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Equity Investments


# Liquidity and the Post-Earnings-Announcement Drift

Tarun Chordia, Amit Goyal, Gil Sadka, Ronnie Sadka & Lakshmanan Shivakumar

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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 from the long-short SUE strategy are significantly positive, at 9.8 percent per month for the period 1972–2005.

Because of the illiquidity of the stocks, the trading strategy is likely to be unprofitable after adjusting for transaction costs. We used several different measures of illiquidity to test the impact of the PEAD trading strategy. The results show that the PEAD trading strategy is profitable in all cases, but the profitability is significantly reduced when transaction costs are taken into account.

potentially profitable trading strategies. The results show that the PEAD trading strategy is profitable in all cases, but the profitability is significantly reduced when transaction costs are taken into account. This finding is consistent with Rubinstein's definition of the PEAD anomaly.



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