Analyst Coverage and the Profitability of Bold Recommendations

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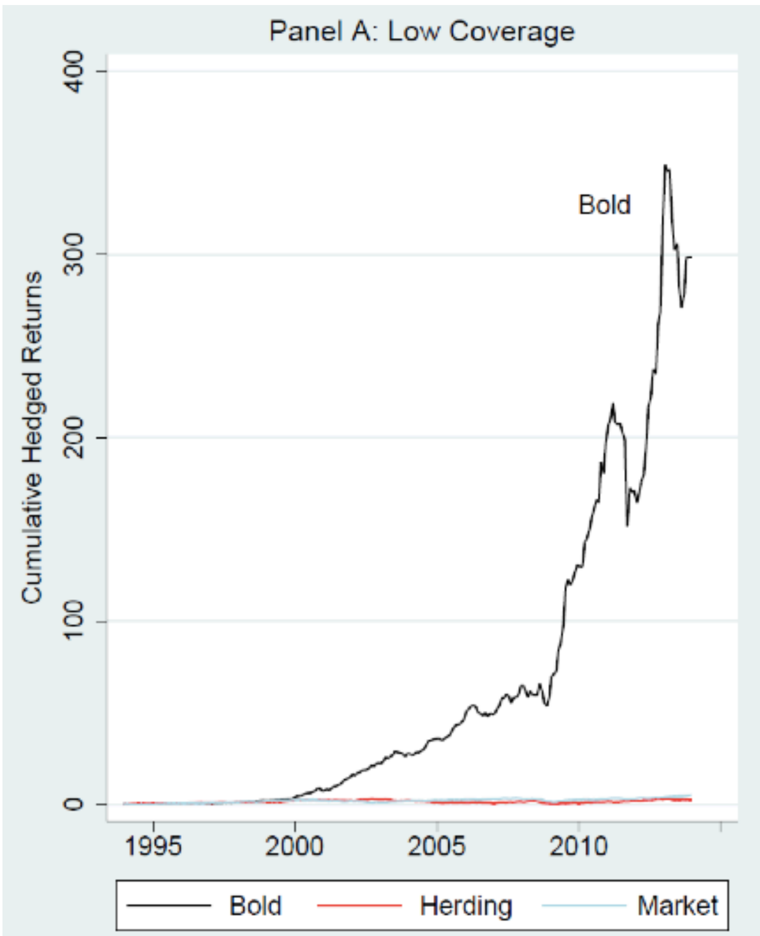
Figure 1: Panel A

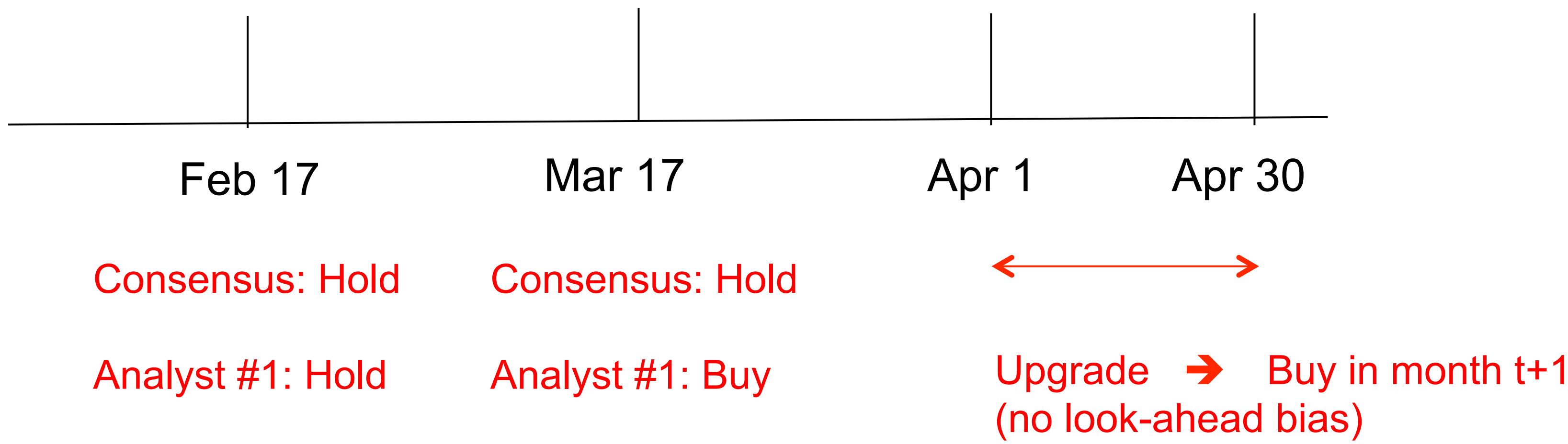


Simple Trading Strategy

- Select firms followed by less than three analysts
- Buy (Sell) when rec'd upgraded (downgraded)
- Bold, not herding

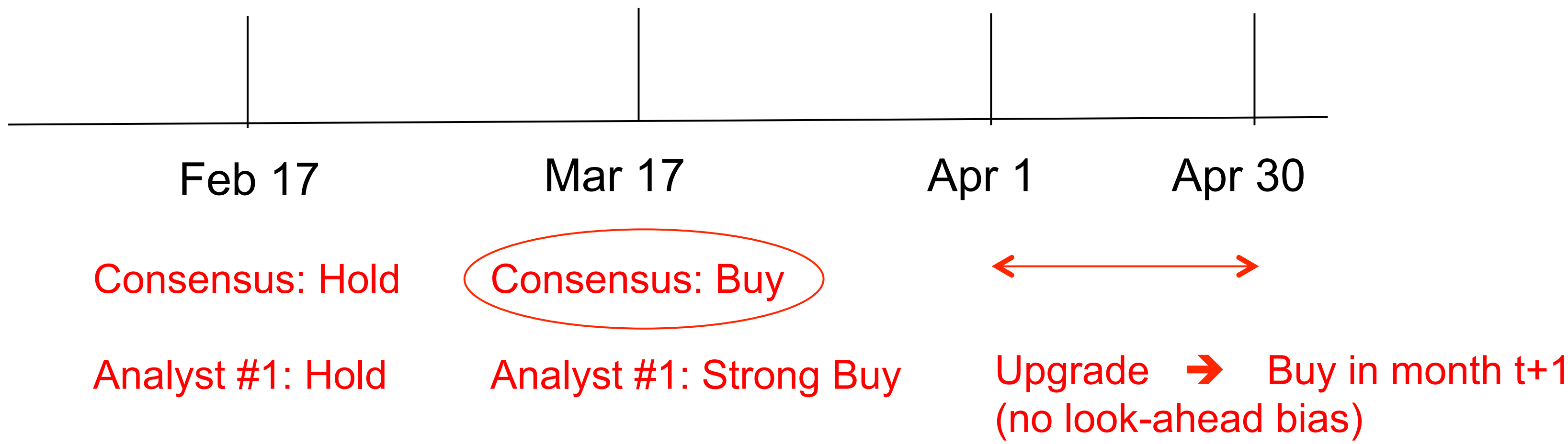
Yields 34% per year

Timeline / Definition



- "Bold" if it deviates away from the *prior period* consensus recommendation (Clement and Tse, 2005)

Timeline / Definition



- "Bold" if it deviates away from the *prior period* consensus recommendation (Clement and Tse, 2005)
- Robustness: "Bold" if it is different from the *contemporaneous* consensus.

Things to Note

- Stock recommendation, not EPS forecast
  - EPS forecast is merely one of the many items an analyst forecasts to support their valuation and stock recommendation
- Change in recommendation, not level
  - Upgrade or Downgrade (Francis and Soffer, 1997)

Outline

- Motivation
- Hypothesis
- Research Design
- Data
- Conclusion

Motivation

- Why would some analysts deviate away from the "herd”, and issue "bold" recommendations?

Hypothesis

- Analysts issue bold rec'd when they believe they have some comparative advantage (e.g., higher ability or private info)
- But this belief is less likely to be correct for firms followed by many analysts
  - Because prices of those firms incorporate a richer set of info (Roulstone, 2003; and Bowen, Chen, and Cheng, 2008)
- And conversely, more likely to be correct when followed by few analysts

Hypothesis (to paraphrase)

- Analysts should assess the skill of the peer analysts before deviating, and larger peer groups make this task difficult
- Prior studies find that overconfidence is more prevalent for difficult tasks (Svenson, 1981, Barber and Odean, 2001)
- Analysts who deviate away from the consensus tend to be overconfident when there are many other peer analysts.

Tension (alternative prediction)

- Whether our hypothesis is correct is an empirical question
  - Analyst coverage is endogenous
  - More or less effort needed for high coverage?

Research Design

	Herding	Bold
Low		
Medium		
High		

- Partition the firm-months into three equal groups: Low, Medium, and High coverage

Trading Strategy

- Each month, IBES announces the consensus stock rec’d, EPS forecast, # of analysts, etc. for each firm
- We infer the identity of analysts underlying these consensus, and their stock rec’d and EPS forecast (Glushkov, 2009)
- If stock rec’d are upgraded (downgraded), buy (sell) in the following month t+1 (Jegadeesh, Kim, Krische, and Lee, 2004)

Table 1 Sample Selection

Coverage	Number of firm-months	Percentage (%)
Low (< 3 analysts)	300,709	36.74
Medium (3 ≤ analysts ≤ 5)	242,691	29.65
High (≥ 6 analysts)	274,983	33.60
Total	818,383	100.00

Table 2 Buy-and-Hold Return

	Herding	Bold	Bold – Herding
Low	0.75*	2.56***	1.81***
Medium	0.74***	0.67**	-0.07
High	0.26**	0.08	-0.18
Low – High	0.48	2.48***	1.99***

Figure 1: Panels A and B

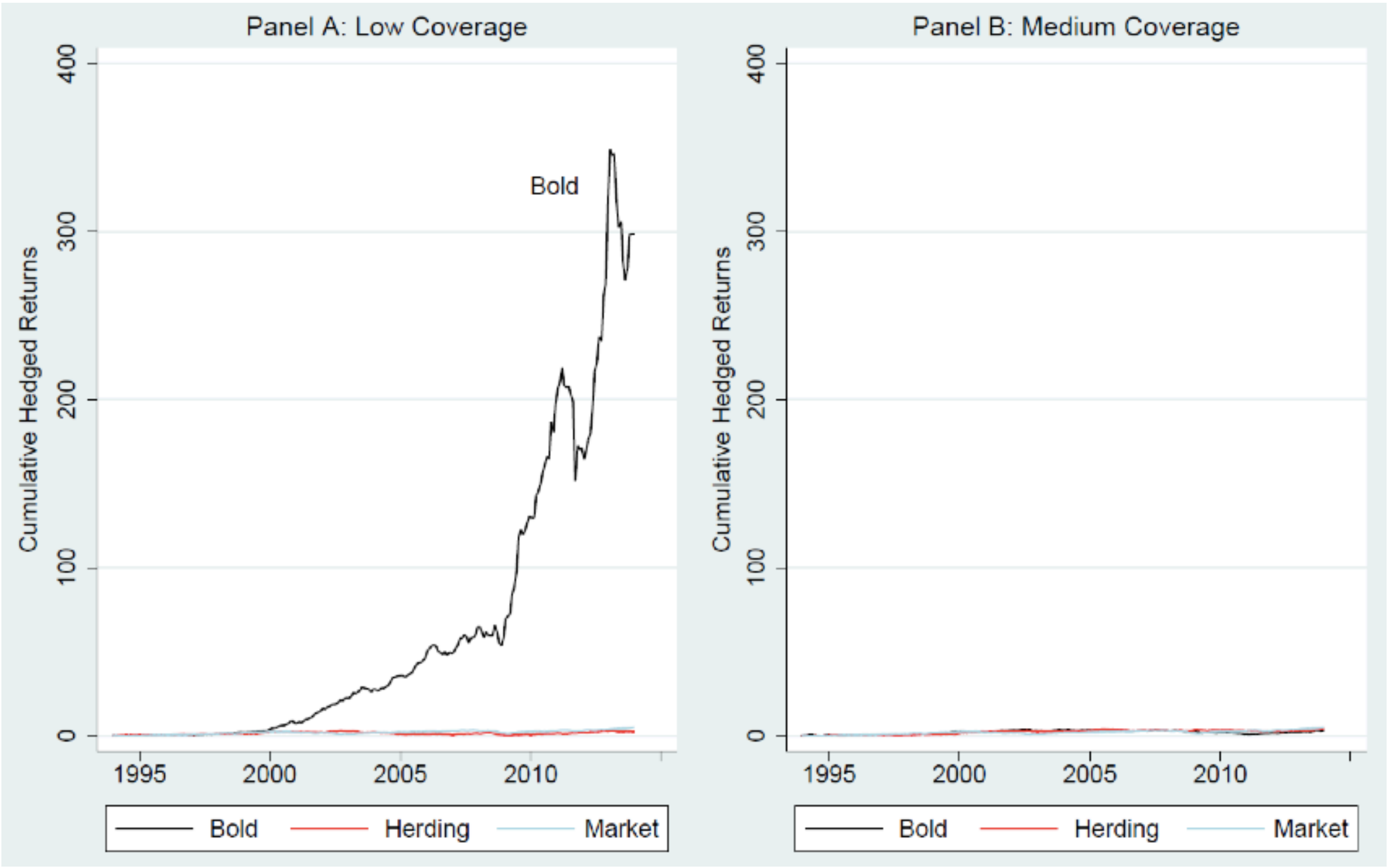


Figure 1: Panels D and E

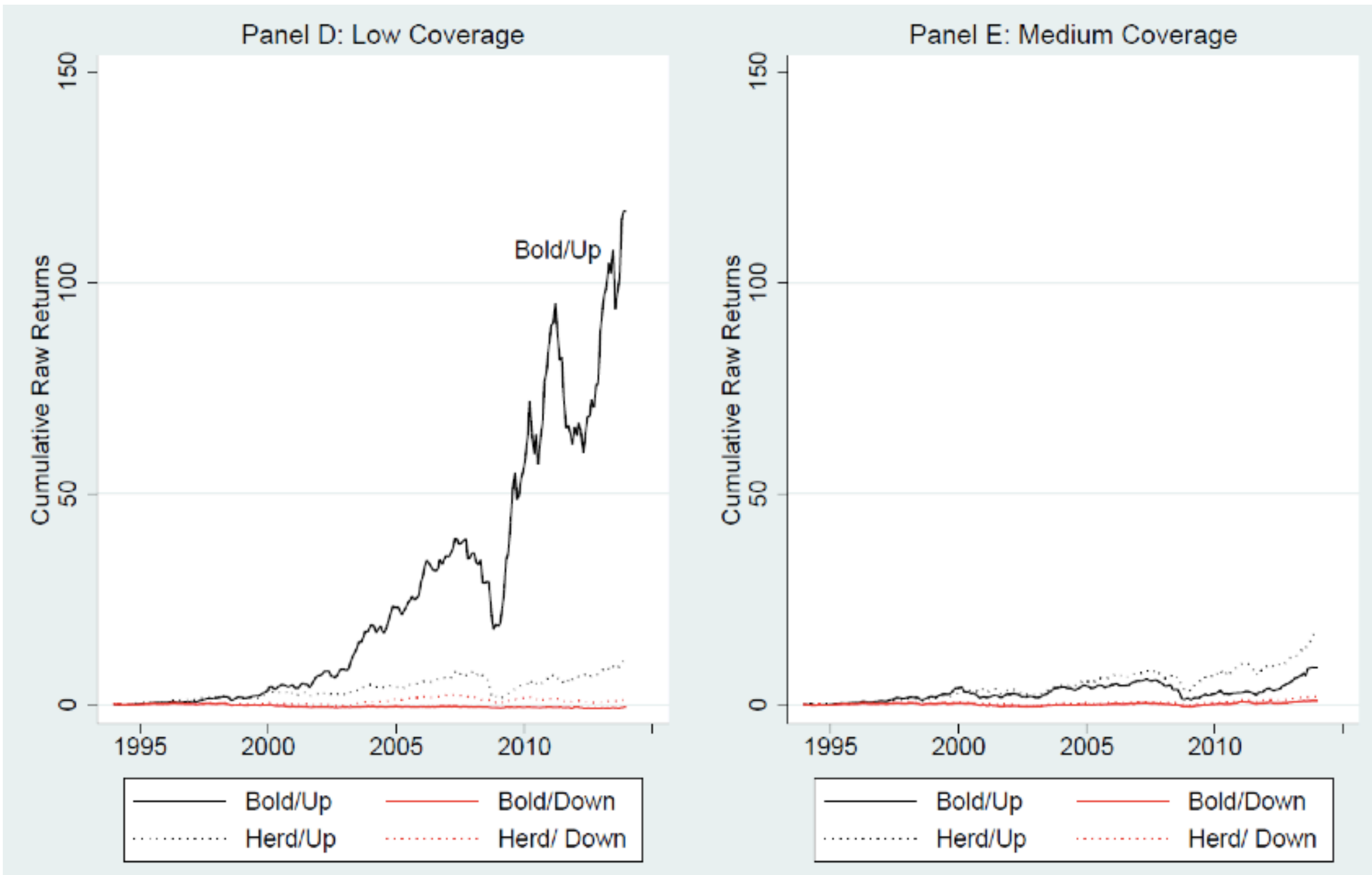


Table 3 Risk-Adjusted Return

	Herding	Bold	Bold – Herding
Low	0.73	2.49***	1.76***
Medium	0.71	0.62	-0.09
High	0.35	0.13	-0.22
Low – High	0.38	2.36***	1.98***

Table 4 Effect of Earnings Announcement

	Herding	Bold	Bold – Herding
Low	0.62	3.87***	3.25**
Medium	0.63	0.49	-0.13
High	0.19	-0.18	-0.37
Low – High	0.43	4.05***	3.62**

Table 5 Earnings Surprise (Consensus)

	Herding	Bold	Bold – Herding
Low	0.30	0.67***	0.38
Medium	0.14	0.09	-0.05
High	0.15***	0.07	-0.08
Low – High	0.15	0.60***	0.45

Table 5 Earnings Surprise (Individual)

	Herding	Bold	Bold – Herding
Low	0.88*	1.80***	0.92
Medium	0.53	-0.05	-0.58
High	0.29*	0.39	0.10
Low – High	0.59	1.41*	0.82

Table 5 Earnings Surprise

		Herding	Bold
Low coverage (analysts < 3)	Upgrade	-0.24* (-1.72)	-0.15** (-2.23)
	Downgrade	-0.54*** (-4.11)	-0.82*** (-4.18)
	Hedged Surprise = Upgrade – Downgrade	0.30 (1.56)	0.67*** (3.30)

Consensus EPS Surprise

		Herding	Bold
Low coverage (< 3 analysts)	Upgrade	-0.60* (-1.84)	-0.19 (-0.87)
	Downgrade	-1.48*** (-3.60)	-1.99*** (-3.21)
	Hedged Surprise = Upgrade – Downgrade	0.88* (1.67)	1.80*** (2.67)

Individual EPS Surprise

Table 6 Selection Bias

	Herding	Bold	Bold – Herding
Low	3.35	5.84**	2.49
Medium	4.22	1.17	-3.05
High	1.34	-0.13	-1.47
Low – High	2.01	5.97**	3.96

Table 7 Initial Stock Price Reaction

	Herding	Bold	Bold – Herding
Low	1.06***	1.23***	0.17
Medium	0.92***	1.18***	0.26
High	0.65***	0.77***	0.12
Low – High	0.41**	0.46**	0.05

Conclusion

- Why do some analysts deviate away from the consensus?
  - They think they have relatively higher ability / private info
  - Perception less (more) likely to be right when info environment is more (less) transparent
- Highly profitable to trade based on [bold, low] recommendations
- Prior literature documents very low returns (Barber et al., 2001)
- Profitability is partly due to the earnings news
- EPS forecast appears biased to support the stock recommendations
- Rules out alternative explanations (e.g., selection bias)

Thank you

Comments? → Email: fscheong@nyu.edu