



# Analyst coverage network and stock return comovement in emerging markets<sup>☆</sup>



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## ABSTRACT

This paper shows that analyst coverage networks (ACN) play an important role in explaining stock return commonalities across Latin American stocks. First, pairs of stocks connected by analysts exhibit higher comovement and excess comovement. Second, firms easily traded by foreign investors are more strongly affected by common coverage. Third, international analysts are an important source of across-country excess comovement. Finally, by creating the network at the brokerage house level and exploiting exogenous changes in ACN around the MSCI LATAM Index reviews, this study addresses endogeneity concerns related to the effect of ACN on commonalities.

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## 1. Introduction

Stock return comovements and stock market linkages in emerging markets have been matters of great interest among researchers, policy makers and investors (Bekaert and Harvey, 2003; Forbes and Rigobon, 2002; and Rigobon, 2002). When portfolio managers and retail investors choose an asset allocation strategy, they consider the potential advantages of portfolio diversification both within and across countries. For that reason, many researchers are interested in the level of correlation among financial markets and their main determinants (Lahrech and Sylwester, 2011; Chen et al., 2002; and Bekaert et al., 2005). Financial crises in developed and emerging countries, changes in investor regulation, financial integration and countries' cross-sectional characteristics have been exploited to test changes in the comovement of stock returns and synchronicity (Morck et al., 2000; Jin and Myers, 2006; Bae et al., 2012 and Balli et al., 2015). In this paper we seek to introduce a new source of excess comovement between pairs of stocks across Latin American countries. Specifically, we are interested in the effects of information produced and disseminated by analysts who are simultaneously following a pair of firms  $i$  and  $j$  (analysts in common) on stock return comovement and excess comovement.<sup>1</sup>

We provide evidence about the informational importance of analyst coverage networks, specifically common coverage, in explaining the excess of correlation between pairs of stocks with shared coverage. We show that if investors trade based on

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<sup>1</sup> Throughout this paper we refer to analysts simultaneously following a pair of firms  $i$  and  $j$  as common coverage or shared coverage.

information provided by analysts, the stock return pairwise correlation between firm  $i$  and firm  $j$  is positively associated with the number of analysts they have in common. That is, because analysts produce and disseminate common information (useful) about both firms. Muslu et al. (2014) called this *the coverage-specific information spillover hypothesis*. In addition, the authors argue that analysts face a trade-off between the type of information that they produce and the cost of producing it. For that reason, analysts produce a mix of three types of information. On one side, there is firm-specific information, which is highly rewarded by investors, but it requires more time and effort. On the other side, there is market-wide (broad) information, which has lower production costs but less impact on investors, given that other analysts can produce the same information. In the middle, there is *coverage-specific information*, which is information that is relevant about the pool of firms that an analyst is following. To reduce production costs, analysts provide information that emphasizes commonalities among the stocks in their coverage.<sup>2</sup>

In addition, if an analyst uses the same model, inputs or methodology to make earnings forecasts for the pool of firms that she follows, the error term contained in the signal will be correlated, thus increasing stock commonalities (Israelsen, 2016). In other words, under rational Bayesian updating investors cannot completely differentiate the error component from the signals and cannot identify the correlation in forecast errors. Therefore, investors will update their beliefs and trade based on those signals, increasing the return correlation between pair of firms if the error terms of the earnings forecast are positively correlated. Following Muslu et al. (2014) and Israelsen (2016), we create two measures of common coverage and provide evidence that comovement and excess comovement between pairs of stocks within and across countries in emerging markets can be explained by the network created by analysts. Specifically, the common information generated by analysts influences investor demand, thus affecting the commonality in returns.

In this paper, we are interested in analyst coverage networks in Latin America as an important channel (shared coverage) that affects stock return comovement for pairs of stocks both across and within countries. Employing analyst information (from I/B/E/S) for the period 2000–2014, we construct the analyst coverage network and we identify the pairs of firms connected by analysts in common for six Latin American countries (Argentina, Brazil, Chile, Colombia, Mexico and Peru) to address the following research question: *Do firms with higher shared analyst coverage have more stock return comovement and excess comovement compared to firms that do not have common analysts?* The goal of this paper is to show that analysts are important in explaining contagion among financial markets and pairs of stocks.

Previous studies have been interested in the effect of correlated information generated by common analysts within a particular country (i.e., the US market). In contrast, we provide evidence of the informational role of analysts in a broader context, employing an across-country analysis. This approach helps us to show that analysts have not only an isolated effect within a country or specific market, their effect is spread out across different countries. It is important to highlight that our sample differs from the previous studies, not only in the markets involved, but also for the advantages of creating across-country connections. Using six Latin American countries, we attempt to show that common analysts affect stock return commonalities between pair of firms in the same market and, more importantly, across different markets. Moreover, across-country results are robust to different specifications, which help us to reinforce the contribution of this paper to the literature on stock return commonalities. However, one disadvantage of our sample compared to previous studies that employ the US analyst network (Israelsen, 2016 and Muslu et al., 2014) is that our network is sparser and the level of correlation between pairs of firms is lower than in the US market. Nevertheless, we find that connections generated by analysts matter.<sup>3</sup>

In terms of the research question, our results show that pairs of stocks that are connected by analysts in common have a greater raw return correlation (comovement) and excess comovement compared to pair of firms that do not share any analysts. Also, we provide different cross-sectional tests to support the hypothesis that investors find the common information provided by analysts to be useful for trading. In terms of economic significance, one standard deviation increase in the shared coverage rises by 1.5% the pairwise correlation of weekly returns (comovement) denominated in local currency when we consider the full sample. Moreover, when using weekly returns denominated in US dollars the correlation increases by 1%. With respect to excess comovement, one standard deviation increase in the shared coverage rises on average by 2% the excess comovement, again when we consider the full sample. Taking into account that the average excess comovement is 2% the economic impact of the analyst coverage network is important.

When we split the sample in within- and across-country connections, we find that one standard deviation increase in common coverage increases the comovement on average by 1.5% and 0.3%, respectively. In the case of excess comovement, the economic magnitude of one standard deviation increase in the shared coverage increases the excess comovement by 2% and 0.2% when we consider the within- and across-country subsamples, respectively.

We also provide evidence that the effect of analyst coverage networks is larger for pairs of stocks that belong to the MSCI Latin American Index. These results suggest that when investors face fewer trade restrictions, information is better reflected in prices that induces a higher level of excess comovement. Moreover, we test the effect of domestic and international analysts on commonalities of stocks both across and within countries. We provide evidence that although international analysts are the source of excess comovement on pairs of firms across countries, within countries, domestic and international analysts have similar effects. Our cross-sectional results are consistent with the hypothesis that the diffusion of information is faster for investible stocks than for noninvestible stocks (Bae et al., 2012) and confirm the importance of analyst characteristics in the

<sup>2</sup> Muslu et al. (2014) refer to this as the *comovement prediction*.

<sup>3</sup> Israelsen (2016) and Muslu et al. (2014) show that their analyst networks are highly dense; the number of pair of firms connections is large.

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