Pacific-Basin Finance Journal 29 (2014) 1–17

Contents lists available at ScienceDirect

Pacific-Basin Finance Journal

journal homepage: www.elsevier.com/locate/pacfin

The information content of analyst recommendation revisions — Evidence from the Chinese stock market☆

George J. Jiang [a,*], Liangliang Lu [b], Dongming Zhu [c,d]

[a] *Department of Finance and Management Science, College of Business, Washington State University, Pullman, WA 99164, United States*
[b] *Shanghai Advanced Institute of Finance, Shanghai Jiaotong University, Shanghai 200030, China*
[c] *School of Economics, Shanghai University of Finance and Economics, Shanghai 200433, China*
[d] *Key Laboratory of Mathematical Economics of Ministry of Education, Shanghai University of Finance and Economics, Shanghai 200433, China*

ARTICLE INFO

Article history:
Received 21 December 2012
Accepted 9 March 2014
Available online 19 March 2014

JEL classification:
G12
G14
G20
G23

Keywords:
Analyst recommendation revisions
Market reactions
Chinese stock market
Short-sale restriction
Behavior of individual investors

ABSTRACT

The Chinese stock market has witnessed a dramatic increase of analyst coverage over the past years. While analyst revisions clearly exhibit optimistic biases, we find significant market reactions to both upgrades and downgrades. However, in contrast to findings in existing literature for other markets, our results show that market reactions to downgrades are generally weaker than to upgrades in the Chinese stock market. We examine two hypotheses, one related to short-sale restriction and the other to the behavior of individual investors, and show that the latter is a more plausible explanation of relatively weaker market reactions to downgrades in the Chinese stock market. Finally, we show that the added value of revisions cannot be entirely credited to a small group of "lead" analysts. Our study adds to the literature with findings on the role of analysts in emerging stock markets of unique institutional settings.

☆ The authors wish to thank the editor S. Ghon Rhee, an anonymous referee, Januj Juneja and seminar participants at the Shanghai University of Finance and Economics for their helpful comments and suggestions. The last two authors gratefully acknowledge support from the Key Laboratory of Mathematical Economics (SUFE) of the Ministry of Education and China's Leading Academic Discipline Program (211 Project) for the Shanghai University of Finance and Economics (the 4th phase). The usual disclaimer applies.
* Corresponding author. Tel.: +509 335 4474; fax: +509 335 3857.
E-mail addresses: george.jiang@wsu.edu (G.J. Jiang), lllu@saif.sjtu.edu.cn (L. Lu), zhu.dongming@mail.shufe.edu.cn (D. Zhu).

http://dx.doi.org/10.1016/j.pacfin.2014.03.002
0927-538X/

1. Introduction

Analysts are known to play an important role in gathering, processing and disseminating information in the stock market. Through issuing recommendation revisions (i.e., upgrades or downgrades), analysts convey their opinions on stock valuation to the market and investors. The key question is whether recommendation revisions issued by analysts add value to investors. While it is well documented that analysts tend to issue favorable reports in terms of both earnings forecasts and recommendations,[1] the literature documents significant evidence that analyst recommendation revisions have significant information content for future stock returns.[2] However, existing studies also document that the information content of analyst recommendation revisions may vary among different countries. For example, Jegadeesh and Kim (2006) examine the value of analyst recommendation revisions in G7 countries and find that the value of analyst recommendation revisions is higher in countries with larger stock markets, for instance the US and Japan. They also observe that stock prices react insignificantly to analyst recommendation revisions in Italy. Ryan and Taffler (2006) use data from the UK stock market and find that following analyst recommendation revisions increases investors' profits. There are also a number of studies examining market reactions to analyst recommendation revisions in smaller, less developed or emerging stock markets, such as Yazici and Muradoğlu (2002) for Turkey, Schmid and Zimmermann (2003) for Switzerland, Glezakos (2007) for Greece, Liden (2006) for Sweden, and Fjeldsted (2005) for Denmark, among others. To our knowledge, there has been no study that thoroughly examines the information content of analyst recommendation revisions in the Chinese stock market.

We fill the gap in the literature and examine the added value of analyst recommendation revisions in the Chinese stock market. Our study contributes to the literature with additional findings on the role of analysts in emerging stock markets. In particular, we note that the Chinese stock market has several unique institutional features. One unique feature of the Chinese stock market is that short-sale is restricted.[3] Both the theoretical and empirical literatures have shown that short-sale restriction or short-sale constraint leads to overvaluation of stocks and tend to slow down the price discovery process (see, e.g., Miller, 1977; Jarrow, 1980; Jones, 2002; Chang et al., 2007; Bai et al., 2006). One particular implication of short-sale restriction is that negative information may not be immediately incorporated into stock prices (see, e.g., Diamond and Verrecchia, 1987).

The other important feature of the Chinese stock market is that compared to stock markets in developed countries, it is dominated by individual investors. Based on the 2010 data (China Securities Depository and Clearing Corporation Limited, 2010), 99.5% of investor accounts in China are individual accounts and only 0.5% are institutional accounts. Individual investors are often subject to various behavioral biases, such as the well-known disposition effect (see, e.g., Odean, 1998; Weber and Camerer, 1998; Chen et al., 2004). Moreover, individual investors may not be sophisticated enough to distinguish informative recommendation revisions from biased analyst opinions. As such, they may totally ignore analyst recommendation revisions or blindly follow analyst recommendation revisions (Daniel et al., 2002). Moreover, the stock market in China is still at its preliminary stage since its establishment in 1990. Analysts may not be skillful enough to provide quality and informative recommendation revisions. In addition, the trading of futures contracts on stock market indexes has only recently been launched in the China Financial Futures Exchange and there is still no trading of option contracts on individual stocks. This further limits the role of sophisticated investors in the stock price discovery process. These unique features of the Chinese stock market provide an interesting setting to examine market reactions to analyst recommendation revisions.

[1] Existing studies show that there is generally an optimistic bias in analyst earnings forecasts and analyst recommendations. Studies on biases in earnings forecasts include Fried and Givoly (1982), Brown et al. (1985), Ali et al. (1992), and Kang et al. (1994) among others. Studies on biases in recommendations include Rajan and Servaes (1997), Lin and McNichols (1998), Michaely and Womack (1999), Barber et al. (2001), Brav et al. (2000), and Jegadeesh et al. (2004), among others.

[2] For example, see Stickel (1995), Womack (1996), Francis and Soffer (1997), Barber et al. (2001), Boni and Womack (2006), Jegadeesh et al. (2004), and Jegadeesh and Kim (2006, 2010), among others.

[3] Prior to March 31, 2010, short-sale is strictly prohibited in the Chinese stock market. The restrictions have since been slightly relaxed. Six brokerages were initially approved to engage in short-sale and the list was later expanded to include additional 5 brokerages. However, only stocks in the SSE 50 Index and SZSE Index are allowed for short-sale. In addition, investors must borrow stocks that they short beforehand from the brokerages and also must have at least RMB 5 million in their security account.