

Momentum and Disposition Effect in the Frontier Market in Sri Lanka

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Abstract

This study aims to investigate whether the disposition effect leads to momentum in stock returns. The researcher identifies two sub-periods: from 2015 to 2018, before the economic crisis, and from 2019 to 2022, during the economic crisis. The results indicate that a higher capital gain overhang is associated with lower momentum returns both before and during the economic crisis. Therefore, the disposition effect was negatively related to momentum returns before the economic crisis (2015-2018), during the economic crisis (2019-2022), and throughout the entire period considered by the researcher (2015-2022), and this relationship was statistically significant. The study aims to provide investors with a framework to enhance their trading strategies and portfolio performance. Understanding this link empowers investors to capitalise on behavioural inefficiencies, potentially gaining an edge through timing mechanisms that anticipate momentum-driven movements.

Keywords: Disposition Effect, Frontier Market, Economic Crisis, Momentum

1. Introduction

Momentum is initially defined as stocks that perform the best (or worst) over a three- to twelve-month period tend to continue performing well (or poorly) over the subsequent three- to twelve-month period (Jegadeesh & Titman, 1993). Based on historical results, the momentum effect suggests that stock returns are predictable.

Securities with momentum are thought to have a higher probability of continuing in the same direction than of changing course. Momentum is an oscillator in technical analysis used to help determine trend lines. A momentum trader would frequently take a long or short position in a stock, hoping that its momentum will continue in either an upward or downward direction if its price, earnings, or revenues accelerate. This approach is not recommended for beginners, as it relies more on transient price fluctuations than on a stock's underlying value (Muga & Santamaría, 2007).

Numerous researchers, including Kahneman & Tversky (1979), Grossman & Stiglitz (1980), Malkiel (1995), Carhart (1997), and Hirshleifer et al.(2003), have highlighted numerous instances of investor irrationality. This concept forms the core of behavioural finance, which

examines how psychological factors influence financial decision-making. In recent years, this field has gained traction among both economists and market participants. Increasingly, scholars are paying closer attention to behavioural biases, recognising their significant role in shaping market behaviour. Behavioural finance suggests that investors often rely more on intuition and personal experience than on objective, rational analysis. The disposition effect discusses investor irrationality. The disposition effect, as defined by Shefrin & Statman (1985), refers to investors who tend to sell winners too early and hold losers too long. Shefrin & Statman (1985), the founders of the disposition effect, utilise prospect theory to explain this phenomenon. Other than these two scholars, Goo et al.(2010), Lin (2011), Weber & Camerer (1991), Armansyah (2018), Song & Jeong (2017), Odean (1998), Kaustia (2010), Hens & Vlcek (2011) have used prospect theory as a basis when explaining the disposition effect.

Black (1986) described irrational investors as noise traders. Additionally, the author has identified that noise traders introduce inefficiency into the trading process. For rational investors, trading against irrational investors in competitive marketplaces is expensive and risky because their judgments are unpredictable and difficult to predict. Shleifer & Vishny (1997). Investor preferences are explained using prospect theory. These irrational investors' beliefs and preferences could explain the use of psychological biases and heuristics. According to Baker & Nofsinger (2002), the dynamics of the prospect theory can be used to infer psychological biases in decision-making. They claim that when faced with risk, decision-making involves the processes of editing and evaluation, from which numerous biases can be inferred. Prospect theory-derived biases include mental accounting, status quo bias, reference point bias, and disposition impact. In other words, the disposition effect is a psychological bias derived from prospect theory.

This study aims to investigate the extent to which the disposition effect, in which investors are prone to sell assets that have gained value while holding onto those that have declined, contributes to the persistence of momentum in stock returns in Sri Lanka's frontier market. Specifically, the research examines whether behavioural biases among local investors result in predictable patterns in asset prices that align with momentum-based anomalies. Understanding this relationship could provide insight into how cognitive biases manifest in less-developed financial markets and whether they result in inefficiencies that can be exploited for strategic investment decisions (Baker & Nofsinger, 2002).

2. Literature Review

Grinblatt & Han (2005) suggest that momentum in stock prices, where prices continue to move in the same direction after news, is influenced by the disposition effect, a behavioural bias in which investors tend to sell winning stocks too early and hold onto losing ones too long.

When good news hits the market, prices usually rise. However, investors who have gained from a stock may quickly sell to lock in their profits, putting downward pressure on the price and slowing its climb. Conversely, when bad news arrives, investors holding losing stocks often refuse to sell at a loss, thereby slowing the rate of price decline. Though prices may eventually settle around the stock's true value in the long run, in the short term, they tend to move in the same direction as the initial market reaction, creating momentum.

Grinblatt and Han argue that this effect changes depending on the overall gains or losses investors have in a stock. If most investors are sitting on losses and receive good news, or on gains and receive bad news, they are less likely to react emotionally, and the stock price reflects the news more directly, without delay. Their research supports this theory by showing that stocks with significant unrealised gains tend to outperform those with significant unrealised losses. They found that measuring unrealised gains and losses is more accurate in predicting future returns than the traditional momentum metric, which usually focuses only on the past 12 months of returns.

Goetzman & Massa (2008) found that additional conclusions can be drawn from the Grinblatt & Han (2005) model. Additionally, these scholars have found lower trading volumes and lower stock-level volatility. These researchers' data also support the existence of a component with a similar disposition effect. Lower returns are linked to a stock's exposure to the disposition effect.

Shumway and Wu (2005) challenge the traditional assumption that historical stock returns can reliably predict future performance. Their findings indicate that past returns, both in their sample and in the USA markets during the same period, lack predictive power. Instead, they propose that investors' average unrealised gains or losses, the difference between the current price and the purchase price of held stocks, serve as a more accurate indicator of future returns. The study emphasises that stocks held by investors who are prone to the disposition effect, the tendency to sell winning stocks too early and hold onto losing ones, exhibit stronger momentum patterns. By constructing variables that reflect unrealised gains and losses based on investor trading behaviour, the researchers demonstrate that these behavioural metrics outperform traditional momentum indicators, such as past 12-month returns, in forecasting future price

movements. Their results support the theory that momentum in stock returns is primarily driven by the disposition effect, as investor reluctance to sell at a loss or eagerness to realise gains influences short-term price trends.

Sadhwani and Bhayo (2021) investigate whether the disposition effect in the United States stock market is driven by momentum or its opposite. According to the Fama-MacBeth regression results, momentum is driven by the disposition effect rather than vice versa.

Hur, Pritamani, and Sharma (2010) explored how the disposition effect, a tendency for investors to sell winning stocks too early and hold onto losing ones, can lead to momentum in stock prices. They proposed that this momentum is especially strong in stocks that individual investors predominantly hold, as these investors are more susceptible to such behavioural biases. Their research found that the more individual investors own a stock, the more likely it is that the disposition effect will influence its price movements. This pattern held true across different ways of measuring individual investor ownership. Notably, the results were consistent for both high-return and low-return stocks, suggesting that the findings were not simply due to restrictions on short selling.

Hur and Sing (2019) found that momentum is stronger when the disposition effect and anchoring biases operate in the same direction, and that momentum profits decline when these biases operate in opposite directions. Companies with a higher proportion of retail investors tend to have better disposition and earnings momentum than those with a lower proportion. A sample of stocks with a higher presence of retail investors would yield a larger magnitude of momentum profit than a sample with a lower presence of retail investors when the disposition effect and anchoring bias reinforce each other. Compared to companies with more analyst coverage, the disposition effect-driven momentum earnings are more substantial for stocks with less analyst coverage. Due to the reinforcement of anchoring bias and the disposition effect, the sample of stocks with less analyst coverage is expected to produce a more significant momentum profit than the sample with more analyst coverage. Stock illiquidity, driven by the disposition effect, generated momentum. For the least liquid shares, the effects of anchoring-bias-driven momentum and the enhancement of disposition-effect-driven momentum are expected to be more pronounced.

3. Methodology

For this study, the researcher defines the timeframe from 2015 to 2018 as the pre-crisis period, and the years from 2019 to 2022 as the economic crisis period in Sri Lanka. This classification aligns with findings by George, George, & Baskar (2022) and assessments by the World Bank, which identify the onset and intensification of Sri Lanka's economic crisis within the 2019–2022 window. According to the World Bank (2022), Sri Lanka's economic crisis began in 2019, characterised by escalating debt vulnerabilities, fiscal imbalances, and declining investor confidence. George, George, and Baskar (2022) report that, between 2019 and 2022, the country faced significant macroeconomic shocks, such as currency depreciation and rising inflation, which disrupted financial markets. Data from the Colombo Stock Exchange and the Central Bank of Sri Lanka corroborate the heightened market instability during this period. Therefore, the selected period captures the transition from relative economic stability to severe fiscal and social disruption, providing a meaningful context for analysing market behaviour and investor responses.

To calculate the disposition effect, the reference price must be determined, and ultimately, the capital gain overhang turnover in the stock is calculated. Closing prices and share volumes are collected daily from all companies listed on the Colombo Stock Exchange.

In conducting this study, the researcher selected a sample of 166 companies from the 290 firms listed on the Colombo Stock Exchange. The selection was made through a simple random sampling technique, with the chosen firms being those engaged in uninterrupted trading activity during the study period.

Uninterrupted trading is essential for constructing reliable benchmarks of historical purchase prices and for accurately capturing investor behaviour with respect to gains and losses. Grinblatt and Han (2005) demonstrate that the disposition effect is measured using capital gain overhang, which depends on consistent price histories. Frazzini (2006) contends that trading interruptions impede the calculation of reference prices, thereby distorting the behavioural measures under investigation. Recent studies in emerging markets have adopted this approach, limiting samples to continuously traded firms to ensure methodological validity (Barberis & Xiong, 2009; Kaustia, 2010).

According to the Global Industry Classification Standard (GICS), the CSE includes 20 distinct industries. However, sectors such as energy and software services were excluded from the sample, as their listed companies were inactive during parts of the research timeframe. Additionally, the study focused exclusively on voting shares (N), despite the exchange offering

five categories of securities: voting shares (N), non-voting shares (X), warrants (W), rights issues (R), and preference shares (P).

The sample distribution across sectors is as follows: 12 companies from materials, 19 from capital goods, three from commercial and professional services, one from transportation, one from automobiles and components, eight from consumer durables and apparel, 25 from consumer services, five from retailing, two from food staples and retailing, 25 from food, beverage and tobacco, one from household and personal products, five from healthcare equipment and services, 10 from banking, 26 from insurance, one from telecommunications services, four from utilities, and nine from real estate management and development.

To calculate individual stock returns, monthly closing stock prices of companies listed on the Colombo Stock Exchange will be collected.

To calculate capital gain overhang and stock turnover, the study utilises daily records of closing prices, trading volumes, turnover data, and the number of trading days for each company listed on the Colombo Stock Exchange (CSE). These datasets were obtained from the “32 Daily Shares Price List” maintained in the CSE’s data repository. Additionally, monthly stock returns were calculated using the highest and lowest monthly closing prices, sourced from the “Monthly Highest and Lowest Closing Prices” file available within the same data library.

To estimate the disposition effect, the researcher applies the capital gains overhang model introduced by Grinblatt & Han (2005). This approach requires calculating reference prices, which serve as benchmarks for assessing unrealised capital gains or losses. Determining these reference prices involves analysing the number of trading days for which daily price and volume data are available. These inputs are crucial for developing a reliable measure of investor behaviour based on historical trading activity. The reference price can be calculated as follows,

$$RP_t = \frac{1}{k} \sum_{n=1}^T \left(V_{t-n} \prod_{r=1}^{n-1} [1 - V_{t-n+r}] \right) P_{t-n}$$

In this model, Where V_t reflects the stock turnover on date t , T is the total number of trading days with daily price and volume data available over the preceding eight years. Weights is the phrase in parenthesis that multiplies P_{t-n} , and k is a constant that guarantees that the total of all the weights equals one. The probability that the shares bought on date $t-n$ have not been traded is reflected in the weight on P_{t-n} .

Then, to calculate capital overhang, take the difference between the stock price at the end of the month and reference prices, which are divided by the stock price at the end of the month. Proxy for capital gains overhang for each stock at the end of each month t is:

$$g_t = \frac{P_t - RP_t}{P_t}$$

In addition to Grinblatt & Han (2005), Sadhwani & Bhayo (2021) will use the capital gain overhang (CGO) as the independent variable, with individual stock returns serving as the dependent variable. To calculate the stock return at the end of each month, consider the stock's closing price at the end of each month. Individual stock returns can be calculated as follows.

$$r_t = (p_t - p_{t-1}) / p_{t-1}$$

Where r_t is the monthly return on the stock, p_t is the stock's price at time t , and p_{t-1} is the stock's price in time $t-1$ (previous month).

Monthly stock returns serve as a proxy for momentum returns in this study. This methodology has been widely adopted in previous research. For example, Sadhwani and Bhayo (2021) examined the disposition effect and momentum in the United States stock market using monthly closing prices. Similarly, Grinblatt and Han (2005) utilised monthly returns to construct momentum returns in United States shares, and Rouwenhorst (1998) applied this approach to investigate momentum effects in emerging markets. Consequently, the present study maintains consistency with the established literature by employing this method to calculate momentum returns.

4. Results and Discussion

Cross-sectional regression (Fama and MacBeth Step) (Sadhwani & Bhayo, 2021) obtains the average CGO coefficients across periods. Below are the “average CGO coefficients” of the three datasets the researcher considers.

Period	Average CGO coefficients
2015-2018 (before the economic crisis)	-0.8343
2019-2022 (During the economic crisis)	-0.8288

2015-2022	-0.8461
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Table 1: Average CGO Coefficients

To determine whether the average CGO coefficient is positive and statistically significant, the researcher typically conducts hypothesis testing on the coefficient value obtained from the "Cross-Sectional Regression" step.

When performing the t-test, the researcher assesses whether the p-value associated with the t-test statistic provides evidence to reject the null hypothesis in favour of the alternative hypothesis. If the p-value is very small, less than 0.05, the researcher can conclude that the average CGO coefficient is significantly different from zero and that there is a statistically significant relationship between CGO and Momentum Returns.

A p-value less than 0.05 indicates that the relationship between CGO and Momentum Returns is statistically significant.

The average beta values of -0.8343, -0.8288, and -0.8461 indicate that, on average, for each unit increase in CGO, there is an estimated decrease of 0.8343, 0.8288 and 0.8461 units in momentum returns. Since the value is negative and the relationship is statistically significant, it suggests that higher CGO is associated with lower momentum returns.

Researchers can conclude that, with a very small p-value and a negative average beta, researcher has substantial evidence to suggest that the disposition effect (CGO) was negatively related to momentum returns before the economic crisis (2015-2018) during the economic crisis (2019-2022), and during the whole period researcher considers (2015-2022) for the study, and this relationship is statistically significant. In other words, on average, stocks with higher levels of CGO tend to have lower Momentum Returns.

Sadhwani and Bhayo (2021) found that unrealised gains and losses (CGO positive or negative) are critical drivers of momentum profits. Their findings suggest that stocks with significant aggregate unrealised capital gains have higher returns than stocks with significant aggregate unrealised capital losses. The study found that CGO and momentum returns are related, but a negative relationship suggests that CGO can explain momentum returns. However, when the CGO increases for a stock, its future returns tend to decline. Based on their findings, Hur &

Singh (2019) noted that the disposition effect, driven by behavioural biases among individual investors, influences the momentum effect.

Although momentum theory typically implies return continuation, the observed negative relationship between Capital Gain Overhang (CGO) and momentum indicates that the disposition effect may also produce reversal dynamics. Previous research demonstrates that investor reluctance to realise gains or losses can lead to price underreaction, potentially resulting in reversals rather than continuations. Grinblatt and Han (2005) find that the disposition effect induces underreaction, potentially leading to momentum but also to subsequent reversals when capital gain overhang is elevated. Riley, Summers, and Duxbury (2020) contend that CGO serves as a dynamic reference point for investors; when CGO is negative, investors anchor to past losses, thereby suppressing momentum and potentially generating contrarian effects. Similarly, Ahmed and Doukas (2020) emphasise that the disposition effect's influence on momentum is heterogeneous, with negative CGO sometimes linked to weaker or reversed momentum. Zheng, Zhang, and Zhu (2022) further report that in international markets, low CGO values are associated with a negative risk–return trade-off, indicating that CGO can account for both continuation and reversal, depending on the context. Collectively, these studies support the interpretation that the disposition effect underlies momentum but manifests conditionally, with high capital gain overhang predicting declining rather than continuing returns.

The literature review identifies the disposition effect as a primary driver of positive momentum. However, empirical findings indicate a statistically significant negative relationship between capital gain overhang and momentum returns. This contradiction underscores the influence of contextual factors, especially during economic crises, on investor behaviour.

Multiple theoretical explanations may account for this divergence. First, market overreaction and reversal patterns often dominate during crisis periods, prompting investors to sell winners prematurely and retain losers, which weakens momentum effects (De Bondt & Thaler, 1985; Jegadeesh & Titman, 1993). Second, crisis-induced behavioural changes, such as increased risk aversion and liquidity constraints, can modify trading behaviour and diminish the persistence of momentum returns (Daniel, Hirshleifer, & Subrahmanyam, 1998). Third, the observed negative relationship may result from the prevalence of contrarian strategies in emerging markets, where investors capitalise on short-term reversals rather than on momentum (Rouwenhorst, 1998).

Positioning these findings within alternative theoretical frameworks advances the behavioural finance literature by demonstrating that the disposition effect does not consistently drive positive momentum. Instead, its influence appears contingent upon broader market conditions, including economic crises that intensify reversal dynamics and investor overreaction.

Sri Lanka's market structure is characterised by lower liquidity, higher volatility, and greater sensitivity to macroeconomic shocks, which differentiates it from developed and larger emerging markets. Recent studies highlight that Sri Lankan investors exhibit strong behavioural biases, including loss aversion and herding, which can amplify market inefficiencies (Lasantha & Kumara, 2022; Chandrasiri, Dissanayake, & Weligamage, 2021). Moreover, the economic crisis of 2019–2022 introduced severe fiscal imbalances, currency depreciation, and inflationary pressures (World Bank, 2022; George, George, & Baskar, 2022), creating conditions under which traditional momentum strategies may fail to persist.

Empirical evidence from Sri Lanka indicates that frontier markets are more likely to exhibit reversal dynamics instead of momentum persistence. In crisis conditions, investors frequently liquidate positions prematurely or employ contrarian strategies to safeguard capital (Inderscience, 2025). These findings challenge the generalizability of results from developed markets and contribute to behavioural finance theory by showing that the disposition effect may weaken or even reverse momentum in frontier market contexts.

This study advances frontier market research by demonstrating that the Sri Lankan case extends, rather than replicates, established models. It highlights how crisis-driven behavioural shifts and unique frontier market characteristics influence the disposition–momentum relationship. This contextual innovation offers valuable insights for academics and practitioners aiming to understand behavioural inefficiencies in under-researched markets.

5. Conclusion

The researcher obtained average Capital Gain Overhangs of -0.8343, -0.8288, and -0.8461 for the periods 2015-2018 (before the economic crisis), 2019-2022 (during the economic crisis), and 2015–2018 (overall study period), respectively. The researcher concludes that, on average, stocks with higher capital-gain overhang tend to have lower momentum returns. This study found a relationship between capital gain overhang and momentum returns. However, a

negative relationship suggests that capital gain overhang can explain momentum returns: when capital gain overhang increases in a stock, future returns decline.

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