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OVERREACTION AND UNDERREACTION IN STOCK MARKETS: A REVIEW

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ABSTRACT

Contrary to the conventional belief that the markets are rational and efficient (Fama E, 1970), investors overreact to both good and bad news. This may cause unjustifiable up and down movements in the stock price and enable investors to make irrational, short-term profits. The prices won't reflect the true value of the stock when the market is inefficient and hence this will be followed by a correction in the prices. Persistent overweighting of recent information and underweighting of long-term fundamentals by irrational investors will result in overreaction. This happens in the case of overconfident informed investors. This paper is a review of the works that analyse the overreaction in stock market.

KEYWORDS: Market Efficiency, Overreaction, Underreaction, Behavioural Finance