Article Type: Research Paper

Investor sentiment and herding in Islamic stocks: An exploration of the moderating role of market capitalization

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Abstract

Research aims: This study examines the impact of investor sentiment on herding behavior in the Indonesian Islamic stock market, with market capitalization as a moderating variable.

Design/Methodology/Approach: A quantitative approach is used with secondary data from the Indonesian Stock Exchange (IDX) in the period 2022-2023 on 70 Islamic companies. Investor sentiment was measured using the Google Search Volume Index (GSVI), while herding behavior was analyzed using the Lakonishok, Shleifer, and Vishny (LSV) method. Market capitalization is categorized into blue chip, middle chip, and lower chip, and moderated regression analysis (MRA) is applied. The data used meets the criteria of 136 data.

Research findings: Investor sentiment significantly influences herding behavior among domestic and foreign investors. Positive sentiment drives stock purchases, while negative sentiment accelerates sell-offs. Market capitalization strengthens the impact of sentiment on herding, especially in small-cap stocks, which are more sensitive to market fluctuations.

Theoretical contribution/ Originality: This study highlights the moderating role of market capitalization in sentiment-driven herding, providing new insights into the dynamics of Islamic stock markets.

Practitioner/Policy implication: Regulators should monitor sentiment-driven volatility, while investors need to consider market capitalization when making decisions to mitigate risks.

Research limitation/Implication: This study is limited to the Indonesian Islamic stock market and uses GSVI as the sole sentiment measure. Future research could explore broader sentiment indicators for deeper insights.

Keywords: Herding Behavior; Investor Sentiment; Islamic Stocks; Market Capitalization

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DOI: 10.18196/jai.v26i2.25951

CITATION:
Pranata, R. M., Jamaludin, A., Nandang, N., & Wanta, W. (2025). Investor sentiment and herding in Islamic stocks: An exploration of the moderating role of market capitalization. *Journal of Accounting and Investment, 26*(2), 787-802.

ARTICLE HISTORY
Received:
17 Feb 2025
Revised:
22 Apr 2025
19 May 2025
Accepted:
20 May 2025

JAI Website:

Introduction

Herding behavior, defined as the tendency of investors to follow the majority rather than rely on fundamental information, has long been a concern in financial studies. From an Islamic economic perspective, herding without rational analysis can contradict sharia principles, as it neglects the values of prudence and the use of reason (*ʿaql*), which are essential in muamalah transactions. When investors blindly follow others without understanding the substance of the transaction, such actions may involve elements of *gharar* (uncertainty), which is prohibited in Islam due to its potentially harmful and speculative nature (Maulana & Rozak, 2021).

In global stock markets, herding behavior is often linked to high price volatility and reduced market efficiency (Chiang & Zheng, 2010). In Islamic stock markets, this behavior becomes even more relevant due to sectoral restrictions and ethical principles that differentiate them from conventional markets (Rizal & Damayanti, 2019).

In Indonesia, the Islamic stock market continues to grow, with the Jakarta Islamic Index (JII) as one of the indices that shows significant growth in market capitalization every year. Data from the Financial Services Authority (FSA) noted that Islamic stock market capitalization reached 47% of the total stock market capitalization in Indonesia in 2021, with the number of investors increasing every year (Zakie & Rafik, 2017). However, research on herding behavior in Islamic stocks is still limited compared to conventional markets.

Herding in the Islamic stock market exhibits unique dynamics. Some literature finds that the ethical principles underpinning Islamic markets, such as the prohibition of speculation (*gharar*) and usury, can reduce herding tendencies (Medhioub & Chaffai, 2018). However, other studies show that herding still occurs, especially when the market experiences extreme conditions, such as significant declines (Rizal & Damayanti, 2019).

The different characteristics of Islamic and conventional stocks add to the complexity of herding analysis. For example, Islamic stocks often attract retail investors with varying levels of financial literacy, so their investment decisions may be influenced more by investor sentiment than fundamental analysis (Chaffai & Medhioub, 2018).

Investor sentiment is one of the important variables in influencing herding behavior. Optimistic sentiment, for example, can trigger collective stock purchases, while pessimistic sentiment often triggers mass sell-offs (Ah Mand et al., 2021). In the context of Islamic stock markets, investor sentiment is not only influenced by economic information but also by moral and religious factors. Studies on the GCC stock market found that Islamic investors exhibit stronger herding patterns during periods of high volatility (Medhioub & Chaffai, 2018).

Research into the role of investor sentiment as a driver of herding behavior has been a major focus in the behavioral finance literature. Ren and Wu (2020) used text-based sentiment analysis to identify herding behavior in the Chinese stock market, finding that investors with pessimistic sentiments were more likely to exhibit herding behavior than those who were optimistic (Ren & Wu, 2020). A similar study by Yoon and Oh (2022) highlighted the influence of social media in shaping sentiments that trigger herding, especially among retail investors after the COVID-19 pandemic (Yoon & Oh, 2022).

Sibande et al. (2021) revealed that anti-herding behavior in the currency market depends on the extremes of investor sentiment, where bullish sentiment tends to strengthen anti-herding compared to neutral sentiment. In the UK mutual fund market, Hudson et al. (2018) showed herding among fund managers influenced by investor sentiment in a unidirectional manner, with different fund structures resulting in varying herding patterns.

Research by Choi and Yoon (2020) reveals that herding behavior in the Korean stock market is prevalent during periods of extreme market conditions, with investor sentiment playing a significant role in driving this phenomenon. Similarly, Vieira and Pereira (2015) examined the connection between investor sentiment and the intensity of herding in Portugal's market. However, their findings indicate that sentiment has a limited impact on herding behavior in this smaller market.

Another study by Blasco et al. (2018) noted that high sentiment at the time of negative information release increases herding among financial analysts, while optimism under more easily interpreted conditions tends to reduce herding. In addition, Sheikh et al. (2023) show that herding is more dominant during periods of pessimism in Chinese markets, while in Pakistan, reverse herding behavior appears more frequently.

From a global perspective, Aharon (2020) found that fear, as measured through the VIX index, has a significant impact on herding behavior across all market segments, with higher intensity in small-cap portfolios. Other studies, such as by Kholdy et al. (2021), revealed that investor sentiment affects market volatility through buy-herding and sell-herding mechanisms, with a greater impact on small stocks.

The research indicates that the sentiment of investors significantly influences herd behavior, with variations observed across different market types, sentiment conditions, and structures of financial institutions. These results highlight the need for further studies to understand the complex interactions between sentiment, herding behavior, market dynamics, and the role of market capitalization in moderating these interactions.

Market capitalization is one of the key determinants in herding analysis. Small-cap stocks are often more susceptible to herding behavior due to low liquidity and limited information exposure (Indārs et al., 2019). Small-cap stocks in Islamic markets are especially prone to herding behavior because these stocks tend to attract more retail investors who are less informed and have lower levels of financial literacy. In the Indonesian Islamic stock market, small-cap companies often face challenges in attracting institutional investors, so herding is more likely to occur among retail investors (Zakie & Rafik, 2017).

Research on herding in the Islamic stock market remains very limited, particularly in Indonesia. Most existing literature focuses on conventional markets, with minimal exploration of the role of investor sentiment and market capitalization within the context of Islamic stocks (Ah Mand et al., 2021). Furthermore, the findings from previous studies are often contradictory: some suggest that the ethical principles inherent in Islamic stocks help reduce herding behavior, while others indicate that herding still occurs, especially during periods of extreme market conditions (Rizal & Damayanti, 2019). From an Islamic perspective, herding behavior is generally discouraged, particularly when it is not based on rational analysis or due diligence. Such behavior may violate Sharia principles by leading to decisions driven by speculation, emotion, or social pressure rather than informed judgment. It can potentially introduce elements of gharar (uncertainty) and

maysir (speculation), which are prohibited in Islam, thus rendering irrational herding behavior impermissible in the framework of Islamic finance.

This study aims to fill this gap by investigating whether herding behavior is more dominant in Islamic stocks or tends to be anti-herding. Additionally, this research explores the moderating role of market capitalization, particularly focusing on small-cap stocks, and examines how investor sentiment influences herding behavior within the Indonesian Islamic stock market.

Literature Review and Hypotheses Development

The Islamic View of Behavioral Finance

As a subfield of finance, behavioral finance examines the impact of psychological and social elements on financial decision-making, including within Islamic finance. The unique framework of Islamic finance, governed by Sharia principles that forbid riba (interest), *gharar* (uncertainty), and *maysir* (speculation), results in investor behavior that differs from conventional financial systems (Ramadhani, 2019). Research indicates that financial conduct in Islamic finance is influenced by a blend of moral, ethical, and psychological factors, prompting investors to make choices that are not only rational but also aligned with their religious beliefs (Boukerroucha & Bouheraoua, 2022).

In Islamic finance, the integration of Islamic values with behavioral finance theory creates an opportunity to understand market dynamics better. One aspect discussed is how religious beliefs can influence behavioral biases such as herding. For example, studies found that investors in Islamic financial systems tend to avoid speculation and focus on real asset-based investments, which can mitigate some of the negative impacts of behavioral biases such as overconfidence and loss aversion (Abdelsalam & El-Komi, 2016). Social and moral aspects are also important factors in Islamic wealth management. Al-Abbadi and Abdullah (2017) highlight that psychology-based financial management in the Islamic context seeks to promote social welfare through socially responsible investments. This approach helps investors to not only achieve personal financial goals but also contribute to the development of the wider society.

In comparison to conventional finance, the study of behavioral finance within Islamic finance remains a relatively nascent field. Numerous studies indicate that adopting a behavioral approach in Islamic finance shows considerable promise for addressing current gaps in the academic literature. Boukerroucha and Bouheraoua (2022) note that harmonization between market efficiency and behavioral finance approaches can help create a more stable Islamic market that is aligned with Islamic values.

The Effect of Investor Sentiment Towards Herding Behavior

Investor sentiment is a psychological factor that strongly influences investment decision-making, including the tendency to engage in herding behavior. Investor sentiment is

defined as a collective emotional state that reflects overall market optimism or pessimism. When optimistic sentiment dominates, investors tend to exhibit uniform stock-buying behavior, following the actions of the majority, who are considered safer or more profitable (Ren & Wu, 2020). Conversely, when pessimistic sentiment dominates, investors tend to sell stocks en masse, reflecting widespread fear or concern (Yoon & Oh, 2022).

Sentiment-driven herding can occur under extreme market conditions. During bullish market periods, excessive optimism often leads to excessive copycat behavior, where investors follow market trends without considering fundamental analysis (Choi & Yoon, 2020). Conversely, in bearish market periods, negative sentiment triggers massive sell-offs, reinforcing herding behavior based on fear or concern of potential further losses (Sibande et al., 2021).

In Islamic markets, sentiment also has a moral and religious dimension. Investors influenced by moral beliefs tend to make decisions based not only on economic information but also on ethical principles, such as fairness and sustainability. However, in situations of high uncertainty, negative sentiment can still drive herding behavior in Islamic markets, similar to what is observed in conventional markets (Boukerroucha & Bouheraoua, 2022).

The relationship between sentiment and herding reflects how investors' collective emotions can direct market behavior. In many cases, sentiment-driven herding creates market imbalances, such as price bubbles or sharp market declines. Therefore, understanding the influence of sentiment on herding is essential to identify market behavior patterns and develop appropriate mitigation strategies. The objective of this research is to delve deeper into the connection within the realm of Islamic equities, where ethical and faith-based considerations significantly influence investment choices.

H_1: *Investor sentiment positively affects herding behavior in Islamic stocks.*

Moderation Role of Market Capitalization

Investor sentiment is a key factor influencing herding behavior, but its influence may vary depending on market capitalization conditions. Market capitalization reflects the size and total value of a company as reflected by its share price. Large-cap stocks tend to have high liquidity and better information exposure, so sentiment-driven herding behavior may be more restrained in these markets (Indārs et al., 2019). In contrast, small-cap stocks are often less liquid, with more limited information, and thus more susceptible to sentiment-driven herding, whether optimistic or pessimistic (Sibande et al., 2021).

When optimistic sentiment dominates, small-cap stocks often experience disproportionate price increases as investors tend to follow the collective trend without considering the fundamental value of the company (Yoon & Oh, 2022). Conversely, under

conditions of pessimistic sentiment, small-cap stocks are more prone to mass sell-offs due to their low liquidity and high influence on collective decisions (Choi & Yoon, 2020).

On the other hand, large-cap stocks often have more dominant institutional investors, who tend to make decisions based on fundamental analysis. Therefore, sentiment has a more limited influence on herding behavior in the large-cap stock market. However, during periods of high volatility or market crises, even large-cap stocks can exhibit herding, especially when collective sentiment reaches extremes (Hudson et al., 2018).

H_2: *Market capitalization moderates the effect of investor sentiment on herding behavior in Islamic stocks.*

The conceptual framework describes and explains the relationship between investor sentiment and herding moderated by market capitalization. Figure 1 below presents the conceptual framework.

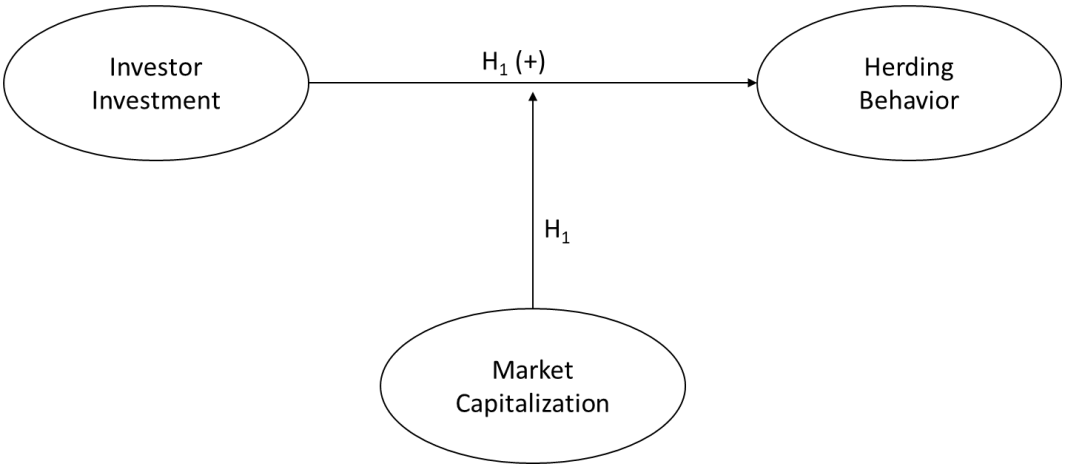

Figure 1 Conceptual Framework

Research Method

Employing a quantitative methodology, this research aims to investigate the correlation between investor sentiment and herd behavior in Islamic firms listed on the Indonesia Stock Exchange (IDX), with market capitalization serving as a moderating factor. The investigation utilizes secondary data obtained from credible sources, including Google Trends for investor sentiment information and the IDX for stock market statistics.

The population in this study consists of all Islamic companies listed on the JII index BEI from 2022 to 2023, with 70 Islamic companies used as research samples. This sample selection includes all Islamic companies without sector discrimination, thus providing a broader representation of the Islamic market in Indonesia.

The measurement of herding in this study uses the Lakonishok, Shleifer, and Vishny (LSV) approach, which is a popular method for measuring the intensity of collective behavior (herding) in financial markets. The LSV method calculates how far the proportion of buy or sell transactions by investors in a particular stock deviates from the market average, thus providing a clear metric for identifying herding patterns. In this study, the herding analysis is conducted in detail for the buy and sell sides and differentiated by domestic and foreign investors. The LSV formula is customized for each category, namely:

$$LVS_{i,t} = \left|\frac{B_{i,t}}{N_{i,t}} - P_t\right| - AF_{i,t} \ldots (1)$$

$LSV_{i,t}$ is the herding measure for the i-th stock at time t, representing the extent to which investors collectively follow similar trading behavior. $B_{i,t}$ denotes the number of investors who buy or sell the i-th stock at time t, while $N_{i,t}$ represents the total number of investors actively trading the i-th stock at the same time. P_t refers to the expected probability of stock purchases at time t, which is anticipated to be close to the average proportion of purchases. Lastly, $AF_{i,t}$ is an adjustment factor that accounts for random variations around P under the independent decision hypothesis, ensuring a more accurate assessment of herding behavior. A significant positive LSV value indicates the presence of a herding phenomenon in the stock.

Investor sentiment is measured using GSVI (Google Search Volume Index). GSVI is a quantitative indicator that represents the volume of online searches related to a particular stock or market on Google (Da et al., 2011). GSVI is calculated based on search trends that indicate investor interest in a particular stock. This research adopts keywords relevant to the sample companies, such as “AALI”, and “BRIS”. GSVI is considered to reflect investor sentiment, as increased search volume is usually associated with market optimism or uncertainty.

Market capitalization is used as a moderating variable in this study. The company's market capitalization is divided into three categories. *Blue Chip* companies are those with the largest market capitalization, often characterized by price stability and high liquidity, making them attractive to investors seeking lower risk. *Middle Chip* companies fall into the medium capitalization category, displaying moderate liquidity, which positions them between stability and growth potential. *Lower Chip* companies, on the other hand, have small capitalization and are more susceptible to market volatility and herding behavior, making them riskier investments with potentially higher returns.

The research model uses moderated regression analysis to test the effect of investor sentiment on herding with market capitalization as a moderating variable. The model used is:

$$Herding_{i,t} = \beta_0 + \beta_1 Sentiment_{i,t} + \beta_2 Market\ Cap_i + \beta 3\ (Sentiment_{it} \times Market\ Cap_i) + e_i \ldots (1)$$

Where $Herding_{i,t}$ represents the herding behavior in company i at time t, reflecting the tendency of investors to follow collective trading patterns. $Sentiment_{i,t}$ captures investor sentiment, which is measured using the GSVI to gauge market perception. $Capitalization_i$ classifies companies based on their market capitalization, distinguishing them into different investment categories. The interaction term ($Sentiment_{i,t} \times MarketCap_i$) serves as a moderating variable, examining how investor sentiment interacts with market capitalization to influence herding behavior. Lastly, $e_{i,t}$ represents the error term, accounting for unobserved factors that may affect the model's estimations.

Result and Discussion

This section presents the results and discusses the study, examining the relationship between investor sentiment and herding behavior in Islamic stocks moderated by market capitalization. The analysis is based on a quantitative approach using secondary data from 70 firm-year observations of Islamic companies listed on the JII at the IDX during 2022 and 2023. This sample includes all Islamic firms on the JII without sectoral restrictions, providing a broad representation of the Islamic stock market in Indonesia. Investor sentiment data were obtained from Google Trends, while stock and market capitalization data were sourced from the IDX. The following discussion explores how investor sentiment affects herding behavior and the moderating impact of market capitalization.

Table 1 Descriptive Statistic

Variabel	Mean	Std	Min	Max
Sentiment	47.696	29.669	0.552	98.688
Market Cap	1.710	0.674	1.0	3.0
Buy	4.796	5.938	-4.783	14.810
Sell	31.616	9.681	7.398	57.235
Buy Domestic	0.876	6.173	-9.772	9.994
Sell Domestic	-2.384	11.094	-19.418	19.460
Buy Foreigner	25.388	12.135	4.364	58.713
Sell Foreigner	35.654	15.490	5.581	72.775

Descriptive statistics from Table 1 shows that the average investor sentiment (Sentiment) stands at 47.696 with a standard deviation of 29.669, reflecting a fairly wide variation from a minimum value of 0.552 to a maximum of 98.688. It indicates a diverse level of sentiment in the market, ranging from very low to very high. Meanwhile, market capitalization has an average of 1.710 with a standard deviation of 0.674, ranging from 1 to 3, indicating that most companies fall within the small to medium capitalization categories.

Market activity also exhibits an interesting pattern. The average buying activity is 4.796 with a standard deviation of 5.938, with values ranging from -4.783 to 14.810, indicating that some periods experienced negative buying activity, reflecting market stress. In contrast, selling activity has a much higher average of 31.616 with a standard deviation of 9.681, with values between 7.398 and 57.235, suggesting that the market tends to engage more in selling than buying.

When examining the behavior of domestic investors, the average domestic buying activity is 0.876 with a standard deviation of 6.173, spanning from -9.772 to 9.994, indicating a low level of activity with significant variability, including negative values. Domestic selling activity tends to be negative, with an average of -2.384 and a standard deviation of 11.094, with values ranging from -19.418 to 19.460, suggesting that domestic investors are more inclined to reduce their market positions.

Foreign investors, on the other hand, demonstrate a different pattern. The average buying activity of foreign investors is 25.388, with a standard deviation of 12.135, ranging from 4.364 to 58.713, with no negative values, indicating a more consistent buying pattern. Foreign selling activity is also substantial, averaging 35.654 with a standard deviation of 15.490, with values ranging from 5.581 to 72.775, reflecting the dominance of foreign investors in market activity compared to domestic investors.

Table 2 Hypothesis Analysis Result

Variable	Buy	Sell	Buy Domestic	Sell Domestic	Buy Foreigner	Sell Foreigner
Intercept	-0.63	22.27***	2.11	-4.20	14.97***	18.56***
Sentiment	0.06	0.06	-0.00	-0.02	0.09**	0.26***
Market Cap	3.00**	-1.65	-1.49	3.16	-3.74***	-3.37***
Sentiment x Market Cap	-0.03	0.11***	0.02	-0.03	0.15***	0.13***
R-squared	0.46	0.751	0.23	0.49	0.857	0.890

Note: **p-values < 0.1; **p-values < 0.05; ***p-values < 0.01*

The moderation analysis results (Table 2) show the relationship between sentiment and market capitalization on investor herding behavior in six regression models: Buy, Sell, Buy Domestic, Sell Domestic, Buy Foreigner, and Sell Foreigner. The focus of the analysis includes the main relationships between the variables, the moderating effect (interaction between Sentiment and Market Cap), and the ability of the model to explain the variability of the data. This analysis is conducted to test Hypothesis 1 (H_1), which states that investor sentiment affects herding behavior in Islamic stocks, and Hypothesis 2 (H_2), which posits that market capitalization moderates the effect of investor sentiment on herding behavior in Islamic stocks.

In the Buy model, Sentiment (β = 0.06, p-values > 0.1) is not significant, indicating that investor sentiment does not significantly drive overall buying activity, thus failing to support H_1 in this model. However, Market Capitalization (β = 3.00, p-values < 0.05) has a significant positive effect, suggesting that firms with larger market capitalization experience more buying activity. The moderating effect between Sentiment and Market Cap (β = -0.03, p-values > 0.1) is not significant, meaning that market capitalization does not strengthen the effect of sentiment on buying behavior, thereby failing to support H_2. The Buy model has an R^2 of 0.46 (46%), indicating a moderate ability to explain variability in the data.

In the Sell model, Sentiment (β = 0.06, p-values > 0.1) is not significant, meaning investor sentiment does not significantly impact selling activity, thereby failing to support H_1.

Market Capitalization (β = -1.65, p-values > 0.1) is also not significant, suggesting that firm size does not directly influence selling behavior. However, the moderating effect between Sentiment and Market Cap (β = 0.11, p-values < 0.01) is highly significant, implying that market capitalization strengthens the impact of sentiment on selling behavior, thus supporting H_2 in the Sell model. The Sell model has an R^2 of 0.751 (75.1%), indicating strong explanatory power.

In the Buy Domestic model, Sentiment (β = -0.00, p-values > 0.1) and Market Cap (β = -1.49, p-values > 0.1) are not significant, meaning neither variable significantly influences domestic investor buying behavior, resulting in no support for H_1 in this model. The interaction term (Sentiment × Market Cap, β = 0.02, p-values > 0.1) is also not significant, meaning that market capitalization does not moderate the relationship between sentiment and domestic investor buying, thus failing to support H_2. The Buy Domestic model has an R^2 of 0.23 (23%), suggesting that sentiment and market capitalization have only a minimal impact on domestic investor buying behavior.

In the Sell Domestic model, none of the variables (Sentiment, Market Cap, or the interaction effect) are significant (p-values > 0.1), reinforcing the idea that selling behavior among domestic investors is influenced by other factors. As a result, both H_1 and H_2 are not supported in this model. The Sell Domestic model has an R^2 of 0.49 (49%), suggesting moderate explanatory power but no significant relationships in this model.

In the Buy Foreigner model, Sentiment (β = 0.09, p-values < 0.05) is significant, indicating that investor sentiment encourages buying activity by foreign investors, thereby supporting H_1 in this model. Market Cap (β = -3.74, p-values < 0.01) is highly significant, suggesting that firms with larger market capitalization experience lower foreign investor buying activity. The moderating effect between Sentiment and Market Cap (β = 0.15, p-values < 0.01) is highly significant, meaning that market capitalization strengthens the influence of investor sentiment on foreign buying behavior, thus supporting H_2. The Buy Foreigner model has an R^2 of 0.857 (85.7%), demonstrating a strong ability to explain variance in foreign investor buying behavior.

In the Sell Foreigner model, Sentiment (β = 0.26, p-values < 0.01) is highly significant, showing that investor sentiment strongly influences foreign investor selling behavior, thus supporting H_1. Market Cap (β = -3.37, p-values < 0.01) is also highly significant, indicating that firms with larger market capitalization experience lower selling activity from foreign investors. The moderating effect between Sentiment and Market Cap (β = 0.13, p-values < 0.01) is highly significant, suggesting that market capitalization amplifies the impact of sentiment on selling, thereby supporting H_2. The Sell Foreigner model has an R^2 of 0.890 (89.0%), showing the highest explanatory power among all models.

These results suggest that foreign investors' herding behavior is more responsive to Sentiment and Market Cap compared to domestic investors, aligning with H_1 and H_2 in the case of foreign investors. For foreign investors, the moderating effect of Market Cap strengthens the influence of Sentiment in both buying and selling, which is evident from the relatively high R^2 values (85.7% for buying and 89.0% for selling). In contrast, for

domestic investors, the relationship between Sentiment, Market Cap, and herding behavior is much weaker, with the variables being largely insignificant and R^2 values being lower, indicating no support for H_1 and H_2 in the domestic investor models. This finding confirms the importance of Sentiment in influencing foreign investor behavior, while other factors may be more relevant to explain domestic investor behavior.

The Effect of Investor Sentiment Towards Herding

Herding behavior has long been a concern in financial studies due to its impact on market volatility and price efficiency (Chiang & Zheng, 2010). In the context of the Islamic stock market, herding becomes more complex due to sectoral restrictions and ethical principles that distinguish it from conventional markets (Rizal & Damayanti, 2019). As a subfield of finance, behavioral finance examines the impact of psychological and social elements on financial decision-making, including within Islamic finance. The unique framework of Islamic finance, governed by Sharia principles that forbid riba (interest), *gharar* (uncertainty), and *maysir* (speculation), results in investor behavior that differs from conventional financial systems (Ramadhani, 2019). However, this study shows that investor sentiment still plays a role in driving herding, albeit with different patterns across investor groups.

The results of this study found that investor sentiment has a positive effect on Foreigner Buy herding and Foreigner Sell herding but has no effect on overall Buy herding, overall Sell herding, Domestic Buy herding, and Domestic Sell herding. This finding is in line with previous studies, which show that herding tends to be stronger among foreign investors who have limited access to local information, thus relying more on global sentiment indicators (Medhioub & Chaffai, 2018). Optimistic sentiment among foreign investors can trigger collective buying (buy herding), while pessimistic sentiment causes massive selling (sell herding) (Ah Mand et al., 2021). In this context, studies have found that investors in Islamic financial systems tend to avoid speculation and focus on real asset-based investments, which can mitigate some of the negative impacts of behavioral biases such as overconfidence and loss aversion (Abdelsalam & El-Komi, 2016).

On the other hand, the unproven relationship between investor sentiment and herding among domestic investors suggests that other factors, such as an understanding of local economic conditions and a preference for Islamic value-based investments, may reduce herding tendencies (Chaffai & Medhioub, 2018). Domestic investors may rely more on fundamental information or have a higher level of financial literacy related to the characteristics of Islamic stocks. This finding also supports the view that the principles of prohibiting speculation (*gharar*) and usury in Islamic stocks may inhibit sentiment-driven herding behavior (Medhioub & Chaffai, 2018). Additionally, social and moral aspects in Islamic wealth management promote socially responsible investments, helping investors achieve both personal financial goals and broader societal development (Al-Abbadi & Abdullah, 2017).

Research has demonstrated that sentiment exerts a stronger influence on herding behavior during periods of market volatility (Choi & Yoon, 2020; Sibande et al., 2021). The

findings of this investigation indicate that overseas investors are more susceptible to sentiment fluctuations compared to their domestic counterparts, who tend to exhibit greater consistency in their investment choices. This observation aligns with the work of Blasco et al. (2018), which indicates that elevated sentiment levels coinciding with the release of negative information intensify herding tendencies among institutional investors.

Moreover, this finding also corroborates the view that the Islamic market has unique dynamics in terms of herding. Previous research has found that although Islamic stocks attract value-oriented investors, herding can still occur, especially during high volatility (Medhioub & Chaffai, 2018). In this context, the results indicate that herding in the Islamic stock market is more influenced by foreign investor groups than domestic investors, who may have a more value-based investment approach and Shariah principles. As behavioral finance theory suggests, the integration of Islamic values with investor psychology can lead to more stable and socially responsible market behaviors (Boukerroucha & Bouheraoua, 2022).

The Role of Market Capitalization on Investor Sentiment and Herding Relationships

Market capitalization is an important factor in analyzing herding behavior, especially since small-cap stocks are more susceptible to investor sentiment and market volatility (Indārs et al., 2019). The results of this study show that market capitalization strengthens the relationship between investor sentiment and herding in overall Sell herding, Buy Foreigner herding, and Sell Foreigner herding. This finding is in line with previous studies that found that herding is more intense in stocks with small capitalization due to limited liquidity and limited information exposure (Zakie & Rafik, 2017).

In the Islamic stock market, market capitalization plays a role in determining the level of influence a stock has on investor sentiment. Small-cap stocks tend to be more susceptible to herding behavior due to fewer institutional investors and more limited media exposure (Chaffai & Medhioub, 2018). Research indicates that financial conduct in Islamic finance is influenced by a blend of moral, ethical, and psychological factors, prompting investors to make choices that are not only rational but also aligned with their religious beliefs (Boukerroucha & Bouheraoua, 2022). As a result, when market sentiment deteriorates, investors react more quickly by engaging in massive sell herding, as seen in the results of this study on overall sell herding and foreigner sell herding. Negative sentiment may exacerbate the herding effect on small-cap stocks as investors tend to focus more on liquidity risk and higher fundamental uncertainty than large-cap stocks (Ah Mand et al., 2021).

These findings also suggest that market capitalization plays an important role in the relationship between investor sentiment and buy-foreigner herding. Foreign investors, who often face limitations in understanding specific factors in the Indonesian sharia market, are more likely to engage in buy herding on certain stocks that have smaller capitalization and are more easily influenced by market trends (Medhioub & Chaffai, 2018). In Islamic finance, the integration of Islamic values with behavioral finance theory

creates an opportunity to understand market dynamics better. One aspect discussed is how religious beliefs can influence behavioral biases such as herding. In bullish market conditions, high optimism encourages foreign investors to buy stocks without considering in-depth fundamental analysis (Choi & Yoon, 2020). Thus, the results of this study confirm that market capitalization strengthens the relationship between investor sentiment and buy herding, especially among foreign investors.

The findings of this study have important implications for both investors and policymakers. For investors, especially foreign investors, understanding the role of sentiment in herding behavior is crucial, particularly during periods of market volatility. Investors should be cautious about small-cap stocks, which are more vulnerable to sentiment-driven herding. Regulators can enhance market stability by promoting transparency, improving access to information, and fostering financial literacy to reduce reliance on sentiment indicators.

This study contributes to behavioral finance by highlighting the role of psychological and social factors in the Islamic stock market, where ethical principles like the prohibition of speculation influence investor behavior. The study also underscores the importance of market capitalization in herding behavior, suggesting that behavioral finance models should integrate market characteristics and investor sentiment. This research broadens the scope of behavioral finance by incorporating Islamic ethical values, offering new insights into how sentiment and market dynamics interact in Islamic finance.

Conclusion

The research revealed that market capitalization and investor sentiment significantly influence share trading decisions in the Islamic stock market, particularly among foreign investors, suggesting the presence of herding behavior. The proposed hypothesis regarding the impact of investor sentiment on investment behavior was confirmed, but only among foreign investors, as domestic investors did not exhibit a significant response to sentiment-driven trading. The findings indicate that positive sentiment encourages stock purchases, while negative sentiment prompts sales, aligning with previous studies suggesting that investor sentiment can drive herding behavior. However, contrary to expectations, Sharia principles prohibiting speculation and usury do not entirely mitigate herding behavior, as they remain prevalent, particularly during periods of high market volatility. Market capitalization also plays a crucial role in moderating the effects of sentiment, particularly in foreign investor trading, where larger firms experience less sentiment-driven volatility compared to smaller-cap stocks.

Despite these findings, this study has several limitations, including its focus solely on Islamic stocks, limiting its applicability to conventional markets. Additionally, market capitalization was the only moderating variable analyzed, while other factors, such as macroeconomic conditions, global financial trends, and regulatory policies, could further influence investor sentiment and herding behavior. Future research should explore comparisons between Islamic and non-Islamic markets to assess whether similar patterns

emerge. Policymakers should enhance transparency and financial literacy programs to mitigate irrational trading behavior, while financial institutions can develop risk management strategies tailored to the Islamic stock market. Moreover, investors should incorporate fundamental analysis alongside sentiment trends to avoid excessive speculation. As digital finance continues to evolve, future research should also investigate how emerging technologies and trading platforms shape sentiment and trading behavior in Islamic financial markets.

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Conflicts of Interest

The authors declare no conflict of interest. The funders had no role in the design of the study; in the collection, analyses, or interpretation of data; in the writing of the manuscript, or in the decision to publish the results.