitz and Pedersen (2013) highlight that studying value and momentum jointly is more powerful than examining each in isolation.² This paper is largely motivated by the empirical literature testing trading signals with combinations of momentum and reversal.³ By taking both mean reversion and time horizon of TSM directly into account, this paper develops an asset price model and demonstrates the explanatory power of the model through the outperformance of the optimal strategy.

This paper is also largely inspired by Koijen, Rodríguez and Sbuelz (2009), who propose a theoretical model in which stock returns exhibit momentum and mean-reversion effects. This paper is however different from Koijen et al. (2009) in two aspects. First, in Koijen et al. (2009), the momentum is calculated from the entire set

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¹Recently, Chiarella, He and Hommes (2006), He and Li (2012, 2015) and Li and Liu (2016) have developed models to explore the role of the time horizon in momentum trading.

²They find that separate factors for value and momentum best explain the data for eight different markets and asset classes. Furthermore, they show that momentum loads positively and value loads negatively on liquidity risk; however, an equal-weighted combination of value and momentum is immune to liquidity risk and generates substantial abnormal returns. In the theoretical heterogeneous agent literature, by studying the joint impact of fundamental and momentum trading, people find that the mean-reverting fundamental trading plays a stabilizing role, momentum trading plays a destabilizing role in the market and the interaction between them contributes to the complexity of market price behavior, see, for example, Chiarella (1992), Chiarella, Dieci and He (2009) and Chiarella, Dieci, He and Li (2013).

³For example, Balvers and Wu (2006) and Serban (2010) show empirically that a combination of momentum and mean-reversion strategies can outperform pure momentum and pure mean-reversion strategies for equity markets and foreign exchange markets respectively.

of historical returns with geometrically decaying weights, instead of a moving average with a fixed looking-back period. This reduces the price dynamics to a Markovian system and enables a thorough analysis of the performance of the hedging demand. Such average that implies a mean-reverting feature of momentum is however different from the moving average widely used in empirical literature. In this paper, we follow the empirical literature and model TSM by the standard moving average with a fixed look-back period. Our model of momentum complements in a unique way to the theoretical study of Kojien et al. (2009) and many empirical studies that do not systematically study the role of moving averages with different looking-back periods. We explicitly study the impacts of different looking-back periods on the performance of momentum-related trading strategies. Second, instead of studying the economic gains of hedging due to momentum in Kojien et al. (2009), we focus on the performance of the optimal strategy comparing with market index, TSM, and mean-reversion trading strategies.

The paper is organized as follows. We first present the model and derive the optimal asset allocation in Section 2. In Section 3, we estimate the model with 12-month TSM to the S&P 500 and conduct a performance analysis of the optimal portfolio. We then investigate the time horizon effect in Section 4. Section 5 concludes. All the proofs and robustness analysis are included in the online appendices.

2. THE MODEL AND OPTIMAL ASSET ALLOCATION

In this section, we introduce an asset price model and study the optimal asset allocation problem. Consider a financial market with two tradable securities, a riskless asset B satisfying

$$\frac{dB_t}{B_t} = rdt \quad (2.1)$$

with a constant riskless rate r , and a risky asset. Let S_t be the price of the risky asset or the level of a market index at time t where dividends are assumed to be reinvested. Equity returns display short-run momentum and long-run reversal, as we have discussed in the previous section. Following the literature and motivated by Kojien et al. (2009), we model the expected return by a combination of a momentum component m_t based on the moving average of past returns and a long-run

mean-reversion component μ_t based on market fundamentals such as dividend yield. Consequently, we assume that the stock price S_t follows

$$\frac{dS_t}{S_t} = [\phi m_t + (1 - \phi)\mu_t]dt + \sigma'_S dZ_t, \quad (2.2)$$

where ϕ is a constant,⁴ measuring the weight of the momentum component m_t , σ_S is a two-dimensional volatility vector (and σ'_S stands for the transpose of σ_S), and Z_t is a two-dimensional vector of independent Brownian motions. The uncertainty is represented by a filtered probability space $(\Omega, \mathcal{F}, P, \{\mathcal{F}_t\}_{t \geq 0})$ on which the two-dimensional Brownian motion Z_t is defined. As usual, the mean-reversion process μ_t is defined by an Ornstein-Uhlenbeck process,

$$d\mu_t = \alpha(\bar{\mu} - \mu_t)dt + \sigma'_\mu dZ_t, \quad \alpha > 0, \quad \bar{\mu} > 0, \quad (2.3)$$

where $\bar{\mu}$ is the constant long-run expected return, α measures the rate at which μ_t converges to $\bar{\mu}$, and σ'_μ is a two-dimensional volatility vector. The momentum component m_t is defined by a standard moving average (MA) of past returns over $[t - \tau, t]$,

$$m_t = \frac{1}{\tau} \int_{t-\tau}^t \frac{dS_u}{S_u}, \quad (2.4)$$

where delay τ represents the time horizon. The way we model momentum in this paper is consistent with the TSM documented recently in Moskowitz et al. (2012), who show that “the past 12-month excess return of each instrument is a positive predictor of its future return.” The resulting asset price model (2.2)–(2.4) is characterized by a stochastic delay integro-differential system, which is non-Markovian and has the following property.

Proposition 2.1. *The system (2.2)–(2.4) has an almost surely continuously adapted pathwise unique solution (S, μ) for a given $\mathcal{F}_0$ -measurable initial process $\varphi : \Omega \rightarrow C([-\tau, 0], R)$. Furthermore, if $\varphi_t > 0$ for $t \in [-\tau, 0]$ almost surely, then $S_t > 0$ for all $t \geq 0$ almost surely.*

We now consider a typical long-term investor who maximizes the expected utility of terminal wealth at time $T(> t)$. Let W_t be the wealth of the investor at time t

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⁴The dominance of market fundamentals and TSM, measured by ϕ , can be time-varying, depending on market condition. For simplicity we take ϕ as a constant parameter in this paper.

and π_t be the fraction of the wealth invested in the stock. Then it follows from (2.2) that the change in wealth satisfies

$$\frac{dW_t}{W_t} = (\pi_t[\phi m_t + (1 - \phi)\mu_t - r] + r)dt + \pi_t \sigma'_S dZ_t. \quad (2.5)$$

Assume the preferences of the investor is given by a CRRA utility with a constant coefficient of relative risk aversion γ . The investment problem of the investor is given by

$$J(W, m, \mu, t, T) = \sup_{(\pi_u)_{u \in [t, T]}} \mathbb{E}_t \left[\frac{W_T^{1-\gamma} - 1}{1 - \gamma} \right], \quad (2.6)$$

where $J(W, m, \mu, t, T)$ is the value function corresponding to the optimal investment strategy. We apply the maximum principle for optimal control of stochastic delay differential equations and derive the optimal investment strategy.

Proposition 2.2. *For an investor with an investment horizon $T - t$ and constant coefficient of relative risk aversion γ , the optimal wealth fraction invested in the risky asset is given by*

$$\pi_u^* = \frac{\phi m_u + (1 - \phi)\mu_u - r}{\gamma \sigma'_S \sigma_S} + \frac{(z_u)_3 \sigma_S}{\gamma p_u^3 \sigma'_S \sigma_S}, \quad (2.7)$$

where z_u and p_u are governed by a backward stochastic differential system (B.6) in Appendix B.2. Especially, when $\gamma = 1$, the preference is characterized by a log utility and the optimal strategy is given in closed form

$$\pi_t^* = \frac{\phi m_t + (1 - \phi)\mu_t - r}{\sigma'_S \sigma_S}. \quad (2.8)$$

This proposition states that the optimal fraction (2.7) invested in the stock consists of two components. The first component characterizes the myopic demand for the stock and the second component corresponds to the intertemporal hedging demand. When $\gamma = 1$, the optimal strategy (2.8) in closed form characterizes the myopic behavior of the investor. This result has a number of implications. Firstly, when the asset price follows a geometric Brownian motion process with mean-reversion drift μ_t , namely $\phi = 0$, the optimal investment strategy (2.8) becomes

$$\pi_t^* = \frac{\mu_t - r}{\sigma'_S \sigma_S}. \quad (2.9)$$

This is the optimal investment strategy with mean-reverting returns obtained in the literature, e.g., Campbell and Viceira (1999).

Secondly, when the asset return depends only on the momentum, namely $\phi = 1$, the optimal portfolio (2.8) reduces to

$$\pi_t^* = \frac{m_t - r}{\sigma'_S \sigma_S}. \quad (2.10)$$

If we consider a trading strategy based on the trading signal indicated by the excess moving average return $m_t - r$ only, with $\tau = 12$ months, the strategy of long/short when the trading signal is positive/negative is consistent with the TSM strategy used in Moskowitz et al. (2012). By constructing portfolios based on excess returns over the past 12 months and holding for one month, Moskowitz et al. (2012) show that this strategy performs the best among all the momentum strategies with look-back and holding periods varying from one month to 48 months. Therefore, if we only take fixed long/short positions and construct simple buy-and-hold momentum strategies over a large range of look-back and holding periods, (2.10) shows that the TSM strategy of Moskowitz et al. (2012) can be optimal when mean reversion is not significant in financial markets. On the one hand, this provides a theoretical justification for the TSM strategy when market volatilities are constant and returns are not mean-reverting. On the other hand, the optimal portfolio (2.10) also depends on volatility. This explains the dependence of momentum profitability on market states and volatility documented in Hou, Peng and Xiong (2009) and Wang and Xu (2015). In addition, the optimal portfolio (2.10) defines the optimal wealth fraction invested in the risky asset. Hence the TSM strategy of taking a fixed position based on the trading signal may not be optimal in general.

Thirdly, the optimal strategy (2.8) implies that a weighted average of momentum and reversal strategies is optimal. Intuitively, it takes into account the short-run momentum and long-run reversal, two well-supported market phenomena. It also takes into account the timing opportunity with respect to volatility.

In summary, we provide a theoretical support for optimal strategies combining momentum and reversal documented empirically (see, for example, Balvers and Wu, 2006 and Serban, 2010). In the rest of the paper, we estimate the model to the S&P

500 and evaluate empirically the performance of the optimal strategy comparing to the market and trading strategies based on pure mean-reverting or pure TSM documented in the literature. Due to the closed-form optimal strategy (2.8) that facilitates model estimation and empirical analysis, we mainly focus on $\gamma = 1$. For $\gamma \neq 1$, we numerically solve the optimal portfolio (2.7) and examine the values added by the hedging demand in Section E.4.

3. MODEL ESTIMATION AND PERFORMANCE ANALYSIS

In this section we first estimate the model to the S&P 500. Based on the estimation, we then examine the performance of the optimal strategy (2.8) with respect to the log utility ($\gamma = 1$) and the Sharpe ratio, comparing to the performance of the market index and the optimal strategies based on pure momentum and pure mean-reversion models. By comparing the performance of the optimal strategy to that of the TSM strategy, we demonstrate the optimality of combining market fundamentals and time opportunity with respect to market trend and volatility. We also conduct out-of-sample tests on the performance of the optimal strategy and robustness analyses on the effect of short sale constraints, market states, sentiment, volatility, and hedging (when $\gamma \neq 1$).

3.1. Model Estimation. In line with Campbell and Viceira (1999) and Kojien et al. (2009), the mean-reversion variable is affine in the (log) dividend yield, $\mu_t = \bar{\mu} + \nu(D_t - \mu_D) = \bar{\mu} + \nu X_t$, where ν is a constant, D_t is the (log) dividend yield with $\mathbb{E}(D_t) = \mu_D$, and $X_t = D_t - \mu_D$ denotes the de-meaned dividend yield. Thus the asset price model (2.2)-(2.4) becomes

$$\begin{cases} \frac{dS_t}{S_t} = [\phi m_t + (1 - \phi)(\bar{\mu} + \nu X_t)]dt + \sigma'_S dZ_t, \\ dX_t = -\alpha X_t dt + \sigma'_X dZ_t, \end{cases} \quad (3.1)$$

where $\sigma_X = \sigma_\mu/\nu$. The uncertainty in system (3.1) is driven by two independent Brownian motions. Without loss of generality, we assume the Cholesky decomposition on the volatility matrix Σ of the dividend yield and return,

$$\Sigma = \begin{pmatrix} \sigma'_S \\ \sigma'_X \end{pmatrix} = \begin{pmatrix} \sigma_{S(1)} & 0 \\ \sigma_{X(1)} & \sigma_{X(2)} \end{pmatrix}.$$

Thus, the first element of Z_t is the shock to the return and the second is the dividend yield shock that is orthogonal to the return shock.

To be consistent with the momentum and reversal literature, we discretize the continuous-time model (3.1) at a monthly frequency. This results in a bivariate Gaussian vector autoregressive (VAR) model of return R_t and dividend yield X_t ,⁵

$$\begin{cases} R_{t+1} = \frac{\phi}{\tau}(R_t + R_{t-1} + \cdots + R_{t-\tau+1}) + (1 - \phi)(\bar{\mu} + \nu X_t) + \sigma'_S \Delta Z_{t+1}, \\ X_{t+1} = (1 - \alpha)X_t + \sigma'_X \Delta Z_{t+1}. \end{cases} \quad (3.2)$$

We use monthly S&P 500 data over the period 1871:01– 2012:12 from the home page of Robert Shiller (www.econ.yale.edu/~shiller/data.htm) and estimate model (3.2) using the maximum likelihood method. We set the instantaneous short rate $r = 4\%$ annually. The dividend yield is defined as the log of the ratio between the last period dividend and the current index (Campbell and Shiller, 1988). The total return index is constructed by using the price index series and the dividend series.

The estimations are conducted separately for given time horizon τ varying from one to 60 months. Empirically, Moskowitz et al. (2012) show that the TSM strategy based on a 12-month horizon better predicts the next month's return than other time horizons. Therefore, in this section, we follow Moskowitz et al. (2012) and focus on the performance of the optimal strategy with a looking-back period of $\tau = 12$ months and a one-month holding period. The effect of time horizon τ varying from one to 60 months is examined in the next section.

For comparison, we estimate the full model (FM) (3.2) with $0 < \phi < 1$, the pure momentum model (MM) with $\phi = 1$, and the pure mean-reversion model (MRM) with $\phi = 0$. For $\tau = 12$, Table 3.1 reports the estimated parameters, together with the 95% confidence bounds.⁶ For MM ($\phi = 1$), there is only one parameter $\sigma_{S(1)}$ to be estimated. For FM, it shows that the momentum effect parameter $\phi \approx 0.2$, which is significantly different from zero. This implies that the market index can be explained by about 20% of the momentum component and 80% of the mean-reverting

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⁵To be consistent with the momentum and reversal literature, we use simple return to construct m_t and also discretize the stock price process into simple return rather than log return.

⁶Accordingly, the range of μ_t ($= \bar{\mu} + \nu X_t$) is $[0.10, 0.65]$.

TABLE 3.1. Parameter estimations of the full model (FM), pure momentum model (MM) with $\tau = 12$, and pure mean-reversion model (MRM).

Parameter	α	ϕ (%)	$\bar{\mu}$	ν
FM (%)	0.46 (0.03, 0.95)	19.85 (8.70, 31.00)	0.36 (0.26, 0.46)	0.20 (-0.60, 1.00)
MRM (%)	0.55 (0.07, 1.03)		0.37 (0.31, 0.43)	$2.67 * 10^{-5}$ (-0.46, 0.46)
Parameters	$\sigma_{S(1)}$	$\sigma_{X(1)}$	$\sigma_{X(2)}$	
FM (%)	4.10 (3.95, 4.24)	-4.09 (-4.24, -3.93)	1.34 (1.29, 1.39)	
MRM (%)	4.11 (3.97, 4.25)	-4.07 (-4.22, -3.92)	1.36 (1.32, 1.40)	
MM (%)	4.23 (4.09, 4.38)			

component.⁷ Other parameter estimates in terms of the level and significance in Table 3.1 are consistent with those in Koijen et al. (2009).

We also conduct a log-likelihood ratio test to compare FM ($0 < \phi < 1$) to MM ($\phi = 1$) and MRM ($\phi = 0$), showing that the FM is significantly better than MM and MRM.⁸ This implies that FM captures the short-run momentum and the long-run reversion in the market index and fits the data better than MM and MRM.

3.2. Performance Analysis. Based on the previous estimations, we now examine the performance of the optimal portfolio (2.8) (based on log utility) with respect to the utility of the portfolio wealth and Sharpe ratio, comparing to those of the market index and of the MM and MRM.

We first compare the realized utility of the optimal portfolio wealth invested in the S&P 500 index based on the optimal strategy (2.8) with a look-back period $\tau = 12$ months and one-month holding period to the utility of a passive holding investment in the S&P 500 index with an initial wealth of \$1. As a benchmark, the

⁷This is consistent with Chu, He, Li and Tu (2015) showing that about 20% of times the market index return can be explained by non-fundamental variables, including various momentum variables, while about 80% of times can be explained by fundamental variables.

⁸The test statistic 13100 (6200) is much greater than 12.59 (3.841), the critical value with six (five) degrees of freedom at the 5% significance level, for the MM (MRM).

(a) Optimal portfolio weight of FM

(b) Utility of FM

(c) Portfolio weight of MM

(d) Utility of MM

(e) Portfolio weight of MRM

(f) Utility of MRM

FIGURE 3.1. The time series of the optimal portfolio weight, (a) (c) and (e), and the utility of the optimal portfolio wealth, (b), (d) and (f), for the optimal portfolio (2.8), the pure momentum portfolio (2.10) and the pure mean-reverting portfolio (2.9), respectively, from 1876:01 to 2012:12 for $\tau = 12$, where the utilities of the optimal portfolio wealth denoted by $\ln W_t^*$ and the market index denoted by $\ln W_t$ are plotted in solid red and dash-dotted blue lines respectively.

log utility of an investment of \$1 at index from 1876:01⁹ grows to 5.765 at 2012:12. For $\tau = 12$, we calculate the moving average m_t of past 12-month returns at any point of time based on the market index from 1876:01 to 2012:12. With an initial wealth of \$1 at 1876:01 and the estimated parameters in Table 3.1, we calculate the monthly investment of the optimal portfolio wealth W_t based on (2.8) and record the realized utilities of the optimal portfolio wealth. Based on the calculation, we report the optimal wealth fractions π_t of (2.8) in Fig. 3.1 (a) and the evolution of the utilities of the optimal portfolio wealth ($\ln W_t^*$) over the same time period in Fig. 3.1 (b), showing that the optimal portfolios (solid red line) outperform the market index (dash-dotted blue line) measured by the utility of portfolio wealth. Fig. 3.1 (e) shows that the performance of the pure mean-reversion strategy is about the same as the market index but worse than the optimal strategies (2.8). Comparing Fig. 3.1 (b) with Fig. 3.1 (d) and (f), we see that the optimal strategy outperforms the market index, the pure momentum and pure mean-reversion strategies. A Monte Carlo analysis in Appendix C provides further evidence of the outperformance of the optimal strategy (2.8) compared to the market index, pure momentum and pure mean-reversion strategies.

One interesting observation is the big jumps in the utilities of the optimal portfolio wealth during the period of the Great Depression in the 1930s in Fig. 3.1 (b). This observation is consistent with Moskowitz et al. (2012), who find that the TSM strategy delivers its highest profits during the most extreme market episodes. Comparing to the optimal portfolio weights of FM in Fig. 3.1 (a), the leverage of the pure momentum strategies is much higher (Fig. 3.1 (c)), while the optimal pure mean-reversion strategies do not capture the timing opportunity of the market trend and market volatility with almost constant and low investment, about 20% invested in the market index (Fig. 3.1 (e)). As a result, the optimal strategy for MM model under-performs the market portfolio.

We also implement the rolling window estimation procedure to avoid look-ahead bias. For $\tau = 12$, we estimate parameters at each month by using the past 20

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⁹Considering the robustness analysis for τ varying from one to 60 months in the next section, all the portfolios start at the end of 1876:01 (60 months after 1871:01).

years' data and report the results in Fig. D.1 in Appendix D. We then report the time series of the index level (a), the simple return of the S&P 500 (b), the optimal portfolio (c), and the utility of the optimal portfolio wealth (d) in Fig. D.2, showing a strong performance of the optimal portfolios over the market. We also report the results of the pure momentum and the pure mean reversion strategies in Fig. D.3 based on the 20-year rolling window estimates. Overall, the results demonstrate the robustness of the outperformance of the optimal trading strategies compared to the market index, pure momentum and pure mean-reversion strategies.¹⁰

TABLE 3.2. The Sharpe ratios of the optimal portfolio and the market index with corresponding 90% confidence interval and the Sharpe ratio of the optimal portfolio based on Monte Carlo simulations.

	Optimal portfolio	Market index	Monte Carlo
Sharpe ratio (%)	5.85	2.11	6.12
	(1.86, 9.84)	(-1.88, 6.10)	(5.98, 6.27)

We next use the Sharpe ratio to examine the performance of the optimal portfolio. For empirical applications, the (ex-post) Sharpe ratio is usually estimated as the ratio of the sample mean of the excess return on the portfolio and the sample standard deviation of the portfolio return (Marquering and Verbeek, 2004). The average monthly return on the total return index of the S&P 500 over the period 1871:01–2012:12 is 0.42% with an estimated (unconditional) standard deviation of 4.11%. The Sharpe ratio of the market index is 2.11%. For the optimal strategy (2.8), the return of the optimal portfolio wealth at time t is given by $R_t^* = (W_t^* - W_{t-1}^*)/W_{t-1}^* = \pi_{t-1}^* R_t + (1 - \pi_{t-1}^*)r$. Table 3.2 reports the Sharpe ratios of the passive holding market index portfolio and the optimal portfolios for $\tau = 12$ together with their 90% confidence intervals (see Jobson and Korkie 1981). It shows that, by taking the timing opportunity (with respect to the market trend and market volatility), the optimal portfolio outperforms the market. We also conduct a Monte Carlo analysis based on 1,000 simulations and obtain an average Sharpe ratio of 6.12% for the optimal portfolio. The result is consistent with the outperformance of the optimal

¹⁰We also implement the estimations for different window sizes of 25, 30 and 50 years and find that the performance of strategies is similar to the case of 20-year rolling window estimation.

portfolio measured by the portfolio utility (with an average terminal utility of 8.71 for the optimal portfolio). In summary, using two performance measures, we have provided empirical evidence of the outperformance of the optimal strategy (2.8) compared to the market index, pure momentum and pure mean-reversion strategies, providing empirical support for the analytical optimal strategy derived in Section 2.

3.3. Comparison with TSM. We now compare the performance of the optimal strategy to the TSM strategy of Moskowitz et al. (2012). The momentum strategies in the empirical studies are based on trading signals only. Following Moskowitz et al. (2012), we first examine the cumulative excess return defined by

$$\hat{R}_{t+1} = \text{sign}(\pi_t^*) \frac{0.1424}{\hat{\sigma}_{S,t}} R_{t+1}, \quad \hat{\sigma}_{S,t}^2 = 12 \sum_{i=0}^{\infty} (1 - \delta) \delta^i (R_{t-1-i} - \bar{R}_t)^2, \quad (3.3)$$

where 0.1424 is the sample standard deviation of the total return index, $\hat{\sigma}_{S,t}^2$ is the ex-ante annualized variance for the total return index calculated as the exponentially weighted lagged squared month returns with the constant 12 to scale the variance annually, and $\bar{R}_t$ is the exponentially weighted average return based on the weights $(1 - \delta) \delta^i$. The parameter δ is chosen so that the center of mass of the weights is $\sum_{i=1}^{\infty} (1 - \delta) \delta^i = \delta / (1 - \delta) = \text{two months}$. To avoid look-ahead bias contaminating the results, we use the volatility estimates at time t for time $t + 1$ returns throughout the analysis.

FIGURE 3.2. Log cumulative excess return of the optimal strategy and momentum strategy with $\tau = 12$ and passive long strategy from 1876:01 to 2012:12.

With a 12-month time horizon Fig. 3.2 illustrates the log cumulative excess return of the optimal strategy (2.8), the momentum strategy and the passive long strategy from 1876:01 to 2012:12. It shows that the optimal strategy has the highest growth rate and the passive long strategy has the lowest growth rate. The pattern of Fig. 3 in Moskowitz et al. (2012) is replicated in Fig. 3.2, showing that the TSM strategy outperforms the passive long strategy.

TABLE 3.3. The Sharpe ratio of the optimal portfolio, market index, TSM and MMR for $\tau = 12$ with the 90% confidence interval.

	Optimal portfolio	Market index	TSM	MMR
Sharpe ratio (%)	5.85	2.11	-0.03	4.16
	(1.86, 9.84)	(-1.88, 6.10)	(-4.01, 3.96)	(0.18, 8.15)

To explore the optimality of combining market fundamental and timing opportunity with market trend, we next compare the performance of two strategies: one follows from TSM in Moskowitz et al. (2012) and the other is based on the sign of the optimal strategies $sign(\pi_t^*)$ as the trading signal, which is called *momentum and mean-reversion (MMR) strategy* for convenience. For a time horizon of $\tau = 12$ months, we report the Sharpe ratios of the portfolios for the two strategies in Table 3.3 from 1881:01 to 2012:12, together with the ones for the market index and optimal portfolio reported in Table 3.2. By comparing the performance of TSM and MMR, we find that the the fixed position strategy based on momentum and reversal trading signal is more profitable than the pure TSM strategy of Moskowitz et al. (2012). Note that the only difference between these two strategies is that MMR considers market fundamentals as the mean-reverting component. Also, the only difference between the optimal strategy and the MMR strategy is that the former considers the size of the portfolio position, which is inversely proportional to the variance, while the latter always takes one unit of long/short position. These observations imply that combining market fundamentals and market-timing with respect to market trend and volatility is optimal for investment.

3.4. Out-of-Sample Tests. To provide further evidence on the optimal strategy, we implement a number of out-of-sample tests on the performance of the optimal strategies by splitting the whole data set into two sub-sample periods and using the

first sample period to estimate the model. We then apply the estimated parameters to the second portion of the data and examine the out-of-sample performance of the optimal strategies.

(a) The portfolio weight: 1942:01–2012:12

(b) The utility: 1942:01–2012:12

(c) The portfolio weight: 2008:01–2012:12

(d) The utility: 2008:01–2012:12

FIGURE 3.3. The time series of out-of-sample optimal portfolio weight and utility of the optimal portfolio wealth (the solid lines) for 1942:01–2012:12 in (a) and (b) and for 2008:01–2012:12 in (c) and (d) with $\tau = 12$ compared to the utility of the market index (the dotted line).

In the first test, we split the whole data set into two equal periods: 1871:01 to 1941:12 and 1942:01 to 2012:12. With $\tau = 12$, Fig. 3.3 (a) and (b) illustrate the corresponding time series of the optimal portfolio and the utility of the optimal portfolio wealth from 1942:01 to 2012:12, showing that the utility of the optimal strategy grows gradually and outperforms the market index, even though the data in the two periods are quite different (the market index increases gradually in the first period but fluctuates widely in the second period).

Many studies (see, for example, Jegadeesh and Titman 2011) show that momentum strategies perform poorly after the subprime crisis in 2008. In the second test, we use the subprime crisis to split the whole sample period into two periods and focus on the performance of the optimal strategies after the subprime crisis. The results are reported in Fig. 3.3 (c) and (d), showing that the optimal strategy still outperforms the market over the sub-sample period, in particular, during the financial crisis period around 2009 by taking large short positions in the optimal portfolios. We use data from the last 10 and 20 years as the out-of-sample test and find the results (not reported here) are robust.

(a) Portfolio weight of MM

(b) Utility of MM

(c) Portfolio weight of MRM

(d) Utility of MRM

FIGURE 3.4. The time series of out-of-sample optimal portfolio weight and utility of the optimal portfolio wealth (the solid lines) compared to the utility of the market index (the dotted line) for 1942:01–2012:12.

We also implement the out-of-sample tests for MM and MRM and report the results in Fig. 3.4. Consistent with the in-sample results illustrated in Fig. 3.1, the

high leverage of the pure momentum strategies lead to big utility loss. The mean-reversion strategies have very stable portfolio weights and fail to capture the timing opportunity of the market trend. Therefore, both cannot outperform the market.

3.5. Short-sale Constraint. Investors often face short-sale constraint. To evaluate the performance of the optimal strategies without short selling and borrowing (at the risk-free rate), we restrict the portfolio weight $\pi \in [0, 1]$. Table 3.4 reports the terminal utilities and the Sharpe ratios of the optimal portfolio with and without short-sale constraint, compared to the passive holding market index portfolio. The portfolio utilities confirm the out-performance without the constraints, while the Sharpe ratios show that the optimal portfolio with short-sale constraint outperforms the market, even the optimal portfolio without short-sale constraint. It seems that the constraint improves portfolio's Sharpe ratio. This less-intuitive observation is actually consistent with Marquering and Verbeek (2004 p. 419) who argue that *"While it may seem counterintuitive that strategies perform better after restrictions are imposed, it should be stressed that the unrestricted strategies are substantially more affected by estimation error."* Indeed, Table 3.4 shows that the estimated optimal portfolio weight without constraint has higher standard error but lower mean level than that with constraint.

TABLE 3.4. The terminal utility of the portfolio wealth, Sharpe ratio, mean and stand deviation of the portfolio weights for the optimal portfolios with and without short-sale constraint, comparing with the market index portfolio.

	Utility	Sharpe Ratio	Average weights	Std of weights
With constraints	10.35	0.12	0.43	0.46
Without constraints	17.06	0.06	0.23	1.74
Market index	5.76	0.02		

3.6. Market States, Sentiment, Volatility, and Hedging. The momentum literature shows that momentum profitability can be affected by market states, investor sentiment and market volatility. For example, Cooper, Gutierrez and Hameed (2004) find that short-run (six months) momentum strategies make profits in an up-market and lose in a down-market, but the up-market momentum profits reverse

in the long run (13–60 months). Hou, Peng and Xiong (2009) find momentum strategies with a short time horizon (one year) are not profitable in a down-market, but are profitable in an up-market. Similar results are also reported in Chordia and Shivakumar (2002), specifically that common macroeconomic variables related to the business cycle can explain positive returns to momentum strategies during expansionary periods and negative returns during recession periods.

To investigate the performance of the optimal strategies under different market states, we follow Cooper et al. (2004)¹¹ (and report the results in Appendix E) and find an unconditional average excess return of 87 basis points per month (Table E.1) In up months, the average excess return is 81 basis points and it is statistically significant. In down months, the average excess return is 101 basis points; this value is economically significant although it is not statistically significant. The difference between down and up months is about 20 basis points, which is not significantly different from zero, based on a two-sample t -test (p -value of 0.87).

Controlling for market risk, we use an up-month dummy¹² to capture incremental average return in up-market months relative to down-market months. We compare the regression results (in Table E.2) for the optimal strategy, the pure momentum strategy, pure mean-reversion strategy and the TSM strategy in Moskowitz et al. (2012) for $\tau = 12$ respectively. Except for the TSM, which earns significant positive returns in down markets, both down market returns α and the incremental returns in up market κ are insignificant for all other strategies. We also control for market risk in up and down months separately (Table E.2). All the results are consistent.

Other way to see the effects of market state on portfolio returns is to look at its predictive powers. We run predictive regression of excess portfolio returns on the up-month dummy and find that up-market has no additional predictive power to portfolio returns over down-market (insignificant κ), down-market has significant

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¹¹We define market state using the cumulative return of the stock index (including dividends) over the most recent 36 months. We label a month as an up (down) market month if the three-year return of the market is non-negative (negative). We compute the average return of the optimal strategy, compare the average returns between up and down market months.

¹²The results are robust when we replace the up-month dummy with the lagged market return over the previous 36 months (not reported here).

predictive power to TSM returns (Table E.3). Also down-market has insignificant predictive power to FM, MM and MRM, but among them, the effect is relatively strong in FM, and weak in the MRM. We obtain similar results for the CAPM-adjusted return.

In terms of the effects of investor sentiment and market volatility on portfolio performance, Baker and Wurgler (2006, 2007) find that investor sentiment affects cross-sectional stock returns and the aggregate stock market. Wang and Xu (2015) find that market volatility has significant power to forecast momentum profitability. However, Moskowitz et al. (2012) find that there is no significant relationship of TSM profitability to either market volatility or investor sentiment. We find that both investor sentiment and market volatility have no predictive power on portfolio returns (see Tables E.4 and E.5 in Appendix E).

Overall, we find that returns of the optimal strategies are not significantly different in up and down market states. We also find that both investor sentiment and market volatility have no predictive power for the returns of the optimal strategies. In fact, the optimal strategies have taken these factors into account and hence the optimal strategies are immune to market states, investor sentiment and market volatility.

The analysis in this section is focused on the myopic optimal portfolio with $\gamma = 1$. For $\gamma \neq 1$, we have conducted an analysis in Appendix E on the effect of the hedging demand, showing that the hedging plays more important role in long time horizon investment.

4. TIME HORIZON EFFECTS

The predicting power of moving averages on the short-run momentum and long-run reversal has been well documented empirically in cross sectional and time series momentum literature. Due to the closed-form of (2.8), we are able to explicitly examine the dependence of the optimal results on different time horizons. The previous section focuses on $\tau = 12$ months. In this section we allow the time horizon τ to vary from one to 60 months and examine the performance of the optimal strategies with different time horizon.

FIGURE 4.1. The estimates of parameters (a) α ; (b) ϕ ; (c) $\bar{\mu}$; (d) ν ; (e) $\sigma_{S(1)}$; (f) $\sigma_{X(1)}$ and (g) $\sigma_{X(2)}$ with respect to time horizon τ from one month to 60 months.

4.1. Estimations and explanatory power. For given time horizon τ we estimate model (3.2) and report the estimated parameters (in monthly terms) for τ ranging from one month to five years, together with the 95% confidence bounds, in Fig. 4.1. On the key parameter ϕ , Fig. 4.1 (a) shows that the momentum effect is significantly different from zero when time horizon τ is more than nine months, indicating a

significant momentum effect for τ beyond nine months.¹³ Note that ϕ increases to about 50% when τ increases to three years and then decreases gradually when τ increases further. The estimation results (with respect to the level and significance) on other parameters in Fig. 4.1 are consistent with Koijen et al. (2009).

The explanatory power of the model on the market index depends on the specification of the time horizon τ . We compare different information criteria, including Akaike (AIC), Bayesian (BIC) and Hannan–Quinn (HQ) information criteria for τ from one month to 60 months (Fig. F.1 of Appendix F). Combining with the estimation in Fig. 4.1 (a), the results imply that the market returns are best explained by the model with a momentum component based on the moving average over the past 18 months to two years and more importantly the mean-reverting component, indicating by $\phi \leq 50\%$, dominates the market index. In general the explanatory power of the momentum component in the model becomes increasingly significant over the short time horizons but less so over the long time horizons. This is consistent with studies showing that the short-run (one to two years), rather than the long-run, momentum better explains market returns.

We estimate $\sigma_{S(1)}$ and the 95% confidence bounds of the optimal strategy of MM ($\phi = 1$) (Fig. F.2 (a)) for $\tau \in [1, 60]$ and find that as τ increases, the volatility of the index decreases dramatically for short time horizons and is then stabilized for longer time horizons. This implies high volatility associated with momentum over short horizons and low volatility over long horizons. We also compare the information criteria for different τ (not reported here) and find that all the AIC, BIC and HQ reach their minima at $\tau = 11$, implying that the average returns over the previous 11 months can predict future returns better for MM. This result is consistent with the finding of Moskowitz et al. (2012) that momentum returns over the previous 12 months better predict the next month's return than other time horizons. In addition, we conduct the log-likelihood ratio test to compare FM to MM ($\phi = 1$)

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¹³ For τ from one to eight months, ϕ is indifferent from zero statistically and economically. This implies that, for small look-back periods of up to nine months, it is the mean-reversion instead of momentum that plays more important role in the model. This observation is helpful when we explain the results of the model for small look-back periods in the following discussion.

and to MRM for different τ . It is found that (see Appendix F for the details) FM is significantly better than MM and MRM for all time horizon τ .

4.2. The effect of time horizon on performance. With the estimated parameters of FM for $\tau = 1, 2, \dots, 60$ over the full sample in Fig. 4.1, we report the utility of the terminal wealth of the optimal portfolio, compared to the utility of the market portfolio, at 2012:12 in Fig. 4.2 (a). It shows that the optimal strategies consistently outperform the market index for τ from five to 20 months.¹⁴

FIGURE 4.2. The terminal utility of the optimal portfolio wealth (a) from 1876:01 to 2012:12, (b) from 1945:01 to 2012:12, and (c) the average terminal utility of the optimal portfolios based on 1000 simulations from 1876:01 to 2012:12, comparing with the terminal utility of the market index portfolio (the dash-dotted line).

We have observed from Fig. 3.1 (d) for $\tau = 12$ that the Great Depression in the 1930s has greatly improved the utilities of the optimal portfolio. To clarify this observation, we also examine performance using the data from 1945:01 to 2012:12 to avoid the Great Depression period. We re-estimate the model, conduct the same

¹⁴When τ is less than half a year, Fig. 4.2 (a) shows that the optimal strategies do not perform significantly better than the market. As we indicate in footnote 13, the model with a small look-back period of up to half a year performs similarly to the pure mean-reversion strategy. Note the significant outperformance of the optimal strategy with one-month horizon in Fig. 4.2 (a). This is due to the fact that the first order autocorrelation of the return of the S&P 500 is significantly positive ($AC(1) = 0.2839$) while the autocorrelations with higher orders are insignificantly different from zero. This implies that the last period return could well predict the next period return.

analysis, and report the terminal utilities of the optimal portfolios in Fig. 4.2 (b) over this time period. It shows that the optimal strategies still outperform the market and moreover the performance of the optimal strategies over the more recent time period becomes even better for all time horizons. Consistent with the results obtained in the previous section, this result indicates that the outperformance of the optimal strategy is not necessarily due to extreme market episodes, such as the Great Depression.

We also conduct further Monte Carlo analysis on the performance of the optimal portfolios based on the estimated parameters and 1,000 simulations in Fig. 4.1 and report the average terminal average utilities in Fig. 4.2 (c). The result displays a different terminal performance from that in Fig. 4.2 (a). In fact, the terminal utility in Fig. 4.2 (a) is based only on one specific trajectory (the real market index), while Fig. 4.2 (c) provides the average performance based on 1,000 trajectories. We find that the optimal portfolios perform significantly better than the market index (the dash-dotted constant level) for all time horizons beyond half a year. In particular, the average terminal utility reaches its peak at $\tau = 24$ months, which is consistent with the result based on the information criteria (in Fig. F.1, particularly the AIC).

FIGURE 4.3. The Sharpe ratio of the optimal portfolio (the solid blue line) with corresponding 90% confidence intervals (a), the average Sharpe ratio based on 1,000 simulations (b) for $\tau \in [1, 60]$, compared to the passive holding portfolio of market index (the dotted black line) from 1881:01 to 2012:12.

We also compare the Sharpe ratios of the passive holding market index portfolio to that of the optimal portfolios from 1881:01 to 2012:12 for τ from one month to 60 months together with their 90% confidence intervals and report the results in Fig. 4.3 (a). It shows that, by taking the timing opportunity (with respect to the market trend and market volatility), the optimal portfolios (the dotted blue line) outperform the market (the solid black line) on average for time horizons from six to 20 months. We also conduct a Monte Carlo analysis based on 1,000 simulations and report the average Sharpe ratios in Fig. 4.3 (b) for the optimal portfolios. It shows the outperformance of the optimal portfolios over the market index based on the Sharpe ratio for the look-back periods of more than six months. These results are surprisingly consistent with that in Fig. 4.2 under the utility measure. In addition, we show (in Appendix F) that the pure momentum strategies underperform the market in all time horizons from one month to 60 months. We also conduct some out-of-sample tests (in Appendix F), showing that the optimal strategies still outperform the market index for time horizons up to two years. In summary, we have demonstrated the consistent outperformance of the optimal portfolios over the market index and pure strategies under the two performance measures when the time horizons of the TSM component are short.

4.3. The effect on short-sale constraint. For different time horizon, Fig. 4.4 (a) and (b) report the terminal utilities and the Sharpe ratio for the optimal portfolio with and without short-sales constraint, respectively, comparing with the passive holding market index portfolio, showing the outperformance under the constrain. We also examine the mean and standard deviation of the optimal portfolio weights and report the results in Fig. 4.4 (c) and (d) with and without short-sale constraint. The results for $\tau = 12$ in the previous section also hold for all time horizons. That is, with the constraint, the optimal portfolio weights increase in the mean while volatility is low and stable. On the other hand, without the constraint, the volatility of the optimal portfolio weights varies dramatically. In line with the argument of Marquering and Verbeek (2004), the improved performance under the constrain comes from the small estimation error.

FIGURE 4.4. The terminal utility of wealth (a) and the Sharpe ratio (b) for the optimal portfolio, the mean (c) and the standard deviation of the optimal portfolio weights, with and without short-sale constraints, compared with the market index portfolio.

4.4. Comparison with TSM with different time horizons. As in the previous section for $\tau = 12$, we use the Sharpe ratio to examine the performance of the optimal strategy π_t^* in (2.8) and compare with the passive index strategy and two strategies for time horizons from 1 month to 60 months and one month holding period. We report the Sharpe ratios of the portfolios for the four strategies in Fig. 4.5 (a).¹⁵ For comparison, we collect the Sharpe ratio for the optimal portfolio and the passive holding portfolio reported in Fig. 4.3 and report the Sharpe ratios of the TSM strategy using a solid green line and of momentum and mean-reversion strategy using a dotted red line together in Fig. 4.5 (a) from 1881:01 to 2012:12.

¹⁵The monthly Sharpe ratio for the pure mean-reversion strategy is 0.0250, slightly higher than that for the passive holding portfolio (0.0211).

We have three observations. Firstly, the TSM strategy outperforms the market only for $\tau = 9, 10$ and the momentum and mean-reversion strategy outperform the market for short time horizons of $6 \leq \tau \leq 13$ months. Secondly, by taking the mean-reversion effect into account, the momentum and mean-reversion strategy performs better than the TSM strategy for all time horizons. Finally, the optimal strategy significantly outperforms both the momentum and mean-reversion strategy (for all time horizons beyond four months) and the TSM strategy (for all time horizons).

FIGURE 4.5. (a) The average Sharpe ratio for the optimal portfolio, the momentum and mean-reversion portfolio and the TSM portfolio with $\tau \in [1, 60]$ and the passive holding portfolio from 1881:01 until 2012:12. (b) Terminal log cumulative excess return of the optimal strategies and TSM strategies with $\tau \in [1, 60]$ and passive long strategy from 1876:01 to 2012:12.

Fig. 4.5 (b) shows the terminal values of the log cumulative excess returns of the optimal strategy (2.8) and the TSM strategy with $\tau \in [1, 60]$, together with the passive long strategy, from 1876:01 to 2012:12.¹⁶ It shows that the optimal strategy outperforms the TSM strategy for all time horizons (beyond four months), while the TSM strategy outperforms the market for small time horizons (from about two to 18 months). The terminal values of the log cumulative excess return have similar

¹⁶Note that the passive long strategy introduced in Moskowitz et al. (2012) is different from the passive holding strategy studied in the previous sections. Passive long means holding one share of the index each period; however, passive holding in this paper means investing \$1 in the index in the first period and holding it until the last period.

patterns to the average Sharpe ratio reported in Fig. 4.5 (a), especially for small time horizons.

We also compare the performance of the optimal strategy to the TSM strategy of Moskowitz et al. (2012) by examining the excess return of buy-and-hold strategy when the position is determined by the sign of the optimal portfolio strategies (2.8) with different combinations of time horizon τ and holding period h . We find that, consistent with the finding in Moskowitz et al. (2012), strategy $(\tau, h) = (9, 1)$ performs the best.

In summary, we have demonstrated that the optimal strategies consistently outperform the market index and pure strategies for time horizon of the TSM component from five to 20 months, showing the predicting power of moving averages on the short-run momentum and long-run reversal.

5. CONCLUSION

To characterize the short-run time series momentum and long-run mean reversion in financial markets, we propose a continuous-time model of asset price dynamics with the drift as a weighted average of mean reversion and moving average components. By applying the maximum principle for control problems of stochastic delay differential equations, we derive the optimal strategies. By estimating the model to the S&P 500, we show that, by combining market fundamentals and timing opportunity with respect to market trend and volatility, the optimal strategy based on the time series momentum and reversal outperforms significantly, both in-sample and out-of-sample, the S&P500 and pure strategies based on either time series momentum or reversal only. The outperformance holds for out-of-sample tests, is immune to the short-sale constraint, market states, investor sentiment and market volatility. More importantly, the outperformance of the optimal strategy holds for all the moving average components based on short-time horizons between six months to two years. The results show that the profitability pattern reflected by the average return of commonly used strategies in much of the empirical literature may reflect

neither the profitability of the combined optimal strategy nor the effect of portfolio wealth.

The model proposed in this paper is simple and stylized. The weights of the momentum and mean-reversion components are constant. When market conditions change, the weights can be time-varying. Hence it would be interesting to model their dependence on market conditions. This can be modelled, for example, as a Markov switching process or based on some rational learning process. We could also consider incorporating stochastic volatilities of the return process into the model. Finally, an extension of the model to a multi-asset setting to study cross-sectional optimal strategies would be helpful to understand cross-sectional momentum and reversal.

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ONLINE APPENDIX

APPENDIX A. PROOF OF PROPOSITION 2.1

Let $C([-\tau, 0], R)$ be the space of all continuous functions $\varphi : [-\tau, 0] \rightarrow R$. Basically, the solution can be found by using forward induction steps of length τ as in Arriojas, Hu, Mohammed and Pap (2007). Let $t \in [0, \tau]$. Then the system (2.2)-(2.4) becomes

$$\begin{cases} dS_t = S_t dN_t, & t \in [0, \tau], \\ d\mu_t = \alpha(\bar{\mu} - \mu_t)dt + \sigma'_\mu dZ_t, & t \in [0, \tau], \\ S_t = \varphi_t \text{ for } t \in [-\tau, 0] \text{ almost surely and } \mu_0 = \hat{\mu}. \end{cases} \quad (\text{A.1})$$

where $N_t = \int_0^t \left[\frac{\phi}{\tau} \int_{s-\tau}^s \frac{d\varphi_u}{\varphi_u} + (1 - \phi)\mu_s \right] ds + \int_0^t \sigma'_S dZ_s$ is a semimartingale. Denote by $\langle N_t, N_t \rangle = \int_0^t \sigma'_S \sigma_S ds$, $t \in [0, \tau]$, the quadratic variation. Then system (A.1) has a unique solution

$$\begin{cases} S_t = \varphi_0 \exp \left\{ N_t - \frac{1}{2} \langle N_t, N_t \rangle \right\}, \\ \mu_t = \bar{\mu} + (\hat{\mu} - \bar{\mu}) \exp\{-\alpha t\} + \sigma'_\mu \exp\{-\alpha t\} \int_0^t \exp\{\alpha u\} dZ_u \end{cases}$$

for $t \in [0, \tau]$. This clearly implies that $S_t > 0$ for all $t \in [0, \tau]$ almost surely, when $\varphi_t > 0$ for $t \in [-\tau, 0]$ almost surely. By a similar argument, it follows that $S_t > 0$ for all $t \in [\tau, 2\tau]$ almost surely. Therefore $S_t > 0$ for all $t \geq 0$ almost surely, by induction. Note that the above argument also gives existence and pathwise-uniqueness of the solution to the system (2.2)-(2.4).

APPENDIX B. PROOF OF PROPOSITION 2.2

To solve the stochastic control problems, there are two approaches: the dynamic programming method and the maximum principle. Since the SDDE is not Markovian, we cannot use the dynamic programming method. Recently, Chen and Wu (2010) introduced a maximum principle for the optimal control problem of SDDE. This method is further extended by Øksendal, Sulem and Zhang (2011) to consider a one-dimensional system allowing both delays of moving average type and jumps.

Because the optimal control problem of SDDE is relatively new to the field of economics and finance, we first briefly introduce the maximum principle of Chen and Wu (2010) and refer readers to their paper for details.

B.1. The Maximum Principle for an Optimal Control Problem of SDDE.

Consider a past-dependent state X_t of a control system

$$\begin{cases} dX_t = b(t, X_t, X_{t-\tau}, v_t, v_{t-\tau})dt + \sigma(t, X_t, X_{t-\tau}, v_t, v_{t-\tau})dZ_t, & t \in [0, T], \\ X_t = \xi_t, \quad v_t = \eta_t, & t \in [-\tau, 0], \end{cases} \quad (\text{B.1})$$

where Z_t is a d -dimensional Brownian motion on $(\Omega, \mathcal{F}, P, \{\mathcal{F}_t\}_{t \geq 0})$, and $b : [0, T] \times \mathbb{R}^n \times \mathbb{R}^n \times \mathbb{R}^k \times \mathbb{R}^k \rightarrow \mathbb{R}^n$ and $\sigma : [0, T] \times \mathbb{R}^n \times \mathbb{R}^n \times \mathbb{R}^k \times \mathbb{R}^k \rightarrow \mathbb{R}^{n \times d}$ are given functions. In addition, v_t is a $\mathcal{F}_t$ ($t \geq 0$)-measurable stochastic control with values in U , where $U \subset \mathbb{R}^k$ is a nonempty convex set, $\tau > 0$ is a given finite time delay, $\xi \in C[-\tau, 0]$ is the initial path of X , and η , the initial path of $v(\cdot)$, is a given deterministic continuous function from $[-\tau, 0]$ into U such that $\int_{-\tau}^0 \eta_s^2 ds < +\infty$. The problem is to find the optimal control $u(\cdot) \in \mathcal{A}$, such that

$$J(u(\cdot)) = \sup\{J(v(\cdot)); v(\cdot) \in \mathcal{A}\}, \quad (\text{B.2})$$

where $\mathcal{A}$ denotes the set of all admissible controls. The associated performance function J is given by

$$J(v(\cdot)) = \mathbb{E} \left[\int_0^T L(t, X_t, v_t, v_{t-\tau}) dt + \Phi(X_T) \right],$$

where $L : [0, T] \times \mathbb{R}^n \times \mathbb{R}^k \times \mathbb{R}^k \rightarrow \mathbb{R}$ and $\Phi : \mathbb{R}^n \rightarrow \mathbb{R}$ are given functions. Assume **(H1)**: the functions b , σ , L and Φ are continuously differentiable with respect to $(X_t, X_{t-\tau}, v_t, v_{t-\tau})$ and their derivatives are bounded.

In order to derive the maximum principle, we introduce the adjoint equation,

$$\begin{cases} -dp_t = \{ (b_X^u)^\top p_t + (\sigma_X^u)^\top z_t + \mathbb{E}_t[(b_{X_\tau}^u|_{t+\tau})^\top p_{t+\tau} + (\sigma_{X_\tau}^u|_{t+\tau})^\top z_{t+\tau}] \\ \quad + L_X(t, X_t, u_t, u_{t-\tau}) \} dt - z_t dZ_t, & t \in [0, T], \\ p_T = \Phi_X(X_T), \quad p_t = 0, & t \in (T, T + \tau], \\ z_t = 0, & t \in [T, T + \tau]. \end{cases} \quad (\text{B.3})$$

We refer readers to Theorems 2.1 and 2.2 in Chen and Wu (2010) for the existence and uniqueness of the solutions of the systems (B.3) and (B.1) respectively.

Next, define a Hamiltonian function H from $[0, T] \times \mathbb{R}^n \times \mathbb{R}^n \times \mathbb{R}^k \times \mathbb{R}^k \times L_{\mathcal{F}}^2(0, T + \tau; \mathbb{R}^n) \times L_{\mathcal{F}}^2(0, T + \tau; \mathbb{R}^{n \times d})$ to $\mathbb{R}$ as follows,

$$\begin{aligned} H(t, X_t, X_{t-\tau}, v_t, v_{t-\tau}, p_t, z_t) \\ = \langle b(t, X_t, X_{t-\tau}, v_t, v_{t-\tau}), p_t \rangle + \langle \sigma(t, X_t, X_{t-\tau}, v_t, v_{t-\tau}), z_t \rangle + L(t, X_t, v_t, v_{t-\tau}). \end{aligned}$$

Assume **(H2)**: the functions $H(t, \cdot, \cdot, \cdot, \cdot, p_t, z_t)$ and $\Phi(\cdot)$ are concave with respect to the corresponding variables respectively for $t \in [0, T]$ and given p_t and z_t . Then we have the following proposition on the maximum principle of the stochastic control system with delay by summarizing Theorem 3.1, Remark 3.4 and Theorem 3.2 in Chen and Wu (2010).

Proposition B.1. (i) *Let $u(\cdot)$ be an optimal control of the optimal stochastic control problem with delay subject to (B.1) and (B.2), and $X(\cdot)$ be the corresponding optimal trajectory. Then we have*

$$\max_{v \in U} \langle H_v^u + \mathbb{E}_t[H_{v_\tau}^u | t+\tau], v \rangle = \langle H_v^u + \mathbb{E}_t[H_{v_\tau}^u | t+\tau], u_t \rangle, \quad a.e., \quad a.s.; \quad (\text{B.4})$$

(ii) *Suppose $u(\cdot) \in \mathcal{A}$ and let $X(\cdot)$ be the corresponding trajectory, p_t and z_t be the solution of the adjoint equation (B.3). If **(H1)**, **(H2)** and (B.4) hold for $u(\cdot)$, then $u(\cdot)$ is an optimal control for the stochastic delayed optimal problem (B.1) and (B.2).*

B.2. Proof of Proposition 2.2. We now apply Proposition B.1 to our stochastic control problem. Let $P_u := \ln S_u$ and $V_u := \frac{W_u^{1-\gamma}-1}{1-\gamma}$. Then the stochastic delayed optimal problem in Section 2 becomes to maximize $\mathbb{E}_u[\Phi(X_T)] := \mathbb{E}_u[\frac{W_T^{1-\gamma}-1}{1-\gamma}] = \mathbb{E}_u[V_T]$, subject to

$$\begin{cases} dX_u = b(u, X_u, X_{u-\tau}, \pi_u)du + \sigma(u, X_u, \pi_u)dZ_u, & u \in [t, T], \\ X_u = \xi_u, \quad v_u = \eta_u, & u \in [t - \tau, t], \end{cases} \quad (\text{B.5})$$

where

$$\begin{aligned} X_u &= \begin{pmatrix} P_u \\ \mu_u \\ V_u \end{pmatrix}, \quad \sigma = \begin{pmatrix} \sigma'_S \\ \sigma'_\mu \\ ((1-\gamma)V_u + 1)\pi_u\sigma'_S \end{pmatrix}, \\ b &= \begin{pmatrix} \frac{\phi}{\tau}(P_u - P_{u-\tau}) + (1-\phi)\mu_u - (1-\phi)\frac{\sigma'_S\sigma_S}{2} \\ \alpha(\bar{\mu} - \mu_u) \\ ((1-\gamma)V_u + 1)\left\{ -\frac{\gamma\pi_u^2\sigma'_S\sigma_S}{2} + \pi_u\left[\frac{\phi}{\tau}(P_u - P_{u-\tau}) + \frac{\sigma'_S\sigma_S}{2}\phi + (1-\phi)\mu_u - r\right] + r \right\} \end{pmatrix}. \end{aligned}$$

Then we have the following adjoint equation

$$\left\{ \begin{array}{l} -dp_u = \{ (b_X^{\pi^*})^\top p_u + (\sigma_X^{\pi^*})^\top z_u + \mathbb{E}_u[(b_{X_\tau}^{\pi^*}|_{u+\tau})^\top p_{u+\tau} + (\sigma_{X_\tau}^{\pi^*}|_{u+\tau})^\top z_{u+\tau}] \\ \quad + L_X \} du - z_u dZ_u, \quad u \in [t, T], \\ p_T = \Phi_X(X_T), \quad p_u = 0, \quad u \in (T, T + \tau], \\ z_u = 0, \quad u \in [T, T + \tau], \end{array} \right. \quad (\text{B.6})$$

where

$$\begin{aligned} p_u &= (p_u^i)_{3 \times 1}, \quad z_u = (z_u^{ij})_{3 \times 2}, \\ (b_X^{\pi^*})^\top &= \begin{pmatrix} \frac{\phi}{\tau} & 0 & [(1-\gamma)V_u + 1]\frac{\phi}{\tau}\pi_u^* \\ 1-\phi & -\alpha & [(1-\gamma)V_u + 1](1-\phi)\pi_u^* \\ 0 & 0 & (1-\gamma)\left\{ -\frac{\gamma\pi_u^{*2}\sigma'_S\sigma_S}{2} + \pi_u^*\left[\frac{\phi}{\tau}(P_u - P_{u-\tau}) + \frac{\sigma'_S\sigma_S}{2}\phi + (1-\phi)\mu_u - r\right] + r \right\} \end{pmatrix}, \\ (b_{X_\tau}^{\pi^*}|_{u+\tau})^\top &= \begin{pmatrix} -\frac{\phi}{\tau} & 0 & -[(1-\gamma)V_{u+\tau} + 1]\frac{\phi}{\tau}\pi_{u+\tau}^* \\ 0 & 0 & 0 \\ 0 & 0 & 0 \end{pmatrix}, \quad \Phi_X(X_T) = \begin{pmatrix} 0 \\ 0 \\ 1 \end{pmatrix}, \quad L_X = 0, \\ (\sigma_X^{\pi^*})^\top &= \begin{pmatrix} (\sigma_{1X}^{\pi^*})^\top \\ (\sigma_{2X}^{\pi^*})^\top \end{pmatrix}, \quad (\sigma_{iX}^{\pi^*})^\top = \begin{pmatrix} 0 & 0 & 0 \\ 0 & 0 & 0 \\ 0 & 0 & (1-\gamma)\pi_u^*\sigma_{S(i)} \end{pmatrix}, \quad i = 1, 2, \quad (\sigma_{X_\tau}^{\pi^*}|_{u+\tau})^\top = \mathbf{0}_{2 \times 3 \times 3}. \end{aligned}$$

The Hamiltonian function H is given by

$$\begin{aligned} H &= \left[\frac{\phi}{\tau}(P_u - P_{u-\tau}) + (1-\phi)\mu_u - (1-\phi)\frac{\sigma'_S\sigma_S}{2} \right] p_u^1 + \alpha(\bar{\mu} - \mu_u)p_u^2 \\ &\quad + [(1-\gamma)V_{u+\tau} + 1] \left\{ -\frac{\gamma\pi_u^{*2}\sigma'_S\sigma_S}{2} + \pi_u \left[\frac{\phi}{\tau}(P_u - P_{u-\tau}) + \frac{\sigma'_S\sigma_S}{2}\phi + (1-\phi)\mu_u - r \right] + r \right\} p_u^3 \\ &\quad + \sigma'_S \begin{pmatrix} z_u^{11} \\ z_u^{12} \end{pmatrix} + \sigma'_\mu \begin{pmatrix} z_u^{21} \\ z_u^{22} \end{pmatrix} + [(1-\gamma)V_u + 1]\pi_u\sigma'_S \begin{pmatrix} z_u^{31} \\ z_u^{32} \end{pmatrix}, \end{aligned}$$

so that

$$H_\pi^{\pi^*} = [(1-\gamma)V_u + 1]p_u^3 \left\{ -\gamma\pi_u^*\sigma'_S\sigma_S + \frac{\phi}{\tau}(P_u - P_{u-\tau}) + \frac{\sigma'_S\sigma_S}{2}\phi + (1-\phi)\mu_u - r \right\} + [(1-\gamma)V_u + 1]\sigma'_S \begin{pmatrix} z_u^{31} \\ z_u^{32} \end{pmatrix}.$$

It can be verified that $\mathbb{E}_u[H_{\pi_\tau}^{\pi^*}|_{u+\tau}] = 0$. Therefore,

$$\langle H_\pi^{\pi^*} + \mathbb{E}_u[H_{\pi_\tau}^{\pi^*}|_{u+\tau}], \pi \rangle = \pi_u H_\pi^{\pi^*}.$$

Taking the derivative with respect to π_u and letting it equal zero yields

$$\begin{aligned} \pi_u^* &= \frac{\frac{\phi}{\tau}(P_u - P_{u-\tau}) + \frac{\sigma'_S\sigma_S}{2}\phi + (1-\phi)\mu_u - r}{\gamma\sigma'_S\sigma_S} + \frac{\sigma_{S(1)}z_u^{31} + \sigma_{S(2)}z_u^{32}}{\gamma p_u^3 \sigma'_S\sigma_S} \\ &= \frac{\phi m_u + (1-\phi)\mu_u - r}{\gamma\sigma'_S\sigma_S} + \frac{\sigma_{S(1)}z_u^{31} + \sigma_{S(2)}z_u^{32}}{\gamma p_u^3 \sigma'_S\sigma_S}, \end{aligned} \quad (\text{B.7})$$

where z_u and p_u are governed by the backward stochastic differential system (B.6).

This gives the optimal investment strategy.

Especially, if $\gamma = 1$, the utility reduces to a log one. Then the parameter matrices in the adjoint equation (B.6) become

$$(b_X^{\pi^*})^\top = \begin{pmatrix} \frac{\phi}{\tau} & 0 & \frac{\phi}{\tau} \pi_u^* \\ 1 - \phi & -\alpha & (1 - \phi) \pi_u^* \\ 0 & 0 & 0 \end{pmatrix}, \quad (b_{X_\tau}^{\pi^*}|_{u+\tau})^\top = \begin{pmatrix} -\frac{\phi}{\tau} & 0 & -\frac{\phi}{\tau} \pi_{u+\tau}^* \\ 0 & 0 & 0 \\ 0 & 0 & 0 \end{pmatrix},$$

$$\Phi_X(X_T) = \begin{pmatrix} 0 \\ 0 \\ 1 \end{pmatrix}, \quad L_X = 0, \quad (\sigma_X^{\pi^*})^\top = (\sigma_{X_\tau}^{\pi^*}|_{u+\tau})^\top = \mathbf{0}_{2 \times 3 \times 3}.$$

Since the parameters and terminal values for dp_u^3 are deterministic in this case, we can assert that $z_u^{31} = z_u^{32} = 0$ for $u \in [t, T]$, which leads to $p_u^3 = 1$ for $u \in [t, T]$. Then the Hamiltonian function H is given by

$$\begin{aligned} H = & \left[\frac{\phi}{\tau} (P_u - P_{u-\tau}) + (1 - \phi) \mu_u - (1 - \phi) \frac{\sigma'_S \sigma_S}{2} \right] p_u^1 + \alpha (\bar{\mu} - \mu_u) p_u^2 \\ & + \left\{ -\frac{\pi_u^2 \sigma'_S \sigma_S}{2} + \pi_u \left[\frac{\phi}{\tau} (P_u - P_{u-\tau}) + \frac{\sigma'_S \sigma_S}{2} \phi + (1 - \phi) \mu_u - r \right] + r \right\} p_u^3 \\ & + \sigma'_S \begin{pmatrix} z_u^{11} \\ z_u^{12} \end{pmatrix} + \sigma'_\mu \begin{pmatrix} z_u^{21} \\ z_u^{22} \end{pmatrix}, \end{aligned}$$

and the (myopic) optimal strategy is given by

$$\pi_u^* = \frac{\phi m_u + (1 - \phi) \mu_u - r}{\sigma'_S \sigma_S}.$$

APPENDIX C. MONTE CARLO ANALYSIS OF THE PERFORMANCE FOR $\tau = 12$

To provide further evidence of the optimal strategy, we conduct a Monte Carlo analysis. For $\tau = 12$ and the estimated parameters, we simulate model (3.1) and report the average portfolio utilities (the solid red line in the middle) based on 1,000 simulations in Fig. C.1 (a), together with 95% confidence levels (the two solid green lines outside), comparing to the utility of the market index (the dash-dotted blue line). It shows that firstly, the average utilities of the optimal portfolios are better than that of the S&P 500. Secondly, the utility for the S&P 500 falls into the 95% confidence bounds and hence the average performance of the optimal strategy is not statistically different from the market index at the 95% confidence level. We also plot two black dashed bounds for the 60% confidence level. It shows that, at the 60%

confidence level, the optimal portfolio significantly outperforms the market index. Fig. C.1 (b) reports the one-sided t -test statistics to test $\ln W_t^* > \ln W_t^{SP500}$. The t -statistics are above 0.84 most of the time, which indicates a critical value at 80% confidence level. Therefore, with 80% confidence, the optimal portfolio significantly outperforms the market index. In summary, we have provided empirical evidence of the outperformance of the optimal strategy (2.8) compared to the market index, pure momentum and pure mean-reversion strategies.

FIGURE C.1. (a) Average utility ((the solid red line), the 95% confidence bounds (the solid green lines) and the 60% confidence bounds (the dotted blue lines) and (b) one-sided t -test statistics based on 1,000 simulations for $\tau = 12$.

APPENDIX D. ROLLING WINDOW ESTIMATIONS

In this appendix, we provide some robustness analysis to the rolling window estimations.

For fix $\tau = 12$, we estimate parameters of (3.2) at each month by using the past 20 years' data to avoid look-ahead bias. Fig. D.1 illustrates the estimated parameters. The big jump in estimated $\sigma_{S(1)}$ during 1930–1950 is consistent with the high volatility of market return illustrated in Fig. D.2 (b). Fig. D.1 also illustrates the interesting phenomenon that the estimated ϕ is very close to zero for three periods of time, implying insignificant momentum but significant mean-reversion effect. By comparing Fig. D.1 (b) and (e), we observe that the insignificant ϕ is accompanied by high volatility $\sigma_{S(1)}$.

FIGURE D.1. The estimates of (a) α ; (b) ϕ ; (c) $\bar{\mu}$; (d) ν ; (e) $\sigma_{S(1)}$; (f) $\sigma_{X(1)}$ and (g) $\sigma_{X(2)}$ for $\tau = 12$ based on data from the past 20 years.

Fig. D.2 illustrates the time series of (a) the index level and (b) the simple return of the S&P 500; (c) the optimal portfolio and (d) the utility of the optimal portfolio wealth from 1890:12 to 2012:12 for $\tau = 12$ with 20-year rolling window estimate of parameters. The index return and π_t^* are positively correlated with a correlation of 0.0620. In addition, we find that the profits are higher after the 1930s.

FIGURE D.2. The time series of (a) the index level and (b) the simple return of the total return index of S&P 500; (c) the optimal portfolio and (d) the utility of wealth from 1890:12 until 2012:12 for $\tau = 12$ with 20-year rolling window estimated parameters.

Based on the rolling window estimates of $\sigma_{S(1)}$ (similar to Fig. D.1 (d)) for MM ($\phi = 1$), Fig. D.3 illustrates the time series of (a) the optimal portfolio and (b) the utility of wealth for MM from 1890:12 to 2012:12 for $\tau = 12$. By comparing Fig. D.2 (d) and Fig. D.3 (b), the optimal strategy implied by MM suffers huge losses during the high market volatility period, while Fig D.2 illustrates that the optimal strategy implied by FM makes significant profits during the big market volatility period. Fig. D.3 (c) and (d) illustrate the time series of the optimal portfolio and the utility of wealth for the MRM based on 20-year rolling window estimated parameters (similar to Fig. D.1). After eliminating the look-ahead bias, the pure mean-reversion strategy cannot outperform the stock index any longer.

FIGURE D.3. The time series of the optimal portfolio and the utility of wealth for the pure momentum model (a) and (b) and pure mean-reversion model (c) and (d) from 1890:12 to 2012:12 for $\tau = 12$ with 20-year rolling window estimated parameters.

APPENDIX E. ROBUSTNESS ANALYSIS

In this appendix, we provide a robustness analysis of market states, sentiment, volatility, and hedging demand.

E.1. Market States. First, we follow Cooper et al. (2004) and Hou et al. (2009) and define market state using the cumulative return of the stock index (including dividends) over the most recent 36 months.¹⁷ We label a month as an up (down)

¹⁷The results are similar if we use the alternative 6-, 12- or 24-month market state definitions, even though they are more sensitive to sudden changes in market sentiment.

market month if the market's three-year return is non-negative (negative). There are 1,165 up months and 478 down months from 1876:02¹⁸ to 2012:12.

TABLE E.1. The average excess return of the optimal strategy for $\tau = 12$.

	Observations (N)	Average excess return
Unconditional return	1,643	0.0087 (2.37)
Up market	1,165	0.0081 (4.09)
Down market	478	0.0101 (0.87)

We compute the average return of the optimal strategy and compare the average returns between up and down market months. Table E.1 presents the average unconditional excess returns and the average excess returns for up and down market months. The unconditional average excess return is 87 basis points per month. In up market months, the average excess return is 81 basis points and it is statistically significant. In down market months, the average excess return is 101 basis points; this value is economically but not statistically significant. The difference between down and up months is 20 basis points, which is not significantly different from zero based on a two-sample t -test (p -value of 0.87).¹⁹

We use the following regression model to test for the difference in returns:

$$R_t^* - r = \alpha + \kappa I_t(UP) + \beta(R_t - r) + \epsilon_t, \quad (\text{E.1})$$

where $R_t^* = (W_t^* - W_{t-1}^*)/W_{t-1}^*$ is the month t return of the optimal strategy, $R_t - r$ is the excess return of the stock index, and $I_t(UP)$ is a dummy variable that takes the value of 1 if month t is in an up month, and zero otherwise. The regression intercept α measures the average return of the optimal strategy in down market months, and the coefficient κ captures the incremental average return in up market months relative to down months. We also replace the market state dummy in (E.1) with the lagged market return over the previous 36 months (not reported here), and the results are robust.

¹⁸We exclude 1876:01 in which there is no return to the optimal strategies.

¹⁹The p -values for the pure momentum strategy, pure mean-reversion strategy and TSM are 0.87, 0.87 and 0.67 respectively.

TABLE E.2. The coefficients for the regression (E.1)-(E.2).

	FM	MM	MRM	TSM	FM	MM	MRM	TSM
α	0.0094 (1.46)	0.0476 (1.34)	-0.0000 (-0.01)	0.0060 (3.23)	0.0086 (1.44)	0.0423 (1.32)	0.0002 (0.18)	0.0058 (3.29)
κ	0.0005 (0.06)	0.0041 (0.10)	-0.0005 (-0.32)	-0.0014 (-0.63)	-0.0008 (-0.11)	-0.0034 (-0.09)	-0.0002 (-0.14)	-0.0017 (-0.81)
β	-1.0523 (-12.48)	-6.7491 (-14.60)	0.3587 (22.97)	-0.1548 (-6.39)				
β_1					0.1994 (1.90)	0.7189 (1.27)	0.0708 (3.84)	0.1341 (4.30)
β_2					-2.5326 (-22.16)	-15.5802 (-25.31)	0.6991 (34.88)	-0.4964 (-14.63)

The first four columns of Table E.2 report the regression coefficients of (E.1) for FM, MM, MRM and the TSM strategy in Moskowitz et al. (2012) for $\tau = 12$ respectively. We see that for all strategies, the differences in returns between down and up market are not significant. Also, the returns in down market are not significant, except for the TSM which earns significant positive returns in down market. The results are consistent with those in Table E.1.

To further control for market risk in up and down market months, we now run the following regression:

$$R_t^* - r = \alpha + \kappa I_t(UP) + \beta_1(R_t - r)I_t(UP) + \beta_2(R_t - r)I_t(DOWN) + \epsilon_t. \quad (E.2)$$

The regression coefficients are reported in the last four columns of Table E.2. Again, we obtain similar results to (E.1).

TABLE E.3. The coefficients for the regression (E.3)-(E.4).

	Excess return				CAPM-adj return			
	FM	MM	MRM	TSM	FM	MM	MRM	TSM
α	0.0083 (1.22)	0.0409 (1.08)	0.0002 (0.14)	0.0057 (3.03)	0.0094 (1.46)	0.0476 (1.34)	0.0000 (-0.01)	0.0060 (3.23)
κ	0.0006 (0.07)	0.0037 (0.08)	-0.0002 (-0.14)	-0.0012 (-0.53)	0.0005 (0.06)	0.0041 (0.10)	-0.0005 (-0.32)	-0.0014 (-0.63)

When we regress excess return on dummy variable of previous month's state $I_{t-1}(UP)$:

$$R_t^* - r = \alpha + \kappa I_{t-1}(UP) + \epsilon_t, \quad (E.3)$$

we find insignificant κ in Table E.3, which indicates the insignificant incremental predictive power of up market state for returns of all strategies. However, we observe significant estimate of α for TSM, and larger t -statistics of α for FM and MM (although not significant at conventional level) than that of MRM. This implies that down market state predicts TSM returns, and it also has stronger predictive power for the optimal strategy and pure momentum strategy compared to that of mean reversion. We obtain the same result for the CAPM-adjusted returns:

$$\begin{aligned} R_t^* - r &= \alpha^{CAPM} + \beta^{CAPM}(R_t - r) + \varepsilon_t, \\ R_t^* - r - \beta^{CAPM}(R_t - r) &= \alpha + \kappa I_{t-1}(UP) + \epsilon_t. \end{aligned} \tag{E.4}$$

In summary, whereas cross-sectional momentum usually generates higher returns in up months in Hou et al. (2009), we do not find significant differences in returns between up and down months for the strategies from our model and the TSM. The TSM has significant positive returns in down market months, which also has significant predictive power to next month's TSM returns.

TABLE E.4. The coefficients for the regression (E.5).

	FM	MM	MRM	TSM
a	0.0059	0.0267	0.0005	0.0040
	(1.77)	(1.74)	(1.49)	(2.57)
b	0.0040	0.0134	-0.0003	0.0023
	(1.20)	(0.87)	(-1.01)	(1.48)

E.2. Investor Sentiment. In this subsection, we examine if investor sentiment predicts returns of the optimal strategies:

$$R_t^* - r = a + bT_{t-1} + \epsilon, \tag{E.5}$$

where T_t is the sentiment index constructed by Baker and Wurgler (2006).²⁰ We see from Table E.4 that none of the estimates of b is significant, which suggests that investor sentiment has no predictive power for returns of optimal strategies and of the TSM. We also examine monthly changes of the level of sentiment by replacing T_t with its monthly changes and their orthogonalized indexes. The results are similar.

TABLE E.5. The coefficients for the regression (E.6)-(E.7).

	FM	MM	MRM	TSM	FM	MM	MRM	TSM
α	0.0037 (1.06)	0.0421 (1.11)	-0.0014 (-1.00)	0.0053 (2.78)	-0.0020 (-0.27)	-0.0151 (-0.36)	0.0012 (0.80)	0.0025 (1.19)
κ	0.0138 (0.25)	0.0141 (0.05)	0.0137 (1.21)	-0.0232 (-1.48)				
κ_1					0.1043 (1.34)	0.5763 (1.33)	-0.0127 (-0.80)	0.0016 (-0.07)
κ_2					0.1026 (1.80)	0.5564 (1.75)	-0.0098 (-0.84)	0.0084 (0.53)

E.3. Market Volatility. We now examine the predictability of market volatility for portfolio returns:

$$R_t^* - r = \alpha + \kappa \hat{\sigma}_{S,t-1} + \epsilon_t, \quad (\text{E.6})$$

where the ex-ante annualized volatility $\hat{\sigma}_{S,t}$ is given by (3.3). Table E.5 shows that the estimated κ 's are insignificant, implying that volatility has no predictive power for returns of optimal strategies and of the TSM. We obtain similar results even if we separate volatility into up and down market months as Wang and Xu (2015):

$$R_t^* - r = \alpha + \kappa_1 \hat{\sigma}_{S,t-1}^+ + \kappa_2 \hat{\sigma}_{S,t-1}^- + \epsilon_t, \quad (\text{E.7})$$

where $\hat{\sigma}_{S,t}^+$ ($\hat{\sigma}_{S,t}^-$) is equal to $\hat{\sigma}_{S,t}$ if the market state is up (down) and otherwise zero.

E.4. Hedging Demand. Taking the advantage of the closed-form solution, previous discussions concentrate on the case of $\gamma = 1$. For $\gamma \neq 1$, the optimal portfolio weight is the sum of the myopic and hedging demands. The optimal strategy (2.7) is determined by a coupled forward backward stochastic differential equations (FBSDEs) with time delay, to which there is no efficient way to find numerical solution (Ma and Yong, 1999 and Delong, 2013). Given the current state of the art of FBSDEs with time delay, we are only able to conduct a limited exploratory analysis on the hedging demand.

We follow the Picard iterations scheme developed in Bender and Denk (2007). Due to the non-Markovian structure of time-delayed BSDEs, the conditional expectation in (B.6) in Appendix B has to be taken with respect to the whole information

²⁰The data on the Baker-Wurgler sentiment index from 07/1965 to 12/2010 is obtained from the Jeffrey Wurglers website (<http://people.stern.nyu.edu/jwurgler/>).

$\mathcal{F}_t$. Therefore, we estimate the expected values by approximating the Brownian motion by a symmetric random walk as in Ma, Protter, Martin and Torres (2002). Specifically, we first simulate the 2^T trajectories of the forward processes S_t and μ_t for t from 1 to T based on the approximating binomial random walk. The parameters are chosen based on Table 3.1 and the initial values $S_t = \varphi_t$, $t \in [-\tau, 0]$ and $\mu_0 = \hat{\mu}$ are chosen as the corresponding initial values of S&P 500 and the dividend yield. A unique solution (p, z) to the backward part (B.6) is obtained as the limit of the sequence of the processes $(p^{(n)}, z^{(n)})$ governed by

$$p_t^{(n)} = \mathbb{E} \left[\Phi_X(X_T) + \int_t^T \left\{ (b_X^{\pi^{(n-1)}})^\top p_u^{(n-1)} + (\sigma_X^{\pi^{(n-1)}})^\top z_u^{(n-1)} + (b_{X_\tau}^{\pi^{(n-1)}}|_{u+\tau})^\top p_{u+\tau}^{(n-1)} + (\sigma_{X_\tau}^{\pi^{(n-1)}}|_{u+\tau})^\top z_{u+\tau}^{(n-1)} \right\} du \middle| \mathcal{F}_t \right],$$

with $(p^{(0)}, z^{(0)}) = (1, 0)$. For the n -th iteration, $\pi^{(n-1)}$ and hence $W^{(n-1)}$ can be obtained after knowing $(p^{(n-1)}, z^{(n-1)})$. This algorithm is feasible for small terminal time T but impractical for longer durations due to an enormous number of trajectories that have to be generated. We consider terminal time T up to 12 months and choose the relative risk aversion $\gamma = 5$. To examine the values added by the hedging demand, we compare the optimal strategy and the myopic strategy. For the optimal and suboptimal investment strategies, we determine the certainty equivalent return and report the annualized loss C following the suboptimal strategic allocation. Specifically, the annualized utility cost C is given by

$$C = \left[\frac{J_2 + 1/(1-\gamma)}{J_1 + 1/(1-\gamma)} \right]^{1/[T(1-\gamma)]} - 1, \quad (\text{E.8})$$

where J_1 and J_2 are the value functions following the optimal and myopic strategies, respectively.

TABLE E.6. The utility costs (in %) of behaving myopically for terminal times up to one year and time horizons up to six months with $\gamma = 5$.

T	1	3	6	9	12
$\tau = 1$	-0.26	-0.97	-1.83	-1.86	-3.01
$\tau = 3$	-0.64	-1.01	-1.64	-5.30	-8.17
$\tau = 6$	-12.99	-12.77	-12.81	-16.34	-24.39

Table E.6 reports the utility costs for terminal time up to one year and time horizon up to six months. Two observations are obtained. Firstly, intuitively, the myopic strategy suffers a big loss for long investment horizons. Table E.6 confirms this intuition and shows that the costs of myopic strategy increase as terminal time increases. Secondly, the time delay effect in stock returns also enlarges the costs of the myopic strategy.

APPENDIX F. THE EFFECTS OF TIME HORIZONS

F.1. Estimations and Information Criteria. We present different information criteria, including Akaike (AIC), Bayesian (BIC) and Hannan–Quinn (HQ) information criteria for τ from one month to 60 months in Fig. F.1. We see that the AIC, BIC and HQ reach their minima at $\tau = 23, 19$ and 20 respectively. We also observe a common increasing pattern of the criteria level for longer τ .

FIGURE F.1. (a) Akaike, (b) Bayesian, and (c) Hannan–Quinn information criteria for $\tau \in [1, 60]$.

We present the estimation of parameter $\sigma_{S(1)}$ for MM in Fig. F.2 (a) for $\tau \in [1, 60]$. We also conduct a log-likelihood ratio test to compare FM to MM and MRM with respect to different τ . The statistic is much greater than 12.59, the critical value with six degrees of freedom at the 5% significance level for MM. Comparing to MRM, the test statistic is much greater than 3.841, the critical value with one degree of freedom at 5% significance level. This implies that FM explains the market returns better than MM or MRM.

F.2. Performance of the Pure Momentum and Pure Mean-reversion Strategies.

With the estimated parameter $\sigma_{S(1)}$ in Fig. F.2 (a), we compare the performance of the pure momentum strategies to the market index (in terms of the terminal utilities of the portfolios of MM and the index at 2012:12) in Fig. F.2 (b) for $\tau \in [1, 60]$. It shows that the pure momentum strategy under-performs the market index for all the time horizons. We also examine the evolution of the utility of the optimal portfolio wealth and of the passive holding index portfolio from 1876:01 to 2012:12, finding that the optimal strategies outperform the market index over the whole time period for τ from five to 20 months consistently.

FIGURE F.2. The estimations of $\sigma_{S(1)}$ (a) and the utility of terminal wealth for the pure momentum model for $\tau \in [1, 60]$.

F.3. The Out-of-sample Test for Different Time Horizons. To see the effect of the time horizon on the results of out-of-sample tests, we split the whole data set into two equal periods: 1871:01–1941:12 and 1942:01–2012:12. For given τ , we estimate the model for the first sub-sample period and do the out-of-sample test over the second sub-sample period. We report the utility of terminal wealth for $\tau \in [1, 60]$ using sample data of the last 71 years in Fig. F.3. Clearly the optimal strategies still outperform the market for $\tau \in [1, 14]$.

APPENDIX G. COMPARISON WITH MOSKOWITZ, OOI AND PEDERSEN (2012)

We compare the performance of the optimal strategy to the TSM strategy of Moskowitz et al. (2012) by examining the excess return of buy-and-hold strategy

FIGURE F.3. The terminal utility of the wealth for the optimal portfolio, compared to the passive holding market index portfolio (the dotted line), with out-of-sample data from (a) 1942:01 to 2012:12, (b) 2008:01 to 2012:12, and (c) the utility evolution of the optimal strategies from 2008:01 to 2012:12 for time horizons from 1 to 60 months.

when the position is determined by the sign of the optimal portfolio strategies (2.8) with different combinations of time horizon τ and holding period h .

For a given look-back period τ , we take long/short positions based on the sign of the optimal portfolio (2.8). Then for a given holding period h , we calculate the monthly excess return of the strategy (τ, h) and report the results in Appendix G. Table G.1 reports the average monthly excess return (%) of the optimal strategies, skipping one month between the portfolio formation period and holding period to avoid the one-month reversal in stock returns, for different look-back periods (in the first column) and different holding periods (in the first row). The average return is calculated in the same way as in Moskowitz et al. (2012). We calculate the excess returns of the optimal strategies over the period from 1881:01 (10 years after 1871:01 with five years for calculating the trading signals and five years for holding periods) to 2012:12.

For comparison, Table G.2 reports the average returns (%) for MM.²¹ Notice that Tables G.1 and G.2 indicate that strategy $(\tau, h) = (9, 1)$ performs the best. This is

²¹Notice the position is completely determined by the sign of the optimal strategies. Therefore, the position used in Table G.2 is the same as that of the TSM strategies in Moskowitz et al. (2012).

TABLE G.1. The average excess return (%) of the optimal strategies for different look-back period τ (different row) and different holding period h (different column).

$(\tau \setminus h)$	1	3	6	9	12	24	36	48	60
1	0.1337 (1.28)	0.1387 (1.84)	0.1874* (3.29)	0.1573* (2.83)	0.0998 (1.84)	0.0222 (0.42)	0.0328 (0.63)	0.0479 (0.90)	0.0362 (0.66)
3	0.0972 (0.93)	0.0972 (0.93)	0.0972 (0.93)	0.0972 (0.93)	0.0972 (0.93)	0.0972 (0.93)	0.0972 (0.93)	0.0972 (0.93)	0.0972 (0.93)
6	0.2022 (1.93)	0.2173* (2.28)	0.2315* (2.60)	0.1462 (1.75)	0.0700 (0.88)	-0.0414 (-0.58)	0.0199 (0.32)	0.0304 (0.53)	0.0014 (0.02)
9	0.3413* (3.27)	0.3067* (3.12)	0.2106* (2.28)	0.1242 (1.45)	0.0333 (0.41)	-0.0777 (-1.16)	-0.0095 (-0.17)	0.0000 (0.00)	-0.0450 (-1.11)
12	0.1941 (1.85)	0.1369 (1.40)	0.0756 (0.80)	-0.0041 (-0.04)	-0.0647 (-0.76)	-0.0931 (-1.30)	-0.0234 (-0.41)	-0.0137 (-0.30)	-0.0587 (-1.46)
24	-0.0029 (-0.03)	-0.0513 (-0.51)	-0.0776 (-0.79)	-0.0591 (-0.62)	-0.0557 (-0.61)	-0.0271 (-0.34)	0.0261 (0.40)	-0.0020 (-0.03)	-0.0082 (-0.15)
36	0.0369 (0.35)	0.0602 (0.59)	0.0517 (0.52)	0.0419 (0.43)	0.0416 (0.44)	0.0657 (0.81)	0.0351 (0.49)	0.0273 (0.42)	0.0406 (0.64)
48	0.1819 (1.74)	0.1307 (1.30)	0.1035 (1.06)	0.0895 (0.93)	0.0407 (0.43)	-0.0172 (-0.21)	0.0179 (0.24)	0.0500 (0.70)	0.0595 (0.86)
60	-0.0049 (-0.05)	-0.0263 (-0.26)	-0.0800 (-0.81)	-0.1160 (-1.20)	-0.1289 (-1.41)	-0.0396 (-0.49)	0.0424 (0.55)	0.0518 (0.69)	0.0680 (0.92)

consistent with the finding in Moskowitz et al. (2012) for equity markets although the 12-month horizon is the best for most asset classes.

TABLE G.2. The average excess return (%) of the optimal strategies for different look-back period τ (different row) and different holding period h (different column) for the pure momentum model.

$(\tau \setminus h)$	1	3	6	9	12	24	36	48	60
1	-0.0144 (-0.14)	0.0652 (0.89)	0.0714 (1.34)	0.0689 (1.52)	0.0568 (1.37)	-0.0040 (-0.12)	0.0006 (0.02)	0.0010 (0.04)	-0.0133 (-0.57)
3	0.1683 (1.61)	0.1915* (2.16)	0.1460 (1.91)	0.1536* (2.20)	0.0764 (1.17)	-0.0360 (-0.69)	-0.0290 (-0.72)	-0.0143 (-0.45)	-0.0395 (-1.38)
6	0.2906* (2.78)	0.2633* (2.79)	0.2635* (3.01)	0.1884* (2.29)	0.1031 (1.34)	-0.0484 (-0.75)	-0.0130 (-0.26)	0.0157 (0.40)	-0.0281 (-0.77)
9	0.4075* (3.91)	0.3779* (3.78)	0.2422* (2.62)	0.1538 (1.76)	0.0545 (0.66)	-0.0735 (-1.05)	-0.0217 (-0.38)	-0.0047 (-0.10)	-0.0460 (-1.12)
12	0.2453* (2.35)	0.1660 (1.67)	0.0904 (0.94)	0.0122 (0.13)	-0.0748 (-0.86)	-0.1195 (-1.63)	-0.0602 (-1.02)	-0.0454 (-0.95)	-0.0798 (-1.88)
24	0.0092 (0.09)	-0.0242 (-0.24)	-0.0800 (-0.81)	-0.0962 (-1.03)	-0.0955 (-1.06)	-0.0682 (-0.88)	-0.0081 (-0.13)	-0.0140 (-0.24)	-0.0211 (-0.39)
36	-0.0005 (-0.01)	0.0194 (0.19)	0.0219 (0.23)	0.0212 (0.22)	0.0113 (0.12)	0.0030 (0.04)	0.0127 (0.18)	0.0241 (0.37)	0.0206 (0.33)
48	0.0779 (0.74)	0.0733 (0.73)	0.0231 (0.24)	0.0019 (0.02)	-0.0392 (-0.42)	-0.0676 (-0.83)	-0.0004 (-0.01)	0.0435 (0.61)	0.0382 (0.55)
60	-0.0568 (-0.54)	-0.0852 (-0.84)	-0.1403 (-1.41)	-0.1706 (-1.77)	-0.1986 (-2.15)	-0.1091 (-1.36)	-0.0043 (-0.06)	0.0157 (0.22)	0.0239 (0.34)