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

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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 corrective price movement after the surprise is consistent with extant research on underreaction. The mispricing-correction hypothesis explains the superior returns of contrarian strategies noted here and elsewhere in the literature.


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