Financial Analysts and Their Contribution to Well-Functioning Capital Markets

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Contents

Abstract

Well-functioning capital markets rely on a complex set of institutions and participants that ensure capital is allocated to its best possible use, and that information flows between firms receiving capital and the investors who provide it. In this manuscript, we endeavor to understand whether, how, and under what circumstances sell-side research contributes to the functioning of capital markets. We review major findings in the literature, address significant regulatory and technological changes, and offer suggestions for future research.

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Sell-Side Analysts and Capital Markets

Capital markets provide the medium through which firms with productive value obtain financing from investors. Well-functioning capital markets, like those in the United States, rely on a complex set of institutions and participants that ensure capital is allocated to its best possible use and that high-quality information flows between firms receiving capital and the investors who provide it [Piotroski and Roulstone, 2004]. Figure 1.1 highlights the most important players in efficient markets. Analysts, along with regulators, auditors, providers of capital, and other entities, are central to the flow of information between firms and investors. For example, analysts provide valuable research that many of the other participants find useful. Most obviously, institutional investors incorporate the firm-specific information analysts generate into their own analyses and investment decisions. The benefits flow through to the firms, which find capital easier to obtain when analysts collectively convey their prospective economic opportunities and risks.

In this monograph, we view analysts in the context of their role as key capital market intermediaries. Research on analysts is voluminous, with evidence spanning at least five decades. At this point in

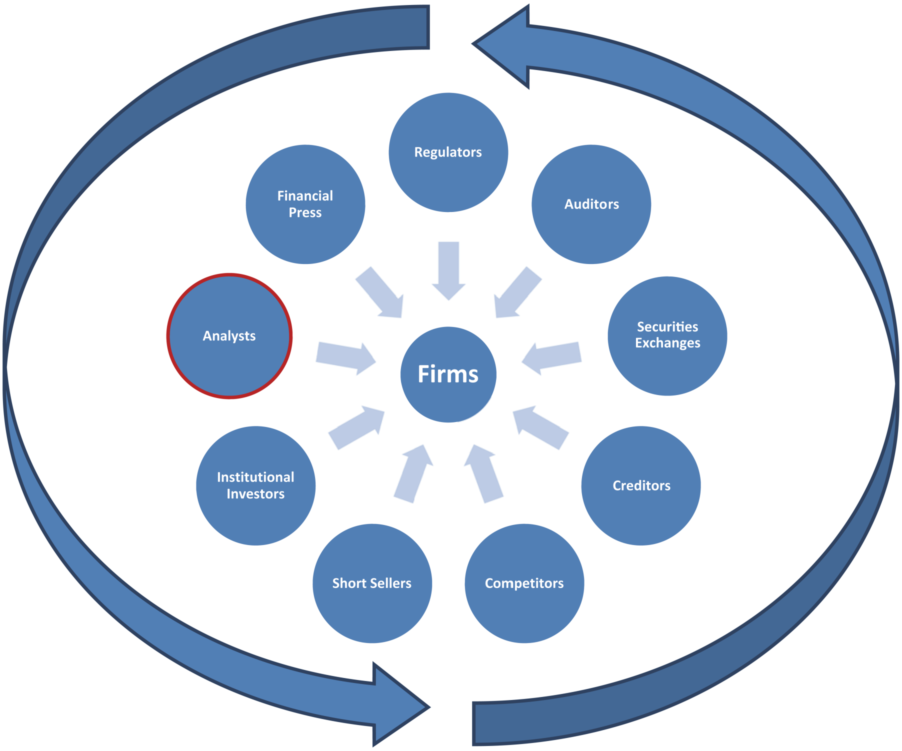

Figure 1.1: Capital market structure, external monitors, information intermediaries and the flow of information.

the development of this mature literature, it is appropriate to take an inventory of the state of the literature, and identify the next directions for future research. Our objective is to discuss analysts' role in well-functioning capital markets.

The past several decades have seen an upheaval in the typical activity performed by analysts that coincides with increasing globalization of securities markets, increased market volatility, new regulations, and technology. The ways in which such changes affect analysts and are affected by analysts are complex; we discuss analysts' positioning within the economic environment throughout this monograph. The near future holds even more significant changes, one of which is the Markets in Financial Instruments Directive approved by the European Union in

2014 (MiFID II) and currently set to take effect on January 3, 2018, which requires brokerages to price different services separately (e.g., research and trading). We highlight several recent regulatory changes, and discuss how they align with the empirical evidence to date on analysts' role in efficient capital markets. The impending MiFID II developments raise questions about the viability of sell-side research within brokerages. We therefore seek to understand whether, how, and under what circumstances sell-side research contributes to the functioning of capital markets.

Our primary focus is on analysts' activities, the information that is important to them, who benefits from their activities, and how regulation and information technology have changed their environment in recent years. We question the restrictive focus on analysts' quantitative outputs that characterizes some prior research, and instead focus on the information environment, the constituents that analysts serve, and their contribution to well-functioning capital markets. Within this broader perspective, we identify opportunities to advance the academic literature on financial analysts' activities and contributions.

Section 2 gives a recent historical overview of analysts' institutional setting. Section 3 discusses the basics of a career in sell-side research. Section 4 highlights the sources of information available to analysts. Sections 5 and 6 discuss the nature of the information analysts generate and how this information is useful to the capital markets, respectively. In Section 7, we critically assess how research characterizes analysts' conflicts of interest. Section 8 discusses the pitfalls of using regulations as "natural experiments," as is common in accounting and finance research. Section 9 considers Reg FD as a case study of research inference. Section 10 briefly highlights evidence of analysts' value in capital markets, and Section 11 concludes.

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