



# The investment value of the frequency of analyst recommendation changes for the ordinary investor

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## ABSTRACT

We find that analysts who frequently revise their stock recommendations outperform those who do not. This result holds for portfolios formed on the basis of favorable changes in recommendations as well as unfavorable changes. The frequency of revision captures information incremental to factors known to identify superior recommendations. Although much of the frequently revising analysts' advantage follows events proxied by abnormally high returns or trading volume, it does not appear to derive from more public events such as earnings announcements. Further, these analysts outperform their counterparts even over the short-run, suggesting that this is not simply a “quantity over quality” phenomenon. In summary, our results imply that the superior profitability of frequently revising analysts emanates at least partly from their ability to generate private information using their superior skill. Overall, the ordinary investor is better off following the advice of analysts who revise their recommendations more frequently.

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## 1. Introduction

One of the oldest questions in finance is whether investment professionals, a.k.a. “experts,” can predict or impact the market. Much of the literature suggests that when analysts speak, investors listen.<sup>2</sup> Dimson and Marsh (1984) find that analysts' predictions of future stock returns are exaggerated, but directionally correct on average. Elton et al. (1986) find that abnormal returns congruent with the nature of the recommendation exist for up to two months after the recommendation is made, while Womack (1996) finds significant excess returns for up to six months after recommendation downgrades. Similarly, Barber et al. (2001, 2003), and Jegadeesh et al. (2004) find that abnormal returns increase with a stock's level or change in average recommendation. These empirical findings are consistent with Grossman and Stiglitz (1980) that information gatherers bring new information to the market to justify their compensation.

Most of the earlier studies have focused on the aggregate performance of recommendations and recommendation revisions. More recently, there is a host of papers providing evidence on cross-sectional differences in recommendations' profitability. One reason for

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<sup>2</sup> The empirical research on this topic dates back to Cowles (1933), and was later refined and expanded by Black (1971), Bidwell (1977), and Groth et al. (1979) Logue and Tuttle (1973), among others. These early studies were mixed in their conclusions; some found that recommendations were primarily a reaction to past returns and held little, if any, predictive value, while Black (1971) and Copeland and Mayers (1982) found that highly rated stocks on Value Line experienced positive abnormal returns while low-rated stocks experienced negative abnormal returns. Logue and Tuttle (1973) found predictive value in the sell recommendations, but not in the buy recommendations, made by brokerage houses.

these differences is that some analysts may have better skill or better access to private information. Ertimur et al. (2007) and Loh and Mian (2006) find that analysts who issue more accurate forecasts also make more profitable recommendations. Li (2005), and Mikhail et al. (2004) document that the past performance of an analyst's recommendations tends to persist in the future. Fang and Yasuda (2011) find that top-ranked All-American analysts, who tend to be more experienced than lower-ranked All-American and other analysts, recommend better investments as measured by subsequent risk-adjusted returns. Jegadeesh and Kim (2006) show that analysts who make bolder recommendations than the consensus have a greater price impact. Loh and Stulz (2011) argue that star analysts and more experienced analysts tend to issue more influential stock recommendations than do other analysts. However, Emery and Li (2009) suggest that analyst status can be likened to a "popularity contest" from which subsequent recommendations do not yield positive abnormal profits – and in some cases even yield negative profits.

Another reason for the cross-sectional differences in analysts' recommendations is that some analysts may have distorted incentives. For example, Barber et al. (2007) find that analysts employed by investment banks provide less profitable buy recommendations than analysts employed by independent research firms. Recommendation profitability can also differ based on corporate events. For example, Bradley et al. (2008), and Loh and Stulz (2011) indicate that recommendations issued concurrently with companies' earnings announcements are more influential. Finally, there is evidence that recommendations accompanied by earnings forecasts are more profitable (e.g. Kecskes et al., 2010), and that other items included in analysts' reports, such as price targets and qualitative analysis, also impact the profitability of recommendations (e.g. Asquith et al., 2005).

In this paper we investigate the relative performance of analysts' recommendation changes based on how frequently they revise a typical recommendation. There are at least three reasons to believe that analysts who differ by the frequency of revision may have differential profitability for investors. Analysts compare their own assessment of a firm's fundamental value with the market price and revise their recommendation when they see a substantial change relative to their outstanding recommendation. It is possible that some analysts have better knowledge of the industry, more timely access to management, suppliers, and customers, or alternatively are able to process publicly available information more efficiently than others. We expect that analysts with an advantage in information or skill are able to identify mis-valuation in stock prices more often, and thus revise their recommendations more frequently. Therefore, trading on their recommendations will be more profitable to investors in terms of exploiting short-term mispricing. Frequent recommendations can also reflect more timely communication with investors, an aspect of analyst performance deemed important by Institutional Investor survey participants (Leone and Wu, 2007).

Alternatively, one could argue that analysts who revise their recommendations more often are acting on noise, perhaps owing to overconfidence (Barber and Odean, 2000; Odean, 1998). Accordingly the analysts who revise recommendations less frequently are the ones who actually uncover new information. Furthermore these analysts may be more cautious and perhaps use multiple valuation screens before making their recommendation revisions. By this reasoning, investors may be better off following the recommendations of analysts with less frequent revisions.

Additionally, it is possible that the type of information the analyst has determines how frequently he or she changes recommendations. If this is the case, analysts with short-term information will more frequently change recommendations while analysts with long-term information will not change recommendations as frequently. Therefore investors will be better off in the short-run following the recommendations of analysts with more frequent revisions. However, the analysts with less frequent revisions may provide more value to investors in the long-run.

Our study examines whether the frequency of recommendation revisions relates to their profitability. We attempt to generate a profitable trading strategy for investors by focusing on performance differences at the analyst level, similar in spirit to Li (2005), Barber et al. (2007), and Fang and Yasuda (2011). The findings herein could potentially help the ordinary investor, who has limited time and resources and is likely to follow just one or a few analysts, identify superior performers from the universe of all sell-side analysts based on a simple measurable yardstick of frequency of recommendation changes in the recent past. Our study also contributes to the academic literature by providing information about the sources of competitive advantage in sell-side equity research. Finally, our work complements some of the findings in the buy-side literature. Yan and Zhang (2009) find that the positive alphas associated with institutional investors are concentrated in those institutions whose focus is on short-term, rather than long-term, profits. Although the work environment of sell-side analysts substantially differs from that of buy-side managers in terms of regulations, bases for evaluation and compensation, employers, and responsibilities (Schipper, 1991), to the ordinary investor the primary question remains unchanged: which type of analyst yields more profitable recommendations?

We then explore some of the potential reasons for why frequently revising analysts yield greater returns. The source of this higher profitability could, for example, be an enhanced ability to interpret publicly available information. However, we find no statistical difference between frequently and infrequently revising analysts in the percentage of recommendation changes that occur around earnings announcements, and the difference in profitability between the two groups is not concentrated in those revisions that are made during earnings announcement periods. Additionally, it is possible that frequently revising analysts respond more quickly to other information events proxied by abnormally large stock returns or trading volume (in the spirit of Leone and Wu, 2007). Indeed, we find that frequently revising analysts respond more quickly both to large stock price changes and above-average turnover than do infrequently revising analysts, and those responses yield much higher profits. Finally, we examine whether the underperformance of infrequently revising analysts is driven simply by their relative lack of revisions. We compare the short-run profitability of the two analyst groups by excluding from our portfolios all outstanding recommendations older than two months, and find very similar results to our "long-run" analysis. Thus it appears that those analysts who most frequently revise their recommendations do better even in the short-run; they do not outperform their counterparts simply on the basis of quantity. Overall, our results suggest that at least part of the superior profitability of frequently revising analysts' recommendations derives from a better knowledge of the industry or companies they cover or from more timely access to management, suppliers, and customers.

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