



Contents lists available at ScienceDirect

## Journal of Financial Economics

journal homepage: [www.elsevier.com/locate/jfec](http://www.elsevier.com/locate/jfec)

## Sell on the news: Differences of opinion, short-sales constraints, and returns around earnings announcements<sup>☆</sup>

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### ARTICLE INFO

#### Article history:

Received 17 May 2007

Received in revised form

1 March 2008

Accepted 17 April 2008

Available online 23 February 2009

#### JEL classifications:

D82

G14

G19

#### Keywords:

Differences of opinion

Earnings announcements

Institutional ownership

Limits to arbitrage

Market efficiency

Short-sales constraints

### ABSTRACT

Miller [1977. Risk, uncertainty, and divergence of opinion. *Journal of Finance* 32, 1151–1168] hypothesizes that prices of stocks subject to high differences of opinion and short-sales constraints are biased upward. We expect earnings announcements to reduce differences of opinion among investors, and consequently, these announcements should reduce overvaluation. Using five distinct proxies for differences of opinion, we find that high differences of opinion stocks earn significantly lower returns around earnings announcements than low differences of opinion stocks. In addition, the returns on high differences of opinion stocks are more negative within the subsample of stocks that are most difficult for investors to sell short. These results are robust when we control for the size effect and the market-to-book effect and when we examine alternative explanations such as financial leverage, earnings announcement premium, post-earnings announcement drift, return momentum, and potential biases in analysts' forecasts. Also consistent with Miller's theory, we find that stocks subject to high differences of opinion and more binding short-sales constraints have a price run-up just prior to earnings announcements that is followed by an even larger decline after the announcements.

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<sup>☆</sup> We thank Chris Anderson, Linda Bamber, Jim Bodurtha, Mike Bradbury, Yoel Beniluz, Sandeep Dahiya, Dan Dahlwahl, Diane Del Guercio, Hemang Desai, Patricia Fairfield, Suresh Govindaraj, Zhaoyang Gu, Ben Jacobsen, Srinu Krishnamurthy, Charles M.C. Lee, George Panayotov, Mark Peterson, Sundaresh Ramnath, Srinu Sankaraguruswamy, Joe Sinkey, Paul Spindt, Cameron Truong, Lawrence Weiss, Frank Zhang, seminar participants at Australian National University, Barclays Global Investors, Baruch College, California State University-Fullerton, Columbia University, Georgetown University, Massey University, Monash University, National Bureau of Economic Research (NBER) Behavioral Economics Meeting, Rutgers University, University of Kansas, an anonymous referee, and the editor (G. William Schwert) for their helpful comments on earlier drafts. Valentin Dimitrov acknowledges the partial financial support from the David K. Whitcomb Center for Research of Financial Services. Prem Jain acknowledges financial support from the McDonough Chair at Georgetown University, Paul Koch acknowledges financial support as the O. Maurice Joy Chair at the University of Kansas, and Sheri Tice acknowledges financial support as the Norman Mayer Professor of Business at Tulane University. Koch also acknowledges support from Massey University, where he served as visitor while this research was conducted. This paper combines two earlier papers: "Sell on the news: differences of opinion and returns around earnings announcements" by Valentin Dimitrov, Prem C. Jain, and Sheri Tice, and "Overpricing and earnings announcements" by Henk Berkman and Paul D. Koch.

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## 1. Introduction

Miller (1977) hypothesizes that stock prices reflect an optimistic bias so long as differences of opinion exist among investors about stock value and pessimistic investors do not take adequate short positions due to institutional or behavioral reasons. In equilibrium, the overvaluation cannot persist indefinitely. With periodic announcements that reduce differences of opinion among investors, optimistic investors, on average, are disappointed and stock prices move closer to their fundamental values as investors “sell on the news”.

Testing Miller’s prediction on the role of differences of opinion is important because it is opposite of those from several popular asset pricing models. For example, differences of opinion relate closely to firm-specific volatility. In contrast to Miller (1977), traditional equilibrium capital asset pricing models conclude that firm-specific volatility is not associated with expected returns (e.g., Sharpe, 1964; Lintner, 1965). Some models even predict that firm-specific volatility should be positively associated with expected stock returns (e.g., Merton, 1987).

Our main objective is to present new evidence on the effects of differences of opinion and short-sales constraints on stock prices. Prior empirical work on differences of opinion has not generated convincing evidence in favor of or against the Miller hypothesis. For example, Diether, Malloy, and Scherbina (2002) examine monthly returns on portfolios of stocks sorted by dispersion of analysts’ forecasts of earnings. Consistent with the Miller hypothesis, they find that stocks with high dispersion of analysts’ forecasts have lower future returns relative to stocks with low dispersion of analysts’ forecasts. In contrast, Johnson (2004) shows that the findings of Diether, Malloy, and Scherbina (2002) can be explained away by financial leverage. He concludes that the results are not consistent with the Miller hypothesis.<sup>1</sup> Beyond dispersion of analysts’ forecasts, other volatility-related variables such as stock return volatility can be used as proxies for differences of opinion. Consistent with the Miller hypothesis, Ang, Hodrick, Xing, and Zhang (2006) find a negative relation between idiosyncratic volatility and returns. However, based on extensive robustness tests, Bali and Cakici (2008) conclude that no robust relation exists between idiosyncratic volatility and returns.

Nagel (2005) extends this literature by examining the monthly returns on portfolios sorted by both differences of opinion and institutional ownership (his proxy for short-sales constraints). He finds that the poor performance of high differences of opinion stocks is concentrated among firms with low institutional holdings. In contrast, Diether, Malloy, and Scherbina (2002), Ang, Hodrick, Xing, and Zhang (2006), and Bali and Cakici

(2008) do not incorporate the role of short-sales constraints in their analysis. In this paper, we investigate overpricing in relation to both differences of opinion and short-sales constraints in a more powerful setting.

Potentially the most important shortcoming of prior research testing the Miller hypothesis is the assumption (implicit or explicit) that differences of opinion are reduced over a long time horizon of several months. No specific event is used to study the reduction in differences of opinion and its effect on stock prices. Instead, the authors typically use monthly returns in the manner of traditional tests of capital asset pricing models. In such settings, it is difficult to isolate the effect of differences of opinion from other effects such as financial leverage, momentum, or post-earnings announcement drift. A second important limitation of prior research is a lack of evidence about how and when stocks become overvalued. Without such evidence, findings of systematically low returns could indicate either mispricing or low risk.

We take a different approach to develop a sharper and more powerful test based on an important implication of the Miller model. Assuming that at least some investors are short-sales constrained, the Miller (1977) model suggests that higher differences of opinion about stock value result in larger overvaluation. This is because the more optimistic investors’ opinions diverge further from the beliefs of the average investor. When new information is released (such as through earnings announcements), differences of opinion among investors are reduced. Upon the release of new information, average returns around those events are expected to be lower for stocks with high differences of opinion than for stocks with low differences of opinion, holding short-sales constraints fixed. To capture the effect of reductions in differences of opinion on stock prices, our analysis focuses on the three-day excess returns around earnings announcements conditional on differences of opinion as well as on short-sales constraints. Our focus on short-window returns also mitigates concerns that the results could be explained by differences in systematic risk. Over short windows, the effects from errors in the measurement of risk premia should be small.<sup>2</sup>

We choose earnings announcements as events that reduce differences of opinion among investors because managers make conscious efforts to communicate relevant information to the market through this process. Beyond information on current earnings, these announcements provide substantial details to help the market understand the financial information just released. In most cases, firms also hold a conference call in which the chief financial officer (CFO) or the chief executive officer (CEO) or both discuss the quarterly results and take questions from financial analysts. The earnings announcements and the conference calls are among the most anticipated events through which a large amount of information is conveyed to the market. This process is

<sup>1</sup> In addition, Chen and Jiambalvo (2004) show that the Diether, Malloy, and Scherbina (2002) results can be explained away by the well-known post-earnings announcement drift phenomenon. We control for this possibility and find that our results are robust.

<sup>2</sup> Our approach of focusing on earnings announcements is similar to that of La Porta, Lakonishok, Shleifer, and Vishny (1997), who examine the difference between earnings announcement period returns on value and glamour stocks.

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