A Tough Act to Follow: Contrast Effects in Financial Markets

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A contrast effect occurs when a previously-observed signal inversely biases perception of the next signal. As an example from experimental psychology, men rate female students less attractive if the men recently viewed pictures of beautiful actresses. This paper seeks to understand whether contrast effects can distort prices in sophisticated, liquid equity markets. The authors find that investors mistakenly perceive earnings news today as more impressive if yesterday's earnings surprise was bad and less impressive if yesterday's surprise was good. They further show that their results cannot be explained by alternative explanations including slow dissemination of information from previous earnings announcements.