

ANALYST INCENTIVES AND SIGNALS: THE ROLE OF THE INSTITUTIONAL AND DISCLOSURE ENVIRONMENT

by R.L. Brown, H.W.H. Chan and R.W. Faff

Company reports issued by brokers are an important form of communication between analysts and investors. These reports play a key role in the analysis and dissemination of information that is relevant to the valuation of publicly listed companies. Although brokers have issued company reports for more than a hundred years, it is only in the past thirty years that these reports have been the subject of extensive and independent research. Initially, researchers assumed that the only objective that brokers had in issuing reports was to generate trading commissions and that the most effective way to achieve this objective was to ensure that the recommendations were as accurate as possible. While these remain powerful forces, in recent times it has been recognised that the issues are frequently more complex. In deciding on the timing and contents of company reports, brokers face a complex set of incentives, some of which conflict. A major purpose of this research is to measure the extent to which brokers' reports appear to be affected by these conflicting objectives.

The incentives faced by brokers include:

- generating trading commissions;
- protecting the broker's reputation;
- maintaining access to company management;
- protecting the broker's relationship(s) with client(s);
- minimising the risks of litigation; and

- minimising the risk of alienating institutional shareholders.

Clearly, there may be significant conflicts between these objectives. To give a simple example, if a broker reaches a negative conclusion about a company that is also a client, then there is a conflict between the broker's objective of protecting its reputation as an accurate analyst and its objective of protecting its relationship with a client. Until recently, US empirical evidence suggested that brokers were indeed biased against issuing negative forecasts and recommendations to the market. This situation has been described as an incentive *problem*. However, current US researchers argue that the incentive structure does not necessarily result in biased and untimely advice because the outcome can be affected by other factors such as institutional shareholding, recent issuance of shares and whether good or bad news is to be released.

We will investigate these issues in the Australian context. First, we will investigate whether the timeliness and accuracy of broker reports on companies with which they are affiliated differ systematically from other broker reports. Second, we will assess the effect of broker reputation on the information disclosure process and ask whether a higher reputation enhances report credibility and reduces information asymmetry for investors. Third, we will investigate whether these relationships are affected by whether the news is "good" or "bad" and whether the level of institutional ownership is low or high. Finally, we will compare the strength of alternative signals: does the stock market take more notice of what the broker says (in a report) or what the broker does (in the broker's own share trading)?

We expect that the results of our research will contribute to the formulation of Australian policy. In August 2004 the Australian Securities and Investments Commission issued a new policy “Licensing: Managing Conflicts of Interest [PS 181]”. This policy relied heavily on overseas empirical work; we are unaware of any published Australian empirical work. However, the relevance of US studies is limited by significant institutional differences between the US and Australia. Until recently, US practice has been for brokers to release their reports via conference calls involving a few key participants, whereas Australian law requires public disclosure simultaneously to all participants. Paul Irvine (University of Georgia) has examined related issues in Canada and we believe that his research is more relevant to Australia than the US research because the Canadian market is more like our own in terms of the number of companies, the industrial structure and the intensity of analyst coverage. However, his data was limited to only 100 companies for just one year. One of our objectives is to re-examine Irvine’s findings using Australian data, and to enhance the reliability of the results by studying reports on approximately 300 companies over an 8-year period.

Our study should lead to regulatory and policy responses that are more appropriate to the Australian institutional environment. The ability of policy makers to balance the benefits and costs of regulation in the areas of competition, consumer protection and the allocation of resources can only be improved by having available detailed, reliable and independent Australian evidence.