

Andreas Krause



Financial analysts

# Positive analyst coverage

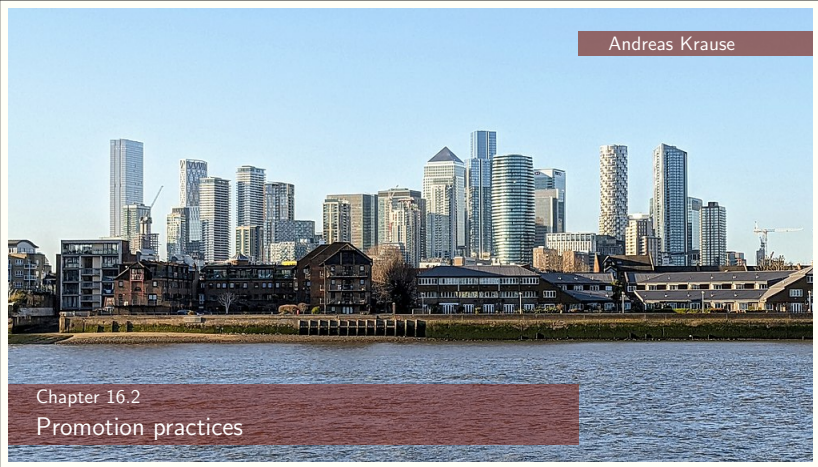
- ▶ Financial analysts provide an assessment of the future prospects of securities for investors
- ▶ These recommendations are overall overly positive
- ▶ It is common to attribute this apparent bias to a desire by investment banks to attract future business from companies
- ▶ The reaction to the bias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

## 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

# 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



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Chapter 8.1  
Financial analyst access to company information

## 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

## 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



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Chapter 8.2  
Obtaining future investment banking business



## 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

# 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 effective



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Chapter 10  
Regulation of financial analysts

## 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?
- ! An analyst refusing to publish biased reports that benefit the investment bank may find it difficult to retain his job and competitors will also unlikely seek to employ him

# 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



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Andreas Krause  
Department of Economics  
University of Bath  
Claverton Down  
Bath BA2 7AY  
United Kingdom

E-mail: [mnsak@bath.ac.uk](mailto:mnsak@bath.ac.uk)