Short Sale Constraints

Heterogeneous Interpretations

Asymmetric Price Reactions to Earnings Announcements

Discussion by

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Overall: A good paper

In our paper (Berkman et al. (2009)):

Overvaluation occurs as investors study variety of news before earnings are announced.

Overvaluation occurs because of

(i) Heterogeneous beliefs

+

(ii) Short sale constraints

Chang, Xu and Zheng focus on earnings announcements. Overvaluation at earnings announcements also occurs because of (i) and (ii).

Explanation of hypotheses: Discussion needs improvement. For example, I don't understand "selective registration of optimistic interpretations of earnings news…."

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Authors' thinking in my words:

First assume no heterogeneous interpretation.

Define Good News as $0.10.

Assume a P/E of 15.

Then, price will go up by $1.50

Define Bad News as -$0.10

Then, price will go down by -$1.50.

Difference= | $1.50 | - | -$1.50 | = 0.00

Hypothesis: this difference should increase with Abnormal Trading Volume (heterogeneous interpretation).

Conclusions in the paper:

1. Price reactions are stronger to bad news when investors interpret earnings news homogenously. Consistent with Reed (2007) and D&V (1987). See first row in Table 1, Panel B (-0.87%).

⇨ The difference is low (somewhat negative!).

2. Price reactions are stronger to good news when investors interpret earnings news heterogeneously. Consistent with Miller (1977) and Xu (2007). See third row in Table 1, Panel B (+2.68%)

⇨ The difference is high.

The pattern (both to good news and bad news) is more pronounced when the short sale constraints are more binding. (Panel C).

But, results in Panel C seem to be driven by "low heterogeneous group." That group should not produce "negative" difference. So, it is not completely clear what is going on.

Consider "Risk" Effect: Table 1, Panel A (Overall Result):

Returns associated with top earnings surp: 2.86%

Return associated with bottom earnings surp: -1.94%

Authors: "Price reactions are stronger to good news than to bad news"

And: "Risk" effect in this paper is 0.4%. So, subtract that:

2.46% (instead of 2.86%)

-2.34% (instead of -1.94%).

Comments on ESURP:

1. "Why investors disagree at earnings announcements?"

What does it mean to say, "Earnings are complex?"

Maybe, Investors agree on good and bad earnings (ESURP.) It is not very complicated to understand ESURP numbers themselves (researchers seem to).

Maybe, it is the other concurrent announcements such as guidance at the time of earnings announcements that are difficult to interpret. If that is the case, ESURP shall not capture "good" and "bad" news even if the model is true.

2. Even if we buy that ESURP is a reasonable variable, what is real ESURP?

   Is the average ESURP essentially zero and is the distribution symmetric? If not, one wonders how one should think about "good" and "bad" news.

Table 1 sorts ESURP in deciles.

Is the average ESURP in the largest decile comparable to that in the smallest decile?

In other words, it is not clear that “bad” news is comparable to “good” news.

Use -3e, -2e, -e, +e, +2e, +3e, etc. and study the same.

Also, possibly,

In this way, one may keep earnings news constant and study the effect of heterogeneous interpretation (trading volume).

General difficulty in studies when some or all the important variables are contemporaneous

It is difficult to establish causality or test hypotheses.

Proxy for Heterogeneous Interpretation of News:

Trading Volume.

Large Good News:	High Trading Volume
Large Bad News:	High Trading Volume

So, maybe: High Trading Volume does not arise only from heterogeneous interpretation of news.

Maybe, there is herding (momentum).

Sorting by Trading Volume may imply sorting by News (Absolute value of surprise).

Correlated variables

(a) Trading Volume,
(b) News (absolute value of earnings surprise), and
(c) Heterogeneous Interpretation

Table 1, Panel B:

Low Abnormal Volume category

Table 1:

Bad News: -1.39% Good News: +0.52%

(really: -1.79%) (really: +0.12%)

Overall: Low returns.

Low abnormal trading volume: Low returns.

High Abnormal Volume category

Bad News: -2.92% Good News: +5.60%

(really: -3.32%) (really: +5.40%)

Overall: High returns.

High abnormal trading volume: High returns.

A different look (sorting):

Consider news of any amount, say $0.10

As trading volume increases, the reaction to news should be more positive.

(i) Extreme Bad News (D1)

Low Trading Volume: -1.39%
(Low differences of opinion)

High Trading Volume: -2.92%
(High differences of opinion)

The result is not consistent with theory. But, maybe, the amount of news is not the same.

(ii) Extreme Good News (D10)

Low Trading Volume: 0.52%
(Low differences of opinion)
High Trading Volume: 5.60%
(High differences of opinion)

The result is consistent with the idea of "heterogeneous reactions." But, the difference is very large ("news").

Section 5.1 (Berkman et al.)

We concentrate on ex-ante variables.

Idea: Combine the two effects.

Section 5.2 (P.E.A.D.)

These results are fine to the best of my knowledge.

But, do they really belong in this paper?

Should there be reversal if “Good News” implies over-valuation?