

JFQA 2006 Symposium on Stock Analysts: An Introduction

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PHONE: (206) 543-4598
FAX: (206) 616-1894
E-MAIL: jfqa@u.washington.edu
URL: <http://www.jfqa.org>

University of Washington
School of Business Administration
115 Lewis Box 353200
Seattle, WA 98195-3200 USA

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PURPOSE AND FOCUS

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Hendrik Bessembinder, Editor

Stock analysts process massive amounts of information in an attempt to forecast earnings, assess stock valuations, and recommend investor trading strategies. If analysts possess the appropriate comparative advantage in information processing and have the proper incentives, their efforts can enhance overall welfare by improving the accuracy of market prices and the efficiency of resource allocation. However, both analysts' abilities and their incentives have been the focus of a sometimes contentious debate. The seven papers in this symposium provide new insights into analysts' incentives, information processing capabilities, and potential biases.

Green investigates whether analyst rating changes convey information that is useful to subscribing investors. He notes that clients often pay considerable amounts for access to brokerage firm research reports, even though the recommendations are disseminated to the public via newswire services only hours later. He documents that reports containing rating changes spur marked increases in trading activity upon their dissemination to subscribers. This information is valuable, as subscribers who trade quickly and before the public release of the reports earn post-trading-cost abnormal returns exceeding 1% per event.

Boni and Womack observe that analysts almost always specialize according to industry, and document that the value of analyst recommendations to investors is attributable mainly to their ability to rank stocks *within* the industry in which they specialize, and not to an ability to forecast relative returns across industries. They also document that analysts tend, to their detriment, to change ratings in response to industry returns. Despite the existence of this momentum bias, their evidence supports the conclusion that analysts possess specialized information processing skills.

Cheng, Liu, and Qian observe that, while most research focuses on analysts employed by brokerage firms, institutional investment managers also have access to the recommendations of independent and "buy-side" analysts. They develop a model implying that investment managers' optimal weighting of buy-side and sell-side analyst reports depends on information quality, estimated analyst bias, and the degree of uncertainty about analyst biases, as well as on the quantity of assets under management. Relying on unique survey data, the authors report evidence consistent with the model's implications.

Conrad, Cornell, Landsman, and Rountree describe how studying analyst responses to new public information can potentially distinguish whether analysts develop private information and whether they are biased in their public recommendations. They document that analysts are likely to downgrade stocks following substantial price declines, but do not find a similar effect after substantial price increases. The authors argue that this evidence is consistent with a conflict of interest hypothesis, where analysts are reluctant to downgrade stocks on the basis of their private information.

However, Clarke, Ferris, and Jayaraman also investigate the assertion that analysts are slow to downgrade stocks, perhaps due to conflicts of interest arising from business affiliations. They focus in particular on stocks whose financial condition is deteriorating, studying analyst recommendation revisions for a set of firms that eventually file for bankruptcy and for a control sample of non-bankrupt firms with similar z-scores. The authors report that analyst recommendations decline monotonically in the quarters prior to bankruptcy, both in absolute terms and relative to the matched sample. Further, they find that affiliated analysts are no more optimistic than unaffiliated analysts.

Sorescu and Subrahmanyam study both cross-sectional variation in analysts' information processing skills and investors' reactions to analyst revisions. They

document that rating changes by analysts who are more experienced and who are affiliated with higher reputation brokerage firms have greater predictive power for stock returns, but that investors appear to place insufficient weight on analyst skill, while placing too much weight on the magnitude of the revision. Their study therefore supports that analysts are skilled in processing information, and some more so than others, but calls into question whether investors make optimal use of the information supplied by analysts.

Houston, James, and Karceski study IPO firms, comparing offer prices to analysts' post-issue target prices and to valuations derived from the stock prices of comparable firms. They document that offer prices were discounted during the "bubble" period of 1999–2000 as compared to earlier years, both relative to analysts' target prices and relative to comparable firm valuations. They note that one explanation for discounted offer prices during the bubble period is enhanced agency problems. However, the authors also advance the alternative explanation that underwriters may have perceived an unusually high risk of litigation due to possible post-issue share price declines.

This symposium is the endogenous outcome of seven sets of authors electing to submit their high quality papers focused on the economics of stock analysts to the JFQA within a period of less than a year. I anticipate that the papers as a group will comprise an effective and useful resource to JFQA subscribers, and I hope that you will benefit from reading them as much as I have.