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Sentiment changes, stock returns and volatility: evidence from NYSE, AMEX and NASDAQ stocks

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Abstract

Using US stock portfolios that are formed on book-to-market equity (B/M), long term reversals, momentum, and size, a long sample period (1965–2007), and the comprehensive sentiment index of Baker and Wurgler ([2006](#)), this article shows that contemporaneous returns of extreme portfolios are significantly related to monthly sentiment changes and tend to be higher during periods of negative sentiment. Stock returns, however, seem to Granger-cause sentiment changes and are more important in predicting sentiment changes than vice versa. In addition, conditional return volatility is significantly affected by lagged volatility rather than sentiment changes.

Keywords:

sentiment

book-to-market

momentum

reversal

volatility

Notes

¹ Zhang, for instance defines the term investor sentiment as a representation of market participants' beliefs about future cash flows relative to some objective norm (the true fundamental value of the underlying asset; p. 9).

² The index (level and changes) is collected from www.stern.nyu.edu/~jwurgler, where it is publically available.

³ See <http://mba.tuck.dartmouth.edu/pages/faculty/ken.french>. The site provides more details on the construction of the portfolios. Also see previous empirical studies for further details and discussion, such as Fama and French ([1993](#), [1995](#), [1996](#)), among others.

⁴ Their regression also includes a market return as a control variable, since high volatility stocks may have higher betas.

⁵ Testing for a unit root yields an Augmented Dickey–Fuller (ADF) test statistic for the level of sentiment equal to -2.1777 , and an ADF test statistic for the first difference of the level of sentiment equal to -8.7783 (the 1% critical value is -3.4456 ; the 5% critical value is -2.8676).

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