

Axonwave for Measuring Investor Sentiment

Investment based on genuine long-term expectation is so difficult to-day as to be scarcely practicable. He who attempts it must surely... run greater risks than he who tries to guess better than the crowd how the crowd will behave...
Keynes, John Maynard, (1936) *The General Theory*...

The Problem

The behaviour of a great many individual investors is frequently assumed to be entirely random noise that has no tendency or meaningful effect on the market. If this assumption is false, then investing is riskier than previously thought, making a clear understanding of investor sentiment important for rational investors. There is a growing body of evidence that investor sentiment does, indeed, have a short-term effect on stock prices.

Determining Sentiment

Many different techniques have been used to estimate investor sentiment. Let us consider two popular approaches.

1. Investor sentiment can be estimated directly through questionnaires and surveys.

The accuracy of these can be affected by all the usual issues, including self-selection bias, insufficient response options, sample size issues, and self-serving responses. This approach is costly and time-consuming – information gathered this way might not be timely enough for effective action. Questionnaires do have the advantage that they represent individual investors and can also make it possible to identify the *type* of investor.

2. Investor sentiment can be indirectly derived by observing investor behaviour that is likely to reflect the state of mind of a group of investors.

For example, a high put/call option ratio might suggest pessimism. However, this conclusion is not as clear as it appears. After all, for every pessimistic buyer of a put option, there is a corresponding, and correspondingly optimistic, seller. It is not possible with this method to distinguish between institutional and individual investors. Of course, it also gives no information about the majority of investors who have *not* traded any options. Presumably, the “noisiest” and most irrational investors would also be the least likely to use sophisticated instruments like options.

Another Source

The shared failing of both the survey-type measures and the proxy-type sentiment measures provided in the examples above is that they ignore a rich and direct approach, that is, *to see what investors are saying themselves about their sentiment* in their unprompted spontaneous writings.

There is a large (and rapidly increasing) amount of untapped investor sentiment information in newsletters, blogs, editorials, articles, and other free-text sources. Reading these free-text sources with an eye for the writer’s sentiment can give good results that, unlike survey methods, will not influence the subjects, and unlike indirect methods like put/call ratios, do not require the analyst to infer sentiment through a proxy measure.



An ideal reviewer of these free-text sources would be fast, consistent, tireless, and have the ability to "read between the lines". The Axonwave Content Intelligence System (CIS) is able to quickly read large volumes of text with an understanding of pre-defined concepts. When reading an investor's blog, if the concept "Provisional Hold" were coded, the Axonwave CIS can locate matching text like "I'm inclined to sell if the company doesn't announce any new contracts in the next few weeks". With a traditional text search engine, the best you could hope for would be to find the word "hold" in the text. In this case, you would have come up empty, while the Axonwave CIS would find the concept of hold, and a nuanced concept at that.

Through the Axonwave CIS, a user's personal investment profile can be used to customize the mining of free-text investor sources for sentiment information that has been hitherto unavailable. Used correctly, any new information gives an investor an asymmetrical advantage in the market.