Conditional Test of Individual Stock Sentiment and Cross-section of Stock Returns

Investor sentiment is the attitude of investors to anticipated price movement. Whether investor sentiment affects stock prices is a question of long-standing interest to economists. Previous studies have always been focused on market-level sentiment, which is the general prevailing attitude of investors as to anticipated price development in a market. At a given point in time, there is only one market sentiment for all stocks in the investment universe. However, the investors' sentiment concerning each stock is heterogeneous: even when the sentiment about the overall market is bullish, investors may not be uniformly optimistic about all stocks; for some stocks, investors may be pessimistic. And there are various degrees of optimism and pessimism across stocks. This cross-sectional heterogeneity of sentiment, independent of market sentiment, calls for a more refined measure of sentiment at individual stock level (risk-neutral skewness). This paper completes previous studies by examining the influence of the firm-level sentiment measure (risk-neutral skewness) on cross-sectional predictability patterns in stock returns, instead of using market-wide sentiment. For firm-level sentiment measure, we use a model-free and ex-ante measure of risk-neutral skewness developed by Bakshi, Kapadia, and Madan (2003). This definition of risk-neutral skewness has been used by Conrad, Dittmar, and Ghysels (2012) and Rehman and Vilkov (2012).

Our first finding is that stocks with higher firm-level investor sentiment are the stocks about which investors are more bullish and have a more optimistic view. These stocks tend to be overpriced; the future expected return is lower. Stocks with lower firm-level investor sentiment are the stocks about which investors are more bearish. These stocks tend to be undervalued; the future expected return is higher.

Our second finding is that the short legs of each long-short anomaly strategy have lower returns (greater profits) for stocks with high sentiment than for stocks with low sentiment. The positive average profit on each long-short strategy reflects the unexplained cross-sectional difference in average returns that constitutes an anomaly. Due to short-sale constraints, the profits of the long-short strategy arise primarily from overpricing of stocks in the short leg, and such overpricing is greater for high-sentiment stocks.

In future, we will extend our individual firm sentiment measure to empirical asset pricing and corporate finance studies.

YI ZHOU
Assistant Professor of Finance
Department of Finance
College of Business
Florida State University
yizhou@business.fsu.edu
Office: 850-644-7865