



# Diffusion of optimistic and pessimistic investor sentiment: An empirical study of an emerging market



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## ABSTRACT

This study explores the optimistic and pessimistic investor sentiments of three major institutional investors (foreign investors, trust investors, and dealers) in the Taiwan stock market and investigates the interactions and effects of these types of sentiment. Related indices are first calculated to examine whether investor sentiments are contagious among stock investors. Next, optimistic and pessimistic sentiments are differentiated to examine how each of them diffuses in the market. Finally, an index of dynamic sentiment spillover is estimated to investigate the diffusion effect of institutional investor sentiment under varying market performance. The results of this study confirm that, under favorable market performance when institutional investors are optimistic, the diffusion effect of investor sentiment is nonsignificant. By contrast, the diffusion effect of pessimistic sentiment is significant, indicating that investor sentiment contagion is asymmetric.

## 1. Introduction

Previous studies indicate that a firm's capital stock is purchased at a premium when investors are optimistic about the future prospects of the firm. Therefore, investor sentiment is a predictor of stock returns and can serve as a price-discovery indicator (Brown & Cliff, 2005; Baker & Wurgler, 2006, 2007; Corredor, Ferrer, & Santamaria, 2013). Investor sentiment can explain not only individual stock performance but also the difference in expected stock returns across different countries (Schmelming, 2009). Furthermore, several studies assert that optimistic and pessimistic investor sentiments exert distinct effects on stock returns. For example, Ding, Charoenwong, and Seetoh (2004) and Zhang and Semmler (2009) verify that optimistic sentiment is more significantly correlated with stock returns compared with pessimistic sentiment.

The aforementioned studies indicate that investor sentiment leads stock returns unidirectionally. The present study investigates investor sentiment from a dissimilar perspective, specifically, we aim to examine the sentiments of institutional investors and to analyze the interactions of these sentiments. Subsequently, an index of dynamic sentiment spillover is estimated to explore how optimistic and pessimistic sentiments are correlated and how the diffusion of investor sentiment is influenced by market performance. Compared with previous studies that mainly examine large, developed markets (e.g., the United States) (Brown & Cliff, 2005; Baker & Wurgler, 2006), this study targets a small, open, emerging market (i.e., Taiwan) to analyze investor sentiment from a different perspective. The development of the stock market in Taiwan has entailed more than 50 years of history. The Taiwan Stock Exchange (TWSE) began its operation in 1962. Since then, the domestic stock market has operated as an order-driven market involving an electronic communication approach. Compared with other advanced stock markets, in which investors prefer investment through stock funds, those in the domestic stock market favor direct investment; hence, its ratio of retail investors is higher than those in other stock markets. To increase the incentives for retail investors, the TWSE had disclosed increasingly

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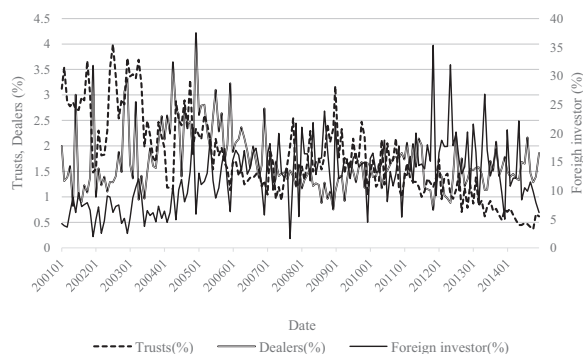


Fig. 1. The ratio of trade volume by the three types of investor to the total trade volume.

comprehensive information. For example, information regarding nonretail investors, or institutional investors, has become more transparent and accurate for retail investors.

In the Taiwanese stock market, investors are divided into three types: namely (a) foreign professional investment institutions (hereafter referred to as foreign investors), (b) security investment trust companies (hereafter referred to as trusts), and (c) security dealers (hereafter referred to as dealers). As shown in Fig. 1, which illustrates the ratio of trade volume by the three types of investor to the total trade volume of the domestic stock market, foreign investors attain the highest trade volume among the investor types. However, this does not imply that the trade of foreign investors directs the entire market because generally, the information held by such investors is less than that of domestic institutional investors. For example, Agarwal, Faircloth, Liu, and Rhee (2009) propose that foreign investors generally underperform domestic investors in trading activities, and their inferior performance is attributable to non-initiated orders. In addition, foreign investors might experience higher information costs. Therefore, foreign investors might refer to the investment decisions of domestic institutional investors. Jeon and Moffett (2010) also find evidence of information asymmetries between foreign and domestic institutions in the Korean market, and foreign investors tend to buy/sell shares that domestic institutions sell/buy in the herding year. Nevertheless, domestic institutional investors occasionally perceive a high level of influence from foreign investors who hold a high ratio of stock share or trade volume, thus prompting them to follow the investment behaviors of the foreign investors. For example, Choe, Kho, and Stulz (1999) find evidence showing that the Korean stock market adjusted quickly and efficiently to large sales by foreign investors.

Domestic institutional traders might also differ in their behaviors. In contrast to dealers in foreign exchange markets, those in the Taiwanese stock market do not provide bid and ask prices. In other words, the Taiwanese market is order-driven and do not involve quotations, and is dissimilar to markets such as New York Stock Exchange, in which dealers are professional traders who also provide information regarding asset liquidity. Therefore, dealers in the Taiwanese stock market are institutional investors who base their trades on self-interests. A trust can be an open-end fund that is affected by the investment and withdrawal of fund investors. For example, during a financial crisis, a trust advisor might decide to sell a stock in response to fund redemption despite the underestimated stock price. The difference between the investment behaviors of dealers and trusts might be attributable to the difference between their fund limitations.

The present study explores the investor sentiment of three institutional investors in the Taiwan stock market. Previous studies on market microstructure define a buy–sell imbalance (BSI) as a characteristic of transaction demand (Kraus & Stoll, 1972; Lakonishok, Shleifer, & Vishny, 1992; Sias, 1997; Wermers, 1999; Chordia & Subrahmanyam, 2004). Therefore, the BSI can be applied to determine the demands of stock market traders. Kumar and Lee (2006) uses trading volume records to calculate the BSI of retail investors across various stock portfolios, investigating retail investor sentiments, whether such investors trade stocks in concert, and whether the BSI significantly affects stock returns. On the basis of Kumar and Lee (2006), the present study also uses the BSI as an indicator for assessing investor sentiment. Particularly, we quantify the sentiments of three types of institutional investor and analyze the interactions of these sentiments. First, this study investigates the correlations between institutional investor sentiments, and then differentiates optimistic and pessimistic investor sentiments to examine whether the degree of correlation between these two sentiments varies.

This study also entails estimating the index of dynamic sentiment spillover to examine the diffusion of investor sentiment under varying market performance and to verify whether investor sentiment contagion is asymmetric. Previous studies confirm that optimistic and pessimistic sentiments can exert an asymmetric effect on stock returns. Therefore, the present study explores this topic from the opposite perspective, that is, we investigate whether the rise and fall of a stock market also exert an asymmetric effect on investor sentiment.

Exploring the effect of investor sentiment on stock returns provides insight into the portfolios of stock prices and returns. Therefore, investor sentiment can function as a price discovery indicator to formulate effective investment portfolios. The effect of stock returns on sentiment diffusion among various investors is an essential topic that has been rarely explored. For example, Canbas and Kandir (2009) examine the stock market in Turkey and verify that previous stock portfolio returns can affect investor sentiment; however, this effect was unidirectional. In other words, investor sentiment cannot be used to predict stock returns. Canbas and Kandir (2009) also investigate emerging markets, obtaining results dissimilar to those pertaining to the United States. Overall, empirical evidence relating to investor sentiments remain insufficient for elucidating the asymmetrical relationship between

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