Should Investors Trust Equity Analysts?

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ABSTRACT

This paper studies the holistic issue of the combination of analyst projection accuracy, diversity, and distribution. It first tracks the earnings per share and sales projections of a number of equity analysts for 17 representative U.S. companies using data from 1978 to 2012. It also compares the analysts’ consensus of earnings per share, sales, rating, and price target zone to identify the degree of concentration among the opinions. It finds that the magnitudes and coefficient variations of projection errors are small, and the analysts’ opinions are insignificantly diversified. Analysts’ projections are not significantly skewed, but pessimistic opinions dominate. The results suggest that the projections issued by equity analysts are generally precise, and following their opinions is technically feasible. Analysts’ mistakes are more due to inappropriate investment timing and less due to their abilities to pick firms with robust future performance.

Keywords: Analyst, Equity, Investment Recommendation, Projection

1. INTRODUCTION

In this study, I track the earnings per share (EPS) and sales projections of equity analysts to explore the precision of the whole analyst industry, rather than the performance of an individual. I also provide statistical measures of analysts’ consensus of EPS, sales, rating, and price target zone. I attempt to provide answers to three main questions: whether the projections of equity analysts are accurate; whether the standard deviations of the projections are too large to allow investors to find the general consensus opinion; and whether analysts share systematic bias.

The meanings of answering these questions are threefold. Firstly, the quality of analysis determines the profitability of investment recommendations and directly affects returns. Barber, Lehavy, McNichols, and Trueman (2001) prove such important role of equity analysts by showing that purchasing or selling short stocks with strong buy or sell consensus recommendations yields annual abnormal returns of at least 4%. Untiedt and Pidun (2013) prove that in corporate portfolio management, passive portfolio managers rely on the quality of analyst to a large extent. Kunz (2011) further documents that analysts are subject to their cognitive abilities in terms of perception and interpretation of the firm measurements.

Secondly, analyst opinions affect corporate capital structure and market environment. Gilson, Healy, Noe, and Palepu (2001) conclude
that financial analysts with industry expertise can improve capital market intermediation function. Chang, Dasgupta, and Hilary (2006) provide evidence that firms covered by fewer analysts are less likely to issue equity compared with debt. At an earlier time, Moyer, Chatfield, and Sisneros (1989) support the role of analyst monitoring as an efficient device for controlling agency-related costs of debt and equity and as a response to the information demands of investors. Hall and Stanley (2012) also suggest that diversity and governance policies appear to have played only a modest role in explaining corporate performance, while analysts’ opinions can significantly affect the performance.

Thirdly, analyst projection interferes with the future equity returns by setting market expectation. Bhojraj, Hribar, Picconi, and McInnis (2009) show that the firms exceeding analyst forecasts can generate a short-term stock price benefit compared with firms that underperform forecasts. Kasznik and McNichols (2002) document that abnormal annual returns are significantly greater for firms meeting expectations and the market assigns a higher value to firms that meet expectations consistently. Fuchs and Sarstedt (2010) address that narrow samples in empirical management research are sufficient proof of the divergence between market expectation and practical implementation.

In the U.S. equity market, the pool of equity analyst is highly diversified in terms of expertise and experience. Numerous recommendations issued by stock analysts lead to the most common question: are they reliable? In fact, this question includes three concerns: the precision, the standard deviation, and the distribution pattern of analysts’ projections. Precision refers to the quality of analysts’ projections as a whole. However, even though the mean of analyst projections is accurate, a large projection standard deviation might confuse investors who are unsure about which individual analyst opinion they should follow. Furthermore, abnormal skewness and kurtosis of analyst opinions represent analyst irrationality and larger risk of following such opinions.

Some previous studies address the issue of analyst projection precision and conclude that analyst’s models produce better forecasts than naïve time series models, martingale, and submartingale models (Brown and Rozeff, 1978). Consistently, Unlu and Yan (2009) find that changes in aggregate analyst recommendations forecast future market excess returns and changes in industry-aggregated analyst recommendations predict future industry returns. However, these studies focus on the comparison among models, rather than track the projection and the true accounting value.

Other studies emphasize the role of the diversification of analysts’ opinions and explore the reasons of such divergence. Barry and Jennings (1992) demonstrate that diversity of opinion can increase even when the amount of private information increases. Herrmann and Thomas (2005) conclude that market expectations align with consensus forecasts more closely and then correct toward the more accurate consensus forecasts. Sadka, and Scherbina (2007) suggest that analyst disagreement coinciding with high trading costs leads to the persistent mispricing. Cheong and Thomas (2011) find that the magnitudes of deviations of EPS forecast do not vary with firm scale, but Ball (2011) argues that this is due to the data processing problem. Kini, Mian, Rebello, and Venkateswaran (2009) suggest that analyst sector diversification enhances forecast accuracy in an international context but it detracts from forecast accuracy in the U.S. context. Few of these studies directly provide the absolute standard deviation and the relative coefficient of variation of analyst forecasts to address the difficulty for investors to follow investment recommendation due to such diversified opinions.

Even fewer previous studies conclude on the distribution pattern of analyst opinion, mainly due to data scarcity. The description of recommendations and the projection surprise can directly reveal the possible biasness, herding behaviors, and irrationality of analysts. Conrad, Cornell, Landsman, and Rountree (2006) find that following large stock price increases, analysts are equally likely to upgrade or down-
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