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Answering Financial Anomalies: Sentiment-Based Stock Pricing

Edward R. Lawrence, George McCabe & Arun J. Prakash

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Abstract

The efficient market hypothesis (EMH) assumes that investors are rational and value securities rationally. A rational investor would value a security by its net present value; the price of a stock in this framework is based on the discounted cash flow or the present value model. Although the EMH-based model is partially successful in computing fundamental stock prices, other anomalies such as high trading volume, high volatility, and stock market bubbles remain unexplained. These models assume

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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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