

Sense and sentiment: a behavioural approach to risk premium modelling

A. Rúa Vieites; E. Vaquero Lafuente; J.J. García Petit

Abstract-

Estimates of risk premium derived from classical financial theory have consistently shown deviations from the observed levels. These limitations have been linked to the rational foundations of these theories that rely on asset prices as the main information source. This article focuses on the need to increase the information available through the consideration of behavioural factors. Therefore, the paper proposes an alternative methodology to estimate the risk premium incorporating investor sentiment as a source of additional information. This model is tested on the US market with the objective of obtaining a more accurate measure of the risk premium that the one provided by classical financial approaches. It also offers an alternative explanation to risk–return relationship based on investment sentiment. Finally, the use of behavioural approaches to the treatment of the risk premium will favour the control of market anomalies such as the momentum effect.

Index Terms- Risk premium; sentiment; valuation; betas; momentum

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