

INVESTOR SENTIMENTS: A DEEP DIVE INTO THE COLLECTIVE MOOD OF THE MARKET

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ABSTRACT

Investor sentiment, the collective mood and perception of market participants, is a dynamic force that significantly influences financial markets. Investor sentiment is a critical driver of financial markets, reflecting the collective perceptions, attitudes and emotions of market participants. This study explores the multifaceted nature of investor sentiments. This study investigates the primary factors that contribute to shifts in investor sentiment, including economic indicators, corporate performance, geopolitical events, and broader macroeconomic trends. It analyzes how information asymmetry, behavioral biases, and social influences collectively contribute to the formation of investor sentiment. This study aims to provide a comprehensive understanding of how investor psychology influences the financial markets. Understanding investor sentiment is crucial for market participants, policymakers, and researchers seeking to comprehend market movements and develop effective risk management strategies. The study provides insights into the complex interplay of psychological, economic, and technological factors that underpin investor sentiment, contributing to a comprehensive understanding of contemporary financial markets.

Keywords: Investor Sentiment, Financial Market, Policymakers, Behavioral Biases, Sentiment Analysis.

Introduction:

The inception of Standard Finance can be attributed to John Stuart Mill in 1844 when he introduced the concept of "homo-economicus." This term signifies the belief that humans are rational beings who consistently seek to maximize their utility through a logical evaluation of various available options. This concept laid the groundwork for the development of the Expected Utility Theory (EUT). In 1944, Von Neumann and Morgenstern further advanced the EUT, building on the assumption of homo-economicus. The theory posits that decision-makers,

operating under risk, make decisions by comparing the expected utility values of the alternatives at hand. The underlying assumption is that individuals base their decisions on the ultimate outcomes and their current state of wealth. Since then, standard finance models have exerted a pervasive influence on the financial realm in recent decades.

But the failure of standard finance models in explaining the reasons behind Stock Market anomalies, bubbles and crashes led to birth of a new domain of finance i.e. behavioral finance. Behavioral Finance is an advanced area of economics that brings a lot of curiosity and intent to investors due to the reason that explains how and why market might be inefficient. It uses the learning of social science, cognitive psychology and human studies to clarify the irrational behavior that is not being secured by the conventional models and theories.

As per (Baker and Wurgler 2007) in the domain of behavioural finance “there are two major assumptions, namely limited arbitrage and the presence of investor sentiment. The first major underpinning of behavioral finance is limited to arbitrage. Arbitrage can be defined as the simultaneous purchase and sale of the same or essentially similar security in two different markets for different prices. One-way behavioral finance formalizes the possibility of limited arbitrage through the noise trader model, which is one of the most cited alternatives to the efficient market theory. The second major foundation of behavioral finance is investor sentiment.

Investor sentiment is a key factor in valuing stocks and is influenced by both global and local factors. It can be measured using pricing errors made by investors. Global investor sentiment has a significant impact on domestic sentiment and global economic conditions. Investor sentiment is interdependent with economic policy uncertainty, US interest rates, and financial assets. Shocks are transmitted through investor sentiment in both bullish and bearish market conditions. Investor sentiment plays a crucial role in the decision-making process of investors and affects equity returns in different industries. Optimistic investor sentiment positively affects equity returns in certain sectors, while pessimistic sentiment has no impact on stock returns in other industries. Over the last years, there is an ongoing debate between conservative theorists and behavioral theorists about drivers of investment decisions. Predominantly, the discipline of conventional finance was characterized by the assumption that markets are efficient and investors are rational. This means that investors use all relevant information available to them while taking investment decisions(Hassan Al-Tamimi and Anood Bin Kalli 2009). Investment decisions of investors are influenced by rational orirrational factors that contribute to the efficiency or inefficiency of security markets. The inefficiency is generally attributed to the behavioral biases of investors. Individual investors are more prone to behavioral biases than institutional investors (Shanthikumar and Malmendier 2011). Individual investor behavior is documented in (Barber and Odean 2000) amongst others. Investors in the capital market may be institutions or individuals. In the capital market the role of individual investors cannot be ignored

since household's savings account for the major share of the gross savings in the country. Investor behaviour is characterized by volatility and over-reaction in both upward and downward movement of the stock market and various factors influence their decision-making processes. Investor psychology affects investment decisions. Before the results become certain, investors make investment decisions. Psychologists have found that as decisions become more difficult and involve higher levels of uncertainty, the decisions tend to be more greatly influenced by emotions and feelings (Cianci, 2008).

Literature Review:

Baker and Wurgler (2006) analysed the link between investor sentiment and different types of returns in US stock market. This study used principal component analysis (PCA) to create an investor sentiment index on the basis of common variation in six underlying proxies for sentiment over a period of 1962-2001, including closed-end fund discount, NYSE share turnover, quantity and average first-day returns on IPOs, equity share in new issues and dividend premium. Regression analysis was used to see if the irrational investment behaviours of investors had an effect on the excess returns in the stock market. The study's conclusions suggest that stock market returns on the US stock market may be predicted by using investor mood.

Tetlock (2007) conducted a study to look into how the media affected stock market returns between 1984 and 1999. The Wall Street Journal's (media) column's daily material was used by the researcher. Dow Jones Industrial Average's daily returns and daily log of volume traded on the NYSE were obtained from the Wharton Research Data Services database. The study came to the conclusion that American media significantly affect market gains.

Fernandes et al. (2013) examined the influence of investors' sentiments on the share market of the European Union (EU), and Portugal in particular. The research was done to check the impact not only on the aggregate level, but also on the individual industry level impact was checked for a time frame of 1997-2009 on 3-months, 6-months and 12-months basis. Consumer Confidence Index and EU Economic Sentiments Indicator were taken as the proxies of investors' sentiments. After conducting regression analysis, it was identified that the investors' sentiments are the negatively related to the overall market returns on 1 to 12 months basis, but in case of industry wide relationship there is no particular relation except low relationship with telecommunication sector. But if we take case of time frame more than one month then the sentiments have a significant impact on utility and technology index too.

Corredor et al. (2015) examined the link between the proxies of investors' sentiments and the share market returns of the Poland, Hungary and Czech Republic stock market. The variable undertaken for the study was – average ratio of the trading volume of the foreign stocks in all

countries, stock size, book-to-market ratio and dividend per share whereas for proxy of investors' sentiments – Consumer Confidence Index of the selected three countries were undertaken and the time frame for which the data was collected was from 2001-2011. The study concluded that the sentiments of investors were one of the most influential variables to the stock prices of all selected markets, and in particular the influence on these markets than most of the Central European nations. The effects get more statistically significant when the shares are very much influenced by the sentiments of investors. Additionally, the results have reflected that the effect was not the same in every country; instead it was more prominent in the Czech Republic and Poland, which further proves that there prevail many country specific factors that might be influencing the investors' sentiments in every market.

Li et. al (2017) focused on establishing a relationship between the share market returns in USA and sentiments of the investors. Two key variables taken into account were – Consumer Sentiment Index, developed by University of Michigan Consumer Survey and BW sentiment index, for a time frame of 1978–2014 on a monthly basis. Unit root test and quantile causality test were applied to understand the relationship. From unit root test it was identified that the relationship only existed in the lower quantiles when it is investigated for sentiments of investors to the share market returns. And when the test was run for the inverse relationship, the test shown that there lies no significant relationship, but it became quite significant when the proxy undertaken was index of consumer confidence. So, it can be concluded from this research that sentiments of investors provide the future direction of the stock returns.

Khan and Saleem (2022) analysed the connection between equity returns of the Pakistan Stock Exchange and investor sentiments. PSX (Pakistan Stock Exchange) official website and the published annual reports of 61 non-financial and financial enterprises from KSE-100 index for the years 2008-2019 were used to gather data for the study. Equity Returns, Share Turnover, Money Flow Index, and Price Earnings Ratio were used as variables in the study. Link between equity returns and investors sentiment was examined using Vector Auto Regression Model (VAR). The study found a strong positive association of share turnover and money flow index with the equity returns of the KSE-100 index. Additionally, a substantial inverse relationship between the Price Earnings Ratio and equity returns was discovered.

Objectives of the Study:

1. To understand the concept of investors sentiments in India.
2. To provide a comprehensive review of existing on investor sentiments, both globally and within the Indian context, to establish the current state of knowledge.

Research Methodology:

- **Nature of Research study:** The above study is conducted using the descriptive research design. Here the authors attempted to elaborate the role of investors' sentiments in Indian stock and how understanding the concept of investors' sentiments is crucial in comprehending market dynamics and predicting stock price movements.
- **Methods of data collection:** Secondary sources of data collection are used in this study. Mainly the data is collected from research articles, magazines and internet websites.

Conclusion:

This study contributes to the broader understanding of the symbiotic relationship between investor sentiments and stock market dynamics, providing insights that can inform more robust risk management strategies and contribute to the development of a more resilient and adaptive financial system.

The findings emphasize the need for market participants, policymakers, and financial analysts to incorporate a comprehensive understanding of investor sentiments into their decision-making processes. Recognizing the significance of sentiment analysis in predicting market trends and fluctuations becomes imperative for navigating the complexities of contemporary financial landscapes.

In conclusion, this conceptual study delves into the intricate relationship between investor sentiments and the stock market, shedding light on the nuanced dynamics that influence financial markets. The exploration of investor sentiments as a crucial factor in shaping stock market behavior reveals the interconnectedness of psychological factors with economic outcomes. The study has underscored the impact of emotions, perceptions, and cognitive biases on investment decisions, contributing to the understanding of market fluctuations beyond traditional economic indicators.

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