

## **Test for Investor Rationality for Companies Listed at the Nairobi Stock Exchange**

### **Abstract:**

Investors have traditionally been viewed as economically rational individuals who make decisions based on all available information. They have been assumed to use probability functions to arrive at the most optimal decision. More recent studies propose that investors are irrational and systematically overreact to good and bad information events. The concept of the rational investor has been supported by among others Efficient Market Hypothesis and Modern Portfolio Theory. Other studies opposed to the notion of rational investors have identified psychological biases that influence decision making process of an investor, and leading them to make irrational decisions. Several anomalies have been identified that deviate from rational behavior. The objective of this paper was to test for investor rationality for companies listed at the Nairobi Stock Exchange. This paper tested overreaction by investors to news and performance of companies listed at the Nairobi Stock Market as an anomaly that has been proven in other markets. The test involved forming companies into two portfolios, one of extreme good performers and the other of extreme poor performers during the base year. Performance of these portfolios was analyzed for a nine year period from the year of portfolio formation. The results are consistent with the notion of overreaction, showing that investors overreact to both good and bad news. Over the study period the loser portfolio outperformed the winner portfolio by about 35.92%. This confirms that investors are irrational and make decisions based on some biases.