Does an Analyst's Stock Recommendation cause Anomalous Price Drift? A Study of the Indian Stock Market

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Do analysts add value to the investment decisions of the market participants? Or do they contribute to the noise and cause significant price responses? Analysts have played a crucial role in the developed markets in influencing the investment decisions of individuals and corporates. This study discusses the role of analysts in influencing stock prices and the market behavior of Indian firms by empirically analyzing the stock recommendations of analysts using event study methodology. Data of Nifty 50 indexed-firms, (the benchmark index of the National Stock Exchange (NSE) in India) for the period 2012-18 have been used for analysis. It was found that although analysts caused some delayed price response of stocks and anomalous drift in stock prices resembling the market under-reaction for their bullish recommendations, they failed to significantly influence the stock prices of firms on the announcement day. Implications for investors and recommendations for future studies in this area are mentioned.

Key Words: *Analysts' Recommendations, Event Study Methodology, Market Under-reaction, National Stock Exchange (NSE), Stock Prices*

INTRODUCTION

The proponents of market efficiency agree to a large extent that no buyer or seller is large enough to influence or have an impact on the market price of the stock given the equal and costless access to information to all. A stock analyst has a privileged access to news reports and information of the firms that he follows and recommends. An analyst is an informed market participant who makes independent evaluation of firms' reports to issue stock recommendations, and publishes his forecasts on firms' earnings. A stock analyst (referred as Stock Broker in US market) advises his clients in equity investments and do trading on behalf of his clients for a commission (stock

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brokerage). Therefore, an analyst actively guides the financial allocation and investment decisions of the investors. An analyst acts as an essential link between the market and the other market participants.

Majority of the studies have focused on the role and influence of analysts on the stock prices of the firms in the context of developed economies (Sorescu and Subrahmanyam, 2006; Conrad, Cornell, Landsman and Rountree, 2006; Loh and Stulz, 2011; Jiang, Lu, and Zhu, 2014). The studies show that analysts have significantly influenced the stock prices of firms by issuing stock recommendations. They have even exhibited the stock picking and market timing abilities to guide their clients in profitable investments and equity trading strategies as they often issue stock revisions based on the firms' decisions and market dynamics. The studies on stock analysts have assumed more scope in the developing economies viz., India (Chatterjee, Kumar and Chatterjee, 2019). However, the research literature on the role, behavior and influence of analysts in India is still at a nascent stage. The study focuses on the influence of stock analysts on the stock prices of firms in Indian stock market. The study empirically examines the stock recommendations of independent analysts issued on the firms listed on Nifty 50, NSE (The National Stock Exchange). The Nifty 50 stocks are considered as these stocks cover 68% of the total market liquidity and act as the best representative proxy of the Indian stock market. As the analyst following (coverage) of firms is influenced by the firm size and liquidity (Bhushan, 1989), it is appropriate to study the stocks indexed in Nifty 50. The findings of the study indicate no significant market reaction for analysts' stock recommendations on the day of announcement. However, a significant delay is recorded in the stock prices of firms for analysts' BUY recommendation. There is an anomalous price drift for analysts' ACCUMULATE recommendations followed by delayed price reaction indicating a short-run market under-reaction.

LITERATURE REVIEW

The literature review discusses the role, behavior and influence of analysts in different stock markets to establish a basic understanding on the influence of analysts on a given stock market and the corresponding market reaction.

The literature on market efficiency postulates, "In a perfect capital market, no buyer or seller is large enough to influence or have an impact on the ruling stock price, and all traders have equal and costless access to information about a firm. The stock prices of firms fully reflect all available discounted information" (Fama, 1970; Miller and Modigliani, 1961). No version of the efficient market hypothesis or the perfect capital markets was confirmed or denied, and there was evidence for profitable trading opportunities for investors supporting the weak-form of market inefficiency (Boldt and Arbit, 1984; Slezak, 2003). De Bondt and Thaler (1985) proposed the market over-reaction hypothesis which showed superior returns for prior loser firms over prior winner firms in the long-run indicating a market over-reaction of loser firms

in the subsequent years. The market over-reaction hypothesis acts as a break-through proposition for studies on the influence of market participants following corporate news and announcements. Market participants consist of individual investors, analysts and other informed traders, and insiders. Bowman and Iverson (1998) observed an essential dichotomy between the market reaction of firms and market over-reaction, and they put forth that market over-reaction is distinct and different from the market reaction. In the short-run, the market reacts to unexpected news, and in the long run, the stock prices of firms deviate from the equilibrium due to waves of investors' optimism and pessimism leading to market over-reaction.

An early study on the analysts' recommendations (Abarbanell and Bernard, 1992) discussed the relation between analysts' recommendations and stock markets over-reaction. It said that analysts' underreacted to recent firms' earnings announcement, and the subsequent delayed price reaction of firms to such announcement, i.e., market under-reaction. However, such an under-reaction to firms' news was only partially explained by the under-reaction behavior of analysts. Studies on analysts' behavior showed that analysts following the publically traded firms exhibited the stock-picking ability and the market-timing ability (Womack, 1996). The analyst following and coverage of firms depend on a number of firm criteria, namely, the ownership structure of the firm, the market capitalization, and the volatility of firms' return, the market sensitivity of the firms (Bhushan, 1989); firm's disclosure policy (Hope, 2003; Lang and Lundholm, 1996); analysts compensation policy of the brokerage house and their relationship with the firm (Hong and Kubik, 2003; Stickel, 1992).

Womack (1996), Piotroski and Roulstone (2004), Loh and Stulz (2011), and Jiang, Lu, and Zhu (2014) found that analyst recommendations significantly influenced the stock prices of the firms. The analyst factors like their relative information advantage (Piotroski and Roulstone, 2004; Jiang, Lu, and Zhu, 2014), timing of recommendation (Womack, 1996), the influential status of analysts (Loh and Stulz, 2011; Sorescu and Subrahmanyam, 2006) significantly influenced the stock price behavior. The stock return volatility of the firms determined the frequency of analysts' recommendation issued. Conrad, Cornell, Landsman and Rountree (2006) found asymmetry in recommendations following the positive and negative returns of stocks as analysts exhibited an optimistic bias for stocks with large price increases and thus issued recommendation upgrades more frequently. The stocks with large-price decline received recommendation downgrades by analysts. Analysts issued periodic new recommendations or revisions, i.e. upgrade or downgrade or no change in recommendations, depending on any new information available to them. Jiang, Lu, and Zhu (2014) showed a significant market reaction of publically traded Chinese firms for recommendation downgrades and upgrades. The influential status of analysts' among the brokerages caused significant price reactions in the market. The stock recommendation revisions issued by influential analysts or stars or leaders differed for