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ARTICLES

A More Predictive Index of Market Sentiment

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Abstract

Recently, finance literature has turned to non-economic factors such as investor sentiment as possible determinants of asset prices. Using mutual fund data, I calculate a new sentiment measure, a perceived loss index. The advantage of the loss index is that it can determine perceived risk for different categories of equities, including market capitalization, style and sector. Results provide evidence that the perceived loss index outperforms all other sentiment and systematic risk measures in predicting future medium run returns, especially for one- and two-year horizons. This evidence pertains not just to broad market returns but also to capitalization-style and sector specific indice returns as well. In addition, I provide evidence that the loss index can be used as a quantitative measure to detect bubbles and financial crises in financial markets.

Keywords:

Financial markets Behavioral finance

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Notes

1. See Fischer and Statman [2000] and Baker and Wurgler [2006].

2. In the regressions below I use PLI calculated with various half lives. The PLI with a half life of one year returned the highest R-square.

3. See Appendix for a more detailed explanation.

4. More specifically, this index uses all funds classified as growth, value, core, small cap, mid cap, large cap, small growth, small value, small core, mid growth, mid value, mid core, large growth, large value and large core.

5. Due to the recent financial crisis I have updated the figures to include the level of the index up until January 1, 2009.

6. The data are taken from Kenneth French's website, ttp://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html.

7. The MSCI index levels I use include the US Investable Market 2500, Small Cap Value, Small Cap Growth, Large Cap Value, Large Cap Growth, Growth, Value, Small Cap 1750, Large Cap 300, and MSCI REIT Index.

8. For graphical analysis I use the S & P 500 data because it goes back farther in time, where as, the MSCI Indices start in 1992.

9. Using the benchmarkrecommended by Newey and West [1987] that the number of lags chosen should equal 4(n/100) {2/9} and suggested by others that n {1/4} I obtain a lag equal to six.

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