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Implications of Data Restrictions on Performance Measurement and Tests of Rational Pricing

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Abstract

We argue that the previously documented association between ex ante information (e.g. earnings forecasts) and the subsequent, apparently predictable security price performance is exaggerated. The exaggeration stems from non-random deletion of data, especially in highly right-skewed distributions of long-horizon security returns. Our simulations demonstrate that both forecast optimism and negative abnormal returns are induced when "extreme" observations of ex post long-horizon performance are truncated from samples of rationally priced, unbiased earnings forecasts. Our results suggest caution in interpreting the results of the accounting and finance research that examines the predictability of long-horizon performance based on ex ante information.

JEL Classification: G14, M41, C24

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