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Comparable firms and the precision of equity valuations

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Abstract

I investigate the relationship between the amount of information provided by a firm's comparables (i.e., firms in the same line of business as the firm being valued) and the precision of the firm's equity valuation. When investors have more information, previous studies argue that investors can make a more precise estimate of a firm's true equity value and this implies a lower (excess) stock return volatility around corporate events such as earnings announcements. I develop a simple model that shows a negative relationship between the amount of information provided by a firm's comparables and the firm's stock return volatility. Using alternative measures of information provided by comparables and different definitions of comparables, I consistently find a negative and significant relationship between these information measures and stock return volatility, *ceteris paribus*. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Why are some stocks more precisely valued than others? Some scholars posit that when investors have more information about a stock, they can make a more precise estimate of its true value. For example, Atiase (1985) argues that there is more information on large firms and implies that this should increase the precision of their stock valuation. In support of this argument, he finds that large firms have a lower stock price reaction to earnings announcements than small firms. More information means the pre-announcement price of the stock more accurately forecasts the information contained in the announcement, *ceteris paribus*. Therefore, the announcement is less surprising and the stock price reaction to the announcement is reduced.

Other information proxies besides size have been considered in the literature. For example, Barry and Brown (1984) propose the firm's period-of-listing (POL) as a proxy for the amount of information on the stock. They focus on the relationship between information and stock returns and find that a longer POL is associated with lower returns after controlling for size, beta and interactive effects.¹ Their results suggest an inverse relationship between POL and the magnitude of stock price reactions to corporate announcements, *ceteris paribus*.

The number of analysts following a firm has also been posited as a proxy for the amount of information on a stock (i.e., differential information across securities). For instance, Brennan et al. (1993) find that stocks followed by many analysts react more quickly to common information than stocks followed by fewer analysts.

I propose a new proxy for differential information that explains cross-sectional differences in the magnitude of security price reactions to corporate announcements beyond that previously suggested in the literature. This proxy follows from the regular use of comparables (i.e., firms in the same industry as the firm being valued) in stock valuation. For example, in a survey of investment firms, Carter and Van Auken (1990) report on the popularity of comparables' multiples in valuation. This technique can be as simple as multiplying the comparables' average price-earnings (PE) ratio times the firm's earnings to get an estimate of the firm's stock value.

Besides the survey data cited above, everyday discussions of valuation in the popular press and valuation books attest to the popularity of using comparables' multiples in valuation.² Moreover, Kaplan and Ruback (1995) find that, in their sample, the use of comparables' multiples is about as accurate as

¹ Consistent with Barry and Brown's results, Clarkson and Thompson (1990) find that the betas for IPO firms decline significantly as time passes and information increases. In particular, there is an abrupt decline in betas after the first earnings announcement.

² Other popular multiples include book-to-market, price-to-cash flow, etc. (see Damodaran, 1994).

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