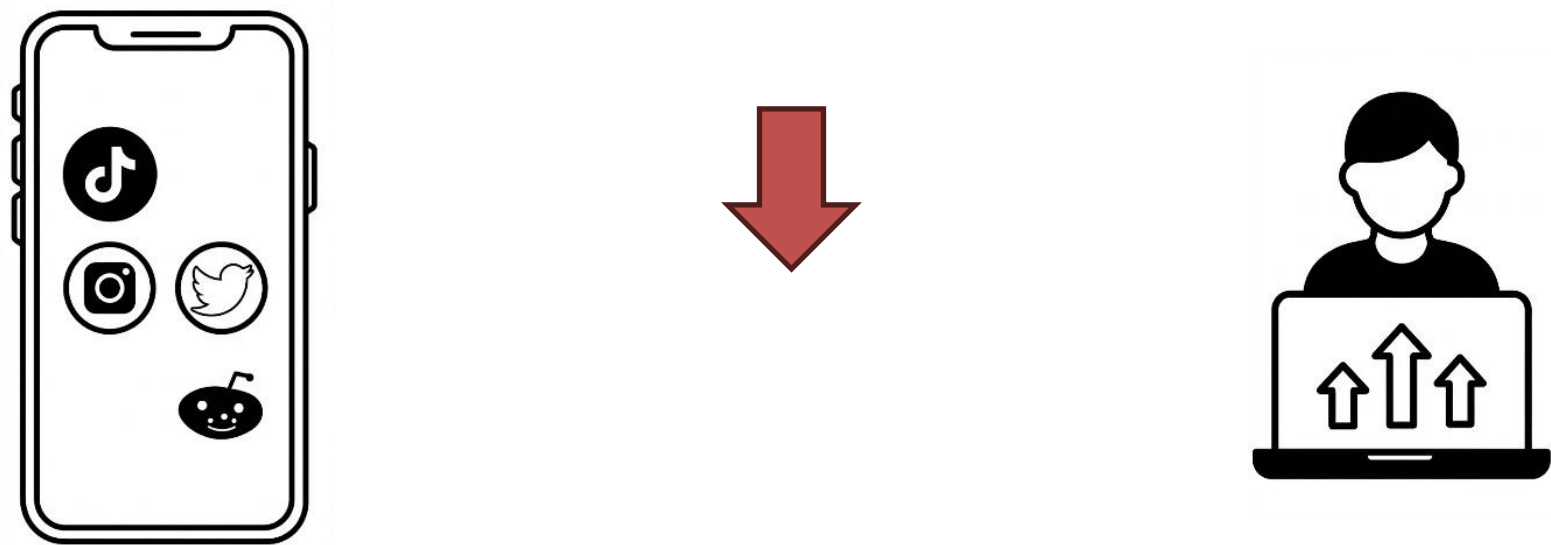
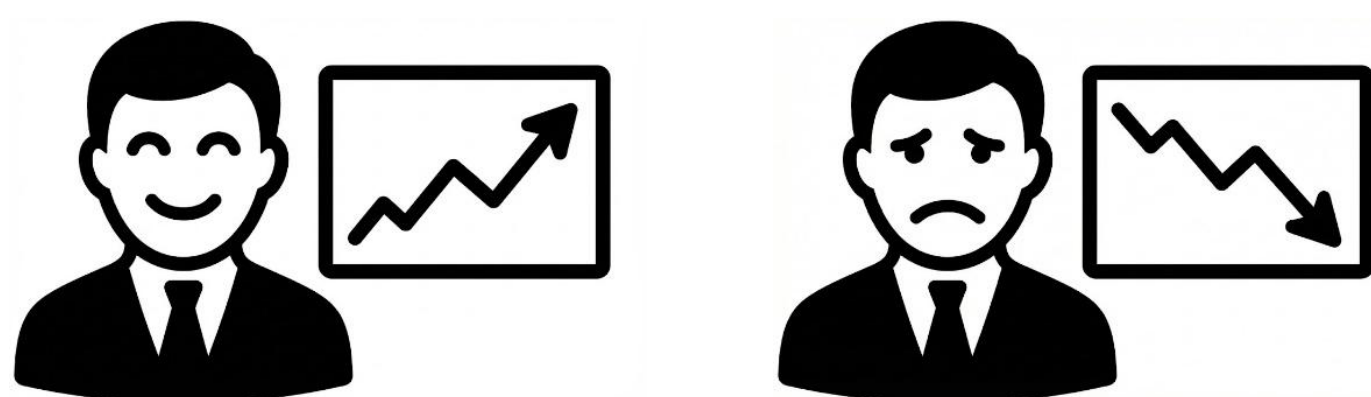


MOTIVATION

Increased Role of Social Media + Surge in Retail Trading



Investor Sentiment now spreads more rapidly and affects the financial markets more broadly than ever



To quantify the effects of the latent investor sentiment, we rely on proxies: surveys, composite indexes, textual measures, LLM, etc.

How should we evaluate these empirical measures of sentiment?

APPROACH

I argue that using return predictability of sentiment is an incomplete test, we should rely on misvaluation mechanism, as implied by theory.

Using a parsimonious signaling model, I connect theory to testable empirical conditions. If sentiment manifests in prices, then **joint conditions of sentiment-induced misvaluation** should hold:

- 1) Contemporaneity Condition
- 2) Predictability Condition
- 3) Consistency Condition

I use two *Sentiment Statistics* that summarize how each measure aligns with the joint conditions.

Next, I evaluate 11 measures of investor sentiment using these conditions in a GMM framework:

8 surveys, 3 indexes from literature

BW: Baker and Wurgler (2006)
BW_{PLS}: Huang et al. (2015)
SENT_{Mng}: Jiang et al. (2019)

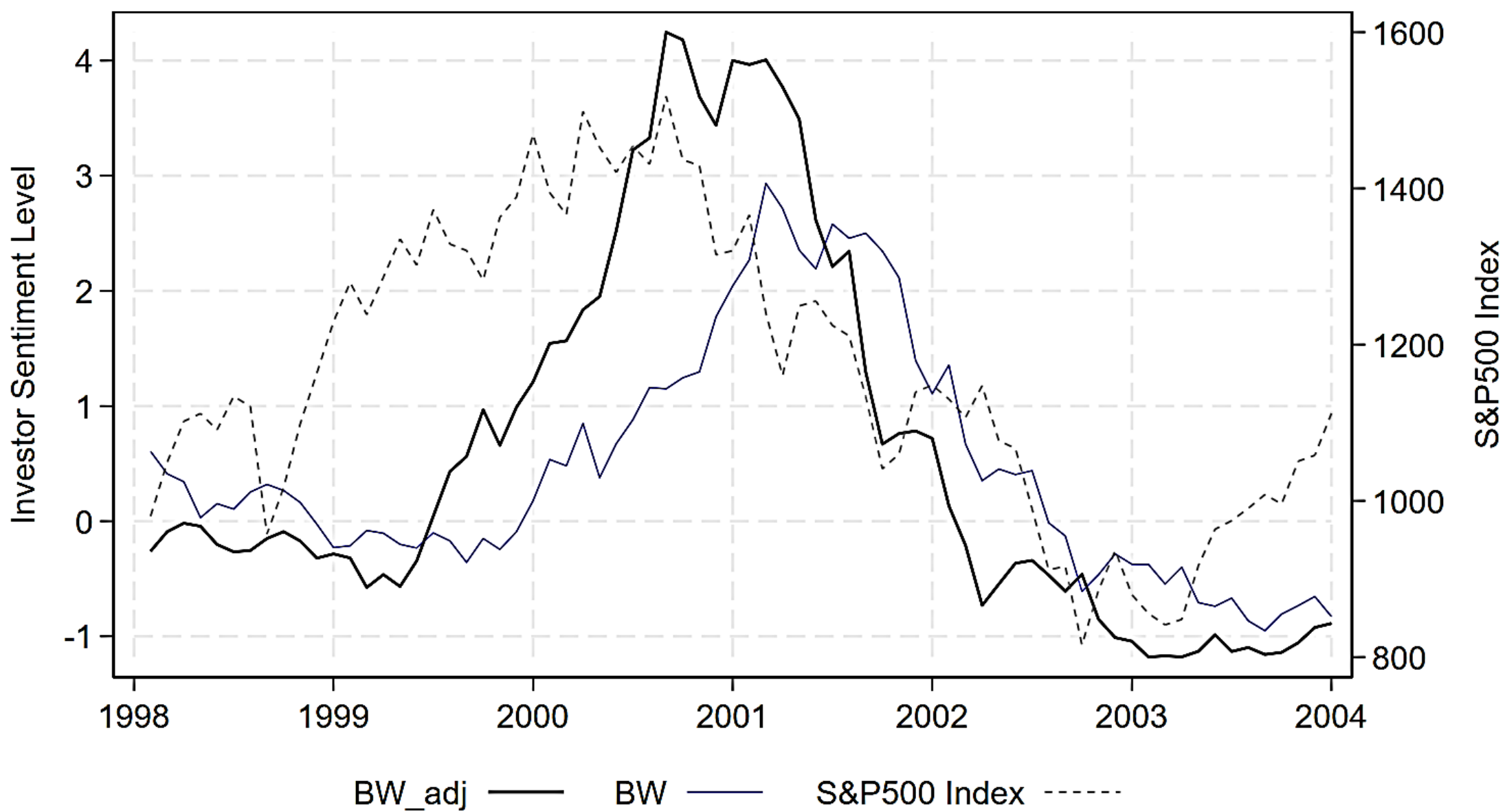
RESULTS

Common proxies of investor sentiment **do not** fully satisfy these joint conditions

	Contemporaneity (returns)	Contemporaneity (volatility)	Predictability	Consistency
Surveys	✓			
Existing Indexes		✓	✓	

Existing indexes from the literature (BW, BW_{PLS}, SENT_{Mng}) may reflect lagged investor sentiment. To fix this, I introduce three new measures that explicitly incorporate the contemporaneous relationship in their design, and satisfy the joint conditions better

- 1) LSEG MarketPsych (MPsy)
- 2) Adjusted Baker and Wurgler (BW_{adj})
- 3) BW_{adj} + Conference Board Confidence Survey (CBW_{adj})



I show that the new measures, exhibiting higher sentiment statistics, have more robust forecasting power:

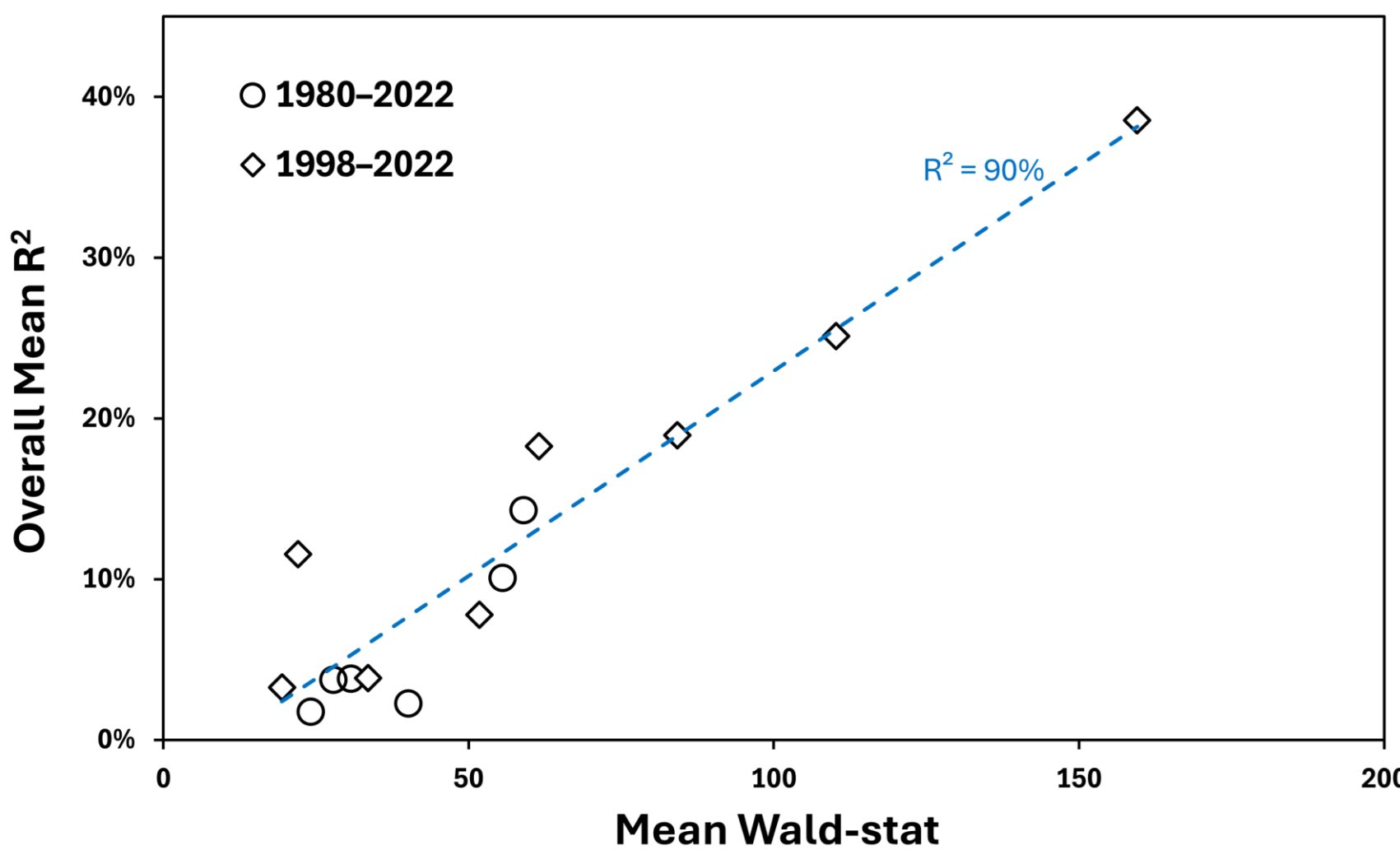
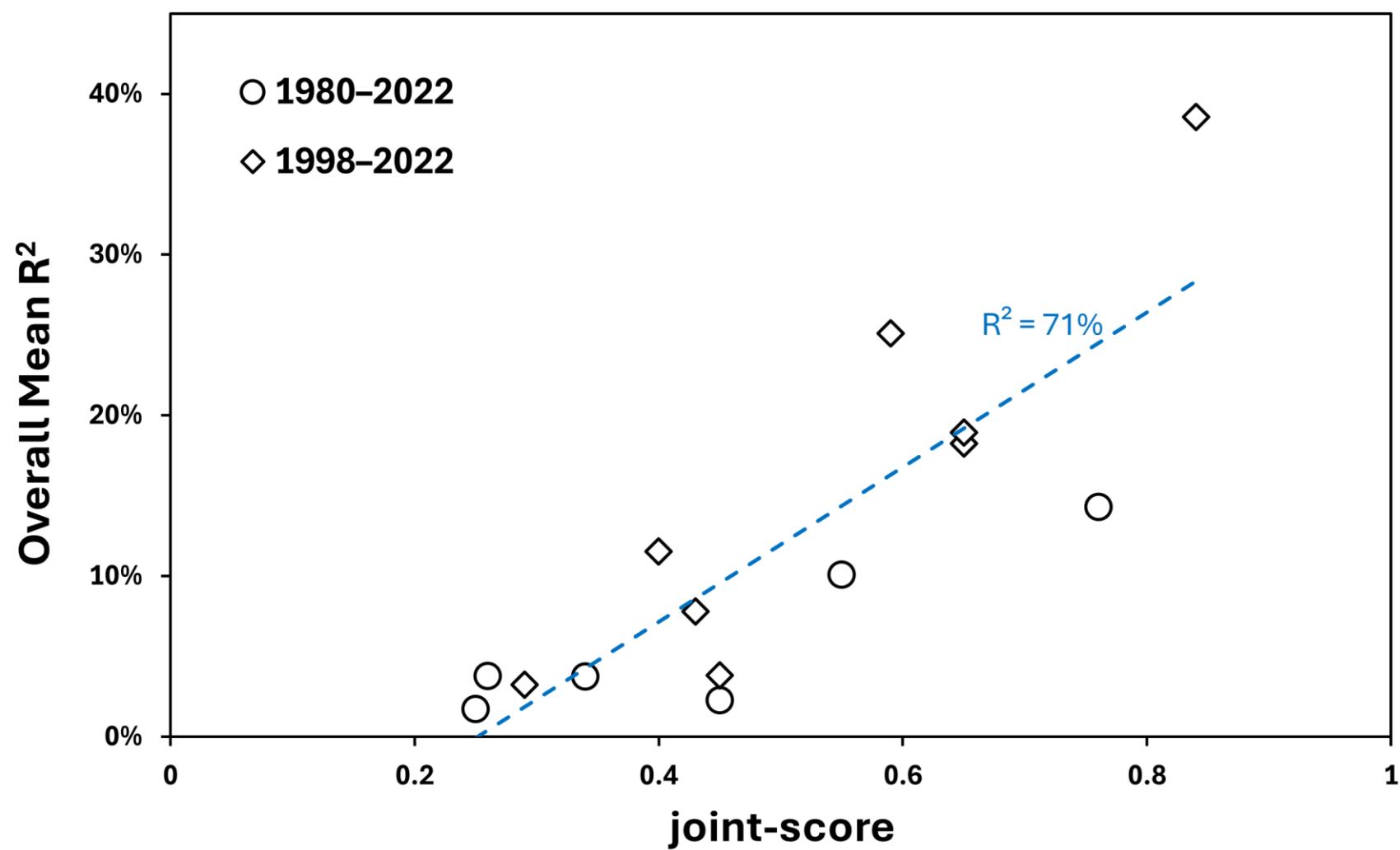
- In-sample and out-of-sample, particularly over long horizons
- Bootstrap resampling
- In presence of other predictors of returns

The robust forecasting power of new measures extends beyond market returns to other asset markets:

- 1) Flows to active equity mutual funds
- 2) Changes in the VIX
- 3) Changes in aggregate credit spreads

INTUITION

The two sentiment statistics are positively correlated with overall return forecasting power



The intuition behind these findings:

A sentiment measures that captures the correction of misvaluation should also explain its buildup.

I move the discussion beyond the conventional question of “Does this sentiment measure predict returns best?” toward “Does this sentiment measure behave in ways that theory requires if sentiment affects prices?”

CONTRIBUTIONS

By connecting theoretical and empirical behavioral finance literature, this paper:

- provides a unified empirical framework, grounded in theory, for testing and constructing sentiment measures
- shows that the effects of the measures that are aligned with this framework exceed the effects of those commonly used in literature

The true impact of investor sentiment on different asset markets can be greater than documented in the literature.

