

Can the institutional managers capitalize on the buy-side analysts' report?

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This study will try to resolve two different opinions regarding the institutional investors: one says that the money managers are able to differentiate between the good and bad recommendation provided by the sell-side and the other one indicates that the managers lack the ability. In addition, whether the managers can exploit the drawback of the buy-side analysts will be examined by constructing a portfolio strategy.

Keywords Analysts, Anchoring bias, Recommendation

Introduction

Institutional investors form their investment decision based on the information collected individually or provided by either buy-side analysts or sell-side analysts. While there have been rigorous researches conducted on the sell-side analysts, the studies regarding the buy-side analysts are limited. One possible explanation can be that the buy-side analysts disseminate privately, whereas the sell-side research is publicly available. The relation between the sell-side analysts and the client or target audience make the analysts face the conflict of interest. On the other hand, buy-side analysts are more likely to product the unbiased information to the target audience. Nonetheless, even with a few studies, it is revealed that the buy-side analysts are less accurate and more optimistic in forecasting the earnings than the sell-side.

In order for the institutional managers to make a good investment decision, they have to take account of two sources of information. Tilting on only one side may hurts the managers' reputation because of the underperformance of portfolios. This study will try to resolve two different opinions regarding the institutional investors: one says that the money managers are able to differentiate between the good and bad recommendation provided by the sell-side and the other one indicates that the managers lack the ability. In addition, whether the managers can exploit the drawback of the buy-side analysts will be examined by constructing a portfolio strategy.

Cheng, Liu and Qian (2006) studied the two sources of information provided by analysts, buy-side analysts and sell-side analysts. They conducted a research on how money managers take advantage of two sources in making an investment. According to them, fund managers are able to adjust the weights on buy-side analysts' information. If the quality of buy-side analysts'

signal increases, the quality of sell-side analysts' signal decreases, the degree of sell-side analysts' bias increases, or the uncertainty of sell-side analysts' bias increases, fund managers put more weights on the buy-side analysts' information. These findings imply that the fund managers are able to detect or identify the quality of information produced by either sell-side analysts or buy-side analysts.

On the other hand, the previous research carried out by Busse, Green and Jegadeesh (2012) implies that fund managers lack the ability to differentiate between good and bad recommendations made by sell-side analysts. To test their hypothesis, the adjusted returns related to the trades, the change in recommendation, the purchases or sales, and the different holding periods are examined. Their findings are consistent with previous studies indicating that the sell-side analysts' recommendations are informative and fund managers do take advantage of analysts' recommendation in making the trading decisions. But, it is also discovered that the fund managers are unable to notice any inherent biases embodied in sell-side recommendations resulted from the conflict of interest.

These two researches have common findings that the recommendations are informative and the institutional investors capitalize on the information. In addition, while the information prepared by buy-side analysts is thought of as the unbiased one, these two researches are based on the assumption that the sell-side analysts face the conflict of interest, implying that the report or recommendation prepared by the sell-side analyst is biased. On the other hand, two studies are contradictory. Given that the money managers lack the ability to identify the quality of sell-side analysts' signal, the optimal weight of either buy-side or sell-side analysis is less likely to be achieved. In other words, founded on these two researches, we can't clearly decide whether the

fund managers are able to adjust the weights depending on the degree of quality of recommendations.

However, if we take for granted the fact that the sell-side analysts suffer from the conflict of interest and that we are not able to measure the degree of biasness, we may have a different story regarding the weight on information. Cheng, Liu and Qian find that funds rely more on buy-side analysts. It was discovered that the magnitude of reliance changes. But, what if the change results not from the quality of sell-side analysis, but from the degree of agreement between money managers and buy-side analysts? Looking at two studies from this angle makes more sense. Institutional investors are less likely to assess the bias or quality of sell-side analysis; therefore, the adjustment of weight depends on how much the managers are in accordance with the buy-side analysis.

In order to test this postulation, this study compares the trading volume of stocks. I collect the four different subsets of stocks; (a) stocks with the buy recommendations from both sides, (b) stocks with the buy recommendation from sell-side analysts but the sell recommendation from buy-side, (c) stocks with the sell recommendation from sell-side analysts but the buy recommendation from buy-side, and (d) the stocks with the sell recommendation from both sides. This paper examine the trading volume of each subset and expects to see the purchases of (a) and sales of (b), (c), and (d). These expectations are based on the findings that the money managers rely more on the buy-side analysts. But, I am expecting to see the sales for the subset (c) because there should be the good quality of information held by the sell-side analysts who make the sell-recommendation even with the bias of optimism. And, it is where the

funds adjust the weight of recommendation, reducing the weight on buy-side and increasing that on sell-side.

Money managers will tilt on one side without adjusting the weight if returns decrease when following sell-side recommendation for the stock (c). For them to keep practicing the weighing-strategy, the returns should be positive for all subsets of stocks. To test, I compute the raw returns and adjusted returns. For the adjusted returns, as Chen, Jegadeesh, and Wermers (2000) and Jegadeesh, Kim, Krische, and Lee (2004) indicate that trades and revisions are slanted toward other characteristics, DGTW-adjusted abnormal returns are computed.

One thing that most researchers or market participants use most frequently is the earnings forecasts. The earnings forecasts can be used to have a glimpse of the market expectation or different opinions of analysts. Groysberg, Healy and Chapman (2008) reveal that buy-side analysts are more optimistic and less accurate in forecasting earnings. They provide the possible explanations for the underperformance of buy-side analysts. First, there is higher retention rate of lower quality analysts and the other one is that buy-side analysts don't compare their analysis to that of sell-side analysts. This finding is consistent with Groysberg et al. (2007) saying that buy-side analysts make less optimistic stock recommendation but their earnings forecasts are relatively optimistic.

One interesting finding related to the earnings forecasts was discovered by Cen, Hilary, and Wei (2013). Based on their study, sell-side analysts suffer from the anchoring bias in estimating the future profitability of a firm. Analysts are inclined to anchor on the industry norm. If the firm has forecast earnings per share that is lower than the industry median, the analysts make optimistic forecasts. Founded on the optimistic forecasts, authors measure the CAF (the

industry cross-sectional anchoring measure) and constructed the portfolio based on the degree of CAF. They found that CAF trading strategies are profitable even after taking transaction costs into account.

Considering the discoveries of previous studies, it is reasonable to expect to see that the buy-side analysts will suffer more from the anchoring bias because they are producing more optimistic earnings forecasts. If so, the portfolio based on the degree of CAF (buy-side) will generate higher returns than that of sell-side. Regarding the anchoring bias and the CAF strategies, this research follow the methodology used in Cen, Hilary, and Wei (2013) with the information from buy-side analysts.

Description of Data

The data source is Thomson Financial/Nelson Information's directory of fund managers.

Analysts' recommendation will be obtained from the Institutional Brokers' Estimate System (I/B/E/S).

This study will collect data regarding individual stock returns, prices, trading volume, total number of outstanding shares, and listings from the Center for Research in Security Prices (CRSP).

The financial data for stock will be acquired from COMPUSTAT.

Sample period is from 1983 to 2013.

Methodology

To test the anchoring bias and the portfolio strategies founded on the CAF, this study follows the previous study conducted by Cen et al. (2013). The portfolio will be constructed by the double sorting on CAF and size. CAF is computed by the following formula,

$$CAF = \frac{F.FEPS - I.FEPS}{|I.FEPS|},$$

where F.FEPS indicates the individual firm's FEPS (forecast earnings per share) and I.FEPS represents the industry median FEPS.

For the optimistic test, this study adopts the approach similar to that in Cowen et al. (2006).

The abnormal returns over various holding periods will be computed as the following:

$$AR_{i,t}(H) = \prod_{\tau=t}^{t+H} (1 + r_{i,\tau}) - \prod_{\tau=t}^{t+H} (1 + r_{dgtw,\tau}),$$

where, $r_{i,\tau}$ is the daily return for stock i , and $r_{dgtw,\tau}$ is the daily benchmark return.

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