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The persistence of relative performance in stock recommendations of sell-side financial analysts ☆

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Abstract

Analysts with above-median risk-adjusted performance in the estimation period persistently outperform those with below-median performance in the subsequent holdout period. The annualized risk-adjusted returns of trading strategies based on performance persistence are statistically and economically significant, with a magnitude around 10% even after adjusting for transaction costs and trading delays. This stems mostly from past above-median performers and is not simply a decomposition of previously documented post-event return drift. The results support the hypotheses that more information is contained in above-median performers' recommendations and that investor reaction to these recommendations is incomplete during the event periods.

JEL Classification: C12; G11; G12; G14

Keywords: Capital markets; Analyst recommendations; Performance persistence

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1. Introduction

In this paper I examine the performance persistence of the so-called "sell-side" financial analysts who work for a brokerage house and provide research for the house and its clients. These analysts are prominent in the investment process; indeed, the financial press has called the decade of the 1990s the "Age of the Analysts." While analysts have traditionally influenced institutional investors, they have increasingly influenced individual investors as well.

I measure analyst performance using risk-adjusted returns on portfolios created with analyst recommendations. Performance persistence, or persistence in the relative performance differences among individual analysts, is measured by the correlation between the differences in individual analyst performance in the estimation period to the one-period-ahead holdout sample. I find significant persistence in relative performance differences among individual analysts. Specifically, analysts whose recommended portfolios generate stronger abnormal returns in the estimation period continue to produce recommended portfolios with stronger abnormal returns in the subsequent holdout periods. The annualized risk-adjusted returns of trading strategies based on performance persistence are statistically and economically significant, with a magnitude around 10% even after adjusting for transaction costs and trading delays. When I separately investigate analysts with above-median and below-median performance, denoted as past winners and losers, respectively, I find performance persistence in buy recommendations for past winners; analyst performance for sell recommendations also exhibits persistence, but much less consistently. Given little post-event return drift in the overall sample, the performance persistence in buy recommendations is not simply a decomposition of the previously documented post-event return drift (Elton et al., 1986; Stickel, 1995; Womack, 1996). Given that past winners' recommendations outperform those of past losers, both within the event period and in the post-event period, the results support the hypotheses that there is more information contained in past winners' recommendations and that investor reaction to these recommendations is incomplete during the event periods, with a substantial portion of the incomplete reactions realized around subsequent earnings announcements, stock recommendation dates, and earnings forecast dates.

My paper is related to the literature that examines differential analyst performance and subsequently explains this difference. Richards (1976), Brown and Rozeff (1980), O'Brien (1987), Coggin and Hunter (1989), O'Brien (1990), Butler and Lang (1991), Sinha et al. (1997), and Cooper et al. (2001) investigate differences in the earnings forecast accuracy across analysts; Sinha et al. (1997) is the closest in spirit to my paper. They find that superior earnings forecasters in one period tend to be superior in subsequent holdout periods, which suggests persistence in earnings forecast accuracy. Prior literature also attempts to explain within-sample differences in both the forecast accuracy (Mikhail et al., 1997; Clement, 1999; Jacob et al., 1999) and the abnormal returns associated with stock recommendations and earnings forecast revisions (Stickel, 1995; Gleason and Lee, 2003).