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Analysis of Brokers' Call: The Free Stock Recommendations

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ABSTRACT

The focal point of a stock broker's job is finding and retaining a client base of investors. They advise investors on when to buy and sell stocks and keep them apprised of stock market trends and projections. Brokers recommend securities on the basis of their analysis. Investors rely almost entirely upon the advice of brokers and they do not question these recommendations. Therefore relying on the broker is likely to remain a crucial element of the client-broker relationship. This study examines the Brokers Call column of the Hindu Business Line. The study reveals significant difference between the actual return and the predicted return. Further the advisors' fail to predict actual the market movement.

KEYWORDS: Brokers Call, Recommendations, Actual Return, Predicted Return

1. Introduction

The broking industry is emerging as a high growth segment in the Indian financial services sector, in terms of business growth, distribution and network, and enterprise value. The brokerage industry is grown a lot in the recent years. The basic function of a brokerage firm is to execute orders for clients. These brokerage houses differ enormously in the type of clientele they attempt to attract. The brokerage houses with their number of products to offer to the customers have been successful in attracting a large number of investor/clients. They provide three types of stock broking services. One concerned to only execution, which means that the broker will only carry out the client's instructions to buy or sell a share. The other concerned with advisor dealing, where the broker advises the investor/client on which shares to buy and sell, but leaves the final decision to the investor. Rose (1951) opine that decisions regarding activity on the stock market must be made rapidly if they are to be effective and most traders do not have the information necessary for making accurate predictions. One of the most important functions of the broker will be to provide access to emerging markets and analysis of potential investment opportunities. All of this information is less likely to be available to individual retail investors. Therefore they depend on the advisory brokers some time for accurate information. Salmanowitz (1977) opine that brokers continue to recommend securities on the basis of technical analysis and fundamental analysis. Further he opines that unsophisticated investors rely almost entirely upon the advice of brokers and they do not question these recommendations. Therefore relying on the broker is likely to remain a crucial element of the client-broker relationship. Discretionary dealing, where the stockbroker ascertains the client's investment objectives and then makes all dealing decisions on the client's behalf. Previous studies reveal mixed opinion on the performance of recommended shares. Therefore this study evaluates the Brokers' Call column of The Hindu Business Line on free stock recommendation.

Reminder of the paper is organized as follows. Section 2 presents the review of literature. Data and sample selection are presented in section 3, methodology is presented in the section 4, and empirical results are discussed in section 5 and conclusions are presented in section 6.

2. Review of Literature:

A few previous researchers examined the stock price reactions to the announcement of stock recommendations in USA and Europe. They also analysed the information value of free stock recommendation. The results of the previous research are briefly presented below.

Bjerring. et.al. (1983) reveal that an investor following the recommendations would have achieved significantly positive abnormal returns, even after allowing for transactions cost. Peterson (1987) find that the reviews convey information to the market as significant abnormal returns are found over a 3-day period around release of the information. There is no statistically significant subsequent price reaction after this 3-day period, consistent with market efficiency. Liu et. al. (1990) indicates that the "Heard-on-the-Street" (HOTS) column of The Wall Street Journal on common stock prices column appears to have an impact on stock prices on the publication day. They also find a smaller, but statistically significant, impact on two days preceding the publication. Stickel (1995) opine that buy and sell recommendations of brokerage house influence stock prices. Trahan and Paul (1995) results show that the publication of this second-hand information has a positive and significant impact on stock prices at the time of publication. They also find that the abnormal returns quickly disperse and the recommendations examined here do not provide superior returns over longer holding periods. Womack (1996) opines that analysis of new buy and sell recommendations of stocks by security analysts at major U.S. brokerage firm's shows significant, systematic discrepancies between pre recommendation prices and eventual values. The initial return at the time of the recommendations is large, even though few recommendations coincide with new public news or provide previously unavailable facts. However, these initial price reactions are incomplete. For buy recommendations, the mean post event drift is modest (+2.4%) and short-lived, but for sell recommendations, the drift is larger (-9.1%) and extends for six months. Analysts appear to have market timing and stock picking abilities. Kim et. al. (1997) finds an initial coverage report with a buy recommendation by an analyst has a significant effect on firm value, increasing share prices of NYSE/AMEX firms by approximately 4% and NASDAQ firms by 7%. Their result also provides evidence that there is value to the information collection activities of brokerage firms and analysts and that an element of this value accrues to the benefit of their important clients. Francis and Leonard (1997) find that stock recommendations and earnings forecast revisions together explain about 5% of the variation in excess returns cumulated over days (-1,+1) relative to the report publication dates. Their results indicate that recommendations are informative. Further they report that as a group, and after controlling for earnings forecast revisions, variables capturing the level of and the revision in stock recommendations explain a significant (at the .02 level) portion of the variation in cumulative abnormal returns. They also find that investors attach significantly (at the .02 level) larger weights to the earnings forecast revisions in reports containing buy recommendations than they do to revisions in reports containing holds or sells. Michaely and Kent (1999) reveal that underwriter analysts recommend share perform more poorly than "buy" recommendations by unaffiliated brokers prior to, at the time of, and subsequent to the recommendation date. They show that the market does not recognize the full extent of this bias. The results suggest a potential conflict of interest inherent in the different functions that investment bankers perform. Barber. et. al., (2001) documents that purchasing (selling short) stocks with the most (least) favourable consensus recommendations, in conjunction with daily portfolio rebalancing and a timely response to recommendation changes, yield annual abnormal gross returns greater than four percent. Further they find that less frequent portfolio rebalancing or a delay in reacting to recommendation changes diminishes these returns; however, they remain significant for the least favourably rated stocks. Barber. et. al., (2003), reveals that after a string of years in which security analysts' top stock picks significantly outperformed their pans, the years 2000 and 2001 were disasters. During those two years, the stocks least favoured by analysts earned an average annualized market-adjusted return of 13.44 percent whereas the stocks most highly recommended underperformed the market by 7.06 percent, are turn difference of more than 20 percentage points. Jegadeesh et. al., (2004) reveals that analysts from sell-side firms generally recommend

"glamour"(i.e., positive momentum, high growth, high volume, and relatively expensive) stocks. Naive adherence to these recommendations can be costly, because the level of the consensus recommendation adds value only among stocks with favourable quantitative characteristics (i.e., value stocks and positive momentum stocks). In fact, among stocks with unfavourable quantitative characteristics, higher consensus recommendations are associated with worse subsequent returns. In contrast, they find that the quarterly change in consensus recommendations is a robust return predictor that appears to contain information orthogonal to a large range of other predictive variables. Malloy (2005) provide evidence that geographically proximate analysts are more accurate than other analysts. They also reveal that the stock returns immediately surrounding forecast revisions suggest that local analysts impact prices more than other analysts. Further he opines that these effects are strongest for firms located in small cities and remote areas. O Brien. et al. (2005) hypothesize that affiliated analysts have incentives to respond promptly to good news but prefer not to issue bad news about client companies. Using duration models of the time between an equity issue and the first downgrade, they find affiliated analysts are slower to downgrade from buy and hold recommendations and significantly faster to upgrade from hold recommendations, in both within-analyst and within-issuer tests. Their findings indicate that banking ties increase analysts' reluctance to reveal negative news, and that reform efforts must carefully consider the incentives of affiliated and unaffiliated analysts to initiate coverage and convey the results of the research. Green (2006) opines that early access to stock recommendations provides brokerage firm clients with incremental investment value. He also finds that short-term profit opportunities persist for two hours following the pre-market release of new recommendations. His results are robust within sub-periods and a calendar-based strategy produces positive abnormal daily returns. Further he reveals that recommending firms' market makers shift their quotes accordingly, providing indirect evidence that clients make use of the informational advantage that arises from analysts' opinion changes. Brown et. al., (2009) show that the market's reaction is strongly influenced by the analyst's reputation, the divergence of opinion among analysts and the number of analysts following the stock.

3. Data and sample selection:

The study analyzes 923 buy recommendations from January 2011 to December 2011. The study restricts the sample to Brokers' Call buy recommendation appeared in The Hindu Business Line. The closing and opening prices of the stocks are collected from the official website of NSE. In the case of intraday, one day's opening and closing prices is taken into account, under short term t+1 day, t+2 day, one week, one month prices and one year prices are taken into account.

4. Methodology of the study:

Target return, opening return, closing return, T+1 day return, T+2 day return, one week return, one month return and short term returns are calculated to evaluate the buy recommendations. Further average return, standard deviation, z-test, positive return and negative return are used in the analysis. The target return and the return for a given period is given by the following equation

Target return:

Market Price: Is the current price at which a share can be bought or sold on the day of prediction.

Target price: Is the projected price level as stated by an investment analyst or advisor.

Return for a given Period:

$$\frac{Pt \; - \; Market\ price}{Market\ price}$$

Pt : is the price of share for a given period, i.e. opening price, closing price, T+1 day price, T+2 day price, one week price, one month price and one year price.

Market Price: Is the current price at which a share can be bought or sold on the day of prediction.

Two sample z-test is used to compare and evaluate the target return and the buy and hold return for a given period. The test statistics for significance of difference between targets return and buy and hold return for a given period is given by;

z-test:

$$z = \frac{\bar{x}_1 - \bar{x}_2}{\sigma}$$

$$\bar{x}_1 - \bar{x}_2$$

$$\sigma_{x_1 - x_2} = \sqrt{\frac{\sigma_1^2}{n_1} + \frac{\sigma_2^2}{n_2}}$$

- ✓ σ1 and σ2= sample standard deviations
- ✓ 1 = sample mean of first sample i. e., target return
- ✓ 2 = sample mean of second sample e i. e., buy and hold return for a given period.
- ✓ n1 and n2 = sample size

One sample sign test is used to compare the actual positive and negative returns of the recommended shares. The sign test statistic is given by;

$$z = \frac{\bar{p} - p}{\sigma_p}$$

$$\sigma_p = \sqrt{\frac{pq}{n}}$$

$\bar{p}$ = proportion of success/Positive return in the sample

p = Hypothesised proportion of positive return

q = Hypothesised proportion of negative return

n = number of return in the sample.

σ_p = Standard error of the proportion

5. Evaluation of Brokers Call:

This study compares the actual return for a given period and the predicted return and the results of free stock recommendation are presented below.

Table 1 about here

The average predicted return of all advisors is 24.73 percent. The average t+1 day opening return, t+1 day closing return, one week return, fortnight return, one month return is positive where as it is the negative average short term. The predicted return is significantly different from t+1 day opening, t+1 day closing, one week, fortnight, one month and short term return. Further all the advisors fail to predict the actual returns of the shares suggested by them.

Table 2 about here

All the advisors predicted positive return for 97 percents of the shares. Sign test result reveals insignificant difference between actual positive and actual negative returns for intraday closing, one week, and forth night. Examination of the actual returns in short term holding period reveals negative returns for 86.66 percents of the recommended shares. However, the actual positive and actual negative returns for one month and short term is significantly different. Further all the advisors fail to predict the low and negative return on the share.

6. Conclusion:

This study examines the free stock recommendation appeared under the column "Brokers Call" in the Hindu Business Line. The analysis reveals that the suggestions given by the advisors are inaccurate in t+1 day opening, t+1 day closing and short-term. Further the advisors failed to predict the actual future market price and return of the companies. Therefore, it is better not to rely on the predictions of these stock broking houses for investment decisions. However this conclusion cannot be generalized due to small sample study period.

Appendix
Table No. 1

Difference between the Predicted Return and Actual Returns of All Advisors

	TARGET RETURN	T+1 DAY OPENING RETURN	T+1 DAY CLOSING RETURN	ONE WEEK PRETURN	FORTH NIGHT RETURN	ONE MONTH RETURN	SHORT TERM RETURN
AVERAGE	0.247391	0.0876868	0.0849952	0.0775858	0.063848406	0.022297167	-0.62745738
N	923	923	923	923	923	923	918
STD.DEV	0.253868	1.3083821	1.3176677	1.37404533	1.36420773	1.36169032	1.55360350
Z TEST		3.6404774	3.6766838	3.69201097	4.018515165	4.937048743	16.8392455

*The critical value for 5 percent levels of significance is 1.96 respectively.

Table No 2.
Difference between Positive and Negative Actual Returns of All Advisors

	TARGET RETURN	T+1DAY OPENING RETURN	T+1DAY CLOSING RETURN	ONE WEEK PRICE RETURN	FORTH NIGHT PRICE RETURN	ONE MONTH PRICE RETURN	SHORT TERM PRICE RETURN
Proportion of +	0.9707	0.5727	0.5136	0.4820	0.4826	0.4598	0.1334
Proportion of -	0.0293	0.4273	0.4864	0.5180	0.5174	0.5402	0.8666
Z		4.3806	0.8247	-1.0886	-1.0539	-2.4397	-22.2629

*The critical value for 5 percent levels of significance is 1.96 respectively.

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