Andreas Krause

Financial analysts

- Financial analysts play an important part in making investment banks visible to investors and companies alike.
- They assess the value of companies and provide investment recommendations; such recommendations, in connection with the analysis, is valuable to investors.
- In relation to companies, providing such analyst reports will showcase their expertise and attract clients seeking advise from the investment bank.
- However, analyst coverage has been found to be overly positive and for this reason come under regulatory scrutiny.
- We will explore the reason for overly biased analyst reports and what effect the regulatory effort had.

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Positive analyst coverage

- Financial analysts provide an assessment of the future prospects of securities for investors
- These recommendations are overall overly positive
- It is common to attribute this apparent bias to a desire by investment banks to attract future business from companies
- The reaction to the bias becoming obvious was to introduce regulation seeking to break the link between analyst recommendations and future investment bank income

Positive analyst coverage

→ Financial analysts publish reports and forecasts about the future prospects of companies. There is strong evidence that these assessments are not biased and do not reflect the reality of companies.

- The role of financial analysts is to provide information for investors that is helpful in informing their decision-making. They also provide information in the form of a target price for the stock at some point in the future, which we can interpret as a forecast of the price.
- The recommendation, and thus the forecasts, are shown empirically to be overly positive, thus the forecasts is positively biased.
- A common explanation of this positive bias is that investment banks seek to please the companies with positive coverage in the hope of obtaining additional investment banking business in return.
- With this bias being well-known and persistent, attempt have been made to severe the ties between financial analysts attracting investment banking business and recommendations to investors.

→ We will explore the issue of why a positive bias exists and also how regulation has failed to address this issue successfully.

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Further explanations for positively biased analyst recommendations

- Many behavioural explanations have been offered, for example a cognitive bias where analysts are not sufficiently critical of companies
- Investment banks and individual analysts selecting which companies to cover will select those they are most positive about
- Financial analysts might only obtain access to information if they are reporting positively about a company

Further explanations for positively biased analyst recommendations

→ A wide range of explanations for the observed positive bias of financial analysts have been offered.

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  - Apart from the aim of attracting investment banking business, a positive bias in analyst recommendations has also been explained with theories from behavioural finance. This approach explains the positive bias with traits of human behaviour rather than a conscious decision of financial analysts to provide a biased recommendation.
  - One such explanation is a cognitive bias in which financial analysts get too close to the company and readily accept the positive frame in which companies explain their decisions, they lack critical distance due to the company due to their frequent interactions and familirity with people and processes.
- A selection bias can also be used to explain the overly positive recommendations. Financial analysts will select companies to cover they believe are having good prospects. Hence only reports by those seeing a company positively are written by these financial analysts, but those reports of financial analysts that are critical of the company will never be written as these financial analysts do not cover the company.
- Another reason for a positive bias might be that it is necessity as information will be provided by the company only if they can be assured that it is used in a positive way. Hence financial analysts provide more positive reports in order to gain access to better information.

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Access to information

- Financial analysts are not only using publicly available information to compile their reports and recommendations
- Access to senior managers at analyst conferences and the ability to interact with them provides additional insights
- Companies prefer positive coverage, so might be more willing to enable access to financial analysts with positive recommendations
- We will explore how such privileged access can be optimal, even if a bias in the recommendation is required

Access to information

→ A key requirement for financial analysts is to have access to information. We will see how the requirement to access information might affect the recommendations of financial analysts.

- Financial analysts use more than publicly available information; relying only on publicly available information would not add much value for most investors, hence financial analysts have to go beyond assembling this publicly available information.
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  - We will explore how such an arrangement does not have to be detrimnetal, but can benefit the company and the investors following such recommendations.
  - These benefits exist despite analyst recommendations showing a positive bias.

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Chapter 8.1

Financial analyst access to company information

→ The model we are going to discuss is based on Chapter 8.1 of the book 'Theoretical Foundations of Investment Banking'. A more detailed description of the model, additional steps for its solution, and a more in-depth discussion of results can be found there.

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Discussion of the model results

- Financial analysts publish overly positive recommendation with the aim of getting access to information
- Despite the bias, analyst recommendations are better due to access to additional information

? Regulation requires that information is disclosed equally and publicly, how can companies provide better access to some investment banks?

! Soft information can be gained through personal interactions; information might also be obtained on how confident managers are about their future prospects

Discussion of the model results

→ Now that we have derived the main results of the model, as far as relevant for us, we will briefly discuss some implications as well as limitations of this model. This will allow us to interpret the model in its context of the initial problem and enables us to apply it appropriately in a realistic context.

- We found that analyst reports are positively biased as only this allows them access to more detailed company information. It is companies that induce a positive bias by withholding information from those analysts that seek to provide a truthful assessment of the company's prospects. Their analyst reports would suffer from a lack of detailed information that other analysts might have, albeit at the price of not assessing them objectively.
- The forecast error reduces despite this bias due to the improved information, which benefits investors relying on this information. While the bias reduces the benefits of the more precise information financial analysts have access to, the effect of the more precise information outweighs this effect.
- Companies are required allowed to give access information equally to all financial analysts and all information needs to be properly disclosed. Nevertheless there can be informational advantage to some financial analysts.
- While pure fact have to be disclosed, impressions on management ability and the confidence managers have about projects they are leading can be invaluable information to provide context for the disclosed information. Managers can be more or less openly discussing these aspects with financial analysts.

→ Financial analyst recommendations are overly positive in order to gain access to better information; this bias is benefiacial to those using the recommendation despite the bias due to better-quality information.

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→ Financial analyst recommendations are overly positive in order to gain access to better information; this bias is benefiacial to those using the recommendation despite the bias due to better-quality information.

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- Financial analysts publish overly positive recommendation with the aim of getting access to information
- Despite the bias, analyst recommendations are better due to access to additional information

? Regulation requires that information is disclosed equally and publicly, how can companies provide better access to some investment banks?

! Soft information can be gained through personal interactions; information might also be obtained on how confident managers are about their future prospects

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Companies seeking positive coverage

- Providing analyst coverage and selling their reports is not profitable to investment banks
- Analyst coverage is often provided as part of the agreement after the issue of securities
- Analyst coverage also allows contact to the senior management of companies with the aim to secure future business
- Companies are more likely to seek advice from investment banks that see them positively

Companies seeking positive coverage

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Chapter 8.2

Obtaining future investment banking business

→ The model we are going to discuss is based on Chapter 8.2 of the book 'Theoretical Foundations of Investment Banking'. A more detailed description of the model, additional steps for its solution, and a more in-depth discussion of results can be found there.

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Discussion of the model results

- In order to gain future business from clients, investment banks publish positively biased analyst reports
- This bias is limited by the effect it has on the value analyst reports have to investors

? Apart from profitability concerns, could investment banks bias their analyst reports as much as they want?

! If analyst reports are too biased, they will lose credibility and investors will not trust that companies have been advised well

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- The issue is not only the loss in reputation, but also that the effect of a positive analyst report on the stock price is lost. If the bias is too large, the report becomes worthless to investors and the report will not give the positive effects to the company they had hoped for and insisted for on a positive bias.

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- We will investigate whether such regulation is effective6-¿

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- The main idea is that as one of the reasons for the bias in recommendations is that financial analysts seek to attract business from companies they are covering, this link needs to be broken and financial analysts cannot be paid according to how much additional business they generate.
- Instead they should be paid only based on the quality of their recommendation; this should eliminate any incentive to change their recommendations to account for the preferences of companies for positive analyst coverage.
- Such regulation should be effective and is known as Chinese Walls, as there is no connection between the financial anlyst and other investment banking business.

→ We will show that such Chinese Walls are not having the desired effect on analyst recommendations.

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Preventing biased analyst reports

- Financial analysts are regulated with the aim to improve the quality of their reports
- As they bias their reports such that investment banks can attract income from clients, their remuneration is supposed to be unaffected by such income
- Focussing solely on the accuracy of their reports is supposed to eliminate this bias
- We will investigate whether such regulation is effective6-¿

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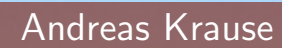

Chapter 10

Regulation of financial analysts

→ The model we are going to discuss is based on Chapter 10 of the book 'Theoretical Foundations of Investment Banking'. A more detailed description of the model, additional steps for its solution, and a more in-depth discussion of results can be found there.

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Discussion of the model results

- Chinese Walls are ineffective as investment banks can set benchmark salaries that indirectly reward biased reports
- Information on analyst quality is more likely to be effective, provided companies prefer investment banks that have high-ability analysts
- ? Is remuneration the only motivation for analysts to provide biased or unbiased reports?
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Discussion of the model results

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Summary of key results

- Financial analysts are important in attracting additional business to investment banks and a positive bias in recommendations is used to this end
- This bias can be limited if information on the quality of analyst forecasts is available and companies seek investment banks with strong analysts
- Regulatory efforts of severing the link between gaining investment banking business and analyst remuneration are not effective

Summary of key results

→ We can now summarize the key results we have obtained about the biased recommendations of financial analysts and the attempts at regulating them.

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