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How Does the Stock Market Absorb Shocks?[☆]

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Abstract

Using a comprehensive set of news stories, we find a stark difference in market responses to positive and negative price shocks accompanied by new information. When there is a news story about a firm, positive price shocks are followed by reversal, while negative ones result in drift. This is interpreted as the stock market overreaction to good news and underreaction to bad news. These seemingly contradictory results can be explained in a single framework, considering the interaction of retail investors with attention bias, and arbitrageurs with short-run capital constraints. Consistent with this hypothesis, we find that both patterns are stronger when the attention bias is stronger, and when the arbitrage capital is scarce.

Keywords: stock return predictability, news, limits to arbitrage, limited attention, overreaction, underreaction, text analysis

JEL Classification: G12 , G14

1. Introduction

In a frictionless market as described by Fama (1970), stock prices reflect all new information about firms immediately and completely. So returns following a price shock are not predictable. This is true whether the price shock is accompanied by measurable new information (“news shocks”) or not (“no-news shocks”). There is however, evidence that the returns following shocks are somewhat predictable. A growing body of literature documents that shocks are not perfectly absorbed right away. But how does the stock market absorb shocks? What are the predictable patterns in stock returns after a shock? As described in the survey by Tetlock (2014) the literature is surprisingly ambiguous regarding the dominant patterns. Following a shock some studies find return reversal, while others find drift. Both overreaction and underreaction have been reported. Furthermore, there is no standard unifying theoretical framework that simultaneously captures the patterns in the data. As a result, many papers continue to be written as if testing and rejecting Fama (1970) remains a high research priority, even so many decades later.

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