



Analysts' reinitiations of coverage and market underreaction

Aurélien Philpott¹

Département de finance, assurance et immobilier, Faculté des Sciences de l'Administration, Université Laval, Pavillon Palais-Prince, Québec City, Québec, G1V0A6, Canada



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ABSTRACT

I study the informativeness of reinitiations of coverage, which are defined as the resumption of coverage of a stock by a broker after more than six months of interruption. Reinitiations are associated with a significant short-term market response, in particular when the same analyst is assigned to the stock. However, I show that this market response is incomplete. Interestingly, the price patterns that follow the issuance of regular upgrades of recommendation and reinitiations differ significantly. Prices adjust quickly after a regular upgrade, while reinitiations are followed by a sustained price increase in the following six months, which does not revert during the following two years. I assess the economic magnitude of this initial underreaction by setting up a trading strategy. I show that reinitiations of coverage are the only type of recommendation that delivers significant positive abnormal returns after transaction costs with a three- and six-month investment horizon. I study and reject several candidate explanations in relation to momentum, and PEAD. Then, I investigate an information/superior ability hypothesis. I find that reinitiations are a more accurate signal than other recommendation types. Besides, the earnings conference call transcripts show that those analysts were able to maintain active relationships with the firms, even during the interruption of coverage. Their activity level is associated with more informative reinitiations of coverage. In particular, their participation rank in conference calls, which can be seen as a proxy for ability and proximity to the management appears to be a strong predictor of the drift after the reinitiation takes place.

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1. Introduction

In perfectly efficient markets, we would not need financial analysts. However, the existence of frictions could give them a useful role to play, either for the benefit of investors, or for the firm itself. For instance, Gleason and Lee (2003), or Ivkovic and Jegadeesh (2004) explained that analysts reduce information asymmetry by distributing publicly available information more evenly across the market. Derrien and Kecskes (2013) highlight the monitoring benefits Jensen and Meckling (1976) had first identified. As soon as we start thinking about their role, we are also led to study the different signals analysts release, and to wonder which ones

are the most informative. For instance, Womack (1996) showed that upgrades are more informative than mere reiterations of recommendation.

My paper and my results can be reconciled with the information agent view, and the idea that all analysts are not informed all the time, but some analysts might be informed in particular circumstances. To that purpose, I focus on a specific signal, which had never been studied so far: reinitiations of coverage.

I define a reinitiation of coverage as the first report issued by an analyst after a period of interruption of at least six months. Several reasons can lead a broker to discontinue the coverage of a firm: the analyst might have left the broker, the stock might have been placed on a restricted list because of regulatory requirements, or the analyst might believe that the firm's prospects are poor. The latter is reflected in McNichols and O'Brien (1997) self-selection hypothesis: analysts would prefer to stop the coverage of a firm rather than downgrade it and potentially damage their relationship with its management. In a similar vein, Scherbina (2008) argues that terminations of coverage enable analysts to withhold bad news about the firms they cover. Kelly and Ljungqvist (2007) find

E-mail address: aurelien.philpott@fsa.ulaval.ca

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that exogenous terminations of coverage² carry no information about the future performance of the covered firms, unlike a control group of endogenous terminations. I filter out resumptions of coverage that are less than six months old in order to remove terminations of coverage that are motivated by regulatory or other exogenous reasons. Thus, it is likely that analysts who chose to reinstate a coverage did preserve their relationship with the top management of the companies. Besides, in line with previous studies, I differentiate both rating levels and changes,³ and I call a reinstatement upgrade (downgrade), a reinstatement issued with a higher (lower) rating than the last rating known before the discontinuation.⁴ It is noteworthy that a reinstatement can be issued by the same analyst that discontinued the coverage, or by a different analyst working for the same broker.

Reinstatements of coverage can be expected to be informative on several groundings: by maintaining good relationships with the managers of the firm at the time of the discontinuation, the analysts may have preserved their access to soft information. Besides, they benefit from their previous knowledge of the firm, its management, and its industry. Since analysts are usually specialized in industries, they continue to be informed in the trends of a firm's sector, and keep an eye on a firm's specific news even after discontinuing its coverage. All of that helps them form a first opinion as to whether it would be time to resume the coverage. This first opinion is then confirmed or denied when they invest time and effort updating their valuation model, and after they meet the management of the company in order to assess their assumptions.⁵ In the paper, I provide empirical evidence that they continue to be in touch with the firm management. Indeed, I show that when those analysts continue to participate in earnings conference calls between the discontinuation of coverage and the resumption, they are very active (both by their assiduity, or the number of questions asked), and they are granted the opportunity to ask their questions early on in the Q&A session, which has been claimed to be a strong signal of connectivity with the management (for example in [Cen et al., 2016](#)). Finally, these analysts have a valuable timing option at hand: nothing compels them to resume the coverage of a specific company, and they can strategically choose both the precise moment when their report is sent to the market and the level of their new rating. In other words, reinstatements could manifest their market timing skills, their ability to discover new pieces of information, and could be explained by their connectivity with the management. These new pieces of information could come from various sources: notably, inside information, or the discovery of public information that had been neglected by investors or analysts in an inefficient market. In those instances, the signal sent by the analyst at the time of the reinstatement would not be immediately and fully incorporated in the stock price, but only gradually, which would lead to the existence of a drift. Reinstatements are a rare signal, they can easily be mistaken for regular upgrades of recommendation, and the stock market is flooded with other signals that look quite similar but are actually meaningless and introduce a lot of noise (for example, in the data, many analysts suspend the coverage of a firm only to resume it a few days later). In the paper, I also test and reject alternative explanations for the existence

of the drift: I show that the drift cannot be explained by analysts chasing momentum, or by recent positive earnings surprises.

I test the aforementioned hypotheses and the results tend to confirm the intuition. Reinstatements by the same analyst lead to a stronger immediate market reaction than reinstatements by a different analyst, which highlights the value of prior knowledge of the firm (reinstatements with a positive rating issued by the same analyst lead to a two-day cumulative abnormal return of 1.70% which is significantly bigger than the 1.07% that comes from reinstatements by a different analyst). Furthermore, I find that reinstatement upgrades lead to a stronger short-term market reaction than reinstatements with a positive rating (for example, 2.31% two-day cumulative abnormal return versus 1.70% in the case of reinstatements by the same analyst). Reinstatement upgrades by the same analyst are associated with a stronger short-term response than initiations of coverage. The short-term market response to reinstatement upgrades and regular upgrades is very similar, which confirms the idea that market participants treat both signals similarly. However, I uncover the existence of a significant delayed price reaction and document the existence of a persistent drift after a reinstatement announcement (cumulative abnormal returns of 3.31% for reinstatement upgrades by the same analyst). This result sharply differentiates reinstatements of coverage from regular upgrades: indeed, even though regular upgrades are followed by an immediate market response of the same magnitude as reinstatements, the asset pricing implications of upgrades are short lived and the price adjustment is very quick, the price starting to slowly mean-revert after two days. On the other hand, the valuation effect that follows reinstatements does not revert over the horizon of my study, showing that it takes longer for all the information content of this signal to get into prices.

I assess the economic relevance of this anomaly by testing whether a profitable investment strategy can be implemented with these recommendations. Indeed, according to [Barber et al. \(2002\)](#), it is unsure whether investors can actually trade on analysts' recommendations and make a profit: the authors show that strategies based on purchasing stocks that have the most favorable recommendations are unlikely to generate abnormal returns that survive transaction costs. I form calendar-time portfolios and design a trading strategy that incorporates transaction costs, estimated from the algorithm developed by [Corwin and Schultz \(2012\)](#). With a three-month horizon, investing in reinstatements by the same analyst produces an average monthly abnormal return of 0.55%, and investing in reinstatement upgrades by the same analyst generates an average monthly abnormal return of 0.64%. Both are significantly greater than zero and strictly dominate the monthly abnormal returns that come from initiations of coverage or regular upgrades (neither of them are statistically different from 0). Similar results still hold when I use a six-month investment horizon.

I show that, contrary to analysts who initiate a coverage or upgrade a recommendation, analysts who reinstate a coverage do not appear to be momentum chasers that produce overly optimistic forecasts. On the contrary, they are the most accurate, and their timing is excellent.

Finally, I investigate the information/ability hypothesis. If analysts reinstate the coverage based on their ability to discover pieces of information that had been neglected by the market, or that were given to them by the management, they should produce more accurate earnings forecasts, and we should observe improvements in future firm profitability. I document that reinstatements of coverage generate the lowest price-deflated forecast errors of all types of recommendations. I look at the change in operating performance (measured by the industry adjusted return on asset and EBIT margin). The profitability of firms subject to reinstatements by the same analyst and reinstatement upgrades by the same analyst increases significantly both on the year the reinstatement takes place and in the following year. On the other hand, the profitability of

² In their paper, exogenous terminations correspond to a broker's decision to terminate the coverage of a whole sector, or the closure of a brokerage house.

³ [Womack \(1996\)](#) and [Jegadeesh et al. \(2004\)](#) both documented that recommendation changes lead to a stronger short-term market reaction than reiterations of rating.

⁴ Positive reinstatements come with a rating of buy or strong buy.

⁵ Moreover, anecdotal evidence indicate that the reinstatement reports are more likely to be several pages long, instead of a few lines as in the case of reiterations of recommendations.

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