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Initiation of brokers' recommendations, market predictors and stock returns

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Abstract

We study more than 5000 broker recommendations on companies listed on the Australian Stock Exchange, focusing in particular on 'initiating recommendations'. We find that returns on initiating recommendations are significantly different from zero in the 6 months following the release of the recommendation. We also find that 'strong buy' and 'buy' recommendations provide better predictions than those formed from market-based variables cited in the literature. In contrast to the short event window studies in the US, there is no significant difference between returns on initiating and continuing recommendations. Mean returns on all categories of recommendations on technology-related companies are negative, reflecting the technology bubble in the period of our study. Finally, variables, such as broker prestige and membership of the Australian All Ordinaries Index have no explanatory power.

JEL classification: G14

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1. Introduction

Broking firms invest considerable resources to enable their analysts to produce investment recommendations and there is a considerable research literature on the extent to which such

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recommendations are able to predict future returns. Investment recommendations may be either 'initiating' or 'continuing'. An initiating recommendation is the first occasion on which a particular broking firm has released a recommendation on a given company. All other recommendations are continuing. If one role of the analyst is to bring new information to the attention of the market, then initiations are potentially of special significance because, conditional on the information already available to the market, they may include a greater quantum of new information than is likely to be found in a continuing recommendation. Peterson (1987), Sayrak and Dhiensiri (2002) and Irvine (2003), among others, have examined the short-window effect of initiations on stock prices.

In the past decade, an extensive literature has reported on the ability of market variables, such as momentum, turnover, book-to-market ratio, sales growth rate and earnings forecasts to predict returns. Jegadeesh et al. (2004) have linked these strands of the literature by seeking to disentangle analysts' forecasting ability from the forecasting ability of these variables. They use US data to examine whether analysts make their recommendations using signals found in market variables.

We contribute to the literature in four ways. First, we measure the extent to which initiating recommendations, as compared to continuing recommendations, can predict stock returns in the 6 months following the release of the recommendation. To measure this ability, we control for market-based variables, such as past monthly momentum, past turnover, the book-to-market ratio and market capitalization. In addition, we control for the amount of information already in the market, as proxied by the consensus view of brokers[1] already covering the company. Second, we examine whether broker prestige and broker market share affect the findings. We conjecture that the greater is the prestige of the broker making a recommendation, the greater the credibility that market participants may accord to the recommendation. Third, by studying Australian data, we provide the first evidence of its kind for a market outside the US. A significant difference between the two markets is that Australian law mandates continuous disclosure rather than quarterly reporting. Fourth, we examine the robustness of the results to different operational definitions of 'initiating'.

The remainder of the paper is structured as follows. Section 2 provides a review of the literature. In Section 3, the data and research design are discussed. In Section 4, the results are presented. Finally, a conclusion is provided in Section 5.

2. Literature review

2.1. Initiations of broker coverage

The initiation of coverage by a broker requires a commitment of resources and time to analyze the company. There can be substantial direct costs as well as the opportunity cost of being unable to cover a different company. One reason brokers publish recommendations is to generate trades and thus commissions. The extent of their success in this endeavour will depend in part on their track record. Thus, there is an incentive for broking firms to publish recommendations that they believe will perform well.[2] An initiation of coverage is more than a mere updating of clients.

[1] We use the terms 'broker' and 'broking firm' interchangeably. We use the term 'analyst' to refer to the individual who makes the investment recommendation. An analyst works for a broking firm and will write a recommendation that will be issued in the name of the broking firm for the use of its clients.

[2] Although this incentive has not prevented complaints that some recommendations have served the interests of the broking firm rather than provided useful and timely information to investors.