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# What is overreaction?

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Overreaction in the financial market is said to occur if the market price moves upward too much after good news or moves downward too far after bad news. It is hard to identify overreaction until a subsequent price reversal is observed.

The most prevailing evidence of market overreaction is captured by a negative serial correlation in security prices. This means a positive price movement on one day is followed by a negative movement the next day.

**WHY IS IT IMPORTANT?**

Overreaction is a behavioural bias that reflects investors' overweighting of new information. When prices reverse, investors are often shocked.

If the overreaction lasts for only a short while, contrarian strategies that bet against the excessive price movements may be profitable.

A prolonged overreaction is more problematic as it can be a manifestation of an inefficient market where irrational investors distort the prices away from their equilibrium. Such mispricing can lead to a slow movement of capital in the financial market.

In extreme cases, overreaction can lead to bubbles and crashes.

Bubbles form when rising prices lure investors into the market regardless of fundamentals. When smart money starts to exit, the falling prices may also produce an overreaction on the downside.

For example, when the dot.com bubble burst, not only did market correction cause unprofitable technology firms to fold, but the selling pressure also affected good stocks such as Amazon, eBay and Cisco.

The financial market is not the only place where overreaction is observed. In an office setting, managers may overreact to more sociable subordinates, expecting them to perform better than their peers.

When the subordinates do not do well subsequently, the managers may attribute the underperformance to the difficulty of the tasks or the unfairness of the tasks.

A bigger problem is when overreaction is compounded by other biases such as fear and herding in society. For example, if everyone reacts sharply to a piece of negative news due to fear and uncertainty, the overreaction and herding can cause social unrest and upheaval.

The recent supermarket run is an example of a short-term overreaction which was corrected subsequently by pictures of supermarket shelves brimming with consumables and food.

**IF YOU WANT TO USE THE TERM, JUST SAY:**

"The effective remedies to correct overreaction include high-quality information disclosure and the presence of more rational investors than irrational ones."

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