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Liquidity and the Post-Earnings-Announcement Drift

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Abstra

The post … icts with market e … ent drift occurs n … h-earnings-surprise … value-weighte … n the most illiqu … mpact costs. By using … count for 70–100 … exploit the earnings

One of t … form market efficienc … D), or earnings … ing unexpectedly high earnings subsequently outperform companies reporting

unexpectedly low earnings. More specifically, a company's standardized unexpected earnings (SUE) is defined as the difference between the last available quarterly earnings and the earnings during that same quarter in the previous year, scaled by the standard deviation of this difference over the previous eight quarters. A trading strategy that each month goes long the stocks in the top decile of SUE and short the stocks in the bottom decile of SUE earns, on average, 90 bps per month (10 percent annually) over the 1972–2005 period.

The goal of this article is to demonstrate that stock liquidity is an important consideration for understanding the persistence of the PEAD anomaly over the years. Previous studies have not taken trading costs into account in the calculation of abnormal returns. We studied the impact of illiquidity on the profitability of the PEAD trading strategy and show that this strategy is likely to be unprofitable after adjusting for transaction costs.

First, we studied the relationship between the PEAD and illiquidity by using double-sorted portfolios. Our findings suggest that the PEAD is prevalent mainly in illiquid stocks. We examined the profitability of the long–short SUE strategy after sorting stocks into decile portfolios on the basis of their illiquidity. For this analysis, we used the Amihud measure of stock illiquidity, which is the average of the daily price impacts of the order flow (i.e., the daily absolute price change per dollar of daily trading volume). Returns ... percent per month fo... .

Because ... ng a PEAD trading s... impact. We used sev... trading strategie... t of the poten... f the PEAD anon... Rubinstein's definitio...

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