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ScienceDirect
Journal of Financial Economics 85 (2007) 457–489
JOURNAL OF Financial ECONOMICS
www.elsevier.com/locate/jfec

Are small investors naive about incentives?☆

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Received 16 February 2005; received in revised form 27 November 2006; accepted 1 February 2007
Available online 10 April 2007

Abstract

Security analysts tend to bias stock recommendations upward, particularly if they are affiliated with the underwriter. We analyze how investors account for such distortions. Using the NYSE Trades and Quotations database, we find that large traders adjust their trading response downward. While they exert buy pressure following strong buy recommendations, they display no reaction to buy recommendations and selling pressure following hold recommendations. This "discounting" is even more pronounced when the analyst is affiliated with the underwriter. Small traders, instead, follow recommendations literally. They exert positive pressure following both buy and strong buy recommendations and zero pressure following hold recommendations. We discuss possible explanations for the differences in trading response, including information costs and investor naiveté.
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JEL classifications: G14; G25; G29; D82; D83

Keywords: Stock recommendations; Trade reaction; Individual and institutional investors; Conflicts of interest; Behavioral finance

☆We would like to thank Nick Barberis, Stefano DellaVigna, Ming Huang, Ilan Kremer, Charles Lee, Roni Michaely, Marco Ottaviani, Oguz Ozbas, Josh Pollet, Paul Schultz, René Stulz, Adam Szeidl, Richard Thaler, Kent Womack, an anonymous referee, and seminar participants at Harvard, London Business School, Northwestern University, Stanford, Università Bocconi (IGIER), University of Florida, University of Illinois at Urbana-Champaign, University of Madison-Wisconsin, USC, UT Austin, University of Utah, and Washington University in St. Louis as well as the SITE (Economics & Psychology) 2003, NBER Behavioral Finance Fall 2003, WFA 2004, N.Y.Fed/Ohio State University/JFE 2004, and HBS IMO 2005 conferences for very helpful comments. Michael Jung provided excellent research assistance.
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doi:10.1016/j.jfineco.2007.02.001

1. Introduction

Stock recommendations of security analysts exhibit a strong upward bias. While the scale of recommendations ranges from "strong sell" and "sell" to "hold," "buy," and "strong buy," only 4.5% of all recommendations recorded in the IBES data set through December 2002 are in the strong sell and sell categories. Analysts' true scale appears to be shifted upward. The upward bias is even more pronounced for analysts who are affiliated with the underwriter of the recommended stock.

In this paper, we document the trade reaction of investors to recommendations. Using the NYSE Trades and Quotations database, we investigate how large and small traders respond to recommendations issued by affiliated and unaffiliated analysts.

We find three main results. First, both large and small traders display significant trade reactions. But only large traders adjust their trading response to the upward distortion. They exhibit a positive abnormal trade reaction to strong buy recommendations, *no* reaction to buy recommendations, and significant *selling* pressure after holds. Small traders, by contrast, follow recommendations literally. They exhibit a positive abnormal reaction to both buy and strong buy recommendations and no reaction to holds. Second, large traders react significantly less positively to buy and strong buy recommendations if the analyst is affiliated. Small traders, instead, do not respond differently to affiliated recommendations. Third, small investors appear to take less account of the informational content of a recommendation change (or the lack thereof). For example, small investors respond positively to mere reiterations of unaffiliated buy and strong buy recommendations, while large investors do not display any significant reaction. The results are robust to alternative econometric specifications, including alternative investor and analyst classifications, controls for analyst and brokerage heterogeneity, and tests for front running of large traders.

Our results reveal systematic and robust differences in how small and large investors react to analyst reports. It is harder to pin down the explanation for these differences. One possibility is that information about analyst distortions is more costly for small investors—the costs of adjusting their trading behavior outweigh the benefits. In fact, the benefits could be small or even zero due to the arbitrage of large investors. Alternatively, small investors might not seek information about analyst distortions even if the costs of obtaining such information are low. They take recommendations at face value and trust analysts too much, in line with experimental results on advice-giving with misaligned incentives and the literature on investors' reaction to firms' accounting choices and security issuance decisions (Cain, Loewenstein, and Moore, 2005; Daniel, Hirshleifer, and Teoh, 2002).

To differentiate between these explanations would require estimates of the costs of and returns to information about analyst distortions. However, informational costs are hard to measure objectively. The returns are, in principle, easier to calculate, but the NYSE Trades and Quotations database does not allow such calculations since it reveals only aggregate trade imbalances, not investors' portfolio strategies.

As a second-best approach, we analyze the relation between abnormal returns and trade imbalance. Using an event-study methodology, we find that small investors' net (buy minus sell) trade reaction predicts significantly lower abnormal returns than large investors' net trade reaction over six and twelve months. The difference is insignificant if we assume a three-month holding period. We also calculate the portfolio returns to

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