



On the information role of stock recommendation revisions[☆]

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ABSTRACT

We examine the information transmission role of stock recommendation revisions by sell-side security analysts. Revisions are associated with economically insignificant mean price reactions and often piggyback on recent news, events, long-term momentum, and short-run contrarian return predictors, typically downgrading after bad news and upgrading after good news. However, the revisions are usually information-free for investors. The findings go against the long-standing view that recommendations are an important means by which analysts assimilate information into stock prices. They disagree with the view of policymakers that analysts' stock picks materially impact stock prices.

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1. Introduction

In an informationally perfect market, stock prices reflect all available information, indicating to investors the expected return on their investments. In reality, information is rarely perfect, and this allows economic agents to improve

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information efficiency by profiting from costly information discovery and incorporating their information into security prices (Grossman, 1976, 1995; Grossman and Stiglitz, 1980).¹ In this study, we focus on the information role of security analysts through their recommendations to buy, hold, and sell stocks (sometimes called stock picking). In the information role, if analysts believe markets are reasonably efficient then they revise their recommendations based on new price-to-value comparisons built from private information and the belief in their superior ability to create information by processing public information. A widely accepted view is that analysts are information agents and they convey negative information through revision downgrades (e.g., revising a buy to a hold) and positive information through revision upgrades (e.g., revising a hold to a buy). Studies show that stock prices fall over 4% at downgrades and rise over 3% at upgrades. In the information role view, such returns are evidence of better stock picking that rewards analysts' reputations and yields career opportunities.

Although the analyst information role is widely accepted, there are reasons to call into question the interpretation of revisions in the information role and the revisions evidence. Because revisions provide the same information to all watchful investors at the same time, they are unlikely to be of much value to any single investor. This suggests that revisions could be an inefficient method for brokerages to profit from their information discovery effort, given their other means for profiting on their valuable information. Second, the evidence suggests that the value of the information transmitted through revisions is inordinately large. Simple calculations show the yearly value of revision stock returns, per brokerage, tops \$100 billion, which exceeds brokerage equity value. Third, over a third of the revisions are contrary to the measured returns (see Conrad et al., 2006). Fourth, extant research questions the importance of the information role by advancing other purposes for revisions, which we collectively call the marketing role. These include influencing brokerage-client relations through exchange of revisions for management information or other quid pro quos (Schipper, 1991; Francis and Philbrick, 1993); building reputation for stock picking in analyst rankings crafted by *Institutional Investor* (I/I) and the *Wall Street Journal* (WSJ) (Stickel, 1992); promoting brokerage investment banking business (Lin and McNichols, 1998; Michaely and Womack, 1999; Ljungqvist et al., 2006; Kolasinski and Kothari, 2008); and boosting brokerage trading revenue (Jackson, 2005; Irvine et al., 2007). Both the information role and the marketing role are consistent with the fact that brokerages annually spend large sums for analysts' research.

This paper reports new evidence of stock-returns behavior around revision announcements that overturns prior revisions evidence. Prior findings often use daily or overnight stock returns to measure the value of analyst information transmission. We show that almost 80% of the revisions are in response to corporate events, which frequently release firm-specific information about earnings and investments a few hours before revisions are announced. Thus, the daily and overnight return measures for analyst information have a basic identification problem as they contain reaction to the events, making them prone to erroneous inferences. To avoid this identification problem, we measure revision returns using a narrow return intervals around daytime revision announcements, similar to the approach of Graham et al. (2006) for identifying daytime dividend announcement returns from other event returns. We find the mean 40 minutes revision announcement returns are economically unimportant (-0.03% for downgrades and 0.03% for upgrades). These results are robust to wider windows of one hour and two hours and they agree with growing evidence showing that stock prices react in minutes to new information (Dann et al., 1977; Barclay and Litzenberger, 1988; Kim et al., 1997; Busse and Green, 2002; Chordia et al., 2008).

Moreover, we report revision pre-returns, from the day before and until the revision announcement, are economically large and agree with the revisions, on average (-3.7% before downgrades and 1.1% before upgrades). Our analysis suggests the pre-returns are triggered by followed firm events.

Revision post-returns trend in the direction of the revisions on average, falling 65 basis points (bps) after downgrades and rising 47 bps after upgrades. However, up to two-thirds of the post-return can be explained by the pre-return, pre-events, and known predictors of long-term momentum and short-run return reversals. The 19–20 bps residual post-return is economically small and below round-trip transaction costs. Although the residual could reflect analyst information, it is also true that it could reflect additional predictors of future returns and changes in expected returns that are allied with the corporate news and events.

A central question raised by our findings is as follows: Why is there so much news just before analysts announce their revisions? Perhaps analysts' leak their information just before revising. Because the news is mostly about corporate operations, management is a likely source for analysts' information. However, because of Reg FD, after October 2000 management is barred from selectively disclosing privileged information to analysts. Thus, if analysts systematically leak their information, then more revisions should follow corporate events before Reg FD than after. Yet, we find the opposite. Moreover, many revisions are contrary to the news. Events and news give analysts rich opportunities to apply their superior skills to process news into new information. However, although such processing can occur, we find revisions are typically information-free. A third possibility is that analysts, in pursuit of their careers, strategically piggyback revisions on events, returns, and future return predictors, to better align their revisions with recent and future returns. This can improve analyst stock picking reputation and spur trading, boosting brokerage revenues and analyst income, and reducing the chance of job loss. The accepted WSJ analyst rankings, for example, which rely partly on picked stock returns measured from before to

¹ Bekaert and Harvey (2000), Shleifer (2000), and Basak and Croitoru (2006) provide detailed discussions of speculators and risk arbitrageurs as information agents.

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