Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

When are Analyst Recommendation Changes Influential?

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Presented by Roger Loh at Citi Global Quant Conference, Barcelona

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Other tests

Influential recommendation changes
Small average reactions overall
Our Influential Definition

Influential recommendation changes

- Nov 1, 2007: Meredith Whitney (CIBC) downgraded Citigroup saying that it needs to raise capital or cut its dividend to cope with the credit crisis. Citi dropped 6.9%, the CEO quit 2 days later, and the analyst apparently received death threats.

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

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Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

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Our paper

- We identify recommendation changes (*Recchg*s) that impact the firm's stock in a visible way.

- We investigate when *Recchg*s have such noticeable impact and who makes such calls.

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Data and methodology
Influential vs. Non-Influential
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Literature examines only the average reaction

- Papers such as Stickel (1995), Fang and Yasuda (2007), Altinkilic and Hansen (2009), Ivkovic and Jegadeesh (2004).
  - But if the average reaction to a downgrade is about –1%, –1% may be statistically significant but it is hardly noticeable by any investor.
  - Averages also do not answer our question on which *Recchg*s are influential.

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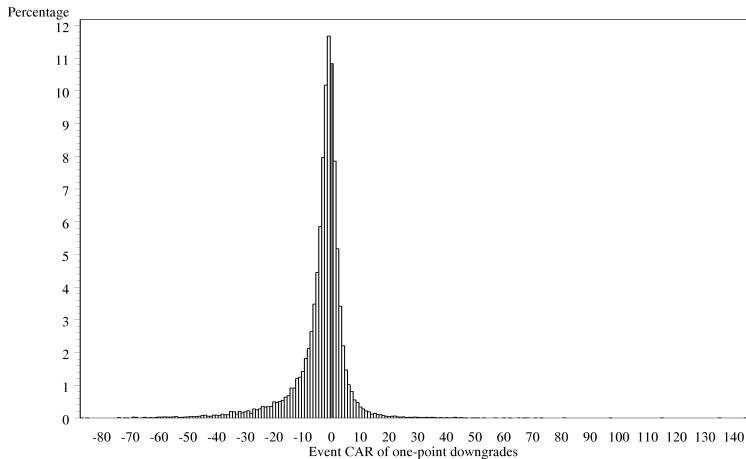## Literature examines only the average reaction

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  - But if the average reaction to a downgrade is about –1%, –1% may be statistically significant but it is hardly noticeable by any investor.
  - Averages also do not answer our question on which *Recchg*s are influential.

Other problems with averages

- Lots of *Recchg*s have returns close to zero or in the wrong direction. See Fig 2a.
- Many *Recchg*s are issued together with firm news releases.
- Averages are dominated by large stocks.

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
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Fig2a: Histogram of 1-point downgrades

Many obs in the shaded zero bin & many have wrong-sign returns

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

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Influential: We must notice the impact!

Influential Definition

A *Recchg* is influential if its abnormal return reaction is in the right direction and more than 1.96 times the stock's prior idiosyncratic volatility of returns.

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Data and methodology
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Other tests

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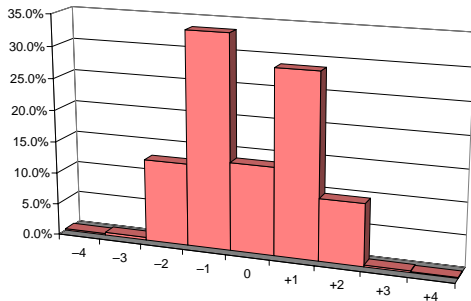
- We also use an abnormal turnover definition (a *Recchg* that causes abnormal high trading volume is also important)

- Our analyses use a sample that removes *Recchg*s issued together with major firm news so that we can attribute the stock price reaction to the *Recchg* itself.

Influential recommendation changes
Data and methodology
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Other tests

Recchg Sample
Influential definition
Firm-news contamination
Fraction of influential *Recchg*s

Data

- IBES US Detail recommendations, 1994–2006. Five-point rating scheme from 1[Strong Sell] to 5[Strong Buy] so that *Recchg* ranges from –4 to +4.

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- IBES US Detail recommendations, 1994–2006. Five-point rating scheme from 1[Strong Sell] to 5[Strong Buy] so that *Recchg* ranges from −4 to +4.
- Panel B of Table 1 shows the distribution of 154,134 *Recchg*s. Bulk falls within −2 to +2.

Influential recommendation changes
Data and methodology
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Other tests

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Influential definition

1. **Influential in abnormal returns** if CAR_i has the same sign as *Recchg* and $|CAR_i| > 1.96 \times \sqrt{2} \times \sigma_\varepsilon$

   - 2-day $CAR_i = \prod\limits_{t=0}^{1} (1 + R_{it}) - \prod\limits_{t=0}^{1} \left(1 + R_{it}^{DGTW}\right)$
   - σ_ε is the stdev of residuals from a time-series regression of past 3-month (days –69 to –6) firm returns R_{it} against market returns R_{mt} and the Fama-French factors *SMB* and *HML*.

Influential recommendation changes
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Other tests

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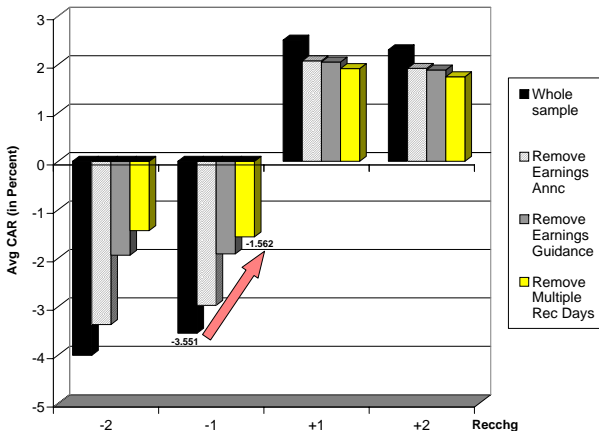
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2. **Influential in abnormal turnover** if *abturn* is $> 1.96 \times \sqrt{2} \times \sigma_{abturn}$

   - where $abturn = \ln turnover - \overline{\ln turnover}$
   - $\overline{\ln turnover}$ is the past 3-month average daily ln *turnover*
   - $\ln turnover = \ln(turnover + 0.00000255)$.

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

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If we sequentially remove firm-news contaminated days...

...Avg $|CAR_i|$ drops. (Note: $\approx \frac{1}{3}$ of Recchgs are contaminated!)

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

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Fraction of influential *Recchg*s

Fraction of influential *Recchg*s

- Only 11.7% of *Recchg*s are influential in returns.
- 12.8% influential in turnover.

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- Only 11.7% of *Recchg*s are influential in returns.
- 12.8% influential in turnover.
- 4.8% are influential in *both* returns and turnover. 6.9% are influential in returns only, and 8% are influential in turnover only.

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Bottomline...

- Few *Recchg*s are influential. The typical reaction cannot be noticed by investors.
- But there are more influential *Recchg*s than expected based on chance alone. Analysts add value by virtue of the fact that there are influential *Recchg*s.

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

Effect of influential *Recchg*s
Analyst and firm characteristics
Ever Vs. Never Influential

Effect of influential *Recchg*s

- Higher Leader-Follower Ratios (Cooper, Day, & Lewis, 2001): Other analysts hurry to revise after them.
- Increases in return volatility, turnover, analyst activity, magnitude of earnings forecast revisions. Consistent with a paradigm shift occuring (Hong, Stein, & Yu, 2007). Investors view the firm differently after an influential *Recchg*.
- Large industry returns. Veldkamp (2006) predicts that analysts may want to produce industry information.

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Data and methodology
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Other tests

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Characteristics	Influential based on firm's abnormal returns			
	Not Influ	Influential	Difference	
			Influ – Not	t-stat
Table 3, Panel C: Change in firm environment around recommendation				
Leader-Follower Ratio of rec	2.032	3.176	1.144***	(12.21)
Δ Volatility of daily ret ×100	-0.081	0.350	0.431***	(21.41)
Δ Daily turnover ×100	0.004	0.096	0.092***	(18.95)
Δ in # of EPS forecasts	-0.359	4.978	5.337***	(9.65)
Δ in FY2 |Forecast Revision|×100	0.034	0.127	0.093***	(3.93)
Fraction with large industry vw return	0.042	0.123	0.080***	(18.45)

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

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Analyst and Firm characteristics: Table 3

| Characteristics | Influential based on firm's abnormal returns | | | |
| | Not Influ | Influential | Difference | |
			Influ – Not	t-stat
Panel A: Analyst and recommendation characteristics				
Forecast accuracy quintile	2.810	2.771	-0.039***	(-2.75)
Away from consensus	0.358	0.416	0.058***	(9.84)
Star analyst	0.159	0.205	0.046***	(9.53)
Absolute analyst experience (# Qtrs)	28.451	29.644	1.192***	(4.63)
Relative analyst experience	2.652	3.354	0.702***	(5.03)
Concurrent earnings forecast	0.446	0.510	0.064***	(10.15)
Influential before (any stock)	0.562	0.664	0.102***	(15.57)
Influential before (same stock)	0.100	0.137	0.037***	(9.99)
Panel B: Firm characteristics prior to recommendation				
B/M ratio	0.484	0.498	0.014***	(2.78)
Size ($m)	8971.683	7451.049	-1520.6***	(-5.49)
Institutional ownership	0.608	0.634	0.027***	(8.44)
Dispersion ×100	14.167	15.119	0.952	(1.31)
Total volatility ×100	2.876	2.556	-0.319***	(-11.79)
Daily turnover ×100	0.655	0.603	-0.052***	(-7.42)
# of EPS forecasts	86.669	72.422	-14.247***	(-15.56)

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

Effect of influential *Recchg*s
Analyst and firm characteristics
Ever Vs. Never Influential

Table 4: Predicting Influential *Recchg*s

22 variables in the probit model to gauge the marginal effect (impact of one stdev change of each variable on the baseline influential probability *ceteris paribas*).

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

Effect of influential *Recchg*s
Analyst and firm characteristics
Ever Vs. Never Influential

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Explantory Variable	Influential in returns	
	Coefficient	Marg. Eff
Influential before (any stock)	0.154***	2.88%
	(8.35)	
Influential before (same stock)	0.065***	1.21%
	(2.93)	
Rec level	0.045***	0.80%
	(4.01)	
Absolute value of *recchg*	-0.017	-0.16%
	(-1.00)	
Upgrade Dummy	0.080***	1.50%
	(4.01)	
Reg FD Dummy	0.206***	3.85%
	(8.82)	
Settlement Dummy	0.093***	1.73%
	(3.84)	

Table 4 (part 1 of 3)

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Data and methodology
Influential vs. Non-Influential
Other tests

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Analyst and firm characteristics
Ever Vs. Never Influential

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Table 4 (part 1 of 3)

- Being influential in the past begets more success.

- Upgrades are more influential.

- Regulatory reforms improves influential probability.

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

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Analyst and firm characteristics
Ever Vs. Never Influential

Predicting Influential *Recchg*s, analyst variables

Explantory Variable	Influential in returns	
	Coefficient	Marg. Eff
Past Forecast accuracy quintile	-0.011*	-0.24%
	(-1.90)	
Away from consensus	0.147***	2.74%
	(9.87)	
Star analyst	0.207***	3.87%
	(9.36)	
Absolute analyst experience	-0.001*	-0.41%
	(-1.96)	
Relative Analyst experience	0.001	0.14%
	(0.84)	
Concurrent earnings forecast	0.119***	2.22%
	(7.87)	
Past Leader-Follower Ratio (LFR)	0.006***	0.36%
	(2.74)	

Table 4 (part 2 of 3)

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

Effect of influential *Recchg*s
Analyst and firm characteristics
Ever Vs. Never Influential

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Table 4 (part 2 of 3)

Biggest marginal effects are from:

- Recchg away from the consensus.
- Star analyst status (from Institutional Investor poll).
- Concurrently issued earnings forecasts.

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

Effect of influential *Recchg*s
Analyst and firm characteristics
Ever Vs. Never Influential

Predicting Influential *Recchg*s, firm variables

Explanatory Variable	Influential in returns	
	Coefficient	Marg. Eff
Log(B/M)	-0.100***	-1.51%
	(-9.66)	
Log(Size)	-0.082***	-2.49%
	(-10.67)	
Price momentum	0.031**	0.34%
	(2.38)	
Log(Institutional ownership)	0.049**	0.38%
	(2.15)	
Log(Turnover)	0.042***	0.62%
	(2.82)	
Log(Idiosyncratic volatility)	-0.351***	-3.45%
	(-15.10)	
Dispersion	0.032***	0.38%
	(3.13)	
Log(Analyst activity)	-0.138***	-2.17%
	(-11.49)	

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Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

Effect of influential *Recchg*s
Analyst and firm characteristics
Ever Vs. Never Influential

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- Low B/M (growth) firms and small firms are more likely to have influential *Recchg*s
- Low idio. volatility firms
- Low analyst-activity firms

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

Effect of influential *Recchg*s
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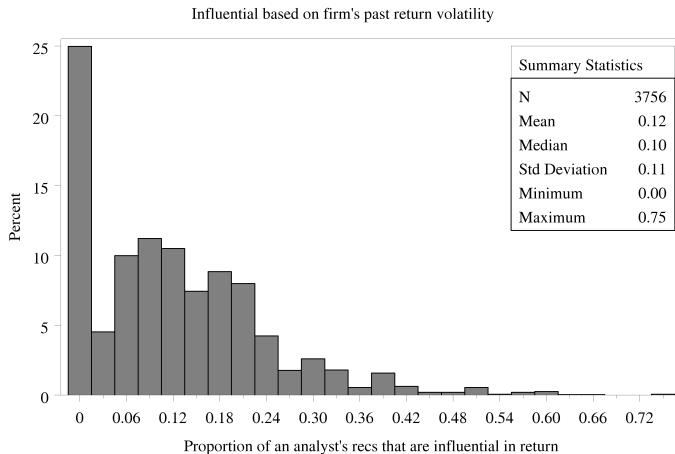Ever Vs. Never Influential

Table 5: Ever Influential vs. Never Influential

- 25% (1 in 4 analysts) have never issued any influential *Recchg*.

- For ever influential analysts, 22% (1 in 5) of their *Recchg*s are influential

Characteristics	Influential based on firm's abnormal returns			
	Never	Ever Influential	Difference Ever–Never	t-stat
Number of Analysts	935	2,821		
		75.1%		
% influential recs for typical analyst	0.0%	22.1%		
Forecast accuracy quntile	2.894	2.819	-0.076***	(-3.20)
Away from consensus	0.357	0.367	0.010	(1.52)
Was once a Star analyst	0.092	0.253	0.161***	(12.91)
Absolute analyst experience (# Qtrs)	18.09	24.42	6.329***	(10.11)
Relative analyst experience	-1.26	1.36	2.624***	(9.61)
Concurrent earnings forecast	0.477	0.462	-0.015*	(-1.66)

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

Effect of influential *Recchg*s
Analyst and firm characteristics
Ever Vs. Never Influential

Fig 3a: Histogram of an individual's influential fraction

- Ability to be influential is a skill and not random.

Influential based on firm's past return volatility

Summary Statistics	
N	3756
Mean	0.12
Median	0.10
Std Deviation	0.11
Minimum	0.00
Maximum	0.75

Proportion of an analyst's recs that are influential in return

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

Earnings forecast revisions
Alternative influential definitions

Earnings forecast revisions

- Studies have examined avg CARs to earnings forecast revisions but never looked at our influential definition.

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

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Earnings forecast revisions

- Studies have examined avg CARs to earnings forecast revisions but never looked at our influential definition.
- With a sample that removes corporate news-contaminated revisions, we find only 5% of earnings forecast revisions are influential. But **influential fraction doubles** when revision is accompanied by a recommendation.
- Hence, impactful research is more likely to be conveyed with a *Recchg*.

Tabel 7, Panel A: Forecast revisions sample

Forecast Revision Sample	Influential based on abnormal:	All forecast revisions			Revisions with Recs		
		Not Influ	Influential	Percent	Not Influ	Influential	Percent
Annual	Returns	286,813	13,402	4.5%	18,094	2,023	10.1%
	Turnover	283,672	16,543	5.5%	17,676	2,441	12.1%
Quarterly	Returns	105,570	5,346	4.8%	6,268	799	11.3%
	Turnover	104,125	6,791	6.1%	6,081	986	14.0%
LTG forecasts	Returns	42,258	1,750	4.0%	3,119	310	9.0%
	Turnover	41,055	2,953	6.7%	2,930	499	14.6%

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

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Alternative influential definitions

1. *Recchg*s could be stale if the prior rating is too old. We get the same results if we define *Recchg* as the current rating minus the prevailing consensus, or the current rating minus the last rating by any analyst.

2. If a *Recchg* causes the entire market to move, we may understate the influential fraction. But, we get similar results with a raw return-based influential definition.

3. We remove *Recchg*s when the [-2,-1] return is large, as an extra proxy for significant firm news. We get a similar influential fraction of *Recchg*s.

4. We remove recommendation days from the computation of idiosyncratic volatility. Influential fraction goes up slightly to 12.1%.

Influential recommendation changes
Data and methodology
Influential vs. Non-Influential
Other tests

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- We suggest an alternative approach to judge the impact of a recommendation change.

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Data and methodology
Influential vs. Non-Influential
Other tests

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  - We see the value of analysts—*Recchg*s have influential impact 12% of the time.
  - But the bulk of recommendations have little visible impact.

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Data and methodology
Influential vs. Non-Influential
Other tests

Conclusion

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    - We see the value of analysts—*Recchg*s have influential impact 12% of the time.
    - But the bulk of recommendations have little visible impact.
- Analysts are serially influential. Some analysts (stars, bold, etc.) are more likely to be influential, and some types of firms (growth, small, low activity, etc).
- Recommendation changes, not earnings forecast revisions, are the usual avenue that leads to significant moves in stock prices.