

Sentiment and Returns: Analysis of Investor Sentiment in the South African Market

Naeem. K. Dalika

0409917W

Supervisor: Mr Yudhvir Seetharam

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DECLARATION

I, Naeem. K. Dalika, declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce in Finance at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination at this or any other university.

Naeem K Dalika

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Definitions of Terms and Abbreviations

AMH: Adaptive Market Hypothesis

Adaptive Market Hypothesis: A new version of the Efficient Market Hypothesis where efficiency is seen as cyclical – dependent upon the interaction of market participants at any point in time (Lo, 2005).

Bayes Theorem: A theorem in statistics that links the degree of belief in an outcome before and after accounting for evidence (Bayes and Price, 1763).

BE/ME: Book to market is the book value of a share scaled by the market price of the share. The book to market ratio is the inverse of the popularised price to book ratio.

CAPM: Capital Asset Pricing Model

CAPM: The capital asset pricing model of Sharpe (1964), Lintner (1965) and later Black (1972). The model states that under rational and homogenous expectations with regards to risk and return, the market risk of an asset, proxied by the market beta is the sole determinant of an assets expected return.

Cognition: The mental action or process of acquiring knowledge and understanding through thought, experience, and the senses.

EMH: Efficient Market Hypothesis

E/P: The earnings to price ratio or earnings yield is the annual earnings of a security per share at a given time divided into its price per share. It is the inverse of the more common price to earnings ratio.

Herdning: A mentality characterised by a lack of decision making or thoughtfulness, causing people to think and act in the same way as the majority of those around them (Seetharam & Britten, 2013)

Informationally Efficient Market: A belief that markets reflect information with little or no delay, leaving no arbitrage opportunities. Any new information about a given firm is known with certainty, and is immediately priced into that companies stock.

Investor Sentiment: The component of investors' expectations about asset returns that are not justified by fundamentals (Lee, Shleifer & Thaler, 1991).

Investors Intelligence sentiment index: A sentiment index that reflects the outlook of independent financial market newsletter writers.

Odd lot: An order amount for a security that is less than the normal unit of trading for that particular asset. Odd lots are considered to be anything less than the standard 100 shares for stocks.

Order flow: The collective, small securities orders, to either buy or sell a specific security that a broker will send to dealers.

Tax-loss selling hypothesis: This theory predicts that at the end of the tax year investors sell stocks that have declined in value to realise the capital loss and offset it against capital gains tax liability. At the beginning of the new tax year the prices of those stocks that were sold for tax purposes recover thereby resulting in high returns typically in January (Reinganum, 1983)

Saint Petersburg Paradox: This is a paradox related to probability and decision theory in economics. The Saint Petersburg paradox, is a theoretical game used in economics, to represent a classical example were, by taking into account only the expected value as the only decision criterion, the decision maker will be misguided into an irrational decision.

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ABSTRACT

Modern financial theory generally has no room for investor sentiment. The standard argument is that in highly competitive financial markets, suboptimal trading behaviour such as paying attention to sentiment signals unrelated to fundamental value will be eliminated quickly by aggressive arbitrageurs. However, research in recent years illustrates that investor sentiment has a significant impact on the cross section of stock returns. This study contributes to the debate by examining the relationship between investor sentiment and stock returns in the South African Market. Theory predicts that a broad wave of sentiment will disproportionately affect stocks whose valuations are highly subjective and are difficult to arbitrage. To test this prediction we construct an aggregate measure of investor sentiment from several proxies and study the impact that it has on stock returns. The results indicate that investor sentiment has a strong impact on share returns in South Africa. When sentiment is low, subsequent returns are relatively high on smaller stocks, high volatility stocks, extreme growth stocks, and young stocks. When sentiment is high, on the other hand, these patterns fully reverse.

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