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An examination of investor reaction to unexpected political and economic events in Turkey

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Abstract

We investigate investor reaction to the arrival of unexpected information in Turkey from 1997 to 2004. Daily stock returns are used to test two behavioral hypotheses regarding investor reaction to news: The Overreaction Hypothesis (OH) and the Uncertain Information Hypothesis (UIH). We find no evidence of significant price reversals following the arrival of positive news in Turkey, as predicted by the OH. However, a corrective process of positive returns following favorable news exists, consistent with the UIH. These findings suggest that investors in Turkey systematically set security prices below their fundamental values in response to unexpected information, which is rational behavior in a country with a history of significant financial and economic uncertainties.

JEL classification: G14; G15
Keywords: Market efficiency; Investor reaction; Turkish stock market; Behavioral finance

1. Introduction

For more than thirty years, the Efficient Market Hypothesis (EMH) has been the foundation for financial asset pricing, and the leading hypothesis in the finance literature to explain and predict the behavior of investors. The EMH rests on the assumption that investors are rational and they incorporate all available information in order to establish the fundamental value of securities. The EMH further implies that current stock prices are unbiased estimators of their fundamental values, and they adjust instantaneously to unexpected events based on the behavior of investors who react

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rationally to the arrival of new information. There are, however, two extensions to the EMH in the behavioral finance literature that investigate investor reaction when security prices do not adjust instantaneously, the Overreaction Hypothesis (OH) of DeBondt and Thaler (1985) and the Uncertain Information Hypothesis (UIH) of Brown, Harlow, and Tinic (1988, 1993).

The Overreaction Hypothesis postulates that investors overreact to unexpected events by setting security prices too low (high) in reaction to unfavorable (favorable) news. Over time, security prices will eventually reflect fundamental values as investors process the new information. Corrective and reversal movements in security prices will follow the initial overreaction of investors to the unexpected arrival of new information. Consequently, in contrast to instantaneous price adjustment implied by EMH, security prices will gradually rise after the overreaction to bad news, and gradually fall after the overreaction to good news according to the OH. One implication of the OH is that an investor can construct a contrarian trading rule that involves buying losers and selling winners to generate abnormal returns (DeBondt & Thaler, 1985, 1987).

The Uncertain Information Hypothesis suggests that the arrival of unexpected information, whether good or bad, elevates uncertainty and risk in the equity markets. In responding to the increased uncertainty, investors act rationally by initially setting stock prices below their fundamental values. An upward corrective trend in security prices will then follow as the initial uncertainty gradually subsides and prices rise to their fundamental values. This pattern in stock prices predicted by the UIH implies that abnormal returns are in general positive (or at least non-negative) during a corrective period following the arrival of both unfavorable and favorable news.

Fig. 1 provides a graphical representation of the corrective movements in stock prices following the arrival of unexpected favorable and unfavorable information as predicted by both the OH and UIH. In Panel A, investors overreact to new information as explained by the OH, and there is therefore a downward corrective price movement following the arrival of favorable information, and an upward corrective price movement following the arrival of unfavorable information. This pattern of security prices implies that the corrective cumulative abnormal returns are generally negative following favorable news, and positive following the arrival of unfavorable news. In Panel B, security prices adjust upward following the arrival of both favorable and unfavorable information, as predicted by the UIH. The post-event corrective cumulative abnormal stock returns are generally positive in response to any unexpected political or economic event. Such a corrective pattern in stock prices implies that investors react rationally to the increased market risk caused by the arrival of unexpected news.

From both OH and UIH, it follows that corrective cumulative abnormal stock returns will be positive in response to bad news. The OH predicts that corrective cumulative abnormal returns will be negative following good news, whereas the UIH predicts that corrective cumulative abnormal returns will be positive following favorable news. Thus, the OH and UIH offer competing, alternative predictions about corrective stock returns following favorable political or economic news, and an empirical test of post-event cumulative abnormal stock returns following favorable news can empirically determine which hypothesis is more consistent with investors' reactions to new information.

The objective of this paper is to examine investor behavior in the Turkish stock market following major political and economic events from 1997 to 2004 using daily returns from the two major Turkish stock market indexes (ISE-100 Index and ISE-All-Share Index). While previous research has examined investor reaction to unexpected events in advanced stock markets