



Analysts' preference for growth investing and vulnerability to market-wide sentiment



Kotaro Miwa^{a,*}, Kazuhiro Ueda^{b,1}

^a Tokio Marine Asset Management Co., Ltd, 1-3-1, Marunouchi, Chiyoda-ku, Tokyo, Japan

^b Graduate School of Arts and Sciences, The University of Tokyo/CREST, Japan Science and Technology Agency, 3-8-1, Komaba, Meguro-ku, Tokyo, Japan

ARTICLE INFO

Article history:

Received 28 June 2014

Received in revised form 12 August 2015

Accepted 4 November 2015

Available online 14 November 2015

JEL classification:

G2

G14

G17

G23

Keywords:

Investor sentiment

Financial analyst

Stock recommendation

Growth investing

ABSTRACT

Existing studies have argued that the market-wide sentiment primarily affects individual noise traders, rather than other sophisticated market participants. Contrary to this perspective, in this study, we find that the financial analysts, who are sophisticated market participants, may be more vulnerable to sentiment than are other market participants. As a reason for this vulnerability, we focus on analysts' preference for growth investing, and predict that, due to this preference, their fair value estimations for growth stocks would be more upwardly biased by bullish market-wide sentiment than those of other market participants. We also predict that this optimism for growth stocks would lower the investment value of their recommendations. As is consistent with our predictions, we find that, especially during periods of bullish sentiment, analysts consider growth stocks to be undervalued, even though these stocks are in fact overvalued. In addition, we find that recommended stocks experience poor relative return performance, especially after periods of bullish sentiment, and that this poor performance is not observed after controlling for growth factors.

© 2015 Board of Trustees of the University of Illinois. Published by Elsevier Inc. All rights reserved.

**Publication of this paper was supported by a grant-in-aid from Zengin Foundation for Studies on Economics and Finance and a grant-in-aid for scientific research (B) (No. 25280049) from the Japan Society for the Promotion of Science.

1. Introduction¹

Several behavioral finance studies have argued that correlated investor sentiment drives stock prices away from their fundamental values (De Long, Shleifer, Summers, and Waldmann, 1990; Shleifer & Vishny, 1997). As is consistent with this argument, studies have shown that time-varying market-wide sentiment affects cross-sectional stock returns. Lemmon & Portniaguina, 2006 as well as Baker & Wurgler, 2006; Baker & Wurgler, 2007 have used a measure of market-wide investor sentiment to show that difficult-to-value stocks (i.e., small, young, and volatile stocks)

are overvalued, especially when investor sentiment is high. Antoniou, Doukas, and Subrahmanyam (2013) have shown that investor sentiment is positively associated with the profitability of price momentum strategies. Meanwhile, Stambaugh & Yuan, 2012 have concluded that anomalies are stronger and entail higher potential profits in periods following high sentiment. Such effects of sentiment are considered to be attributed to individual noise traders, since market-wide sentiment is considered to primarily affect these traders (De Long, Shleifer, Summers, & Waldmann, 1990; Lee, Shleifer, and Thaler, 1991; Shleifer & Summers, 1990).

On the other hand, Brown and Cliff, 2004 have cast doubt on the view that market-wide sentiment primarily affects individual noise traders. They have argued that the sentiment influences not only individual noise traders, but professional investors as well. In line with their argument, several studies have shown the effects of sentiment on professional financial analysts, who are typically regarded as sophisticated market participants. Bagnoli, Clement, Crawley, & Watts 2009) have reported that some analysts are sensitive to market-wide sentiment, and that the recommendations of these analysts are less profitable than those of their peers. Moreover, Walther & Willis, 2013 have shown that bullish market-wide investor sentiment induces optimistic earnings forecasts. Qian (2009) and Hribar & McInnis, 2012 have found that investor sentiment affects the earnings

* Corresponding author. Tel.: +81 3 3212 8186; fax: +81 3 3212 7576.

E-mail addresses: miwa.tfk@cs.c.u-tokyo.ac.jp (K. Miwa), ueda@gregorio.c.u-tokyo.ac.jp (K. Ueda).

¹ Tel.: +81 3 5454 6675; fax: +81 3 5454 6990.

¹ Abbreviations used in this article: Baker and Wurgler (BW), Chicago Board Options Exchange Market Volatility Index (VIX), weighted least squares (WLS), earnings per share (EPS), and long-term earnings growth (LTG).

expectations for firms that are difficult to evaluate. Further, [Kaplinski and Levy \(2010\)](#) have shown that analysts issue more buy recommendations during periods of high sentiment. In sum, these studies have demonstrated that analysts are influenced by market-wide sentiment; however, they have only shown that financial analysts' output are, at some level, influenced by market-wide sentiment, which significantly influences individual noise traders. As such, they neither support nor oppose the conventional wisdom that market-wide sentiment primarily affects individual noise traders, rather than other more sophisticated market participants.²

In this study, we provide counterevidence to this conventional wisdom. We show that financial analysts, who are regarded as sophisticated market participants, may be more vulnerable to sentiment than other market participants.

As a reason for analysts' vulnerability to sentiment, we focus on their preference for growth investing, i.e., the analysts' excessive focus on firm's growth component. [Jegadeesh, Kim, Krische, and Lee \(2004\)](#) have shown that analysts tend to focus excessively on firm's growth component due to the economic incentives involved, such as promoting a firm's investment banking business ([Barber, Lehavy, McNichols, & Trueman, 2007](#); [Kolasinski & Kothari, 2008](#); [Lin & McNichols, 1998](#); [Ljungqvist, Marston, & Wilhelm, 2006](#); [Michaely & Womack, 1999](#)), and boosting brokerage trading revenue ([Irvine, Lipson, & Puckett, 2007](#); [Jackson, 2005](#)). This behavior results in their preference (optimism) for growth stocks (i.e., positive momentum, high trading volume, high growth, and overvalued stocks). [Jegadeesh, Kim, Krische, & Lee 2004](#) have shown that this behavior is not aligned with the investment value of stock recommendations, except when analysts prefer momentum stocks.

We predict that analysts' preference for growth investing results in excessive preference (optimism) for growth stocks when market-wide sentiment is bullish, for the following reasons. The present value of a firm's growth component can be determined by future cash flows, discounted at the desired rate of return (i.e., the discount rate). Since higher sentiment could indicate a lower discount rate ([Baker and Wurgler, 2006](#); [Lemmon and Portniaguina, 2006](#)), the present value of a firm's growth component is sensitive to market-wide sentiment. Thus, analysts' preference for growth investing (their excessive focus on firm's growth component) results in vulnerability to sentiment regarding their stock recommendations.

To be specific, higher sentiment, which reflect a lower discount rate, induces a higher difference in the present value of growth components, between high- and low-growth firms. Thus, if analysts more prefer growth investing than do other market participants (i.e., the fair value estimates of analysts depend more on the present value of a firm's growth component, than do those of other market participants), their fair value estimates for growth stocks may be more upwardly biased by bullish market-wide sentiment than are the fair value estimates of other market participants. In other words, when market-wide sentiment is higher, fair value estimates

for growth stocks could be higher than those of other market participants.

Analysts' recommendations reflect the difference between analysts' fair value estimation and the market price. Since the market price can be regarded as the market participants' consensus on the fair value, recommendations could reflect the difference in fair value estimations between analysts and other market participants. As such, when market-wide sentiment is higher, growth stocks could receive more favorable recommendations, even if growth stocks are actually overvalued.

In addition, we argue that this behavior is not aligned with the investment performance of stock recommendations, meaning that analysts' optimism for growth stocks during periods of bullish sentiment could negatively impact the investment performance of recommended stocks. Thus, recommended stocks could experience low stock returns, especially after periods of bullish sentiment, due to excessive optimism about growth stocks during those periods.

In this study, we engage in empirical analyses that test these possibilities. We use the BW market-wide investor and Michigan consumer sentiment indices to explore market-wide sentiment effects.

The rest of this paper proceeds as follows. Section 2 presents the development of our hypotheses. Section 3 describes our sample and our definitions of growth indicators. Section 4 presents the empirical results and checks the robustness of the results. Finally, our findings are summarized in Section 5.

2. Hypotheses Development

We begin our study by examining whether analysts' preference for growth investing results in their excessive sensitivity to market-wide sentiment. The valuation of stocks' growth component could be determined by future cash flows, discounted at the discount rate. Since higher market-wide sentiment reflects lower discount rates, higher sentiment induces a larger difference in the present value of growth components between high- and low-growth firms.³ Thus, if analysts' fair value estimation depends more heavily on the evaluation of a firm's growth component than do those of other market participants, fair value estimates for growth stocks could be higher than those of other market participants, especially during periods of bullish market-wide sentiment.⁴ Therefore, analysts' recommendations, which represent the difference in fair value estimations between analysts and other market participants, would be more favorable for high-growth stocks during such periods.

On the other hand, if market sentiment is bearish, growth components are heavily discounted. Lower sentiment induces a smaller difference in the present value of growth components between high- and low-growth firms. Thus, under this circumstance, analysts' preference for growth investing (i.e., high dependence on analysts' fair value estimation on the growth component) results in a small difference in fair value estimation for growth stocks, between analysts and other market. Therefore, analysts' recommendations (differences in fair value estimations between analysts and others) are much less sensitive to a firm's growth.⁵ In other

² Forecast optimism does not reflect the difference between analysts' estimates and market consensus, but rather the difference between analysts' estimates and actual earnings. Thus, the effect of sentiment on earnings forecast optimism, reported by several studies (e.g., [Hribar and McNinis, 2012](#); [Walther and Willis, 2013](#)), does not indicate whether financial analysts are more irrationally influenced by sentiment than are other market participants. In addition, since a higher sentiment index value does not always indicate that stocks, on an average, are overvalued ([Baker and Wurgler, 2006](#)), the time-varying relationship between analysts' bullishness and market-wide sentiment, as reported by [Kaplinski and Levy \(2010\)](#), is not always irrational. Thus, the relationship between stock recommendation bullishness and market-wide sentiment does not always mean that financial analysts are more irrationally influenced by sentiment than are other market participants.

³ On the other hand, the overvaluation of growth components might be attributed to an optimistic (extreme) growth forecast rather than a low discount rate. However, our analysis refutes this possibility. The detailed analysis is presented in Section 4.6.

⁴ Higher sentiment might also affect analysts' valuation of low-growth stocks. However, since expected future cash flow is much smaller for low-growth firms than for those that are high-growth, the impact from bullish sentiment on the valuation of the low-growth firms is smaller than that of the high-growth firms.

⁵ Consistent with the prediction, the result, explained in Section 4.2, reveals that the association between recommendations and growth characteristics during periods of bearish sentiment is much lower than during periods of bullish sentiment; however, it is rarely negative.

Download English Version:

<https://daneshyari.com/en/article/981984>

Download Persian Version:

<https://daneshyari.com/article/981984>

[Daneshyari.com](https://daneshyari.com)