



Relationship between Stock Market Return and Investor Sentiments: A Review Article

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Abstract:

This study initially describes the basic structure of the securities market. The objective of the study is to analyse stock market return relationship with investor confidence. Correlation test had been applied by various researchers to see interaction between the various indices. In this study, different theories and explanations have been studied. Real investors and markets are too complicated to be neatly summarized by a few selected biases and trading frictions. A large body of research shows a role for investor sentiment in the formation of returns. In particular, stocks that are difficult to arbitrage or to value are most affected by sentiment. Unfortunately, there is no one theory that can explain everything.

Keywords: *Investor sentiments, Retail investor, Stock Market return*

1. Introduction

Over the last few decades, the average person's interest in the stock market has grown exponentially. So a brief understanding of stock exchange is required. 'Stock Exchange' as any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities. Stock exchange could be a regional stock exchange whose area of operation/jurisdiction is specified at the time of its recognition or national exchanges, which are permitted to have nationwide trading since inception. Now let us have a look at some of the related terms. An Index shows how specified portfolios of share prices are moving in order to give an indication of market trends. It is a basket of securities and the average price movement of the basket of securities indicates the index movement, whether upwards or downwards. Next is security market, Securities Markets is a place where buyers and sellers of securities can enter into transactions to purchase and sell shares, bonds, debentures etc. It can be divided into primary markets that are those markets where a company issue shares for the first time through IPO and secondary market gives liquidity to those shares. Through secondary market like, NSE, BSE, various buyers and sellers can trade their securities.

Further, it performs an important role of enabling corporate, entrepreneurs to raise resources for their companies and business ventures through public issues. Transfer of resources from those having idle resources (investors) to others who have a need for them (corporate) is most efficiently achieved through the securities market. Stated formally, securities markets provide channels for reallocation of savings to investments and entrepreneurship. Savings are linked to investments by a variety of intermediaries, through a range of financial products, called 'Securities'. An example of security is Stock prices that change every day as a result of market forces. By this we mean that share prices change because of supply and demand. If more people want to buy a stock (demand) than sell it (supply), then the price moves up. Conversely, if more people wanted to sell a stock than buy it, there would be greater supply than demand, and the price would fall. Theoretically, earnings are what affect

investors' valuation of a company, but there are other indicators that investors use to predict stock price. But it is investors' sentiments, attitudes and expectations that ultimately affect stock prices

Now looking at investor sentiments, there is a role for retail investor sentiment in the equity pricing process. Some of the various ways of measuring sentiment, ordered from origins in investor psychology to responses by corporate insiders, include: surveys, mood proxies, retail investor trades, mutual fund flows, trading volume, dividend premia, closed-end fund discounts, option implied volatility, first-day returns on initial public offerings, volume of initial public offerings, new equity issues, and insider trading.

Moving further we see that global integration has led to the widening and intensifying of links. Over the past few years, the financial markets have become increasingly global. The Indian market has gained from foreign inflows through the investment of Foreign Institutional Investors (FIIs). Following the implementation of reforms in the securities industry in the past few years, Indian stock markets have benefited tremendously and have managed to stand out. So the need arose to study whether there is relationship between the stock market return and investor confidence or sentiments.

2. Objectives

The following objectives have been formed for the current study.

1. To understand the index price movement.
2. To study the insights of these changes on customer perception.
3. To measure investor sentiments
4. To study whether there is any relationship between market return and investor sentiments.

3. Literature Review

The study of market or investor sentiment has its basis in the theories of the Kyle (1985) and Black (1986) noise trader models. Both suggest that, if some traders trade on 'noisy' signals, unrelated to fundamental data, then market prices can deviate from intrinsic value, thereby violating the efficient markets hypothesis of Fama (1970). The 'behavioral' perspective continues to surmise that interplay between noise traders and arbitrageurs establishes prices (Shleifer and Summers 1990). This is contrary to the EMH that theorizes the market price of an asset deviates minimally from the present values of expected future cash flows, and that the actions arbitrageurs readily absorb demand shocks and shifts in investor sentiment.

Shleifer (2000) mentions two major foundations of behavioral finance: limited arbitrage and investor sentiment. Investor sentiment is mainly driven by two phenomena: the representativeness heuristic, i.e. the tendency of people to view events as representative of some specific class and ignore the laws of probability in the process, and conservatism, which leads people to a slower updating of models in the face of new evidence than is necessary. These two drivers result in overreaction and underreaction of investors on stock markets.

Jackson (2003) also analyzes a unique dataset of individual investor trades in Australia and examines whether the investment decisions of individual investors aggregate in a systematic way. He finds that the aggregation assumption holds across 56 unrelated brokerage firms and across sub-periods and across subsets of stocks. This somewhat extends the result of Barber, Odean, and Zhu (2003) that trades of individual investors are correlated within a single brokerage firm. In addition, he finds that individual investor trades exhibit negative feedback trading at a weekly frequency and substantial persistence. Regarding the relationship between individual investor trading and future stock returns, he finds that net trades of full-service brokerage clients positively and significantly forecast future short-term market and cross-sectional returns.

Kumar and Lee (2006) also proves that retail investor trades are systematically correlated and retail investors buy and sell stocks in concert. In particular, they find that changes in retail sentiment induce co-movement in stock returns. Like Barber, Odean, and Zhu (2006), Kumar and Lee observe the most significant results in securities where arbitrage is difficult.

Bernstein and Pradhuman (1994) studied three groups of investors—large, medium, and small (in the sense of large Wall Street strategists, medium writers of investment newsletters, and small individual investors). Newsletter writers are often described as semiprofessionals, midway between amateur individual investors and professional Wall Street strategists and found that the sentiment of Wall Street strategists is a useful contrary indicator while looking at the view of Solt and Statman(1988) and Clarke and Statman (1998) they analyzed weekly Investors Intelligence observations beginning in 1964 and found no statistically significant relationship between the level of sentiment of newsletter writers and DJIA or S&P 500 returns in the following 4 weeks, 26 weeks, or 52 weeks.

Barberis, Shleifer and Vishny (1998) aim to explain the empirical evidence of under-reaction of stock prices on news about companies earnings and overreaction on series of good or bad news. They base it on evidence from psychology, and they have a model where the representative investor prices assets incorrectly. Namely, the investor assumes that earnings follow one of two regimes, a trend stationary or a mean reverting process, while earnings are actually a random walk. Therefore this model has a component of irrationality in investor's beliefs While Allen, Morris and Shin (2004) try to explain overreaction of stock prices to noisy public information by heterogeneous private information of investors and higher order beliefs, in a fully rational setting.

Some researchers have suggested that the returns to small-cap stocks are related to the sentiment of small investors whereas the returns to large-cap stocks are related to the sentiment of large investors. For example, Lee, Shleifer, and Thaler (1991) concluded that small investors concentrate their holdings in small-cap stocks, thus creating such a link. Elton, Gruber, and Busse (1998) disputed these conclusions. When we analyzed the link between individual investor sentiment and small-cap versus large-cap returns, (fisher, 2000) found no support for the argument that the sentiment of small investors follows the performance of small-cap stocks more closely than the performance of large-cap stocks.

(Fisher Kenneth, L.,2000) found the the relationship between the sentiment of individual investors and future S&P 500 returns was found to be negative and statistically significant. Individual investors are wiser in their investment actions than in their sentiment. Although they found a negative and statistically significant relationship between the sentiment of individual investors and future S&P 500 returns, but found a positive, although not statistically significant, relationship between the actual stock allocations in the individual investors' portfolios and future S&P 500 returns.

Some theory argues that the dynamic interplay between noise traders and rational arbitrageurs establishes prices (e.g., Shiller (1984), Shleifer and Summers (1990)). According to this view, in addition to innovations in fundamentals, factors such as the correlated trading activities of noise traders also induce co movements and arbitrage forces may not fully absorb these correlated demand shocks. While looking at the views of Kumar, A., & Lee, C. (2006)

They used a database of more than 1.85 million retail investor transactions over 1991– 1996, to show that these trades are systematically correlated—that is, individuals buy (or sell) stocks in concert. Moreover, consistent with noise trader models, they found that systematic retail trading explains return co movements for stocks with high retail concentration (i.e., small-cap, value, lower institutional ownership, and lower-priced stocks), especially if these stocks are also costly to arbitrage.

Macroeconomic news and analyst earnings forecast revisions do not explain these results. Collectively, our findings support a role for investor sentiment in the formation of returns.

Looking at the view of (Baker & Wurgler, 2006) 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. They utilize interim advances in behavioral finance theory to provide sharper tests for the effects of sentiment. In particular, in the many behavioral models of securities markets inspired by De Long et al. (1990), investors are of two types: rational arbitrageurs who are sentiment-free and irrational traders prone to exogenous sentiment. They compete in the market and set prices and expected returns. But, arbitrageurs are limited in various ways. These limits come from short horizons or costs and risks of trading and short selling. So, prices are not always at their fundamental values. In such models, mispricing arises out of the combination of two factors: a change in sentiment on the part of the irrational traders, and a limit to arbitrage from the rational ones.

Now suppose instead that we view investor sentiment as simply optimism or pessimism about stocks in general, and we allow the limits to arbitrage to vary across stocks. A large body of research shows that arbitrage tends to be particularly risky and costly for certain stocks: namely those that are young, small, unprofitable, or experiencing extreme growth. Such stocks tend to be more costly to buy and to sell short (D'Avolio, 2002). Such stocks have a high degree of idiosyncratic variation in their returns, which makes betting on them riskier (Wurgler and Zhuravskaya, 2002). Such stocks' higher volatility may lead to second-guessing by the investors

4. Conclusion

A pioneering and well-known set of studies of sentiment and aggregate stock returns appeared in the 1980s. They were largely a theoretical, testing in various ways whether the stock market as a whole could be mispriced. Authors looked for: the tendency of aggregate returns to mean revert; volatility in aggregate stock index returns that could not be justified by volatility in fundamentals, which is in fact another way of characterizing mean reversion in returns; or predictability of aggregate returns using simple valuation ratios like the ratio of aggregate dividends to stock market value. The standard finance model, where unemotional investors always force capital market prices to equal to the rational present value of expected future cash flows, has considerably been difficult to justify the market prices.

It was seen in various studies that the inexperienced retail or individual investor are more likely than the professional to be subject to sentiment. It was seen that the same securities that are difficult to value also tend to be difficult to arbitrage and stocks that are difficult to arbitrage or to value are most affected by sentiment.

The stocks most sensitive to investor sentiment will be those of companies that are younger, smaller, more volatile, unprofitable, non-dividend paying, distressed or with extreme growth potential, or having analogous characteristics. Whereas "bond-like" stocks will be less driven by sentiment which provide funds to the arbitrageur, ultimately leading to withdrawals from contrarian arbitrageurs just when the mispricing is greatest (Shleifer and Vishny, 1997). By not paying dividends, such stocks' fundamentals remain far in the future and therefore subject to speculation (Pontiff, 1996). Thus, again, we might expect that sentiment has a greater effect on such stocks

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