

Franco et al. (forthcoming) find that reports using straightforward language generate more trading volume and also higher abnormal returns (price changes). Hsieh and Hui (2013) also find a positive association between readability and stock market returns for a sample of 2930 reports. They attribute this finding to a reduction in the dispersion of expected future earnings brought about by readable reports, and thus a lower discount rate in valuing the firm.

To the contrary, a more complex report could signal far-reaching industry and company knowledge on behalf of the analyst and thus improve credibility. In this case, the trading impact should increase with the complexity of a report. Also for these hypotheses there is empirical support. Twedt and Rees (2012) examine the impact of roughly 2000 analyst reports and find that readability has no direct impact on the market. However, they find a significant interaction effect: higher readability causes a weaker market reaction (abnormal returns) to the content of the report if the analyst's recommendation deviates from the mean consensus recommendation. Twedt and Rees argue that complexity is seen as a signal of superior analyst knowledge.

These empirical results are difficult to reconcile. They could be the result of the sample composition: Twedt and Rees restrict their sample to reports that initiate coverage, whereas De Franco et al. also include updates on existing coverage. When initiating coverage, the publishing analyst is often new to the company and thus first has to build a reputation of being insightful and knowledgeable. So for initiation of coverage, a more complex report may be a more powerful signal of ability and effort than for an update report. Moreover, Twedt and Rees find that high complexity only coincides with high abnormal returns if the analyst's recommendation deviates from the mean consensus recommendation, whereas De Franco et al. only measure the direct effect of readability on trading volume.

To shed more light on the relationship between the readability of an analyst report and the market's reaction, we conduct a laboratory experiment, focusing on the following research questions. Firstly, we examine the relationship between report readability and the reader's judgment concerning the competence and credibility of the analyst, thus examining whether report readability is a signal for analyst competence. Secondly, we examine the relationship between report readability and the perception of the contents of the report, thus examining whether less readable reports lead to greater ambiguity. Finally, we examine the relationship between readability and the decision to trade in a stock, thus examining whether ambiguity aversion or perceived analyst competence have any impact on trading decisions in this context.

The laboratory experiment does not capture all aspects of the real world to which we would like to generalize, but it has the great benefit of allowing the manipulation of the only variable of interest (readability) while holding all other variables constant. This results in a higher internal validity, which allows the examination of causal relationships. In addition, it provides insights into the judgments that precede the investment decision, which are difficult to obtain with empirical–archival methods (Hirst et al., 1995).

The results are relevant not only in providing additional insights into the so far inconsistent empirical results regarding the impact of readability on equity markets. They

also shed some more light on the role of information dissemination in financial markets as an explanation for trading activity.

2. Method

The experiment was conducted with 401 undergraduate business students in their first, second and third year of a bachelor program at EBC Hochschule campuses in Berlin, Düsseldorf and Hamburg. Students received the following cover story: a rich uncle has died and has left an inheritance of €100,000 for the student. The terms of the inheritance stipulate that the funds will only be at the student's disposal 10 years from now. Until then, the student has no access to the funds, but can allocate them between two investable assets: a risk-free government bond, yielding 2% per annum, and shares of a (fictional) pet food manufacturing company, Canina.

Students have to decide which percentage of the funds (between 0% and 100%) should be allocated to shares of Canina, the rest will be invested in government bonds. Students are told that they later have to explain their investment decision to the custodian of the inheritance in a questionnaire.

To assist in the asset allocation decision, students are provided with an analyst report on Canina, containing a short profile of the company, recent trends in the pet food industry, a comment on quarterly results which missed expectations and a comment on a planned acquisition, which looks reasonably priced and exposes the company to Emerging Market growth. The analyst report also includes selected income statement, balance sheet and valuation figures (the price/earnings and the enterprise value/operating profit ratio, dividend yield) and a recommendation of the analyst (“buy”).

There are three versions of the research report which only differ in their readability. The Flesch Reading Ease index, adjusted for the German language according to Amstad (1978), is 11 for the difficult report, 46 for the normal report and 62 for the easy report. A higher complexity was introduced by using longer and nested sentences and longer words, for example compound nouns. The content of all three reports is identical, and we did not introduce any technical terms that would require expert knowledge in the more complex versions.

Students are randomly assigned one of the three reports, and they do not know that the report is issued in different levels of readability. After the students have submitted their investment decision, i.e. the percentage of the inheritance to be invested in shares of Canina, they are asked to state their age, gender and location and to respond to the following 11 statements on a five-level Likert-type rating scale (from “strongly disagree” = 1 to “strongly agree” = 5):

1. I am well versed in equity markets.
2. I like to take risks if they could pay off.
3. I try to avoid doubts in financial decisions.
4. The analyst report is comprehensible.
5. The analyst report is unambiguous.
6. The analyst is competent.

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