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DECOMPOSING THE INVESTOR SENTIMENT

Abstract:

This paper analyzes the components of the influential Baker and Wurgler (BW) indices of investor sentiment and their contribution to the volatility of U.S. stock portfolios. Using the Klein - Chow (2013) symmetric method of variance decomposition, we orthogonalize the five proxies of sentiment (dividend premium, first-day return on IPOs, number of IPOs, closed-end fund discount, and equity share in new issues) and determine the proportions of systematic risk contributed by these measures. We find that even portfolios that show no economically significant contemporaneous or lagged sensitivity to the BW indicators may still exhibit important sentiment risk, which raises serious questions about the validity of some of the proxies or the use of Principal Component Analysis to compute the sentiment indices. For instance, after controlling for the Fama - French three factors and for momentum, for the time interval 07/1965 - 12/2014, the first-day return on IPOs explains roughly 9.8 and 19.2 percent of the systematic variance of high 10 - low 10 (long-short) Fama - French portfolios formed on variance and on accruals, respectively. For the same interval and portfolios, the overall BW sentiment-levels indicator explains, respectively, 1.7 and 0.0 percent of the systematic risk.

Keywords:

Systematic Risk Decomposition, Investor Sentiment, Principal Component Analysis, Fama-French Portfolios