

Does bad economic news play a greater role in shaping investors' expectations than good economic news?

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Using consistency in monthly returns as a proxy for good and bad news, I show that investors overreact to a series of favorable and unfavorable news. However, bad news plays a greater role in shaping investors' expectations than good news. Consistent losers exhibit stronger price momentum in Year 1 followed by a more pronounced and persistent price reversal in Years 2 through 5 relative to their consistent winner counterparts. This evidence is robust to the three-factor Fama-French model and momentum factor. Results reported in this study provide general support to the psychology-based theories, but none of the existing models fully captures the weighting differential that negative and positive information signals play in shaping investors' expectations.

Key words: Good and bad economic news; Return consistency; Shaping investors' expectation; Consistent winners; Consistent losers; Momentum; Reversal.

JEL classification: G11; G14

1. Introduction

The conventional market model is built on the assumption that market participants are careful, rational, and wealth maximizing individuals. It follows that available information is immediately incorporated into market prices in an unbiased manner (e.g., Fama, 1970, 1991, 1998). However, a large body of empirical research over the last three decades shows that a firm's expected returns can be discernable from its stock price performance in the past. This body of research has been attributed to investors' sentiments (e.g., DeBondt and Thaler, 1985, 1987; Daniel, Hirshleifer, and Subrahmanyam, 1998; Barberis, Shleifer, and Vishny, 1998). Lee (2001) argues that to affect asset market price formation, the investing behavior of market participants must be systematic (i.e., their errors must be correlated across individuals). He goes on to say that academic research plays a significant role in identifying cues that are factored into investors' decision-making mechanism.
