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VALUATION RATIO STYLE INVESTING AND ECONOMIC SENTIMENT IN EUROZONE MARKETS

Abstract:

This paper explores the role of sentiment in style investing for a sample of eight Eurozone markets and makes a distinction between fundamentals-driven sentiment and sentiment based on non-fundamental information. We find that style returns are not stable overtime: on average, value portfolios tend to outperform growth portfolios, however, during financial crises the effect is either reversed or disappears. We also find that sentiment has a more significant effect on portfolio returns during financial crises. For example, for Germany during the US financial crisis, the variance of fundamental sentiment accounts for 19.65% of the value portfolio variance and the variance of non-fundamental sentiment for a further 24.67%. These results are robust to the choice of valuation ratios in defining investment style. Impulse Response Functions from a Panel Var model indicate that, on average, a shock to non-fundamentals driven sentiment has a negative effect on portfolio returns while a shock to fundamentals driven sentiment has a positive effect on returns.

Keywords:

Style Investing, Valuation Ratios, Sentiment, Financial Crisis

JEL Classification: G11, G12