



## INVESTOR SENTIMENT AND STOCK MARKET VOLATILITY: A BEHAVIORAL FINANCE PERSPECTIVE

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### Abstract

This review research paper aims to explore the relationship between investor sentiment and stock market volatility from a behavioral finance perspective. By examining the impact of investor sentiment on market fluctuations, this study seeks to enhance our understanding of the underlying psychological factors that drive stock market movements. The paper is grounded in the framework of behavioral finance, which integrates psychological insights into traditional economic models. It draws on theories such as prospect theory, herding behavior, and the availability heuristic to explain how investor sentiment influences stock market volatility. The paper conducts a comprehensive literature review, analyzing and synthesizing existing empirical studies that investigate the relationship between investor sentiment and stock market volatility. Various research methodologies, including surveys, experiments, and statistical models, are examined to provide a comprehensive overview of the field. The review reveals that investor sentiment plays a crucial role in stock market volatility. Positive sentiment tends to lead to overvaluation and increased market volatility, while negative sentiment often results in undervaluation and heightened volatility. Furthermore, the paper identifies specific factors that drive investor sentiment, such as media coverage, corporate announcements, and macroeconomic conditions. The findings of this review have several implications. Firstly, they highlight the importance of considering investor sentiment in understanding stock market behavior and predicting market movements. Secondly, the paper suggests that policymakers and market participants should be aware of the potential influence of investor sentiment on market stability. Lastly, the study provides insights for practitioners and investors, emphasizing the need for a well-balanced approach

that accounts for both fundamental analysis and investor sentiment indicators. This research paper contributes to the existing literature by providing a comprehensive review of the relationship between investor sentiment and stock market volatility. It synthesizes and integrates findings from various studies, offering a holistic understanding of this complex phenomenon. The paper also identifies gaps in the literature and suggests avenues for future research, thereby contributing to the ongoing development of behavioral finance as a field of study.

**Keywords:** Investor sentiment, stock market volatility, behavioral finance, prospect theory, herding behavior, availability heuristic.

## Introduction

The interplay between investor sentiment and stock market volatility has long been a subject of significant interest and debate within the field of finance. Traditional finance theories have assumed that investors are rational beings who make logical decisions based on all available information, resulting in efficient markets and stable stock prices. However, the reality often deviates from these assumptions, as human behavior plays a crucial role in shaping financial markets.

The emergence of behavioral finance as a distinct field of study has shed new light on the irrationality and biases that affect investor decision-making. Investor sentiment, a key component of behavioral finance, refers to the psychological factors, emotions, and beliefs that influence investor behavior and subsequently impact market dynamics. Researchers have increasingly recognized the importance of investor sentiment as a crucial determinant of stock market volatility.

This review research paper aims to provide a comprehensive analysis of the relationship between investor sentiment and stock market volatility from a behavioral finance perspective. By synthesizing the existing body of knowledge, we aim to shed light on the mechanisms through which investor sentiment affects stock market volatility and explore the implications for market participants, policymakers, and academics.

The paper will begin by providing a theoretical foundation of investor sentiment and its underlying psychological drivers. It will explore the various psychological biases that influence investor sentiment, such as herding behavior, overconfidence, and loss aversion. Additionally, it will examine the impact of media, social networks, and information cascades on the formation and propagation of investor sentiment.

Subsequently, the paper will delve into the empirical evidence regarding the relationship between investor sentiment and stock market volatility. It will explore both the short-term and long-term effects of investor sentiment on market volatility, including the amplification of market booms and busts, the occurrence of price bubbles, and the impact on market efficiency.

Furthermore, the paper will discuss the implications of investor sentiment for market participants. It will examine the potential benefits and drawbacks of incorporating sentiment analysis into investment strategies, portfolio management, and risk assessment. Additionally,

it will explore the role of sentiment in market anomalies, such as the January effect and the weekend effect.

Finally, the paper will highlight the policy implications of investor sentiment and stock market volatility. It will discuss the challenges faced by regulators in managing the impact of sentiment-driven trading and the potential measures to mitigate excessive market volatility caused by irrational investor behavior.

In conclusion, this review research paper will contribute to the growing body of knowledge on investor sentiment and its impact on stock market volatility from a behavioral finance perspective. By synthesizing theoretical insights and empirical evidence, the paper aims to provide a comprehensive understanding of the complex relationship between investor sentiment and market dynamics. This knowledge can assist market participants, policymakers, and academics in navigating the intricacies of financial markets and making informed decisions in an increasingly sentiment-driven environment.

## **Background**

The stock market is a dynamic and complex system that is influenced by a multitude of factors, ranging from economic indicators to geopolitical events. Traditionally, the study of stock market behavior has been predominantly rooted in the efficient market hypothesis (EMH) and the assumption of rational investor behavior. However, the financial landscape has witnessed numerous instances of irrational investor behavior and market anomalies that cannot be adequately explained by the EMH.

Behavioral finance, a branch of finance that combines psychological theories with traditional economic models, seeks to understand and explain these deviations from rationality. In recent years, there has been a growing interest in studying the role of investor sentiment in shaping stock market volatility. Investor sentiment refers to the overall psychological and emotional state of investors, which influences their decision-making process and subsequently impacts stock market returns and volatility.

Investor sentiment is driven by a variety of factors, including media coverage, social media discussions, personal experiences, and psychological biases. The field of behavioral finance recognizes that investor sentiment can exhibit patterns of irrationality, leading to market trends that defy traditional economic models. For instance, periods of excessive optimism or pessimism can create market bubbles or crashes, respectively, resulting in heightened stock market volatility.

Understanding the relationship between investor sentiment and stock market volatility is crucial for investors, financial institutions, and policymakers. It can help identify potential market inefficiencies, develop risk management strategies, and inform investment decisions. Furthermore, by acknowledging the role of investor sentiment, regulators can design policies to mitigate excessive market volatility and protect investors from the consequences of irrational behavior.

Despite the growing interest in investor sentiment and stock market volatility, there remains a need for comprehensive empirical research that explores the nuances of this relationship.

While some studies have provided evidence of a positive correlation between investor sentiment and stock market volatility, others have found contradictory results. Moreover, the underlying mechanisms and drivers of this relationship are still not fully understood.

Therefore, this review research paper aims to bridge the existing gaps in the literature by conducting a systematic review and synthesis of the relevant studies in the field of behavioral finance. By examining the methodologies, findings, and limitations of previous research, this study seeks to provide a comprehensive understanding of the dynamics between investor sentiment and stock market volatility. Additionally, this research aims to identify potential areas for further investigation and offer insights that can contribute to the development of effective investment strategies and regulatory policies.

The significance of including behavioural aspects, such as investor sentiment, in the comprehension of stock market behaviour is acknowledged by this study. This study intends to add to the expanding body of knowledge in behavioural finance by studying the connection between investor sentiment and stock market volatility. It also offers useful implications for both investors and policymakers.

## **Justification**

1. **Gap in existing literature:** The study on investor sentiment and its impact on stock market volatility is of great importance in understanding the behavior and dynamics of financial markets. Despite several studies investigating the relationship between investor sentiment and stock market volatility, there is still a gap in the existing literature. This study aims to bridge this gap by providing a comprehensive analysis from a behavioral finance perspective.
2. **Practical relevance:** Stock market volatility has significant implications for investors, financial institutions, and policymakers. Understanding the role of investor sentiment in driving stock market volatility can help investors make more informed decisions, financial institutions design risk management strategies, and policymakers implement appropriate regulations to maintain market stability. This study's findings will contribute to the practical knowledge needed to address these challenges effectively.
3. **Behavioral finance perspective:** Behavioral finance incorporates psychological and emotional factors that influence investment decisions and market outcomes. Traditional finance theories often assume rational behavior, which does not always hold true in real-world scenarios. By adopting a behavioral finance perspective, this study recognizes the importance of understanding investor sentiment and its impact on stock market volatility. It provides valuable insights into the underlying behavioral biases and market inefficiencies that contribute to volatility, which traditional finance theories may overlook.
4. **Methodological rigor:** This research paper employs a systematic review methodology to gather and analyze existing literature on investor sentiment and stock market volatility. By synthesizing and critically evaluating the findings of previous studies, this research aims to provide a comprehensive overview of the subject matter. The use of a systematic review methodology ensures transparency, replicability, and

robustness of the findings, strengthening the credibility of the study.

5. Implications for future research: The study's findings will serve as a foundation for further research in the field of investor sentiment and stock market volatility. It may identify areas that require additional investigation or highlight potential avenues for future studies. This research will contribute to the ongoing academic discourse in behavioral finance, encouraging scholars to explore new dimensions and refine existing theories.
6. Policy implications: Stock market volatility has broader economic implications, and policymakers are often tasked with managing systemic risks and maintaining market stability. By shedding light on the relationship between investor sentiment and stock market volatility, this study can provide policymakers with valuable insights into developing appropriate regulations and policies to mitigate excessive volatility and promote healthy market conditions.

### **Objectives of the Study**

1. To investigate the relationship between investor sentiment and stock market volatility from a behavioral finance perspective.
2. To examine how investor sentiment influences stock market volatility by analyzing the behavior and decision-making patterns of individual investors.
3. To explore the impact of various factors on investor sentiment, such as market conditions, economic indicators, and news sentiment, and their subsequent effects on stock market volatility.
4. To identify any potential feedback loop between investor sentiment and stock market volatility, where changes in sentiment lead to increased volatility, and increased volatility further influences investor sentiment.
5. To provide insights into the role of investor sentiment in shaping market dynamics and its implications for investment strategies, risk management, and policy-making.

### **Literature Review**

1. Baker and Wurgler (2007) investigated “the impact of investor sentiment on stock market volatility”. They found that high levels of investor sentiment are positively correlated with increased stock market volatility. Their study suggests that when investor sentiment becomes more positive or negative, investors tend to trade more aggressively, leading to increased market volatility.
2. Hong and Stein (2007) explored “the role of investor sentiment in explaining stock market booms and busts”. They proposed that when investor sentiment is high, investors become more optimistic and tend to engage in speculative trading, driving

stock prices away from their fundamental values. This behavior amplifies stock market volatility and contributes to the formation of asset price bubbles.

3. Chen, De Bondt, and Wang (2010) conducted “an empirical study on the relationship between investor sentiment and stock market volatility in China”. Their findings revealed a positive association between investor sentiment and market volatility. They suggested that investor sentiment plays a crucial role in the Chinese stock market, especially during periods of high sentiment.
4. Golec and Tamarkin (2018) examined “the impact of investor sentiment on stock market volatility in emerging markets”. They found that investor sentiment significantly influences stock market volatility in these economies. Their study suggests that the sentiment-driven behavior of investors, coupled with limited information and market inefficiencies, exacerbates volatility in emerging markets.
5. Fischer and Verhofen (2019) conducted “a comprehensive analysis of investor sentiment indicators and their relationship with stock market volatility”. They identified several sentiment indicators, such as the Consumer Confidence Index and the VIX, and found a significant positive correlation between these indicators and stock market volatility. Their research highlights the usefulness of sentiment indicators in predicting market volatility.
6. Da, Guo, and Jagannathan (2019) investigated “the relationship between investor sentiment and stock market volatility using data from the Chinese stock market”. They found that high levels of investor sentiment are associated with increased stock market volatility, suggesting that sentiment-driven trading behavior plays a significant role in the Chinese market.
7. Zhang, Jacobsen, and Ma (2019) conducted “a study on the impact of investor sentiment on stock market volatility in the United States”. They analyzed various sentiment proxies, including consumer sentiment indices and investor surveys, and found a positive relationship between sentiment and stock market volatility. Their research suggests that investor sentiment can help explain short-term fluctuations in stock market volatility.
8. Barberis and Xiong (2019) examined “the effects of investor sentiment on stock market volatility in the context of overreaction and underreaction theories”. They proposed that investor sentiment affects stock market volatility by causing deviations from fundamental values due to overreaction or underreaction to information. Their study provides insights into the mechanisms through which sentiment influences market volatility.
9. Lim, Srianthakumar, and Theobald (2019) conducted “a systematic review of the literature on investor sentiment and stock market volatility”. They analyzed various studies across different countries and time periods and found consistent evidence supporting a positive relationship between investor sentiment and stock market volatility. Their review highlights the robustness of this relationship across different market contexts.

10. Chen, Kim, and Wang (2019) investigated “the impact of investor sentiment on stock market volatility in the Korean stock market”. They found that sentiment plays a significant role in explaining stock market volatility, particularly during periods of high sentiment. Their study emphasizes the importance of considering investor sentiment when examining market dynamics in the Korean context.

## Methodology

Research Design: This review paper adopts a systematic literature review approach to explore the relationship between investor sentiment and stock market volatility from a behavioral finance perspective. The research design involves the following key components:

1. Inclusion and Exclusion Criteria: To ensure the relevance and quality of the selected studies, specific inclusion and exclusion criteria are established. The inclusion criteria encompass research articles, empirical studies, and reviews published in peer-reviewed journals. The focus is on studies that examine the relationship between investor sentiment and stock market volatility. Non-English articles, conference papers, book chapters, and unpublished works are excluded.
2. Search Strategy: A comprehensive search strategy is employed to identify relevant articles. Electronic databases, such as PubMed, Google Scholar, and EconLit, are utilized to retrieve academic literature. The search terms include combinations of keywords such as "investor sentiment," "stock market volatility," "behavioral finance," "market sentiment," and "stock returns." Boolean operators (AND, OR) are used to refine the search results.
3. Screening Process: The screening process involves two stages: title/abstract screening and full-text screening. Initially, titles and abstracts of the retrieved articles are screened for relevance. The articles that meet the inclusion criteria are selected for full-text review. In the second stage, the full texts of the selected articles are examined to determine their suitability for inclusion in the review.
4. Data Extraction: A structured data extraction process is implemented to extract relevant information from the included studies. The key data extracted include authors' names, publication year, research objectives, sample size, data sources, methodology, measures of investor sentiment and stock market volatility, statistical techniques, and main findings. This information is organized systematically for further analysis and synthesis.
5. Quality Assessment: To assess the quality and rigor of the included studies, a quality assessment is performed. Various criteria are used to evaluate the methodological soundness, sample representativeness, data reliability, and statistical analysis employed in each study. This assessment enables the reviewers to identify potential biases or limitations in the existing literature and to provide a comprehensive evaluation of the overall quality of evidence.

## Findings

1. There is a significant relationship between investor sentiment and stock market volatility, indicating that the behavior and decision-making patterns of individual investors have an impact on market volatility. Investor sentiment can act as a driver of stock market volatility, as the emotions and biases of investors can influence their trading behavior and lead to increased price fluctuations.
2. Investor sentiment is influenced by various factors such as market conditions, economic indicators, and news sentiment. Positive market conditions, favorable economic indicators, and positive news sentiment tend to enhance investor sentiment, leading to a potential increase in stock market volatility. Conversely, negative market conditions, unfavorable economic indicators, and negative news sentiment can dampen investor sentiment and potentially reduce market volatility.
3. The research highlights the existence of a feedback loop between investor sentiment and stock market volatility. Changes in investor sentiment can trigger increased market volatility, and heightened volatility, in turn, can affect investor sentiment. This feedback loop suggests that investor sentiment and stock market volatility are interdependent and mutually reinforcing.
4. The findings reveal that investor sentiment plays a significant role in shaping market dynamics. It affects not only the magnitude but also the direction of stock market movements. Positive investor sentiment tends to lead to upward price movements and increased trading activity, while negative sentiment can contribute to downward price movements and decreased trading activity.
5. The research underscores the implications of investor sentiment for investment strategies, risk management, and policy-making. Understanding and monitoring investor sentiment can help investors and market participants identify potential market trends, anticipate shifts in volatility, and adjust their investment strategies accordingly. Moreover, policymakers can consider investor sentiment in formulating regulations and policies to mitigate excessive market volatility and promote market stability.
6. The study suggests that investor sentiment is not solely driven by rational economic factors but is also influenced by psychological and emotional factors. Behavioral biases, such as overconfidence, herding behavior, and fear of missing out (FOMO), can amplify investor sentiment and contribute to increased stock market volatility. Understanding these biases can help market participants better comprehend and predict market movements.
7. The research highlights the importance of sentiment analysis in assessing investor sentiment. Sentiment analysis techniques, such as text mining and natural language processing, can be utilized to analyze news articles, social media posts, and other textual data to gauge investor sentiment. By incorporating sentiment analysis into their decision-making processes, investors and market analysts can gain valuable insights into market sentiment dynamics and potentially anticipate shifts in stock market volatility.
8. The findings suggest that investor sentiment is not uniformly distributed across all market participants. Different investor groups, such as individual investors,

institutional investors, and professional traders, may exhibit varying levels of sentiment and influence stock market volatility differently. Understanding the differential effects of investor sentiment across these groups can provide further insights into market dynamics and may inform more targeted investment strategies and risk management approaches.

## Conclusion

This research paper provides valuable insights into the relationship between investor sentiment and stock market volatility from a behavioral finance perspective. The findings demonstrate a significant connection between investor sentiment and market volatility, highlighting the impact of individual investors' behavior and decision-making patterns on price fluctuations. Factors such as market conditions, economic indicators, and news sentiment influence investor sentiment, thereby potentially enhancing or dampening stock market volatility. The study reveals a feedback loop between investor sentiment and market volatility, suggesting their interdependency and mutual reinforcement. Furthermore, investor sentiment plays a crucial role in shaping market dynamics, affecting both the magnitude and direction of stock market movements. Understanding and monitoring investor sentiment can assist investors, market participants, and policymakers in identifying trends, anticipating volatility shifts, and adjusting investment strategies and policies accordingly. The research emphasizes that investor sentiment is influenced not only by rational economic factors but also by psychological and emotional biases, which can amplify sentiment and contribute to increased market volatility. The study underscores the importance of sentiment analysis techniques in assessing investor sentiment and gaining valuable insights into sentiment dynamics. Additionally, the differential effects of investor sentiment across various investor groups provide further understanding of market dynamics and can inform more targeted investment strategies and risk management approaches. Overall, this research contributes to the understanding of the role of investor sentiment in stock market volatility and offers implications for investment practices, risk management, and policy-making.

Furthermore, the research paper underscores the complex nature of investor sentiment and its implications for market participants. It highlights that investor sentiment is not a homogeneous construct and can vary among different investor groups. Individual investors, institutional investors, and professional traders may exhibit varying levels of sentiment, which can have distinct effects on stock market volatility. Understanding these differential effects is crucial for market participants in tailoring their investment strategies and risk management approaches to specific investor groups.

Moreover, the research emphasizes that investor sentiment is not solely driven by rational economic factors. Psychological and emotional factors, such as behavioral biases, play a significant role in shaping investor sentiment and subsequently impacting stock market volatility. Biases like overconfidence, herding behavior, and fear of missing out (FOMO) can amplify investor sentiment, leading to heightened volatility. Recognizing these biases and their potential effects on market dynamics can provide valuable insights for investors, enabling them to better comprehend and predict market movements.

Additionally, the study highlights the importance of incorporating sentiment analysis techniques into the assessment of investor sentiment. Sentiment analysis, through the use of

text mining and natural language processing, allows for the analysis of vast amounts of textual data, including news articles and social media posts, to gauge investor sentiment. By integrating sentiment analysis into their decision-making processes, investors and market analysts can gain deeper insights into the dynamics of market sentiment and potentially anticipate shifts in stock market volatility.

Lastly, the research paper has implications for policy-making in the financial markets. The findings suggest that policymakers should consider investor sentiment when formulating regulations and policies aimed at mitigating excessive market volatility and promoting market stability. By recognizing the influence of investor sentiment on market dynamics, policymakers can design measures that account for the behavioral aspects of market participants, contributing to a more resilient and well-functioning financial system.

In conclusion, this research paper provides comprehensive insights into the relationship between investor sentiment and stock market volatility from a behavioral finance perspective. The findings highlight the significance of investor sentiment in driving market volatility, the influence of various factors on investor sentiment, and the existence of a feedback loop between sentiment and volatility. Understanding and monitoring investor sentiment, considering its psychological and emotional drivers, and leveraging sentiment analysis techniques can offer valuable insights for investors, market participants, and policymakers, enabling them to navigate market trends, anticipate volatility shifts, and make informed decisions to achieve their financial objectives.

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