



Analyst forecasts and European mutual fund trading



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ABSTRACT

This paper addresses the questions whether European mutual fund managers rely on sell-side analyst information and whether this behavior impacts fund performance. Results show that mutual funds significantly increase (decrease) their holdings in stocks when any of the consensus forecast measures increases (decreases) within the quarter prior to the observation period. Furthermore, mutual fund managers primarily attribute high information value to consensus forecast revisions that contain positive information, that are based on a sufficiently high number of inputs, and with more unanimous inputs to the consensus. Finally, following sell-side research seems to be beneficial for mutual fund managers since our results show that stock trades that are in line with analyst forecast revisions significantly outperform trades that are contrary to analyst research.

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1. Introduction

The impact of sell-side analysts' research on stock markets has been documented by many previous papers (e.g., [Asquith et al., 2005](#)). Therefore, it is not farfetched to assume that one group of market participants that might make use of this informative source are mutual fund managers. Systematic short-term evaluations, limited time capacities, and information overload from various sources provoke managers' need for a detailed summary of future prospects of different stock alternatives. Professional research analysts providing forward-looking opinions can act as such a summarizing source (e.g., [Elton et al., 1986](#)).

In line with the argument that most fund families are too small to offer comprehensive in-house research ([Brown et al., 2012](#)), [O'Brien and Bhushan \(1990\)](#) suppose that sell-side analysts act as information intermediaries to institutional investors. Due to their industry expertise research analysts are much more specialized and should perform the task of analyzing companies better than mutual fund managers that possess a rather general perspective. Analyst research also helps institutional investors to satisfy fidu-

ciary duties and to stick with their internal decision making policies (e.g., [O'Brien and Bhushan, 1990](#); [Frankel et al., 2006](#)). Furthermore, we expect sell-side research to be valuable as the subscription is quite costly and mutual fund managers often pay for this information with soft-dollar commissions (see [Conrad et al., 2001](#)).

This paper addresses the question whether European mutual fund managers rely on sell-side analyst information when trading stocks and whether those trades that are in line with analyst forecast revisions outperform trades that are contrary to analyst research. The effect of research analysts on institutional investment decisions has been analyzed by only a limited number of empirical studies employing mostly US data. For example, [Chen and Cheng \(2006\)](#) find that changes in aggregate US institutional ownership is positively correlated with consensus recommendations. They measure more buyer-initiated than seller-initiated large trades around favorable recommendations and vice versa for unfavorable recommendations. In a recent working paper, [Costello and Hall \(2011\)](#) confirm this result for individual mutual fund portfolios. More precisely, they document a positive correlation of changes in fund holdings and changes in analyst recommendations. In particular star analysts belonging to the *Institutional Investor All-American Research Team* seem to have a significant impact on

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the trading of fund managers. As a matter of fact, Fang and Kosowski (2007) find that funds closely following star analysts' recommendations perform better than other funds.

Despite the awareness that the responsiveness of a fund manager's trades to changes in analysts' recommendations decreases in the manager's skill (Kacperczyk and Seru, 2007), a large number of fund managers seem to pay attention to analyst reports. On the one hand, Brown et al. (2012) document that analyst recommendation revisions can drive herd behavior among US mutual funds. Mutual funds seem to herd into stocks with consensus sell-side upgrades and herd out of stocks with consensus downgrades. On the other hand, Chan et al. (2005) detect herding in response to the lack of reliable information, measured through the dispersion of analysts' earnings forecasts.

We present several results that contribute to the literature and shed light on the impact of sell-side analyst research on mutual fund trading. First, we conduct one of the first studies that analyzes this effect among a large sample of over 4300 European mutual funds across a broad stock universe.¹ Most other studies in this field of research, including the working papers, use US data. Employing a sample of European mutual funds from 01 June, 2005 to 31 December, 2009, we can face the question if the European managers, similarly to their US counterparts, make use of external information such as sell-side analyst forecasts.

Second, we extend the existing literature by analyzing three different measures reflecting analyst forecast revisions. While prior studies only focus on recommendation changes and earnings forecast revisions (e.g., Chen and Cheng, 2006; Brown et al., 2012), we additionally include implied return revisions as analyst forecast measure into our analyses. We ascribe the assumed importance of implied returns, measured as the ratio of an analyst's target price forecast relative to the prevailing stock price, to the findings of Asquith et al. (2005) and Brav and Lehavy (2003). Both studies document that target price revisions contain valuable information apart from earnings forecasts and stock recommendation revisions for capital markets.

Third, we combine our analyses with results from the corporate governance literature. Based on the findings that institutional investors (and their monitoring efforts) translate into higher earnings quality (see, e.g., Velury and Jenkins, 2006) and the result that the quality of financial disclosure and the quality of analyst research are complements (Lang and Lundholm, 1996; Frankel et al., 2006), we proxy the quality of analyst research by the firm-specific level of institutional ownership. This setting allows us to analyze if not only the market as a whole realizes the positive impact of institutional ownership on analyst research (see Frankel et al., 2006), but also fund managers as one specific group of market experts.

And finally, we contribute to the literature by analyzing if following sell-side analyst research influences the performance of the funds' stock trades more positively than an investment behavior that contradicts analyst forecasts.

With respect to our findings, results show that mutual fund portfolio weight changes positively correlate with each consensus revision forecast measure when analyzing the three analyst measures separately. European mutual funds significantly increase (decrease) their holdings in stocks when the consensus stock recommendation, earnings forecast, or implied return forecast increases (decreases) within the quarter prior to the observation period. The results regarding the first two forecast measures are in line with the existing literature (see, e.g., Brown et al., 2012). Regarding

the implied return forecast revision, to the best of our knowledge, no other study has yet analyzed its impact on investment decisions of mutual fund managers. Nevertheless, our findings complement those of Brav and Lehavy (2003) who show that target prices contain investment value for market participants in general.

To simultaneously condition on the information conveyed through each of the other two consensus revision measures, we run a regression including all three different consensus forecast measures. Results show that the earnings revision measure and the implied return revision measure significantly influence European mutual fund managers' trading decisions, when considering the revision measures simultaneously, whereas the consensus recommendation revision does no longer impact fund managers. One explanation of the reduced economic impact of the recommendation revision variable on mutual fund trading (once controlling for the other two measures) might be reduced informativeness of the measure itself due to potential conflicts of interests (see, e.g., Agrawal and Chen, 2008).

Next, we focus on different consensus forecast characteristics that might translate into higher informativeness of analyst research. Our results show that mutual funds appear to rather increase their holdings based on consensus recommendation upgrades compared to their reduction in holdings based on consensus recommendation downgrades. This finding is in line with Costello and Hall (2011). While we can also confirm this observation for earnings forecast revisions, we find European fund managers to use both positive and negative information, in terms of implied return forecast revisions, to base their trading decisions on.

We also show that consensus forecast revisions based on a broader analyst coverage (in terms of the number of consensus inputs) have a higher impact on European mutual fund holding changes. This can be explained by the finding of Alford and Berger (1999) that higher analyst following is associated with greater forecast accuracy. Moreover, we find that the holding changes respond less to analyst forecast changes when the consensus inputs of analysts are becoming more dispersed. It seems as if mutual fund managers prefer consensus forecasts with a higher informativeness in which analyst forecasts are more unanimous. However, European mutual fund managers do not seem to respond more to consensus forecast changes in case these are based on a higher number of high quality inputs (i.e., from star analysts or from analysts working for local brokerage houses).

Next, we can show that the importance of analyst forecast revisions for mutual fund trading increases in the level of foreign institutional ownership. This result might be due to active monitoring performed by foreign institutions (see Ferreira and Matos, 2008) that translates into higher reporting quality and ultimately more accurate analyst forecasts (see Frankel et al., 2006). On the contrary, we do not find an increase in the informativeness of analyst forecasts, as measured by mutual fund holding changes, among domestic institutional investors. Ferreira and Matos (2008) explain this by less monitoring of domestic compared to foreign institutional investors, due to existing business relations between domestic institutional investors and local corporations.

Finally, based on Chen et al. (2000) and Kothari and Warner (2001) who argue that active fund management should be evaluated by its trading decisions, we find that stock trades that are *in accordance with* analyst forecast revisions (namely recommendation changes and implied return revisions) significantly outperform stock trades that are *in contrast to* forecast revisions. Hence, our results show that following analyst research is (ex-post) beneficial for mutual fund managers.

The paper continues as follows. In Section 2 we describe our data and present some descriptive statistics of the fund and stock universe. Section 3 focuses on the impact of the three analyst forecast measures on mutual fund trading and analyzes the impact of

¹ In a recent working paper, Frey and Herbst (2012) provide first evidence with respect to this question. Within their paper, they analyze the impact of buy-side and sell-side recommendations on trading decisions and fund performance of a sample of 14 European mutual funds investing in European equities.

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