



ELSEVIER

Available online at [www.sciencedirect.com](http://www.sciencedirect.com)



International Journal of Forecasting 23 (2007) 127–145

*international journal  
of forecasting*

[www.elsevier.com/locate/ijforecast](http://www.elsevier.com/locate/ijforecast)

# Institutional and individual sentiment: Smart money and noise trader risk? <sup>☆</sup>

Maik Schmeling\*

*Leibniz Universität Hannover, Germany*

---

## Abstract

Using a new data set on investor sentiment, we show that institutional and individual sentiment seem to proxy for smart money and noise trader risk, respectively. First, using bias-adjusted long-horizon regressions, we show that institutional sentiment forecasts stock market returns at intermediate horizons correctly, whereas individuals consistently get the direction wrong. Second, even the simplest possible trading strategies based on investor sentiment show clear tendencies toward being profitable after controlling for systematic risk. Finally, IV regressions show that institutional investors take into account expected individual sentiment when forming their expectations, in a way that is consistent with the view that individual investors can be a proxy for noise trader risk. However, there is evidence of structural change.

© 2006 International Institute of Forecasters. Published by Elsevier B.V. All rights reserved.

*JEL classification:* G11; G12; G14

*Keywords:* Individual investor sentiment; Institutional investor sentiment; Predictive regressions; Noise trader; Smart money

---

## 1. Introduction

This paper empirically investigates two questions that have been subject to a large amount of research effort and debate in financial economics, namely (i) does investor sentiment matter for stock returns, and (ii) what is the difference between individual and institutional investors in financial markets?

While it seems to be generally accepted that institutions differ from individuals due to their size and sophistication (Kaniel, Saar, & Titman, 2005), there is considerable disagreement in how these two investor groups differ from each other and how this difference affects market processes like price formation and liquidity provision. Several studies find institutions to be informed investors or “smart money”<sup>1</sup> (e.g. Chakravarty, 2001; Jones & Lipson, 2004; Sias, Starks, & Titman, *in press*) and individual investors to be

---

<sup>☆</sup> We would like to thank two anonymous referees, Lukas Menkhoff and Rafael Rebitzky for very helpful comments and especially Manfred Huebner for providing the data.

\* Department of Economics, Koenigsworther Platz 1, D-30167 Hannover, Germany.

*E-mail address:* [schmeling@gif.uni-hannover.de](mailto:schmeling@gif.uni-hannover.de).

---

<sup>1</sup> We refer to institutions as smart money in the sense of informed investors (e.g. Campbell & Kyle, 1993) and not in the narrower context of mutual fund flows only as in Zheng (1999).

irrational noise traders or “dumb money” (Bange, 2000; Frazzini & Lamont, 2005). However, this evidence is accompanied by the finding that institutions deliberately herd in and out of stocks (see e.g. Nofsinger & Sias, 1999; Sias, 2004) and that they rely heavily on momentum-style strategies (Badrinath & Wahal, 2002; Griffin, Harris, & Topaloglu, 2003). Furthermore, “dumb” individuals seem to earn excess returns by providing immediacy for institutional trading demands at high frequencies (Campbell, Ramadorai, & Voultehenaho, 2005; Kaniel et al., 2005). Therefore, the evidence from real-world trading data so far is not conclusive regarding the role of these two investor groups.

The question whether sentiment, or the mood and expectations of investors, matter for stock returns is more controversial, and supporters from the behavioral side (e.g. Shiller, 2003) and critics from the rational camp (e.g. Fama, 1998) each have arguments in favor of this view or against it. While theoretical models have early incorporated the existence of noise traders into equilibrium asset pricing (DeLong, Shleifer, Summers, & Waldmann, 1990; Kyle, 1985), empirical evidence on the relevance of investor sentiment does not provide clear findings (see e.g. the polar results in Brown & Cliff, 2005; Wang, Keswani, & Taylor, 2006).

We affiliate these two questions and investigate whether the sentiment of institutional investors or individuals matters for aggregate stock market movements and whether the influence of sentiment of these two groups is systematically different. Using a new data set that covers both institutional and individual investors we find, first, that sentiment matters for several stock markets around the world and over intermediate horizons of up to 1 1/2 years. Second, there is a sharp difference between the two investor groups. Institutional investor sentiment forecasts stock returns correctly on average. Individual sentiment negatively predicts market movements in a way that is consistent with the hypothesis that overoptimistic (overpessimistic) noise traders drive markets away from intrinsic values. This overoptimism or overpessimism has to be corrected eventually so that prices return to their intrinsic values over intermediate to long horizons, which gives rise to the negative relationship between individual sentiment and expected stock returns (see e.g. Brown & Cliff, 2005; Lemmon & Portniaguina, *in press*). Third, in line with these findings, institutional investors become more

pessimistic (optimistic) when they expect individuals to be more optimistic (pessimistic) since they recognize that prices might have been driven above (below) their fundamental values. Also, institutional investors become more optimistic (pessimistic) when they expect individuals to become even more (less) optimistic (pessimistic) since they recognize that noise traders might push prices even higher above (further below) fundamental values, as discussed in the behavioral finance literature (see Shleifer, 2000).

Therefore, our contribution to the literature is twofold. We first employ a new data set that covers genuine investor sentiment from a weekly survey, twice-separated on individual and institutional investors as well as on short and medium forecasting horizons based upon several major stock markets around the world. This data set allows us to analyze investor sentiment while controlling for factors such as the geographical location of a market, forecast horizon and sophistication of investors. This is new to the literature since previous studies have had to rely on proxies for (mostly institutional) sentiment (e.g. Bodurtha, Kim, & Lee, 1995; Neal & Wheatley, 1998) or experimental data (DeBondt, 1993), or rather examine sentiment of investors for the US market exclusively (Kumar & Lee, 2006; Lee, Jiang, & Indro, 2002; Wang et al., 2006).

Second, we contribute to the literature by directly extending a new empirical modelling approach from Brown and Cliff (2005) to the case of two investor groups. Earlier studies employing sentiment data have focussed on short run predictability in first or second moments (Lee et al., 2002; Wang et al., 2006). Following Brown and Cliff (2005) we investigate longer term effects of sentiment on stock markets, since the building up of excessive optimism or pessimism, i.e. sentiment, is likely to be a persistent process whose effects on stock prices would be hard to detect over short horizons of one or two months. Whereas Brown and Cliff limit their analysis to individuals, we jointly analyse the impact of both individuals and institutions on stock prices, and complement their approach with further analyses that all point to the main result of this paper: individual sentiment is a proxy for noise trader risk, and institutions seem to be smart money.

The rest of the paper unfolds as follows: the next section derives testable hypotheses from earlier studies and Section 3 describes the data set. Section 4 shows results from long-horizon regressions, Section 5 presents

متن کامل مقاله

دریافت فوری ←

**ISI**Articles

مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات