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Do independent research analysts issue more or less informative recommendation revisions?☆

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ABSTRACT

This paper studies whether independent research analysts issue more informative stock recommendation revisions than investment bank analysts. I find independent analyst recommendation upgrades and downgrades significantly less informative. I also investigate whether the identified differences in informativeness are the result of systematic cross-sectional variation in analyst ability, portfolio complexity, and brokerage firm resources. Including these variables reduces the disparity in information content between groups. However, independent revisions continue to have lower informativeness. I follow prior research and compute daily buy-and-hold abnormal returns to portfolios formed based on analyst firm type. I find that investment bank analyst portfolios generally outperform those of independent research analysts. Lastly, I examine market reactions before and after the Global Settlement Agreement that was enacted to limit the perceived conflicts in the industry. Lastly, investment bank analyst upgrades generate an 18.7% greater reaction in the post-regulation period, suggesting the Global Settlement helped mitigate biased research. Independent analysts continue to issue less informative recommendations.

1. Introduction

I compare the market response to stock recommendation revisions from analysts employed by independent research firms (INDs hereafter) to revisions originating from investment bank analysts (hereafter IBANKs). Prior research by Barber, Lehavy, and Trueman (2007) investigates the long-term stock recommendation performance of investment banks and independent research firms by comparing returns to portfolios based on the recommendation level and analyst firm type. They find that daily abnormal average returns to independent research firm buy recommendations outperform those of investment banks. Using somewhat different methods than Barber et al., my main results show that the market reacts to revisions from IBANK analysts more strongly than to IND revisions. After controlling for the direction of the recommendation revision along with analyst and brokerage characteristics, I continue to demonstrate that IND recommendation revisions generate a significantly smaller market reaction.

This paper is partially motivated by recent regulation in the financial community. In April 2003, ten large investment banks agreed to settle with the New York State Attorney General and the Securities and Exchange Commission (SEC) regarding charges of conflict of interest among security analysts.[1] The agreement required the sanctioned banks to pay nearly one billion dollars in penalties along with $460 million to fund independent research. In addition to these payments, sanctioned banks were ordered to provide three sources of independent research along with their own research reports. Thus, the settlement seems to imply that analysts who work for independent research firms are free from the conflicts of interest that cause investment bank analysts to issue biased, presumably inferior, analyst reports.

Recently, the usefulness of independent analyst reports has been called into question. According to Susan Mathews, a former SEC official who implemented the independent research requirement under the Global Settlement, "A lot of money was spent and not very many people were using the research."[2] One large investment bank subject to the settlement, Credit Suisse, found that their retail clients accessed the provided independent research 110 times on the first year and only 16 times on the second year.[3] In addition, anecdotal evidence suggests that investment banks would provide clients with

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[1] Analyst conflicts have been attributed to several factors. An analyst's salary and bonus may be linked to quantifiable measures such as his or her firm's underwriting fees (see, e.g., Dugar & Nathan, 1995; Lin & McNichols, 1998). Additionally, brokerages whose analysts issue negative reports on potential or current clients may be excluded from lucrative advisory and underwriting engagements as retribution (see, e.g., Siconolfi, 1995; Solomon & Frank, 2003).

[2] Kim (2009).

[3] According to the Credit Suisse website.

independent research when they did not cover a particular stock rather than as a complement to their internally generated research.

Ex ante, multiple factors may contribute to a lower demand for independent research, even though INDs are not subject to the underwriting conflicts faced by investment bank analysts. First, analysts from investment banks have access to a larger pool of resources and additional information channels not available to independent research firms. Second, the profitability and large size of investment banks likely lead to higher pay to retain the best performing analysts. Boni and Womack (2002) indicate that full-service investment banks compensate their analysts better than others. Lastly, cross-sectional differences in the number of firms and industries covered may reduce independent research quality.

My paper is most closely related to Clarke, Khorana, Rau, and Patel (2011) who examine independent analyst research. Similar to my results, they report that independent analyst recommendations generally have lower information content. However, their focus is on the effect that recent regulation had on the propensity of analysts to issue optimistic research following the regulation. The aim of this study is to first determine the differential information content of investment bank versus independent research, then to explore factors that might explain the discrepancy. I investigate how the market perceives the quality of recommendations from these two groups while controlling for recommendation revision type (upgrades, downgrades, reiterations), revision magnitude (high versus low magnitude), analyst characteristics (busyness, experience) and brokerage characteristics.

Another way that this paper contributes to the literature is that I reconcile the results from my first set of analyses with results reported by Barber et al. (2007). Barber finds that daily abnormal average returns to independent research firm buy recommendations portfolios outperform those of investment banks. Conversely, they find the investment bank hold/sell recommendations outperform independent research firm hold/sells. Utilizing an event methodology, my findings contrast those of Barber et al. in that I find no evidence that independent revisions have higher information content, even after controlling for a multitude of factors known to be associated with market reaction. I then examine the recommendation performance of IBANK and IND analysts by forming portfolios based on their upgrades to "buy" and downgrades to "hold" or "sell" categories. Similar to the short-term findings, and in contrast to Barber et al., both the IBANK "buy" and the IBANK "sell" portfolios generally outperform IND portfolios. This discrepancy appears to be due to the research design decision to include returns to reiterations of a recommendation, which significantly impacts the performance of each portfolio.

In this paper, I first provide descriptive statistics on the distribution of upgrades, downgrades, and reiterations by analyst firm type. I also compare the information content of stock recommendation revisions of IBANKs with those of INDs by examining the three-day abnormal return around stock recommendation revisions. Each before/after recommendation combination (e.g., a "buy" recommendation upgraded to a "strong buy," a "buy" downgraded to a "hold," or a "buy" later reaffirmed as a "buy") is partitioned to determine whether the market reacts differently to upgrades, downgrades, and reiterations by analyst firm type. I find that IBANKs are less likely to issue revisions that skip recommendation categories (low-magnitude revisions) than are INDs.[4] This may imply that IBANK revisions are timelier. Additionally, IBANKs issue relatively more reiterations across all recommendation levels. I find that IBANK upgrades and downgrades generate a greater market reaction for both revisions that move one recommendation category and revisions that skip one or more categories. IND reiterations are significantly more informative at three of the five reiteration levels.

Using a sample of recommendation revisions from 1996 through the end of 2007, I regress event-period abnormal returns on an indicator variable for analyst firm type, indicators for revision direction, and the interaction of the analyst firm type and revision direction. I find IND recommendation upgrades and downgrades significantly less informative than revisions from IBANKs.

Next, I examine whether variations in analyst and brokerage characteristics across firm type explain the information content differences in recommendation revisions. To complete this analysis, I introduce proxy variables for analyst ability, brokerage firm resources, and portfolio complexity in my analysis. Specifically, I incorporate analyst experience, forecast accuracy, All-American status, and a recommendation timeliness measure as proxies for ability. The year-specific number of companies and industries followed act as my proxies for portfolio complexity. Lastly, I include the size of the brokerage firm as a proxy for firm resources.[5] I find that my set of explanatory variables helps explain the market reaction to recommendation revisions. However, IBANK revisions remain significantly more informative than IND revisions even after including these explanatory variables and other controls.

To compare with Barber et al., and since IBANK stock recommendations are likely more widely disseminated than those of INDs, I compare the long-term performance of the stock recommendations of IBANK and IND analysts. I examine the recommendation performance of IBANK and IND analysts separately by forming portfolios based on their upgrades to "buy" and downgrades to "hold" or "sell" categories. Similar to the short-term findings, both the IBANK "buy" and the IBANK "sell" portfolios generally outperform IND portfolios.[6] Thus, despite potential underwriting and trading-based conflicts, IBANK recommendations seem to provide superior recommendation revisions.

My paper then addresses whether the Global Settlement Agreement has affected the market reaction to analyst recommendation revisions. I divide my observations into pre- and post-Global Settlement subsamples with the first month after the agreement was reached as the breakpoint. Similar to Clarke et al., findings indicate that, after controlling for analyst characteristics, brokerage characteristics, and company control variables, IBANK upgrades are significantly more informative in the post-Settlement period than they were in the prior period. Also, the magnitude of the difference between the informativeness of IBANK versus IND upgrades increases in the post-Settlement period. Additionally, I find that the information content of downgrades remains constant across time periods.

Lastly, I examine whether actual conflicts of interest cause recommendations from investment bank analysts to be of lower information content. I separate each investment bank analyst recommendation revision into two categories: those from affiliated analysts and those from unaffiliated analysts. I define affiliation similar to prior research (Jacob, Rock, & Weber, 2008), by classifying an analyst as affiliated if the analyst's employer has been involved in any equity or debt related deal or advised in any merger or acquisition in the three years prior to the recommendation or three years subsequent to the date of the recommendation revision. After including analyst affiliation in the analysis, I find that INDs continue to issue less informative recommendation revisions, in both upgrades and downgrades compared to both affiliated and unaffiliated investment bank analysts.

The findings in this paper potentially contribute to the literature in several ways. I find IBANK upgrades and downgrades to be significantly more informative, as measured by short-window abnormal

[4] Mikhail, Walther, Wang, and Willis (2006) find that the best analysts are less likely to issue revisions that skip recommendation categories.

[5] The rationale for including these particular variables, along with specific definitions, is provided in Section IV.

[6] I find that the research design decision to include returns to reiterations of a recommendation significantly impacts the performance of each portfolio.