

## Forecast Dispersion, Investor Sentiment and the Cross Section of Stock Returns

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**Abstract :** This paper explores the role investor sentiment plays in the relationship between analyst forecast dispersion and stock returns. With short sale constraints, stock prices are determined by the optimistic investors. During the high sentiment periods when investors suffer more from psychological bias, there are more optimistic investors. This is the first paper to document that following the high sentiment periods, stocks with the most analyst forecast dispersion are overpriced, earning significantly negative returns, while those with the least analyst forecast dispersion are not overpriced as the degree of belief dispersion is low. However, following the low sentiment periods, both are not overpriced. A portfolio which longs the least dispersed stocks and shorts the most dispersed stocks yields significantly positive returns only following the high sentiment periods. My findings can potentially reconcile the puzzling risk effect and mispricing effect in the literature. The risk (mispricing) effect suggests a positive (negative) relation between analyst forecast dispersion and future stock returns. Presumably, the magnitude of the mispricing effect depends on the proportion of irrational investors and their bias, which is positively related to investor sentiment. During the high sentiment period, the mispricing effect takes over and the overall effect is negative. During the low sentiment period, the percentage of irrational investors is mediate, and the mispricing effect and the risk effect counter each other, leading to insignificant relation.

**Keywords :** analyst forecast dispersion, short-sale constraints, investor sentiment, stock returns

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