Overreaction evidence from large-cap stocks

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Abstract

Purpose

The purpose of this paper is to assess the performance of a contrarian investment strategy focusing on frequently traded large-cap US stocks. Previous criticisms that losers' gains are not due to overreaction but due to their tendency to be thinly traded and smaller-sized firms than winners are addressed.

Design/methodology/approach

Portfolios based on past performance are constructed and it is examined whether contrarian returns exist. The Capital Asset Pricing Model (CAPM), Fama and French three-factor model and the Carhart's (1997) momentum portfolio are used to test whether excess returns are feasible in a contrarian strategy.

Findings

The results show an asymmetric performance following portfolio formation. Although both, winners and losers portfolios, have gains during holding periods, losers outperform winners at all times, and with a differential of up to 29.2 per cent 36 months after portfolio formation. Furthermore, the loser and the winner portfolios' alphas are significant, suggesting that the CAPM and the multifactor models are unable to explain return differentials between winners and losers. Our evidence supports two main conclusions. First, stock market overreaction still holds for a sample of large firms. Second, this is robust to the Fama and French's (1993, 1996) three-factor model and Carhart's (1997) momentum portfolio. Findings emphasize the relevance of a contrarian strategy when rebalancing

winners and buying previous loser large-cap US stocks.

Originality/value

This paper is the first, to the authors' knowledge, to examine frequently traded large-cap US stocks to avoid infrequent trading and size concerns.

Keywords

Overreaction
CAPM
Stock market anomaly
Three-factor model

Citation

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