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Implications of limited investor attention to customer–supplier information transfers

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ABSTRACT

This study focuses on the market reaction to information transfers from economically linked customers. I examine whether investors have limited attention with respect to the information contained in customer earnings announcements for suppliers. Using 1083 unique customer–supplier relationships for the period 1983–2011, I find that the cumulative abnormal returns of a supplier surrounding and following linked customers' earnings announcements are positively related to the earnings information of the customers, suggesting that customer earnings announcements convey information to suppliers. I also find that the post-earnings announcement drift in customers contributes to the cross-firm reaction, and the predictability of customer earnings surprises for suppliers' future returns is not entirely due to limited investor attention.

1. Introduction

This study aims to identify predictable returns by using ex ante economic links between customers and suppliers. Recent studies on the limited investor attention hypothesis,[1] which state that investors' limited attention to the arrival of new information causes return anomalies, show that investor inattention is more likely when a large number of same-day earnings announcements are made by other firms (Hirshleifer, Lim, and Teoh, 2009) or when there are a large number of Friday earnings announcements (Dellavigna & Pollet, 2009). Investor inattention is also more likely when publicly available information about economically linked firms is neglected (Cohen & Frazzini, 2008). More importantly, evidence on the limited attention to economically linked firms suggests that information diffuses from customers to suppliers, generating predictable returns across linked assets.

In this paper, I examine whether investors have limited attention with respect to the information contained in customer earnings announcements for suppliers. More specifically, I investigate the immediate responsiveness of a firm's abnormal returns surrounding the announcement dates of its linked customers as well as the delayed responsiveness of stock returns following linked customers' earnings announcements. The disclosure of customer–supplier links between firms was required according to Statement of Financial Accounting Standards (SFAS) No. 14 before 1997 and based on SFAS No. 131 after 1997, and this information is available for public use. When news about a linked firm is released to the market, the stock price of the supplier firm should respond immediately to that news if investors consider these ex ante links. In contrast, if investors pay limited attention to such links, the stock price of the supplier will react slowly to the linked firm's earnings news, and delayed abnormal returns can be expected. As a result, limited investor attention to a linked firm's announcements (i.e., a customer's unexpected earnings news)[2] leads to market underreactions.

By examining 1083 unique customer–supplier relationships between 1983 and 2011, I find that the cumulative abnormal

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[1] The limited attention hypothesis by Cohen and Frazzini (2008) states that stock prices underreact to firm-specific information that induces changes in the valuation of related firms, generating return predictability across assets. In particular, stock prices underreact to negative (positive) news involving related firms and, in turn, generate negative (positive) price drift.

[2] Unexpected earnings news, unexpected earnings, earnings surprises, earnings news, and earnings-related information are exchangeable terms in this paper.

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returns of a supplier surrounding and following linked customers' earnings announcements are positively related to the unexpected earnings news of customers. The findings indicate that there is a direct, immediate relation between supplier returns and customer earnings surprises, and customer earnings surprises are positively related to post-customer earnings announcement supplier returns. Additionally, these results are robust to controlling the same-industry effect, the ratios of firm size, and the percent of supplier sales from the linked customer, as well as with respect to the delayed returns over different horizons and the alternative measures of earnings surprises. Because customer–supplier links between firms are typically associated with information transfer, the main results suggest that limited investor attention to the arrival of new information about economically linked firms generates abnormal stock returns.

The limited investor attention hypothesis by Cohen and Frazzini (2008) argues that customer returns predict suppliers' future returns because investors pay limited attention to the customer–supplier link. To identify whether the predictability of supplier returns is the consequence of increases in customer returns due to customer earnings surprises, I further test how much the customer post-earnings announcement drift contributes to the cross-firm reaction between supplier returns and customer earnings surprises. The evidence supports the notion that an investor's underreaction to a customer's earnings surprise leads to a drift in the customer's post-earnings announcement returns (Bernard & Thomas, 1989), which, in turn, is reflected in the supplier's returns. In other words, the post-earnings announcement drift in customers contributes to the cross-firm reaction, and the predictability of customer earnings surprises for suppliers' future returns is not entirely due to limited investor attention to earnings-related information transfers.

This paper contributes to the existing literature in several ways. First, the paper adds to the growing stream of studies on the implications of limited attention for stock returns. Cohen and Frazzini (2008) examine how investors' limited attention to economically related firms leads to predictable future stock returns by testing "customer momentum", which is defined as a monthly strategy of buying firms whose customers had the most positive returns in the previous month and selling firms whose customers had the most negative returns in the previous month. If investors pay limited attention to the stock returns of economically linked firms, one would expect investors to be inattentive to earnings-related information from such firms. Consequently, I hypothesize that market underreactions for suppliers are related to limited investor attention to earnings announcements by economically linked customers. I test this hypothesis by examining immediate (delayed) market reactions surrounding (following) earnings announcements by economically linked customers. Although most studies investigate market reactions around the time of a firm's own earnings announcements,[3] I focus on market reactions around the time of earnings announcements by related firms because investors tend to ignore the publicly available link between suppliers and economically related customers. That is, investors are inattentive to customer–supplier links, and stock returns are therefore predictable.

Second, this study provides new insight into information diffusion. The customer–supplier links between firms are longstanding public relationships. Thus, the earnings information released by customers is closely related to the earnings information for suppliers. Prior studies have shown that one firm's earnings news can be useful in updating earnings expectations for other firms in the industry.[4] For instance, Ramnath (2002) examines intra-industry information diffusion by investigating the market reaction experienced by a firm that announces its earnings subsequent to the first announcing firm in the same industry when the earnings of the latter are unexpected. A recent study by Kovacs (2011) further shows that a firm's post-earnings announcement drift is driven by information diffusion from subsequent-announcing industry peers. If earnings information is transferred from other firms in the industry, one would also expect that investors would perceive the earnings-related information from economically related announcing customers to be useful in updating their expectations for suppliers. Thus, earnings information would be expected to be transferred from economically related firms. I find that the immediate and delayed returns of a supplier[5] surrounding and following customers' earnings announcements are positively related to customers' unexpected earnings, confirming that customer earnings announcements convey information for suppliers.

The remainder of the paper is organized as follows. Section 2 reviews the related studies and develops hypotheses. Section 3 presents the sample selection and research design. The empirical results are provided in Section 4. Section 5 reports several robustness checks. Finally, Section 6 concludes the paper.

2. Related studies and hypotheses

2.1. Limited investor attention

This paper builds on the finance literature on limited investor attention and its effects on financial markets. Recent empirical studies have related limited investor attention to asymmetric selling behavior (Barber & Odean, 2008), demographic shifts (Dellavigna & Pollet, 2007), and relevant information at the time of previous extraneous news (Huberman & Regev, 2001). Using share turnover as a proxy for investor attention, Hou, Peng, and Xiong (2009) show that price underreaction to earnings news is weak when investors are attentive, but the price drift caused by investors' overreaction is strong with investor attention. In the same vein, Loh (2010) finds that investor inattention and the underreaction to stock recommendations lead to post-recommendation drift. In contrast, Da, Engelberg, and Gao (2011) use the Google search volume index (SVI) as a proxy for investor attention and show stronger price momentum among stocks with higher levels of SVI. Yuan (2012) finds that high market-wide attention generates heavy trading and price changes by analyzing the ability of market-wide attention-grabbing events, which are measured as record-breaking events for the Dow index and front-page articles about the stock market. Bae and Wang (2012) investigate whether the China-name affects investor attention and firm value and find that the returns of China-name stocks are, on average, more than 100% higher than those of non-China-name stocks. Bae and Wang attribute this phenomenon

3 Koch and Sun (2004) test announcement reactions around the firm's subsequent dividend changes conditioned on the sign of the firm's unexpected earnings. Kovacs (2011) examines the effect of same-industry peers' earnings announcements on the post-earnings announcement drift. Cohen and Frazzini (2008) investigate market reactions to news about related firms but do not relate the phenomenon to the price response of suppliers around (after) the customer's earnings announcement.

4 Earnings-related information transfers in the industry examined in prior studies include, among others, Freeman and Tse (1992), Ramnath (2002), and Kovacs (2011).

5 On the basis of Regulation SFAS No. 131, the suppliers need to report the identity of customers representing more than 10% of their total sales in interim financial reports issued to shareholders. Thus, the customer is important to suppliers based on sales. However, there is no information available about how important the supplier is to the customer. Therefore, this study only focuses on the effects of customer earnings surprises on supplier returns.