STOCK MARKET BEHAVIOR AFTER LARGE PRICE CHANGES AND WINNER-LOSER EFFECT

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ABSTRACT

This study examines the behavior of stock prices following large price changes. It also examines the presence of disposition prone investors and effect of size on stock returns. The study uses daily prices data from Pakistan Stock Exchange (Formerly, Karachi Stock Exchange (KSE)) for the period of January 2001 to July 2012. Our findings suggest that winners perform better than losers after experiencing large price shocks thus showing a momentum behavior. This also suggests that most of the investors in KSE behave rationally and we do not find any evidence of disposition effect in KSE. Further, pooled regression estimates show that size is positively related to post-event abnormal returns. The fixed effect model shows the presence of unobservable firm-specific and time specific effects that account for price continuation.

Keywords: *Market Efficiency, Event Study, Disposition Effect*

Research Objectives

The study focuses on the disposition effect phenomena in Pakistani stock market. The study also highlights the useful potential strategies for both winners and losers. The effect of size on market reversal is also explained. It also explains how the reversals in prices effects the return distribution of investors.

Methodology

The present study uses the same methodology as used by the Cox and Peterson (1994), Cressy and Farag (2010). The returns are calculated using market model and performance of winners and losers is compared to find out the answers to our first two research questions. The remaining two research questions need a pooled Ordinary Least Square (OLS) to explain the important factors causing market reversal and the effect of size on firm's abnormal returns. The returns for each security are calculated for the study period by using event study methodology. We formed the event for each security on the day it faces a 10% increase or decrease in the price (regardless of value). The securities facing 10 % increase in price called as winners and who lost 10 % or more are treated as losers (Cressy and Farag 2010). The estimation period for the β is 100 days (-105, -6) and the test period will be +1 to +120 days (see e.g., Cox and Peterson 1994, Cressy and Farag 2010).

Results

Our results for both winners and losers are very interesting and surprising as well. Winners after price reversals become losers and earn negative CAARs and losers on the other hand, perform better. The factor responsible for this reversal mostly considered is the overreaction. Further, we regress post event ARs on log of market capitalization and trading volume. The coefficients of event day return (AR_{it0}) are positive suggesting the return continuation in the same direction, but these are insignificant. Size is negatively related to post event ARs which indicates smaller size firm have high ARs. These results are insignificant for winners suggesting absence of size effect in Pakistani market. Losers are mostly smaller firms because they have greater tendency to give negative ARs as

compared to winners. Trading volume is positively related to post event ARs suggesting higher trading activity for both the winners and losers make the prices to move in the same direction of initial large change. For large initial increase there is buying pressure which moves up the prices further generating positive returns for holders. On the contrary, for large initial declines there comes net selling pressure which further pushes prices downwards and negative ARs continues for losers.

Findings

We find evidence inconsistent with the winner-losers anomaly. In KSE the winners remain winners while the losers continue to lose more. This shows the absence of winner-loser effect in KSE. Investors respond rationally to new information and act accordingly. We find the investors behave rationally and there is no existence of disposition effect in KSE. These findings are inconsistent with Cressy and Farag (2010) who say market reversals show the presence of disposition prone investors. Winners earn a cumulative abnormal return (CAR) of 6.07% by holding winners for 20 days. Larger firms have larger ARs in the post event investigation period. Firm size that is measured by market capitalization is positively related to post event ARs.

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