THE OVER-REACTION EFFECT IN THE STOCK EXCHANGE OF THAILAND: AN EMPIRICAL STUDY

ABSTRACT

One of the main cornerstones of traditional financial theory is the Efficient Market Hypothesis (EMH). However, several violations of EMH have been discovered to the contrary of explanation provided by traditional financial theory. One of the key discoveries was the over-reaction effect of investors to recent information over base-rate data by De Bondt and Thaler (1985), which has been further studied in many different markets. Inspired by the work of De Bondt and Thaler (1985), this study investigated the over-reaction effect in the Stock Exchange of Thailand during 2012–2017 and the total return to investors based on the contrarian trading strategy by tracking performance of past losers and winners portfolio. In terms of method of analysis, this study tracked the total return index of stocks listed in the Stock Exchange of Thailand tracked during 2012–2014 to identify top 20% winners and bottom 20% losers. Equal weighted portfolios of winners and loser portfolios were formed with Cumulative Average Returns (CARs) tracked during 2015-2017 for comparison of performance. Mean difference and t-test were performed to test statistical significance. The results show that loser portfolios outperformed winner portfolios by 35.48%, 31.77%, and 55.87% at 1 year, 2 years, and 3 years after ranking, respectively. The differences between the returns generated by loser and winner portfolio were statistically significant from the 27th month onward. This study provides supporting evidence for the over-reaction effect in the Stock Exchange of Thailand during the study period. Results of portfolio tracking suggest that over-reaction of investors in the Stock Exchange of Thailand may present an opportunity for “contrarian trading strategies” over a medium term holding period. In other words, contrarian investors could benefit from tracking performance of underpriced stocks, for which the market has underestimated earning potential and business prospects and avoiding position in overpriced “hot” stocks, for which the market has overreacted to positive news, resulting in overpricing.

Keywords: Behavioral Finance, Over-Reaction Effect, Contrarian Trading Strategies, Efficient Market Hypothesis (EMH)