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The efficiency of earnings forecast pricing



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A B S T R A C T

Prior research has suggested that the information content associated with analysts' forecast revisions is not immediately incorporated into a firm's stock price. We find that the apparent anomaly is concentrated in low-priced firms that receive favorable earnings revisions. Variables (such as analyst coverage and celebrity status) cannot reliably explain variations in price formations. Finally, we find that the magnitude of the post-forecast revision drift has decreased after 2002. Overall, our results suggest that the analysts' forecast revisions anomaly can be explained by a combination of random statistical variations and transaction costs.

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1. Introduction

Past research has indicated that the information content associated with revisions of analyst forecasts is not immediately and fully incorporated into a firm's stock price. Givoly and Lakonishok (1980) first report this post-forecast revision drift in a small sample of firms. Stickel (1991) suggest that firms with a recently revised consensus forecast tend to earn abnormal returns for about six months in the direction of the revised forecast. He proposes that the mean cumulative abnormal return three months after the revised consensus forecast is economically significant (approximately 5% for firms with the most positive revisions and –3% for firms with the most negative revisions). Gleason and Lee (2003) estimate abnormal returns of a comparable magnitude and show that analyst coverage and all-star status mitigate the delayed response to analyst forecasts.

The existence of a delayed response to a publicly available signal challenges the efficient market hypothesis and most of known anomalies have attracted extensive research that has scrutinized their

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robustness to alternative econometric techniques and to various conditioning variables. However, much less research has been conducted on post-forecast revisions than on other anomalies such as post-earnings announcement drift or the accrual anomaly. To the extent that the post-forecast revision drift exists, it may be affected by certain types of market friction. In this study, we re-investigate the market pricing of forecast revisions, with an emphasis on the roles of different types of friction in the pricing of forecast revisions. In particular, we consider three main types of friction that have been proposed in literature on other market anomalies: a low price level and liquidity (e.g., [Bhushan, 1994](#); [Ball et al., 1995](#)), the riskiness of the investment (e.g., [Mendenhall, 2004](#); [Mashruwala et al., 2006](#)), and a low level of investor sophistication (e.g., [Bartov et al., 2000](#); [Collins et al., 2003](#)). To assess the stability of cross-sectional differences in the market response to the forecast revisions, we conduct our analyses across different sample periods spanning from 1994 to 2008.

We first calculate the buy-and-hold size-adjusted abnormal return (BHAR) in the months following earnings forecast revisions by financial analysts. We find that different variables (such as volatility, trading volume, or institutional ownership) that have played a role in explaining other anomalies do not consistently affect the delayed response to analyst forecasts across different sample periods. In contrast, price level is key to the existence of a delayed response during the overall sample period and each of its sub-periods. Consistent with [Gleason and Lee \(2003\)](#), we also find that the post-forecast revision drift appears to be mitigated when the coverage is large and when the forecast is issued by a celebrity analyst. However, these findings are affected by the choice of sampling period and control variables. For example, the celebrity analyst effect disappears when we consider the 2003–2008 sub-period. The effect of coverage disappears when we control for variables that have been shown to affect other anomalies.

We then consider an alternative approach to the BHAR specification. Prior studies (e.g., [Fama, 1998](#); [Mitchell and Stafford, 2000](#)) suggest that a monthly calendar-time portfolio approach provides more robust statistical inferences for long-term abnormal performance. An additional advantage of this approach is that we can easily consider positive and negative forecast revisions separately (e.g., [Huang and Zhang, 2011](#)). We form a hedge portfolio to implement this approach. We go long (short) on firms that received a favorable (unfavorable) earnings revision in the previous months. Consistent with our other findings, we identify an abnormal positive return for the hedge portfolio. However, we find that there is no abnormal return in the short portfolio with unfavorable revisions. This apparent anomaly is concentrated in the sample of firms that receive favorable earnings forecast revisions. The absence of a clear theoretical explanation for this result supports the idea that the apparent anomaly can be explained by the existence of random statistical variation (e.g., [Fama, 1998](#)).¹ Importantly, we also find that the abnormal returns exist only in low-priced firms. In contrast, the other partitioning variables (such as volatility, trading volume, institutional ownership, coverage, and celebrity status) do not affect the delayed response to analyst forecasts based on the calendar-time portfolio approach. These results suggest that price level is a key factor in the sub-sample of firms in which the drift is present (i.e., firms that receive favorable earnings revisions). Further, our analyses across different sample periods indicate that the magnitude of the drift has decreased after 2002.

Finally, we conduct additional analyses to explore possible explanations for the presence of the drift identified in the sub-sample. We estimate the transaction costs of the portfolio in which firms with low stock prices receive favorable earnings forecast revisions. We use the methodology proposed by [Keim and Madhavan \(1997\)](#) and [Bushee and Raedy \(2006\)](#) to estimate these costs. On the one hand, we find that this portfolio earns an approximately 8% abnormal return over a six-month horizon. On the other hand, we obtain an estimate of the transaction costs of approximately 6% for a “round trip”. We also investigate whether the main source of the drift (i.e., small price stocks with positive forecast revisions) is concentrated around the next four earnings announcements and the next six forecast revisions. We find that much of the incomplete price response to a given revision is corrected when

¹ The lack of significant abnormal returns for unfavorable forecast revisions during our overall sample period can be due to the offsetting of positive and negative random statistical variations in different sub-periods. We find a downward drift for the portfolio of firms with unfavorable forecast revisions in the 1994–1998 period, but this drift essentially disappears when we consider the overall sample (1994–2008) period. In fact, there is a positive upward trend in the 1999–2002 period, followed by a small downward trend in the 2003–2008 period. See Section 4.3 for further details.

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