A CLOSE LOOK ON THE IMPACT AND PERFORMANCE OF FINANCIAL ANALYSTS

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ABSTRACT OF THE DISSESRTATION

A Close Look on the Impact and Performance of Financial Analysts

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This dissertation consists of two essays on financial analysts' stock recommendations. The first essay examines the relationship between corporate social responsibility (CSR) report and the value of financial analysts' stock recommendation revisions. We find that the value of stock recommendations for socially responsible companies is lower than non-socially responsible companies. Also, we show that there is an inverse relation between the level of information on CSR strengths and concerns and the value of financial analysts' stock recommendations. Furthermore, when we focus on the sensitivity of change of CSR ratings, our result indicates that the value of stock recommendations is negatively associated with a firm's improvement on CSR score. As a firm experiences more change in social responsibility strengths and concerns, the value of analysts' stock recommendations decreases. Our results imply that the value of recommendation is a function of firms' CSR ratings and the amount of information on CSR strengths and concerns. In the second essay, we hypothesize that a perception of higher ability is implicit when an analyst makes a bold recommendation, and that this self-assessment is more likely to be correct when there are few analysts covering the firm. Consistent with our hypothesis, we find that it is highly profitable to trade based on bold recommendations for firms with low analyst coverage (risk-adjusted return of 30% per year), but not bold recommendations for high coverage firms. Herding

recommendations, whether for firms with low or high coverage, are not profitable. The profit from this trading strategy is related to the news released during earnings announcements.

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Dedication

To my parents and brother.

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2.3.1 Buy-and-Hold Return

Table 2.3 investigates our hypothesis that bold analysts have higher ability than herding analysts, but only when they are following firms with low analyst coverage. We tabulate the mean one-month buy-and-hold return, separately (a) for herding and bold recommendations, (b) for recommendations that are upgraded, downgraded, and not revised, and (c) for firms with low and high analyst coverage. To avoid look-ahead bias, the holding period for our buy-and-hold portfolio starts at the beginning of the following month after the revision of analyst recommendations. See Appendix A for an illustration of recommendation classification and trading strategy.

For low coverage firms (Panel A), we find that the hedged return (i.e., the one-month buy-and-hold return of upgraded stock minus that of downgraded stock) is highly profitable at 2.25% per month (31% per year) when based on bold recommendations. The hedged return of bold recommendations is significantly higher than that of herding recommendations (1.76% per month). Notably, most of this hedged return comes from the long side rather than the short side (1.02% per month vs 0.74% per month), which means that our trading strategy is profitable without taking any short positions.

However, for high coverage firms (Panel B), the hedged returns of both bold and herding recommendations are low (even thought they are statistically significant). More importantly, the difference in hedged return between bold and herding recommendations is insignificant.[6]

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[6] As a further breakdown on analyst coverage, the hedged returns for bold recommendations is 2.75% (for the case of 1 analyst), 1.87% (2 analysts), 0.80% (3 analysts), and 0.28% (4 and more analysts).