OVER/UNDER REACTION BEHAVIOR AND ESTIMATION ERROR OF EARNINGS INFORMATION: A TEST OF REPRESENTATIVENESS AND ANCHORING-ADJUSTMENT HEURISTIC

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ABSTRACT

The main objective of this research is to examine representativeness and anchoring-adjustment (Tversky and Kahneman, 1974) on investors’ over/under reaction to earnings information, and the consequence on earnings estimation and stock valuation. In particularly, the over/under reaction suchness is over/under reaction to the earnings information that persistent in long-term, and under reaction to the earnings information that change extremely in short-term.

This research designed with 2x2 laboratory experiment. The design is tested in four sets of securities which differ according to their mean levels of earnings. The four sets of four securities form a 2x2x4, full factorial. Data are analyzed by repeated measures ANOVA within-subject. Twenty students of Magister Science and Magister Management of UGM as participants in the experiment trade 16 securities by online (LAN).

The results show that investors relied too heavily on previous earnings and have made the level and pattern of the previous earnings as their initial belief (anchor). They overreact to the current earnings information when confirm the initial beliefs, and also overreact against the persistent earnings formed. The overreaction behavior occur is because representativeness heuristic bias. On the contrary, they behave under reaction to the current earnings information when disconfirms the initial beliefs, and also underreact to the pattern of earnings that change extremely. The under reaction behavior happen is because anchoring-adjustment heuristic bias. Consequently, when the previous and current earnings shape low (high) persistence earnings trend, they underestimated (overestimated) to the future earnings or made error in earnings estimation and underpriced (overpriced) to the securities accordingly or mispriced.

It can be also concluded that the error of earnings estimation and stock mispriced as consequence of usage of representativeness or anchoring-adjustment heuristic, indicates that Post Earnings Announcement Drift (PEAD) in capital market can be explained by psychological perspective.

KEYWORDS: representativeness and anchoring-adjustment heuristic, overreaction and under reaction, error of earnings estimation and share mispriced, PEAD