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The behavioral basis of sell-side analysts' herding [☆]



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ABSTRACT

Sell-side analysts move away from the prevailing consensus as their confidence increases. As their confidence falls, they herd toward the prevailing consensus. Confidence as well as the associated propensity to move away from the herd increase as firms become more difficult to analyze. This behavior is consistent with such analysts having lower meta-cognitive skills.

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Brian *Look. You've got it all wrong. You don't Need to follow me. You don't Need to follow anybody. You've got to think for yourselves. You're all individuals.*
Crowd *YES! WE'RE ALL INDIVIDUALS!*
Brian *You're all different.*
Crowd *YES. WE ARE ALL DIFFERENT.*
Follower: *I'm not.*

Monty Python, "The Life of Brian"

1. Introduction

Psychology points to behavioral determinants of herding. Herding is an unconscious social behavior originating from the primitive portion of our brain. This herding impulse is advantageous to our survival by demonstrating that we are the same

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as the crowd for reasons of self-preservation, to avoid rejection and to defuse an excuse to attack (Prechter, 2001). Such emotional impulses to herd are often inappropriate and potentially counterproductive to success in financial situations. However, these emotional impulses are ‘hardwired’ in the deepest, most primitive part of our brain and have a very powerful and unconscious influence on our behavior. We analyze the behavioral determinants of sell-side analysts’ herding.

The analysts we study move away from the consensus forecast (“anti-herd”) as they become more confident (and *vice versa*). The confidence we observe, however, does not appear to be related to their ability: the analysts appear to be unskilled and unaware of it. In particular, the positive relationship between confidence and herding is consistent with analysts being more confident when they are less skilled. This lower skill is associated with a reduced ability to reflect on, and learn from, success or failure in tasks; in other words, lower skills result in lower metacognitive ability (Kruger and Dunning, 1999).¹ Metacognition is the ability to think about, or reflect on, your thoughts.

A quasi-rational, or behavioral basis for analyzing herding as herding appears contrary to analysts’ economic interests. If you are an analyst, it should pay to stand out from the crowd. Forecasts and recommendations that are *closer* to the consensus have no effect on the market (Jegadeesh and Kim, 2009; Loh and Stulz, 2011).² Sell-side analysts are “employed by brokerage houses to follow firms in an industry and generate information about them such as earnings forecasts and stock recommendations” (Hong et al., 2000, p. 122). Hong et al. (2000, p. 122) continue by noting that “. . . [sell-side analysts’] clients are institutional investors or the ‘buy side’ . . . [and a sell-side analyst’s] compensation includes fees from the trading volume she generates and the investment banking business that she brings in, her ability to do so in the long run depends in part on her perceived forecasting ability”. Juergens and Lindsey (2009) estimate the abnormal commissions generated by analyst recommendations to be worth between \$9 million and \$168 million annually for the bulge-bracket firms they study.³

Sell-side analysts perform an economically useful service by incorporating information in markets which are not perfectly informationally efficient (Grossman and Stiglitz, 1980; Fama, 1990, p. 1605). The more an analyst herds, the less she potentially adds to the information set.⁴ Indeed, if her forecast is the same as the prevailing consensus, her forecast, on the face of things, adds nothing. Clement and Tse (2005) and Jegadeesh and Kim (2009) argue that the relationship between, or *lack* of any relationship between, returns and forecasts is compelling evidence that analysts herd.^{5,6} Analysts may herd, and provide no new information to the market, if they are utilizing the same information set as other analysts.⁷ Herding is also economically rational given analysts’ career concerns (Scharfstein and Stein, 1990; Hong et al., 2000): being wrong when everyone else wrong is preferable to being wrong on your own.⁸

An analyst who herds needs a consensus to herd toward. If herding implies following-the-leader, there must be a leader to follow. If there were no forecasts, there could be no herding. Therefore, the first analyst to make a forecast cannot herd. Guttman (2010) uses game theory to model how analysts decide *when* to issue forecasts and finds two possible equilibria, one of which results in temporal clustering of forecasts. Kim et al. (2011) present empirical evidence consistent with Guttman (2010) and suggest that skilled analysts delay their *revisions*⁹ strategically as a signal of their skill. However, there are advantages to being ahead of the crowd (Cooper et al., 2003; Juergens and Lindsey, 2009; Jegadeesh and Kim, 2009; Loh and Stulz, 2011). Do any advantages accrue to *not* being ahead of the crowd? Delaying a forecast may give an analyst more time to process information. As time passes, the information set available to analysts should increase. Later, rather than earlier, forecasts have been shown to be more accurate (O’Brien, 1988) and more accurate forecasts have been found to be associated with increasing profits (Loh and Mian, 2006).

¹ The experimental design introduced in Section 2 of this paper will include a test of a proxy for analysts’ overconfidence. Prechter’s (2001) arguments for herding, summarized in the opening paragraph of this paper, suggest that confidence may be a feature influencing herding. The relationship between herding, confidence and metacognition is not directly tested in a specific regression where it is proxied by a particular variable, or combination of variables. Rather, our inferences regarding confidence, herding and metacognition are inferred through the examination of patterns that become evident through considering a number of regression analyses based on sub-groups and sub-periods.

² Loh and Stulz demonstrate that only 12% of analysts’ forecasts are influential. They define “influential” as having an influence on the market.

³ Juergens and Lindsey (2009) suggest that producing the forecasts is only part of analysts’ work; buy-side analysts generate business for traders. Bayer et al. (2010) suggest that, in addition to forecasting earnings, analysts produce other forecasts (such as cash flow), issue recommendations to buy, sell or hold stocks, analyze price movements, suggest target prices, and provide written arguments justifying these decisions. Asquith et al. (2005) provide useful background on analysts’ activities by presenting a detailed analysis of the contents of their reports as well as further information on the effect of the contents of these reports on prices.

⁴ We define herding in equation (1) below. An observation of zero for the variable *herd_{it}* indicates that there is *no* marginal contribution of the forecast. The summary statistics presented in Table 3 confirm that the average contribution is indeed zero.

⁵ Womack (1996) and Barber et al. (2001) present seminal analyses demonstrating that returns are associated with changes in sell-side analysts’ recommendations. These studies argue that markets cannot be fully informationally efficient (Grossman and Stiglitz, 1980; Fama, 1990).

⁶ Bernhardt et al. (2006), in contrast, argue that there is evidence supporting anti-herding.

⁷ If the information set remains constant, reiteration of the informational *status quo* may itself be informative. Bikhchandani and Sharma (2000) suggest that the behavior of analysts using the same information set, and reaching the same conclusions, might create a spurious impression of herding. Such spurious herding, according to Bikhchandani and Sharma, should be contrasted with the intentional behavior summarized by Spyrou (2013 – see footnote 8). The analysis we will present indicates that the documented herding behavior is not spurious. It need not be the case that the cognitive processes driving this herding behavior are processes of which herders are aware; therefore, the behavior need not be “intentional”.

⁸ Spyrou (2013) reviews and discusses the literature on herding in financial markets. He identifies six theoretical frameworks adopted for analyses of herding: herding driven by reputational or labor market concerns, herding as a rational choice when investors have short horizons, informational cascades, irrational herding affected by sociological factors, rational feedback by rational traders exploiting systematic biases, and behavioral models of herding (such as sentiment driven behavior).

⁹ We stress that Kim et al.’s study is limited to revisions to forecasts which have already been made public. In contrast, this paper only considers an analyst’s initial forecast.

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