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Summary of article;

“A model of investor sentiment”

by Barberis, Shleifer, Vishny

Punch line

Empirical research has uncovered two families of pervasive regularities: *underreaction* and *overreaction* of stock prices subject to series of good or bad news. The authors use a model of investors sentiment, which is consistent with the empirical findings, to explain such tendencies.

Main questions addressed and contribution of the paper

The intuitive background for this paper is earlier observations of mispricing of securities. Earlier studies have lacked explanations on these abnormalities in stock's returns. These authors seek to form a model of how people form expectations, that again leads to mispricing. The author's model and earlier uncovered regularities are consistent with *representativeness* and *conservatism*. Representativeness is the tendency of experimental subjects to view events as typical or representative of some specific class and to ignore the laws of probability in the process. Conservatism is defined as the slow updating of models in the face of new evidence. Underreaction evidence in particular is consistent with conservatism. The investor in the model doesn't realize that earnings follow a random walk, but switches between two states and that there is a different model governing earnings in each state. In Model 1, earnings are mean-reverting; in Model 2, they trend. The main question is to identify how the representative, risk-neutral investor reacts to good or bad earnings announcements in time series. The paper seeks evidence in both statistical and psychological terms.

Main results

- $P_t = N_t/\delta + y_t(p_1 - p_2 q_t)$, this proposition indicates that in addition to discounted cash- flows (N_t/δ), there exist an individual reaction ($p_1 - p_2 q_t$) to news (y_t) announcements for determining prices, market inefficiency.
- Proposition 2 sets the boundaries for proposition 1, where the model can explain both underreaction and overreaction.
- The investor puts more weight in Model 2 if he sees two consecutive shocks of the same sign. Similarly, if state tomorrow is the opposite of today, the weight in Model 1 increases.

Structure summary of the paper

- Introduction: Background for the research, goals and objectives stated.
- The evidence: Statistical evidence of over-and underreactions (maths) and some psychological evidence (representativeness vs conservatism).
- A model of investor sentiment: Informal description of assumptions and beliefs, and the formal model.
- Model solutions and empirical implications: Basic results, implications of model for prices, some simulation experiments and relationships between the model and originated evidence.
- Conclusion: Basic findings.

Conclusion

In making forecasts, investors pay too much attention to the strength of the evidence they are presented with and too little attention to its statistical weight. The theory specially predicts that, holding the weight of information constant, one-time strong news events should generate an overreaction.