



Optimism pattern of all-star analysts



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ABSTRACT

This paper studies what drives the change in optimism among all-star analysts. Using unique hand collected data for the entire career of all-star analysts, the paper discovers the optimism patterns in their forecasts and recommendations. On the one hand, while analysts tend to issue more optimistic estimate forecasts, they are less likely to issue optimistic recommendations after becoming all-stars. On the other hand, analysts appear to be less optimistic in terms of both estimates and recommendations after being eliminated from the all-star list. The results are significant controlling for forecast accuracy, firm coverage, and job separation effect. This is the first study to look at both the optimism pattern of all-star analysts, and the effect of demotion from all-star team on analyst optimism.

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1. Introduction

A number of analyst behavioral studies seek to explain the biased earnings forecasts among analysts (Butler & Lang, 1991; Hilary & Hsu, 2013). Some papers have tied analyst earnings forecasts to their career concerns (Hong, Kubik, & Solomon, 2000; Hong & Kubik, 2003). While many papers find that analysts tend to be optimistic rather than pessimistic, to our knowledge, none of the previous findings have looked at the change of optimism throughout the entire career of an analyst. Provoked by this idea, the focus of the paper shall fall upon the effects of becoming an all-star analyst and being eliminated from all-star analyst list on the optimism changes in estimate forecasts and recommendations.

Institutional Investor has been selecting All-America Research Team annually since 1972. Institutional investors, or the “buy side,” such as hedge funds and mutual funds across the US, Europe and Asia, answer a questionnaire created by *Institutional Investor* that covers 8 categories and 65 investment sectors each year. The votes awarded to each analyst are weighted according to the size of the participant’s firm and the place it awards each analyst. The company ranking reflects the number of positions its analysts achieved. Although an analyst’s compensation and reputation largely depend on the *All-Star* ranking, she needs to balance the interests of the “buy side” with those of the “sell side”: institutional investors prefer accurate forecast information, whereas investment bankers care about trading commissions and favorable reports for initial public offerings (Hong & Kubik, 2003).

Previous literatures have mounted on analyst bias, such as issuing overly optimistic recommendations, and the relationship between their forecast accuracy and career concerns. For example, Hong et al. (2000) find that inexperienced analysts are more likely to be terminated for inaccurate earnings forecasts than are their more experienced counterparts; additionally, inexperienced analysts deviate less from consensus forecasts. These findings are broadly consistent with past career concerns that have motivated herding theories. However, these literatures divide analysts into experienced and inexperienced groups first, and then compare the differences between them. None of them study the behavioral change of a single analyst across their career. Scharfstein and Stein (1990), and Zwiebel (1995) suggest that herding among agents should vary with career concerns. And some multi-agent models can produce a link between career concerns and herd behavior, suggesting that an agent’s propensity to herd might vary over different stages of their professional life. Hence, it is intuitively reasonable to question the degree of analyst optimism across time, particularly around the stage of all-star.

The hand-collected all-star analyst list contains individuals who were voted on the All-America Research Team between 1998 and 2010. After merging with the detailed data from I/B/E/S and screening with some criteria, the main all-star sample includes 333 distinct analysts. I/B/E/S offers detailed earnings forecast and recommendation histories of each analyst, to whom a specific code has been assigned in the database. Using this I/B/E/S analyst code, this paper is able to track and divide the data into three sub-periods, before becoming all-star analysts (Pre-All-Star), after becoming all-stars (All-Star), and after being eliminated from all-stars (Post-All-Star), respectively. This paper examines the changes in analyst optimism after these two major types of career changes of analysts. In addition, since there are career concerns related

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to analyst forecasts, this paper controls for analyst switching brokerage house and changing the number of firms that they cover after being promoted/demoted. Lastly, we study the impacts of regulations and macro-economic conditions on analyst forecast optimism.

We find that analysts become more optimistic with respect to estimate forecasts after becoming all-star analysts. This finding is consistent with previous career concerns theory. [Hong and Kubik \(2003\)](#) find that controlling for accuracy, analysts who are optimistic relative to the consensus are more likely to experience favorable job separations (e.g., moving up to a high-status brokerage house). The fact that analysts are less optimistic during their beginning of careers also confirms the finding by [Hong et al. \(2000\)](#) that controlling for accuracy, inexperienced analysts are more likely to be terminated for bold forecasts that deviate from the consensus. In addition, [Hilary and Hsu \(2013\)](#) find that analysts consistently depress their forecasts and benefit from “low-balling”; particularly, they point out that those analysts are more likely to become all-stars, this supports our findings. Examining analysts’ recommendations (as opposed to forecasts) suggests that they are less aggressive in terms of promoting stocks.

The demotion effect on estimate forecast is in line with our intuition. Given the reason that analysts would like to be ranked all-stars again in the future, they may have to lower their optimism in forecast in order to improve their accuracy, since forecast accuracy is one of the key factors to select all-star analysts. The paper shows that analysts indeed decrease their optimism in their forecast estimates in order to raise their accuracy. In addition, the paper shows that analysts are less likely to issue optimistic recommendations after being eliminated from all-stars. [Clarke, Khorana, Patel, and Rau \(2007\)](#) find that analysts do not deviate from their previous optimism level after exogenous shocks such as job separation. [Hong and Kubik \(2003\)](#) suggest that analysts are less aggressive in their recommendations once they have been moved up to a higher brokerage house. Overall, this paper controls for changes in firm coverage and job separation, and finds the results are strong both economically and statistically. The title of All-Star influences analyst optimism pointedly.

Although I/B/E/S database does offer analyst consensus of recommendations, we calculate the consensus that excludes an analyst’s own estimate/recommendation to measure the optimism level. Therefore, this paper defines that an analyst casts an optimistic forecast/recommendation if her estimate/recommendation is above the consensus of other analysts. Regarding the three sub-periods, we use a three-year time horizon for all the stages. For instance, if an analyst became an all-star for the first time in 2005, then we proceed to study their earnings forecast and recommendations during 2002–2004 (pre) and 2006–2008 (during), respectively. Similarly, the post-all-star stage is three years after the elimination from all-stars. The estimates and recommendations given during the year she became an all-star analyst are excluded. In order to measure forecast accuracy, we adopt the measure that [Clement \(1999\)](#) used in his paper, namely proportional mean absolute forecast error (PMAFE).

With respect to the impacts of regulations on the optimism changes, we study the impact of Global Settlement Initiative and divides the sample into Pre-Global-Settlement-Initiative (Pre-GSI) and Post-Global-Settlement-Initiative (Post-GSI) subperiods, from January 1997 through April 2003, and from May 2003 through December 2011, respectively. As we expect analysts would be less bold to issue optimistic forecasts after the settlement.

As important as regulations, macro economy can influence earnings forecasts as well. Since the market was systemically optimistic during the late 90’s, this paper proceeds to exclude tech-bubble period and re-runs the main tests. The refined results remain both qualitatively and quantitatively unchanged.

The main contributions of this paper are as follows. This is the first study that examines the change of an analyst optimism levels in their forecasts and recommendations across her career: instead of studying the qualitative question whether analysts are optimistic, the paper

asks when they become optimistic; this paper is the pioneer in studying the effect of being eliminated from all-star analyst list. This approach is different from previous papers that have studied analyst behaviors by groups, and tried to explain forecast optimism by linking optimistic forecasts to banking affiliations, trading incentives, career concerns, and abilities. The fact that analysts are at various optimistic levels at different all-star status can be helpful in analyzing and interpreting earnings forecasts.

The rest of the paper will proceed as follows. Section 2 is a literature review. Section 3 introduces both the hypotheses that the paper will test. Section 4 describes the data and measurements. Section 5 provided the main results and explanations. Section 6 includes some robustness tests. Last but not least, Section 7 will conclude the findings and discuss the potential future research.

2. Related literatures

Inspired by [O’Brien \(1988\)](#)’s examination on analyst forecast accuracy, [Butler and Lang \(1991\)](#) find that analysts are persistently optimistic or pessimistic relative to consensus forecasts. During their four-year sample period (1983–1986), at least 69% of individual analysts’ average annual forecast fell above average annual earnings, although there is little evidence of consistent forecast bias over long periods. Their finding supports this paper’s result that analysts are not consistently optimistic during their career.

[Hong et al. \(2000\)](#) argue that analysts’ herding of earnings forecasts is related to their career concerns. They find that inexperienced analysts deviate less from consensus forecasts, in that inexperienced analysts are more likely to be terminated for inaccurate and bold earnings forecasts than are their more experienced counterparts. Their finding is consistent with existing career concern motivating herding theories.

[Scharfstein and Stein \(1990\)](#) build a model linking herding behavior to reputation concerns. They argue that under certain circumstances, managers simply mimic the investment decisions of other managers, ignoring the substantive private information. Replacing managers with all-star analysts, their finding can contribute to explain why all-star security analysts tend to be systematically optimistic. [Zwiebel \(1995\)](#) also supports this point of view.

[Hong and Kubik \(2003\)](#) conduct research into analysts’ career concerns and their biased earnings forecasts. By examining earnings forecasts and job separations, they find that relatively accurate forecasters are more likely to experience favorable career outcomes such as being hired by a high-status brokerage house. Furthermore, brokerage houses do not solely care about accuracy; relatively optimistic analysts are more likely to experience favorable job separations. They suggest that analysts are rewarded for promoting stocks generally and not just for stocks underwritten by brokerage houses. This paper is consistent with their point of view regarding how brokerage houses reward optimistic analysts.

[Clement \(1999\)](#) examines the factors that affect analyst accuracy. He finds that forecast accuracy is positively associated with analysts’ experience and employer size, and negatively associated with the number of firms and industries followed by the analyst. We adopt his measure of forecast accuracy as a control variable. Our results are significant both economically and statistically after controlling for forecast accuracy. Also inspired by his finding, we control for number of firms an analyst follows.

[Mola and Guidolin \(2009\)](#) use mutual fund affiliation to explain analyst optimism. Their finding indicates that sell-side analysts are likely to assign frequent and favorable ratings to a stock after the analysts’ affiliated mutual funds invest in that stock. And the greater the portfolio weight of a stock in the fund family, the more optimistic the stock ratings from affiliated analysts become. In order to alleviate the concern of analysts’ affiliation, we compare test results under different regulation backgrounds. The results remain the same.

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