Security Analysts and Capital Market Anomalies

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Summary

Objective: this paper examines whether analysts make recommendations based on the information about stock return anomalies

Sample: monthly observations from 1993 to 2014

Findings:

- Analysts fail to make their recommendations to take advantage of anomalies, but also their recommendations are often contradictory to anomaly predictions

- When analyst recommendations and anomaly prescriptions contradict, anomaly returns are amplified

- Analysts whose recommendations are aligned with anomaly signals are more skilled and generate greater recommendation announcement returns

Literature

Positive effects:

- Expected returns (Kelly and Ljungquist, 2012)
- Share price informativeness (Graham, Harvey, and Rajgopal, 2005)
- Earnings management (Yu, 2008)

Negative effects:

- Pressure on managers to manage earnings (Degeorge, Patel, and Zeckauser, 1999)
- Pressure on analysts to issue biased reports for private benefits (Dechow, Hutton, and Sloan, 2000; Lin and McNichols, 1998; Michaely and Womack, 1999).

Contribution:

This paper links the information on return anomalies with analyst recommendations

Skills for financial analysts

Ethical and Professional Standards
Learn about putting investors first in critical and everyday practice.

Quantitative Methods
From time value of money analysis to correlation analysis and regression, learn robust quantitative methods.

Economics
Delve into supply and demand, the monetary system, inflation, effects of government regulation, and much more.

Financial Reporting and Analysis
Learn the details of the financial reporting system (emphasis on international standards, IFRS) and analysis of taxes, debt, global operations, and more.

Corporate Finance
From corporate governance to capital structure decisions, we cover complex issues in corporate finance.

Equity Investments
Study the types of equity securities, equity portfolio measurements, and much more.

Fixed Income
Study fixed income security types, portfolio benchmarks, and other complex topics.

Derivatives
Learn about forward markets, future markets, option markets, and more.

Alternative Investments
Examine real estate, private equity, commodities, and more.

Portfolio Management and Wealth Planning
Examine the essentials of managing different types of portfolios successfully.

1) Are they supposed to know these anomalies

2) Is the anomaly list updated in the course "Equity Investments"

3) Do they still remember the content after they finish exams?

Alternative explanations: data mining

Fama (1998) states that academics have likely tested thousands of variables, so it is not surprising to find that some of them predict returns in-sample, even if in reality none of them do.

Generalize this argument

- Financial analysts have incorporated many possible signals into the stock price through recommendations or earnings forecasts.

- The reason that analysts fail to make their recommendations to take advantage of anomalies is that only these anomalies survive in analyst forecasts

Analyst recommendations around anomalies

The results are generally different for the two types of anomalies:

- MGMT: mispricing caused by firm managers' decisions
- PERF: mispricing related to firm performance

Analyst recommendations are contradictory to MGMT anomalies but consistent with PERF anomalies

	MGMT			PERF	
	Rec	ΔRec		Rec	ΔRec
Long	3.53	-0.06	Long	3.91	0.04
2	3.64	-0.05	2	3.85	0.01
3	3.78	-0.02	3	3.78	-0.03
4	3.92	-0.02	4	3.70	-0.07
Short	4.09	0.02	Short	3.72	-0.11
Long - Short	-0.56***	-0.08***	Long – Short	0.19***	0.15***

Explanations :

- Does it mean that analysts are not completely unable to take advantage of anomaly information?
- Does it mean that financial analysts are good at analyzing performance related signals?

Analyst recommendations around anomalies-continued

How analyst recommendations are correlated with anomalies is the **key of the paper**

1) What kind of anomalies do analysts know?

McLean and Pontiff (2016) classify anomalies into four different types: (i) event, (ii) market, (iii) valuation, and (iv) fundamentals.

- One conjecture is that analyst recommendations may be consistent with some anomaly types but not others
- What is the implication?

2) Under what scenarios, analysts issue biased recommendations though they may be aware of anomalies

- Can we test the following incentives?
  - pursue investment banking business
  - need to maintain good relationships with management for access to private information
  - avoid downgrades in stocks in which clients have holdings

Effect of institutional holdings

Tests on the plausible explanation: analysts may issue biased recommendations mainly to cater to institutional investors' preferences for overvalued stocks

Evidence: analyst recommendations are similarly biased for stocks with low and high institutional ownership

Additional thoughts: Cao, Han, and Wang (2017) show that institutions tend not to buy more of a stock with good news that they already overweight; they are reluctant to sell a stock with bad news that they already underweight.

The level of ownership $\neq$ information demand

Intuition:

- Information demand is more or less affected by institutional investors' trading constraints.
- Maybe further analysis can be done for investment constraint proxies

Skilled analysts

Heterogeneity among analysts: the correlation between analysts' recommendation values and the two composite mispricing scores among all of the stocks covered by the analyst during the past three years.

This correlation measure is regressed on several analyst characteristics

	$Corr_{MGMT}$				$Corr_{PERF}$			
AllStar	-0.004	-0.014**	-0.003	-0.011*	0.007	0.012**	0.006	0.012*
	(-0.74)	(-2.21)	(-0.56)	(-1.75)	(1.43)	(2.00)	(1.21)	(1.85)
Away from consensus	-0.001	-0.000	-0.001	-0.001	-0.001	-0.004	-0.001	-0.003
	(-0.25)	(-0.03)	(-0.41)	(-0.30)	(-0.39)	(-1.14)	(-0.17)	(-1.00)
Accuracy	0.004**	0.002	0.005**	0.002	0.006***	0.005**	0.005***	0.005**
	(2.10)	(0.63)	(2.21)	(0.75)	(3.01)	(2.42)	(2.78)	(2.14)
FirmExp	-0.000	-0.001	-0.000	-0.001	-0.001*	-0.001**	-0.001*	-0.001*
	(-1.06)	(-1.49)	(-0.97)	(-1.47)	(-1.95)	(-2.17)	(-1.66)	(-1.68)
TotalExp	-0.000*	-0.000	-0.000**	-0.001**	0.001***	-0.000	0.001***	0.001**
	(-1.78)	(-0.55)	(-2.20)	(-1.99)	(2.73)	(-0.02)	(3.65)	(2.55)
Ln(BrokerSize)	-0.008***	-0.007***	-0.008***	-0.007***	0.004***	0.002	0.004***	0.002
	(-5.45)	(-3.81)	(-5.26)	(-3.69)	(3.13)	(1.18)	(2.74)	(1.21)
Coverage	-0.000	-0.000**	-0.000	-0.000**	0.000	0.000*	0.000	0.000
	(-0.75)	(-2.30)	(-0.63)	(-2.37)	(1.56)	(1.66)	(0.94)	(1.45)
Average Size	0.000**	0.000*	0.000**	0.000	0.000	-0.000	0.000	0.000
	(2.45)	(1.74)	(2.13)	(1.29)	(0.16)	(-0.46)	(0.77)	(0.05)

Except forecast accuracy, how to explain the results of other analyst or brokerage characteristics? For example, *TotalExp* and *AllStar*

Skilled analysts

- Is there a group of analysts whose skills focus on analyzing return anomalies?

- Do analysts from the same brokerage firm possess similar skills?

- Is there a time-series variation in such skills?

Conclusion

Research question: linking analysts with stock anomalies

Empirical tests: quite comprehensive and well designed

Main comments: ruling out alternative explanations