J. Finan. Intermediation 20 (2011) 441–457

Contents lists available at ScienceDirect

J. Finan. Intermediation

journal homepage: www.elsevier.com/locate/jfi

Competition and optimistic advice of financial analysts: Evidence from IPOs ☆

Enrico Sette *

Bank of Italy, Economic Research Department, Via Nazionale 91, 00184 Rome, Italy

ARTICLE INFO

Article history:
Received 14 July 2009
Available online 12 October 2010

Keywords:
Affiliated analyst
Analyst recommendation
Analyst optimism
Competition
IPO

ABSTRACT

This paper investigates whether competition affects the degree of optimism in recommendations on Initial Public Offerings (IPOs) issued by affiliated sell-side analysts. Competition is measured by the number of unaffiliated analysts covering the IPO. Since the measure of competition is likely to be endogenous, it is instrumented using the number of analysts who cover stocks in the same industry as the IPO, one quarter before the one in which the recommendation is issued. The results show that affiliated analysts issue less optimistic recommendations when more unaffiliated analysts cover the IPO, suggesting that competition has a causal effect in mitigating the incentives of affiliated analysts to issue favorable investment recommendations. The paper also shows that recommendations issued by analysts affiliated with co-managers of the IPO are significantly less optimistic than those issued by analysts affiliated with the lead underwriter, and that competition affects only the degree of optimism of the latter.

1. Introduction

This paper investigates whether competition impacts the degree of optimism in recommendations issued by affiliated sell-side analysts on Initial Public Offerings (IPOs). Financial analysts provide

☆ The views expressed in this paper are my own and do not necessarily reflect those of the Bank of Italy. This paper is a revised version of Chapter 2 of my Ph.D. dissertation. I am especially grateful to Antoine Faure-Grimaud and Hyun Shin for their helpful supervision. I also thank Rocco Macchiavello, Andrea Prat, Andrea Tiseno, Michela Verardo, Fabian Waldinger, Lucy White and seminar participants at the LSE, Bank of Italy, Luiss, ESEM-Vienna 2006, EFA-Lubiana 2007, for helpful comments and suggestions. The Editor (Manju Puri) and two anonymous referees provided very helpful comments. All errors are my own.

* Fax: +39 06 4792 3488.
E-mail address: enrico.sette@bancaditalia.it

1042-9573/$ - see front matter
doi:10.1016/j.jfi.2010.10.002

expert advice that facilitates investors' decision making in the capital markets. However, analysts may have conflicts of interest which create incentives to provide biased advice. The paper discusses the channels through which competition may impact the incentives of affiliated analysts to make optimistic recommendations. Next, the paper empirically investigates whether competition affects the probability that affiliated analysts issue the most optimistic recommendation (“Strong Buy”). Finally, the paper presents a set of robustness checks and extensions.

Markets for expert advice are increasingly important in modern economies. While there is extensive theoretical research investigating different features of such markets, there is little empirical evidence on the effect of competition on the incentives of experts to provide correct advice to the public. The market for financial information is especially suited to address this question since it is one of the most important markets for expert advice and there is plenty of data on the information provided by financial analysts to market participants.

This study focuses on IPOs. These are an important segment of the capital market and recommendations issued by financial analysts often represent the main source of information available to investors on newly listed companies. Concentrating on IPOs also helps to design the empirical analysis. When a firm goes public, one or more investment banks (lead underwriters) provide assistance with all the necessary activities (valuation, release of information to market participants, etc.) and often act as a market maker. Following the IPO, the lead underwriter has a clear interest in having its analysts push out favorable recommendations to support the stock. Therefore, it is possible to identify a group of analysts, those affiliated with the lead underwriter, who have stronger incentives to provide optimistic recommendations. This also suggests that coverage of the IPO by unaffiliated analysts, who are less likely to feel pressed to issue optimistic recommendations, can proxy for the intensity of competition faced by affiliated analysts.

However, coverage of the IPO by unaffiliated analysts is likely to be correlated with firms' unobservable characteristics, such as quality or riskiness. In fact, unaffiliated analysts are more likely to cover IPOs with better prospects, or to refrain from covering very risky, or hard-to-evaluate IPOs. Such firms could also represent, on average, promising investment opportunities, and affiliated analysts may be more likely to issue optimistic recommendations about such IPOs just because they are better companies. In order to identify a causal effect of competition from unaffiliated analysts on the degree of optimism of affiliated analysts, the model is estimated through instrumental variables (IV). The measure of competition is instrumented by the number of analysts who issue recommendations on stocks (both IPOs and non-IPOs) in the same industry as the IPO, one quarter before the one in which the recommendation by an affiliated analyst is issued.

This work builds upon the large literature which documents an excessive optimism in recommendations by affiliated analysts. A recent survey paper by Mehran and Stulz (2007) lists 29 papers investigating this topic. The early studies by Dugar and Nathan (1995), Rajan and Servaes (1997), Lin and McNichols (1998) and Michaely and Womack (1999), show that affiliated analysts issue more optimistic recommendations than unaffiliated analysts. James and Karceski (2006) document that firms with poor aftermarket performance are given more optimistic recommendations by affiliated analysts. Hong and Kubik (2003), Jackson (2005) and Fang and Yasuda (2007, 2009), investigate the role of analyst reputation in mitigating bias.

Further recent evidence documenting stronger optimism from affiliated analysts is provided by Malmendier and Shantikumar (2007), who also investigate the extent to which investors are able to discount biased recommendations. They show that small traders do not discount bias in recommendations, while large traders react to “Strong Buy” recommendations, do not react when observing “Buy” recommendations, and sell following “Hold” recommendations. Agrawal and Chen (2008) show that recommendation levels are positively associated with the importance of brokerage revenues. They also suggest that investors are able, on average, to discount bias. However, they do not focus specifically on IPOs.

This paper is also related to Bradley et al. (2003, 2008) who investigate the behavior of analysts covering IPOs towards the end of the quiet period, during which affiliated analysts cannot issue information about the IPO. Bradley et al. (2003) show that most IPOs receive analyst coverage in the few days following the end of the quiet period. They also show that IPOs experience abnormal returns when coverage is initiated, and that these are larger following a “Strong Buy” recommendation even