Chapter 19

Investor Sentiment and Stock Returns: Out of Sample Evidence

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ABSTRACT

In this chapter, the authors investigate the relationship between investor sentiment and stock returns in an out of sample market, namely Borsa Istanbul. The authors use the Consumer Confidence Index as an investor sentiment proxy, while utilizing BIST Second National Index as a measure of small capitalized stock returns. The sample period spans from January 2004 to May 2014. By using monthly data, the authors employ cointegration test and error-correction based Granger causality models. The authors’ findings suggest that there is a long-term relationship between investor sentiment and stock returns in Borsa Istanbul. Moreover, a unidirectional causal relationship from investor sentiment to stock returns is also found.

INTRODUCTION

Efficiency of the capital markets is a widely debated topic in finance literature. The first view suggests that capital markets are efficient and security prices reflect all available information. Nevertheless the second approach comes up with a different explanation. This approach denies the efficiency of the capital markets. A number of market anomalies are used as evidence against the efficiency of the capital markets. Moreover, reasons as well as existence of market anomalies are widely investigated. Attempts to explain market anomalies on a rational ground failed in some occasions. On the contrary, sentiment is found to exacerbate anomalies (Stambaugh, Yu, & Yuan,
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2012). Thus, physiological explanations appeared as a remedy to clarify the roots of deviations from market efficiency. Kahneman and Tversky (1979) is a pioneering study that introduces investor psychology as a significant factor in capital markets and the area is referred to as behavioral finance.

Aim of this study is to investigate the relationship between investor sentiment and stock returns in Borsa Istanbul. The sample period extends from January 2004 to May 2014. We use Consumer Confidence Index as an investor sentiment proxy, while BIST Second National Index is used to measure small capitalized stock returns. We employ cointegration test and error-correction based Granger causality models by using monthly data. The majority of relevant empirical studies use sorted portfolio returns for measuring returns of small capitalized firms. Instead we use an index that exclusively reflects performance of small capitalized firms, namely BIST Second National Index. Furthermore, a great body of literature employs market-driven sentiment measures to proxy investor sentiment. Up to our best knowledge, this study is the first to establish a connection between consumer confidence index and a market index designed for small firms.

The rest of the paper is organized as follows. The next section examines investor sentiment issue. The third section summarizes the literature. The fourth section presents the methodology and data. And the fifth section reports the empirical results. The last section concludes the paper.

INVESTOR SENTIMENT

Behavioral finance approach includes a number of sub-theories. The term “noise” has a unique position among these theories. The term noise is originated by Black (1986) and it refers to “incorrect signals” shared among the participants of the capital markets. The investors who try to exploit noise are called noise traders. Moreover, noise trading cannot be attributed to specific group investors. On the contrary, noise trading may have a pervasive character across the capital markets. Thus, diversifying the noise originated security price deviations would not be possible. In this manner, noise would earn a systematic character as a source of risk and it should be involved in the return generation processes. Limited arbitrage makes it easier for noise trading to impact asset prices (Shtinger & Summers, 1990).

Although noise introduces additional risks, investors in fact benefits from its existence. As noise originates from incorrect signals, information reflects the correct signals in the market. However, the potential problem arises from the correctness of the signals reaching the marketplace. If every market participant trades on the correct signals, nobody would find counterparty. Since all participants share the very same information, all expectations regarding the future would be the same. This harmony in expectations would prevent security trades. Nevertheless, if some of the participants make noisy decisions, they would constitute ideal counterparties for rational investors. As a result, we may expect a positive association between the volume of noise trading and the liquidity of the general market. However, since the correct signals do not guarantee a good return, rational investors would not be able to fully exploit the incorrect expectations of the noise traders. Security prices would always reflect noise as well as information (Black, 1986, p.530-532).

De Long, Shleifer, Summers and Waldmann (1990) associate noise trading with investor sentiment. Beginning with the separation between rational investors and noise traders suggested by Black (1986), they attempt to better explain the motives behind the noise traders. De Long et al. (1990) suggest that rational expectations determine the decisions of rational investors. On the contrary, noise traders' investment decisions are influenced by their sentiment. Sentiment determines the level of expectations of noise traders and these expectations may be lower or higher...