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Does foreign investor demand for information affect forecast accuracy? Evidence from the Chinese stock markets

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ABSTRACT

Prior international accounting studies have examined mainly the supply side of analyst research. Specific trading rights and financial reporting systems in China provide a unique opportunity to test both demand and supply factors of analyst information. For shares traded only by less-informed foreign investors, the increased information demand may create incentives for analysts to exert greater efforts than for shares traded by local investors. This study provides evidence that analyst effort (proxied by analyst coverage) and expertise (proxied by consensus cross-analyst forecast variability) affect forecast accuracy more significantly for shares traded by foreign investors than for shares traded by local investors. Additionally, I find that the relation between analyst characteristics and relative forecast accuracy is stronger for shares traded by the foreign investors. The findings are consistent with analysts responding to demands for information by less-informed investors.

1. Introduction

The Chinese financial markets have become increasingly important for investors around the world.[1] Issues such as financial analysts' earnings forecasts and analysts' activities in China, however, have received little attention in the academic literature. Foreign investors had only two ways to invest in equity securities in China between 1991 and 2000. They could either buy B shares traded only in China or buy H shares of Chinese companies traded in Hong Kong. In contrast, local Chinese investors could buy only A shares of companies traded in China. Financial analysts followed almost all B shares or H shares but only a handful of A shares.

This study is motivated by the extensive analyst coverage of shares traded by foreign investors and leads to the question of why analysts mostly followed shares issued only for foreign investors and followed few shares traded only by local investors. I am interested in exploring two research questions on the phenomenon. First: Do analyst effort and expertise affect earnings forecast accuracy differently for shares traded only by foreign investors than for shares traded only by local Chinese investors? Second: Are the findings consistent with analysts responding to demands for information by foreign investors?

I document and discuss information related to the motivation question and later combine it with the two research questions. Next, I empirically test the ability of analyst coverage and forecast variability to explain consensus forecast accuracy and proxies of individual analyst effort and expertise to explain relative forecast accuracy across the different types of shares. The specific trading rights and financial reporting standards in China provide a unique opportunity to examine these associations. Finally, for the second research question, I examine whether analysts respond to increased demand from foreign

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[1] Five Chinese companies are now among the world's ten largest companies by market value (Hoe, 2007).

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investors by exerting greater effort and gravitate to fulfill the increased demand for information by the less-informed foreign investors.For shares traded only by foreign investors, the increased demand for earnings information among foreign investor clienteles may create incentives for analysts to intensify their efforts. Analyst following and consensus volatility may have a stronger impact on forecast accuracy, and analysts with superior characteristics (Barniv, Myring, & Thomas, 2005; Bonner, Walther, & Young, 2003; Clement, 1999; Clement & Tse, 2003; Jacob, Lys, & Neale, 1999; Mikhail, Walther, & Willis, 1997) are more likely to issue a superior forecast relative to their peers. For the A shares traded by local investors, weaker investor demand for analysts' information may reduce the economic incentives of analysts to extend their efforts and would have a smaller effect on analysts' consensus forecast accuracy and forecast accuracy relative to their peers.

Most studies focus on the supply side of analyst forecast accuracy in the United States (e.g., Brown, Hagerman, Griffin, & Zmijewski, 1987; Brown & Mohd, 2003) and across countries (e.g., Barniv et al., 2005; Hope, 2003). A few studies report that analysts tend to respond to investors' information demands (e.g., Frankel, Kothari, & Weber, 2006; Lang, Lins, & Miller, 2004; Moyer, Chatfield, & Sisneros, 1989).[2] Prior studies find that local investors in China are better informed than foreign investors and that information asymmetry plays a significant role in the pricing of shares of companies traded only by foreign investors versus shares traded by local investors (Chakravarty, Sarkar, & Wu, 1998; Chan, Menkveld, & Yang, 2003; Chan, Menkveld, & Yang, 2008). One inference from these articles is that less-informed foreign investors experience special needs for additional information and, in response, analysts have a greater incentive to exert effort. They become more active and provide more coverage for shares traded by foreign investors. The extra analyst effort and expertise should have a greater effect on forecast accuracy and on analysts' performance relative to their peers.

This study examines whether analyst effort and expertise explain consensus and relative forecast accuracy better for B and H shares than A shares. Specifically at the consensus level, the number of analysts and consensus cross-analyst forecast variability are used as proxies for analyst effort and expertise. Additionally, at the individual analyst level, I use analysts' frequency of forecasts and the length of the time interval between the forecast issue date and the earnings announcement date as proxies for effort, and each analyst's experience and the percentage of companies followed by the analyst in the same industry as proxies for expertise. I expect these proxies and additional control variables to better explain accuracy for shares traded by foreign investors than for shares traded by local investors. In additional analyses, I examine whether these analyst characteristics explain the relative forecast accuracy better for firms with higher foreign ownership. Findings supporting this expectation would indicate that analysts respond to the specific demand for information by foreign investors. Foreign investors could invest in B and/or H shares; therefore, I also examine and compare the relations between accuracy and analyst characteristics using shares traded by foreign investors in China and shares of Chinese companies traded by foreign investors in Hong Kong.

Consistent with the research expectations, I find analyst coverage and consensus cross-analyst forecast variability affect forecast accuracy more significantly for shares traded by foreign investors than for shares traded by local investors after controlling for firm size and earnings effects. The relations between the proxies for analyst's effort and expertise and the relative forecast accuracy are also stronger for shares traded by the foreign investors. Finally, I find that, higher foreign-investor ownership, a proxy for investor demand, increases forecast accuracy, and the proxies for analyst's effort and expertise better explain the relative forecast accuracy for companies with higher foreign ownership.[3]

Overall, this study contributes to the literature in three ways. First, by examining the association of forecast accuracy with specific characteristics across different types of shares, it complements prior studies that examine the impact of (a) listing location on forecast accuracy (Lang, Lins, & Miller, 2003); (b) differences in forecast accuracy associations between U.S. and non-U.S. firms (Das & Saudagaran, 1998; Das & Saudagaran, 2002); (c) the association between accounting disclosures and forecast accuracy (Hope, 2003); (d) and the association between the legal and financial reporting environments and relative forecast accuracy of individual analysts (Barniv et al., 2005). The specific associations (c) and (d) have not been examined in prior research in China.

Second, with regard to specific and unique attributes of the Chinese equity markets, the study complements prior studies that examine (a) the information asymmetry between different types of shares (Chan et al., 2008); (b) the value relevance of different accounting standards used for financial reporting by types of shares (Abdel-khalik, Wong, & Wu, 1999; Chen, Chen, & Su, 2001; Lin & Chen, 2005; Liu & Liu, 2007; Sami & Zhou, 2004); (c) and various Chinese capital market, accounting, and regulatory issues (Allen, Qian, & Qian 2005; Ball, Kothari, & Robin, 2000; Ball, Robin, & Wu, 2000; Chen & Yuan, 2004; DeFond, Wong, & Li, 2000; Haw, Qi, & Wu, 2000; Haw, Qi, Wu, & Wu, 2005; Sun & Tong, 2003).

Third, given the idiosyncratic investor rights in China, I examine whether foreign ownership affects consensus forecast accuracy and relative forecast accuracy of individual analysts. With regard to information demand, the study complements prior research on investor demand and analyst informativeness (e.g., DeFond & Hung, 2007; Frankel et al., 2006), particularly by indicating that analysts respond to demand for information by less-informed foreign investors.

[2] While primarily examining the supply side in the United States, Frankel et al. (2006) conclude that analysts become more informative when investors can derive greater benefits from their private information, and the desire to supply private information becomes a significant impetus of analyst activity.

[3] Forecast accuracy may affect foreign ownership, and this introduces endogeneity concerns. I use the Hausman test and find no simultaneity in the regressions. I also reversed the multivariate regressions using foreign ownership as the dependent variable and find a nonsignificant coefficient on forecast accuracy as an independent variable. The results imply that ownership is not affected by forecast accuracy. More details are discussed in the additional analyses section.