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Sell-Side Financial Analysts and the CFA® Program

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Abstract

We examine the effects the Chartered Financial Analyst® (CFA) designation program has on recommendation performance and career outcomes of the analysts who complete the CFA Program and become CFA charterholders. For these analysts, both their recommendation performance and their chances of making Institutional Investor's All-America Research Team increased during the 1993–2015 period. These effects are attributable to the CFA Program curriculum. The results remain largely stable over the pre- and post-2000 subperiods, and they survive an array of robustness checks.

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Editor's Note

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Notes

[1] CFA Institute is the professional organization of both buy-side and sell-side analysts. Buy-side analysts work for money managers and provide research for in-house use by money managers, and sell-side analysts work for brokerage firms and provide research for the firms' clients. Unless otherwise stated, in this article, we use the term "analysts" to refer to sell-side analysts. Also, we use "brokerage firm" or "firm" to refer to an analyst's employer, and we use "company" to refer to the entity that an analyst covers.

[2] Relatively little literature on the CFA Program exists. This literature often uses small samples and focuses on buy-side analysts (see Shukla and Singh 1994; Brockman and Brooks 1998; Miller and Tobe 1999). De Franco and Zhou (2009) compared forecast performance, as measured by timeliness and accuracy, of sell-side equity analysts with and without a CFA designation.

[3] US regulators introduced six major changes to analyst research in the early 2000s: Regulation Fair Disclosure (Reg FD) in 2000, NASD Rule 2711 and NYSE Rule 4722 in 2002, the Sarbanes–Oxley Act of 2002, the Global Analyst Research Settlement (Global Settlement) of 2003, and the SEC's Regulation Analyst Certification of 2003.

[4] CFA Institute, "The CFA Charter," CFA charter factsheet (2016), www.cfainstitute.org/programs/cfaprogram/Documents/cfa_charter_factsheet.pdf.

[5] See www.cfainstitute.org/programs/cfaprogram/Pages/cfa_candidate_insights.aspx.

[6] The four parts of the Candidate Body of Knowledge are ethical and professional standards, tools, asset valuation, and portfolio management. Each exam level covers all four parts, but with a different focus. Level I focuses on tools, which include quantitative methods, economics, financial statement analysis, and corporate finance. Level II focuses on asset valuation, which includes analyses of equity and debt investments, derivatives, and alternative investments. Level III focuses on portfolio management. Each exam level also gives 10%–15% weights to ethical and professional standards.

[7] See www.cfainstitute.org/programs/cfaprogram/Documents/1963_current_candidate_exam_results.pdf.

[8] See www.cfainstitute.org/community/membership/process/Pages/work_experience.aspx.

[9] See, e.g., Rottenberg (1980) for a review of earlier literature and Card (1999), Goldhaber and Brewer (2000), Angrist and Guryan (2004), and Kugler and Sauer (2005) for more recent examples. Note that this literature differentiates between mandatory licensing and voluntary certification, such as mandatory licensing/certification for lawyers, dentists, physicians, and teachers and voluntary certification for auto mechanics.

[10] Our study focuses on investment recommendations for the following reasons. Recommendations provide an important assessment of companies by sell-side analysts (see Bradshaw 2004), and they are highly valued by investors (see Womack 1996; Francis and Soffer 1997; Barber, Lehavy, McNichols, and Trueman 2001). Bradshaw (2009) illustrated a simple schematic of analysts' actual decision making, which starts with publicly available information and ends with a justifiable recommendation released to investors that during the process of earnings forecasting is an intermediate product. Bradley, Clarke, Lee, and Ornthanalai (2014) found that compared with management guidance and earnings announcements, analysts' recommendations are the most important information disclosure channel.

[11] With Equation 1, we essentially use a diff-in-diff approach for estimations (see Bertrand and Mullainathan 2003).

[12] Some researchers have also used instrumental variables and Heckman’s (1979) two-step procedure to deal with selection bias (see Heckman, Ichimura, Smith, and Todd 1998). The two methods face practical challenges here. Appropriate instrumental variables, such as measures of innate ability, are not readily available. The decision to complete the CFA Program again is not available to CFA charterholders, which is likely to render Heckman’s (1979) procedure inaccurate. Moreover, the timing of an analyst’s decision to go through the CFA Program is unknown, further weakening the efficacy of Heckman’s procedure.

[13] Because each level of the CFA Program exams is offered once a year (Level I has been offered twice a year since 2003) and analysts need to have at least three years of relevant work experience, it takes at least three years to finish the CFA Program. Moreover, because there is no time limit for a candidate to complete the program, analysts can take a few years off between the preparations for the exams. Therefore, the actual amount of time for an analyst to finish the program could be much more than three years. Further, some analysts could finish the exams before gaining the required experience, whereas other analysts could meet the minimum experience requirement before finishing all three exams.

[14] Our approach is similar to that of the Wall Street Journal’s rankings, which give a weight of 2, 1, 0, –1, and –2 to stocks that the analysts rated 1 through 5. Alternative weighting schemes of recommended stocks do not affect our results.

[15] In our empirical exercises, after controlling for analyst and year fixed effects in the regressions, the results barely changed with or without brokerage fixed effects. This outcome reflects the fact that the brokerage fixed effects are highly correlated with the analyst fixed effects. The results with brokerage fixed effects are available on request.

[16] The results in Table 4 show that the identical empirical model appears to have greater explanatory power in the earlier subperiod than in the later subperiod. A further investigation found that much of the explanatory power derives from the analyst fixed effects, and the fixed effects happen to produce a better fit in the earlier subperiod. Several economic forces could jointly contribute to the different roles of the analyst fixed effects for the two subperiods. A series of regulatory reforms have been introduced and implemented since the early 2000s, which have inevitably affected analysts’ research and behavior. Also, the financial markets have evolved dramatically since the turn of the century, especially with innovations and technological advances in

the financial sector that have reshaped the microstructure of trading and processing and the dissemination of information. Additionally, the later subperiod featured several big market swings and two economic recessions, including the 2008 financial crisis and the ensuing Great Recession. Those episodes had profound and long-lasting effects on the financial sector as a whole. Because these economic forces overlap with each other and tend to work jointly, it is not easy to isolate the effect of each force on the explanatory power of the analyst fixed effects.

[17] In particular, controlling for selection bias by using the Heckman (1979) approach does not change any of the findings in the article. The results are available on request.