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Stock characteristics and herding in financial analyst recommendations

Wen-Yi Lin, Po-Jung Chen & Sheng-Syan Chen

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Abstract

Most studies investigating the herding of financial analysts focused on the impact of analyst attributes on herding, while firm characteristics may also contribute significantly to herding. The primary objective of this study is to examine whether analyst recommendations prefer stocks with firm characteristics associated with future returns and demonstrate the so-called ‘characteristic herding’ behaviour. Thus, in this study, we incorporate within Welch's (2000) model those characteristics of firms relating to future returns; as a result, we find that ‘characteristic herding’ is discernible in the recommendations of financial analysts. This tendency towards herding in analyst recommendations increases with the firm size and book-to-price ratio of the stock. One of these two firm characteristics positively correlates with the future returns of stocks while the other displays a negative correlation. Consequently, the ‘characteristic herding’ of analysts is caused in part by recommendations made on account of stock fundamentals and in part by other reasons. This may dampen the impact of future

returns on herding. It has also been observed that herding exists in the market regardless of bull market or bear market. No significant inferiority is reported in analyst performance with herding when compared to the performance without herding.

Notes

[1] See Keynes (1936, p. 156).

[2] This study uses the software ‘Research Wizard’ provided by Zacks Investment Research to obtain the recommendation data. The top three brokers in the sample are the Bank of America, with a total of 470 observations, followed by A. G. Edwards (461) and J. P. Morgan (423). To avoid legal conflict with individual brokerage houses, Zacks does not permit researchers to buy the detailed database unless they have the approval of all brokerage houses.

[3] Revisions from or to a ‘6’ are, however, excluded from the sample.

[4] Refer to Appendix for the details of the calculation process.

[5] The study also adopted New York Stock Exchange (NYSE) Composite Index and American Composite Index as market conditions indicators to categorize the market and obtained a similar result (result not shown here due to limited space).

[6] If an analyst made a prior recommendation of 1 (strong buy) for a stock while the current market consensus (C) is 3 (hold), making a new recommendation of 2 (buy) or 3 will be grouped into ‘Herding’ or otherwise ‘No herding’. Another scenario is that if an analyst made a prior recommendation of 2 (buy) for a stock while the market consensus is 3 (hold), making a new recommendation of 3 for the same stock will be categorized as ‘Herding’. If the recommendation is 2 or other, however, it is categorized as ‘No herding’.