

Post Earning Announcement Drift and Behavioural Finance: A literature Review

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Post Earnings Announcement Drift (hereafter PEAD) is the inclination for a stock's cumulative abnormal returns to drift for a few weeks (even for several months) following after positive/negative earnings announcements. It is a scholastically very much archived anomaly initially found by Ball and Brown (1968). From that point forward it has been considered and affirmed by endless scholastic in numerous international markets (Rouwenhorst 1998). There are various approaches to characterize (or approaches to channel stock with positive reaction to profit) earnings higher than analyst estimates, earnings higher than some average earnings or stock's price appreciation during earning announcement period higher than expected. Each factor shows strong forecast capacity for the stock's future returns, and it use some blend of factors just to enhance PEAD effect. Charles Jones and Robert Litzenberger (1970) loan backing to the hypothesis that stock market is not efficient as some proponents of the random walk theory have claimed. That is, the market does not adjust instantaneously and effectively for every item of information which is available in form of quarterly earnings is not fully discounted by market at the time it gets accessible. If it were then, stock selection method based on available quarterly earnings should not give average and over time returns fundamentally different than market Foster G, et al. (1984) studied 56,000 quarterly earning observations covering the 1974 to 1981 time period. The study found that the that systematic post-announcement drifts in security returns are

associated with the sign or magnitude of unexpected earnings changes and drifts are a persistent phenomenon over the 1974 to 1981 period with no evidence of being concentrated in a specific sub period.

In an interesting set of three papers Barnard and Thomas investigated the size of and potential explanation for PEAD (1989, 1990 and Bernard 1993). Barnard and Thomas (1989) tried to separate between contending explanation of “post-earnings-announcement drift.” Bernard and Thomas (1990) presented evidence that stock prices fails to reflect the implication of current earning for future earnings. In particular, the three days price reactions to announcements of earning for quarter $t+1$ through $t+4$ are predictable, based on earnings of quarters. Significantly all the more, the sign and magnitude of the three days responses are identified with autocorrelation structure of earnings as though stock prices fail to reflect the degree of which every firm’s earning series differ from a seasonal random walk. Bont, and Taler (1990) suggested that the financial analyst and so the investors they advise ‘overreact’ to recent earnings announcement news and enter a ‘correction’ stage once earning are announced with price gradually changing to the reality of recent announced earnings.

Brennan (1991) of University of California, Los Angeles (UCLA) has remarked that the most extreme challenge to financial theorist postured by recent work on market responses to earning announcements is the proof of Ou and Penman (1989 a,b) that the market underutilizes information that is valuable in anticipating future earnings. Bartove (1992) empirically tested that exploration of a specific market inefficiency explanation for observed post earnings announcement drift in stock prices. He studied regardless of whether the observed relations between expected earnings in quarter t and stock price changes in quarter $t+1$ represents failure of the market to portray the time series properties of earnings correctly.

Jegadeesh and Titman (1993), in their paper reported that strategies which buy stocks that have performed well in past and sell stocks that have performed inadequately in past produce significant positive returns over 3 to 12 months holding periods. Jegadeesh and Titman explored the profitability of these strategies was not because of their systematic risk or to delayed stock price reactions to common factors. Even though, part of abnormal returns generated in the first year after portfolio formation disseminates in the following two years. A similar pattern of return around the earning announcements of past winners and losers was also archived. Ball et al. (1993) studied competitive product market, product prices and thus

firm's revenues incorporate the cost of equity capital. The study used annual earnings and return data from 1950 to 1988, and researchers found a statistically significant positive association between changes in equities relative risks and in earnings. Scholars took a note of that the earnings reported by companies, which enter computations of the 'earning surprises' in PEAD studies themselves, mirror the equity cost of capital. Scholars additionally took a note of that this positive connection between risk and earnings 'surprises' will be veiled by the negative relation between debt on the balance sheet and earnings directed through interest charges made against reported earnings in the profit and loss account.

Bhushan (1994) contends for an 'informational perspective' on reported PEAD. The study essentially points out an attention to that the mispricing is present does not mean it is a profitable strategy for even smartest and most perceptive investor to try and exploit. The study results suggested that the distribution of PEAD over the market does to be sure correlated with different proxies for transaction cost faced by traders looking to arbitrage on the basis of risk; these include the volume of trade in the stocks and the number of analysts covering its fortune.

Michaely et al. (1995) examine market responses to initiations and omissions of cash dividend payments. Study found that the magnitude of short run price reactions to omission is more prominent than for initiations. In the year following the announcement price keeps on drifting in the same direction, though the drift following omission is stronger and more robust. This post dividend initiation / omission price drift is distinct from and more affirmed than those following earnings surprises. Barberis et al. (2001) study economy with single risky asset. The work is material to the capital market on aggregate level. The study shows that their model fits well with a few empirical observations. Price-dividend ratios are contrarily identified with future stock returns. The returns are predictable in time series, weakly correlated with consumption, and have a high mean. The equity premium is legitimized on the grounds that loss-averse investors require a high reward for risky or excessively volatile asset Barberis and Huang (2001) further expound the model and concentrate on firm level returns.

Fama, (1998) admitted to finding the PEAD research proof as 'an anomaly above suspicious'. He also specified that PEAD has survived robustness checks, including extension to more recent data. Though, the anomaly is stronger for small stocks. The short-term continuation of returns archived by Jegadeesh and Titman (1993) is also an open riddle, yet it is still rather

new and further tests are all together. Daniel K., et al. (1998), proposed a theory of securities market under and over reactions based on two well-known psychological biases investor's overconfidence about the accuracy of private information and biased self-attribution which causes awry shifts in investor's confidence as a function of their investment outcomes. The study has shown that overconfidence infers negative long lag autocorrelation, excess volatility, and when administrative activities are correlated with stock mispricing, public event based return predictability. Biased self-attribution includes positive short leg autocorrelations momentum. Short run earnings "drift" yet negative correlation between future returns and long term past stock market and accounting performance. One vital element in DHS (Daniel, Hirshleifer, Subrahmanyam) involves the relationship between the character of data (private or public) and the market reaction. In the DHS model investors may underreact to public information around a firm, but then this need not prompt drift. This happens when the general information is gotten at the same time by the firm's managers and the investors. However if firms managers received the information beforehand secretly and chose to release it publically at a later date then subsequent under reaction by investor will typically occur in conjecture with public drift. The hypothesis likewise offers a few untested implications and suggestion for corporate financial policy.

Hong and Stein (1999) propose a model including two groups of investors- news watchers and momentum traders. The news watchers essentially focus on their private information about future fundamentals and don't endeavour to gain information from price trends, while the momentum traders primarily focus on information to be picked up from price trends. The study additionally assumes that information about future fundamentals diffuse step by step through the news watcher groups. Because of this slow dissemination of data, equity prices underreact to fundamental news. Hong and Stein (1999) contend that the momentum traders who follow price trends leads to overreactions. Momentum traders quicken the price trend brought on by the news watchers who first receive the information about changes in future fundamentals. Chordia and Shivkumar (2006) studied whether earnings momentum and price momentum are related. Both, time-series and cross-sectional asset pricing tests they found that price momentum is caught by systematic component of earnings momentum. In time-series and in cross-sectional asset pricing tests, the prescient force of past returns is subsumed by a zero investment portfolio that is long on stocks with high earnings surprises and short on stocks with low earnings surprises. Forner and Sanabria (2010) studied whether behavioural theories can explain post-earnings announcement drift (i.e. earnings momentum)

in the Spanish market. Specifically, Forner and Sanabria tried models proposed by Barberis et al. (1998), Daniel et al. (1998) and Hong and Stein (1999). Each of these behavioural models draws on two premises – cognitive biases and limits to arbitrage accepted that it would vary with a given nation's social and institutional elements. The results provided little proof in backing of hypothesis used to test whether these models can without a doubt clarify the earnings momentum anomaly in the Spanish market. The authors believed that a few attributes of the Spanish market, for example, its lower score on the Individualism Index, lower levels of investor protection and code-law-based legal framework, may clarify why their outcomes vary from those got in the USA.

Jacob et al. (2000), lend support to the hypothesis that post earnings announcement drift (PEAD) is caused by investors failure to incorporate the implications of current earnings for future earnings. Specifically they have showed that the subset of firms where over differencing of quarterly earnings surprises is most likely to have happened. Given the steadiness of the PEAD overtime, Jacob et al. (2000) suggested that the prior research on PEAD overestimates investor's naiveté.

Lihong Liang (2002) presented proof showing indicating post-earnings announcement drift can be mostly credited to investor's information processing biases. The outcomes recommend that drift happens when investor overreact to their private information, which is consistent with a typical ramifications of two models (Daniel et al. (1998); and Fischer, (2001)). The outcomes additionally show that drift can be ascribed to investors under reaction to more reliable earning announcement, which is predictable with experimental studies in psychology (Griffin and Tversky, 1992) and accounting (Bloomfield and et al.,1998). Also, this study gives understanding into the bewildering relationship between forecast dispersion and drift reported in earlier research. The empirical results loan assurance to cases that anomalies, for example, post-earnings announcement drift, represent market inefficiencies emerging from imperfect investors' information processing behaviours. Angel, et al. (2002) utilize day by day transactions information from 2000 to demonstrate that short sellers in Nasdaq-listed stocks can foresee the bearings of future earnings surprises and in addition to stock returns.

Kothari et al. (2003) studied the stock market reaction to aggregate earnings news. The study found that the connection amongst returns and earnings is significantly diverse in aggregate data. In the first place, returns are inconsequential to past earnings, proposing that prices neither underreact nor overreact to aggregate earning news. Second, aggregate returns are

contrarily corresponded with concurrent earnings; in the course of the most recent 30 years. Kothari et al. (2003) suggested that earnings and discount rates move together after some time, and gives new proof that discount-rate shocks explain a noteworthy fraction of aggregate stock returns.

Chan, (2003) examined an extraordinary database recording news headlines about organizations in the United States for period 1980 to 2000. The study examined returns of a subset of stocks after public news about them is released and compared them with different stocks with comparable month to month returns, yet no identifiable public news. There is a noteworthy distinction between return patterns for the two sets. The study found an evidence of post-news drift, which bolsters investors underreact to information. This was strongest after bad news. Likewise, the study also discovered some proof of reversal after extreme price movements that were unaccompanied by public news. At end study concludes as follows

“Post-earnings announcement drift is important but does not drive all of the under reaction I have found. Excluding stocks that had earnings announcement eliminates any trace of post-news-winner drift. Investors do not appear to underreact to good news, aside from positive earnings announcements”.

Chen, et al. (2015) provided an evidence supporting the argument that with limited information processing ability, investors pay more attention to the overall market on days with important macroeconomic news announcement and allocate relatively less attention to firm-level news on those days to show that investor underreact to earnings announcements with giving equal importance to macroeconomic news announcement which is significantly weaker than otherwise. The study showed that the post-earnings announcement drift is reduced by about 20 per cent over short horizon due to the effect of macroeconomic news announcement. Under market conditions with less uncertainty, macroeconomic news has an immediate and more pronounced effect on investor reaction to earnings surprises.

Shanthikumar (2004) research breaks down trade-initiation by small and large traders for one year taking after earning announcements and inspects the prescient capacity of occasion time trading for future returns. The collection of evidence focuses to both large and small traders under reaction to earning announcements, with small traders under reaction more extreme in the first month. In month one, large traders profit by drift, however after that small traders appear to revise and conceivably overreact. Mendenhall (2004) looked at whether the size of

post-earning announcement drift is related with the risk confronted by arbitrageurs, who may see the anomaly as a trading opportunity. The study found that the size of the drift is unequivocally identified with the arbitrage risk measure developed by Wurgler and Zhuravskaya (2002). The outcomes bolster the perspective of post-earnings announcement drift as an under reaction to earning information. Zhang (2008) analysed the responsiveness of analyst estimates to current earnings announcement. The outcomes show significant cross-sectional variation in analyst responsiveness and recommend that this variation is identified with the cost and benefits connected with prompt forecast updates. All the more significantly, the study found that with responsive forecast revisions, a greater amount of the market reaction takes place in the event window and less in the drift window, suggesting that analyst responsiveness mitigates the post-earnings-announcement drift and encourages market efficiency.

Ayers et al. (2010) analysed whether the two distinct post-earnings-announcement drifts connected with seasonal random walk-based earnings and analyst earnings surprises are inferable from the trading activities of distinct sets of investors. The study anticipated and observed that small (large) traders keep on trading toward in the direction of seasonal random walk-based (expert based) earning surprise after earnings declarations. The study observed that when small (large) traders respond all the more completely to seasonal random walk (analyst) based earning surprise at the earnings declarations, the respective drift constricts. It further suggests that delayed small trades associated with random walk-based surprises are steady with small traders' inability to comprehend time-series properties of earnings, though delayed large trades associated with analyst-based surprises are more reliable with a longer price discovery process. They additionally found that the analyst-based drift has declined in recent years.

Late evidence in a PEAD study by Battalio and Mendenhall (2005) demonstrates that trade in large block of shares (the exceptionally ones that tend to move price most) don't display the same gullible earnings expectations. Circumstantially Battalio and Mendenhall affirm the presence of substantial, statistically significant and economically valuable returns to following a counter-PEAD trading methodology even when no time-series benchmark of earnings expectations is used. Grinblatt and Han (2005) model explains PEAD as a result of a prospect theory style utility function consolidated with an utilization of separable mental records by investors. Jegadeesh and Titman (2005) observed such patterns in price and PEAD

in company stock price returns as the two focal anomalies in financial markets making an interest for behavioural clarifications of financial phenomena.

Garfinkel and Sokobin (2006) looked at the relationship between post-earning announcement returns and distinctive measures of volume at the earning date. The study found that post-event returns are entirely expanding in the part of volume that is unexplained by earlier trading activity. The study found that deciphered unexplained volume as a pointer of sentiment difference among financial investors and presume that post event returns are increasing in ex ante opinion divergence. Their proof is reliable with Varian (1985), who recommends that opinion divergence might be dealt with as an additional risk element influencing asset prices. Lerman et al. (2008) found that post-earning announcement drift is concentrated in firms in which a more noteworthy part of volume occurs on the announcement day. The study segregated stocks in view of both the earnings surprise and the portion of volume over the earlier quarter that happens on the earnings announcement. And further they report that the earning surprise hedge portfolio earns 4.31 per cent for per quarter and the volume hedge portfolio earns 2.71 per cent for per quarter. Examining returns to consolidating the two techniques, It found that organizations with both extreme positive (negative) earnings surprises and high (low) announcement period volume earn 4.97 per cent (-2.67 per cent) over the quarter, a spread of 7.64 per cent. Livnat and Mendenhall (2006) estimate firms with seasonal random walk forecast errors in the top (bottom) quintile earn 0.8 per cent (-2.38 per cent) over the following quarter, and firms with analyst forecast errors in the top (bottom) quintile earn 1.70 per cent (-2.70 per cent) over the following quarter. The study found that analyst forecasts lead to return patterns around future earnings announcements that vary from those observed when utilizing time-series models, proposing that the two sorts of surprises may catch to somewhat different types of mispricing.

Hirshleifer et al (2008) observed that individual investors are net purchasers after both positive and negative extreme earnings news. Reliable with the idea that bad news is more striking than good news; they likewise find that the amount of abnormal trading is more prominent after extreme negative earnings surprise than after extreme positive surprises.

Ganapathi Narayanamoorthy (2006) utilized accounting conservatism to distinguish a formerly undocumented source of predictable cross sectional variation in Standardized Unexpected Earnings' autocorrelations viz. the indication of the latest earnings realization and present evidence that the market ignores this variation ("loss effect"). Narayanamoorthy (2006) findings proves the Bernard and Thomas finding that stock price neglect to mirror the

degree to which quarterly earning series vary from a seasonal random walk and amplifies it by demonstrating that the market systematically underestimates time-series properties resulting from accounting conservatism. Jegadeesh and Livnat (2006) observed post earnings announcement drift to be stronger when the revenue surprise was in the same heading as the earnings surprise. This outcome ended up being strong to different controls, including the extents of stock held by institutional investors, arbitrage risk, and turnover (earlier 60-month average trading volume). These findings were similar to the earlier proofs that earnings surprises have a more steady impact on future earnings growth when they comprise of higher revenue surprises than when they comprise of expense surprises.

Chen (2007) provides an efficient market explanation for the post-earning announcement drift. The study demonstrated that the relationship between post announcement returns and past quarterly earnings are together determined by the autocorrelation structure of the quarterly earnings and future amendments in earnings persistence after current income declarations. In particular, the study found that post- earnings-announcement drift moves in firms encountering upward persistence revisions toward future quarters, and when future persistence revisions is descending, post announcement returns show reversal patterns. This confirmation underpins the contention that the post- earnings-announcement drift is an impression of the preannouncement price response to persistence revisions towards future quarterly reporting.

Francis et al. (2007) analysed whether rational investor reactions to information uncertainty (IU) clarify properties of returns to the post-earnings-announcement-drift (PEAD) trading anomaly. Consistent with a rational learning clarification, the study discovered that (1) unexpected earnings (UE) flags that are characterized a shaving greater IU have more quieted initial market responses; (2) extreme UE portfolios are portrayed by securities with higher IU than non- extreme UE portfolios; and (3) within the extreme UE portfolios, high IU securities are more pervasive and procure bigger abnormal returns than low IU securities. Further tests demonstrated that prior evidence of greater PEAD profitability for higher idiosyncratic volatility securitises explained by the greater information uncertainty associated with these securities. Bird et al. (2011) attempted to give confirmation to bolster a new explanation: the PEAD is especially an impression of the level of market uncertainty and sentiment that prevails amid the post-announcement time frame. It found that uncertainty plays a role in disclosing how investors respond to information and suggests that it ought to be incorporated

as an element in pricing models while the way that market sentiment additionally has a role in another instance of the importance of human behaviour in establishing prices.

Chordia et al. (2009) found that the post-earnings-announcement drift occurs in highly illiquid stocks. Chordia et al. studied both liquid and illiquid stocks. The researcher studied the trading strategy that goes long high-earning surprise stocks and short low-earnings-surprise stocks which gave a monthly value weighted return of 0.04 per cent in the most liquid stocks and 2.43 per cent in the most illiquid stocks. The illiquid stocks are having very high transaction cost and high market impact costs. By using a large number of estimates, it found that transaction cost represent 70-100 per cent of the paper profit from a long-short strategy intended to exploit the earnings momentum anomaly. Yan and Zhao (2009) attempted to link the value-glamour anomaly specifically to post-earnings-announcement drifts. The firms were sorted into quintiles as indicated by a measure of value. And then firm were allocated into six categories in terms of the signs of the quarterly earnings surprise (+/- /0) and the earnings announcement abnormal returns (EARs) (+/-). The study found that glamour stocks are more volatile around earnings declaration dates. The drift patterns of value and glamour stocks are distinctive: glamour stocks show much bigger negative drift following negative earnings surprises and EARs, while value stocks show much bigger positive drift following positive earnings surprises and EARs.

Chen, et al. (2015) tested the effect of XBRL (eXtensible Business Reporting Language) on information asymmetry in the developing markets of China. The study concentrated on the relationship amongst XBRL and information asymmetry (proxies by Post-Earnings-Announcement Drift, PEAD) crosswise over two ownership structures: state-owned enterprises (SOEs), which are overwhelming in China, and non-state-owned enterprises (non-SOEs). It found that information asymmetry reduces fundamentally, as reflected by a noteworthy decrease in PEAD, after the compulsory adoption of XBRL, and it lessens more altogether in SOEs than non-SOEs. The results remain robust after it controlled for business sector and accounting factors that may impact PEAD. The study not just backings XBRL's part in enhancing market efficiency of the developing market, but also first archives the effect of government ownership on the execution of XBRL.

Choi, et al. (2016) inspected the relationship between insider trading amid the pre-earnings announcement period and the extent of the post-earnings announcement drift (PEAD). Consistent with insiders' private data being incorporated into prices through their trading, it

found that the PEAD is essentially lower when earning declarations are preceded by insider exchanging. This negative relationship between insider exchanging and PEAD is more grounded when information asymmetry amongst insiders and outsider is higher, and when inside and outside monitoring of insider trade is weaker. However, in contrast to their primary results, the study found that in instances of affirming insider trading (i.e., high level of insider purchasing (selling) preceding large positive (negative) earnings surprises), PEAD is fundamentally bigger. Choi, et al. proof recommends that such trades depend on insiders' private data about earnings surprises in consequent quarters and the market fails to fully account for the data contained in these trades. Overall, the study concludes that insider trading add to stock pricing efficiency by passing on insiders' private information to the market.

Conclusion:

In this paper, from existing literature we confirm that the consistency of anomalous profits based on Post Earning Announcement is a statistically and financially noteworthy anomaly. Neither is it illusory, nor is it a rarity of the experimental design. It might be a consequence of market inefficiency. And the main contribution this paper is to test the predictions of earnings momentum (PAD) and market efficiency of the Indian market, whose cultural and institutional characteristics differ from those of the US and European markets. Because these characteristics also differ across country, the present study believe that a test based on an aggregate of India, as Doukas and McKnight (2005) do, cannot adequately reflect these psychological differences. Therefore, the present study responds to this problem by focusing exclusively on the Indian stock market. Regarding the existence of momentum in the Indian market, till date no study has been carried out in Indian stock market. So this research is its self a pioneering research in Indian Stock market.

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