

Financial Analysts Journal >
Volume 51, 1995 - Issue 4

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FEATURE ARTICLES

Overreaction, Underreaction, and the Low-P/E Effect

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Pages 21-30 | Published online: 02 Jan 2019

Cite this article <https://doi.org/10.2469/faj.v51.n4.1917>

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Abstract

Although earnings surprises have been studied extensively, they have not been examined in the context of contrarian strategies. Positive and negative earnings surprises affect “best” (high-P/E) and “worst” (low-P/E) stocks in an asymmetric manner that favors worst stocks. Long-term reversion to the mean, in which worst stocks display above-market returns while best stocks show below-market results, regardless of the sign of the surprise, continues for at least 19 quarters following the news. These results are consistent with mispricing (overreaction to events) prior to the surprise, and a correction of the mispricing following the surprise. The results suggest that contrarian strategies based on earnings surprises can generate positive returns.

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