Overreaction and the Availability Bias

Psychology of an Investor

One consequence of having emotion in the stock market is the overreaction to new information. According to the theory of efficient markets, new information should more or less be reflected instantly in a security's price. For example, good news should raise a business's share price accordingly, and that gain in share price should not decline if no new information has been released since.

Reality, however, tends to contradict this theory. Often, participants in the stock market predictably overreact to new information, creating a larger-than-appropriate effect on a security's price. Furthermore, it also appears that this price surge is not a permanent trend—although the price change is usually sudden and sizable, the surge usually erodes over time.

Winners and Losers

In 1985, behavioral finance academics Werner De Bondt and Richard Thaler released a study in the *Journal of Finance* called "Does the Stock Market Overreact?" In this study, the two examined returns on the New York Stock Exchange for a three-year period. From the stocks on the exchange, they separated the best 35 performing stocks into a "winners portfolio" and the worst 35 performing stocks were then added to a "losers portfolio." De Bondt and Thaler then tracked each portfolio's performance against a representative market index for three years.

Surprisingly, it was found that the losers portfolio consistently beat the market index, while the winners portfolio consistently underperformed. In total, the cumulative difference between the two portfolios was almost 25% during the three-year time span. In other words, it appears that **the original "winners" became "losers,"** and vice versa.

So what happened? In both the winners and losers portfolios, investors essentially overreacted. In the case of loser stocks, investors overreacted to bad news, driving the stocks' share prices down disproportionately. After some time, investors realized that their pessimism was not entirely justified, and these losers began rebounding as investors came to the conclusion that the stock was underpriced. The exact opposite is true with the winners portfolio: investors eventually realized that their exuberance wasn't totally justified.

According to the availability bias, people tend to heavily weight their decisions toward more recent information, making any new opinion biased toward that latest news.

This happens in real life as well. For example, suppose you see a car accident along a stretch of road that you regularly drive to work. Chances are, you'll begin driving extra cautiously for the next week or so. Although the road might be no more dangerous than it has ever been, seeing the accident causes you to overreact, but you'll be back to your old driving habits by the following week.

Avoiding Availability Bias

Perhaps the most important lesson to be learned here is to retain a sense of perspective. While it's easy to get caught up in the latest news, short-term approaches don't usually yield the best investment results. If you do a thorough job of researching your investments, you will better understand the true significance of recent news and will be able to act accordingly.

[Don't overreact to new information.]

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