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Answering Financial Anomalies: Sentiment-Based Stock Pricing

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Abstract

The efficient market hypothesis (EMH) assumes that investors are rational and value securities based on their present value; the price of a security is determined by the present value of its expected future cash flows. In this paper, we present a new model of stock pricing that relaxes the EMH assumption that investors are rational. We assume that investors are computationally bounded and that they use high volatility trading strategies. We show that this model can explain several financial anomalies, such as the momentum effect, the volume effect, and the market microstructure noise. We also show that this model can be used to relax the EMH assumption that investors are rational. We assume that investors are computationally bounded and that they use high volatility trading strategies. We show that this model can explain several financial anomalies, such as the momentum effect, the volume effect, and the market microstructure noise.

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Notes

¹We assume the dividends have extremely high growth g_s , where $g_s > r$ until time T . Afterward, we assume dividends grow at a constant rate g_n , where $g_n < r$. The current price of the high-growth stock is then:

$$P_0 = \frac{DIV_1}{(r - g_s)} \left[1 - \left[\frac{1 + g_s}{(1 + r)} \right]^T \right] + \frac{DIV_1(1 + g_s)^{T-1}(1 + g_n)}{(1 + r)^T * (r - g_n)}$$

²See Sharpe [1978, p. 315] for a fuller description of this method.

³Future dividends are computed from the current dividends and the growth rate. The discount rate is computed using CAPM. The growth rate is computed from the company-specific information (usually a multiple of ROE and the plowback ratio).

⁴For details about the formula and a description of each term, see Shleifer [[2000](#), pp. 134-143].

⁵For a firm with abnormally high growth, Equation ([3](#)) can be modified accordingly.

⁶The remaining three companies were added much later to the Dow Jones Index.

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