4-15-2019

Risk Premiums and Political Cycle Sentiment: Exploring the Role of Small Cap Valuations

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I. Introduction

Multiple studies have sought to explain why average U.S. stock market returns are higher when a Democrat holds the executive office. Santa-Clara and Valkanov (2003) found a connection between this return differential and portfolios sorted on the basis of market capitalization. Sy and Zamen (2011) approach the question using size sorted portfolios with a conditional version of Fama and French’s (1992) three-factor pricing model. They find there is a statistically significant difference between the market and size factor loadings between administrations, and after allowing risk to vary the abnormal Democrat returns disappear.

Neither model specification allows investor sentiment to play a role in return formation. Baker and Wurgler (2006) argue it is a mistake to assume the cross section of returns depends only on the cross section of systemic risks. They present evidence showing investor sentiment can have significant effects on the expected value of returns, especially for firms with highly subjective valuations that are the riskiest and costliest to arbitrage. These small, speculative, hard to arbitrage firms are the same firms previous studies have identified as the main source of abnormal Democrat returns.

II. Research Methods

The above graphs show values and distributions of the factors used. The chart to the right shows the sentiment and the Baker-Wurgler investor sentiment index, as well as the version of the index that is orthogonal to the business cycle. Democratic and Republican administrations are also represented as a binary variable.

III. Data

The empirical investor sentiment index used in this analysis are from Baker and Wurgler (2006) and available online from Bonye’s website. Baker and Wurgler based their investor returns on six orthogonalizing procedures:

- Cross-Sectional Sorting - The average difference between the bet returns and their market prices. This is an interesting proxy for sentiment as it is possible to control for both diversifiable and non-diversifiable factors on the other side, and it shows where the market has been slow to price in the bad news from the previous administration.
- Parameter Tests - The value of parameter changes in the Bonye/Fama/French/French (1992) model. The investor sentiment index captures this proxy for sentiment in terms of arbitrage returns. This methodology is very similar in spirit to the market in which market short-selling constraints are present only after the administration has changed.
- Returns Analysis - The returns under each administration. This is the most direct measure of sentiment. It shows the joint effect of sentiment on returns.
- Number of New Ordains (we) - A high entry return to initial public offerings can be treated as a sentiment shock. It is used in conjunction with other market models to get new variations.

IV. Results

This analysis shows risk premiums alone cannot fully explain the abnormal returns during Democratic presidencies. After controlling for risk factors there are still unexplained returns in the smallest decile portfolio. Using the insights gained from Baker and Wurgler concerning investor sentiment, a likely explanation emerges. The returns or lack of returns realized from investment in the smallest firms is due to a combination of overly pessimistic or overly optimistic investors and the presence of arbitrage constraints. Firms located in the smallest decile are severely limited to arbitrage compared with larger, more established firms. Investor sentiment in this case, whether positive or negative, represents a force pushing stock prices away from rational valuations.

V. Conclusions


References


For additional research, please refer to the references provided in the text.