



The value of stock analysts' recommendations: Evidence from emerging markets

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ABSTRACT

This is the first study to empirically examine post-recommendation buy and hold abnormal returns in emerging markets. By analyzing a sample of 13 emerging countries over the decade from 1996 to 2005, we find that stock prices react strongly to stock analyst recommendations and revisions. We also find that there is a stronger positive bias in analyst recommendations and revisions in emerging markets compared with that in developed markets. In our cross-sectional analysis, we find that the Market-to-Book ratio is the primary indicator for Buy and Strong Buy recommendation regressions. This indicates that stock analysts in emerging markets prefer high growth stocks with attractive characteristics.

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1. Introduction

Emerging markets are often viewed by investors in developed markets to be too exotic, too risky, too hard to research on and too difficult to invest in. As such, there should be a significant informational role for security analysts providing stock recommendations in emerging markets. This is the first study to explicitly investigate the value of stock analyst recommendations and revisions within emerging markets.

In recent years, emerging markets have experienced astonishing levels of growth, significantly outpacing their more developed counterparts. As such, investment banking firms have not allowed this growth to pass unnoticed, putting particular emphasis on emerging security markets. Accordingly, the top investment banks and fund managers are poised to explore the abundant opportunities offered by emerging markets. On behalf of their clients, capable analysts are actively researching the emerging markets that are held in high regard. In turn, their knowledge of such markets and their investment insights are highly valued by investors. To a certain degree, the analyst is analogous to a stock promoter, and their opinions inevitably exert a significant influence on investors' decisions to purchase recommended stocks.

The growth in the demand for analysts' skills can be explained in two ways. First, stock recommendations have been found to be particularly valuable to investors in developed countries. Empirical studies that have focused on the value of analyst recommendations include those of Barber, Lehavy, McNichols, and Trueman (2001), Boni and Womack

(2006), Jegadeesh, Kim, Krische (2004) and Jegadeesh and Kim (2006), Lim and Kong (2004), Stickel (1995) and Womack (1996). These studies have confirmed that, by following a stock analyst's recommendations, one can earn abnormal returns in the markets studied. Second, aside from the fact that analysts are often good at picking mispriced stocks, the rapid expansion in the security business of emerging markets, the significant economic growth and the improving profitability of corporations in these regions has also acted to stimulate the growth in demand for analyst recommendations.

A number of interesting questions can therefore be asked: given the fact that emerging markets are growing at a dramatic pace and that such markets are gaining significant attention from investment bankers, what is the value of stock analyst recommendations in emerging markets compared with similar recommendations in developed markets? What are the characteristics of such recommendations in developed and emerging markets – are analysts more biased in emerging markets? What factors are affecting the value of those recommendations? These are pertinent research questions given that the quality of information in emerging markets is argued to be different to that in developed markets (see Chan and Hameed (2006) and references therein).

This paper examines the post-recommendation abnormal returns in emerging markets by uniquely applying Loughran and Ritter's (1995) Buy-and-Hold abnormal returns (BHARs) measure based on both emerging stock market indices and control firm benchmarks to assess the value added by analyst recommendations and revisions in 13 emerging markets around the world from 1996 to 2005. We find that stock prices react significantly to recommendations and revisions. Investors can therefore act on the valuable information provided by stock analysts to make abnormal gains in emerging markets. However,

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there is more variability in the value added by stock analyst recommendations in emerging markets and there is no significant difference in the skills of analysts based in different geographical regions. The abnormal returns of Buy recommendations are greater than those reported in earlier studies in the United States (Barber and Loeffler (1993), Barber et al. (2001) and Womack (1996)) based on the MSCI Emerging Market Index. For Sell recommendations, the abnormal returns are similar to those seen in earlier studies from the United States based on the emerging markets index. Our results also confirm the findings of Lim and Kong (2004), Michaely and Womack (1999) and Womack (1996) and in that Sell recommendations have greater and longer impacts on the market than Buy recommendations.

Jegadeesh and Kim (2006) have shown that in G7 countries (the US, Britain, Canada, France, Germany, Italy and Japan), the cumulative returns gained following analysts' recommendation revisions can create significant value for investors. The US's cumulative returns are the biggest in the group since it awards the best skilled analyst with higher remunerations. This paper finds that, investment returns from emerging markets are greater in magnitude than the documented results for G7 countries.

There is considerable evidence of positive bias in analyst recommendations in developed markets (Dugar and Nathan (1995), Jegadeesh and Kim (2006) and Michaely and Womack (1999)). A major reason for this bias is that analyst recommendations need to appear consistent with the business direction dictated by their firm. In this study, the proportion of Strong Buy and Buy recommendations on a yearly basis are at least double the number of Underperform, Sell and Strong Sell recommendations across the sample. We find that whilst analysts' favourable bias is less severe than in the US, it is more prominent than in other G7 countries.

In cross-sectional analyses, we explore the potential factors that might explain the abnormal returns generated by analyst recommendations. In this we find that Market-to-Book ratio is the primary indicator for BHARs from Buy and Strong Buy recommendations. As Market-to-Book ratio is a key indicator of the firm's growth prospects, the results indicate that the market and stock analysts respond more favourably to firms with higher growth opportunities. This is consistent with Jegadeesh et al.'s (2004) argument that stock analysts prefer to recommend high growth stocks – as their glamorous characteristics, high trading activities and positive price momentum make them attractive to investment banking clients. Hence, whilst analyst recommendations do add value we also find evidence of bias in stock analyst recommendations within emerging markets.

We believe that this study offers three important contributions to present understanding. First, we focus on a large sample of emerging markets from 1996 to 2005, which compares favourably with the limited sample size seen in most analyst studies to date. Secondly, we provide comparative analyses of stock analyst recommendations in emerging markets against international evidence. Thirdly, we provide a better understanding of the firm-specific factors that drive biases in emerging stock market analysts' recommendations. This paper adds a new dimension to the analyst recommendation literature by exploring the evidence from emerging markets.

The remainder of this paper is organised as follows: Section 2 reviews the existing literature on the value of stock analyst recommendations; Section 3 describes the dataset used; Section 4 describes the methodology; Section 5 assesses whether stock analyst recommendations provide investment value; whilst Section 6 examines the determinants of the value of those recommendations; and finally, Section 7 concludes.

2. Literature review on stock analysts' recommendations

Most of the research on investment recommendations has focused on analysts' stock-picking abilities, testing whether analysts' recommendations can be used to gain abnormal returns.

In an early study on the topic, Bjerring, Lakonishok, and Vermaelen (1983) found a significant and positive relationship between stock price reactions and analyst recommendations from a leading Canadian brokerage house. Meanwhile, Dimson and Marsh (1984) measured the correlation between forecast return and actual return and suggested that analysts are able to distinguish winners from losers in the market. Elton, Gruber, and Grossman (1986) examined larger capitalisation stocks, looking at 720 analysts at 33 brokerage firms between 1981 and 1983. They focused on changes each month to a new rating from a lower ("upgrade") or a higher ("downgrade") one. Their findings suggested that upgrades result in significant (beta-adjusted) excess returns of 3.43% in the month of the announcement, whilst downgrades result in negative excess returns of -2.26% . A potential weakness of the work lies in the exclusive use of calendar monthly returns. That is, if markets respond rapidly to new information, an analysis of monthly returns will not adequately reveal the actual response to the recommendation change and what other relevant information (such as earnings releases) might have occurred in the same month. By not using daily returns, the power of the tests determining the response to the recommendation change is significantly diluted.

Following the event study methodology, Beneish (1991) found significant positive (or negative) stock price reactions following the announcement of buy (or sell) recommendations in the "Heard on the Street" column in the *Wall Street Journal*. Meanwhile, Stickel (1992) found a positive relation between the performance and an analyst's reputation. In this, he found that reputable analysts supply more accurate earnings forecasts than other analysts. As he argued, the cumulative abnormal return following upward forecast revisions by credible analysts is significantly higher than the cumulative abnormal return following upward forecast revisions by other analysts. Furthermore, Womack (1996) found that not only is there a positive (or negative) stock price reaction following buy (or sell) recommendations, there is also a long-term drift that is longer for sell recommendations. Barber et al. (2001) has documented that the strategy of buying stocks with the most favourable recommendations and selling short stocks with least favourable recommendations yields an annual abnormal return that is greater than 4%. Jegadeesh et al. (2004) examined the performance of trading strategies based on analysts' recommendation revisions, finding that quarterly changes in recommendations are robust predictors of future returns, and that profitability is not driven by any stock characteristics. More recently, Jegadeesh and Kim (2006) confirmed the value of analysts' recommendations in G7 countries.

Whilst there is much evidence that security analyst's recommendations have significant impacts on stock prices, there is also considerable evidence of positive biases in analyst's recommendations. A major reason for this optimistic bias is that analyst's recommendations are in line with the management policy of their firms. Along these lines, Elton et al. (1986) found that 48% of analyst ratings were buys, whilst only 2% were sells. Similarly, Lin and McNichols (1998) provided evidence that analyst recommendations for initial and seasoned public offering clients are systematically more optimistic and Chahine (2004) examines whether optimistic analyst forecasts explain the long-run abnormal returns following initial public offerings. Moreover, Dugar and Nathan (1995) and Michaely and Womack (1999) presented evidence that financial analysts employed by brokerage firms providing investment banking services to companies are more optimistic, relative to other analysts, in their earning forecasts and investment recommendations. Finally, Chen, Chan, and Steiner (2002) showed that different types of brokerage firms affect the price reaction around recommendation revisions. As we can see, there exists considerable evidence regarding the influence that analyst research activities have on international stock markets.

The predominant explanation for analysts' favourable bias revolves around their conflict of interests. Bias in research or brokerage firms'

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