

Deciphering Decisions

Reaction to Earnings Reports

Introduction

The study of stock price reactions to earnings announcements has revealed several anomalies that challenge the efficient market hypothesis. This paper reviews recent evidence indicating that stock prices often underreact or overreact to earnings announcements, leading to persistent anomalies.

Post-Earnings-Announcement Drift

One of the most studied anomalies is the post-earnings-announcement drift, where stock prices continue to move in the direction of the earnings surprise for several months following the announcement. This drift suggests that the initial reaction to earnings news is incomplete.

Studies by Bernard and Thomas (1989, 1990) and others have documented that the cumulative abnormal returns (CARs) for firms with positive earnings surprises continue to rise, while those for firms with negative surprises continue to fall. This behavior is inconsistent with the efficient market hypothesis, which would predict an immediate and complete adjustment of stock prices to new information.

Evidence of Underreaction

Several studies have documented underreactions to earnings announcements. For example, Bernard and Thomas (1989) showed that the initial response to earnings announcements is often too small and that stock prices continue to

adjust over a period of six months or more. This underreaction is evident in the post-earnings-announcement drift, where CARs continue to drift upwards for firms with good news and downwards for firms with bad news.

One potential explanation for this underreaction is that investors fail to fully incorporate the implications of current earnings for future earnings. Studies have shown that stock prices often do not reflect the autocorrelation structure of earnings, leading to predictable stock price movements following earnings announcements.

Overreaction to Earnings

In contrast to the evidence of underreaction, some studies have found evidence of overreaction to earnings announcements. DeBondt and Thaler (1987) documented that stocks with extreme prior returns tend to experience reversals, suggesting that prior price movements may have been overreactions.

Similarly, Ou and Penman (1989) found that firms with high earnings-to-price (EP) ratios tend to have higher future returns, which could be indicative of an overreaction to past earnings trends. However, the evidence for overreaction is mixed, and some studies have found that these patterns can be explained by risk factors or other anomalies.

Reconciling Underreaction and Overreaction

The seemingly contradictory evidence of underreaction and overreaction can potentially be reconciled by considering the different contexts and time horizons of these phenomena. For example, while post-earnings-announcement drift suggests underreaction in the short term, long-term reversals may indicate overreaction to longer-term earnings trends.

Furthermore, the evidence suggests that different market participants may react differently to earnings news. Institutional investors and analysts may underreact due to conservative forecasting, while individual investors may overreact to salient news, leading to the observed anomalies.

Functional Fixation Hypothesis

The functional fixation hypothesis posits that investors fixate on reported earnings figures without fully adjusting for the economic implications of accounting methods. Hand (1990) provided evidence for this hypothesis by showing that stock prices react to earnings components that should have been anticipated by the market, such as accounting gains from debt-equity swaps.

Conclusion

The evidence reviewed in this paper suggests that stock prices do not always react efficiently to earnings announcements. Both underreaction and overreaction have been documented, challenging the efficient market hypothesis. Understanding these anomalies and their underlying causes is crucial for investors and researchers in the field of behavioral finance.