

COMPANIES & MARKET

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MONDAY FEBRUARY 22 1999



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Profit from the prophets

Do analysts add value? Stockmarket practice and academic theory are sharply divided on this question. Investment banks and brokerage houses spend billions of dollars a year analysing securities, presumably because they think it helps their clients generate superior returns. Yet if you believe, as most academics do, that markets are reasonably efficient, then investors cannot trade profitably on the basis of public information, such as analyst recommendations, since all such data is instantly incorporated into share prices.

Several studies carried out in the late 1970s backed the academics, by appearing to show – embarrassingly – that the average stock which has no analyst following it actually outperforms the average stock that does. However, new research by Brad Barber, a professor at the University of California, **Reuven Lehavy**, an accounting professor at Berkeley, and two colleagues, provides some much needed relief for Wall Street *et al.* Not only is their study larger and more rigorous than any previous one; it suggests that following analysts' share tips can be hugely profitable.

The four professors studied more than 360,000 recommendations made by more than 4,000 US equity analysts between 1985 and 1996. Each stock was given a rating – from one for a “strong buy” to five for a “strong sell” – based on the average advice of all analysts following it. The

professors then constructed five portfolios, grouping the highest-rated firms into one, the next best into a second and so forth. They then monitored their performance, with stocks moving between them as they fell in and out of favour.

The results surprised even the authors. The first portfolio of “strong buys” and “buys” earned an average annual return of 18.8 per cent over the 11 years, beating a broad US stockmarket index (the Wilshire 5000), which turned in 14.5 per cent. The last portfolio of “sells” underperformed, dramatically, averaging only 5.8 per cent. As most institutional investors would kill to beat an index by a few basis points, the size of these returns is hard to overstate.

To make sure their results were not a fluke, the professors controlled various factors, such as analysts' tendency to favour larger companies. They only rebalanced the portfolios at the end of the trading day on which a recommendation became public, to exclude any return investors might have earned from having advance knowledge. Even after those adjustments the top “buys” produced an average annual return of 4.2 per cent above the risk-free rate of interest.

To give their research a practical application, the authors then proposed a trading strategy: buy the first portfolio, sell short the fifth and you should generate an annual average return of 12.2 per cent, or 11.8 per cent after controlling for market risk,

size and so forth.

Unfortunately there are two snags. The first is that the abnormal returns are most pronounced among small and medium-sized firms, which stands to reason since these are less well followed, giving analysts more scope to add value. For the few hundred largest firms, comprising 70 per cent of the US market's capitalisation, the study finds no reliable differences between “buys” and “sells”.

Second, to garner those splendid returns requires a very active trading strategy, turning over your entire portfolio up to four times a year. The resulting transaction costs gobble up virtually all of the extra return.

This neatly explains why this apparent market inefficiency persists – it is too costly to arbitrage away. That does not make the research worthless, says Professor **Lehavy**. Managers considering buying back or issuing stock might want to use this information. Big institutions probably have lower transaction costs than the study assumes, and could thus trade profitably. Even retail investors, assuming they wanted to trade (and were thus committed to paying transaction costs) should buy highly recommended stocks and sell those out of favour. The billions lavished on analysts seem a good investment after all.

Can Investors Profit from the Prophets? Working paper submitted to the Journal of Finance.



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