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Financial Analysts' Forecasts and Stock Recommendations: A Review of the Research

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Abstract

This surveys reviews research regarding the role of financial analysts in capital markets. The survey builds on the perspectives provided by Schipper (1991) and Brown (1993). We categorize papers published mainly since 1992 and selectively discuss aspects of these papers that address or suggest key research topics of ongoing interest in seven broad areas: analysts' decision processes, the determinants of analyst expertise and distributions of individual analysts' forecasts, the informativeness of analysts' research outputs, analyst and market efficiency with respect to information, effects of analysts' economic incentives on their research outputs, effects of the institutional and regulatory environment (including cross-country comparisons), and the limitations of databases and various research paradigms.

Contents

1

Introduction

This survey reviews research related to the role of financial analysts in the allocation of resources in capital markets.[1] Two important papers published in the early 1990s provide perspectives on the literature in this area, one appearing in *Accounting Horizons* (Schipper, 1991) and the other appearing in the *International Journal of Forecasting* (Brown, 1993a). Our survey begins by summarizing the perspectives and directions for future research suggested in Schipper (1991) and Brown (1993a).[2] We then take a look at the highlights of what we have learned and new questions that have emerged since 1992. Our goal is to provide an organized look at the literature, with particular attention to important questions that remain open for further research. Brown (1993a) did not restrict his review of earnings forecasting research to the role of financial analysts. We focus more narrowly on research related

[1] Much of this survey reprints, by permission, Ramnath et al. (2008). Ramnath et al. (2008) provide a detailed taxonomy listing and categorizing every paper published in 11 research journals since 1992. This survey differs from Ramnath et al. (2008) in that this survey selectively and critically reviews examples of the research in each of the seven broad areas of the Ramnath et al. (2008) taxonomy.

[2] Also see Givoly and Lakonishok (1983) for a review of analysts' forecasting research prior to 1983.

to analysts' decision processes and the usefulness of their forecasts and stock recommendations. Kothari (2001) provides an excellent overall review of capital markets research, and we refer the reader to that paper for a broader perspective.

Since 1992 no less than 250 papers related to financial analysts have appeared in the nine major research journals that we used to launch our review of the literature. We also note that during the six months ending February 21, 2008 alone 154 new working papers with the word "analysts" in the abstract have posted to the Social Sciences Research Network, so the task for the next authors of a review article in this area will be even more daunting.

In our review of papers published since 1992, we find much progress in some of the areas identified by Schipper (1991) and Brown (1993a) and less progress in other areas. In particular, the research has evolved from descriptions of the statistical properties of analysts' forecasts to investigations of the incentives and decision processes that give rise to those properties. However, in spite of this broader focus, much of analysts' decision processes and the market's mechanism of drawing a useful consensus from the combination of individual analysts' decisions remain hidden in a black box. Furthermore, we still have much to learn about the relevant valuation metrics and the mechanism by which analysts and investors translate forecasts into present equity values. For example, with renewed popularity of the earnings-based valuation model in the early 1990s, research turned toward an investigation of the model's role in the market's conversion of analysts' earnings forecasts into current equity values. Given the unexpected result that this model does a relatively poor job of explaining the variation in market prices and analysts' price forecasts and recommendations, researchers have turned their attention to examining heuristics that might better explain analyst and market decisions about firm value. We still have much to learn about the heuristics relied upon by analysts and the market and appropriateness of their use.

The rest of this survey draws attention to these and other issues that have arisen since 1992. The next section provides a summary of the questions identified in Schipper (1991) and Brown (1993a) and the directions for future research suggested by those authors, as well as the authors of the four papers commenting on Brown (1993). Section 3 reviews papers published mainly since Schipper (1991) and Brown (1993a) and also identifies new research questions that emerge from our reading of the literature. Section 4 provides concluding comments highlighting the areas we consider most promising for future research.

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