Why Sentiment Matters

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A Primer for Smarter Investing

What Is Investor Sentiment?

Investor sentiment is the overall mood of investors - how bullish or bearish they are on a market or asset.

Sentiment is part of every investor's investment process. Whether for macro investors, stock pickers, or thematic investors, it matters whether a position is consensus or contrarian.

Why is Sentiment Important?

- **Assessing Risk & Reward:** If everyone is already bullish on an asset, expectations are high, and even minor disappointments can trigger a sell-off. Conversely, if sentiment is bearish, it often takes only a small positive catalyst to spark a rebound.
- **Behavioural Biases:** As investors, we're prone to emotional decision-making—getting greedy when markets rise and fearful when they fall. Sentiment analysis provides an objective tool to help manage these biases and avoid herd mentality.
- **Identifying Market Excesses:** Assets go through periods of unbridled optimism and entrenched pessimism. Markets rarely stay at fair value and in equilibrium for long. So active positions are often most attractive when leaning against sentiment extremes.
- **Understanding Consensus:** Most investors are consensus most of the time. It is difficult to make money with consensus views. Some of the best trades come from high-conviction, non-consensus views. Sentiment analysis helps you understand what consensus is, giving you confidence in implementing your non-consensus view.

Bottom line, no one gets all trades right. The aim for any investor is to skew the probabilities of a positive investment outcome in their favour. Understanding the sentiment and positioning of other investors can do exactly that: skew the probability of success in your favour.

Why Sentiment Often Gets Overlooked

Despite its importance in the investment process, sentiment & positioning analysis typically receives too little attention and research effort compared with other aspects of investing.

Investors spend too much time on:

- trying to forecast things that are impossible to forecast (e.g. inflation)
- on things that are interesting, but not market-moving (e.g. Middle East tensions, politics, geo-politics)
- on things where we have no edge (e.g. Fed watching)

On all the above there are as many opinions as there are market participants. Countless hours are spent in morning meetings, in research or just around the desk discussing the hot topic of the day. Macro views are a dime a dozen. There is value in these discussions, but the time spent on them is typically far out of proportion to their impact on investment outcomes.

From experience, the opposite is true of sentiment & positioning analysis. While its benefits to investment outcomes are clear, the time and research effort spent on rigorous sentiment & positioning analysis by research providers and investors alike is far less than it should be.

How Do We Measure Sentiment?

There are several ways to track sentiment and positioning:

- **Surveys**: Direct measures of investor sentiment, such as the AAII, Sentix, and BofA Fund Manager Survey can target different investor groups from retail to institutional investors. Some surveys cover changing topics over time, while others ask the same questions continuously over decades.
- **Positioning data**: More direct than surveys, this reflects actual investor holdings. Funds are required to report their holdings, and organizations like the CFTC publish data on futures and options positions by investor type.
- **Market-implied sentiment**: Some sentiment indicators are derived from market data, such as the VIX (fear gauge), put/call ratios, or hedge funds' beta exposure to equities. These don't directly measure sentiment but provide strong clues about investor positioning.
- **Aggregated indicators**: Some indicators combine multiple sentiment measures into a single index. While this makes monitoring easier, these indicators are often produced by sell-side institutions and designed as marketing tools. They don't always add meaningful value beyond their components.

How Does Sentiment Work?

Sentiment indicators typically act as contrarian signals – meaning extreme readings suggest a market move in the opposite direction is becoming more likely.

When sentiment is extremely **bearish**, it suggests most of the bad news is already priced in, leaving more room for a positive surprise.

When sentiment is extremely **bullish**, it indicates high expectations, making the market more vulnerable to even small disappointment.

How To Use Sentiment?

Sentiment should be one of many factors in an investment process. Every investor will have their own investment process, which typically includes factors such as fundamentals, macro, valuations, momentum, tail risks and ESG alongside sentiment.

No one would nor should build an investment case solely on a single factor.

Key ways to use sentiment & positioning in an investment process include:

- **Idea Generation**: If an asset has extreme sentiment or positioning, it may be worth investigating further. A contrarian position can be powerful when combined with a strong fundamental view and a clear catalyst.
- **Risk Management**: Sentiment can highlight vulnerabilities in your positions. If sentiment is extremely positive, the downside risk increases, and vice versa.
- **Understanding Consensus**: Knowing what the market already expects allows you to assess whether your view is different enough to create an opportunity.
- **Timing Entry & Exit**: Even when you have a strong fundamental view, timing matters. Entering a trade when sentiment is against you and exiting when it becomes consensus can help skew the probability of a successful investment outcome in your favour.

Not All Sentiment Indicators Are Created Equal

There are hundreds of sentiment indicators, but many provide little or no real predictive value.

It is important to be selective. At Sentiment Matters we have tested and scored over 200 sentiment indicators for the following characteristics:

1. **Proven Predictive Power**: The best sentiment indicators have a clear historical relationship with market performance—extreme bearishness followed by strong returns and extreme bullishness followed by weak returns. Surprisingly few indicators meet this standard.
2. **Long History**: Sentiment extremes are rare by definition. To gain confidence in their predictive power, we need indicators with, ideally, decades of data to analyse past patterns.
3. **High Frequency**: Bearish extremes often appear in response to specific events and don't last long. The most useful indicators update at least weekly—daily is even better.

4. **Transparency**: A good sentiment indicator should have a clear, well-documented methodology. Opaque indicators, especially aggregated ones, can be prone to methodological changes or data mining that reduce their trustworthiness.

Bottom Line

Investor sentiment plays a crucial role in risk/reward analysis, managing behavioural biases, and spotting consensus versus contrarian opportunities. While it shouldn't be the sole driver of investment decisions, integrating sentiment into the investment process can help improve timing, enhance risk management, and ultimately increase the probability of successful investment outcomes. Yet, not all sentiment indicators are created equal—being selective in choosing reliable, high-quality indicators is key to making sentiment analysis a valuable tool in decision-making.

Many things factor into an investment decision and opinions diff An investment decision is never made

is a key part of most investment processes. Opinions may differ on how important individual factors like fundamentals, valuations, macro, momentum or sentiment are to making an investment decision, but they will all feature in most investors thought process.

- Relative to its importance in the investment process, it receives too little attention and research effort.

- Sentiment & positioning analysis can keep you from jumping onto a bandwagon too late or catching a falling knife too early.

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Consensus short positions:

- It is human nature to be drawn towards things that are both salient and available. In financial markets, that means the more available (or prominent) an issue is, the more likely we are hugely overstate both its importance and the risk it presents.

- For any investor with a reasonably long time horizon, attempting to ignore whatever the market is focusing on at any given point in time is the sensible (and most lucrative) approach. Unfortunately, this can be close to impossible. For three reasons:
- It is hard to ignore something when everyone else is paying attention to it.
- We are human and thereby exposed to the same risk perception biases as everyone else. We must work exceptionally hard to behave differently.
- Sometimes something will matter to financial markets in a material way and ignoring it won't look smart.