Does sentiment matter for stock returns? Evidence from Indian stock market using wavelet approach

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Does sentiment matter for stock returns? Evidence from Indian stock market using wavelet approach

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Abstract: This article examines the relationship between investor sentiment and stock returns using the data from Indian stock market. We investigate the relationship using a broad set of implicit sentiment proxies and value-weighted market indices. The wavelet method has been used to decompose sentiment variables and stock returns into different timescale frequencies. We find a strong effect of sentiment on return both in the short-and long-run by employing decomposed returns and sentiment proxies at different time-scale frequencies, The study lends support to the fact that whether investors are short-term or long-term traders, their investments activities cannot be delinked from sentiment.

JEL CLASSIFICATION: C22, C32, G10, G12

KEYWORDS: sentiment, stock returns, emerging market, wavelet analysis

1. Introduction

Behavioural finance literature suggests that investors are not entirely rational but normal (Statman, 1999) and cognitive bias induces them to make suboptimal investment decisions (Barberis and Thaler, 2003). Cognitive bias of investors with some combinations of limited arbitrage (Shleifer and Vishny, 1997) and short-sale constraint (Miller, 1977) succumb their ability to differentiate between noise and information (Black, 1986). Therefore, when investors are unusually bullish or bearish due to cognitive bias, irrational or noise traders influence equity prices in equilibrium and generate systematic sentiment risk (De Long et al., 1990). Empirical literature supports a positive (negative) relationship between investor sentiment and contemporaneous (expected) stock returns (Baker and Wurgler, 2006; Baker et al., 2011; Schmeling, 2009).

This paper attempts to revisit the sentiment and equity returns relationship using the data from Indian stock market. Our motivation follows three distinctive arguments. First, whether

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