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Investor Overreaction: Evidence That Its Basis Is Psychological

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Abstract

Probably no subject in recent financial literature has generated more controversy than whether investors behave rationally in pricing stocks, or whether they overreact to market information, resulting in prices being too high or too low. Although the efficient market hypothesis states that, with minor exceptions, securities are rationally priced, repeated evidence has been presented of predictable over- and underreactions. This evidence is based primarily on consistently higher returns for out-of-favor stocks and below-average returns for favored issues. The existence of overreaction in the marketplace, if it can be proven, is important to both investment decision-making and theory, and in more acute cases can be the major cause of financial bubbles and panics.

We present evidence of overreaction by showing that important fundamentals upon which securities prices depend demonstrate little movement in the face of major changes to the returns of favored and unfavored stocks. We can find no explanation

other than psychological influences to account for this finding. The paper also provides evidence that over- and underreaction may be a part of the same process.