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Feedback Trading on the JSE

by

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[1] **Note:** The findings from this working paper does not in any way reflect the views of the Development Finance Centre (DEFIC). The views are only representative of the authors.

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Ailie Charteris and Lorraine Rupande

Abstract

Financial theory rests on the assumption that investors are rational. Evidence, however, demonstrates that this assumption is inappropriate, with many chasing price movements rather than relying on fundamental information to make their trading decisions. The effects of such behaviour on the market depends on the form that this trend chasing takes. Positive feedback trading, buying (selling) when prices rise (fall), is destabilising as it drives prices away from their fundamental values and contributes to volatility. In contrast, the contrarian nature of negative feedback trading, buying (selling) when prices fall (rise), is stabilising as it drives prices back to their fundamental value. This study seeks to determine whether investors follow feedback trading strategies on the South African market using the framework of Sentana and Wadhwani (1992). On average only 23% of the shares showed evidence of feedback trading, with approximately 65% of this being negative feedback trading. These results provide important insights into market efficiency, market timing and the use of trading strategies by investors while also providing useful information for market regulators and arbitrageurs.

Keywords: Feedback trading | individual shares | GARCH | JSE |