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Value of analyst recommendations: International evidence ☆

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Abstract

We evaluate the value of analysts' recommendations in the G7 countries. Stock prices react significantly to recommendation revisions in all countries except Italy. We find the largest price reactions around recommendation revisions and the largest post-revision price drift in the US. Neither differences in the timing of recommendation revisions relative to earnings announcements nor differences in industry coverage explain the superior performance of the US analysts' recommendations. Tests within a subsample of ADRs indicate that the most likely explanation for the superior performance is that the US analysts are more skilled at identifying mispriced stocks than their foreign counterparts.

JEL classification: G14; G15; G24

Keywords: International financial markets; Analyst recommendations; Conflicts of interest

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1. Introduction

Stock analysts form an integral part of capital market operations, providing stock related research for their brokerage clients who use their research reports, earnings forecasts and stock recommendations for investment decisions. Recently, analysts' roles as investment advisors have come under intense scrutiny. Media reports and some anecdotal evidence suggest that analysts compromise their objectivity and issue positive recommendations to curry favor with potential investment banking clients of their employers, rather than for the benefit of the investors who rely on their advice. A recent Fortune article, for instance, claims that the investment advice offered by analysts is "so dishonest and fraught with conflicts of interest that it has become worthless."[1]

Analyst recommendations do contain an element of bias towards being favorable. Earlier papers document that analysts rarely issue sell or strong sell recommendations. Jegadeesh et al. (2004) report that the average analyst rating over the 1985 to 1999 period is close to a buy recommendation and sell or strong sell recommendations make up less than five percent of all recommendations. Furthermore, Lin and McNichols (1998) and Michaely and Womack (1999) find that the analysts employed by the lead underwriters for new equity issues issue more favorable recommendations for those stocks than the other analysts who follow them.[2]

Extant literature finds that despite inherent biases analyst recommendations do add value. Stickel (1995) and Womack (1996) document that recommendation upgrades tend to outperform downgrades, and Barber et al. (2001), Jegadeesh et al. (2004), Boni and Womack(2003) and Green (2006) find that the stocks with the most favorable recommendations outperform the stocks with the least favorable recommendations. These findings indicate that investors can benefit from analysts' recommendations if they consider the relative levels of recommendations across stocks, or if they pay attention to changes in recommendations.

How much value can analysts potentially add? This is certainly a hard question to answer because there is no natural benchmark. In a perfectly efficient market, analysts would not be able to add any value because market prices already would reflect any information analysts might have. If analysts possess unique skills in collecting and analyzing value-relevant information, however, then they can add value, but its magnitude can only be empirically determined. Several papers have examined the value of analyst recommendations in the US to shed light on this issue. The recent controversy about the US analysts' objectivity and the debate about the usefulness of their recommendations, however, indicate that our understanding of how much value analysts can add is far from complete. An examination of the value of analyst recommendations in other developed countries will give us a more comprehensive picture of the extent to which the unique skills of analysts are useful for investors.

This paper examines analyst recommendations in the Group of Seven (G7) industrialized countries and evaluates their value for investors. While the value that analysts add has been extensively studied in the US, that value in the other countries has

[1] See Gimein (2002).

[2] Also see Bradley et al. (2003) for more evidence on conflicts of interest due to investment banking relationships.