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Short-Term Price Overreactions: Identification, Testing, Exploitation

Abstract

This paper examines short-term price reactions after one-day abnormal price changes and whether they create exploitable profit opportunities in various financial markets. Statistical tests confirm the presence of overreactions and also suggest that there is an “inertia anomaly”, i.e. after an overreaction day prices tend to move in the same direction for some time. A trading robot approach is then used to test two trading strategies aimed at exploiting the detected anomalies to make abnormal profits. The results suggest that a strategy based on counter-movements after overreactions does not generate profits in the FOREX and the commodity markets, but in some cases it can be profitable in the US stock market. By contrast, a strategy exploiting the “inertia anomaly” produces profits in the case of the FOREX and the commodity markets, but not in the case of the US stock market.

Keywords: Efficient market hypothesis, Anomaly, Overreaction hypothesis, Abnormal returns, Contrarian strategy, Trading strategy, Trading robot, t test