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A REVIEW OF EMPIRICAL STUDIES ON STOCK MARKET CRASHES AND INVESTOR OVERREACTION

Abstract:

A number of studies investigate the causes and effects of stock market crashes. These studies focus mainly on the factors leading to a stock market crash and on the volatility and co-movements of stock market indexes during and after the crash. However, how a stock market crash affects individual stocks and if stocks with different financial characteristics are affected differently in a stock market crash is an issue that has not received sufficient attention in finance literature. In this paper, we review and compare the empirical findings of seven recent empirical studies published in the Journal of Banking and Finance, the Journal of Investing (three papers), the Journal of Financial Planning, the Banking and Finance Review, and the Journal of Business and Finance Research that use data for the 1987-2008 period that covers nine major stock market crashes.

Empirical findings indicate that stocks with higher betas, larger capitalization, lower levels of illiquidity, and more return volatility one-year prior to the event lose more value in stock market crashes. Empirical studies also find that the stocks of companies with lower profitability and higher debt ratios (i.e., companies with greater bankruptcy risk) and companies with lower levels of liquid assets (i.e., companies with greater technical insolvency risk) tend to lose more value in stock market crashes.

Since Thaler and De Bondt's seminal study published in the Journal of Finance (1985), studying investor overreaction to economic events has been a popular research topic in finance. However, investor overreaction to certain firm characteristics during stock market crashes has not received sufficient attention. Two recent empirical studies published in the Journal of Investing and the International Journal of Business and Finance Research find that investors overreact to the technical insolvency and bankruptcy risk characteristics of firms in stock market crashes. With data for five stock market crashes, these studies demonstrate that stocks that lose more value in crashes tend to gain more value after the crash with a significant market correction in the post-crash market reversal.

Keywords:

1. Stock market crash
2. Firm characteristics
3. Investor overreaction

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