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# Firm-specific information, analysts' superiority and investment value



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## ABSTRACT

Using a sample of Chinese security analysts' recommendations from 2005 to 2010, we examine the source of analysts' superiority and the investment value of their recommendations. Using a calendar-time portfolio approach, we find that, on average, analysts' recommendations are valuable and that analysts are better at analyzing and transferring firm-specific information than market-wide or industry-level information. In addition, we show that the investment value of recommendations increases as firm-specific information becomes more important in stock pricing. Our empirical results are useful in guiding investors and helping brokerage houses to evaluate the output of research departments.

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## 1. Introduction

The securities analyst industry has grown rapidly with the development of the Chinese capital market. The number of practitioners, their salaries and the market influence of the securities-consulting industry has undergone rapid changes over the past few years. Meanwhile, problems related to security analysts, such as the value of the securities analyst industry, the information content of analysts' research reports and the investment value of analysts' recommendations, have caused great concern among academics and practitioners.

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The solutions to these issues will inevitably involve studying analysts' expertise. According to the efficient market hypothesis (EMH), Roll (1988) decomposes the information incorporated into stock prices into three types: market-level, industry-level and firm-specific information. However, the extent to which these three types of information explain the variations in firms' stock returns varies. If firms' stock returns are mainly explained by firm-specific information, investors have a greater need for firm-specific information than for market- or industry-level information. In this case, security analysts who are good at analyzing and transferring firm-specific information will be favored, as their research reports are better able to alleviate the information asymmetry between listed companies and investors. In contrast, if firms' stock returns are mainly explained by industry-level information, then security analysts who are good at analyzing and transferring industry-level information will perform better. Unfortunately, previous studies still provide no consistent conclusion on what makes a superior securities analyst. Some studies have shown that analysts' expertise lies in analyzing and transferring firm-specific information (e.g., Grossman and Stiglitz, 1980; Diamond and Verrecchia, 1991; Bhushan, 1989; Ramnath et al., 2008; Palmon and Yezege, 2012). Other scholars suggest that analysts play an important role during the process of searching, analyzing and transferring industry-level information (e.g., Piotroski and Roulstone, 2004; Chan and Hameed, 2006). The conclusions of these studies are inconsistent due to differences in their research samples and designs. As a securities analyst may be good at analyzing and transferring either firm-specific or industry-level information, which of these is superior is an empirical question. This study attempts to answer the question of what constitutes security analysts' superiority and their role in the capital market.

In this paper, we use 192,012 recommendations issued by Chinese security analysts from 2005 to 2010 and use a calendar-time portfolio approach to study the following two questions: (1) what constitutes Chinese security analysts' superiority? and (2) how do the demand and supply factors of analysts' research activities influence the investment value of recommendations? We calculate three estimates of abnormal returns for each portfolio, namely market-adjusted returns, the intercept of the Capital Asset Pricing Model (CAPM) and the intercept of the Fama and French (1993) three-factor model. The empirical results indicate, first, that Chinese security analysts are better at analyzing and transferring firm-specific information than market- or industry-level information. Specifically, *ceteris paribus*, analysts' research reports increase the ability of firm-specific information to explain variations in stock returns, but reduce the ability of market- and industry-level information to explain variations in firms' stock returns. In addition, covering more firms in the same industry does not improve security analysts' ability to capture the changes in industry-level information and hence improve the investment value of their recommendations. Second, analysts' recommendations have greater investment value when firm-specific information plays a major role in stock pricing, but there is no significant difference in investment value when industry-level information plays a major role in stock pricing.

This paper helps us to understand the comparative advantages of analysts and enriches the literature on the relationship between analyst behavior and  $R^2$ . Assessing the investment value of analysts' recommendations is actually identical to identifying and confirming the source of analysts' superiority. Loh and Mian (2006) suggest that the comparative advantages of superior analysts lie in their ability to accurately predict accounting earnings and then convert them into stock recommendations. Hence, they examine the investment value of recommendations based on the accuracy of accounting earnings predictions. Palmon and Yezege (2012) shows that the advantages of analysts lie in analyzing and transferring firm-specific information, and thus uses the R&D expenditure ratio (as a proxy of the degree of information asymmetry between listed companies and investors) to measure the investment value of analysts' recommendations. As the investment value is rooted in analysts' comparative advantages, any empirical findings regarding when and which research reports have greater investment value will also help to explain analysts' comparative advantages. Our study indicates that Chinese security analysts are better at processing firm-specific than industry information. Unlike Piotroski and Roulstone (2004), who only explore the relationship between the number of analysts following and  $R^2$ , this study combines the supply and demand factors of analysts' research activities and provides more direct and convincing empirical evidence for how analysts' recommendations influence stock prices, which enriches the literature on the relationship between analyst behavior and  $R^2$ .

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