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Buy-side trades and sell-side recommendations: Interactions and information content ☆

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Abstract

We examine the performance of buy-side institutional investor trades and sell-side brokerage analyst stock recommendations, as well as their interactions. Buy-side trades follow sell-side analyst recommendations but not the other way around. While buy-side purchases significantly outperform their sales, the difference in performance is largely concentrated on the day of the transaction. Following recommendation changes, buy-side trades in the same direction as the recommendation change earn the same returns as trades in the opposite direction. Therefore, institutional investors do not exhibit special skills in discerning the quality of recommendations.
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1. Introduction

Timely and accurate dissemination of information is critical for capital markets to function efficiently. Not surprisingly, enormous resources are spent collecting and analyzing market and stock-specific information. The agents involved in these tasks could be compensated for their role, broadly, in two ways. Skilled information producers could set up mutual funds to actively invest in stocks and collect fees from their investors, or,

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alternatively, they could sell their information to investors through research reports, as typically done by sell-side analysts in brokerage firms.

In practice, however, active mutual funds and brokerage analysts who communicate directly with investors coexist. Mutual funds reveal their information through their trades, and sell-side analysts reveal their investment opinion through recommendations. Besides issuing recommendations, sell-side analysts also provide additional services such as helping generate trade commissions for their employer or assisting with investment banking activities.

Sell-side analysts' multi-faceted role potentially exposes them to conflicts of interest. Concerns about such conflicts led to close scrutiny of analysts' activities, which resulted in the 2003 Global Analyst Research Settlement between ten large brokerage houses and the SEC and state regulators, which curtailed their activities in the area of investment banking. While this settlement reduced their involvement in investment banking activities, other potential conflicts remain. For example, Irvine (2001, 2004) finds evidence that trading commissions are an important determinant for the types of information that are released by brokerage analysts. In addition, surveys of institutional investors indicate that providing management access to information is an important service offered by brokerage analysts. As a result, the desire to stay in the good graces of firm management may color the opinions of brokerage firm analysts.

Mutual funds do not face these types of conflicts of interest. Their fees depend on the amount of assets under management, and investors choose funds based primarily on their past performance (Warther, 1995; Sirri and Tufano, 1998). Therefore, one might expect the mutual fund set-up to be the optimal mechanism to deliver the value of stock research to investors in the presence of agency conflicts.

We present a comparative analysis of the performance of stocks recommended by brokerage analysts and stocks that are traded by mutual funds and investigate the relative information content. Several papers in the literature present evidence of the stock-picking skills of mutual funds (e.g., Daniel, Grinblatt, Titman, and Wermers, 1997; Chen, Jegadeesh, and Wermers, 2000; Wermers, 2000, 2004) and sell-side analysts (e.g., Womack, 1996; Barber, Lehavy, McNichols, and Trueman, 2001; Jegadeesh, Kim, Krische, and Lee, 2004; Jegadeesh and Kim, 2006). Our study is the first to investigate the relative information content of active funds' trades and brokerage recommendations using the same sample of stocks and the same sample period.

We also investigate the relation between sell-side analysts' recommendations and mutual fund trades, addressing several issues that have been of interest both in the academic literature and in the popular media. Academic studies often suggest that institutions are sophisticated investors who can sort through recommendations potentially tainted by analysts' incentives. For instance, Malmendier and Shanthikumar (2007) argue that institutions take into account the fact that sell-side analysts tilt their recommendations towards buy ratings but individual investors trade naively and "follow recommendations literally."

The media and many investors also share such perceptions. For instance, a *New York Times* article asserts that "For years, Wall Street's dirty little secret was that its research was devised expressly for two key constituencies: its institutional investors and its corporate clients. If the individual investor wanted to join the party, well, caveat emptor."[1]

[1] *The New York Times*, December 23, 2002, "Can settlements actually level the playing field for investors?"

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