INVESTOR SENTIMENT AND MISPRICING IN THE U.S. STOCK MARKET

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ABSTRACT

Can the presence of a large group of investors with cognitive and emotional biases cause stock prices to deviate from their intrinsic values? Can sentiments induced by irrational exuberances and/or rational expectations of individual and institutional investors cause stock prices to deviate from their true values? We examine the relative effects of rational and quasi-rational sentiments of individual and institutional investors on deviations of S&P500 from its intrinsic value (computed by the dividend valuation model). Specifically, we investigate the following research questions: (i) whether a systematic pricing error exists in the U.S. stock market (ii) whether individual and institutional investor sentiments affect the mispricing in the U.S. stock market (iii) what is the relative impact of sentiments driven solely by rational expectations (rational sentiments) and cognitive biases (quasi-rational sentiments) on pricing errors? An understanding of the types of investors and the nature of their sentiments, which could cause mispricing, is of utmost significance. Such analysis could contribute to the usefulness of employing information on cognitive and emotional biases in predicting stock prices. We employ monthly database of investor sentiments at the individual and institutional level provided by the American Association of Individual Investors and Investors Intelligence respectively and set of 12 variables representing the rational factors. In addition, we use data on S&amp;P500, its P/E ratio, dividend yield and earnings per shares. Using the dividend valuation model we compute the expected return and pricing error variables at different expected growth rate in dividends. Regression results indicate that pricing errors systematically exists in the U.S. stock market independent of growth rates in dividends. Consistent with previous studies, we find that institutional investors have a significant power to destabilize or move the stock prices away from the fundamental values due to unpredictable changes in their sentiments. In addition, we find significant impact of institutional investors’ quasi-rational sentiments while insignificant effects of their rational sentiments on pricing errors. However, we did not find any effects of these two components of sentiments of individual investors on mispricing. We argue that one of the determinants of mispricing is institutional investors’ quasi-rational sentiments that are not rooted in economic fundamentals. A direct implication of these results is that conventional measures of temporal variation in risk omit an important source of risk: noise stemming from biases.