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Investor sentiment, stock mispricing, and long-term growth expectations

Kotaro Miwa*

Tokio Marine Asset Management Co., Ltd., Japan

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ABSTRACT

I analyze whether or not market-wide investor sentiment induces stock mispricing, by affecting the boldness of predictions of firms' long-term earnings growth. I predict that bullish market-wide sentiment induces investors to aggressively separate firms with high growth futures from others, and that this excessive boldness results in a high level of mispricing. Consistent with my prediction, I observe an excessively large dispersion in consensus growth forecasts when proxies for investor sentiment are high at the beginning of the period. Furthermore, stocks with higher-predicted growth experience more negative forecast revisions and lower subsequent stock returns, especially following periods of high investor sentiment.

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1. Introduction

Considerable financial studies debate the role and effect of investor sentiment on asset pricing. Investor sentiment is seen as crowd psychology, revealed through the activity and asset price movements in the market. Traditional asset pricing theory suggests that rational arbitrage necessarily forces prices closer to fundamentals and leaves no role for investor sentiment. However, several behavioral finance studies argue that investor sentiment drives stock prices away from fundamental values (De Long et al., 1990; Shleifer and Vishny, 1997).

Consistent with this argument, studies show that time-varying investor sentiment affects stock prices. Lemmon and Portniaguina (2006) and Baker and Wurgler (2006, 2007; hereafter "Baker/Wurgler") use a measure of investor sentiment to show that difficult-to-value stocks (i.e., small, newer, volatile stocks) are overvalued, especially when sentiment is high. Furthermore, Hribar and McInnis (2012) find that those stocks receive optimistic earnings forecasts during such periods. They argue that, since difficult-to-value stocks are highly influenced by the trading activity of noise traders, valuation of these stocks is considerably affected by investor sentiment.[1]

On the other hand, some studies analyze the sentiment effects on the overall accuracy of analysts' earnings forecasts, which can be regarded as proxies for investor expectations of future payoffs. Walther and Willis (2012) show that financial optimism regarding quarterly earnings forecasts is affected by investor sentiment. These studies raise the possibility that investor sentiment induces stock mispricing by affecting market participants' expectations about a firm's future payoffs. However, while prior studies focus on the sentiment effects on the overall accuracy of forecasts of near term payoffs, few studies analyze the sentiment effect on long-term earnings growth expectations.

* Correspondence to: 1-3-1, Marunouchi, Chiyoda-ku, Tokyo, Japan.
E-mail address: miwa_tfk@cs.c.u-tokyo.ac.jp

[1] Other sentiment effects include the effect on the performance of technology IPO shares (Saade, 2015).

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Long-term earnings growth expectations are crucial to stock price valuations. In many valuation models, an estimated intrinsic value of a firm's stock depends on long-term earnings growth (LTG) expectations (Frankel and Lee, 1998; Gebhardt et al., 2001). For example, according to the Gordon growth model (1962), a price-to-dividend ratio of 20 implies that a 1% increase in long-term dividend growth translates into a 20% return. Consistent with the implication of the model, Copeland et al. (2004) report that analysts' long-term earnings forecasts, a proxy for investor long-term growth expectations, exert a great influence on stock prices.

Therefore, to further pinpoint the sentiment effect on asset pricing, it is essential to examine whether investor sentiment affects investor long-term earnings expectations and thereby induces mispricing.

The extant research reveals that investors' long-term growth expectations, which are represented by analysts' long-term earnings forecasts, are, on average, too extreme, and this results in economically significant mispricing. La Porta (1996) and Chan et al. (2003) reveal that firms with high predicted growth are aggressively distinguished from others. Research shows that this excessive boldness regarding LTG expectations induces significant mispricing; subsequent stock returns are negatively associated with LTG forecasts (Lakonishok et al., 1994; La Porta, 1996; Dechow and Sloan, 1997; Dechow et al., 2000).

Investors may more readily bet on firms' growth potential when market-wide sentiment is more supportive of their preferences, i.e., market-wide sentiment is higher. Thus, I predict that higher sentiment encourages investors to more aggressively distinguish firms with high-predicted growth from others. These excessively bold predictions are then corrected in a subsequent period, and this correction affects subsequent cross-sectional stock returns by reducing mispricing, which was induced by the prior excessively bold predictions. Thus, I predict that firms with higher expected growth experience more negative earnings forecast revisions and lower stock returns, especially after periods of bullish sentiment.

In this study, I present empirical analyses to test these predictions. Following the study of Baker/Wurgler, I use their market-wide investor sentiment index, and the Michigan Consumer Sentiment Index, to explore investor sentiment effects. In addition, following other prior studies (e.g. Mezrich et al., 2001; Chan et al., 2003), I utilize analyst LTG forecasts as a representative proxy for investor expectations of firm long-term earnings growth.

The paper proceeds as follows. Section 2 details the development of my hypotheses. Section 3 presents the sample and descriptive statistics. Section 4 describes the methodologies and results. Finally, I summarize my findings in Section 5.

2. Theory

To test the possibility that investor sentiment affects the boldness of LTG expectations and thereby induces stock mispricing, I examined the following hypotheses.

2.1. Investor sentiment and bold growth forecasts

First, I examined the association between market-wide investor sentiment and investor excessive boldness in LTG predictions. I predict that bullish market-wide sentiment encourages investors to aggressively distinguish firms with high-predicted growth from others, and the boldness of their long-term growth forecasts lowers the accuracy of these growth forecasts. Hence, first I test the following two hypotheses:

Hypothesis 1-1. Bullish investor sentiment induces bold LTG forecasts (boldness in LTG forecasts is positively associated with investor sentiment).

Hypothesis 1-2. The positive association between investor sentiment and forecast boldness lowers the accuracy of these growth forecasts.

The Hypothesis 1-1 addresses the sentiment effect on boldness in LTG forecasts; Hypothesis 1-2 addresses whether the sentiment effect is aligned with forecast accuracy. If both are satisfied, I can say that bullish investor sentiment induces excessive boldness in LTG forecasts.

2.2. Correction of bold forecasts and mispricing

Second, I examined whether excessively bold LTG forecasts caused by bullish market-wide investor sentiment induces stock mispricing. The excessive boldness in the LTG forecasts could be corrected in a subsequent period and that correction could affect cross-sectional stock returns by reducing mispricing, which was induced by the prior excessively bold predictions. If this is the case, firms with high-predicted growth should experience more negative (downward) forecast revisions and lower subsequent stock returns than firms with low-predicted growth, especially when proxies for investor sentiment are high at the beginning of the period.

Accordingly, the hypotheses to be tested are:

Hypothesis 2-1. There is a stronger negative association between the LTG forecasts and subsequent earnings forecast revisions when proxies for investor sentiment are higher.

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