



## Do star analysts know more firm-specific information? Evidence from China

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### ABSTRACT

Using a unique database in China, we extend the literature to further distinguish the information production role of star vs. non-star analysts. We confirm the general conclusion of a positive association between analyst coverage and stock return synchronicity measured by a firm's  $R^2$  in China. The findings from star analysts, however, show that star analyst coverage actually decreases stock return synchronicity. We contend that the firm-specific human capital in star analysts helps the analysts overcome the challenges of information production in an emerging market. The superior firm-specific human capital argument of star analysts is further supported by the negative association of star analysts' firm-specific experiences and stock return synchronicity. Our conclusions are robust to different specifications of star analyst presence and different definitions of analysts' firm-specific experiences. We also find that star analysts exhibit a more accurate earnings forecast than non-star analysts.

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### 1. Introduction

Using the data from 25 emerging markets, Chan and Hameed (2006) find that greater analyst coverage increases stock return synchronicity (a higher  $R^2$  in a market model) and conclude that the information collected by a security analyst contains more market-wide content than firm-specific information. By relating analyst coverage to stock return synchronicity, Chan and Hameed implicitly assume that security analysts are homogeneous, meaning they all have the same skills in the information production process. However, it is natural that security analysts have different human capital endowments and many of them specialize in specific firms. Hence, their ability to produce firm-specific information can vary greatly. For instance, Desai et al. (2000) document that *Wall Street Journal* all-star analysts outperform benchmarks after controlling for other factors. Fang and Yasuda (2010) also find that trading based on All-American analysts' buy-and-sell recommendations earns investors better risk-adjusted returns than those from non-All-American analysts. In general, the literature suggests that security analysts are not homogeneous; some are better than others.

One limitation of a cross-country study, such as Chan and Hameed (2006), is that the data are highly aggregated, and a detailed analysis on the impact of different types of security analysts is

not feasible. The objective of our paper is to extend Chan and Hameed's (2006) study of analyst coverage and stock return synchronicity by examining the difference in human capital among security analysts in an emerging market. We argue that some highly regarded analysts ('star' analysts), due to their superior firm-specific human capital, are able to perform better than other analysts in the production of firm-specific information. Therefore, star analyst coverage, unlike general analyst coverage in previous studies, can provide firm-specific information about the stock price, which in turn decreases stock return synchronicity. Specifically, we distinguish star vis-à-vis non-star analysts and examine whether the two groups produce firm-specific information to different degrees. Our main research question is whether star analysts can produce more firm-specific information about a stock than non-star analysts. Or, put differently, we examine whether the stocks covered by more star analysts exhibit less stock return synchronicity than those covered by more non-star analysts. After confirming that star analysts are able to produce better firm-specific information than non-star analysts, we further investigate the reasons behind the differences. We use two novel ways to measure three kinds of analysts' experience (general, industry, and firm-specific), and then we use the experiences to explain how the role of the information production process differs between the two groups of analysts. Finally, we investigate if star analysts' earnings forecasts are more accurate than those made by non-star analysts. We study these research questions in the context of the Chinese stock market and its analysts.

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The Chinese stock market provides a unique setting for such an analysis for several reasons. First, since 2003, *The New Fortune*, the most authoritative financial magazine in China, began to select star analysts every year based on their performance.<sup>1</sup> Together with analysts' earnings forecast history, we are able to classify analysts' experience into general, industry-specific, and firm-specific experiences. Thus, we have a unique database to conduct our analysis. To the best of our knowledge, other emerging markets do not yet have a history of information on analyst rating. Second, focusing on one emerging market allows us to control the impact of social, political, legal, and economic environments on the activities of analysts in a cross-country study. A one-country study allows us to focus on the research questions. Third, in a cross-country study, Morck et al. (2000) find that stock prices move together more in emerging markets than in developed markets. They suggest that, in emerging markets, weak property rights discourage informed trading and therefore prevent firm-specific information from being incorporated into stock prices; hence, emerging markets have high stock price synchronicity. China, one of the most important emerging markets, has poor legal investor protection according to Allen et al. (2005), and it had the highest stock return synchronicity ( $R^2$ ) among 40 markets in the study by Jin and Myers (2006). In addition, Hutton et al. (2009) find that low corporate transparency is associated with high stock return synchronicity. China also has a high degree of capital market impediments. Piotroski et al. (2011) summarize that China's financial market and listed firms are associated with a poor information environment. It is natural that the opaque nature of the Chinese stock market makes it challenging for any analysts (star or non-star) to produce firm-specific information in China. In order to advance his career or garner performance bonus, an analyst has incentive to provide outstanding coverage. A star analyst is expected to perform a better job than a non-star analyst in the coverage. Therefore, China provides a good setting to compare the information role between star and non-star analysts.

We pinpoint several interesting findings. First, similar to Chan and Hameed (2006), we also find that, without distinguishing between star and non-star analysts, greater analyst coverage increases stock return synchronicity in China. However, after separating star analysts from non-star analysts, we find that greater star analyst coverage actually decreases stock return synchronicity, but greater non-star analyst coverage continues to increase stock return synchronicity. That is, our results suggest that the findings in Chan and Hameed (2006) apply only to non-star analyst coverage in China. We contend that the information role of star analysts and non-star analysts is different. Star analysts, with their superior human capital, are able to increase the flow of firm-specific information into stock price, consistent with the star analysts' firm-specific information advantage. In contrast, non-star analysts contribute more market- or industry-level information to the stock price formation process. Second, we document that the firm-specific information advantage of star analysts mainly comes from their firm-specific experience and general experience rather than from their industry-specific experience. The results suggest that firm-specific and general experience can significantly decrease stock return synchronicity. Finally, we find that star analysts have more accurate earnings forecasts than non-star analysts, which further supports our hypothesis that star-analysts have better firm-specific human capital and thus they are better in the produc-

tion of firm-specific information than non-star analysts. Overall, Chan and Hameed's (2006) important finding that stocks covered by more analysts incorporate greater (lesser) market-wide (firm-specific) information in emerging markets, is likely due to the fact that it is more challenging for non-star analysts to engage in firm-specific information production in emerging markets. Given severe capital market impediments, typical (non-star) security analyst coverage cannot produce much firm-specific information in an emerging market. Instead, such a challenging market requires analysts (such as star analysts) with superior human capital to produce useful firm-specific information.

## 2. Prior literature and hypotheses development

There are three strands of literature related to our study. The first strand relates stock return synchronicity (or  $R^2$ ) from a market model to the price informativeness of the stock. Roll (1988) argues that low  $R$ -squares seem "to imply the existence of either private information or else occasional frenzy unrelated to concrete information." Morck et al. (2000) document that stock prices co-move more in emerging markets than those in developed markets. They contend that a high  $R^2$  in a market model across emerging markets is associated with weak legal protection of investors and property rights in those markets. Jin and Myers (2006) offer a theoretical model and statistical evidence to show that  $R^2$  is positively related to several measures of firm opacity. Using earnings management to represent a firm's transparency, Hutton et al. (2009) find that a firm with low transparency is associated with a high  $R^2$ , i.e., firms with lower transparency produce less firm-specific information for the public. Using a sample of Chinese firms, Gul et al. (2010) document that the extent of foreign ownership and audit quality are inversely associated with  $R^2$ .

The second strand of literature discusses the role of analysts in the information production process in developed and emerging markets. Piotroski and Roulstone (2004) find that, in the US, security analyst activities lead to greater stock price comovement, which increases stock return synchronicity ( $R^2$ ). As suggested by Chan and Hameed (2006), the literature primarily focuses on developed markets and there are only a few studies on emerging markets. Chang et al. (2001) show that country-wide characteristics influence analysts' activities as well as the accuracy of their earnings forecasts. The study by Chan and Hameed (2006) is the one most related to ours. They offer firsthand evidence of analyst coverage and firm-specific information production in emerging markets. Chan and Hameed find that  $R^2$  is positively associated with analyst coverage. Nonetheless, the second strand literature seldom addresses the different human capital levels among security analysts.

The third strand of literature focuses on the heterogeneous nature of security analysts. Desai et al. (2000) document that *Wall Street Journal* all-star analysts outperform benchmarks in a risk-adjusted basis. Bonner et al. (2007) offer empirical evidence to suggest that the market reacts more strongly to earnings forecast revisions by celebrity analysts relative to analysts with low celebrity status. Celebrity status is in part attributed to the forecast performance of the analysts. Fang and Yasuda (2010) find that trading based on All-American analysts' buy-and-sell recommendations earns an investor better risk-adjusted returns than those from non-All-American analysts. These studies suggest that there are human capital differences among security analysts; some analysts are better than others.

By combining three strands of literature, we can draw three general conclusions. First, there is less firm-specific information production in emerging markets due to capital market impediments.  $R^2$  from a market model is positively related to capital mar-

<sup>1</sup> The selection process is similar to the All American Research Team. To select star analysts in the current year, *The New Fortune* sends questionnaires covering all industries to institutional investors. The questionnaire does not pre-list any names. Rather, each respondent writes in the names of the analysts for whom they wish to vote. If a respondent votes for more than one analyst, the respondent ranks the names. *The New Fortune* then adds up the scores and identifies the star analyst selections.

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