

Reaction and price adjustment economics essay

[Economics](#)



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Introduction

I researched 8 different announcements on Irish and UK firms in recent newspapers. I then calculated the return on the share versus the market to find the abnormal return. In each example there is a link to the news announcement and also a paragraph on the market reaction and speed of price adjustment.

Prudential 28th March

<http://www.independent.ie/business/irish/prudential-is-hit-for-30m-by-regulator-after-failed-takeover-29159865.html> Information available from their website (Irish Independent. ie, 2013)

Reaction and Price Adjustment

The market reacted correctly to the announcement. The price decreased by 2.313% on the day of the announcement. This reaction was directly opposite to the index data for that particular day, as the index increased by 3.626%. Considering the severity of the fine from the FSA a share price decrease was expected. The price adjusted quickly to the announcement and readjusted on the 29th March to a more normal level of 1065.00. Prudential may have shown evidence that the stock price is more transparent now after the FSA fine, showing strong signs of strong form EMH

Tullow Oil 28th March

<http://www.irishtimes.com/business/sectors/energy-and-resources/tullow-changed-position-after-tax-advice-1.1341075> Information available from their website (irishtimes.com, 2013)

Tullow Oil

(Announcement 28th March)

Date

Price

Price Change

Index Change

Abnormal Return

2nd April 1, 236.000.406 % increase 10.349% Increase -9.94% 1st April 1,
231.00 No Change Easter Monday (No results available) Unavailable 29th
March 1, 231.00 2.068 % decrease Good Friday (No results
available) Unavailable 28th March 1, 257.000.396 % decrease 3.626%
Increase -4.02% 27th March 1, 262.00

Reaction and Price Adjustment

The market underreacted to the announcement. The price decreased by 0.396% on the day. This was in contrast to the index which increased by 3.626% The stock price decreased by a further 2.068% on the day following the announcement, this suggests that the implications of the CGT liability were not understood fully on the announcement date. The price therefore adjusted slowly. As Tullow may still win the case against Heritage the share price saw a slight rebound on the 2nd April rising by 0.406%

Kenmare 12th March

<http://www.irishtimes.com/business/sectors/energy-and-resources/profit-doubles-at-kenmare-resources-1.1323292> Information available from their website (irishtimes.com, 2013)

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Kenmare**(Announcement 12th March)****Date****Price****Price Change****Index Change****Abnormal Return**

14-Mar-13 33.980.206 % decrease 6.189% Increase -5.98% 13-Mar-13 34.0512.562 % increase 3.436% Decrease 16.00% 12-Mar-13 30.256.347 % decrease 0.761% Increase -7.11% 11-Mar-13 32.34.972 % decrease 2.185% increase -2.79% 08-Mar-13 33.99

Reaction and Price Adjustment

The market reacted correctly to the announcement. The stock price rose by 12.562% the day after the announcement, as expected for profits doubling in value. This indicated a slowness in the price adjustment as the stock price on the announcement date actually decreased. This may indicate the results were not announced until late in the trading day. Apart from the adjustment slowness the stock reaction was in line with positive post earnings announcement price drift. The 13th March showed a strong abnormal return.

Glanbia 13th March

<http://www.irishtimes.com/business/sectors/agribusiness-and-food/glanbia-2012-results-beat-expectations-1.1324080> Information available from their website (irishtimes.com, 2013)

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Glanbia**(Announcement 13th March)****Date****Price****Price Change****Index Change****Abnormal Return**

15-Mar-138592. 128 % increase3. 788% Decrease5. 92%14-Mar-13841. 13. 874 % decrease6. 189% Increase-10. 06%13-Mar-138752. 291 % increase3. 436% Decrease5. 73%12-Mar-13855. 41. 565 % decrease0. 761% Increase-0. 80%11-Mar-13869

Reaction and Price Adjustment

The market reacted correctly to the announcement. The stock price increased by 2. 291% on the announcement date. On the 12th March the price also rose, on the back of expectations that there would be positive news. The price adjusted quickly to the announcement, and was quick to readjust on the 14th March back to normal ground. The 13th and 15th March showed strong abnormal returns.

UTV 19th March

<http://www.irishtimes.com/business/sectors/media-and-marketing/utv-media-profits-fall-10-1.1330870>Information available from their website (irishtimes.com, 2013)

UTV**(Announcement 19th March)****Date****Price****Price Change****Index Change****Abnormal Return**

22-Mar-13 143.541.191 % decrease 0.226% Increase -1.42% 21-Mar-13 145.271.177 % decrease 5.476% Decrease 4.30% 20-Mar-13 147 No Change 1.019% Decrease -0.01% 19-Mar-13 147 1.01 % decrease 2.24% Decrease 1.23% 18-Mar-13 148.5

Reaction and Price Adjustment

The market reacted correctly to the announcement that profits fell. This was shown in the price decreases on the 21st and 22nd of March. However the price adjusted very slowly considering the announcement was on the 19th March, there was relatively little movement for two days. Comparing the return versus the market it must be noted that the 21st March showed a strong abnormal return. This shows a sluggish price response due to the market not being surprised, noted by Rendlemen, Jones and Latane (1982) 1982

Aryzta 11th March

<http://www.irishtimes.com/business/sectors/agribusiness-and-food/aryzta-group-revenues-grow-8-2-per-cent-1.1321966> Information available from their website (irishtimes.com, 2013)

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Aryzta**(Announcement 11th March)****Date****Price****Price Change****Index Change****Abnormal Return**

14/03/2013 43.1500 € 1.529 % increase 1.39% Increase 0.

14% 13/03/2013 42.5000 € No Change 0.18% Decrease 0.18% 12/03/2013 42.

5500 € 1.276 % decrease 0.47% Increase -0.81% 11/03/2013 43.1000 € 0.

583 % increase 0.58% Increase 0% 08/03/2013 42.8500 € 1.494 % decrease 0.

08% Decrease -1.41% 07/03/2013 43.5000 €

Reaction and Price Adjustment

The market reacted correctly to the announcement and in line with the index change on the 11th March. The price adjusted quickly and then fell back before increasing again on the 14th March. This earnings announcement was in line with most post earnings announcement price drifts. Revenues at Aryzta rose 8.2% for the last six months, a number of their businesses showed steady growth. The price reaction was optimistic but conservative also to note the challenging trading conditions outlined by Chief Executive Owen Killian

Datalex 20th March

<http://www.irishtimes.com/business/sectors/transport-and-tourism/datalex-reports-increased-revenues-and-ebitda-for-2012-1.1332286> Information available from their website (irishtimes.com, 2013)

Datalex

(Announcement 20th March)

Date

Price

Price Change

Index Change

Abnormal Return

25/03/20130.9000 €3.069 % decrease0.17% Increase-3.24%
 22/03/20130.9285 €6.724 % increase0.15% Decrease6.87%
 21/03/20130.8700 €No
 Change1.01% Decrease1.01%
 20/03/20130.8700 €4.317 % increase0.89%
 Increase3.43%
 19/03/20130.8340 €

Reaction and Price Adjustment

The market reacted correctly to this announcement as the price increase outperformed the index providing an abnormal return of 3.43% on the announcement date. The price adjusted quickly and actually increased again on the 22nd March by 6.724% before falling back on the 25th March by 3.069% to 90 cents. The 15% revenue increase by Datalex showed that they remain strong despite challenges in the industry. They have managed to gain new customers such as Virgin Australia and Oman Air.

Elan 5th March

<http://www.irishtimes.com/business/sectors/health-pharma/elan-offer-shareholders-20-of-multiple-sclerosis-drug-royalties-1.1317390> Information available from their website (irishtimes.com, 2013)

Elan

(Announcement 5th March)

Date

Price

Price Change

Index Change

Abnormal Return

08/03/20138.6060 €1.971 % decrease0.08% Decrease-1.89%07/03/20138.7790 €2.238 % decrease0.06% Increase-2.30%06/03/20138.9800 €0.111 % decrease1.50% Decrease-1.39%05/03/20138.9900 €1.697 % increase1.94% Increase-0.24%04/03/20138.8400 €

Reaction and Price Adjustment

The market reacted correctly to the announcement as the price increase was close to outperforming the index. The share price held its ground the following day 6th march, but slipped back to levels before the announcement. This showed that the market had uncertainty about the announcement and details of any royalty deals with Biogenor Royalty Pharma remains unfinalised. The price adjusted quickly to the announcement but fell back because of the uncertainty involved. The Elan share price failed

to outperform the market over the days of the announcement, and did not strike an abnormal return.

Question 2. Behavioural Finance

Behavioural Finance is an emerging concept that suggests investors may be prone to behavioural biases in formulating investment decisions. Discuss.

Introduction

Behavioural Finance theorises that investors may not be rational in their investment decisions. The theory explores the implications of psychological factors affecting investor behaviour. Investors can make errors in information processing that lead to biases such as overconfidence, conservatism and representativeness. (Bodie et al., 2010)

Information Processing

Overconfident investors tend to invest in active management schemes that have a higher chance of failure compared to passively managed schemes. Active management schemes are more dominant in the marketplace, representing 90% of the mutual fund industry. Barber and Odean, 2001 found that men tend to trade far more frequently than their female counterparts. This assessment was concluded after studying brokerage accounts of both sexes. In addition they also found that frequent trading led to poor investment performance overall. Conservatism is a bias that makes investors too slow in their response to announcements by a firm. They are unable to take full advantage of a stock price increase by underreacting to the announcement. Representativeness bias fools investors into thinking a

small sample size is the same as a large one and because of this they may act on information too early as a result.

Behavioural Biases

Investors tend to trade off risk versus return and behavioural biases such as framing, mental accounting and regret avoidance come into play. Framing influences decisions by affecting how choices are posed. In the article below Cass Sunstein states that "Framing - The way in which information is presented - Matters" "Attention is a scarce resource" When plain English was used to motorists "Pay your tax or lose your car" payments doubled as a result, emphasising the power of how the message was put across. Investors need to be aware of how risky investments are framed, otherwise they may be taking a larger gamble than they first thought. <http://behavioural-investing.org/2013/02/22/new-review-of-real-world-behavioral-economics-by-cass-sunstein/> Information available from their website (behavioural-investing.org, 2013) With mental accounting, investors segregate decisions, they may risk more with one investment account over another. Gamblers sometimes segregate their winnings from their capital, this is called the "House Money Effect" this tends to lead to more risky decisions, leading the perception of mental accounting to be dangerous. The article below shows how consumers compartmentalise spending, it also shows their attitudes to budgets. There is a good example of how consumers relish a deal even if it means a small saving. <http://www.forbes.com/sites/sap/2011/06/29/mental-accounting-explains-why-you-buy-things-you-dont-need/> Information available from their website (forbes.com, 2011) With regret avoidance people blame themselves for investments that go wrong in unconventional <https://assignbuster.com/reaction-and-price-adjustment-economics-essay/>

businesses. They would prefer to invest in conventional stocks so results would be outside of their decision making. The article below investigates how people who sit on cash because of uncertainty in the markets may regret the decision in the future. <https://www.pwlcapital.ca/en/The-Firm/Perspective-Newsletter/February-2013/Sitting-on-Cash-Could-be-Regret-Avoidance> Information available from their website (pwlcapital.ca, 2013)

Bubbles

Alan Greenspan characterized the dot com boom as 'irrational exuberance'; Ireland went through this overconfidence during the 'Celtic Tiger' years. The below article shows how Ireland could have prevented the property bubble however any warnings were largely ignored by the Irish government, including economist Peter Bacons report circa 2000. In a way behavioural economics came into play and Irelands over confident and exuberant investments proved to be very costly for future generations. <http://www.independent.ie/business/irish/signals-were-flashing-red-on-the-property-bubble-but-were-ignored-26649683.html> Information available from their website (independent.ie, 2011)

The Disposition Effect

Behavioural Investors caught up in the disposition effect will tend to hold on to losing stocks in the hope that they will rise again for eventual profit. By having capital tied up in a losing stock they may be missing out on profits elsewhere. The below article discusses the disposition effect and suggests 3 rules for beating it¹. Look where you're going, not where you've been. If you wouldn't buy that stock now, don't keep it. 2. Rather than telling yourself that you've lost, think of selling bad stocks as paving the way for future <https://assignbuster.com/reaction-and-price-adjustment-economics-essay/>

success. It's a " rollover", rather than a " close out". 3. Instead of thinking only about individual holdings, put them in context. If a good stock still has potential, don't cash out too early. If you're holding a loser, consider the fact that it's holding you back from future gains. <http://www.efinancialnews.com/story/2012-02-14/beating-the-disposition-effect>Information available from their website (efinancialnews.com, 2012)

Arbitrage and Behavioural Finance

Arbitrageurs may not be able to exploit mistakes of behavioural investors due to fundamental risk. The arbitrageur may see a stock being overvalued but they may not want to bet against it as the market may move against them for a longer time. In summary the words of John Maynard Keynes ring true when it comes to arbitrage opportunities.' Markets can remain irrational longer than you can remain solvent'