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The informational feedback effect of stock prices on management forecasts[☆]



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ABSTRACT

Using management earnings forecasts over the period 1996–2010, I find that the sensitivity of forecast revisions to contemporaneous stock returns is increasing in the amount of investors' private information in prices. This effect remains after controlling for various confounds and is robust to the use of mutual fund redemptions as a shock to price changes that is exogenous to fundamental news. Furthermore, investors' private information helps managers improve their forecast accuracy. Together, these findings suggest that stock prices contain information that managers do not otherwise have regarding firms' fundamentals, and that managers incorporate this information in their earnings forecasts.

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1. Introduction

Management forecasts are a key voluntary disclosure mechanism (see [Beyer et al. \(2010\)](#) for a recent review). Prior research presents evidence that managers disclose earnings forecasts to provide additional information and guidance to the market and the market significantly reacts to them (e.g., [Patell, 1976](#); [Jennings, 1987](#); [Anilowski et al., 2007](#); [Rogers et al.,](#)

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2009). This stream of literature primarily views information flows between firms and capital markets as one way – from firms to capital markets. In this paper, I investigate the effect of price information on management forecasts and provide evidence on whether information flows also occur from capital markets to firms. My study builds on a growing literature in financial economics that financial markets can affect the real economy through the managerial learning channel (see Bond et al. (2012) for a review). The idea that market prices are a useful source of information goes back to Hayek (1945). In essence, stock prices aggregate diverse pieces of information from different traders who have no other means of communicating with managers outside the trading process (e.g., Grossman and Stiglitz, 1980; Glosten and Milgrom, 1985; Kyle, 1985). As a result, stock prices can reveal traders' private information that is otherwise not available to managers, and hence affect managers' beliefs about their own firms' fundamentals.

I hypothesize that managers learn from investor information in stock prices when revising annual earnings forecasts.¹ To test this hypothesis, it is not sufficient to simply regress forecast revisions on stock returns over the revision period for at least two reasons. First, a positive relation between contemporaneous stock returns and forecast revisions does not imply causality from the former to the latter: it could arise from correlated information channels that affect both or from reverse causality. Second, even assuming a causal explanation, stock price changes may lead to earnings forecast revisions due to reasons unrelated to learning, such as managers catering to investor sentiment (Lee and So, 2015). One approach used in the literature to address these concerns is to conduct analyses showing that the effect is greater in exactly those firms where theory would predict that the learning channel is likely to be stronger. For example, Chen et al. (2007) show that the correlation between prices and investment is stronger when stock prices contain more information not available to managers and argue that this evidence is consistent with the managerial learning hypothesis.

I follow the empirical methodology of Chen et al. (2007) and examine whether the amount of private information in prices has a positive effect on the association between forecast revisions and stock returns over the revision period. The logic of this approach is as follows. If, at a given point in time, managers forecast future earnings, they will use all the information available to them at that point. This set includes the information aggregated in stock prices, as well as managers' private information that has not found its way to prices yet. In this environment, forecast revisions will be more sensitive to price movements when stock prices contain more information that is new to managers. Noise or information that managers already had will move prices but not affect the revised forecast and thus will decrease the sensitivity of forecast revisions to price changes.

To construct the sample, I start with all management annual earnings forecasts issued between January 1996 and December 2010. I identify 15,977 management forecast revisions over this period. To measure the extent of informed trading and thus the amount of investors' private information in stock prices, I follow Chen et al. (2007) and use a modified version of the probability of privately informed trading. This measure starts with the probability of informed trading (*PIN*), estimated following Easley et al. (2002), and is adjusted for insider trading to remove the effect of managers' private information. It is derived from a structural market microstructure model, in which trades come from either noise traders or informed traders. It directly measures the probability of informed trading by outsiders, and thus captures the amount of investors' private information in stock prices.

I first show that the sensitivity of management forecast revisions to stock returns over the revision period is increasing in the amount of private information in stock prices. This result is consistent with the hypothesis that stock prices with a larger amount of private information provide managers with more new information about their own firms' fundamentals, which, in turn, affects their earnings forecasts. In the test, I include several design features to alleviate the concern related to the delay in management forecasting (i.e., public information is impounded into stock prices immediately whereas it is incorporated into forecast revisions with a delay due to the relatively low frequency of management forecasts). First, I directly control for public information about future earnings (i.e., common signals that affect both forecast revisions and stock returns) using two proxies: contemporaneous consensus analyst forecast revisions and the sum of management's forecast error associated with any quarterly earnings announcement that occurs between the two forecast dates. Second, I control for the effect of the time lag (between the two forecasts) on the revision–return relation because this lag increases the probability that the correlation between stock returns and management forecast revisions is simply due to managers' delay in revising their forecasts. Third, I control for a number of firm-specific and forecast-specific characteristics that may be correlated with my measure of private information and affect the revision–return relation (e.g., the richness of the information environment).

Next, I conduct a test using mutual fund redemptions as a shock to price changes that is exogenous to fundamental news (Edmans et al., 2012) and therefore should result in a lower revision–return sensitivity. The evidence supports this prediction. These first two tests provide evidence that investors' private information affects management forecasts. To provide more direct support on the decision usefulness of investor information, I investigate the effect of price information on management forecast accuracy. I find that the improvement in forecast accuracy is positively related to the magnitude of contemporaneous stock returns; and, more importantly, this positive relation is stronger when the amount of private information in prices is higher, suggesting that investors' private information is new to managers and helps managers

¹ Throughout the paper, I use the wording “investor information” or “price information” to mean investors' private information that is otherwise not available to managers except through the trading process.

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