

# Active Quantitative Equity

## How Sentiment Can Help Investors Choose Better Stocks

- Sentiment is an investment theme that can help investors take advantage of the return opportunities generated by the emotions, perceptions and actions of market participants.
- Sentiment provides a forward view on the likelihood of near-term price changes, serving as a complement to investment themes that are grounded in fundamentals and take shape over the long term.
- Although sentiment is a useful and important theme, we believe investors should be wary of stocks that may benefit in the short term from positive sentiment, but could suffer in the long term if they are overvalued.



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All professional investors strive to remain unemotional about investing. One of the key advantages of a quantitative approach to evaluating stocks is the way it reduces the influence of emotion on investment decisions. But quantitative investing isn't just about avoiding emotion-generated mistakes. It's also about exploiting the emotional and behavioral aspects of investment decision making that can create return opportunities. This month's commentary explores an important signal that, as quantitative investors, we use in our effort to convert investors' emotions into better stock-picking decisions: investor sentiment.

### Understanding sentiment

Market participants are human beings. When faced with uncertainty, emotions affect the way they make decisions. For example, actual economic value created is the ultimate measure of the company's true value and, by extension, the ultimate driver of its stock price. Companies demonstrate the economic value they generate in concrete ways – through their actual, delivered earnings, profitability and growth, leading in turn to dividends paid back to shareholders. But forecasting these dimensions of performance is extremely uncertain. This means that the way market participants, including professional investors, feel about companies – their perception of future earnings, profitability and growth – influences their stock-buying decisions and, at least in the near term, is a primary driver of equity prices.<sup>1</sup>

<sup>1</sup> Behavioral finance theory articulates a number of behavioral biases that contribute to this phenomenon, including:  
**Status quo bias:** Investors tend to under-react to new information.  
**Endowment effect:** Investors tend to ascribe more value to the things they own, simply because they own them.  
**Disposition effect:** Investors tend to sell stocks when their prices increase and keep them when they lose value.  
**Overconfidence bias:** Investors' confidence in their judgments is greater than the objective accuracy of those judgments.

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For further reading on the behavioral anomalies in investing, we recommend "[The Folklore of Finance: How Beliefs and Behaviors Sabotage Success in the Investment Management Industry](#)," from the State Street Center for Applied Research.

In Active Quantitative Equity, we call this phenomenon investor sentiment, and we use a range of objective, quantifiable metrics to measure this collective feeling or perception about the stocks in our universe. These metrics include price changes, trading volumes, changes in forecasts of earnings or sales, hedge-fund positioning (short positions indicate negative sentiment; long ones suggest positive sentiment), and changes in these measures for other firms linked through the supply chain.<sup>2</sup> Together, these and other metrics provide a forward signal of performance that informs our own stock picking in combination with other investment themes.

That broader framework includes the value theme, which looks at fundamental measures of performance in order to uncover stocks that are underpriced compared with their true economic value. In this context, a forward view on sentiment can help to enhance returns and manage risk by indicating, for example, whether a cheap, undervalued stock is likely to realize its value, rather than get cheaper.

### Sentiment in practice

Over the past year, we've observed a negative correlation between sentiment and value. Companies benefiting from positive sentiment have performed strongly, while undervalued companies have underperformed the market. Many companies with positive sentiment are very expensive. (See Figure.)

Figure 1. Over the past year, sentiment has performed strongly while value has declined.

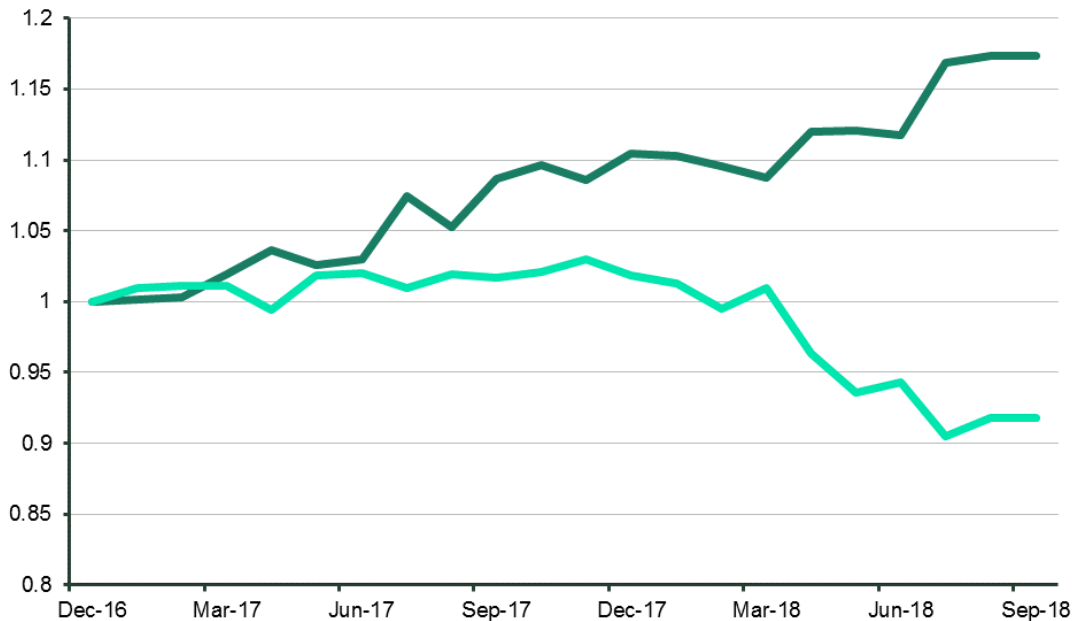


Figure 1.

Cumulative quintile-spread returns of stocks on proprietary measures of sentiment and value, within State Street Global Advisors' world developed-markets core universe.

#### Legend

- Sentiment
- Value

The information contained above is for illustrative purposes only. Source: State Street Global Advisors as of September 30, 2018.

Although sentiment is a useful and important theme, we believe investors should be wary of stocks that may benefit in the near term from positive sentiment, but suffer in the longer term if they are overvalued. We've written recently about the underperformance in recent years of the value theme and our belief that it may be poised for a comeback. Even as we encourage investors to stick with the time-tested principles of value investing, we recognize that it's important to be discerning when investing in value companies. Sentiment measures can help to mitigate the risk of buying a value stock that remains permanently underpriced – and a cheap stock with negative sentiment will likely only get cheaper in the short run.

<sup>2</sup> We use only objective measures rather than, say, polling market participants on the actions they plan to take because subjective data is unreliable: what investors say they're going to do isn't the same as what they actually do.

Making effective use of sentiment in an investment process therefore requires judgment and nuance. Recent months, for instance, have seen big changes in market leadership and market direction; these indicate broad changes in sentiment. The largest reversals in stock prices, broadly indicating increasingly negative sentiment, occurred in the retailing, paper and forest products, software and services, and technology, hardware and equipment sectors. The biggest stock-price increases, generally indicating increasingly positive sentiment, have been in metals and mining, consumer staples, telecom services and autos. These broad shifts in sentiment are interesting, but they are not, in our view, a basis to invest. We believe that a robust range of objective sentiment measures, understood in context with other investment themes, is crucial to convert the market's collective emotions into useful, investable insights.

So, if we move beyond just stock-price moves to take a more multi-dimensional (and, we believe, more useful) view of sentiment, the most notable industry segment today is software and services. The segment has scored very highly on our sentiment measures for more than a year – largely due to strong upward price movements (we refer to this as price momentum), but also because earnings forecasts for companies in this segment have been rising. Even as software and services has the highest sentiment in aggregate, it is also one of the most expensive segments according to our measures. We like the segment for its positive sentiment – but not at all on value.

Striking the right balance between value and sentiment in this situation is just the sort of decision that requires nuanced, experienced judgment, backed by research. Ultimately, our preference is for the valuation theme to win the battle of disagreement. We make this choice because our research and experience have shown that the volatility of sentiment signals when they underperform can be extremely detrimental to portfolio returns. On balance, this has led us to be underweight on software and services firms.

### **The bottom line**

As a forward signal of near-term price changes, sentiment is an important complement to fundamental-driven themes, which take shape over the long term. We believe sentiment is most useful when viewed alongside these longer-term signals. Over the past year, for example, many companies with positive sentiment have also been very expensive. In circumstances like this, we tend to prefer value because sentiment signals tend to be volatile when they underperform, which can be very damaging to portfolio returns.

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## **Glossary**

**Earnings per Share (EPS)** is the portion of a company's profit allocated to each outstanding share of common stock.

**Earnings Growth** is the annual rate of EPS growth

**Growth stock** A company that is anticipated to grow at a rate above the average for the market, rather than yield high income.

**Value stock** A company with solid fundamentals (e.g., dividends, earnings and sales) that tends to trade at a lower price than its peers.

## Marketing communication

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