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Journal of Asset Management and Financing

E-ISSN: 2383-1189

Vol. 14, Issue 4, No. 55, 2027, p 69-90

Received: 19/09/2025

Accepted: 01/12/2025

Research Paper

Investor Sentiment and the Momentum of Excess Stock Returns

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Abstract

The behavioral finance perspective challenges the Efficient Market Hypothesis by asserting that investor decision-making is not driven solely by rationality and profit maximization. Instead, behavioral biases, such as investor sentiment, significantly influence investment decisions and, consequently, stock prices and returns. Accordingly, this study investigates the impact of investor sentiment on the momentum of excess stock returns in both the short and long term within the Tehran Stock Exchange. A screening method was employed to select a sample of 169 listed firms. These firms were analyzed using multivariate regression models with panel data from 2011 to 2022 for the first hypothesis and from 2011 to 2020 for the second and third hypotheses, controlling for year and industry effects. The findings indicate that investor sentiment positively affects the momentum of excess returns in the short term but exerts a negative impact in the long term. Furthermore, the results suggest that investor sentiment has a stronger influence on the momentum of excess returns for smaller firms than for larger firms over the long term.

Keywords: Investor Sentiment, Momentum, Behavioral Finance Approach, Excess Stock Returns

JEL classification: G41, G12, C23, E44

Introduction

Behavioral finance challenges the Efficient Market Hypothesis by arguing that investors' decisions are not driven solely by rational analysis (Mehrani et al., 2023) but are also influenced by psychological factors—most notably investor sentiment—that can distort stock prices and returns (De Long et al., 1990). Accordingly, this study investigates the impact of investor sentiment on the momentum of excess stock returns in both the short and long term, and explores how this effect varies with firm size in the Tehran Stock Exchange, a developing market (Romoozi et al., 2024; Talebzadeh & Sadeghi, 2020) characterized by limited arbitrage opportunities, restrictions on foreign investment, and short-selling constraints (Han & Li, 2017). These market frictions limit rational traders' ability to quickly correct sentiment-driven mispricing, suggesting that investor sentiment positively affects short-term excess return momentum (H1). Over longer horizons, accumulated deviations from fundamental values trigger arbitrage activity, gradually correcting prices, so investor sentiment is expected to negatively affect long-term excess return momentum (H2). Additionally, smaller firms are harder to value and more prone to speculative trading, making them more sensitive to sentiment. Thus, investor sentiment's effect on long-term excess return momentum is stronger for small firms than for large firms (H3). By testing these hypotheses, the study contributes to behavioral finance literature and provides insights for investors seeking to identify sentiment-driven return patterns in emerging markets.

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Hajiannejad, A., Rahrovi Datjerdi, A. and Khodaparast, A. (2027). Analyzing the Effect of Investor Sentiments on the Momentum of Excess Stock Returns in the Listed Companies on Tehran Stock Exchange. *Journal of Asset Management and Financing*, 14(4), 69-90.



Materials & Methods

Using a systematic screening procedure, a final sample of 169 non-financial firms listed on the Tehran Stock Exchange (TSE) was selected. The hypotheses were tested through multivariate panel-data regressions, controlling for year and industry effects. The analysis period spans 2011–2022 for the first hypothesis and 2011–2020 for the second and third hypotheses. The extended period for the first hypothesis reflects the requirements of the long-term excess-return momentum measure, which is based on 36-month forward returns, whereas short-term momentum relies on 12-month forward returns. Accordingly, forward returns from 2021–2023 were incorporated as appropriate. The final dataset includes 24,336 firm-month observations for short-term tests and 20,280 firm-month observations for long-term tests. The empirical model employed in this study is adapted from Han & Li (2017). Excess-return momentum was calculated using cumulative excess returns, defined as realized returns minus the risk-free rate. Investor sentiment (S) was measured using a composite index constructed through principal component analysis (PCA), following Hajiannejad (2023), Tohidi (2020), Ferreira et al., (2021), Khan & Ahmad (2019), Ling et al., (2010), and Baker & Wurgler (2006, 2007), while macroeconomic variables (Z) were included as control variables.

Findings

The results show that investor sentiment significantly influences excess return momentum across different time horizons and firm sizes. Descriptive statistics indicate that average investor sentiment was slightly positive over the study period, while cumulative excess returns exhibited variation across both short- and long-term horizons. Panel regressions—estimated using GLS with cross-sectional weights and White period-clustered covariance to address heteroskedasticity and serial correlation—reveal systematic patterns. In the short term, investor sentiment has a positive and statistically significant effect on excess return momentum, confirming Hypothesis 1 at the 1% level. In the long term, however, the effect becomes negative and significant, supporting Hypothesis 2. This shift in sign reflects a clear mean-reversion pattern, whereby return gradually reverse toward their fundamental value as the investment horizon lengthens. Separate estimations for large and small firms show that the long-term coefficient of investor sentiment is negative for both groups, but considerably larger in absolute value for small firms. A Z-test confirms that the long-term influence of sentiment on excess return momentum is significantly stronger for small firms than for large firms at the 1% level, thereby supporting Hypothesis 3. Overall, all three hypotheses are validated at the 99% confidence level.

Discussion & Conclusion

Short-term expectations of significant gains or losses drive retail and sentiment-driven investors toward aggressive buying or selling. Information asymmetry and structural market frictions amplify these fluctuations and slow price correction, generating momentum that causes stocks to continue upward or downward trends. Consequently, investor sentiment exerts a positive effect on short-term excess return momentum, consistent with Han & Li (2017) and Seok et al., (2019). Over the long run, as prices deviate from intrinsic values, rational and analysis-driven investors are better positioned and increasingly inclined to engage in corrective trading. These actions reduce sentiment pressures and allow the market to gradually revert toward fundamental equilibrium. The effect is particularly pronounced for smaller firms with limited analyst coverage, lower liquidity, and subjective valuation. These results are consistent with Baker et al., (2012) and Baker & Wurgler (2006, 2007). These findings suggest that short-term traders may benefit from periods of elevated positive sentiment, whereas long-term investors should prioritize fundamental analysis and avoid decisions driven solely by sentiment. For smaller firms, prudent decision-making and enhanced disclosure are essential. Regulators and asset managers can mitigate sentiment-induced volatility by improving transparency, expanding analytical coverage, and integrating sentiment indicators into risk management. The study's main limitations include reliance on a single sentiment index, potential influence of uncontrolled external factors, and constraints from sample screening. Future research could employ alternative sentiment measures, include additional macro-level controls, and examine whether effects vary across industries or market cycles to better understand patterns of returns influenced by sentiment in emerging markets.