



EQUITIES

The Disposition Effect and the Under-Reaction to News

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Mounting evidence challenges the traditional view that securities are rationally priced to reflect publicly available information. Specifically, an extensive body of empirical literature reports that stock prices appear to drift after major corporate news announcements.

While positive news is generally met with price appreciation, prices subsequent to the announcement often show positive abnormal drift; similarly, negative news generates negative market reaction around the event, but tends to be followed by a negative drift.

This paper tests whether the “disposition effect” — that is, the tendency of investors to ride losses and realize gains — induces “underreaction” to news, leading to return predictability. Stocks with large unrealized capital gains underreact to, and only to, positive news, while stocks with large unrealized capital losses underreact to, and only to, negative news. These findings are consistent with a world in which trading frictions, captured by the capital gains overhang, impede a speedy transmission of information to stock prices via price impact.

The focus here is on short-term underreaction. The results show that because investors initially underreact to news announcements, stocks with large unrealized capital gains have higher subsequent returns, thereby generating a predictable price drift. As a result, some event-driven equity strategies based on market impact appear to earn significant returns in the subsequent weeks or even months.

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