Investor Sentiment, Disagreement and Return Predictability of Ownership Breadth

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Abstract

We extend theories and empirics in Chen, Hong and Stein (2002) by allowing investors subject to market sentiment to hold a biased belief in aggregate. With a multiple-asset dynamic model, we show that the breadth-return relationship can be either positive or negative depending on the relative strength of two offsetting forces: cross-sectional variation in disagreement and cross-sectional variation in sentiment. Using sentiment index developed in Baker and Wurgler (2006, 2007), we find evidence consistent with our predictions. The stocks in the highest decile of change in breadth underperform those in the lowest decile when market sentiment variation is large. This effect is stronger among stocks that have larger exposure to market sentiment. After removing the extreme sentiment effect, we resurrect the positive breadth-return relationship documented in Chen, Hong and Stein (2002), which would otherwise vanish in an extended sample from 1980Q2 to 2007Q4.

Key Words: Investor Sentiment, Disagreement, Breadth of Ownership, Return Predictability

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