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# Overreaction in the Australian equity market: 1974–1997

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## Abstract

Previous assessment of overreaction in the Australian equity market by Brailsford [Brailsford, T., 1992. A test for the winner–loser anomaly in the Australian equity market: 1958–87, *Journal of Business Finance and Accounting*, 19 (2) 225–241] and Allen and Prince [Allen, D.E., Prince, R., 1995. The winner/loser hypothesis: Some preliminary Australian evidence on the impact of changing risk. *Applied Economics Letters* 2, 280–283] finds no evidence of performance reversal in loser portfolios and no significant difference between the test period performance of winner and loser portfolios. This result is not consistent with evidence from overseas markets and warrants further examination. This study finds evidence of price reversal where monthly portfolio rebalancing is employed but the price reversal disappears when a buy and hold strategy is used. Further analysis reveals that the loser portfolio is dominated by small firms and that any abnormal returns are not exploitable given the lack of liquidity in small capitalisation Australian stocks. It is possible that the lack of consistency between Australian and US research can be explained by the different time periods examined in these studies. © 2000 Elsevier Science B.V. All rights reserved.

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## **1. Introduction**

In their seminal work, DeBondt and Thaler (1985) report that a portfolio of US stocks which perform worst (losers) over an initial 3-year period (rank or portfolio formation period) tend to perform best in the subsequent 3-year period (test period). A similar performance reversal is evident for the rank period winner portfolio, which goes on to perform worst in the subsequent test period. This suggests that stock market investors overreact, that excessive optimism or pessimism causes prices to be driven too high or too low from their fundamental values, and that the overreaction is corrected in a subsequent period. It also suggests an easily implemented profitable trading strategy of buying losers and selling winners and has important implications for the validity of the efficient market hypothesis (EMH) which asserts that all publicly available information is incorporated into asset prices.

Chan (1988) argues that DeBondt and Thaler (DT) fail to control for time-varying risk, and when properly controlled the overreaction disappears. Ball and Kothari (1989) make a similar claim. However, DeBondt and Thaler (1987) and Chopra et al. (1992) provide evidence that differential risk cannot explain the performance reversal of winner and loser firms. Zarowin (1990) claims that firm size can explain this overreaction. He argues that losers tend to be smaller than winners and when size is controlled there is no significant difference in test period performance. However, Chopra et al. (1992) find that the overreaction persists after controlling for size as do Albert and Henderson (1995) after correcting potential biases in Zarowin's methodology. Using UK data, Clare and Thomas (1995) conclude that the difference in performance between the loser and winner portfolios is probably due to the size effect. Dissanaïke (1997) also uses UK data and finds in favour of the overreaction hypothesis after limiting his study to the larger listed companies. Conrad and Kaul (1993) assert that the overreaction observed in this type of study is due to the process of cumulating single period returns over long periods where these single period returns contain errors caused by bid–ask spread bias and infrequent trading. However, Loughran and Ritter (1996) dispute the methodology employed by Conrad and Kaul and show that their conclusions are not valid after correcting the methodology.

Despite the passage of time and several methodological refinements, the conclusions of DT using the basic methodology still appear to hold. While the bulk of research on this issue has been undertaken using US data, there have been a handful of applications in other markets. For example, Clare and Thomas (1995) examine the UK market and find evidence of overreaction, but conclude that this can be explained by the small firm effect. However, Dissanaïke (1997) finds strong evidence of overreaction amongst the larger companies listed on the UK exchange. DaCosta (1994) presents evidence of overreaction in stocks listed on the exchange in Brazil as do Leung and Li (1998) in the case of the Hong Kong stock market. Kryzanowski and Zhang (1992) study the Canadian market and find

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