

The Short of It: Investor Sentiment and Anomalies

by*

Robert F. Stambaugh, Jianfeng Yu, and Yu Yuan

January 26, 2011

Abstract

This study explores the role of investor sentiment in a broad set of anomalies in cross-sectional stock returns. We consider a setting where the presence of market-wide sentiment is combined with the argument that overpricing should be more prevalent than underpricing, due to short-sale impediments. Long-short strategies that exploit the anomalies exhibit profits consistent with this setting. First, each anomaly is stronger—its long-short strategy is more profitable—following high levels of sentiment. Second, the short leg of each strategy is more profitable following high sentiment. Finally, sentiment exhibits no relation to returns on the long legs of the strategies.

* We are grateful for helpful comments from Wayne Ferson, Murray Frank, Paul Irvine, Robert Novy-Marx, Stavros Panageas, Ľuboš Pástor, Jinghua Yan, seminar participants at the University of Minnesota, Shanghai Advanced Institute of Finance (SAIF), and Fudan University, and participants at the 2010 Conference on Financial Economics and Accounting. We also thank Edmund Lee and Huijun Wang for excellent research assistance. Author affiliations/contact information:

Stambaugh: Miller, Anderson & Sherrerd Professor of Finance, The Wharton School, University of Pennsylvania and NBER, phone 215-898-5734, email stambaugh@wharton.upenn.edu.

Yu: Assistant Professor of Finance at the University of Minnesota, 321 19th Avenue South, Suite 3-122, Minneapolis, MN 55455, phone 612-625-5498, email jianfeng@umn.edu.

Yuan: Assistant Professor of Finance at the University of Iowa, and Visiting Assistant Professor at Wharton, 3620 Locust Walk Suite 2300, Philadelphia, PA 19104, phone 215-898-2370, email yuanyu@wharton.upenn.edu.

1. Introduction

Whether investor sentiment affects stock prices is a question of long-standing interest to economists. At least as early as Keynes (1936), numerous authors have considered the possibility that a significant presence of sentiment-driven investors can cause prices to depart from fundamental values. The classic argument against sentiment effects is that they would be eliminated by rational traders seeking to exploit the profit opportunities created by mispricing. If rational traders cannot fully exploit such opportunities, however, then sentiment effects become more likely.

This study investigates the presence of sentiment effects by combining two concepts that are prominent, separately, in the related literature. The first concept is that investor sentiment contains a market-wide component with the potential to influence prices on many securities in the same direction at the same time.¹ The second concept, which traces to Miller (1977), is that impediments to short selling play a significant role in limiting the ability of rational traders to exploit overpricing.² As Miller argues (p. 1154),

A market with a large number of well informed investors may not have any grossly undervalued securities, but if those investors are unwilling to sell short (as they often are) their presence is consistent with a few investments being overvalued.

Combining Miller’s argument with the presence of market-wide sentiment replaces the “few” overpriced investments with potentially many such investments when market-wide sentiment is high. In contrast, periods of low market-wide sentiment, by Miller’s reasoning, should not be accompanied by substantial underpricing.

We explore sentiment-related overpricing as at least a partial explanation for 11 asset-pricing “anomalies” that survive adjustments for exposure to the three factors of Fama and French (1993). These anomalies reflect sorts on measures that include financial distress, net stock issues, composite equity issues, total accruals, net operating assets, momentum, gross

¹Studies addressing market-wide sentiment include Delong, Summers, Shleifer, and Waldman (1990), Shleifer and Summers (1990), Lee, Shleifer, and Thaler (1991), Barberis, Shleifer, and Vishny (1998), Shiller (2001), Brown and Cliff (2004, 2005), Yuan (2005), Baker and Wurgler (2006, 2007), Kaniel, Saar, and Titman (2006), Kumar and Lee (2006), Lemmon and Portniaguina (2006), Bergman and Roychowdhury (2008), Frazzini and Lamont (2008), Livnat and Petrovic (2008), Baker, Wurgler, and Yuan (2009), Yu (2009), Antoniou, Doukas, and Subrahmanyam (2010), Gao, Yu, and Yuan (2010), and Yu and Yuan (2010).

²Studies that investigate the role of short-sale constraints in overpricing include Figlewski (1981), Chen, Hong, and Stein (2002), Diether, Malloy, and Scherbina (2002), Duffie, Garleanu and Pedersen (2002), Jones and Lamont (2002), Scheinkman and Xiong (2003), Lamont (2004), Lamont and Stein (2004), Ofek, Richardson, and Whitelaw (2004), Nagel (2005), and Avramov, Chordia, Jostova, and Philipov (2010).

profit-to-assets, asset growth, return-on-assets, and investment-to-assets.³ For each anomaly, we examine the strategy that goes long the stocks in the highest-performing decile and short those in the lowest-performing decile. We then use the market-wide investor sentiment index constructed by Baker and Wurgler (2006) to explore sentiment effects.

We investigate three hypotheses that result from combining the presence of market-wide sentiment with the Miller short-sale argument. The first hypothesis is that the anomalies, to the extent they reflect mispricing, should be stronger following high sentiment. If the primary form of mispricing is indeed overpricing, then mispricing should be more prevalent when sentiment is high. We find that each of the 11 anomalies is stronger following high levels of investor sentiment (i.e., levels of sentiment above the median value). When averaged across anomalies, 70% of the benchmark adjusted profits from a long-short strategy occur in months following levels of investor sentiment above its median value. Time-series regressions confirm a significant positive relation between investor sentiment and the long-short anomaly profits.

The second hypothesis is that the returns on the “short-leg” portfolio of each anomaly should be lower when sentiment is high. The stocks in the short leg are relatively overpriced compared to the stocks in the long leg, to the extent the anomaly reflects mispricing. Moreover, the stocks in the short leg should be more overpriced when sentiment is high. For each of the 11 anomalies, we find that the return on the short leg is lower following high sentiment. When averaged across anomalies, 78% of the benchmark adjusted profits from shorting that leg occur in months following high sentiment. Time-series regressions confirm a significant negative relation between investor sentiment and the returns on the short leg.

The third hypothesis is that investor sentiment should not greatly affect returns on the “long-leg” portfolio of each anomaly. If, as in the Miller argument, there is no underpricing, then the returns on the long leg should not be higher following low sentiment than following high sentiment. When market-wide sentiment is high, the stocks in the long leg could be overpriced, but the long leg should contain the least degree of overpricing. Overall, we should not expect to see sentiment playing much of a role in the long-leg returns. This hypothesis is also confirmed. None of the 11 long legs exhibit a significant difference between high and low sentiment periods. When averaged across anomalies, the benchmark-adjusted returns on the long leg exhibit only a 4 basis-point monthly difference between high and low sentiment periods. Time-series regressions confirm the absence of a relation between

³Chen, Novy-Marx, and Zhang (2010) report that these anomalies are especially hard to explain using traditional asset pricing models such as the CAPM or Fama-French 3-factor model.

benchmark-adjusted long-leg returns and investor sentiment.

Perhaps the study most closely related to ours is that of Baker and Wurgler (2006), who argue that market-wide sentiment should exert stronger impacts on stocks that are difficult to value and hard to arbitrage. They examine returns on stocks judged most likely to possess both characteristics, as proxied by a number of observable variables. They conclude that market-wide sentiment is associated with cross-sectional return differences that are consistent with the importance of those characteristics. A key difference between our study and theirs is that we consider impediments to short-selling as the major obstacle to eliminating sentiment-driven mispricing. To the extent such mispricing exists, overpricing should then be more prevalent than underpricing, and overpricing should be more prevalent when market-wide sentiment is high. In order to explore the presence of such mispricing effects on a market-wide basis, we examine a broad set of 11 well-documented anomalies relative to the Fama-French three factor model. None of these anomalies are examined by Baker and Wurgler.

Another related study is Yu and Yuan (2010), who show that the correlation between the market's expected return and its conditional volatility is positive during low-sentiment periods and nearly flat during high-sentiment periods. Their study envisions a setting similar in spirit to ours, in that they argue the market is less rational during high-sentiment periods, due to higher participation by noise traders in such periods.

The rest of the paper is organized as follows. Section 2 develops our hypotheses. Section 3 discusses the investor-sentiment data and describes returns on the long-short strategies constructed for each of the 11 anomalies. Section 4 reports the main empirical results. Section 5 investigates the robustness of our results to macroeconomic effects as well as the use of an alternative sentiment index. Section 6 concludes.

2. Hypotheses

Here we develop the hypotheses used to explore mispricing as at least a partial explanation for the broad set of anomalies we consider. Our hypothesized setting combines two prominent concepts: market-wide sentiment and short-sale impediments.

For many years, researchers in finance have argued that empirical evidence supports the notion that the beliefs of many stock-market investors include a common time-varying “sentiment” component that exerts market-wide effects on equity prices. Lee, Shleifer, and Thaler (1991), for example, conclude that market-wide sentiment contributes to the differences be-

tween prices of close-end funds and their net asset values. Ritter (1991) reports evidence of long-run reversals in returns on initial public offering (IPO) stocks, and he concludes that the evidence is consistent with periodic waves of optimism that especially impact the prices of young growth stocks.

Numerous studies have argued that there exist short-sale impediments in the stock market, due to institutional constraints, arbitrage risk, behavioral biases of traders, and trading costs. First, many institutional investors, such as mutual funds, are simply prohibited by their charters from taking short positions. Second, even investors who do not face institutional constraints or high shorting costs can nevertheless be deterred by the risks in arbitrage, as discussed by Shleifer and Vishny (1997). Traders who short a security in the belief that its price is too high can be correct, in that the price will eventually fall, but they face the risk that the price will go up before it goes down. Such a price move, requiring additional capital, can force the traders to liquidate at a loss. A similar risk does not arise for long positions without leverage. Shleifer and Vishny (1997) further argue that such arbitrage risk looms particularly large for institutional managers, whose career paths depend heavily on recent performance. Third, individual investors, due to limited knowledge or behavioral biases, are reluctant to take short positions. For example, Barber and Odean (2008) document that only 0.29% of positions of individual investors are short positions. Finally, shorting can be costly. D'Avolio (2002), for example, finds that many stocks are costly to short due to low supplies of stock loans from institutional investors.

Miller (1977) argues that, with short-sale impediments, overpricing should be more prevalent than underpricing. Investors with the most optimistic views about a stock, relative to the views of other investors, will exert the greatest effect on the stock's price, since their views are not counterbalanced by the valuations of the relatively less optimistic investors. The latter investors are inclined to take no position if they view the stock as undervalued, rather than take a short position. When the most optimistic investors are too optimistic and overvalue the stock, overpricing results. In contrast, underpricing is less likely: as long as the cross-section of views includes the view of rational investors, the most optimistic investors do not undervalue the stock.

Combining market-wide sentiment with Miller's argument about the effect of short-sale impediments leads to our hypotheses. During periods of high market-wide sentiment, the most optimistic views about many stocks tend to be overly optimistic, and many stocks tend to be overpriced. During low-sentiment periods, the most optimistic views about many stocks tend to be those of the rational investors, and thus mispricing during those periods

is less likely. Therefore, mispricing is more likely during high-sentiment periods than during low-sentiment periods. We examine 11 different anomalies. If each of these anomalies at least partially reflects mispricing, we then arrive at our first hypothesis:

Hypothesis 1: The anomalies should be stronger following high investor sentiment.

Consider a long-short strategy whose positive average profit reflects the unexplained cross-sectional difference in average returns constituting an “anomaly.” To the extent that an anomaly represents mispricing, the profits of the long-short strategy can reflect relatively greater overpricing of stocks in the short leg, relatively greater underpricing of stocks in the long leg, or both. In our hypothesized setting, overpricing should be the prevalent form of mispricing, so the profits of the long-short strategy should arise primarily from overpricing of stocks in the short leg. Since overpricing should be greater during high-sentiment periods, we arrive at our second hypothesis:

Hypothesis 2: The short legs of the long-short strategies should have lower returns (greater profits) following high investor sentiment.

The stocks in the long leg are unlikely to be underpriced in our simple scenario. They could be overpriced, and overpricing would be more likely when sentiment is high. If the anomaly’s sorting variable is related to mispricing, however, the overpricing of the stocks in the long leg should be the smallest in the cross-section. Taking this reasoning to its limit, we entertain the possibility that any sentiment-related overpricing of the long-leg stocks is minimal. We thus arrive at our third hypothesis:

Hypothesis 3: The long legs of the long-short strategies should have similar returns following high and low investor sentiment.

It is useful to clarify in our setting the role of cross-sectional dispersion in investors’ views. Arguing that underpricing is unlikely requires the view of rational investors to lie within the cross-section of views across all investors. When sentiment is low, investors’ views must be sufficiently disperse to include rational valuations, even if the latter views are then the most optimistic views. To that extent, cross-sectional dispersion of views is a necessary ingredient of our hypothesized setting.

Our setting does not assign a role for variation over time in the cross-sectional dispersion of views. We simply assume that the views of the most optimistic investors in the cross-section are more likely to be too optimistic when our empirical measure of investor sentiment is high than when it is low. There are various ways that can happen. As our sentiment

measure increases, the cross-sectional mean of investors' views can remain close to a rational valuation level while the cross-sectional dispersion of views increases. Alternatively, as our sentiment measure increases, the dispersion of views can remain relatively constant, or even decline, while the mean of investors' views increases significantly above a rational valuation level. Distinguishing among such scenarios is beyond the scope of our study.

3. Data: Investor sentiment and anomalies

3.1. Investor Sentiment

We measure investor sentiment using the monthly market-based sentiment series constructed by Baker and Wurgler (2006). The index spans over 42 years, from July 1965 to December 2007. Baker and Wurgler (2006) form their composite sentiment index by taking the first principal component of six measures of investor sentiment. The principal component analysis filters out idiosyncratic noise in the six measures and captures their common component. The six measures are the closed-end fund discount, the number and the first-day returns of IPO's, NYSE turnover, the equity share in total new issues, and the dividend premium.

The BW sentiment index is plotted in Figure 1. It appears to capture most anecdotal accounts of fluctuations in sentiment. Immediately after the 1961 crash of growth stocks, investor sentiment was low but rose to a subsequent peak in the 1968 and 1969 "Electronics Bubble." Sentiment fell again by the mid-1970s, but it picked up and reached a peak in the "Biotech Bubble" of the early 1980s. In the late 1980s, sentiment dropped but rose again in the early 1990s, reaching its most recent peak during the "Internet Bubble."

3.2. Anomalies

We explore previously documented differences in cross-sectional average returns that survive adjustment for exposures to the three factors defined by Fama and French (1993). Using the Fama-French model as the benchmark against which to define the set of "anomalies" imposes a higher hurdle than the single-factor CAPM of Sharpe (1964) and Lintner (1965) while still providing a broad set. With the CAPM as the benchmark, the set of documented anomalies would expand to an unmanageable size.

We consider 11 well-documented anomalies:

1 and 2: Financial Distress

Financial distress is often invoked to explain otherwise anomalous patterns in the cross-section of stock returns. However, Campbell, Hilscher, and Szilagyi (2007) find that firms with high failure probability have lower rather than higher subsequent returns (anomaly 1). Campbell et al. suggest that their finding is a challenge to standard models of rational asset pricing. Using Ohlson's (1980) O-score as the distress measure yields similar results (anomaly 2).

3 and 4: Net Stock Issues and Composite Equity Issues

The stock issuing market has been long viewed as producing an anomaly arising from sentiment-driven mispricing: smart managers issue shares when sentiment-driven traders push prices to overvalued levels. Ritter (1991) and Loughran and Ritter (1995) show that, in post-issue years, equity issuers underperform matching nonissuers with similar characteristics (anomaly 3). Daniel and Titman (2006) study an alternative measure, composite equity issuance, defined as the amount of equity a firm issues (or retires) in exchange for cash or services. Under this measure, seasoned issues and share-based acquisitions increase the issuance measure, while repurchases and dividends reduce this issuance measure. They also find that issuers underperform nonissuers (anomaly 4).

5: Total Accruals

Sloan (1996) shows that firms with high accruals earn abnormal lower returns on average than firms with low accruals, and suggests that investors overestimate the persistence of the accrual component of earnings when forming earnings expectations.

6: Net Operating Assets

Hirshleifer, Hou, Teoh, and Zhang (2004) find that net operating assets scaled by total assets is a strong negative predictor of long-run stock returns. They suggest that investors with limited attention tend to focus on accounting profitability, neglecting information about cash profitability, in which case net operating assets, measured as the cumulative difference between operating income and free cash flow, captures such a bias.

7: Momentum

The momentum effect, discovered by Jegadeesh and Titman (1993), is one of the most robust anomalies in asset pricing. It refers to the phenomenon that high past recent returns forecast high future returns. In a contemporaneous study, Antoniou, Doukas, and

Subrahmanyam (2010) find that the momentum effect is stronger when sentiment is high, and they suggest this result is consistent with the slow spread of bad news during high-sentiment periods.

8: Gross Profitability Premium

Novy-Marx (2010) discovers that sorting on gross-profit-to-assets creates abnormal benchmark-adjusted returns, with more profitable firms having higher returns than less profitable ones.

9: Asset Growth

Cooper, Gulen, and Schill (2008) find companies that grow their total asset more earn lower subsequent returns. They suggest that this phenomenon is due to investors' initial overreaction to changes in future business prospects implied by asset expansions.

10: Return on Assets

Fama and French (2006) find that more profitable firms have higher expected returns than less profitable firms. Chen, Novy-Marx, and Zhang (2010) show that firms with higher past return-on-assets earn abnormally higher subsequent returns. Wang and Yu (2010) find that the anomaly exists primarily among firms with high arbitrage costs and high information uncertainty, suggesting that mispricing is a culprit.

11: Investment-to-Assets

Titman, Wei, and Xie (2004) and Xing (2008) show that higher past investment predicts abnormally lower future returns. Titman, Wei, and Xie (2004) attribute this anomaly to investors' initial underreactions to the overinvestment caused by managers' empire-building behavior.

As noted earlier, defining anomalies with respect to the CAPM, using just a single market benchmark instead of the three Fama-French benchmarks, would add substantially more anomalies. Chief among them would be the two additional Fama-French factors: the return spread between small and large firms (SMB)—the “size” factor—and the return spread between firms with high and low book-to-market ratios (HML)—the “value” factor. Baker and Wurgler (2006) document significant effects of investor sentiment on both the size and value factors. They find that, when sentiment is high, subsequent returns are low on stocks judged harder for investors to price: small stocks as well as on stocks at both extremes of the value-growth spectrum. If the size and value factors are viewed as anomalies that reflect only mispricing, then the Baker-Wurgler results would appear to be inconsistent with

our basic story that anomalies are stronger following high sentiment. For example, the size factor, which takes a long position in small stocks, is actually weaker following high sentiment. Many researchers have argued, however, that the size and value factors are not solely the result of mispricing but instead reflect priced systematic risks not captured by the CAPM. If we were to entertain the size and value factors as being part mispricing and part risk compensation, our sentiment story would apply to the “anomalous” mispricing part. Without a model to separate the two parts, however, extending our analysis to the size and value factors seems difficult.

3.3. Long-short strategies

For each of the 11 anomalies, we obtain value-weighted portfolio returns within each decile of the anomaly’s sorting variable. We then construct a long-short strategy using the extreme deciles, 1 and 10, with the long leg being the higher-performing decile (as reported by previous studies and confirmed in our sample period). For all but one of the anomalies, our decile portfolio returns are also used in Chen, Novy-Marx, and Zhang (2010).⁴ For the remaining anomaly—gross profit to assets—we construct portfolios following the procedure in Novy-Marx (2010). We also construct a “combination” strategy that takes equal positions across the long-short strategies constructed in any given month. Most of the portfolio returns cover the period from August 1965 through January 2008. Due to more stringent data requirements, the portfolios sorted by O-score (anomaly 2) and ROA (anomaly 10) are available beginning in January 1972, while the failure-probability portfolios (anomaly 1) start in December 1974.

Table 1 reports properties of monthly returns on the long-short strategies across all months in our sample period. Panel A reports correlations among the long-short return spreads. Overall, the strategies are not highly correlated with each other. For the 11 individual strategies, the percentages of overall variance explained by each of the first five principal components are [32.3, 20.2, 8.9, 8.3, 8.0], and even the last principal component still explains 2.0 percent. Of the 11 strategies, the first one listed—Failure Probability—exhibits the highest correlations with the other strategies, and its correlation with the combination strategy is 0.83. The asset-growth and investment/assets strategies exhibit the lowest correlations with the other strategies, although their correlation with each other is 0.61.

Panel B of Table 1 reports averages and accompanying t-statistics for the excess monthly

⁴We thank Long Chen for providing these data.

returns (returns in excess of the monthly Treasury bill rate) on the long and short legs of each strategy as well as the long/short return spreads. Panel C reports the corresponding values for “benchmark-adjusted” returns, which in this study we define as returns net of what is attributable to exposures to the market, size, and value factors constructed by Fama and French (1993): the excess return on the stock market (MKT), a return spread between small and large firms (SMB), and a return spread between stocks with high and low book-to-market ratios (HML).⁵ That is, the benchmark-adjusted average return on a strategy is the estimate of a_i in the regression,

$$R_{i,t} = a_i + bMKT_t + cSMB_t + dHML_t + \epsilon_{i,t}. \quad (1)$$

where $R_{i,t}$ is the strategy’s excess return in month t . All 11 of the long/short strategies produce significant positive average return spreads in both panels B and C—consistent with their being identified as “anomalies” for this study. The average benchmark-adjusted return spread for the combined strategy is 87 basis points (bp) per month, with the individual strategies ranging from 43 bp (composite equity issues) to 177 bp (momentum).

4. Empirical analysis: Sentiment and returns

4.1. Average returns: Low versus high sentiment

We first classify returns each month as following either a high-sentiment month or a low-sentiment month. A high-sentiment month is one in which the value of the BW sentiment index in the previous month is above the median value for the sample period, while the low-sentiment months are those with below-median values. We then compute average returns separately for the high- and low-sentiment months. Table 2 reports results for excess returns, while Table 3 reports results for returns adjusted by the three Fama-French benchmarks.⁶

First consider Hypothesis 1, which predicts that the anomalies should be stronger following high sentiment than following low sentiment. Tables 2 and 3 reveal that each of the long-short spreads exhibits higher average profits following high sentiment: all of the values in the last column of each table are positive. In Table 2, the t-statistics for 8 of the 11 anomalies reject, at a 0.05 significance level, the null hypothesis of no sentiment-related difference in favor of the (one-sided) alternative represented by Hypothesis 1. The combined

⁵We thank Ken French for supplying updated series of these factors.

⁶The Appendix reports, in Table A1, results based on returns adjusted for just a single market benchmark, instead of the three Fama-French benchmarks. All conclusions are very similar.

long-short spread earns 93 bp more per month following high sentiment, with a t-statistic equal to 4.25. In Table 3, with benchmark-adjustment returns, 7 of the 11 individual t-statistics reject the null in favor of Hypothesis 1, and the combined long-short spread earns 70 bp more per month following high-sentiment (t-statistic: 3.74). In Table 2, the long/short profits on the combined strategy in high-sentiment months account for 80% of that strategy's profits earned across all months. In Table 3, the corresponding share is 70%. Overall, the results in Tables 2 and 3 provide strong support for Hypothesis 1.

Next consider Hypothesis 2, which predicts that average returns on the short leg should be significantly lower following high sentiment than following low sentiment. The support for this hypothesis is especially strong. In both Tables 2 and 3, the short legs of all 11 anomaly strategies have a lower average return following high sentiment, and 10 of them have t-statistics that reject the no-difference null in favor of Hypothesis 2 at a 0.05 significance level. In Table 2, based on excess returns, the short leg of the combined strategy earns 132 bp less per month following high sentiment (t-statistic: -2.41) than following low sentiment. The short leg of that strategy actually earns a negative average excess return of -68 bp per month following high sentiment (t-statistic: -1.54). In contrast, the same short leg earns a positive average excess return of 65 bp following low-sentiment. We see in Table 3 that adjusting for benchmark exposure shrinks the differences between high- and low-sentiment returns on the short leg, as compared to the excess returns reported in Table 2. Nevertheless, in Table 3, the difference for the combined strategy is still 66 bp per month (t-statistic: -3.89), and 78% of the short-leg profits across all months occur in the months following high sentiment.

The evidence in Tables 2 and 3 appears to support an inference that sentiment-driven overpricing is at least a partial explanation for all of the anomalies analyzed here. The anomalies are stronger following high investor sentiment (Hypothesis 1), and the short legs are substantially more profitable in months following high sentiment (Hypothesis 2), to the extent that the short-leg portfolios in those months even return less on average than the T-bill rate.

Finally, consider Hypothesis 3, which predicts that sentiment should not have an appreciable effect on the long-leg returns. If underpricing driven by market-wide sentiment makes a significant contribution to the profitability of the long legs of the anomaly strategies, there should be greater underpricing, and hence higher long-leg returns, following low sentiment. Alternatively, higher long-leg returns following low sentiment could also reflect overpricing of long-leg stocks during high-sentiment periods, despite those stocks' being in the decile of highest overall performance. We don't see much evidence of either scenario.

In Table 2, the long legs do have higher returns following low sentiment, but only 1 of the 11 anomalies (investment/assets) has a t-statistic that rejects the no-difference null in favor of that alternative. The long leg of the combined strategy earns 39 bp less following high sentiment, but the t-statistic is only -0.93. Any evidence for sentiment effects on the long leg become even weaker after benchmark adjustment. In Table 3, none of the t-statistics reject the no-difference null in favor of higher returns following low sentiment. In fact, 8 of the 11 differences go in the opposite direction, although only 1 anomaly (net stock issues) has a significant one-tailed t-statistic (1.69). The benchmark-adjusted return on the long leg of the combined strategy exhibits only a 4 bp difference between high- and low-sentiment periods. Overall, the evidence in Tables 2 and 3 appears to be consistent with Hypothesis 3 as well.

4.2. Predictive regressions

The results reported above are obtained by averaging within high-sentiment versus low-sentiment months, where the high/low classification is simply a binary measure. Here we conduct an alternative analysis, using predictive regressions to investigate whether the level of the BW sentiment index predicts returns in ways consistent with our hypotheses. Table 4 reports of results of regressing excess returns on just the lagged sentiment index. Table 5 reports results of regressing excess returns on the lagged sentiment index as well as the contemporaneous returns on the three Fama-French factors.⁷ The latter regression thus investigates the ability of sentiment to predict benchmark-adjusted returns.

Hypothesis 1—*anomalies are stronger following high sentiment*—predicts a positive relation between the profitability of each long-short spread and investor sentiment. Consistent with this prediction, the slope coefficients for the spreads of all 11 anomalies are positive in both Tables 4 and 5. In Table 4, 9 of the individual t-statistics are significant at a one-tailed 0.05 significance level, while 8 are significant in Table 5. The combination strategy has a t-statistic of 3.79 in Table 4 and 2.98 in Table 5. Returns are measured in percent per month, and the sentiment index is scaled to have zero mean and unit standard deviation. Thus, for example, the slope coefficient of 0.50 for the combination strategy indicates that a one-standard-deviation increase in sentiment is associated with \$0.005 of additional long-short monthly profit on a strategy with \$1 in each leg of the spread.

⁷The Appendix reports, in Table A2, results based on regressing excess returns on the lagged sentiment index and just the single market factor, instead of the three Fama-French factors. The conclusions are very similar.

Hypothesis 2—greater short-leg profits following high sentiment—predicts a negative relation between the returns on the short-leg portfolio and the lagged sentiment level. Consistent with this prediction, the slope coefficients for the short-leg returns of all 11 anomalies are negative in both Tables 4 and 5. In Table 4, all 11 individual t-statistics are significant, while 8 are significant in Table 5. The combination strategy has a t-statistic of -2.90 in Table 4 and -3.01 in Table 5. In Table 4, we see that a one-standard-deviation increase in sentiment is associated with nearly a one percent lower monthly excess return on the short-leg portfolio.

Hypothesis 3 predicts no significant relation between returns on the long-leg and lagged sentiment. Here, for essentially the first time, we see that benchmark adjustment makes a noticeable difference. In Table 4, which is based simply on excess returns without benchmark adjustment, the coefficients for the long-leg returns are all negative, and 5 of the 11 are significant at an 0.05 significance level for a one-tailed test—appropriate against an alternative of sentiment-related mispricing. The combination strategy in Table 4 has a slope of -0.43, which is only half the magnitude for the short leg but is nevertheless significant (t-statistic: -1.85). After adjusting for benchmark exposures, however, we see results that essentially fall right in line with Hypothesis 3. In Table 5, which is based on returns adjusted for exposures to the Fama-French benchmarks, 7 of the 11 long-leg slopes are positive, none significantly, and only 1 of the negative slopes is significant. The combination strategy in Table 5 has a zero slope (to two decimal places) and a t-statistic of 0.15, giving a result that could not be closer to the prediction of Hypothesis 3.

In sum, results from the predictive regressions reported in Tables 4 and 5 deliver the same message as the comparisons of high- and low-sentiment periods in Tables 2 and 3. The data support a scenario in which market-wide sentiment creates overpricing, due to short-sale limitations. Sentiment-driven overpricing appears to be at least a partial explanation for the broad set of anomalies examined here.

We should also note that the potential bias in predictive regressions, as analyzed by Stambaugh (1999), appears not to be a problem in the results reported. The correlations between the predictive-regression residuals and the innovations in sentiment level obtained from a first-order autoregression are small. Applying Stambaugh’s bias correction to the reported slopes in Table 4, for example, produces only small changes in the second decimal place of some of the coefficients and no changes to the others.

5. Robustness

5.1. Controlling additional macro variables

One might be inclined to seek a risk-based explanation of our results, as an alternative to sentiment-driven overpricing. One risk-based explanation would involve an omitted risk factor to which each short leg is sensitive but each long leg is not. If the premium on that risk factor then varies over time in a manner correlated with our sentiment index, our results could obtain. Explaining why, across the 11 anomalies, there would be such differences in loadings between long and short legs presents a challenge. Even if such differences exist, however, there would remain the question of whether the omitted risk factor's premium exhibits the required correlation with sentiment. It seems reasonable to expect that variations in any risk premium would be correlated with some aspect of macroeconomic conditions.

Baker and Wurgler (2006) remove macro-related variation from their sentiment index by regressing raw sentiment measures on six macro variables: the growth in industrial production, the growth in durable, nondurable, and services consumption, the growth in employment, and a flag for NBER recessions. To assess the potential for a risk-based explanation of our results, we control for an additional set of macro-related variables that seem reasonable to entertain as being correlated with a risk premium: the default premium, the term premium, the real interest rate, the inflation rate, and CAY. The default premium is defined as the yield spread between BAA and AAA bonds, and the term premium is defined as the spread between 20-year and 1-year Treasuries. The real interest rate is defined as the most recent monthly difference between the 30-day T-bill return and the CPI inflation rate. Cay is the consumption-wealth variable defined in Lettau and Ludvigson (2001).⁸

Table 6 reports the results of regressing excess returns on the lagged sentiment index, the contemporaneous returns on the three Fama-French factors, and the five lagged macro-related variables. Thus, we investigate whether the ability of sentiment to predict benchmark-adjusted returns is robust to including macro-related fluctuations in addition to those already controlled for by Baker and Wurgler. The effects of investor sentiment remain largely unchanged by including the additional five variables: the coefficients and their t statistics are close to those in Table 5, in which the additional macro-related variables are not included.

⁸The bond yields are obtained from the St. Louis Federal Reserve, the T-bill return and inflation are obtained from CRSP, and Cay is obtained from Sydney Ludvigson's website.

In sum, if an unnamed risk factor indeed drives our results, it seems the variation over time in its premium must not be strongly related to either the six macro variables used by Baker and Wurgler or the five additional variables included in our analysis. Of course, even if such a factor does exist, there remains the challenge of explaining why, across the 11 anomalies, the short legs are sensitive to this factor while the long legs are not.

5.2. Alternative sentiment measures

We also investigate the robustness of our results to using an alternative sentiment index. A number of investor-sentiment studies use the University of Michigan Consumer Sentiment Index (e.g. Lemmon and Portniaguina (2006), Bergman and Roychowdhury (2008)). While the Baker-Wurgler index is a measure of sentiment based on stock-market indicators, the Michigan sentiment index is a survey-based measure. The monthly survey is mailed to a random set of 500 households and asks their views about the economy. To remove macro-related information from the index, we follow a similar approach to Baker and Wurgler (2006). Specifically, we take the residuals from a regression of the Michigan index on the six macro-related variables used by Baker and Wurgler.⁹

Table 7 reports the results of regressing excess returns on the lagged Michigan sentiment index (adjusted as above) as well as the contemporaneous returns on the three Fama-French factors. Our three hypotheses are supported with the Michigan index as a proxy for sentiment. For the combination strategy of the 11 anomalies, the long-short profit is significantly higher following higher sentiment (Hypothesis 1), the short leg has lower returns following higher sentiment (Hypothesis 2), and sentiment exhibits no significant ability to predict the long-leg returns (Hypothesis 3). The patterns of the results across the 11 individual anomalies are also similar to those obtained using the Baker-Wurgler index, as reported in Table 5, although some of them are weaker.¹⁰

6. Conclusions

With impediments to short selling, overpricing becomes more difficult to eliminate, so a firm's stock price can reflect the views of investors who are too optimistic. With market-

⁹The results are essentially the same if we also include the five additional macro variables discussed above.

¹⁰In unreported results, we repeat the same analysis using the Conference Board Consumer Confidence Index as a proxy for sentiment, and the results are largely the same as obtained using the Michigan sentiment index. The results can be provided upon the request.

wide variations in investor sentiment, such overpricing can occur for many stocks during periods of high sentiment.

Long-short strategies for a set of 11 anomalies in cross-sectional returns exhibit empirical properties consistent with a combination of short-sale impediments and market-wide sentiment. Since overpricing is more likely than underpricing in our hypothesized setting, anomalies should be stronger following periods of high sentiment, to the extent that the anomalies reflect mispricing. We indeed find greater profitability of the long-short strategies following high sentiment. If overpricing is the primary source of those greater profits, the short legs of the strategies should be more profitable following high sentiment, and we also find that implication to be supported strongly by the data. Sentiment does not exhibit a significant effect on profits from the long legs of the strategies. The latter result is also consistent with the prediction that underpricing should be less prevalent in our simple setting where short-sale impediments present the key obstacle to traders seeking to exploit mispricing.

This study does not aim to find complete explanations for each of the anomalies considered. Numerous studies have examined the individual anomalies in more detail and have provided more specifically focused contexts and interpretations. We paint the set of anomalies with an intentionally broad brush, given our objective to consider the implications when market-wide sentiment interacts with short-sale impediments. While this approach reveals novel evidence consistent with overpricing as at least a partial explanation for many anomalies, there is certainly more work ahead in order to develop a richer understanding of how sentiment plays a role in pricing financial assets.

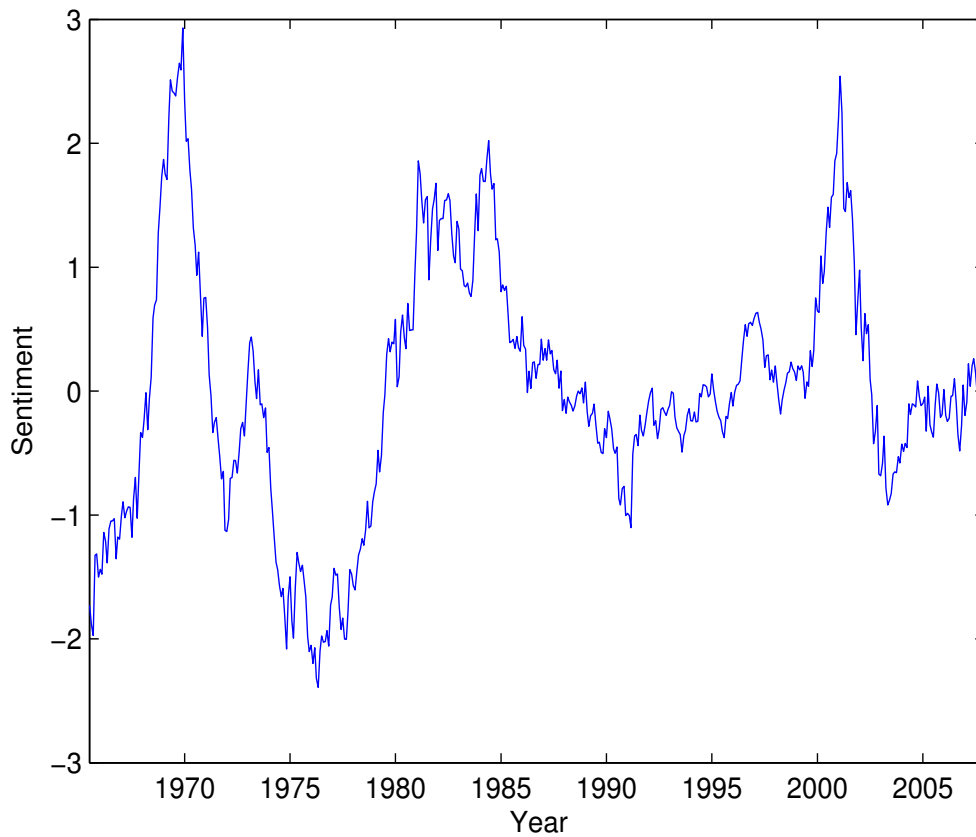


Figure 1. The investor sentiment index from 1965:07 to 2007:12. The sentiment index is the first principal component of six measures. The six measures are the closed-end fund discount, NYSE share turnover, the number of and the average of first-day returns on initial public offerings (IPOs), the equity share in new issues, and the dividend premium. To control for macro conditions, the six raw sentiment measures are regressed on the growth of industrial production, the growth of durable consumption, the growth of nondurable consumption, the growth of service consumption, the growth of employment, and a dummy variable for National Bureau of Economic Research (NBER) recessions.

Table 1
Anomaly Returns Across All Months

The table reports properties of returns across all months for the 11 anomalies and an equal combination of them. The sample period is from 1965:8 to 2008:1 for all but anomaly (1), whose data begin 1974:12, and anomalies (2) and (10), whose data begin 1972:1. The correlation matrix in Panel A is computed using the unequal-length series, applying the method in Stambaugh (1997). The benchmark-adjusted average returns in Panel C are estimates of a_i in the regression,

$$R_{i,t} = a_i + bMKT_t + cSMB_t + dHML_t + \epsilon_{i,t},$$

where $R_{i,t}$ is a strategy's excess return in month t . All t-statistics are based on the heteroskedasticity-consistent standard errors of White (1980).

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
<u>A. Correlations: Long minus short</u>												
(1) Failure probability	1.00											
(2) Ohlson's O (distress)	0.64	1.00										
(3) Net stock issues	0.44	0.38	1.00									
(4) Comp. equity issues	0.40	0.32	0.59	1.00								
(5) Total accruals	0.28	0.19	0.26	0.25	1.00							
(6) Net operating assets	0.20	0.28	0.30	0.20	0.30	1.00						
(7) Momentum	0.53	0.19	0.23	0.25	0.16	0.17	1.00					
(8) Gross profitability	0.28	0.28	0.12	-0.07	-0.14	0.14	0.20	1.00				
(9) Asset growth	0.07	-0.10	0.37	0.33	0.25	0.28	0.13	-0.16	1.00			
(10) Return on assets	0.67	0.62	0.32	0.21	0.12	0.14	0.31	0.35	-0.08	1.00		
(11) Investment/assets	0.04	-0.05	0.26	0.25	0.36	0.28	0.06	-0.19	0.61	-0.08	1.00	
(12) Combination	0.83	0.66	0.65	0.58	0.47	0.48	0.61	0.32	0.37	0.66	0.33	1.00
<u>B. Excess Returns</u>												
<i>Means</i>												
Long leg	0.94	0.51	0.70	0.62	0.72	0.71	1.11	0.69	1.00	0.64	0.91	0.76
Short leg	-0.01	-0.19	0.07	0.20	0.13	0.06	-0.45	0.29	0.04	-0.34	0.15	-0.01
Long minus short	0.95	0.70	0.63	0.42	0.58	0.65	1.56	0.40	0.96	0.98	0.75	0.77
<i>t-statistics</i>												
Long leg	3.97	2.18	3.66	3.47	2.54	2.98	3.81	3.20	3.82	2.56	3.65	3.57
Short leg	-0.01	-0.51	0.27	0.79	0.40	0.22	-1.23	1.33	0.14	-0.88	0.57	-0.05
Long minus short	2.55	2.83	5.11	2.59	3.11	4.41	5.45	2.45	5.34	3.53	5.22	6.91
<u>C. Benchmark-Adjusted Returns</u>												
<i>Means</i>												
Long leg	0.39	0.21	0.20	0.02	0.26	0.25	0.63	0.43	0.22	0.38	0.17	0.28
Short leg	-1.16	-0.93	-0.46	-0.41	-0.34	-0.51	-1.14	-0.23	-0.44	-0.90	-0.37	-0.60
Long minus short	1.55	1.13	0.66	0.43	0.61	0.76	1.77	0.66	0.66	1.28	0.54	0.87
<i>t-statistics</i>												
Long leg	3.39	3.37	3.87	0.29	1.85	2.27	4.95	4.42	1.76	4.40	1.59	7.66
Short leg	-4.53	-6.17	-4.62	-3.85	-2.24	-4.75	-5.11	-2.19	-3.93	-4.29	-3.30	-7.07
Long minus short	5.00	7.13	5.96	3.18	3.09	4.98	5.82	4.30	3.94	5.48	3.78	9.38

Table 2
Anomalies During Periods of High and Low Investor Sentiment:
Excess Returns on Long-Short Strategies

The table reports average returns in excess of the one-month T-bill in months following high and low levels of investor sentiment, as classified based on the median level of the index of Baker and Wurgler (2006). Also reported are returns on a strategy that equally combines the strategies available within a given month. The sample period is from 1965:8 to 2008:1 for all but anomaly (1), whose data begin 1974:12, and anomalies (2) and (10), whose data begin 1972:1. All t-statistics are based on the heteroskedasticity-consistent standard errors of White (1980).

	Long Leg			Short Leg			Long – Short		
	High Sent.	Low Sent.	High –Low	High Sent.	Low Sent.	High –Low	High Sent.	Low Sent.	High –Low
Failure probability	0.77 (2.16)	1.14 (3.74)	-0.38 (-0.81)	-1.10 (-1.54)	1.25 (2.26)	-2.34 (-2.60)	1.86 (3.25)	-0.10 (-0.24)	1.96 (2.72)
Ohlson's O (distress)	0.42 (1.14)	0.61 (2.06)	-0.19 (-0.41)	-0.98 (-1.69)	0.61 (1.33)	-1.59 (-2.15)	1.40 (3.81)	-0.00 (-0.01)	1.40 (2.85)
Net stock issues	0.64 (2.22)	0.75 (3.04)	-0.11 (-0.28)	-0.50 (-1.26)	0.63 (2.10)	-1.13 (-2.28)	1.14 (5.71)	0.12 (0.88)	1.02 (4.20)
Comp. equity issues	0.53 (1.93)	0.72 (3.08)	-0.19 (-0.52)	-0.28 (-0.72)	0.69 (2.13)	-0.97 (-1.91)	0.81 (3.19)	0.02 (0.13)	0.79 (2.46)
Total accruals	0.37 (0.82)	1.07 (3.10)	-0.71 (-1.25)	-0.57 (-1.06)	0.84 (2.22)	-1.41 (-2.14)	0.94 (3.11)	0.23 (1.04)	0.70 (1.88)
Net operating assets	0.50 (1.36)	0.92 (3.01)	-0.43 (-0.90)	-0.57 (-1.37)	0.69 (2.20)	-1.26 (-2.41)	1.07 (4.66)	0.24 (1.29)	0.83 (2.84)
Momentum	0.78 (1.69)	1.43 (4.12)	-0.64 (-1.11)	-1.24 (-2.14)	0.34 (0.76)	-1.58 (-2.16)	2.03 (4.49)	1.09 (3.12)	0.93 (1.64)
Gross profitability	0.59 (1.84)	0.79 (2.73)	-0.20 (-0.47)	-0.06 (-0.18)	0.64 (2.48)	-0.70 (-1.62)	0.65 (2.93)	0.15 (0.64)	0.50 (1.53)
Asset growth	0.79 (2.14)	1.22 (3.26)	-0.43 (-0.81)	-0.60 (-1.30)	0.68 (1.92)	-1.27 (-2.20)	1.39 (5.04)	0.54 (2.34)	0.85 (2.37)
Return on assets	0.61 (1.60)	0.66 (2.10)	-0.05 (-0.10)	-1.10 (-1.78)	0.44 (1.00)	-1.55 (-2.02)	1.72 (4.01)	0.22 (0.65)	1.50 (2.74)
Investment/assets	0.44 (1.19)	1.38 (4.13)	-0.94 (-1.90)	-0.47 (-1.14)	0.78 (2.25)	-1.25 (-2.32)	0.91 (4.48)	0.60 (2.93)	0.30 (1.06)
Combination	0.56 (1.72)	0.95 (3.51)	-0.39 (-0.93)	-0.68 (-1.54)	0.65 (1.96)	-1.32 (-2.41)	1.23 (6.64)	0.31 (2.64)	0.93 (4.25)

Table 3
Anomalies During Periods of High and Low Investor Sentiment:
Benchmark-Adjusted Returns on Long-Short Strategies

The table reports average benchmark-adjusted returns following high and low levels of investor sentiment, as classified based on the median level of the index of Baker and Wurgler (2006). The average returns in high- and low-sentiment periods are estimates of a_H and a_L in the regression,

$$R_{i,t} = a_H d_{H,t} + a_L d_{L,t} + bMKT_t + cSMB_t + dHML_t + \epsilon_{i,t},$$

where $d_{H,t}$ and $d_{L,t}$ are dummy variables indicating high- and low-sentiment periods, and $R_{i,t}$ is the excess return in month t on either the long leg, the short leg, or the difference. Also reported are returns on a strategy that equally combines the strategies available within a given month. The sample period is from 1965:8 to 2008:1 for all but anomaly (1), whose data begin 1974:12, and anomalies (2) and (10), whose data begin 1972:1. All t-statistics are based on the heteroskedasticity-consistent standard errors of White (1980).

	Long Leg			Short Leg			Long – Short		
	High Sent.	Low Sent.	High –Low	High Sent.	Low Sent.	High –Low	High Sent.	Low Sent.	High –Low
Failure probability	0.43 (2.52)	0.33 (2.33)	0.10 (0.44)	-1.65 (-4.33)	-0.58 (-1.81)	-1.07 (-2.19)	2.08 (4.45)	0.91 (2.39)	1.17 (1.95)
Ohlson's O (distress)	0.25 (2.70)	0.16 (2.09)	0.09 (0.72)	-1.24 (-5.29)	-0.60 (-3.23)	-0.64 (-2.16)	1.49 (6.13)	0.76 (3.77)	0.73 (2.32)
Net stock issues	0.28 (3.68)	0.11 (1.68)	0.17 (1.69)	-0.80 (-4.86)	-0.12 (-1.09)	-0.68 (-3.42)	1.08 (6.19)	0.23 (1.79)	0.85 (3.90)
Comp. equity issues	0.08 (0.69)	-0.03 (-0.31)	0.11 (0.72)	-0.64 (-3.62)	-0.17 (-1.57)	-0.47 (-2.26)	0.72 (3.40)	0.14 (0.89)	0.58 (2.23)
Total accruals	0.19 (0.85)	0.34 (2.13)	-0.14 (-0.53)	-0.70 (-2.88)	0.02 (0.15)	-0.73 (-2.53)	0.89 (3.02)	0.31 (1.33)	0.58 (1.60)
Net operating assets	0.22 (1.36)	0.27 (2.04)	-0.05 (-0.24)	-0.87 (-4.94)	-0.15 (-1.25)	-0.72 (-3.40)	1.09 (4.78)	0.42 (2.20)	0.67 (2.30)
Momentum	0.66 (3.64)	0.60 (3.46)	0.06 (0.23)	-1.51 (-4.03)	-0.76 (-3.22)	-0.75 (-1.69)	2.17 (4.46)	1.36 (3.87)	0.81 (1.35)
Gross profitability	0.46 (3.17)	0.41 (3.25)	0.05 (0.26)	-0.40 (-2.43)	-0.06 (-0.47)	-0.33 (-1.59)	0.85 (3.77)	0.47 (2.23)	0.38 (1.24)
Asset growth	0.37 (2.23)	0.07 (0.38)	0.30 (1.29)	-0.82 (-4.48)	-0.06 (-0.48)	-0.76 (-3.43)	1.18 (4.81)	0.13 (0.60)	1.05 (3.35)
Return on assets	0.49 (4.01)	0.27 (2.26)	0.23 (1.35)	-1.26 (-3.98)	-0.51 (-2.01)	-0.75 (-1.88)	1.75 (5.00)	0.78 (2.66)	0.97 (2.16)
Investment/assets	0.01 (0.09)	0.32 (2.53)	-0.31 (-1.57)	-0.73 (-4.31)	-0.01 (-0.07)	-0.72 (-3.34)	0.74 (3.75)	0.33 (1.76)	0.41 (1.54)
Combination	0.30 (5.62)	0.26 (5.40)	0.04 (0.62)	-0.92 (-6.46)	-0.26 (-2.95)	-0.66 (-3.89)	1.22 (7.92)	0.52 (5.01)	0.70 (3.74)

Table 4
Investor Sentiment and Anomalies: Predictive Regressions for
Excess Returns on Long-Short Strategies

The table reports estimates of b in the regression,

$$R_{i,t} = a + bS_{t-1} + u_t,$$

where $R_{i,t}$ is the excess return in month t on either the long leg, the short leg, or the difference, and S_t is the level of the investor-sentiment index of Baker and Wurgler (2006). Also reported are returns on a strategy that equally combines the strategies available within a given month. The sample period is from 1965:8 to 2008:1 for all but anomaly (1), whose data begin 1974:12, and anomalies (2) and (10), whose data begin 1972:1. All t-statistics are based on the heteroskedasticity-consistent standard errors of White (1980).

	Long Leg		Short Leg		Long – Short	
	\hat{b}	t-stat.	\hat{b}	t-stat.	\hat{b}	t-stat.
Failure probability	-0.43	-1.74	-1.80	-2.99	1.37	2.59
Ohlson's O (distress)	-0.24	-0.80	-1.09	-2.31	0.85	2.95
Net stock issues	-0.28	-1.38	-0.84	-2.92	0.55	3.93
Comp. equity issues	-0.21	-1.12	-0.68	-2.38	0.47	2.68
Total accruals	-0.59	-1.82	-0.96	-2.49	0.37	1.77
Net operating assets	-0.34	-1.29	-0.83	-2.76	0.49	3.50
Momentum	-0.69	-2.38	-1.02	-2.41	0.33	1.07
Gross profitability	-0.22	-0.94	-0.54	-2.21	0.32	1.81
Asset growth	-0.48	-1.68	-0.91	-2.66	0.44	2.16
Return on assets	-0.20	-0.66	-1.14	-2.35	0.94	2.79
Investment/assets	-0.70	-2.46	-0.77	-2.51	0.07	0.49
Combination	-0.43	-1.85	-0.93	-2.90	0.50	3.79

Table 5
Investor Sentiment and Anomalies: Predictive Regressions for
Benchmark-Adjusted Returns on Long-Short Strategies

The table reports estimates of b in the regression,

$$R_{i,t} = a + bS_{t-1} + cMKT_t + dSMB_t + eHML_t + u_t,$$

where $R_{i,t}$ is the excess return in month t on either the long leg, the short leg, or the difference, and S_t is the level of the investor-sentiment index of Baker and Wurgler (2006). Also reported are returns on a strategy that equally combines the strategies available within a given month. The sample period is from 1965:8 to 2008:1 for all but anomaly (1), whose data begin 1974:12, and anomalies (2) and (10), whose data begin 1972:1. All t-statistics are based on the heteroskedasticity-consistent standard errors of White (1980).

	Long Leg		Short Leg		Long – Short	
	\hat{b}	t-stat.	\hat{b}	t-stat.	\hat{b}	t-stat.
Failure probability	-0.01	-0.09	-0.92	-2.79	0.91	2.15
Ohlson's O (distress)	0.07	0.95	-0.52	-2.64	0.59	3.03
Net stock issues	0.01	0.13	-0.38	-3.58	0.39	3.38
Comp. equity issues	0.02	0.29	-0.21	-1.89	0.23	1.77
Total accruals	-0.02	-0.12	-0.26	-1.54	0.24	1.21
Net operating assets	0.07	0.72	-0.32	-2.81	0.39	2.86
Momentum	-0.04	-0.30	-0.30	-1.11	0.26	0.76
Gross profitability	0.14	1.40	-0.20	-1.62	0.34	1.94
Asset growth	0.06	0.62	-0.35	-2.88	0.41	2.74
Return on assets	0.14	1.44	-0.58	-2.49	0.71	2.67
Investment/assets	-0.21	-2.07	-0.24	-2.22	0.03	0.22
Combination	0.00	0.15	-0.32	-3.01	0.32	2.98

Table 6
Sentiment and Anomalies, Controlling for Additional Macro Variables: Predictive Regressions for Benchmark-Adjusted Returns on Long-Short Strategies

The table reports estimates of b in the regression,

$$R_{i,t} = a + bS_{t-1} + cMKT_t + dSMB_t + eHML_t + \sum_{j=1}^5 m_j X_{j,t} + u_t,$$

where $R_{i,t}$ is the excess return in month t on either the long leg, the short leg, or the difference, S_t is the level of the Baker-Wurgler sentiment index, and $X_{1,t}, \dots, X_{5,t}$ are five additional macro variables not used by Baker and Wurgler (2006) when removing macro-related fluctuations in sentiment: the default premium, the term premium, the real interest rate, inflation, and CAY. (Baker and Wurgler use the growth in industrial production, the growth in durable, nondurable, and services consumption, the growth in employment, and a flag for NBER recessions.) Also reported are returns on a strategy that equally combines the strategies available within a given month. The sample period is from 1965:8 to 2008:1 for all but anomaly (1), whose data begin 1974:12, and anomalies (2) and (10), whose data begin 1972:1. All t-statistics are based on the heteroskedasticity-consistent standard errors of White (1980).

	Long Leg		Short Leg		Long – Short	
	\hat{b}	t-stat.	\hat{b}	t-stat.	\hat{b}	t-stat.
Failure probability	0.05	0.28	-1.17	-2.97	1.22	2.39
Ohlson's O (distress)	0.07	0.79	-0.52	-2.04	0.58	2.33
Net stock issues	0.02	0.26	-0.44	-3.61	0.46	3.46
Comp. equity issues	0.04	0.43	-0.20	-1.82	0.23	1.73
Total accruals	0.06	0.33	-0.30	-1.49	0.35	1.52
Net operating assets	0.05	0.44	-0.34	-2.61	0.39	2.47
Momentum	0.01	0.05	-0.22	-0.72	0.22	0.58
Gross profitability	0.09	0.83	-0.27	-1.93	0.36	1.86
Asset growth	-0.05	-0.46	-0.35	-2.50	0.30	1.81
Return on assets	0.06	0.59	-0.89	-3.24	0.95	3.01
Investment/assets	-0.28	-2.65	-0.27	-2.23	-0.02	-0.15
Combination	-0.01	-0.22	-0.35	-2.86	0.34	2.68

Table 7
Michigan Sentiment Index and Anomalies: Predictive Regressions
for Benchmark-Adjusted Returns on Long-Short Strategies

The table reports estimates of b in the regression,

$$R_{i,t} = a + bS_{t-1} + cMKT_t + dSMB_t + eHML_t + u_t,$$

where $R_{i,t}$ is the excess return in month t on either the long leg, the short leg, or the difference, and S_t is the level of the Michigan sentiment index. Also reported are returns on a strategy that equally combines the strategies available within a given month. The sample period is from 1965:8 to 2008:1 for all but anomaly (1), whose data begin 1974:12, and anomalies (2) and (10), whose data begin 1972:1. All t-statistics are based on the heteroskedasticity-consistent standard errors of White (1980).

	Long Leg		Short Leg		Long – Short	
	\hat{b}	t-stat.	\hat{b}	t-stat.	\hat{b}	t-stat.
Failure probability	0.23	1.65	-0.45	-1.66	0.68	2.10
Ohlson's O (distress)	0.03	0.52	0.01	0.05	0.03	0.16
Net stock issues	0.07	1.12	-0.36	-2.93	0.43	3.60
Comp. equity issues	-0.06	-0.68	-0.21	-1.69	0.16	1.03
Total accruals	0.02	0.14	-0.39	-2.24	0.41	2.03
Net operating assets	0.06	0.53	-0.41	-3.23	0.47	2.82
Momentum	0.11	0.71	-0.32	-1.15	0.42	1.13
Gross profitability	0.35	2.98	-0.08	-0.66	0.44	2.39
Asset growth	-0.23	-1.82	-0.38	-2.75	0.15	0.78
Return on assets	0.13	1.50	0.07	0.28	0.07	0.25
Investment/assets	-0.20	-1.72	-0.23	-1.84	0.03	0.23
Combination	0.06	1.40	-0.27	-2.68	0.33	3.00

References

- Antoniou, Constantinos, John A. Doukas, and Avanidhar Subrahmanyam, 2010, Sentiment and momentum, working paper, UCLA.
- Avramov, Doron, Tarun Chordia, Gergana Jostova, and Alexander Philipov, 2010, Anomalies and financial distress, working paper, Hebrew University.
- Baker, Malcolm, and Jeffrey Wurgler, 2006, Investor Sentiment and the Cross-section of Stock Returns, *Journal of Finance*, 61, 1645–1680.
- Baker, Malcolm, Wurgler, Jeffrey, 2007, Investor Sentiment in the Stock Market, *Journal of Economic Perspectives* 21, 129-152.
- Baker, Malcolm, Jeffrey Wurgler, and Yu Yuan, 2009, Global, Local, and Contagious Investor Sentiment, Working paper, Harvard University.
- Barber, Brad, and Terrance Odean, 2008, All that glitters: The effect of attention and news on the buying behavior of individual and institutional investors, *The Review of Financial Studies* 21, 785–818.
- Barberis N., Shleifer A., Vishny R., 1998, A model of investor sentiment, *Journal of Financial Economics*, 49, 307–343.
- Bergman, N. and S. Roychowdhury, 2008, Investor Sentiment and Corporate Disclosure, *Journal of Accounting Research* 46, 1057–1083.
- Brown, Gregory W., and Michael T. Cliff, 2004, Investor sentiment and the near-term stock market, *Journal of Empirical Finance* 11, 1–27.
- Brown, Gregory W., and Michael T. Cliff, 2005, Investor sentiment and asset valuation, *Journal of Business* 78, 405–440.
- Campbell, John Y., Jens Hilscher, and Jan Szilagyi, 2008, In search of distress risk, *Journal of Finance* 63, 2899–2939.
- Chen, J., Hong, H., Stein, J.C., 2002. Breadth of ownership and stock returns. *Journal of Financial Economics* 66, 171–205.
- Chen, Long, Robert Rovy-Marx, and Lu Zhang, 2010, An alternative three-factor model, working paper.
- Cooper, Michael J., Huseyin Gulen, and Michael J. Schill, 2008, Asset growth and the cross-section of stock returns, *Journal of Finance* 63, 1609–1652.
- Daniel, Kent D., and Sheridan Titman, 2006, Market reactions to tangible and intangible information, *Journal of Finance* 61, 1605–1643.

- DeLong, Bradford, Andrei Shleifer, Lawrence H. Summers, and Robert Waldmann, 1990, Noise trader risk in financial market. *Journal of Political Economy*, 90, 703–738.
- Diether, K.B., Malloy, K.B., Scherbina, A., 2002. Differences of opinion and the cross-section of stock returns. *Journal of Finance* 57, 2113-2141.
- Duffie, Darrell, Nicolae Garleanu, and Lasse Heje Pedersen, 2002, Securities lending shorting and pricing, *Journal of Financial Economics* 66, 307–339.
- D’Avolio, G., 2002, The market for borrowing stock, *Journal of Financial Economics* 66, 271-306.
- Fama, Eugene and Kenneth French, 1993, Common risk factors in the returns on stocks and bonds. *Journal of Financial Economics* 33, 3–56.
- Fama, Eugene and Kenneth French, 2006. Profitability, investment, and average returns. *Journal of Financial Economics* 82, 491–518.
- Figlewski, S., 1981, The informational effects of restrictions on short sales: some empirical evidence. *Journal of Financial and Quantitative Analysis* 16, 463–476.
- Frazzini, Andrea and Owen Lamont, 2008, Dumb money: Mutual fund flows and the cross section of stock returns, *Journal of Financial Economics*, 88, 299-322.
- Gao, Xiaohui, Jianfeng Yu and Yu Yuan, 2010, Investor sentiment and the idiosyncratic risk puzzle, working paper, Hong Kong University.
- Hirshleifer, David, Kewei Hou, Siew Hong Teh, and Yinglei Zhang, 2004, Do investors overvalue firms with bloated balance sheets, *Journal of Accounting and Economics*, 38, 297–331.
- Jegadeesh, Narasimhan, and Sheridan Titman, 1993, Returns to buying winners and selling losers: Implications for market efficiency, *Journal of Finance* 48, 65–91.
- Jones, C.M., Lamont, O., 2002, Short-sale constraints and stock returns. *Journal of Financial Economics* 66, 207-239.
- Kaniel, Ron, Gideon Saar, and Sheridan Titman, 2008, Individual investor trading and stock returns, *Journal of Finance* 63 , 273–310.
- Keynes, John M., 1936, *The General Theory of Employment, Interest and Money*, Macmillan, London.
- Kumar, Alok, and Charles M.C. Lee, 2006, Retail investor sentiment and return comovements, *Journal of Finance* 61 , 2451–2486.
- Lamont, Owen, 2004, Going down fighting: short sellers vs. firms, working paper, Yale.
- Lamont, Owen, and Jeremy C. Stein, 2004, Aggregate short interest and market valuation,

American Economic Review Papers and Proceedings 94, 29-32.

- Lemmon M., and E., Portniaguina, 2006, Consumer confidence and asset prices: Some empirical evidence, *Review of Financial Studies*, 19, 4, 1499– 1529.
- Lettau, Martin, and Sydney Ludvigson, 2001, Consumption, aggregate wealth, and expected stock returns, *Journal of Finance*, 56, 3, 815– 849.
- Lintner, John, 1965, The valuation of risk assets and the selection of risky investments in stock portfolios and capital budgets, *Review of Economics and Statistics*, 47, 13–37.
- Livnat, Joshua and Christine Petrovits, 2009, Investor sentiment, post-earnings announcement drift, and accruals, working paper, New York University.
- Loughran, T., and J. R. Ritter, 1995, The new issues puzzle. *Journal of Finance* 50, 23–51.
- Miller, Edward M., 1977, Risk, Uncertainty and divergence of opinion, *Journal of Finance* 32, 1151–1168.
- Nagel, Stefan, 2005, Short sales, institutional investors and the cross-section of stock returns, *Journal of Financial Economics* 78, 277–309.
- Novy-Marx, Robert, 2010, The other side of value: Good growth and the gross profitability premium, working paper, University of Chicago.
- Ofek, E., Richardson, M., Whitelaw, R.F., 2004, Limited arbitrage and short sales restrictions: evidence from the options markets, *Journal of Financial Economics* 74, 305–342.
- Ohlson, James A., 1980, Financial ratios and the probabilistic prediction of bankruptcy, *Journal of Accounting Research* 18, 109–131.
- Ritter, Jay R., 1991, The long-run performance of initial public offerings. *Journal of Finance* 46, 3–27.
- Scheinkman, Jose, and Wei Xiong, 2003, Overconfidence and speculative bubbles, *Journal of Political Economy* 111, 1183–1219.
- Sharpe, William, 1964, Capital asset prices: a theory of market equilibrium under conditions of risk, *Journal of Finance*, 19, 425–442
- Shiller, Robert J., 2000, *Irrational Exuberance*, Princeton University Press.
- Shleifer, Andrei, and Larry Summers, 1990, The noise trader approach to finance, *Journal of Economic Perspectives* 4, 19–33.
- Shleifer, Andrei and Robert Vishny, 1997, The limits of arbitrage, *Journal of Finance*, 52, 35–55.
- Sloan, R.G., 1996, Do stock prices fully reflect information in accruals and cash flows about

- future earnings? *Accounting Review* 71, 289–315.
- Stambaugh, Robert F., 1999, Predictive regressions, *Journal of Financial Economics* 54, 375–421.
- Titman, S., Wei, K.C.J., Xie, F., 2004. Capital investments and stock returns. *Journal of Financial and Quantitative Analysis* 39, 677–700.
- Wang, Huijun, and Jianfeng Yu, 2010, Dissecting the profitability premium, working paper, University of Minnesota.
- White, Halbert, 1980, A heteroskedasticity-consistent covariance matrix estimator and a direct test for heteroskedasticity, *Econometrica* 48, 817–838.
- Xing, Yuhang, 2008, Interpreting the value effect through the Q-theory: An empirical investigation, *Review of Financial Studies* 21, 1767–1795.
- Yu, Jianfeng, and Yu Yuan, 2010, Investor sentiment and the mean-variance relation, *Journal of Financial Economics*, Forthcoming.
- Yu, Jianfeng, 2009, A sentiment-based explanation of the forward premium puzzle. working paper, University of Minnesota.
- Yuan, Yu, 2005, Investor sentiment predicts stock returns, working paper, University of Pennsylvania.

Table A1
Anomalies During Periods of High and Low Investor Sentiment:
CAPM-Adjusted Returns on Long-Short Strategies

The table reports average CAPM-adjusted returns following high and low levels of investor sentiment, as classified based on the median level of the index of Baker and Wurgler (2006). The average returns in high- and low-sentiment periods are estimates of a_H and a_L in the regression,

$$R_{i,t} = a_H d_{H,t} + a_L d_{L,t} + bMKT_t + \epsilon_{i,t},$$

where $d_{H,t}$ and $d_{L,t}$ are dummy variables indicating high- and low-sentiment periods, and $R_{i,t}$ is the excess return in month t on either the long leg, the short leg, or the difference. Also reported are returns on a strategy that equally combines the strategies available within a given month. The sample period is from 1965:8 to 2008:1 for all but anomaly (1), whose data begin 1974:12, and anomalies (2) and (10), whose data begin 1972:1. All t-statistics are based on the heteroskedasticity-consistent standard errors of White (1980).

	Long Leg			Short Leg			Long – Short		
	High Sent.	Low Sent.	High – Low	High Sent.	Low Sent.	High – Low	High Sent.	Low Sent.	High – Low
Failure probability	0.38 (2.24)	0.26 (1.86)	0.12 (0.57)	-1.74 (-3.69)	-0.23 (-0.65)	-1.51 (-2.61)	2.12 (3.95)	0.49 (1.17)	1.63 (2.47)
Ohlson's O (distress)	0.10 (0.95)	-0.08 (-0.88)	0.19 (1.30)	-1.40 (-4.10)	-0.31 (-1.17)	-1.08 (-2.47)	1.50 (4.34)	0.23 (0.73)	1.27 (2.71)
Net stock issues	0.40 (4.13)	0.18 (2.59)	0.22 (1.85)	-0.81 (-5.24)	-0.09 (-0.79)	-0.72 (-3.78)	1.20 (6.63)	0.27 (2.00)	0.94 (4.20)
Comp. equity issues	0.32 (2.22)	0.23 (1.97)	0.09 (0.46)	-0.60 (-3.56)	-0.05 (-0.43)	-0.55 (-2.71)	0.92 (4.14)	0.28 (1.76)	0.64 (2.34)
Total accruals	0.03 (0.14)	0.30 (1.78)	-0.27 (-0.93)	-0.96 (-3.60)	-0.06 (-0.34)	-0.90 (-2.76)	0.99 (3.43)	0.36 (1.63)	0.63 (1.73)
Net operating assets	0.20 (1.24)	0.24 (1.98)	-0.04 (-0.21)	-0.90 (-5.41)	-0.07 (-0.55)	-0.83 (-3.98)	1.10 (4.94)	0.31 (1.73)	0.79 (2.75)
Momentum	0.44 (2.01)	0.64 (3.30)	-0.19 (-0.65)	-1.63 (-4.47)	-0.57 (-2.24)	-1.06 (-2.36)	2.08 (4.64)	1.21 (3.56)	0.87 (1.53)
Gross profitability	0.33 (2.29)	0.19 (1.34)	0.14 (0.70)	-0.32 (-1.97)	0.05 (0.32)	-0.36 (-1.70)	0.64 (2.90)	0.14 (0.60)	0.50 (1.55)
Asset growth	0.49 (2.66)	0.51 (2.48)	-0.02 (-0.09)	-0.96 (-5.41)	-0.16 (-1.20)	-0.79 (-3.57)	1.45 (5.56)	0.68 (2.91)	0.77 (2.23)
Return on assets	0.29 (2.07)	-0.05 (-0.34)	0.34 (1.71)	-1.52 (-3.88)	-0.48 (-1.72)	-1.04 (-2.17)	1.81 (4.41)	0.43 (1.30)	1.38 (2.63)
Investment/assets	0.14 (0.88)	0.68 (4.19)	-0.55 (-2.41)	-0.80 (-5.03)	-0.00 (-0.01)	-0.80 (-3.70)	0.94 (4.75)	0.68 (3.30)	0.26 (0.91)
Combination	0.28 (4.82)	0.30 (5.56)	-0.02 (-0.27)	-1.03 (-6.36)	-0.16 (-1.40)	-0.86 (-4.38)	1.30 (7.87)	0.46 (4.28)	0.84 (4.33)

Table A2
Investor Sentiment and Anomalies: Predictive Regressions for
CAPM-Adjusted Returns on Long-Short Strategies

The table reports estimates of b in the regression,

$$R_{i,t} = a + bS_{t-1} + cMKT_t + u_t,$$

where $R_{i,t}$ is the excess return in month t on either the long leg, the short leg, or the difference, and S_t is the level of the investor-sentiment index of Baker and Wurgler (2006). Also reported are returns on a strategy that equally combines the strategies available within a given month. The sample period is from 1965:8 to 2008:1 for all but anomaly (1), whose data begin 1974:12, and anomalies (2) and (10), whose data begin 1972:1. All t-statistics are based on the heteroskedasticity-consistent standard errors of White (1980).

	Long Leg		Short Leg		Long – Short	
	\hat{b}	t-stat.	\hat{b}	t-stat.	\hat{b}	t-stat.
Failure probability	-0.03	-0.19	-1.14	-3.01	1.11	2.39
Ohlson's O (distress)	0.04	0.42	-0.72	-2.79	0.76	2.84
Net stock issues	0.06	1.07	-0.40	-3.95	0.47	3.84
Comp. equity issues	0.08	0.88	-0.24	-2.22	0.32	2.25
Total accruals	-0.12	-0.75	-0.42	-2.17	0.29	1.47
Net operating assets	0.07	0.69	-0.38	-3.41	0.45	3.34
Momentum	-0.21	-1.56	-0.48	-1.79	0.26	0.85
Gross profitability	0.14	1.34	-0.19	-1.55	0.33	1.85
Asset growth	-0.05	-0.37	-0.41	-3.23	0.36	1.89
Return on assets	0.08	0.80	-0.78	-2.77	0.86	2.72
Investment/assets	-0.29	-2.28	-0.30	-2.82	0.02	0.14
Combination	-0.03	-0.83	-0.44	-3.76	0.41	3.68