



American Finance Association

Yes, Discounts on Closed-End Funds are a Sentiment Index: A Rejoinder

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A Rejoinder

OUR POINT WAS AND is simple: Chopra, Lee, Shleifer, and Thaler's (1993) sentiment index doesn't work. Correctly measured, the covariation between closed-end fund discounts and size-based firm returns, no matter how finely broken down by ownership, is no more than a trivial 4 percent. And even that comovement had dried up by the second half of their sample.

Chopra *et al.* attribute our failure to detect more comovement with fund discounts to a flaw in our specification. We still believe our less constrained specification is better than their proposed replacement. But why argue? The marginal contributions of the size variables to explaining the discounts cannot differ by much in two such similar specifications, as readers can easily judge by looking at Panel A of their new Table III. Note particularly their regression for the critical small-firm size group of decile 1 with a reported R^2 of 3.5 percent—smaller even than our upper bound of 4 percent!

An R^2 of 3.5 percent, they concede, suggests “that small stock returns explain only a small fraction of variation in discounts.” But that low R^2 is misleading, they now claim, because “the dependent variable in the regression is effectively a change in the discount, which is purged of market return, while the independent variable, namely DEC1, contains the market return” (see pages 805 and 806 above). To eliminate this supposed bias, Chopra *et al.* first regress the fund discount and the size decile returns separately on the NYSE monthly market returns (VWNY), and then compute the R^2 's between the size regression residuals and the discount regression residuals. They find (see Panel B in their Table III) that the R^2 between the whitened DEC1 returns and the whitened fund discounts is now up to 6.9 percent—still nothing to crow about, perhaps, but higher than their previous 3.5 percent.¹ The 6.9 percent R^2 for the whitened DEC1 is also higher than the 4.1 percent for the whitened DEC10 variable, a result in which Chopra *et al.* take particular satisfaction.

But should they be cheering or crying? Why, after all, should the whitened DEC10 returns be accounting for even as much as 4.1 percent of the variation in the fund discounts? Common small investor sentiment surely cannot explain it. Both the DEC10 returns and the whitening variable VWNY are invoked repeatedly as benchmarks by Chopra *et al.* precisely because they are *not* driven by small investor sentiment. When it comes to explaining variations in the fund discounts, regressions like those in Panel B of their Table III are thus somehow giving them 4.1 percent “for free.” Take that out of the DEC1' or (DEC1 – DEC10)' regressions and we're back down again to

¹ Our figure of 6.9 percent differs from the 9.0 percent they report in their Table III because, after rechecking the data, we found and corrected a number of errors and inconsistencies in the closed-end fund prices and net asset values reported in *The Wall Street Journal*.

a marginal 2.8 percent! And even 2.8 percent is a stretch. Delete just two particularly influential observations (1/74 and 1/75) from their 245-month sample and the comovement vanishes entirely.

With only a trifling 2.8 percent, at most, left to quarrel about, we can safely spare readers (and the patient editor of this journal) the further tedium of going over in detail other claims of Chopra *et al.* that cannot stand up to close inspection (such as their TriCon tests). It's time for all of us to move on to more promising matters.

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REFERENCE

- Chopra, Novin, Charles M. C. Lee, Andrei Shleifer, and Richard H. Thaler, 1993, Yes, discounts on closed-end funds are a sentiment index, *Journal of Finance* 48, 801–808.