

Investor Sentiment and Stock Market Dynamics: A Conceptual Study

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Abstract: Traditional financial theory assumes that markets are efficient and investors behave rationally. However, recurring anomalies such as speculative bubbles, excess volatility, and predictable return patterns challenge this assumption. Behavioural finance addresses these deviations by incorporating psychological biases into investment decision-making. Within this framework, investor sentiment—defined as collective optimism or pessimism not fully justified by fundamental information—emerges as a key driver of market fluctuations. This conceptual study synthesizes the secondary literature to develop an integrated framework that links psychological foundations, sentiment measurement approaches, and stock market outcomes. It explains how cognitive biases such as loss aversion, overconfidence, and herd behaviour shape investor sentiment. The review further highlights how sentiment can be measured through composite indices, survey-based indicators, and market-based proxies. Existing evidence suggests that investor sentiment significantly influences short-term returns, long-term reversals, and market volatility, particularly in emerging markets. The study offers a structured foundation for future empirical research and policy development.

Keywords: Investor Sentiment, Behavioural Finance, Market Volatility, Return Predictability, Emerging Markets, Conceptual Framework.

1. Introduction

Traditional financial theory is primarily grounded in the Efficient Market Hypothesis (EMH), which assumes that stock prices fully and instantaneously reflect all available information, thereby eliminating the possibility of persistent abnormal returns (Fama, 1970; Shiller, 2003). Under this framework, investors are considered rational agents who update beliefs logically and maximize expected utility (Fama, 1970). However, empirical anomalies such as momentum effects, excess volatility, speculative bubbles, and market crashes have repeatedly challenged the assumptions of full rationality and informational efficiency (Shiller, 2003; Baker & Wurgler, 2007). These deviations suggest that psychological and behavioural factors systematically influence financial decision-making (Barberis et al., 1998; Daniel et al., 1998). Investor sentiment has emerged as a critical construct within behavioural finance to explain these deviations from rational asset pricing (Baker & Wurgler, 2006; Schmeling, 2009). Investor sentiment refers to the overall optimism or pessimism of market participants regarding future asset prices that is not entirely justified by fundamental information (Baker & Wurgler, 2006). Unlike rational expectations models, sentiment captures collective emotional states, cognitive biases, and heuristic-driven judgments that shape trading behaviour (Kahneman & Tversky, 1979; Shefrin & Statman, 1985). When sentiment becomes excessively optimistic,

asset prices may rise beyond intrinsic values, whereas widespread pessimism may trigger undervaluation and panic selling (De Long et al., 1990; Shiller, 2003). The growing body of empirical evidence demonstrates that investor sentiment significantly influences stock returns, volatility, and market efficiency across both developed and emerging markets (Brown & Cliff, 2004). Sentiment effects are often stronger in emerging economies due to higher retail participation, lower institutional development, and greater informational asymmetry (Schmeling, 2009). Furthermore, advances in digital communication and rapid information dissemination have amplified the speed and intensity with which sentiment spreads across markets (Baker & Wurgler, 2007; P.H. & Rishad, 2020). Despite this expanding literature, existing studies remain fragmented across theoretical perspectives and empirical settings, highlighting the need for a structured conceptual synthesis (Barberis et al., 1998; Lo, 2004). Accordingly, this paper develops an integrated conceptual framework linking psychological foundations, sentiment measurement approaches, and stock market outcomes.

2. Literature Review

The theoretical foundations of investor sentiment are deeply rooted in behavioural finance, which challenges the assumption of fully rational investors by incorporating psychological biases into economic decision-making (Shiller, 2003; Barberis et al., 1998). Early evidence questioning market efficiency was provided by De Bondt and Thaler (1985), who demonstrated that stock prices systematically overreact to past information, leading to predictable reversals. Prospect Theory, developed by Kahneman and Tversky (1979), further established that individuals exhibit loss aversion and evaluate outcomes relative to reference points rather than absolute wealth levels. This asymmetric perception of gains and losses contributes to patterns of overreaction and underreaction in financial markets (Daniel et al., 1998; Barberis et al., 1998). Similarly, Shefrin and Statman (1985) documented the disposition effect, wherein investors prematurely realize gains and delay recognizing losses, thereby distorting price adjustments and prolonging mispricing.

Overconfidence and biased self-attribution further amplify sentiment-driven trading behaviour (Daniel et al., 1998; Barberis et al., 1998). Overconfident investors tend to overestimate the precision of private information, resulting in excessive trading volume and heightened volatility (Daniel et al., 1998). De Long et al. (1990) formalized the Noise Trader Theory, arguing that irrational traders influenced by sentiment can push prices away from intrinsic values. Because of limits to arbitrage, rational traders may not fully correct such deviations, allowing mispricing to persist (De Long et al., 1990; Stambaugh et al., 2012). Baker and Wurgler (2007) further emphasized that sentiment-driven mispricing is particularly pronounced in stocks that are difficult to value or arbitrage. The Adaptive Market Hypothesis suggests that these behavioural effects may vary across market regimes and evolve (Lo, 2004). Measurement of investor sentiment has evolved from indirect market proxies to composite indices, survey-based measures, and textual analytics. Baker and Wurgler (2006) developed a widely cited sentiment index combining IPO activity, first-day IPO returns, trading turnover, equity share in new issues, and closed-end fund discounts. Their findings indicate that periods of high sentiment are associated with lower subsequent returns for speculative stocks, suggesting temporary overvaluation (Baker & Wurgler, 2006; Baker & Wurgler, 2007). Brown

and Cliff (2004) showed that survey-based sentiment indicators possess short-term predictive power for stock returns. Expanding this perspective, Tetlock (2007) demonstrated that media content and tone significantly influence stock returns, highlighting the informational role of public sentiment. Cross-country evidence from Schmeling (2009) and Baker, Wurgler, and Yuan (2012) confirms that investor sentiment predicts future returns internationally, with stronger effects observed in less developed markets and during periods of global contagion.

Empirical research consistently shows that investor sentiment influences stock returns in both the short and long term. Baker and Wurgler (2006) reported that high sentiment leads to lower future returns for difficult-to-arbitrage stocks, while Stambaugh et al. (2012) found that sentiment-related mispricing is concentrated in overvalued securities. Huang et al. (2015) further demonstrated that aligned investor sentiment serves as a powerful predictor of stock returns, reinforcing the pricing impact of collective optimism or pessimism. In emerging markets, numerous studies documented the significant effects of investor sentiment on contemporaneous and future equity returns, highlighting the vulnerability of such markets to behavioural influences. The persistence of sentiment-driven mispricing is often attributed to weaker arbitrage mechanisms and informational inefficiencies (Schmeling, 2009; De Long et al., 1990). Investor sentiment also plays a crucial role in volatility dynamics. Shiller (2003) argued that changes in fundamentals alone cannot fully explain excess market volatility. Empirical evidence indicates that pessimistic sentiment intensifies downside volatility and amplifies risk perceptions (Baker & Wurgler, 2007; P.H. & Rishad, 2020). López-Cabarcos et al. (2020) further showed that investor sentiment significantly influenced market volatility during the COVID-19 pandemic, particularly in emerging economies. Sectoral analyses reveal heterogeneous sentiment effects across industries, with speculative sectors exhibiting stronger volatility responses (Sharma, 2021). These findings collectively suggest that investor sentiment not only affects pricing efficiency but also contributes to systemic risk, contagion, and market instability (Baker et al., 2012; López-Cabarcos et al., 2020). Although substantial empirical evidence supports the role of investor sentiment, existing studies remain methodologically and contextually dispersed. Many investigations focus on specific markets, time periods, or measurement techniques without integrating psychological theory, mechanisms of sentiment formation, and market outcomes into a unified conceptual structure (Barberis et al., 1998; Lo, 2004). Therefore, a comprehensive conceptual framework is necessary to bridge theoretical insights and empirical findings while accommodating cross-market heterogeneity and regime-dependent dynamics.

3. Methodology

This study adopts a conceptual research design based entirely on secondary data sources. Conceptual research seeks to synthesize and interpret existing knowledge to develop theoretical insights rather than to test hypotheses using primary data. Relevant studies were identified using academic databases such as Scopus, Web of Science, ScienceDirect, and Google Scholar. Keywords including “investor sentiment,” “behavioural finance,” “sentiment index,” “market volatility,” and “emerging markets” were used to retrieve relevant publications. The selected literature was categorized into thematic areas, including theoretical foundations, measurement approaches, return predictability, and volatility effects. Comparative analysis was conducted to

identify common findings, contradictions, and research gaps. Based on this synthesis, a conceptual framework was developed to integrate psychological biases, sentiment measurement mechanisms, and market outcomes.

4. Data Collection

The data for this conceptual study were collected exclusively from secondary sources. These include peer-reviewed journal articles, theoretical papers, reviews, and empirical studies. Only credible and indexed sources were considered to ensure academic rigor. The selection criteria emphasized relevance, citation impact, and contribution to behavioural finance and investor sentiment literature. The reviewed studies encompass both developed and emerging markets, thereby providing a comprehensive understanding of sentiment dynamics across different institutional environments. By relying solely on secondary sources, the study ensures objectivity while synthesizing established knowledge to construct a cohesive conceptual perspective.

5. Analysis and Discussion

Investor sentiment can be conceptualized as a multi-layered construct that originates from individual psychological biases and manifests at the aggregate market level. At the foundational level, cognitive biases such as loss aversion, overconfidence, and herd behaviour shape investor perceptions and decision-making processes (Kahneman & Tversky, 1979; Daniel et al., 1998). These biases collectively generate waves of optimism and pessimism that influence demand for risky assets. At the intermediate level, sentiment becomes observable through measurable indicators. Composite indices, survey responses, and market-based proxies serve as mechanisms for quantifying collective mood (Baker & Wurgler, 2006; Brown & Cliff, 2004). In markets characterized by high retail participation and limited arbitrage, these sentiment measures exert a stronger influence on price formation (Schmeling, 2009).

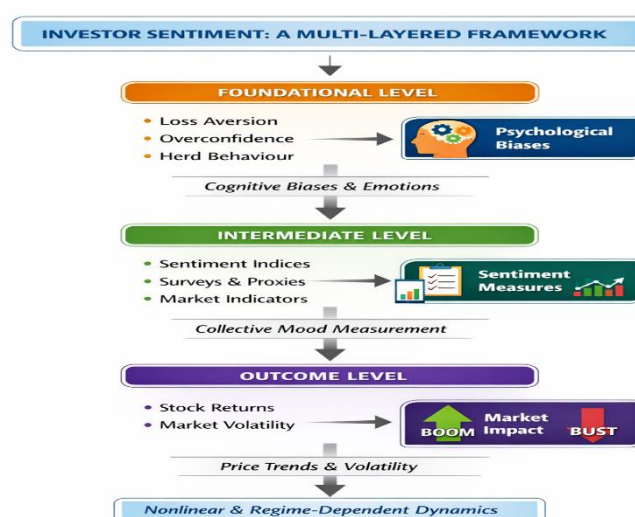


Fig. 1: Conceptual Framework

Source: Literature review

At the outcome level, investor sentiment affects stock returns and volatility. High sentiment is typically associated with short-term price increases followed by long-term reversals, while

negative sentiment intensifies volatility and downside risk (Baker & Wurgler, 2007). These relationships are often nonlinear and regime-dependent, supporting the Adaptive Market Hypothesis proposed by Lo (2004).

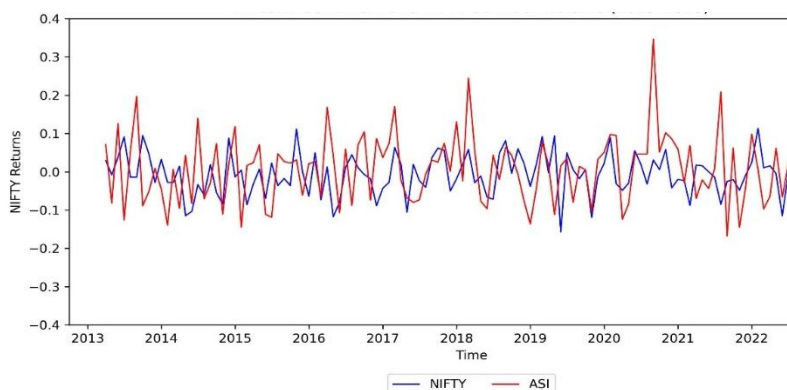


Fig. 2: Investor Sentiment and NIFTY 50 Index Returns (April 2013 – March 2022)

6. Conclusion

Investor sentiment has emerged as a central construct in behavioural finance, challenging the traditional assumption of fully rational markets. The review highlights that psychological biases such as loss aversion, overconfidence, and herd behaviour collectively shape market-wide optimism and pessimism, thereby influencing asset pricing dynamics. Empirical evidence consistently shows that sentiment-driven mispricing is more pronounced in difficult-to-arbitrage stocks and emerging markets, where informational inefficiencies are relatively higher (Baker & Wurgler, 2006; Schmeling, 2009). Furthermore, sentiment not only affects short-term returns but also contributes to long-term reversals and excess volatility (Baker & Wurgler, 2007). These findings suggest that investor sentiment is not merely a temporary anomaly but a persistent market force interacting with structural and institutional factors. Overall, integrating behavioural insights with traditional asset pricing models can enhance market predictability, risk assessment, and policy formulation in both developed and emerging financial systems.

7. Future Suggestions and Recommendations

Future research should explore cross-country comparative analyses to understand sentiment contagion across global markets. Further investigation into nonlinear modelling techniques may provide deeper insights into regime-dependent sentiment effects. The integration of advanced textual analysis and artificial intelligence tools also presents promising avenues for improving real-time sentiment measurement. From a practical perspective, portfolio managers should incorporate sentiment indicators into asset allocation and risk management strategies. Regulators should monitor extreme fluctuations in sentiment to prevent speculative bubbles and systemic instability. Strengthening institutional frameworks in emerging markets may reduce the persistence of sentiment-driven mispricing.

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