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Can analysts pick stocks for the long-run? ☆

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ABSTRACT

This paper examines post-revision return drift, or PRD, following analysts' revisions of their stock recommendations. PRD refers to the finding that the analysts' recommendation changes predict future long-term returns in the same direction as the change (i.e., upgrades are followed by positive returns, and downgrades are followed by negative returns). During the high-frequency algorithmic trading period of 2003–2010, average PRD is no longer significantly different from zero. The new findings agree with improved market efficiency after declines in real trading cost inefficiencies. They are consistent with a reduced information production role for analysts in the supercomputer era.

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1. Introduction

For decades researchers have examined average long-run stock returns after sell-side security analysts revise their recommendations for buying and selling stocks. The universal finding is that the recommendation changes predict future long-term returns in the same direction as the change (i.e., upgrades are followed by positive returns, and downgrades are followed by negative returns). This phenomenon is known as post-revision return drift (PRD). This result has supported the hypothesis that PRD persists because investors typically underreact to analysts, responding partly at their revision announcements and slowly thereafter, perhaps taking months. It has also underpinned the nested hypothesis that security analysts are better-informed, skillful at information discovery from non-public sources (e.g., from insiders) and from neglected public information in inefficient markets, as noted by Grossman and Stiglitz (1980).[1]

This article provides new evidence about PRD that extends the literature in a number of ways. The primary

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[1] Givoly and Lakonishok (1979), Womack (1996), Hong, Lim, and Stein (2000), Gleason and Lee (2003), Jegadeesh, Kim, Krische, and Lee (2004), and Loh (2010) discuss underreaction to analysts.

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contribution is the finding that average PRD is no longer persistently different from zero in the May 2003 through 2010 sample post-period. A second contribution is new results that show a causal relationship between analysts' revisions and PRD is not supported in many tests of the PRD cross-section.

A third contribution is new evidence from the PRD cross-section regarding the investor underreaction hypothesis and the informed analyst hypothesis. Results from tests for underreaction that use proxies suggested by other researchers do not support the underreaction hypothesis in the post-period. For instance, one finding in this article shows there is no significant association between PRD and analysts' coverage, a widely used proxy for underreaction. Tests of the informed analyst hypothesis that employ proxies for better-informed analysts used in prior research, do not support the idea that analysts typically supply new information that correctly picks stocks for the long run. One example is that the PRD cross-section reveals no significant association with extreme revisions, a commonly used proxy for better-informed analysts.

A further contribution of this article is new findings supporting the alternative explanation for the persistence of PRD noted by Barber, McNichols, and Trueman (2001), that transaction costs, a real inefficiency, are high enough to fence PRD from profitable arbitrage trading strategies. The results agree with the explanation that PRD has broadly vanished due to a general decline in transaction costs, pushed down to historic lows by decimalization, the expanded use of supercomputers, and algorithmic trading. The PRD disappearance coincides with notable reductions in transaction costs that have attracted profit-taking arbitrageurs to PRD.[2]

The empirical findings in this article are robust to a number of concerns. First, the bad model concern is addressed by using PRD measures built with different asset pricing models and benchmark returns, including the market return and the return on a similar group of stocks identified by the four-characteristics model return of Daniel, Grinblatt, Titman, and Wermers (1997). Using these same models to estimate returns in both the post-period and the sample pre-period, 1997 through April 2003, suggests that the insignificance of the average PRD in the post-period is unlikely to be the result of switching expected return models. Still, the findings do not preclude that future research could yield expected return models that capture long-run drift effects. Second, the findings are not the result of a particular method for aligning the measurement of the PRD. Third, the conclusions are reinforced for refined types of revisions noted in the literature, which include consensus recommendations and extreme revisions. Lastly, out-of-sample tests confirm a general absence of PRD in the post-period. This test uses international analysts' revisions in the other Group of 7 countries: Canada, France, Germany, Italy, Japan, and the UK.[3] The findings show that drift after analysts' revisions in these countries also is not informative in the post-period, supporting similar findings for U.S. analysts.

PRD is examined from several perspectives, reflecting different ways that researchers have measured PRD, and a variety of samples that are employed for different tests. One PRD measure uses an event study approach in which the revisions are aligned on their announcement date, similar to that used by Womack (1996) and by Jegadeesh, Kim, Krische, and Lee (2004). This measure is examined in the *Event-time sample* (see Appendix A.1 for sample descriptions). A second measure evaluates PRD from a portfolio perspective in calendar time and examines the returns on buy portfolios of upgraded stocks and sell portfolios of downgraded stocks, and compares their differences. This drift measure is similar to that employed in Barber, McNichols, and Trueman (2001) and utilizes the *Portfolio sample*. PRD is examined from a third viewpoint first introduced in this article, which aligns firms on their earnings report announcement dates, and compares the drift for firms with upgrades to the drift for the other firms with continuations (i.e., those with unchanged recommendations), and similarly for the downgrades. This method controls for the influence of post-earnings announcement drift (PEAD) and uses the *Earnings sample*. Revisions in each of these three samples are examined in both the post-period and in the pre-period. This provides opportunities to replicate findings from the earlier studies, and to compare the pre- and post-period PRD behavior side-by-side. PRD is also examined in a sample of consensus recommendations within each period.[4]

Although average transaction costs are lower in the post-period, it is unlikely that they have entirely disappeared (for example, see Beneish, Lee, and Nichols, 2015; Boehmer and Wu, 2013). Under the transaction cost rationale, some PRD is likely present for stocks with relatively high transaction costs. In agreement, after sorting the *Event-time sample* into trading volume deciles, some statistically significant average PRD exists in the lowest decile, or 10% of the revisions. Significant average PRD is also present in the lowest deciles in sorts by firm size and by analysts' coverage of the firm. The *Volume*, *Size*, and *Coverage* (*VSC*) *revisions* that are common to the lowest deciles for all three characteristics, and make up 3% of all revisions, are expected to have high transaction costs. In agreement *VSC revision* stocks have a number of characteristics that are consistent with high transaction costs. Their stock prices are among the lowest, so trading a certain weight of these shares in a given portfolio will be more costly (i.e., requiring the sale of many

[2] In the supercomputer era, the equity trading market was transformed into the supercomputer intermediated market (Angel, Harris, and Spatt, 2012). Along with decimalization that cuts the bid-ask spread increments to 1¢ per share from 6.25¢ (a 16th of a dollar), supercomputers cut electronic transaction costs, institutional commissions, and arbitrage costs to historic lows, enabling high-frequency trading (hundreds and thousands of buy and sell transactions per minute) using complex algorithmic models and software at low cost, fueling growth in hedge funds and trading volume, as well as attenuation of some anomalies (Korajczyk and Sadka, 2004; French, 2008; Chordia, Roll, and Subrahmanyam, 2011; Chordia, Subrahmanyam, and Tong, 2014; Hendershott, Jones, and Menkveld, 2011; Beneish, Lee, and Nichols, 2015).

[3] We thank the referee for suggesting this out-of-sample test.

[4] Dimson and March (1984), Elton, Gruber, and Grossman (1986), Stickel (1992), and Mikhail, Walther, and Willis (2004) also study PRD. Cowles (1933, 1944) does not find evidence of PRD in a much earlier sample period.

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