IS OVERREACTION A MARKET MICROSTRUCTURE ISSUE OR A COMMON HUMAN BEHAVIOR? DIVING INTO NEW TERRITORIES

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ABSTRACT:

Starting with De Bondt and Thaler's seminal work in 1985, the stock market overreaction phenomenon has been thoroughly studied throughout developed markets. De Bondt and Thaler (1985) presented evidence that proved the existence of overreaction in response to particular market events in the US market, which causes stock prices to drift off from their fundamental values such that "Winners" become "Losers" and vice versa. The overwhelming majority of research has always focused on developed stock markets, and very limited literature exists on the presence of the overreaction effect in emerging markets. This study utilizes monthly stock returns sourced from Datastream to investigate the presence of the overreaction hypothesis in geographically proximate yet distinct MENA region countries, including Turkey and Pakistan. The research indicates that the overreaction hypothesis is valid during a specific timeframe, specifically from the 20th to the 60th month of the testing period. Stocks display substantial behavioral continuation for up to 20 months after the formation of portfolios, as initially observed. Thus, the role reversal between "Winners" and "Losers" takes longer in the selected sample period of 2000-2023. A second reversal is observed around the 60-month mark, where formation losers return to underperforming winners. Moreover, January seasonality, firm size, leverage, and equity beta offer little explanation for market overreaction, underscoring the significance of non-Bayesian psychological factors in investor decision-making.

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

1. INTRODUCTION

Starting with the pioneering work of De Bondt and Thaler in 1985, extensive research has delved into the phenomenon of stock market overreactions. The paper hypothesizes that stocks exhibit price reversals over long periods. They explored the tendency of investors to overreact to specific corporate announcements. The study noted that investors typically weigh more on new information while underweighting long-dated information about firms. This overreaction, if observed, will be inconsistent with the weak form of the Efficient Market Hypothesis.

However, their extensive body of research primarily focuses on developed stock markets and mainly on time periods that do not take into consideration changes in the 21st century such as Covid-19, inflation, the 2008 financial crisis, interest rates, or mergers. Barakat and Barakat, 2023 have redone the work of De Bondt and Thaler on the U.S. market for time periods between the years 2000 and 2021. The paper also includes an extension of previous empirical work in the United Kingdom and in Canada for the same time period, 2000-2021. This extensive research on the topic of investor overreaction has only been done for developed markets and updates such as the Barakat and Barakat paper in 2023 do not include the overreaction hypothesis on developing markets. This leaves a noticeable gap in the literature regarding the overreaction effect in emerging markets. To bridge this gap, this research paper focuses on trying to understand the investor overreaction hypothesis and its validity in emerging markets and how it could be used to understand such markets.

Our study employs two overreaction methodologies to examine markets in geographically proximate yet distinct countries in the MENA region, these are Turkey and Pakistan. These countries are specifically chosen for the abundance of data and their influence on the economy and politics of the Middle East. Our