

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.

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