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Asymmetric effects of sell-side analyst optimism and broker market share by clientele ☆

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ABSTRACT

This paper provides evidence for the first time on how different broker clienteles react to earnings forecast and stock recommendations. Greater trade volume is found to be associated with optimistic earnings forecasts while stock recommendations are stronger for analysts affiliated with retail brokerage firms than those affiliated with institutional brokerage firms. We also find that the market share of buy volume (that is, volume from buy orders) substantially rises on recommendation upgrades while the market share of sell volume rises on recommendation downgrades, and that this effect is stronger for retail clientele.

1. Introduction

The analyst's role is integral to the process by which their affiliated brokerage firms generate business.[1] Analysts are ranked by institutional investors based on the quality of their research. These rankings are

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[1] Ramnath, Rock and Shane (2008) provide a comprehensive review and taxonomy of research relating to analysts in financial markets. Trade generation incentives have been investigated by, among others, Hayes (1998), Irvine (2004), Jackson (2005), Cowen, Groysberg and Healy (2006), Agrawal and Chen (2008), Choi, Clarke, Ferris and Jayamaran (2009), and Niehaus and Zhang (2010).

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considered by the brokerage firm as a driver of order flow to the brokerage firm, and therefore are a key determinant of the analyst's remuneration. While extreme forecasts are likely to drive order flow in the short term, analysts' forecasts are moderated by the need to maintain their personal reputation, as well as that of their firm, by providing accurate information to investors. For example, Cowen, Groysberg and Healy (2006) find that analysts working at reputable firms make more accurate forecasts than others, possibly because superior analysts are employed by prestigious investment banks (Hong, Kubik and Solomon (2000)'Hong and Kubik, 2003). Fang and Yasuda (2009) conclude that the analyst's personal reputation is more important than that of their firm. In this paper, we examine the way in which a sell-side analyst's clientele influences their degree of forecast optimism or pessimism, and in turn helps generate trade for their affiliated brokerage.

We show that analysts with mainly retail clientele tend to provide more extreme forecasts and recommendations, on average, than analysts with mainly institutional clientele. These analysts are able to generate additional trading volume through their affiliated brokerage, either due to the inability of their clients to fully account for the bias in the analyst's message (e.g., Malmendier and Shanthikumar, 2007), or due to a lack of importance of a retail analyst's reputation. Ljungqvist, Marston, Starks, Wei and Yan(2007) explain that an analyst's reputational capital ultimately depends on institutional investors' views of the quality of their research. Analysts with mainly retail clients would therefore hold fewer incentives to refrain from providing biased, trade-generating forecasts.[2]

Researchers (Hayes, 1998; Jackson, 2005; Beyer and Guttman, 2011) have utilized theoretical models that consistently predict that analysts bias their forecasts in an optimistic fashion, and that deviating from the consensus forecast generates trade for the analyst's affiliated brokerage. Furthermore, investors will respond asymmetrically to an analyst's deviation from the consensus; due to transaction costs or short-sale constraints, optimistic forecasts will generate more trading volume than pessimistic forecasts. On the other hand, empirical studies that have examined the relationship between analyst optimism and affiliated brokerage market share have largely approached the issue using a linear framework (Jackson, 2005; Niehaus and Zhang, 2010).[3]

This paper is motivated by the apparent inconsistency between the common theoretical predictions, and the empirical evidence found in prior research. This provides an opportunity to corroborate and refine some existing evidence on the nature of the relationship between analyst forecast optimism and broker market share. We also extend the literature by considering the differential impact of analyst optimism for brokerage firms with institutional as opposed to retail clienteles.

There is extensive evidence that different factors motivate trade among retail and institutional investors Barber, Odean and Zhu(2009). Malmendier and Shanthikumar (2007) and Mikhail, Walther and Willis(2007) find that institutional investors (as proxied by large traders) adjust their trading response to analysts' stock recommendations appropriately. However, retail investors (small traders) are prone to taking analysts' recommendations at face value. Of additional interest to this work, Malmendier and Shanthikumar (2007) suggest that institutional investors sufficiently discount recommendations from affiliated optimistic analysts, but retail investors do not account for analyst affiliation in their trading behavior. Boni and Womack (2003) note that retail investors are less likely to realize the extent to which analysts' recommendations are already incorporated into market prices, and that institutional investors possess a greater ability to understand the subtlety of sell-side research.

A further contribution of our paper stems from the ability to classify volume into purchase volume and sales volume. This classification enables a direct test of whether clients trade according to their broker's advice, rather than whether there is a non-directional association between analyst research and affiliated broker volume. For example, an upgrade to a strong buy recommendation may increase the buy volume and decrease the sell volume executed by the affiliated broker. This provides us with a direct test that reconciles the literature on the behavior of retail and institutional investors with the analyst forecast literature.

[2] Star analysts, for whom reputation is presumably most important, almost exclusively work for large investment banks, not retail brokerage firms; analyst reputation appears mainly important in generating investment banking deal flow Clarke, Khorana, Patel and Rau(2007). Poorly performing analysts experience greater job turnover and work for less reputable firms Mikhail, Walther and Willis(1999).

[3] Irvine (2004) is the only researcher to our knowledge who examines the asymmetric relationship between broker market share and analyst forecast optimism in an empirical setting, whereby extreme forecasts in either direction may vary market share.