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## Journal of Banking &amp; Finance

journal homepage: [www.elsevier.com/locate/jbf](http://www.elsevier.com/locate/jbf)

## Do investment banks listen to their own analysts?

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## ARTICLE INFO

## Article history:

Received 2 November 2009

Accepted 14 December 2011

Available online 22 December 2011

## JEL classification:

G11

G14

G24

## Keywords:

Analyst stock recommendations

Conflicts of interest

Security analysts

Investment banks

Institutional investors

## ABSTRACT

To what extent conflicts of interest affect the investment value of sell-side analyst research is an ongoing debate. We approach this issue from a new direction by investigating how asset-management divisions of investment banks use stock recommendations issued by their own analysts. Based on holdings changes around initiations, upgrades, and downgrades from 1993 to 2003, we find that these bank-affiliated investors follow recommendations from sell-side analysts in general, increasing (decreasing) their relative holdings following positive (negative) recommendations. More importantly, these investors respond more strongly to recommendations issued by their own analysts than to those issued by analysts affiliated with other banks, especially for recommendations on small and low-analyst-coverage firms. Thus, we find that investment banks “eat their own cooking,” showing that these presumably sophisticated institutional investors view sell-side recommendations as having investment value, particularly when the recommendations come from their own analysts.

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## 1. Introduction

To what extent conflicts of interest affect the investment value of sell-side analyst research is an ongoing debate. Numerous studies suggest that sell-side analysts issue overly optimistic recommendations to curry favor with covered firms and attempt to win investment banking business for their employers. Such behavior, if it is pervasive, may significantly reduce the investment value of sell-side research. However, several recent studies show that recommendations provided by analysts with potential conflicts of interest do not underperform recommendations provided by other analysts, casting doubt on the importance of such conflicts.<sup>1</sup>

We approach this issue from a new direction. We examine whether institutional investors affiliated with investment banks use stock recommendations issued by their own sell-side analysts. Suppose we discover that an investment bank's money managers disregard (or worse, trade against) the recommendations of the bank's sell-side analysts. Such behavior would be clear evidence that the bank's sell-side recommendations are viewed as not useful

(at best) by institutional investors who are particularly well-positioned to judge.

Our primary findings are that money managers affiliated with investment banks use sell-side research in general, and they particularly listen to their own bank's analysts. Specifically, we study 1.1 million holdings changes for institutional investors affiliated with 58 major US investment banks around 70,000 stock recommendations from 1993 to 2003. We find that these investors increase their holdings after positive initiations and upgrades, and they decrease their holdings following downgrades. More importantly, the changes in holdings are economically and statistically larger when the recommendation is from an affiliated analyst.<sup>2</sup> Further tests show that our results are more pronounced for recommendations on small and low-analyst-coverage stocks.

To our knowledge, we are the first to explore how institutional investors respond to recommendations issued by affiliated and

<sup>2</sup> There are several different channels through which affiliated funds can gain better access to the analyst research at their own brokerage firms. They may do this through trading relations such as those described in Niehaus and Zhang (2010). Alternatively, investment banking business may cause both affiliated funds and affiliated analysts to take favorable actions on the firm. While this is an interesting research topic, it is beyond the scope of this paper. We thank an anonymous referee for suggesting to us the potential channels.

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<sup>1</sup> Examples include Groysberg et al. (2005), Clarke et al. (2006), and Bradley et al. (2008).

unaffiliated analysts.<sup>3</sup> Our results show that sell-side research is used by institutional investors. This fact suggests that relatively knowledgeable market participants view sell-side research as valuable, despite the existence of potential conflicts of interest.

Our results are robust to alternative explanations. For example, we consider the possibility that analyst recommendations and institutional investor holdings changes are joint responses to public events, but we find no evidence to support this. We also explore the hypothesis that affiliated money managers “cherry pick” recommendations based on private information. We find no support for this story either; there is no differential performance between recommendations that are followed and those that are not followed.

The remainder of the paper is organized as follows. We discuss the related literature in Section 2 and sample selection and data in Section 3. Section 4 provides our results. We conclude the paper in Section 5.

## 2. Related literature

There is a large literature on analyst recommendations. It is widely documented that analysts employed by investment banks may issue overly optimistic recommendations to win investment banking business from the companies they cover. Analysts working for IPO/SEO underwriters may issue more optimistic recommendations than other analysts (Michaely and Womack, 1999). Even analysts not employed by underwriters have incentives to issue optimistic coverage to win future investment banking deals (Bradley et al., 2008).

However, the evidence of optimism and its relationship with investment banking deals is not free from debate. For example, Clarke et al. (2006) examine analyst recommendations for bankrupt firms during the period of 1995–2001 and find no evidence for optimism in recommendations by analysts employed by investment banks that have previous business relations with the firms. Clarke et al. (2007), Fleuriet and Yan (2006), and Ljungqvist et al. (2006) find that the relation between optimistic recommendations and future investment banking mandates is not always strong or at least cannot be generalized across all analysts and all types of investment banking deals.

There is some evidence in the literature about the lower announcement returns around recommendations issued by analysts employed by underwriters (Michaely and Womack, 1999). However, Bradley et al. (2008) find that the difference in announcement returns between recommendations issued by underwriter analysts and non-underwriter analysts disappears after controlling for recommendation characteristics and timing. The evidence on long run performance of recommendations issued by underwriter analysts is also mixed. Some studies show that buy or strong buy recommendations by analysts employed by underwriters perform worse (Michaely and Womack, 1999) while other studies fail to find such evidence (Groysberg et al., 2005; Clarke et al., 2006).

## 3. Data and sample selection

We obtain institutional holdings data from Thomson Financial's CDA/Spectrum 13f filings for all common stocks traded on New York Stock Exchange (NYSE), American Stock Exchange (AMEX),

and NASDAQ. Due to a 1978 amendment to the Securities and Exchange Act of 1934, all institutional investors with security assets of \$100 million or more under discretionary management are required to report their holdings each quarter on Form 13f. For reporting purposes, each institution pools together the assets of all client accounts (e.g., trust accounts, corporate pension plan accounts, and mutual fund accounts) into a single filing. This characteristic of the database enables us to examine the use of recommendations at the aggregated institution level, but not at a finer fund level.

We obtain stock recommendation data from I/B/E/S, which collects recommendations from brokerage houses and assigns standardized numerical ratings. The Detail History-Recommendation file provides an entry for each recommendation made by each analyst. Important variables in the file include the date of the recommendation, the name of the analyst and associated bank, the level of the recommendation, the number of analysts following the stock, and the level of the consensus recommendation at mid-calendar month. Our sample period covers the last quarter of 1993 (the beginning of the dataset) to the last quarter of 2003. We stop in 2003 because Thomson Financial has stopped providing the I/B/E/S Broker Translation file.

We classify recommendations into three samples: initiations, upgrades, and downgrades. Following Irvine et al. (2007), we identify analysts' buy and strong buy initiations in the I/B/E/S Detail History-Recommendation file. To ensure that an initiation is not just a result of I/B/E/S adding a bank to the database, we restrict the sample to those initiations by investment banks that first appear in the database at least 180 days prior to any initiation. We follow Green (2006) and classify a recommendation as an upgrade if a stock is upgraded by an investment bank from prior level of sub-buy (i.e. sell, underperform, or hold) to buy or strong buy.<sup>4</sup> Finally, we follow Jegadeesh and Kim (2004) and define a recommendation as a downgrade if a stock is downgraded by an investment bank from a prior level of buy or strong buy to sub-buy. For upgrades and downgrades, we keep the latest one in a quarter in our sample if an investment bank issues more than one recommendation on a stock in the quarter.

To keep the sample formation process manageable, we restrict our attention to the 100 institutions with the most recommendations in I/B/E/S. We focus on recommendations issued by analysts employed by investment banks that have IPO or SEO underwriting activities (so that there are potential conflicts of interest) in our sample period and also have affiliations with institutional investors in CDA/Spectrum (i.e., either there is a parent–subsidiary relationship or both are subsidiaries of another institution). We identify the investment bank with which an analyst is affiliated using the I/B/E/S Broker Translation file. To detect the affiliation relationship between an investment bank and institutional investors, we consult Hoovers Online, the Directory of Corporate Affiliations, Lexis–Nexis, and corporate websites. We also check for M&A news in Lexis–Nexis and *The Wall Street Journal* to identify the exact period for the relationship. Our matching and screening process produces our final working sample of 58 investment banks. Our sample includes all of the major investment banks including the big 10 banks in the Global Settlement of 2003. In our sample, the Carter and Manaster (1990) ranks range from 9 to 1, with both the means and the medians being close to 7.<sup>5</sup> The number of recommendations by each investment bank ranges from 287 to 3600.

<sup>3</sup> Irvine et al. (2004) find that analyst earnings forecasts are more accurate if the asset management division of the same bank holds more of the stock. Mola and Guidolin (2009) find that analyst recommendations are likely to be optimistic if the stock is held by affiliated mutual funds. Neither study, however, examines how institutional investors respond to recommendations issued by analysts affiliated with their own investment banks. Haushalter and Lowry (2009) find that mergers and acquisitions advisors buy (sell) the acquirers that their analysts upgrade (downgrade).

<sup>4</sup> Because an investment bank usually has at most one analyst covering a certain stock, we use investment bank and analyst interchangeably when it comes to coverage.

<sup>5</sup> Following previous studies (e.g., Green, 2006), we do not report the names of investment banks to maintain the confidentiality of the database including the IBES translation file.

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