

DOES THE OVERREACTION HYPOTHESIS STAND THE TEST OF TIME ACROSS COMPARABLE DEVELOPED MARKETS: A TALE OF TWO CRISES

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ABSTRACT

This research examines the enduring validity of the 1985 Overreaction Hypothesis proposed by DeBondt and Thaler across comparable developed markets, utilizing monthly stock return data from CRSP and Compustat. Our findings reveal compelling evidence in support of the continued relevance of the overreaction hypothesis. Intriguingly, we observe a sustained behavioral pattern among stocks, persisting for up to two years after portfolio formation.

In contrast to prior research, we observe a protracted time frame for the hypothesized role reversal between 'Winners' and 'Losers' during the selected sample period (2000 – 2020). Notably, major economic crises such as the 2007-2009 financial crisis and the 2020 COVID-19 pandemic fail to deviate from the established overreaction trend.

Additionally, our analysis indicates a reduced influence of January seasonality. Furthermore, variables such as firm size, leverage, and equity beta appear inadequate in explaining the occurrence of market event overreactions, thereby underscoring the non-Bayesian psychological dimension inherent in investor decision-making processes.

Keywords: Capital Markets, Overreaction, Market Efficiency, CAR, BHAR

1. INTRODUCTION

The weak form of the Efficient Market Hypothesis (EMH) posits that future movements in stock prices are essentially random and cannot be reliably predicted based on past events (Fama, 1970). EMH served as a fundamental framework for understanding capital markets for over a decade, until 1985 when DeBondt and Thaler introduced the notion of investor overreactions to market events. Their overreaction hypothesis proposes that psychological factors influence decision-making in the capital markets, leading to exaggerated responses to events.

Previously, investors were often viewed as rational decision-makers, adhering to Bayesian principles, which involve making rational responses based on data. However, behavioral finance, pioneered by Kahneman and Tversky (1979), has provided substantial evidence that investor psychology often deviates from rational decision-making.

Empirical research on the overreaction hypothesis has produced varying results, with each study attributing the presence or absence of overreaction to different factors. These factors include performance metrics, firm leverage, firm equity beta, sample period, and market value, among others (Dreman and Lufkin, 2000; Conrad and Kaul, 1993; Chopra et al., 1991; Zarowin, 1990; Chan, 1988; Loughran and Ritter, 1996; Fama and French, 1992). Moreover, the evidence suggests that the existence of the overreaction hypothesis varies considerably depending on the market being tested (Claire and Thomas, 1995; Kryzanowski and Zhang, 1992).

Recent empirical work has expanded its focus to examine the overreaction effect in emerging markets, introducing additional variables such as the distribution of investors between institutional and individual investors (Reddy et al., 2020). However, the primary objective of this study is to assess whether the