ABSTRACT:

Real investors and markets are too complicated to be neatly summarized by a few selected biases and trading frictions. We try to study how investor sentiment affects the cross-section of stock returns in the Indian context. Investor sentiment is not straightforward to measure and hence we attempt to measure the aggregate market sentiment by incorporating various sentiment proxies into a sentiment index using the Stock and Watson index methodology, treating overall market sentiment to be an unobserved variable. Consistent with the theory, we find that stocks of low capitalization, younger, unprofitable, high volatility, non-dividend paying, growth companies, or stocks of firms in financial distress, are likely to be disproportionately sensitive to broad waves of investor sentiment. We also find that when beginning-of-period proxies for sentiment are low, subsequent returns are relatively high for small stocks, young stocks, high volatility stocks, unprofitable stocks, non-dividend-paying stocks, extreme growth stocks, and distressed stocks. When sentiment is high, on the other hand, these categories of stock earn relatively low subsequent returns.

Key words: Investor sentiment, cross-section of stock returns, Stock and Watson Index Methodology