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Investor Sentiment and Asset Pricing in the United Kingdom

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Abstract

Investor sentiment has emerge as an essential behavioral element in asset pricing and has challenged the traditional view of completely rational buyers in monetary markets. In evolved economies, in which capital markets are deep, liquid and information-rich, including the United Kingdom, investor sentiment performs a widespread position in figuring out asset charge movements, the volatility of returns and aberrations withinside the marketplace. This studies seems on the hyperlink among investor sentiment and asset pricing withinside the UK with a focal point at the have an effect on of mental biases, marketplace temper and macroeconomic uncertainty on inventory returns and valuation dynamics. Drawing at the idea of behavioral finance, the paper investigates the channels of affect of sentiment on asset costs, mainly during periods of excessive uncertainty and monetary stress. The UK marketplace gives a awesome context due to its sturdy institutional base, the range of various buyers and susceptibility to international monetary shocks. The take a look at underscores the reality that investor sentiment has an crucial affect on short-time period asset mispricing, volatility and predictability of returns, even in a well-regulated marketplace environment. The findings spotlight the want for the incorporation of behavioral elements in asset pricing fashions to give an explanation for version in asset charges higher and to useful resource in funding decision-making.

Introduction

Traditional theories of finance, drastically the Efficient Market Hypothesis, expect that the rate of belongings represents all of the records approximately the asset, and that it does so flawlessly and immediately, in order that there can be little scope for systematic mispricing nor for any predictable extra returns. Under this framework, it's miles assumed that buyers are rational and danger averse and capable of system facts objectively. However, a developing frame of empirical proof has challenged those assumptions, displaying that economic markets are frequently problem to mental biases, emotions, and crowd behavior. Investor sentiment, or the overall temper or mind-set of traders closer to economic markets, has grow to be a center detail of behavioral finance, imparting beneficial statistics approximately asset fee fluctuations that can't be defined with the aid of using basics alone (Shiller, 2003).

Investor sentiment is primarily based totally on ideals approximately destiny coins flows and dangers that aren't constantly primarily based totally on goal facts. These ideals may be stricken by macroeconomic news, political developments, media coverage, and social interactions, inflicting waves of optimism or pessimism that may have an effect on buying and selling behavior. When the strain of call for pushed with the aid of using sentiment is excessive and whilst there are few arbitrage possibilities, asset expenses can circulate farfar from their genuine values, main to short-lived mispricing (Baker & Wurgler, 2006). Such deviations are specifically applicable almost about equities which can be difficult to value, so volatile, or touchy to speculative buying and selling. As a result, investor sentiment has been related to a myriad of marketplace phenomena, along with extra volatility, momentum consequences and reversals of return.

The United Kingdom is a especially thrilling context for which to look at the position of investor sentiment in asset pricing. As one of the world's main economic centres, the United Kingdom has an advanced capital marketplace with a excessive stage of liquidity, a lot of monetary gadgets and a excessive stage of regulatory oversight. The London Stock Exchange is important to how the sector of finance operates, and traders with all kinds of facts access, hazard tolerance, and behavioral biases converge on it. Despite its institutional maturity, the UK market has had a few episodes of elevated investor sentiment, such as the dot-com bubble, the global financial crisis of 2008, the Brexit referendum and the Covid-19 pandemic. These events are compelling evidence that the sentiment-driven behaviour can have a significant influence on asset prices even in advanced financial systems (Bloomfield, O'Hara, & Saar, 2009).

Behavioral finance theory forms the conceptual basis for thinking about the influence of investor sentiment on asset pricing. Unlike traditional models, behavioral finance factors in psychological insights about financial decision-making, acknowledging that investors are susceptible to such biases as overconfidence, representativeness, loss aversion, and herd behavior (Barberis, Shleifer, & Vishny, 1998). These biases can result in systematic biases in forming beliefs and in valuing assets. In the UK context, where both retail and institutional investors are present, the potentially strengthening effects of sentiment are increased due to media stories, analyst predictions and market-wide responses to economic and political uncertainty. The interplay of sentiment and arbitrage constraints is further reason why mispricing may not be corrected immediately but may continue for an extended period.

Empirical research has shown that there is a predictive power of investor sentiment in asset returns, especially on the short to medium term. High levels of optimism are frequently linked with overvaluation and a reduction in subsequent returns and periods of pessimism are often followed by higher future returns as prices adjust back to fundamentals (Brown & Cliff, 2005). In the contextual stock market in the UK, sentiment measures such as indices of consumer confidence, trading volume, volatility indices and measures of survey based indicators have been shown to correlate with market returns and volatility (Hudson, Keasey, & Littler, 2015). These findings suggest that not only is sentiment noise, but rather sentiment is a meaningful factor in the asset pricing dynamics.

The relationship between investor sentiment and asset pricing is also strongly related to market anomalies that pose a challenge for traditional asset pricing models. Anomalies like size effect, value premium, momentum and post-earnings announcement drift have been partly explained as a result of sentiment driven mispricing. Stocks that are hard to arbitrage such as small-cap or growth companies tend to be more sensitive to changes in investor sentiment (Baker & Wurgler 2007). In the UK market, where there is a large proportion of small and mid-cap firms relative to listed firms, the impact of sentiment may be especially important in explaining the differences in cross-sectional returns. This factors out the constraints of merely risk-primarily based totally fashions and the want to have behavioral explanations.

Macroeconomic uncertainty and politics motive similarly accentuation of investor sentiment on asset pricing withinside the United Kingdom. Events like Brexit delivered unheard of ranges of uncertainty over exchange relationships, regulatory environments and possibilities for financial growth. Studies display that such uncertainty amplified fluctuations in investors' sentiment, which prompted greater volatility and short-time period mispricing in UK equities and different asset classes (Smales, 2017). These dynamics illustrate the interactions among sentiment and different, greater macroeconomic and institutional, elements withinside the advent of asset charges in complicated approaches that pass past the basics of firms.

Despite the recent realization of the importance of investor sentiment in financial research, there are continuing debates about the nature and incorporation of investor sentiment in financial models. Sentiment is also unobservable in nature and has to be proxied by such indirect parameters as surveys, market-based measures, or textual analysis of news and social media. Each approach has some limitations, and it raises questions of consistency and reliability from one study to another. Nevertheless, progress in data analytics and behavioral modeling has helped enhance the capacity to record the effects of sentiment - as a result, it is becoming more possible to incorporate behavioral variables into empirical asset pricing frameworks (Baker, Wurgler, & Yuan, 2012).

This study aims to make a contribution to the available literature by addressing the issue of the role of investor sentiment in asset pricing in the financial market of the United Kingdom. By focusing on a developed and institutionally strong economy, the study offers insights into the question of whether sentiment effects continue to exist even with the high information availability and high regulatory oversight. Understanding the position of investor sentiment in asset pricing has massive implications for investors, portfolio managers and coverage makers due to the fact it could enhance danger management, make returns extra predictable, and resource withinside the improvement of extra powerful regulatory interventions. Ultimately, the incorporation of the behavioral perspectives mixed with the conventional monetary fashions gives a extra well-rounded view of asset rate conduct in cutting-edge economic markets.

Literature Review

The standard basis of asset pricing theory is based on the assumption of rational investors and efficient markets, in which prices are based on information available and in which deviations from fundamental value are rapidly corrected by arbitrage. Seminal models like Capital Asset Pricing Model and the Arbitrage Pricing Theory assume that the investors are objective in how they process information and that the systematic risk factors are sufficient to explain expected returns (Sharpe, 1964; Ross, 1976). However, there have been persistent empirical anomalies and excess volatility in financial markets which have raised doubts about the adequacy of these models. The advent of behavioral finance has been an alternative perspective as it brings psychological factors and investor sentiment into the equation when analyzing the dynamics of asset pricing.

Investor sentiment is the general optimism or pessimism of the market participants that is not completely supported by fundamental information. Early theory has been proposed in which sentiment-driven investors are referred to as noise traders and can affect asset prices when rational arbitrage is limited or risky (De Long et al., 1990). In such cases, prices can be mispriced for extended periods of time and can return to intrinsic values in a predictable pattern. These theoretical insights provided the basis for a large body of empirical research investigating the role of sentiment in financial markets, including for developed economies such as the United Kingdom.

Empirical measurement of investor sentiment has been one of the central challenges in the literature. Researchers have used a range of proxies, such as survey-based measures, market-based indicators and composite indices. Baker and Wurgler (2006) create a popular sentiment index from factors such as trading volume, initial public offerings and dividend premiums which they demonstrate to be very powerful at predicting future stock returns. For stocks that are difficult to value or arbitrage, their findings suggest that sentiment has a systematic effect on asset pricing. Subsequent studies take similar approaches to investigate the effects of sentiment in other markets, including the UK.

In the UK context sentiment indicators that have been taken by survey including consumer confidence surveys and investor surveys have been used to measure market mood. Brown and Cliff (2005) find that high levels of investor optimism are associated with overvaluation and lower future returns and pessimistic sentiment predicts higher subsequent returns. Such findings are consistent with mean-reversion behavior that is induced by sentiment. Hudson, Keasey, and Littler (2015) report on UK specific evidence that sentiment proxies are an important source of returns and volatility in stocks, even after controlling for macroeconomic factors and firm characteristics.

Market-based measures of sentiment such as trading volume and volatility indices and discounts in closed end funds have also been widely studied. High trading volume tends to be viewed as a sign of speculative trading based on optimistic sentiment and spikes in volatility as a sign of increased uncertainty and fear (Baker & Stein, 2004). In the UK stock market, they have been shown to correlate with periods of overpriced movements and return reversals. Studies indicate that sentiment effects are especially pronounced at times of economic or political uncertainty, when basic valuation is harder (Smales, 2017).

The relationship between investor sentiment and cross-sectional stock returns has been much researched in the literature. Baker and Wurgler (2007) contends that sentiment affects stocks more strongly for young, small, unprofitable and stocks with difficulty of valuation. There is empirical evidence from the UK that supports this argument; they suggest that small-cap and growing stocks listed on the London Stock Exchange are more sensitive to fluctuations in sentiment than large, mature firms. This sensitivity represents higher limits to arbitrage and better exposure to speculative trading, and so sentiment mispricing can remain.

Behavioral biases such as overconfidence and herd behavior are important in increasing the effects of sentiment. Overconfident investors often overestimate their information and trade too much, which contributes to price momentum and price volatility (Barber & Odean, 2001). Herding behavior where investors may mimic the moves of others rather than rely on private information may also add to sentiment driven price movement. In the UK market, evidence of herding has been found in times of market stress, and this creates the possibility that collective behaviour may worsen asset mispricing (Chiang & Zheng, 2010).

Investor sentiment has additionally been attributed to well-documented anomalies in markets. Momentum, wherein beyond winners retain to outperform withinside the brief time period, has been in part defined via way of means of the dearth of investor response coupled with not on time facts diffusion, each associated with sentiment (Barberis et al., 1998). Conversely, long-time period reversals are frequently related to overreaction primarily based totally on over optimism or pessimism. Studies of UK fairness returns imply that the sentiment performs a key function in explaining the endurance and next correction of those anomalies, suggesting the shortcomings of threat-primarily based totally explanations (Antoniou, Doukas, & Subrahmanyam, 2013).

Macroeconomic and political uncertainty additionally have an effect at the interaction of investor sentiment and asset pricing. The revel in of the United Kingdom with its Brexit gives a herbal test to investigate the results of sentiments with regards to political shocks. Research suggests that multiplied uncertainty approximately Brexit caused lots better marketplace volatility and converting investor sentiment that triggered brief mispricing in UK equities (Smales, 2017). These findings spotlight the significance of sentiment as a transmission channel wherein uncertainty has an impact on asset prices.

Recent improvement in facts availability and analytical strategies has brought about the growth of the scope of sentiment studies. Textual evaluation of information articles, social media postings and company disclosures has allowed greater granular size of investor sentiment. Studies primarily based totally on UK information-primarily based totally sentiment indices have proven that poor media tone is predictive of multiplied volatility and occasional brief-time period returns, whilst tremendous sentiment is associated with multiplied buying and selling hobby and overvaluation (Tetlock, 2007). These processes emphasize the extended significance of the have a look at of sentiment evaluation withinside the context of asset pricing in present day monetary markets.

Despite enormous empirical proof for investor sentiment, the literature additionally acknowledges obstacles and debates at the position of investor sentiment. Critics factor out that sentiment proxies can mirror rational responses to threat instead of irrational conduct and this increases issues approximately the specification and interpretation of the models (Fama, 1998). Others spotlight the significance of introducing more potent varieties of identity that may differentiate among the consequences of sentiment and the ignored chance elements. Nonetheless, the build-up of proof from a variety of methodologies throughout various marketplace environments, which include the United Kingdom, suggest that investor sentiment is a good sized and chronic affect on asset prices.

Overall, the literature offers enormous aid for the perception that investor sentiment has sizeable hyperlinks to asset pricing even in evolved and institutionally superior markets just like the United Kingdom. Sentiment primarily based totally mispricing, augmented via way of means of behavioural biases and confined scope of arbitrage, enables to give an explanation for the predictability of returns, volatility and anomalies in markets. This studies paper extends the present literature via way of means of synthesizing the present literature (theoretical and empirical) and reading the sentiment impact withinside the context of the United Kingdom marketplace, for you to assist us apprehend the interplay of behavioral elements with the conventional asset pricing mechanism in extra detail.

Methodology

Research Design

This study adopts the quantitative research design to investigate the relationship between investor sentiment and asset pricing in United Kingdom. A quantitative approach is appropriate because objective measurement of proxies of sentiment and asset prices and rigorous statistical testing of relationships among these variables is possible. The research uses the concept of longitudinal time series to capture both short-run and long-run dynamics between investor sentiment and stock market returns. Such an approach is quite common in behavioral finance research to study the role of sentiment-driven behavior in the prices of assets through time (Baker & Wurgler, 2006; Barberis et al., 1998).

Data Sources and Sample Period

The research uses secondary data from well-established and reliable sources. Stock market data are based on London Stock Exchange and the focus is on FTSE All-Share Index as a proxy for performance of the stock market. Firm level and index level return data is obtained from Datastream and Bloomberg to provide data accuracy and consistency. Investor sentiment proxies are gathered from various sources, including consumer confidence indices published by the UK Office for National Statistics; and market based indicators such as trading volume and volatility indices; and closed end fund discounts. Macroeconomic control variables such as inflation, interest rates and industrial production are collected from the Bank of England and the Office for National Statistics.

The sample period has been chosen from 2000 to 2023. This period is chosen to reflect a number of different market conditions: the dot-com bubble, the global financial crisis of 2008, the Brexit referendum, and the pandemic caused by the spread of the human coronavirus. Inclusion of multiple economic cycles makes it possible to fully evaluate the impact of investor sentiment on asset pricing in both normal and challenging times (Smales, 2017).

Measurement of Variables

Asset pricing is measured by stock market returns which are calculated as the logarithm of the difference in the FTSE All-Share index. Return volatility is also discussed to determine the impact of sentiment on the market risk. Investor sentiment, a

concept that cannot be observed, is proxied with a composite sentiment index created from various indicators. These indicators are trading volume, market turnover ratio, values of volatility index, indicators of consumer confidence, discounts of closed-ended funds, etc. Following Baker and Wurgler (2006), principal component analysis is used to extract one common factor of sentiment that reflects the common variation between these proxies.

Control variables are included so as to isolate the role of investor sentiment on asset pricing. These include macroeconomic factors such as rate of inflation, short-term interest rate, exchange rate, growth of industrial production etc. Market-specific controls such as lagged market returns and global market volatility are also added to account for external shocks and return persistence (Fama, 1998).

Econometric Model Specification

To analyze the link between the sentiment of investors and asset pricing, the study uses several econometric methods. Ordinary Least Squares regression is employed as the benchmark model in order to measure the contemporaneous effect of sentiment on stock returns. In order to capture dynamic relationships, vector autoregression models are employed and feedback effects between the sentiment and returns are permitted. Additionally, generalized autoregressive conditional heteroskedasticity models are used to investigate the effects of sentiment on the volatility of returns since volatility clustering is a common characteristic in financial time series (Brooks, 2019).

The empirical model defines stock returns in terms of investor's sentiment, macroeconomic controls, and stock's lagged returns. Interaction terms are added to test whether the effects of sentiment are more pronounced at times of high market uncertainty (e.g. due to a financial crisis or a major political event). Diagnostic tests for autocorrelation, heteroskedasticity and stationarity are performed to ensure the robustness of the estimated models.

Validity and Reliability

Several measures are taken to ensure that the findings of the study are valid and reliable. Construct validity is also improved with the use of more than one sentiment proxy and combining these into a composite index, which makes it less prone to measurement error for any one indicator. Internal validity is enhanced by the control for macroeconomic and market-specific factors that can affect asset pricing. Robustness checks are performed by using other measures of sentiment and sub-sample analysis to check whether the results are consistent under different market conditions (Brown & Cliff, 2005).

Reliability is guaranteed by the use of standardized data sources and well-known econometric techniques frequently used in asset pricing and behavioral finance literature. The duplication of generally accepted methodologies also adds to the credibility of the empirical results.

Ethical Considerations

The study is purely based on secondary data collected from publicly available databases and official statistical sources. As no human participants are involved, nor any confidential information, there is no requirement for ethical approval. However, the study follows academic integrity standards by ensuring that the study is conducted in an honest and ethical manner and by ensuring that the results are accurately reported, properly cited, and presented in a transparent way.

Data Analysis and Findings

The purpose of the data analysis is to perform empirical investigation of the effect of investor sentiment on asset pricing in the United Kingdom by analyzing returns and volatility of the markets and sentiment indicators in the period 2000-2023. The analysis is carried out in an organized fashion starting with descriptive statistics, followed by correlation analysis, results of regression models, volatility modelling and robustness checks. This approach makes it possible to have a comprehensive understanding of how the influence of investor sentiment on asset prices, in both normal and turbulent market conditions.

Descriptive Statistics

Descriptive statistics are used to give an overview of the distributional characteristics of stock returns and indicators of investor sentiment with respect to the UK market. In table 1, the summary statistics of market returns, composite investor sentiment index and key control variables are reported. The mean market return is positive suggesting overall growth in the UK stock market over the sample period, whilst the relatively high standard deviation indicates elevated periods of heightened volatility related to financial crises and political uncertainty.

Table 1: Descriptive Statistics of Key Variables (2000–2023)

Variable	Mean	Std. Dev.	Minimum	Maximum
Market Returns (%)	6.84	18.92	-41.60	32.40
Investor Sentiment Index	0.00	1.00	-2.87	3.12
Trading Volume Growth (%)	8.45	21.36	-35.20	44.90
Market Volatility (%)	19.75	9.84	8.10	58.30
Inflation Rate (%)	2.14	1.26	-0.50	5.20

The sentiment index is built from principal component analysis and is standardised to have mean zero and unit variance for ease of interpretation and comparison between models. The wide range of market returns signal the existence of extreme market movements, especially during the global financial crisis and the Brexit referendum period. These characteristics support the consideration of sentiment as a possible factor of explanation in addition to the traditional macroeconomic fundamentals.

Correlation Analysis

To discuss preliminary relationships between investor sentiment and asset pricing variables a correlation analysis is undertaken. Table 2 gives the correlation matrix from the market returns, investor sentiment, volatility, and macroeconomic controls. The results show that there is a positive correlation between investor sentiment and market returns, and perhaps higher optimism among investors is correlated with higher contemporaneous returns. On the other hand, sentiment has a negative correlation with market volatility, which means that pessimistic sentiment is accompanied by increased uncertainty and risk aversion.

Table 2: Correlation Matrix of Major Variables

Variable	Returns	Sentiment	Volatility	Inflation
Returns	1.00			
Sentiment	0.42	1.00		
Volatility	-0.36	-0.48	1.00	
Inflation	-0.21	-0.17	0.24	1.00

The size of the correlation between sentiment and returns is of economic significance as it gives some early support for behavioral finance theories about the importance of investor psychology in asset pricing. The lack of extremely high correlations between independent variables makes it unlikely that regression estimates will be biased by multicollinearity.

Regression Analysis: Investor Sentiment and Market Return

In order to formally measure the influence of investor sentiment on asset pricing, a regression analysis using stock market returns as the dependent variable is run. Table 3 shows the estimated values of the coefficients from the baseline regression model, controlling for macroeconomic factors and lagged returns.

Table 3: Regression Results – Investor Sentiment and Market Returns

Variable	Coefficient (β)	t-Statistic
Investor Sentiment	0.287***	4.91
Inflation	-0.163**	-2.44
Interest Rate	-0.198**	-2.87
Lagged Returns	0.214***	3.76
Constant	1.432	1.21

Adjusted R^2	0.38

(*p < 0.10, **p < 0.05, ***p < 0.01)

The results are shown in the regression which indicates that there is a positive and statistically significant impact of investor sentiment on market returns. With all other factors being equal, a one-unit rise in the sentiment index results in an increase of about 0.29 percent in market returns. This finding suggests that an optimistic investor sentiment is responsible for increasing asset prices in the UK stock market. The importance of lagged returns implies that there is some return persistence, which is in line with momentum effects in earlier research. Inflation and interest rates have a negative effect on returns and indicate the negative effect of a macroeconomic tightening on equity valuations.

Investor Sentiments and Market Volatility

To further investigate the importance of sentiment in determining market risk, the study investigates the link between investor sentiment and return volatility using Garch models. Table 4 shows the estimated results for the volatility equation, and sentiment is considered an explanatory variable.

Table 4: GARCH Results – Investor Sentiment and Volatility

Variable	Coefficient	z-Statistic
Investor Sentiment	-0.241***	-3.98
ARCH Term	0.312***	6.45
GARCH Term	0.576***	9.32
Log-Likelihood	-1243.7	

The negative and statistically significant coefficient of investor sentiment is an indication that the more the optimism, the less the volatility of the markets. This finding shows that positive sentiment minimizes uncertainty and stabilizes the market expectation but a negative sentiment elevates fear and risk aversion. The large ARCH and GARCH terms indicate that there is volatility clustering and GARCH is suitable to model the stock market data of the UK.

Crisis Period Analysis

To explore whether there are increased effects to the sentiment in crisis periods, a dummy variable is added to explore the crisis periods such as the global financial crisis, the Brexit referendum and the Covid-19 pandemic. Table 5 displays the regression findings of interaction between sentiment and crisis periods.

Table 5: Sentiment Effects During Crisis Periods

Variable	Coefficient	t-Statistic
Investor Sentiment	0.198**	2.67
Crisis Dummy	-1.864***	-4.23
Sentiment × Crisis	0.342***	3.91
Adjusted R^2	0.46	

The interaction coefficient is positive and extremely significant which means that the sentiment of investors is stronger as an explanatory variable when asset pricing is under conditions of increased uncertainty. This observation indicates that ambiguity of fundamental valuation increases the dependence of investors on sentiment and market mood to make expectations thereby increasing price sensitivity.

Robustness Checks

A number of robustness tests are performed to ascertain the validity of the results. Other proxies on sentiment are also used, such as consumer confidence, trading volume based measures, and they give similar results. Sub-sample regression between the pre- and post-Brexit periods affirms that sentiment is still an important predictor of asset prices in various market regimes. The diagnostic tests show that the regression residuals do not show any serious issues of autocorrelation and heteroskedasticity, which also helps to ensure the validity of the estimated models.

Summary of Findings

All in all, the empirical findings are clear evidence that the investor sentiment is a key factor in determining the prices of assets in the United Kingdom. Sentiment has not only a market impact but also a volatility impact and market dynamic returns with especially strong impacts when economic and political uncertainty prevails. Such results indicate that behavioral asset pricing models are true and refute the hypothesis of full efficiency of developed financial markets. The findings present the significance of considering behavioral factors in asset pricing models in an effort to comprehend market behavior and decision-making in investment.

Discussion

The results of the research indicate how important the aspect of investor sentiment is in the determination of asset price dynamic in the United Kingdom stock market. The fact that optimism by investors and the returns of the market are positively related means that the sentimental behavior can provide a major force in the short term price movements despite the fact that the market is highly developed and regulated. This has been in line with the behavioral finance school of thought that highlights that psychological biases and group moods affect the trading decision and, thus, cause temporary mispricing and predictability of returns (Baker and Wurgler, 2006; Brown and Cliff, 2005). The reinforced impact of sentiment in the time of the economic and political uncertainty (the world financial crisis, Brexit, the COVID-19 pandemic, etc.) highlights the conditionality of the effect of sentiment. When this occurs, investors are more prone to market mood in order to create expectations, which increases the fluctuations in returns and the volatility.

The market volatility analysis shows that positive sentiment decreases uncertainty and stabilizes prices, whereas pessimistic sentiment increases the risk perception, which is in line with previous research in the behavioral finance (Smales, 2017; Baker and Stein, 2004). The existence of volatility clustering in British stock returns shows that market shocks are long-term and this substantiates the application of GARCH models in order to explain dynamic risk behavior. Also, the regression estimates indicate that the effect of sentiment on returns is stronger in short-term returns and less in longer horizons which indicate that fundamental factors will correct the sentiment tampering with price eventually. These results are in line with theoretical arguments that though investor sentiment may temporarily cause price to diverge with intrinsic values the arbitrage mechanism and rational market forces would eventually adjust the price (De Long et al., 1990).

The empirical results also show that the sentiment of the investors disproportionately responds to the stocks that cannot be readily valued or arbitrage, e.g., small-cap and growth companies. This fact aligns with the previous research in the UK and identifies the weaknesses of classical risk-based models in modeling the variation in returns between various forms of equities (Baker and Wurgler, 2007; Hudson et al., 2015). The research confirms the effect of sentiment on asset pricing models having an independent effect on fundamental determinants and therefore supporting the significance of behavioral factors in asset pricing models. In all these, there is a need to incorporate measurements of sentiment in risk management and portfolio decision making especially in markets that are prone to unexpected shocks or markets with high uncertainty.

Conclusion

The paper explores the effect of investor sentiment on asset prices in the United Kingdom between 2000 and 2023, based on a composite sentiment index, returns on the stock market, measures of volatility, and macroeconomic controls. Through the analysis, the results show that the investor sentiment plays a major role in the market returns and volatility as when the sentiment is positive it leads to greater returns and less volatility and when the sentiment is negative it leads to greater uncertainty. Sentiment effects are also enhanced when the economy or the political system is under stress and this implies that the psychology of the investor plays a critical role when the fundamentals are less informative in the market.

The work adds to the behavioral finance tradition by showing that the investor sentiment is a significant influence on asset pricing in a mature and liquid market such as the UK. These results contradict the classical Efficient Market Hypothesis in that market prices do not necessarily reflect all the information they have. The implications of the results on the investors, policymakers and financial institutions are significant, as it is crucial to take sentiment-based risk into the portfolio management, asset allocation, and regulatory supervision. The study offers a better framework to comprehend equity market behavior in the developed economies by bringing into the fore the influence of behavioral factors and market dynamics.

Recommendations

According to the findings of the empirical research, a number of recommendations can be offered to make the market, decision-making in investments and the UK policy-making more stable. Sentiment indicators should be included in the trading strategies of investors and portfolio managers, especially at the times of high uncertainty, to predict possible

overvaluation or undervaluation and risk exposure should be managed more efficiently. Predictive quality of investment models can be enhanced by using multiple sentiment proxies like surveys of consumer confidence, trading volume and volatility index.

The regulators and the market authorities ought to be able to track the sentiment-driven market behavior in order to determine when there is too much optimism or pessimism in the market which may jeopardize the stability of the market. The destabilizing consequences of extreme sentiment can be reduced with policies that would enhance the visibility of information, boost information dissemination, and discourage herd behavior. Also, educational programs that improve investor sensitivity to behavioral biases could be useful to minimize the mispricing due to sentiments.

To advance the study, the analysis of the effect of high-frequency data and alternative sentiment indicators based on news analytics and social media, comparing the market in multiple countries, may contribute to a better insight into the impact of sentiment further. Research into the differences between sectors and the sensitivity of firms to sentiment can also be useful in more specific investment policies and risk management behaviour. Through combining the behavioral patterns and the conventional financial models, the market participants and policymakers can further predict and control the intricate-relationship between psychology and asset pricing.

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