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Short-term overreaction to specific events: Evidence from an emerging market

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ABSTRACT

This paper investigates the short-term overreaction to specific events and whether stock prices are predictable in the Egyptian stock exchange (EGX). We find evidence of the short-term overreaction in the EGX. Losers ("bad news" portfolios) significantly outperform winners ("good news" portfolios) and investors can earn abnormal return by selling the winners and buying losers. Terrorist attacks have negative and significant abnormal returns for three days post event followed by price reversals on day four post event. Whereas, the tensions in the Middle East region have a negative and significant abnormal returns on event day followed by price reversals on day one post event. Moreover, the formation of a new government has no effect on the average abnormal returns post event in the EGX. The results also show that small firms tend to have greater price reversals compared to large firms. Overall, our results provide evidence of the leakage of information in the EGX.

1. Introduction

Stock markets' anomalies have long been examined in the literature, e.g., overreaction and long-term price reversals (De Bondt and Thaler, 1985), short-term trends or momentum (Jegadeesh and

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Titman, 1993), and excessive volatility of stock prices (Shiller, 1981). De Bondt and Thaler (1985) were the first to empirically examine the overreaction hypothesis in finance. They built on the reasoning of Dreman (1982) and detect a new stock market anomaly based on the Kahneman and Tversky (1974) theory of representativeness. De Bondt and Thaler (1985) argue that price reversals can be predicted using past return data (3–5 years) in case of systematic price overshoot. They formulate two main testable hypotheses. The first hypothesis is that "*large stock price movements will be followed by price reversals in the opposite direction*" (the directional effect of Brown and Harlow, 1988) and the second hypothesis is that "*the larger the initial price movements the greater the subsequent reversals*" (the magnitude effect). This suggests that stock returns exhibit negative serial correlation over long horizons and therefore investors may earn abnormal returns by exploiting this long-term mispricing, which is clearly inconsistent with the weak-form of market efficiency.

George and Hwang (2007) argue that systematic mistakes of irrational investors in responding to new information are the main interpretation of the overreaction hypothesis. They claim that the theory of biased self-attribution of Daniel et al. (1998) may explain these mistakes. Therefore, investors may interpret and react differently to the new information, which leads to two contradictive investment behaviors: price continuation or price reversals.

The existing literature has extensively investigated the overreaction phenomenon in developed markets, but only few studies have focused so far on the overreaction to specific events.[1] The overreaction to specific events in emerging markets has, to the best of our knowledge, not been empirically examined yet. A question therefore arises as to whether stock returns are predictable as a result of specific events in emerging markets and if so what is the portfolios' optimal holding period? This paper tries to fill this gap using data from the Egyptian stock exchange (EGX).

The EGX is one of the most promising emerging markets in the Middle East and North Africa region. Since the start of the economic reform and the privatization program in mid-1990s, EGX has achieved remarkable economic indicators. The average GDP growth rates were 7.2% and 4.2% during the global financial crisis in 2007 and 2008, respectively. Therefore, Egypt was selected by the Economic Reform Forum of the World Bank amongst the best seven countries in the world in undertaking effective steps for economic reform and enhancing the investment climate.[2]

Following the methodology of Cox and Peterson (1994) and Larson and Madura (2003), the present paper examines the short-term overreaction to four major events, namely, terrorist attacks, the formation of new government, tensions in the Middle East region, and the announcement of the privatization of state-owned enterprises (SOEs). Using data for 100 listed firms with no price limits on the EGX over the period 2003–2009, we find evidence of short-term overreaction suggesting that losers (bad news portfolios) significantly outperform winners (good news portfolios) over the event window and that investors can earn abnormal returns by selling winners and buying losers. Terrorist attacks have negative and significant abnormal returns for three days post event followed by price reversal. Positive and significant abnormal returns are reported in day five post event. Tensions in the Middle East region have negative and significant abnormal returns on event day followed by price reversals on day one post event. Moreover, formation of a new government has no effect on the average abnormal returns post event in the EGX. The results also show that small firms tend to have greater reversals compared to large firms in the post event period. This result is consistent with the literature on the overreaction phenomenon (e.g., Cox and Peterson, 1994; Farag and Cressy, 2010). The results also provide evidence of the leakage of information in the EGX.

Our results have important policy implications. First, they provide clear evidence of stock market imperfection. Investors can, therefore, earn abnormal return by exploiting the overreaction anomaly. Second, as the regulatory authorities are keen to raise the level of market efficiency in emerging markets to improve market liquidity, exploring market imperfections works as an early warning system to the regulator.

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[1] See, for instance, Seyhun (1990), Abarbanell and Bernard, 1992, Zivney et al. (1996), Larson and Madura (2001), Kadiyala and Rau (2004), and Edmans et al. (2007).

[2] For more details, see, the World Federation of Exchanges (WFE) statistics in 2009 and 2010. Some institutional factors distinguish the Egyptian stock market from other emerging markets such as the relatively low regulations and the absence of taxes on dividends and capital gains.